Limits to creditor control

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Abbreviations

CA 2006	Companies Act 2006 (UK)
FAccA	Finnish Accounting Act (Kirjanpitolaki 30.12.1997/1336)
FAudA	Finnish Auditing Act (Tilintarkastuslaki 13.4.2007/459)
FBankruptcyA	Finnish Bankruptcy Act (Konkurssilaki 20.2.2004/120)
FCA	Finnish Companies Act (Osakeyhtiölaki 21.7.2006/624)
FCC	Finnish Commercial Code (Kauppakaari 31.12.1734/3)
FCons	Constitution of Finland (Suomen perustuslaki 11.6.1999/731)
FContractsA	Finnish Contracts Act (Laki varallisuusoikeudellisista oikeustoimista 13.6.1929/228)
FPenalC	Finnish Penal Code (Rikoslaki 19.12.1889/39)
FRA	Finnish Act on Recovery to a Bankruptcy Estate (Laki takaisinsaannista konkurssipesään 26.4.1991/758)
FSecMA	Finnish Securities Market Act (Arvopaperimarkkinalaki 26.5.1989/495)
FTortLiaA	Finnish Tort Liability Act (Vahingonkorvauslaki 1.5.1974/412)
HHO	Court of Appeal in Helsinki
IA 1986	Insolvency Act 1986 (UK)
IAS 24	International Accounting Standard 24: Related Party Disclosures
IAS 24 Regulation	Commission Regulation (EU) No 632/2010 of 19 July 2010 amending Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Accounting Standard (IAS) 24 and International Financial Reporting Standard (IFRS) 8
KKO	The Finnish Supreme Court
LMA	Loan Market Association
MAD	Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse)
Second Directive	Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent

1 Introduction

1.1 The topic

Finnish companies law builds upon the notion that companies should be controlled by shareholders through delegated management, because it is the shareholders who are best incentivised to ensure the wealth maximisation capability of the company. This is to change only as the company enters bankruptcy, as it is then when the shareholders' risk has realised so irreversibly that the creditors are allowed to decide how to salvage what can be salvaged for themselves. Up until that point, creditors of the company are assumed to be quiet investors, who do not protect themselves but are instead protected by statutory company law.

This proposition does not hold true in practice on two levels. Firstly, a company is not solvent one night and bankrupt the next morning. The process is slow, and incentives change along the way as the company inches closer to bankruptcy. Shareholders' risk realises before the company formally declares bankruptcy, and thus even while the company is operated as a going concern, its creditors may become its residual risk bearers—the parties whose investments' value most closely follows the fortunes of the company and who thus are the most appropriate to control the company.

Secondly, industry standard loan agreements provide a layer of negotiated creditor protection in the form of control rights. It can be said therefore that the law does not account for the change of the principals of the company, but modern, international lending contract practice does. The control rights become available to the creditors when the debtor is in a contract-defined state of financial distress. Company law by design protects creditors from shareholder opportunism, but it does not provide the shareholders protection against creditor opportunism, because creditor control is exceptional and unexpected. Neither are the creditors empowered by company law when shareholders' risk has realised and the creditors are thus better incentivised to properly manage the company.

This *problem-oriented study*[1] focuses on the regulatory institutions which may limit creditor control. It is assumed that an attack on creditor control by such institutions is by nature coincidental, as the institutions would be designed to regulate other phenomena. In this study, I try to identify these institutions and study whether and how they limit creditor control. After studying the limits to creditor control, I

1. *See Timonen* 1998, pp. 21–22.

evaluate what incentives the limitation mechanisms advance and whether these are the proper incentives.

Thus, at the core are the following questions, each discussed in its own chapter:

(i) How and why does contract practice transfer control to creditors?

(ii) Who should control a limited company?

(iii) Which mechanisms limit the use of creditor control?

(iv) Do the limiting mechanisms encourage the right incentives?

1.2 Structure and scope of this study

Chapter 1 (Introduction) is this chapter, providing an introduction to the topic, discussing the structure and scope of this study, and the methods used.

Chapter 2 (Lender control in syndicate loans) discusses how the control over a limited company might exceptionally cede from the shareholders and the directors to certain creditors. LMA (Loan Market Association) style loan agreements are by no means the only conceivable mechanism achieving this, but they have been chosen because they offer a level of standardisation and are in practice very widely used. An important restriction is that this thesis will discuss only unsecured lenders and term loans.

Creditor control powers arise from negotiated creditor protection, which supplements legal creditor protection regimes. In this respect, the regulation of creditor control powers, i.e. negotiated creditor protection, which is the subject of this thesis, attaches to the pre-existing debate concerning the proper methods and extent of legal creditor protection. However, that debate is outside the scope of this thesis, and it is assumed that negotiated creditor protection is in principle inherently beneficial for both the creditor and the debtor, as lenders who are repeat players would not engage in costly negotiations had they not found the negotiated protection valuable.[2]

Chapter 3 (Agency problems in syndicated loan transactions) gives a high-level overview of the agency problem, first generally in respect of limited companies, and

2. On the debate, *see* e.g. *Enriques – Macey* 2001, *passim*, *Ferran* 2006, *passim*, and *Mülbert* 2006, *passim*, criticising European legal capital rules and in support of the standards-based strategy and negotiated creditor protection employed by the US.

subsequently in the relationship between a company and its creditors. It is assumed that LMA lenders increase their interference with a debtor's management when the debtor's financial standing deteriorates. Therefore the principal-agent relationship existing between a debtor and a creditor is examined in different stages of solvency of the debtor: total solvency, risk of insolvency, insolvency, and bankruptcy. The chapter finally addresses on a general level the regulatory strategies which allow for the reduction of agency costs.

Chapter 4 (Safeguards against creditor opportunism) is the most voluminous chapter in this thesis, discussing mechanisms imposing actual limitations on the use of control by creditors under Finnish law. It starts with the discovery that the mechanisms which limit the use of control power by creditors are not designed with this purpose in mind. Instead, their applicability is to some extent coincidental.

The first mechanism limiting lender control is directors' duties. There are two facets: the directors' role as implementers of the creditors' decisions, and the issue whether directors' duties might extend to non-directors, such as controlling creditors, who use control power belonging to the directors.

The second considered mechanism is a duty of loyalty affecting contracting parties. It is evaluated whether and when the duty might circumscribe contracting parties' discretion to e.g. terminate an agreement. A second aspect to the discussion is provided by good faith duties altering liability between extra-contractual parties. It is considered whether controlling creditors might become liable in tort to the debtor's constituents for extra-contractual damages.

The third mechanism is recovery to the debtor's bankruptcy estate. From the point of view of controlling creditors, it would be unfortunate if the repayments made by the debtor could be recovered to the bankruptcy estate. It is considered whether controlling creditors become related parties for the purposes of recovery and whether and when repayments can be recovered.

An important limitation to scope arises from intra-syndicate decision-making. Syndicate lenders make important decisions concerning the loan by voting. This adds a level of complexity. The syndicate may make a series of decisions leading to liability issues or possible recovery to a debtor's bankruptcy estate—what if it is different lenders who disagree each time? Alas, due to their intricate complexity, these issues can only be touched upon in a mere thesis. Therefore unanimous decision-making by lenders is assumed unless otherwise noted.

Chapter 5 (Synthesis) will attempt to synthesise the ideas presented in the preceding chapters by considering what are the incentives advanced by the identified limiting mechanisms and whether they incentivise taking into account the interests of the correct interest party.

Chapter 6 (Conclusions) finishes off with a summary of conclusions.

1.3 Methodology

1.3.1 Theoretical framework: the agency problem

"A law is an obligation backed by a state sanction" is a classic definition of law. Combining law and economics provides a scientific theory to predict the effects of legal sanctions on behaviour.[3] In other words, law and economics studies *incentives* and their influence on the decision-making of rational actors. Another key interest is how regulation can minimise *transaction costs* to increase economic efficiency.[4]

This thesis has at core legal dogmatics, whose results are considered from the point of view of the agency problem, a concept developed within the the law and economics tradition. Interest conflicts between different interest parties to a limited company are examined in terms of the agency problem. Thereafter, regulation of such interest conflicts is studied using the methods of legal dogmatics. Finally, it is evaluated whether the regulation reduces costs and supports the right incentives.

Law and economics in Finland has concentrated on *de lege ferenda* studies,[5] answering such questions as what kind of regulation would efficiently lead to the intended ends. Traditionally, in legal dogmatics on the other hand, law and economics has in Scandinavian legal tradition been considered to provide arguments which are *allowed* to influence interpretation, but are not necessary. Thus its ability to influence decision-making in a concrete matter at hand has been fairly low.[6] This view is discussed below.

1.3.2 Legal dogmatics

The function of legal dogmatics is from a *theoretical* point of view to *systematise legal rules*. From a *practical* point of view, its function is to *explain the proper meaning*

3. *Cooter – Ulen* 2000, p. 3.
4. *Määttä* 2006, p. 48.
5. *Mähönen* 2004, p. 49.
6. *ibid.*, pp. 49–50 and *Määttä* 2006, pp. 50–51.

of legal rules by means of interpretation.[7] This thesis embraces both functions of legal dogmatics. Theoretical legal dogmatics are represented in one of the aims of this thesis, namely the intention of systematising the regulatory mechanisms which impose limitations on the use of control over a debtor by a creditor. The identified mechanisms are examined using the methods of practical legal dogmatics with the purpose of explaining how they limit the use of control.

Practical legal dogmatics is essentially legal argumentation, whereby one's task is to convince the relevant audience (legal scholars and practitioners of law) that the interpretation one proposes is correct in light of the correct sources of law.[8] In other words, one must ground his argument so that as many rational members of the legal community as possible may, taking into account relevant facts and circumstances, accept the argument.[9] One must found his argument on correct sources of law and formulate his argument so that it takes into account the hierarchy of those sources. This thesis deviates somewhat from the classical hierarchy of sources of law presented by *Aarnio*. According to *Aarnio*, sources or law are divided into three categories:[10]

(i) *Strongly binding sources of law* are sources of law which courts *are obliged to* follow in their argumentation. They are strongly binding in the sense that ignoring them by a judge constitutes misconduct in office. This category comprises of *statutory law* and *customary law*.[11]

(ii) *Weakly binding sources of law* are sources of law which are not strictly binding of the courts, but a court decision not following these sources would likely be subjected to reversal in upper courts. The rationality of legal argumentation requires that these sources of law are taken into account, and therefore, if these sources of law are disregarded, one should state the reasons. Weakly binding sources of law include *the intention of the legislator* as expressed in the *travaux préparatoires*, and *court decisions*. This means that Finland does not recognise the *stare decisis* doctrine.[12]

(iii) *Permitted sources of law* are sources of law which a court is not obliged to follow. However, the legal community customarily strengthens its arguments

7. *Aarnio* 1997, pp. 36–37.
8. *See ibid.*, p. 51.
9. *Aarnio* 1989, p. 285.
10. *ibid.*, 220 *et seq.* and *Tolonen* 2003, p. 22.
11. *Aarnio* 1989, pp. 224–225 and *Tolonen* 2003, p. 23.
12. *Aarnio* 1989, pp. 220–221 and *Tolonen* 2003, pp. 24–25.

> with permitted sources of law. These sources are more important in argumentation for jurisprudence than they are for courts. Permitted sources of law includes jurisprudence, value arguments, realistic (teleologic) arguments, and legal principles.[13]

Aarnio's work, a virtual classic in its field, which represents normative positivism, has become to some extent antiquated by the unaccounted for ascension to the prominence of human rights arguments and constitutionalism, EU law, legal principles,[14] and contextual sources of law.

The FCons represents a general constitutionalisation development, whereby fundamental rights secured by the act have a priority over regular statutory law. Pursuant to Section 106, courts must give preference to a provision in the constitution whenever applying a provision in statutory law to the matter at hand would be in obvious conflict with the constitution. Furthermore, courts should prefer decisions which advance the realisation of fundamental rights, using interpretation which favours fundamental rights.[15] This means that statutory law as enacted by the Parliament is not strictly binding, but its validity is at the discretion of the courts. Finland's ratification of the European Convention of Human Rights also on its part erodes the credibility of *Aarnio's* categorisation. The Convention was ratified not on constitutional level, but on the level of a regular act. Thus the Convention is not more binding of the courts than is statutory law in general. If the Convention and domestic statutory law are in conflict, courts would be required to choose (i) *lex posterior*, i.e., subsequent law over prior law, and (ii) *lex specialis*, i.e., specific provisions over general provisions. In reality, human rights in accordance with the Convention are incorporated in the interpretation of the fundamental rights provisions in the FCons.[16] Thus the Convention has the ability to override regular statutory law and should systematically be on the same level with the constitution, but technically isn't, eroding the validity of the proposition that statutory law is strictly binding.

According to *Pöyhönen* (later *Karhu*), the system of fundamental rights has twofold effects on the law of property[17]: institutional effects and application effects. Institutional effects provide the framework within which the different concepts of the law of property must fit: e.g. what can be the subject of ownership, who can enter

13. *Aarnio* 1989, pp. 220–221 and *Tolonen* 2003, pp. 24–25.
14. *See Mähönen* 2004, pp. 51–52.
15. Gov. prop. 1/1998, Yksityiskohtaiset perustelut: 106 §.
16. *See Pellonpää* 2005, p. 70.
17. Finnish: *varallisuusoikeus*.

into contractual relationships and what contracts can govern etc.[18] In *Pöyhönen's* thinking, functioning markets are a fundamental right, because only functioning markets can enable the efficient use of property rights.[19] He continues that the prohibition of unethical conduct[20], unreasonable legal relations[21] and abuse of rights[22] is so central to a functioning system of fundamental rights that such a prohibition exists without express norms supporting its existence.[23] *Pöyhönen* has also viewed that a *principle of preparation* requires that when engaging in or conducting activities, one must ensure that one's own activities do not in an inappropriate manner hinder other parties' possibilities of realising their ends.[24] A *principle of protection of trust* means that consistent behaviour creates justified expectations on which other parties may build.[25]

European integration in the form of EU law challenges *Aarnio's* traditional view, which does not account for it. *Timonen* has suggested that the hierarchy of sources of law should be amended so that purely national law, including the constitution, are in the hierarchy below EU law.[26] This creates a dichotomy of two separate hierarchies: EU law would have its own hierarchy of sources of law, and so would national law. *Karhu* (né *Pöyhönen*) has abandoned the idea of the necessity of a hierarchy of sources of law altogether. His proposition is that 'presumptive legal positivism', whose logic is based on the authority of primary norms, i.e., statutory law, should be replaced with 'presumptive contextualism', which emphasises perceiving the circumstances in a legally relevant way.[27] This gives rise to legal principles, systematised with the help of the system of fundamental rights, as a tool for perceiving the legally relevant aspects of a matter at hand.[28] Thus in *Karhu's* view, legal principles would provide the structure which points to the correct sources of law.

The validity and role of *legal principles* has been considerably debated in Finland over the last few decades.[29] According to *Tolonen*, for a principle to be a legal principle instead of a pure moral principle, institutional support from legislation,

18. *Pöyhönen* 2003, p. 81.
19. *Ibid.*, p. 83.
20. Finnish: *hyvän tavan vastaisuus*.
21. Finnish: *kohtuuttamat oikeussuhteet*.
22. Finnish: *oikeuksien väärinkäyttö*.
23. *Pöyhönen* 2003, pp. 86–87.
24. *See ibid.*, pp. 110–116.
25. *See ibid.*, pp. 116–120.
26. *See Timonen* 1998, p. 24.
27. *Karhu* 2003, p. 803.
28. *See ibid.*, p. 804.
29. *See Mielityinen* 2006, pp. 81–89 on the views of *Aulis Aarnio*, *Juha Karhu*, *Hannu Tolonen*, *Kaarlo Tuori* and *Raimo Siltala*.

government proposal documents, jurisprudence, or social practices comparable to customary law (contract practice is an example) is required.[30] A separation of *rules* and *principles* is recognised: the former guide legal decision-making strictly and the latter loosely.[31] Legal principles guide decision-making by acting as standards, maxims and rules of thumb.[32] According to *Siltala*, legal principles are not identifiable by their origin, but instead they are identified by the institutional support they enjoy. To *Siltala*, the sources of institutional support need not be of those formally classifiable categories in *Tolonen's* taxonomy. Instead of formal sources, the institutional support a legal principle must enjoy to exist traces back to a more general regulatory ideology which contributes to individual rules.[33] Unlike is the case with formal legal rules, legal principles are influenced by the prevailing values and objectives of social morality.[34]

Law and economics has thus far mostly influenced *de lege ferenda* argumentation, as it has only been recognised as a permitted source of law for the purposes of practical legal dogmatics.[35] However, as some branches of law are clearly influenced by law and economics, their interpretation would benefit from law and economics arguments. *Mähönen* has identified company law as a branch of law whose interpretation *necessitates* taking into account law and economics arguments,[36] thereby essentially supporting a polycentric and contextual view to sources of law whereby the characteristics of some branches of law cause it to deviate from the traditional hierarchy of sources of law. Polycentrism of sources of law and the influence of contextualism on the proper sources appears convincing. The FCA is strongly influenced by the *law and economics* tradition.[37] Thus the act treats the various interest conflicts arising between the different interest parties in light of the agency problem. The general principles set out in Chapter 1 of the act provide the framework for its interpretation—the rules in the other Chapters of the act are to be interpreted in light of the ideas presented by these principles. Section 5 (purpose of the company) and Section 8 (duty of loyalty and care of the directors) have their roots in the agency problem, and therefore the interpretation

30. *See* e.g. *Tolonen* 2003, pp. 42 *et seq.* and *Mielityinen* 2006, pp. 84–85 summarising *Tolonen's* ideas.
31. *Tolonen* 2003, p. 43.
32. *Ibid.*, pp. 49–50.
33. *Siltala* 2003, p. 312.
34. *Ibid.*, pp. 312–313.
35. *Mähönen* 2004, p. 49.
36. *See ibid.*, p. 58. Further, *Mähönen* argues that law and economics arguments should be allowed more influence in interpreting rules in the sphere of the law of contracts. Also *Siltala* has taken a positive stance towards *economic legal dogmatics*. *See Siltala* 2003, pp. 552–556.
37. *Mähönen – Villa* 2006a, pp. 44–49.

of these principles and by extension the provisions which relate to the principles benefits from support by the views expressed in the law and economics tradition.

A central purpose of the law of property is to reduce transaction costs.[38] This is also a central feature of company law. Company law reduces agency costs by acting as a default agreement, i.e. reducing the company's interest parties' need to negotiate. On the other hand, company law pursues the reduction of agency costs which arise from interest conflicts between the interest parties.[39] Thus in this respect, increasing economic efficiency is an implicitly manifested intention of the legislator, which pierces through the whole of these branches of law. In this sense, law and economics arguments can be allowed to influence the interpretation of the regulation in these fields even if a strict categorisation of sources of law is keenly held on to.

Thus a hierarchy of sources of law where different sources categorised *by their origin* have different levels of ability to bind the legal community does not seem a contemporary reality. Interpretation of the law must always be favourable of fundamental and human rights. Certain general legal principles supplement the system of fundamental rights by prohibiting conduct which morality and the law do not condone. These provide a framework for legal institutions such as the limited company or the contract. Such legal institutions must also be understood tied to their regulatory purpose of enabling economic activity. As such, regulation of these institutions can and should be, within the limits provided by the law, given an interpretation which takes into account the purpose of increasing economic efficiency.

1.3.3 Comparative approach

Comparative studies of law compare the same institution, or the rules which govern the same issue, in two or more legal systems with an aim of understanding the reasons for similarities and dissmilarities between the institution as recognised by the legal systems. A practical approach to comparative studies produces information which aids in understanding one's home jurisdiction's legal system, or provides support in developing the law (e.g. drafting new statutory law). From a pedagogical point of view, comparison is helpful in developing a critical view of one's home jurisdiction's legal system.[40]

38. *Määttä* 2006, p. 48.
39. *Armour* et al. 2009c, p. 2.
40. *See* e.g. *Husa* 1998, pp. 13 *et seq.*, pp. 34 *et seq.*

This is not a comparative study, but a study with some comparative elements. Creditor control is contractual control, and the contract practice which is examined in this thesis developed in England and the contracts were written to operate under English law. From time to time, I will point out how English law treats various questions arising from such contracts. This is intended to help in understanding the legal background of the contract practice. The question of to whom directors' duties extend under English and Finnish law stands out as the sole comparative analysis in this thesis. English law recognises wider extension of directors' duties to persons who have not been properly appointed as directors than Finnish law does. The differences and similarities will be considered for the purposes of being able to evaluate whether Finland would benefit from adopting the English model of recognising shadow directors.

2 Lender control in syndicate loans

2.1 A short introduction to syndicate lending

2.1.1 Generally

Creditor control powers are not found in company law, but in contract practice. Thus an evaluation of creditor control powers is not possible without a description of market practice. Corporate lending, instead of bonds, represents the main source of debt financing for European companies, and syndicated lending has become the key way for European companies to financing provided by corporate lenders.[41] Consistently with the rest of Europe, Finland has also witnessed the rise of syndicate lending.[42] Thus syndicated loans were chosen to exemplify the flow of control to the creditors because of their importance in lending practice and because the LMA documentation offers a degree of standardisation.

Syndicated lending is by nature an international affair. Finnish facilities are regularly built upon the *Loan Market Association* (*LMA*)[43] documentation, originally prepared by, *inter alia*, certain Magic Circle law firms in London to operate under

41. *Standard & Poor's* 2011, p. 7. The market for syndicated lending is enormous. In the first quarter of 2011 alone, the volume of the syndicated loan market in Europe, Middle East and Africa rose 30 per cent year-to-year to USD 202 billion, with France Telecom representing the largest deal having executed a EUR 6 billion refinancing facility. *See Reuters* 2011.
42. *Välimäki* 2010, pp. 464–465.
43. *See* http://www.loan-market-assoc.com/.

English law.[44] Notwithstanding the background of the loan documentation, syndicate lending agreements between Finnish borrowers and lenders are routinely made to operate under Finnish law, in contrast with the assumptions on which the documentation is prepared.[45] The LMA documentation enjoys the status of a *de facto* market standard, also in Finland.[46]

What then, is syndicated lending? Syndicated lending is a means of raising debt financing for a company, whereby a consortium of banks participate as lenders by contributing to the same debt facility. Syndicated lending is, put broadly, organised so that the debtor mandates an arranging bank to find syndicate banks which provide the actual money. The syndicate banks will be represented in respect of the borrower by an agent bank, which may or may not be the same bank as the arranger bank. To be sure, it is of course possible, and in practice not unusual in case of a small facility, that a single bank finances the whole facility thereby playing all the roles but that of the borrower's.

The bank syndicate will require that the borrower, in the facility agreement, gives certain covenants for the purposes of monitoring the financial condition of, and controlling certain actions of, the borrower, by the lenders. In case of breach of covenant by the borrower, the syndicate may decide to *accelerate* the facility, that is, render immediately due and payable the principal and the interest accrued. Therefore, the lenders will have access to up-to-date information over the financial standing of the borrower, and more importantly, means of pressuring the borrower into taking certain courses of action in case its financial condition worsens by threatening to accelerate. Because of the often decisive importance of a large syndicate loan on the borrower, the lenders can through the use of covenants acquire actual and total control of the borrower already in financial distress by threatening to invoke the right to accelerate.

44. *See Rhodes* 2004, pp. xxii *et seq.* for a history of the LMA. The LMA loan documentation is not publicly available. However, non-current, adapted versions can be found in *ibid.*, pp. 273–494 and *Mugasha* 2007, pp. 525–630.

45. The LMA documentation assumes, *inter alia*, that the obligors are companies incorporated in England and Wales, that the agent is based in London and that English law governs the transaction. *See ibid.*, pp. 204–205.

46. This is sometimes called the Delaware factor: markets do not desire multiple choices, instead, a virtual legal monopoly will be born if one of the options available is superior to the others and sufficiently responds to market needs. Consider other virtual legal monopolies, such as the state of Delaware (place of incorporation of US listed companies) and the ISDA master agreement (derivative transactions). *See Wood* 2008, pp. 506–507.

2.1.2 Reasons for syndication

From the point of view of the borrower, the advantages of syndicated financing are mainly (i) to be able to raise a larger loan than what would be available with a single lender, and (ii) to establish and maintain a bilateral relationship with several banks, which facilitates future borrowing. Further, the presence of several lending parties to a single loan arrangement allows for more stability and less administrative burden as compared to several individual loans with several banks. Compared to equity or bond issues, syndicated loans require less disclosure and cost less.[47] On the other hand, the lender banks benefit from (i) increased lending possibilities, as many syndicated loans are larger than a single bank could make, (ii) spreading the risk of defaulting borrowers, (iii) complying with regulation whose aim is to limit unsafe lending practices, (iv) earning arrangement fees, and (v) gaining prestige and more lending opportunities.[48]

The increased level of standardisation allows for a secondary market for the loans to form. This brings on further advantages, including: (vi) ability to make a profit out of selling well-performing loans on the secondary market, (vii) ability to dispose of problem loans to parties who are specialised in distressed loans, (viii) ability to get rid of excess loans if the lenders' own borrowing costs rise , and (ix) ability to comply with solidity requirements with more ease. It is also possible to (x) gain access to inside information in respect of a borrower by purchasing a loan on the secondary market.

2.2 The structure of a syndicate loan

2.2.1 Parties to a syndicate loan

Syndicated lending, or multi-bank financing, means extending credit to a borrower by multiple banks acting in concert.[49] The loan is based on a single set of loan agreements and is made on common terms.[50]

The parties to a syndicate loan include (i) the borrower, (ii) the arranging bank who negotiates the terms with the lending banks, (iii) the agent bank, (iv) the actual lending banks, and (v) sometimes, additional guarantors.[51]

47. *Mugasha* 2007, pp. 86–87.
48. *Ibid.*, pp. 88–91.
49. *Ibid.*, p. 2.
50. *Wood* 2007b, p. 3.
51. *Ibid.*, p. 4.

Role of the arranging bank The borrower mandates the arranging bank to arrange for the syndication according to a *term sheet* stating the financial terms.[52] The arranging bank is then responsible for assisting the borrower in preparing an information memorandum in respect of the borrower, finding the lending banks for the borrower, and for negotiating the loan documentation with the borrower on behalf of the bank syndicate. The duties of the arranging bank are not usually set out in detail and it receives a substantial fee for its services.[53]

Role of the agent bank One of the lending banks is appointed as the agent of the lending banks for the purposes of administrative convenience. The agent bank may or may not be the same bank as the arranging bank or one of the arranging banks. The agent bank represents the syndicate *vis-à-vis* the borrower—it is an agent strictly of the banks and not of the borrower. The agent bank usually only has individual control over minor decisions and it is awarded a lowish fee for its tasks.[54] The relationship between the agent bank and the lending banks is that of an agent and a principal and the general rules governing such relationships apply. Under Finnish law, the relationship can be characterised as a commission agreement[55]

Role of the lending banks The lending banks provide the money. The LMA documentation provides that the obligations of the lenders are several, and that the rights are separate as well. Lenders may separately enforce their rights. The lending banks use syndicate democracy when deciding on the use of powers awarded to the syndicate in the facility agreement.

2.2.2 Agency and syndicate democracy

The lenders are represented *vis-à-vis* the borrower by the agent bank. Therefore the agent bank is an agent of the lenders and not of the borrower. In Finland, the relationship of a principal and his agent is to some extent governed by the FCC, Chapter 18,[56] but primarily by the agreement between the parties, i.e. the facility agreement.

52. *Wood* 2007b, p. 4.
53. *Ibid.*, pp. 6–7.
54. *Ibid.*, pp. 120, 122.
55. Finnish: *toimeksiantosopimus*. *See Saarnilehto* 2004, Toimeksisaajan velvollisuudet. Under English law the agent bank owes agent's fiduciary duties to its principals, that is, the lending banks. *See Wood* 2007b, pp. 122–123. However, most facility agreements contain a provision removing agent bank fiduciary duties. *See Mugasha* 2007, p. 412, where the relevant LMA clause is reprinted.
56. Despite its name, the FCC is an ancient and increasingly unimportant piece of legislation. Chapter 18 retains its original 1734 text, save for the repealing of Section 9 in 2003.

The agent bank receives principal and interest payments from the borrower, which it then distributes to the lending banks *pro rata*.[57] Payment to the agent releases the borrower and the lending banks take the risk of their agent becoming insolvent or making mistakes.[58] The agent also receives notices on behalf of the syndicate—e.g. if the borrower is in default, it must notify the agent who must notify the lending banks.[59]

The agent's role is to facilitate the management of the facility and it is not entitled to make major decisions on behalf of the syndicate. Important decisions are made by lenders either unanimously or by a majority of outstandings.[60] Decisions to waive breaches of covenant, to find an adverse change material in the meaning of the material adverse change clause, and to accelerate the facility are usually made with a majority of 50% or 66.7%.[61] Sometimes the agent may have an individual right to accelerate on behalf of the syndicate in cases of emergency.[62]

2.3 Mechanisms giving rise to lender control

2.3.1 Flow of control

This section will explore the mechanisms allowing for the flow of control over debtors, from the shareholders and the board of the borrower, to the company's creditors. The flow of control demonstrated below is a direct result of loan agreements in accordance with the LMA model. Of course, such provisions need not be unique to syndicated lending and could to some extent be included in e.g. bonds. The loan agreements allow the lenders a degree of both direct and indirect control over the borrower. Firstly, the loan agreements include covenants—or undertakings—which circumscribe the operations of the borrower in a variety of ways: the borrower agrees to do something or to refrain from doing something.[63] Such provisions effect a degree of direct control over the borrower.

Secondly, breach of covenant, that is, if the borrower fails to comply with the covenants, constitutes default of the loan agreement, which in turn gives the lenders the right to accelerate, i.e., terminate the loan agreement. Because acceleration

57. *Wood* 2007b, p. 121.
58. *See* FCC, Chapter 18, Section 2.
59. *Wood* 2007b, p. 121.
60. In accordance with the LMA documentation, the majority is calculated from the outstanding loans made, but according to *Wood*, usual practice is to calculate the majorities from participations (principal outstandings plus unused commitments) (*ibid.*, p. 126).
61. *Ibid.*, p. 126.
62. *Ibid.*, p. 121.
63. *Mugasha* 2007, p. 236.

would usually lead to the insolvency of the borrower, the ability to conditionally waive the right to accelerate gives the lenders a strong hand in negotiations *vis-à-vis* the borrower. For example, the lenders might demand the borrower sells some part of its business.

It would be considered rare that the lenders were to have e.g. the right to elect one or more board members, which would in effect give some degree of *legal* control to the lenders.[64] Instead, the control the lenders have is merely *actual*—i.e. the lenders cannot make decisions on the behalf of the company, but only persuade the company to make decisions the lenders find favourable. This thesis only concerns contractual control to the exclusion of lender control through lender-appointed board members.

2.3.2 Covenants

2.3.2.1 Covenants in general

Traditionally, corporate lending practice in Finland has relied on security interests to secure repayment because security interest holders have a strong senior position in insolvency proceedings. Practice has then evolved to embrace covenants which are more in line with the the cash-flow principle.[65] Covenants are, in outline, special provisions in a credit agreement whose purpose is to, *inter alia*, preserve the equal ranking of the lenders' claim in insolvency, preserve asset quality, asset quantity and the solvency of the borrower, and to impose limits to change of business to something that is riskier or that the lenders do not understand.[66] On a more general level, covenants aim at protecting the lenders' claim by protecting borrower liquidity and solvency, and providing the lenders with possibilities for early action in case liquidity and solvency are at risk.[67] In other words, their purpose is to reduce borrower opportunism, i.e. prevent *ex post* devaluation of the lenders' claim.[68]

64. Pursuant to the FCA, Chapter 6, Section 9, the articles of association may provide for the election of less than half of the members of the board by some other instance than the general meeting. In case of a closely held company, the lenders and the shareholders could agree between them that the shareholders undertake to elect board members named by the lenders. However, if the shareholders breach such an agreement and fail to elect the persons named by the lenders, the election is valid and the only available remedies are those which are available for breach of contract.
65. *Villa* 2003b, pp. 141–142 and *Välimäki* 2010, p. 472.
66. *Wood* 2007b, pp. 69–70.
67. *Villa* 2003b, pp. 141–145.
68. *Mülbert* 2006, p. 376.

Through covenants, the borrower undertakes to take or refrain from taking certain actions, or maintaining an existing circumstance. Covenants are tailor-made for each borrower as they reflect the lenders' concerns.[69] Riskier investments call for stricter covenants. Coupled with the contractual remedies at the disposal of the lender and attached to the breach of covenants are the cornerstone of mechanisms giving actual control power over the borrower to the lender. The principal remedy of the lenders is the right to *accelerate*, that is, render immediately due and payable the outstanding loan in case of breach of covenant.

To support the ultimate remedy of cancelling the facility, covenants give lenders various tools designed to reduce the risk of insolvency and to provide an early warning of the vicinity of insolvency. These include means for monitoring the conduct of business and the financial health of the borrower (*information covenants*), general undertakings, e.g. a negative pledge (*general covenants*), and *financial covenants* whose aim is to protect the lenders by allowing taking the actions attached to breach of covenant when the borrower's financial standing deteriorates but long before actual insolvency occurs.

All of these, coupled with the right to accelerate, are intended to give the lenders security in case the borrower runs the risk of becoming insolvent. Let us now look at the different types of covenant in more detail.

2.3.2.2 Information covenants

Monitoring the standing of the borrower and the possible breach of covenants would not be possible without sufficient information. Indeed, sufficient information is a necessary precondition for any negotiated creditor protection.[70] Therefore, the most important information covenants relate to the provision of financial information to the lenders. By means of information covenants, the lenders gain access to information that is substantially more current than publicly available information in the form of financial statements which have been filed with the Trade Register. The financial covenants which set out requirements on the financial condition of the borrower would not be very useful without current information—therefore the information covenants are there to allow for the timely enforcement of the financial covenants.

Standard information covenants require financial statements, compliance certificates, and if the borrower is in default, notification of default.[71] Additionally,

69. *Mugasha* 2007, p. 236.
70. *Mülbert* 2006, p. 376.
71. *Mugasha* 2007, pp. 237–238.

information reasonably requested by the lenders, information in respect of any actual or possible litigation and a right of access and inspection may be included. The financial statements shall usually include both the consolidated statements and the statements for each individual group company, and shall be delivered either annually or more often, e.g. quarterly. Annual financial statements shall usually be audited.[72]

Underlining how material the information disclosure based on information covenants is, comes the fact that the information provided by the borrower in compliance with the information covenants often constitutes *inside information* in accordance with securities legislation in case the borrower is a listed entity.[73] There are certain obligations relating to the management of inside information, *viz.* listed companies are obliged to maintain an insider register (the lenders who receive inside information may also be),[74] and anyone holding inside information is not allowed to trade in the relevant securities.[75] From the flow of inside information to the lenders follows that it might become necessary to erect so-called Chinese walls around the agency department of the agent bank and the relevant departments of the lending banks. Unless the relevant departments are sufficiently insulated, the rest of the lender may not trade in the securities of the borrower without becoming suspect of abuse of inside information.[76]

Additionally, information covenants prescribe that the borrower provides certain other information. This includes Know Your Customer information needed by the lenders to identify the borrower, and for example, possibly any press releases etc. issued by the borrower from time to time.[77]

72. *Wood* 2007b, p. 72.
73. Pursuant to MAD, Article 2, "'Inside information' shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments." Finland implements said Article in the FSecMA, Chapter 5, Section 1.
74. *See* the FSecMA, Chapter 5, Sections 8–11 on company-specific insider registers, which is where the lenders who receive inside information would be entered.
75. The FSecMA, Chapter 5, Section 2 prohibits the use of inside information. Abuse of inside information is criminalised in the FPenalC, Chapter 51, Section 1.
76. English case law has approved the use of adequate Chinese walls. Under English law, circumstances dictate how strong Chinese walls are needed. In *Prince Jefri Bolkiah v KPMG*, KPMG had acted as the accountant of the Brunei Investment Authority, chaired by Prince Jefri Bolkiah. Moreover, KPMG had acted for the BIA in major litigation. Later KPMG accepted to assist the government of Brunei in investigating the BIA relating to alleged misuse of funds. KPMG erected a Chinese wall. A substantial number of partners and employees had worked with BIA and would work for the Brunei government. Prince Jefri Bolkiah sought an injunction to stop KPMG working for the Brunei government. *Held:* Chinese walls are possible but were, in this case, not adequate.
77. *Mugasha* 2007, pp. 237–238.

Information covenants are standard—also in Finland. *Välimäki* has found that every Finnish bank includes information covenants in its standard terms and each of its loan agreements.[78]

2.3.2.3 General undertakings

General undertakings can be divided into *positive undertakings* which require the borrower to *do* something, and *negative undertakings* which require the borrower *refrains from doing* something. The general covenants are designed to limit the conduct of business of the borrower so as to reduce risk of insolvency.[79]

Standard LMA investment grade loan documentation general undertakings include (i) a statement that the borrower is authorised to operate, (ii) a statement of compliance with laws, (iii) the negative pledge, (iv) restrictions to disposals, (v) no mergers, and (vi) no change of business.[80]

The negative pledge In outline, the negative pledge states that the borrower will not create or permit to exist any security over its assets. Moreover, the borrower undertakes to ensure the same applies to its group companies. The purpose of the negative pledge is to thereby give security to unsecured lenders, as their interest would be diluted in the borrower's insolvency if the borrower were allowed to create security interests over its assets.[81]

As regards Finnish law, a negative pledge is effective *inter partes*. However, it is clear that the negative pledge clause does not prevent the effective creation of a security interest *per se* and it is not effective *ultra partes*.[82] Instead, any comfort provided by the negative pledge is thanks to financial incentives: in case of breach of the negative pledge by the borrower, the remedy of the lenders is to accelerate.

It is worth noting that if acceleration leads to insolvency, the security stays in place in favour of the holder of the security interest, effectively diluting the lenders' claim. Because under Finnish law the negative pledge does not prevent creating security interests, it does not replace them as a means for securing the interests of the lenders. The lenders still have to ensure they have adequate security.

78. *Välimäki* 2010, p. 471.
79. *Mugasha* 2007, p. 240.
80. *See ibid.*, pp. 556 *et seq.* where also some other general undertakings are set out, for sample clauses.
81. *See Wood* 2007b, pp. 72–81 for further motivation for the negative pledge clause.
82. *Tepora* et al. 2009, pp. 302–304. This position is in line with the privity of contract doctrine.

Not being able to post its assets as collateral makes further financing from other creditors more expensive, perhaps unavailable to the borrower, making the borrower more dependent on the syndicate.

No mergers The borrower undertakes not to enter into any amalgamation, demerger, merger or other form of corporate reconstruction. This, in effect, may inhibit accruing shareholder value as there is apparent shareholder value increasing effects in takeovers.[83] Creditors already enjoy some statutory protection in amalgamations: the FCA, Part V gives lenders the right to demand adequate safeguards, e.g. security interests, in case of mergers and demergers. The no mergers covenant provides lenders with security in acquisitions which are not realised as mergers or demergers in accordance with the FCA.

One aspect of the no mergers covenant is that it may become broken on the initiative of a third party. E.g. in case of a hostile takeover bid for a publicly traded borrower, the acquirer may not know of the covenant. If the bid is successful, the covenant may be deemed broken and the lenders may accelerate. The right to accelerate might be limited by a contractual duty of loyalty owed to the borrower, especially if the amalgamation does not risk the solvency of the borrower. If the lenders withheld their consent for reasons that demonstrate a breach of the duty of loyalty—e.g. only for the reason of being able to relend that money at a higher interest rate elsewhere—the borrower could seek contractual damages.[84]

If the market has knowledge of the covenant, takeover bids may be reduced. While this on the one hand curbs creating shareholder value, it also on the other hand entrenches the directors as in takeovers the new owner often wishes to appoint its own directors.[85] As it is the duty of the directors to promote the interests of the company,[86] which normally means creating shareholder value,[87] undertaking not to allow amalgamations may not always be in line with the business judgement rule. This is especially so with public companies which may become the target of a hostile takeover. In such a case, the directors are under duty to pursue securing the best possible price for the shareholders.[88] Thus this duty is problematic if the directors have caused the company to enter into an agreement which precludes amalgamations altogether under the penalty of possible

83. *See Easterbrook – Fischel* 1981, pp. 1161 *et seq.*
84. *See* section 4.4 below.
85. *See Wood* 2007b, p. 109, where the issues are discussed in the context of a *no change of control* covenant.
86. FCA, Chapter 1, Section 8.
87. FCA, Chapter 1, Section 5.
88. Gov. prop. 109/2005, p. 41.

acceleration, thus circumscribing the directors' ability to fulfil their fiduciary duties owed to the shareholders.

Restrictions to distributions While not a standard clause in the LMA investment grade documentation, sometimes there may be a dividend restriction clause[89], whose object is to ensure creditors are paid before shareholders. Such a clause might be necessary in leveraged buy-out arrangements or project finance, but is not practicable in companies with dispersed ownership.[90]

This holds true as regards Finnish companies especially, as in accordance with FCA, Chapter 13, Section 7, minority shareholders holding at least one tenth of the share capital may at the annual general meeting demand that dividend is paid despite a board decision to the contrary (*minority dividend*).[91] Therefore, minority shareholders (who may not know of the covenant) may by exercising their statutory rights trigger an event of default.

No change of business and lender consent for business decisions The borrower covenants to keep conducting the business it conducts at the time of entering into the loan agreement. This is important for the risk management of the lenders who wish to prevent change of business into something riskier. Further, loan pricing is partially based on the type of business.[92]

Sometimes there may be an undertaking whereby the borrower undertakes to seek lender consent for certain business decisions other than change of business. Sometimes this may mean that actual control of the company has shifted from the board to the lenders already based on this undertaking alone—this is true e.g. in case the lenders are given an absolute *veto* over business decisions.[93]

Other general undertakings In respect of lender liability issues, the other general undertakings do not seem problematic. The requirement of the continued legality of the business of the borrower, for example, does not shift risk from the lenders to the borrower in so far as the business becoming wholly illegal is concerned. It only moves inevitable insolvency to a prior point in time in case legislative intervention

89. This clause is usually classified as a financial covenant, not a general undertaking.
90. *See Wood* 2007b, p. 92.
91. The minority dividend shall amount to no less than 50% of the earnings of the previous financial period, less any amounts not to be distrubuted in accordance with the articles of association, less normal dividends. Total dividends pursuant to the Section may not exceed (i) 8% of company capital, or (ii) the total of distributable funds.
92. *See Wood* 2007b, p. 95.
93. *Villa* 2003b, p. 152.

renders the business illegal. On the other hand, if it is the board that fails to ensure the borrower operates legally and the lenders accelerate, the shareholders can seek redress by filing a derivative claim for damages on behalf of the company against the directors in accordance with the FCA, Chapter 22.

It is fair to say that some general undertakings may work for the protection of the shareholders from mismanagement by the board as well as the protection of the minority shareholders from the opportunism of the majority shareholders and the board. E.g. a covenant that imposes a *restriction on disposals* can protect shareholders by reducing mismanagement of company assets. It is found to prevent *asset stripping*, that is the sale of the borrower's assets for the consideration of a possibly worthless claim, *a creeping change of business* whereby disposals lead to change of business to something riskier that the lenders and the shareholders may not be able to monitor, and *large scale disposals* to other creditors thereby protecting minority shareholders if a majority shareholder is also a major creditor.[94]

2.3.2.4 Financial covenants

Financial covenants enable the lenders to monitor the financial health of the borrower, and if the borrower's financial standing deteriorates, react accordingly.[95] To be sure, the financial covenants act as an early warning system for the lenders—they are designed to reveal rise in borrower insolvency risk.

The financial covenants are tailored individually for each borrower. In fact, the LMA documentation does not not even include recommended financial covenants for investment grade loans (there are model financial covenants, intended to serve as a starting point for negotiations,[96] for leveraged financing). In any case, there is market practice.[97]

According to *Wood*, financial covenants measure liquidity, solvency and capital adequacy. The tests could be either rolling or a snapshot based on the last (audited or unaudited, annual or quarterly etc.) accounts.[98] According to *Mugasha*, the LMA recommended form financial covenants measure rolling four quarter periods and include tests whose aim is to test for *cashflow cover* (whether the borrower's cash-flow is adequate to service its debts), *interest cover* (whether operating profit covers

94. *See Wood* 2007b, pp. 84–85 for motivation and common exceptions.
95. *Mugasha* 2007, p. 238.
96. *Ibid.*, p. 239.
97. Here it is assumed that Finnish lenders negotiate substantially the same financial covenants as international lenders because no reliable and up-to-date public information on Finnish practice is readily available.
98. *Wood* 2007b, p. 86.

interest costs), *leverage* (overall level of indebtedness), and *capital expenditure* (limits to the amount of capital expenditure).[99]

The breach of a financial covenant constitutes, as is the case with all covenants, an event of default. The lenders have at their disposal a variety of tools in dealing with such a situation, ranging from offering guidance to the borrower to accelerating the facility.[100] To be sure, the financial covenants are included in a facility precisely for the reason that the lenders will be able to act accordingly if the borrower's situation deteriorates. However, the side effect of the ability to put pressure on a borrower already in financial distress is the materialisation of agency problems as a result of a shift of control to creditors.

2.3.3 Default

2.3.3.1 Default generally

The default clause lists events of default—the events or circumstances whose occurrence means the borrower is considered to be in default of the agreement—and the consequences, namely acceleration.[101] The events of default include actions or omissions of the lender, e.g. breach of general undertaking or non-payment, but also other circumstances or events, such as material adverse change, which have not necessarily been caused by the borrower.

The default clause is of major importance because the lenders are relieved of their obligations to lend in case of an event of default. Therefore borrowers will seek to negotiate e.g. grace periods before the lenders can accelerate. The lenders, however, prefer to be able to act quickly and will usually only succumb to restrictions concerning events of default of minor importance.[102]

The different events of default will be explained next, followed by a discussion of the possible consequences.

2.3.3.2 Events of default

The events of default pursuant to the LMA documentation are several and various. The most serious event of default is *actual non-payment*, which sends a strong

99. *Mugasha* 2007, p. 239.
100. *See ibid.*, p. 238.
101. *Ibid.*, p. 245.
102. *Rhodes* 2004, p. 333.

signal of approaching insolvency. It is common to allow for a grace period of some days in case of e.g. a technical fault, but this is at the discretion of the lenders.[103]

Another important event of default is *breach of covenant.* This applies to the financial covenants, the general undertakings and the information covenants. Also *breach of other contractual obligations* may constitute an event of default, however, in case of clauses of minor importance there may be an explicit grace period during which the breach may be remedied before there is considered to be a default.[104]

Cross-default is a clause of very fundamental importance. The cross-default clause provides that it is an event of default if the borrower defaults on any other indebtedness to any other person.[105] The purpose of the cross-default clause is to establish creditor equality by effectively removing preferential treatment as discriminated lenders could trigger a default of all loan agreements. It is also intended to give the lenders leverage in possible work-out negotiations.[106]

A *Material Adverse Change*, or *MAC*, clause may be included as a catch-all, although the LMA documentation does not provide a model clause. The MAC clause enables the lenders to declare a default even if the change in circumstances does not fit to any of the other events of default.[107] An adverse change to the borrower's financial situation is to be considered material if the change would have caused the lenders not to lend or to lend only on significantly stricter terms.[108] Because such changes can be difficult to prove, the lenders want to be able to invoke the clause when the circumstances exist in the lender's opinion. If the MAC clause is too vague, the effect is that a term loan actually becomes an on-demand loan as the lenders can demand payment whenever there has in their opinion been an MAC.[109]

There are several other additional events of default. These include events which signify serious financial problems of the borrower, such as *actual insolvency*, *insolvency proceedings* or *creditor's process* against the borrower, but also events which may be out of the borrower's control, such as it becoming *unlawful* for the borrower to carry out its obligations pursuant to the loan agreement. *Misrepresentation* and *breach of warranty* are events of default.[110] Of note is that these may be already

103. *Mugasha* 2007, p. 246.
104. *Ibid.*, p. 246.
105. *Ibid.*, p. 246.
106. *Wood* 2007b, p. 103.
107. *Mugasha* 2007, p. 248.
108. *Wood* 2007b, p. 106.
109. *Ibid.*, p. 107.
110. *See Mugasha* 2007, pp. 246–248 and *Wood* 2007b, pp. 99–114 for a more comprehensive list of events of default.

covered by the requirement that the borrower continues to be in compliance with the financial covenants and general undertakings.

2.3.3.3 Consequences of default

According to *Villa*, lender reactions to default may range from (i) no reaction to (ii) demands of mitigating the default, (iii) issuing a waiver, (iv) renegotiating the facility, or (v) acceleration (which is detailed below).[111] In accordance with the loan agreement, the lenders are free to decide on the best course of action for each case. The reaction of course depends on the circumstances, i.e. how serious difficulties the default exemplifies.

According to *Wood*, when the borrower is in default, there are four main consequences at the discretion of the lenders, namely (i) cancelling the facility, (ii) cancellation of commitments to give further loans, (iii) cessation of further lending under the conditions precedent clause (the clause sets out requirements on which every tranche of money is conditional), and possibly, (iv) *cross-default* under the cross-default clause of another loan facility.[112]

In accordance with the LMA documentation, the lenders may accelerate any time on or after the occurrence of an event of default. There may be a requirement that the event of default is continuing at the time of acceleration. Acceleration can be one of three things:

(i) Cancelling commitments to lend more money.

(ii) Declaring that the loans will be payable on demand, in effect converting a term loan to an on-demand loan. This may be desirable in order to avoid triggering a cross-default.

(iii) Declaring the outstanding loan and all interest immediately due and payable. This is the most serious reaction as cross-default clauses in other loan agreements will be triggered.

Under the cross-default clause, default of that loan agreement constitutes a default of this loan agreement. Therefore a default of any loan agreement is fundamentally serious as it may render substantially all outstanding debt of the borrower immediately due.[113] The result is the demise of the borrower. The usual borrower reaction

111. *Villa* 2003b, p. 156.
112. *Wood* 2007b, p. 99.
113. *See ibid.*, pp. 103–104.

to a default after the fact is to seek a *waiver*, i.e. lender acknowledgement of the default whereby the lenders waive their right to the remedies attaching to events of default, namely acceleration. A waiver can be conditional on that the borrower takes some actions or that the circumstances ameliorate in a way prescribed by the lenders. Lender passivity in the face of an event of default does not constitute a waiver. Instead, the default continues unless the lenders issue the borrower with a waiver. A waiver can also be issued before the default has occurred so as to avoid cross-default. There may also be a grace period.

Any reaction on the bank's side is made pursuant to a credit decision procedure and normally there is a fee the borrower must pay.[114] Any actions in case of default are in the total discretion of the (majority) lenders. Lenders can in effect dictate conditions which must exist or measures which must be taken if the borrower wishes the lenders continue the facility—hence conditional waivers move actual control from the borrower to the lenders as a negative decision would usually lead to cross-default and thereby to immediate insolvency.

From a practical point of view, the mere *ability* to call a default gives the lenders an upper hand in negotiations *vis-à-vis* the borrower as long as it operates on a going concern basis, but also in restructuring negotiations.[115] The possibility to conditionally waive defaults is the ultimate mechanism whereby *actual control* flows from the borrower to the lenders.

The division of control and risk causes agency problems. These will be discussed in the next chapter.

3 Agency problems in syndicated loan transactions

3.1 Agency problems in general

Jurisprudence has shown considerable interest in the agency problem,[116] which is a general term for the issues that arise when the wellbeing of one party (the *principal*) is dependant on the actions taken by the other party (the *agent*).[117] There are two objective qualifications. Firstly, information asymmetry—the agent

114. *Välimäki* 2010, pp. 475–476.
115. *See Wood* 2007b, p. 99.
116. *See* e.g. *Mähönen – Villa* 2006a, pp. 73–150, *Bergström – Samuelsson* 2009, *passim*, and The Anatomy of Corporate Law by *Kraakman* et al., eds., 2009, *passim* (please refer to the bibliography entry for *Armour* et al. 2009a).
117. *Ibid.*, p. 35.

has better information of the relevant facts reducing the principal's capacity to monitor the agent's performance. Secondly, an interest conflict—the agent may seek to maximise his own wellbeing at the peril of the principal.[118] Because of the asymmetry of information, the principal may not be able to assess the performance of the agent.[119]

The agency problem is not important by itself but is instead used to describe problematic relationships which can be made better with regulation.[120] There are three agency problems which are omnipresent in limited companies:[121]

(i) shareholders—hired management,

(ii) majority shareholders—minority shareholders, and

(iii) the company (by extension its shareholders)—outside parties (in particular creditors of the company)

However, the relevant qualities can be found in other relationships as well: *Bergström* and *Samuelsson* find a fourth agency relationship between existing shareholders and future shareholders.[122]

The agency problem must be kept separate from the legal relationship of agency, which exists when one party, the agent, has the right to represent the other party, the principal, *vis-à-vis* third parties, for the purposes of e.g. creating legal relationships such as contracts between the principal and third parties.[123] In addition to the inherent agency problems identified in limited companies, agency problems may arise in e.g. insurance contracts, employment contracts and commission. Typically, the principal and the agent enter into an agreement according to which the agent pursues certain interests on behalf of the principal, but is free to choose the most suitable means.[124]

118. *See* e.g. *Vahtera* 2011, p. 55.
119. *See* e.g. *Mähönen – Villa* 2006a, p. 87, and *Armour* et al. 2009a, p. 35.
120. *Vahtera* 2011, p. 55.
121. *See ibid.*, p. 55 and *Armour* et al. 2009a, p. 36.
122. *Bergström – Samuelsson* 2009, pp. 21–22.
123. In terms of the agency problem, the management can be seen as the agent of the shareholders, as it is the shareholders (through the company) who bear the upside and downside risk of their actions. In terms of legal agency, nobody is the agent of the shareholders because of separate legal personality of the company. *See* e.g. *Armour* et al. 2009c, pp. 6–9, and *Bergström – Samuelsson* 2009, pp. 62–63 (legal personality of companies generally), *French* et al. 2010, pp. 133 *et seq.* (English law proposition), and *Airaksinen* et al. 2010a, pp. 15–19 (Finnish law proposition).
124. *See* e.g. *Mähönen – Villa* 2006a, p. 87.

The agency problem entails *agency costs*. From a law and economics point of view, agency costs arise from making and enforcing contracts governing the agency relationship.[125] In the principal-agent relationship of shareholders and the management, this includes the explicit as well as implied contracts between the company and its managers.[126] Further costs arise from the lost output due to enforcement costs exceeding benefits.[127] Agency costs can be borne either directly, i.e. when the agent's less-than-optimal performance reduces the earnings of the principal. Shareholders may be faced with the realisation of such costs in three ways: (i) the amount of distributable funds (earnings) is reduced, (ii) on exit, the shares are not as valuable as they could be, and (iii) receiving less on liquidation of the company.[128] Indirect agency costs incur from enforcing agency compliance as *monitoring costs* regardless of the number of principals, and as further *coordination costs* if there are several principals. The principals (the shareholders) must coordinate their decisions, and their monitoring of the agent (the management), between them. Difficulties in decision making lead to delegating more power to the agent. Moreover, if the principals have different goals—*heterogenous preferences*—it is increasingly difficult to ensure the agent does the right thing as there is no single right thing to do, thus increasing coordinating costs.[129]

Mechanisms that circumscribe the agent's possibilities of exploiting the principal benefit not only the principal, but the agent as well. This is because the principal will be prepared to pay more to an honest agent. For example, if a creditor (as the principal) can reduce opportunistic behaviour by the debtor (as the agent), this should lead to cheaper interest rates on lending.[130] Indeed, covenants can benefit both parties by reducing the risk faced by lender and thus allowing for cheaper financing for the borrowers.[131]

3.2 The creditors-company agency relationship

The interests of different parties with an interest in the company's cashflow will inevitably come into conflict—in fact, a conflict of interest arises between debt and equity claimants every time the company decides on the allocation of its

125. *Fama – Jensen* 1983, p. 304.
126. *See Mähönen – Villa* 2006a, pp. 185–266 for a discussion of the *nexus of contracts* theory of the company.
127. *Fama – Jensen* 1983, p. 304.
128. *Mähönen – Villa* 2006a, p. 87.
129. *Armour* et al. 2009a, pp. 36–37.
130. *Ibid.*, p. 37.
131. *See Enriques – Macey* 2001, p. 1172, where the case against legal European-style capital rules and for US-style negotiated lender protection is made.

capital.[132] The principal-agent relationship between a company and its creditors is often examined from the perspective of a vulnerable creditor facing the risk of shareholder opportunism.[133] To be sure, the creditor is considered the principal and the company is his agent. Indeed, European company law fundamentally builds upon the aim of protecting creditors.[134] To be sure, the creditors may fall victim to various kinds of debtor opportunism. At the outset, the debtor may give false information on its financial standing.[135] It is no wonder that the covenants in loan agreements specifically address these issues, reflecting the lenders' concerns.[136] Misrepresentation and breach of warranty are events of default, so as to establish the disclosure of reliable preliminary information, allowing the lenders to make an educated credit decision.

The creditors and shareholders of limited companies have different risk attitudes. Shareholders tend to take *too much* risk while creditors tend to take *too little* risk. This is because of the residual right to earnings of the shareholders: they only stand to lose their initial investment while if the risks taken pay off, all extra goes to them. Fixed creditors do not receive a share of the upside of risks but stand to lose everything if the risks realise.[137] Therefore covenants are intended to reduce volatility, thereby reducing the downside risk borne by creditors but also the upside risk borne by shareholders. In other words, reduced volatility means a reduced number of possible outcomes and a reduced probability of the outcome being in either extreme. According to the *costly contracting hypothesis*, there are significant costs associated with covenants because they reduce the company's flexibility. Therefore borrowers look for an optimal, value maximising set of covenants, comparing the costs and benefits of each covenant.[138] While there are costs related to the use of covenants, companies can benefit from the additional safeguards against too much risk-taking. However, if the covenants are too strict, companies stand to lose potential earnings from lost opportunities.

When entering into a loan agreement, the borrower can lie about its financial situation or motives. After having received the money, the borrower may engage in risk-increasing activity or reduce the amount of funds available for repayment (*asset dilution*), increase the riskiness of the business (*asset substitution*) or increase

132. *Enriques – Macey* 2001, p. 1166.
133. *See* e.g. *Bergström – Samuelsson* 2009, p. 21.
134. E.g. *Enriques – Macey* 2001, p. 1173 and *Armour* et al. 2009b, p. 148.
135. *Ibid.*, p. 116.
136. *Mugasha* 2007, p. 236.
137. *See* further e.g. *Armour* et al. 2009b, pp. 116–117 and *Enriques – Macey* 2001, p. 1169.
138. *See Smith – Warner* 1979, pp. 121 *et seq.*

the company's indebtedness effectively diluting the lenders' claim (*debt dilution*).[139] These are the risks the various covenants try to divert. Restrictions on distributions and disposals, as well as the negative pledge aim at reducing asset dilution. No change of business prevents change of business to something riskier. The financial covenants prevent, *inter alia*, excessive indebtedness. Some covenants work several ways. E.g. the no mergers and no change of control covenants prevent acquisitions by someone who would combine the business with something more risky and possibly guarantee acquisition debt effecting debt dilution.

As we will see below, however, the relationship between the company (as agent) and a creditor (as principal) is materially altered by control powers awarded to creditors. As *Armour* et al. correctly note, when a company declares bankruptcy, its creditors change roles, effectively becoming owners of the company.[140] After that point, the relationship between the relevant interest parties is governed by bankruptcy law. However, as a result of actual control powers awarded by contract, e.g. a loan agreement in accordance with the LMA model, the principal–agency relationship may be flipped before legal bankruptcy when the company is still operating on a going concern basis thanks to especially the financial covenants which provide an early warning system. Lender desire for control of a company operating in the vicinity of insolvency is rational, given that the risk of opportunistic behaviour by shareholders is higher when the company nears some sort of an end period, especially insolvency.[141]

Who, then, should have the right to exercise control in a company? On liquidation, shareholders have the most subordinated position. They receive the residual funds after all other creditors have been satisfied, which can be any amount from zero upwards. Moreover, while the company is operating on a going concern basis, the shareholders are only paid out of its earnings, but on the other hand, they may receive all the extra with no upper limit. This means that they have the strongest incentive to assure the company stays afloat and generates as much profit as possible.[142] Because the shareholders are entitled to residual earnings, they are also the most inclined to favour risk-taking activities, as they benefit the most from increased volatility.[143]

139. *Armour* et al. 2009b, pp. 116–117.
140. *Ibid.*, pp. 115–116.
141. *Enriques – Macey* 2001, p. 1171.
142. *Mähönen – Villa* 2006a, p. 78.
143. *Armour* et al. 2009b, p. 117.

Alternatively, the shareholders can be described as *residual risk bearers*.[144] However, thanks to limited liability, they only risk losing their invested amount, as do the creditors to a company and in this sense the position of shareholders is not different from that of the creditors.[145] Thus, the downside risk of these two constituents is the same save for the difference in the order in which each constituent is paid. The shareholders are residual risk bearers because they are paid last. For taking this risk, and because the shareholders are the most incentivised to make educated decisions, they are awarded residual control powers,[146] and it is these control powers that make the shareholders, in a meaningful sense, the owners of the company.[147] Their risk realises on bankruptcy: the funds available will normally not satisfy in full the claims of creditors in more senior positions and therefore in an economical sense the shareholders no longer have an interest in the company. In accordance with the view that a company should be run in the interests of its residual risk bearers, upon bankruptcy the residual control powers are by bankruptcy law transferred to the creditors. What about operating in the vicinity of insolvency? Could it be said that the situation can become so hopeless even before legal insolvency that the shareholders no longer have a meaningful interest in the company and it is actually the creditors who bear residual risk (as defined above)?

I argue that the answer is yes. Consider the following example:[148]

> "The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors. Consider, for example, a solvent corporation having a single asset, a judgment for $51 million against a solvent debtor. The judgment is on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of $12 million. Assume that the array of probable outcomes of the appeal is as follows:

144. *Fama – Jensen* 1983, p. 302.
145. *See French* et al. 2010, pp. 429–430, criticising describing the shareholders as residual risk bearers on the grounds that it exaggerates the risk borne by the shareholders who do not actually stand to lose more than their invested amount.
146. *See Easterbrook – Fischel* 1983, p. 403. The shareholders have the most appropriate incentives because their gains and losses most closely follow marginal gains and losses.
147. *Mähönen – Villa* 2006a, pp. 78, 90, although noting that it is misleading to call the shareholders the owners of the company.
148. The example is lifted from the Delaware case *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp. (unreported)*, at footnote 55. Also *see Enriques – Macey* 2001, p. 1169 and *Airaksinen* et al. 2010a, p. 29, where similar examples are set out.

		expected value
25% chance of affirmance	($51 mil.)	$12.75 mil.
70% chance of modification	($4 mil.)	$2.8 mil.
5% chance of reversal	($0)	$0
Expected value of judgment on appeal		$15.55 mil.

Thus, the best evaluation is that the current value of the equity is $3.55 million. ($15.55 million expected value of judgment on appeal—$12 million liability to bondholders). Now assume an offer to settle at $12.5 million (also consider one at $17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a $12.5 million offer or a $17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a $12.5 million settlement (under which they get practically nothing). More importantly, they very well may be opposed to acceptance of the $17.5 million offer under which the residual value of the corporation would increase from $3.5 to $5.5 million. This is so because the litigation alternative, with its 25% probability of a $39 million outcome to them ($51 millon − $12 million = $39 million) has an expected value to the residual risk bearer [(i.e. the shareholders)] of $9.75 million ($39 million × 25% chance of affirmance), substantially greater than the $5.5 million available to them in the settlement. While in fact the stockholders' preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that shareholders would prefer rejection of both settlement offers.

But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. [. . .]"

The quote above sets out an example of the *moral hazard* dilemma, which occurs when, in this context, the shareholders receive the upside if the gamble succeeds but do not bear a meaningful or any downside risk. *Airaksinen* et al. conclude that under Finnish law such gambles violating creditor protection should not be regarded as allowed—even if they were for the benefit of the shareholders.

According to them, *at least when the company is worthless*, taking a major risk which may result in either major losses or major earnings should not be allowed.[149] *Gilson* et al. go further stating that when a firm is clearly insolvent and its net assets are clearly negative, the creditors (who then are residual risk bearers) should have the authority to decide on the allocation of the company's assets.[150] The reasoning is that the shareholders are not incentivised to act appropriately because the gain goes to the creditors.[151] I think the emphasised passage neatly underlines how difficult it is to assess when the risk of the shareholders has realised in such a way that the interests of other interest parties start to gain prominence over the interests of the shareholders as the guiding light of the management (at least when the company is worthless—are there other circumstances?) As was explained above, as a theoretical proposition residual risk and residual control rights go hand-in-hand, normally belonging to the same party. From this follows that the shift of control from shareholders to creditors is justified when the residual risk has shifted accordingly. The justification is not only moral, but also economical and functional. Separating decision and control powers from residual risk leads to efficiency loss.[152] From a functional perspective, residual risk bearers have the most interest in decision-making and therefore make the best decisions, and decision-making benefits from decision makers with similar preferences (i.e. decision-making by a single decision maker or a single class of decision makers).[153]

The difficulty lies in recognising the point in which the residual risk of the shareholders has realised and shifted to the creditors. Residual risk bearer is the party whose wealth is directly affected by marginal changes in company value.[154] It is important to note that the company perhaps isn't legally insolvent even if the risk of the shareholders has substantially realised. Consider the requirements for bankruptcy proceedings. Under the FBankruptcyA, insolvency is a prerequisite for bankruptcy proceedings. Insolvency is defined as "otherwise than temporarily not being capable of servicing debts as they fall due".[155] However, it is entirely possible that a debtor has enough cashflow to fulfil its ongoing obligations, e.g. paying suppliers and employers, while likely being incapable of raising refinancing needed in order to service a major term loan that will fall due only in the future. Such a debtor would not be insolvent in the meaning of the FBankruptcyA, but the risk borne by the shareholders could be deemed to having become substantially realised

149. *Airaksinen* et al. 2010a, p. 29. Emphasis here.
150. *Gilson – Vetsuypens* 1994, p. 1006.
151. *See Easterbrook – Fischel* 1983, p. 404.
152. *See* e.g. *Gilson – Vetsuypens* 1994, pp. 1005–1006.
153. *See Easterbrook – Fischel* 1983, p. 405.
154. *Gilson – Vetsuypens* 1994, p. 1006.
155. FBankruptcyA, Chapter 2, Section 1. Translation here.

as there is little hope of escaping insolvency save for unforeseen amelioration of the situation e.g. in the form of a new investor.

When the shareholders no longer have a meaningful positive or negative risk in the company, but the creditors do, in terms of the agency problem the creditors in control have effectively replaced the shareholders as the principal *vis-à-vis* the directors, i.e. the agent. The creditors not only bear negative risk—losing everything—they also bear positive risk—being paid the outstanding amount in full instead of receiving only partial repayment. They are the bearers of residual risk, but only up to the point that their claim is satisfied. It is worth noting that in a situation where the shareholders no longer have any upside or downside risk because of the dire financial standing of the company, the lenders pursuant to an LMA style loan agreement could normally convert their actual control powers to legal control rights by accelerating the loan, causing insolvency and bankruptcy. The material adverse change clause is there to ensure that the acceleration right is exercisable in such a situation.

On the other hand, if the financial standing of the debtor ameliorates so that residual risk shifts back to the shareholders, there is no longer justification for creditor control. If control is in the hands of the creditors while the shareholders bear residual risk, the creditors effectively replace the managers as the agent *vis-à-vis* the shareholders, i.e. the principal in so far as the management–shareholders agency problem is concerned.

This shift of control is not without its problems. Firstly, only sophisticated creditors who have negotiating power have negotiated control powers, which means that other creditors can fall victim to their opportunism.[156] Secondly, it is not clear when the residual risk shifts to the creditors justifying the transfer of residual control. The lenders according to an LMA style loan agreement acquire actual control on breach of covenant, which may or may not be the same point in time that the shareholders no longer bear substantial residual risk. Therefore, if the risk position of the shareholders has not fully realised, they have a downside risk in lender control—they are the principal and the lenders are the agent.

A new set of agency problems arises between lenders who may exercise contractual control and creditors with no control rights. This includes voluntary fixed creditors,

156. Also sophisticated creditors may be at the peril of controlling creditors, but in that case they have priced the risk accordingly. One example is the position of subordinated, junior lenders. Senior lenders can—in an economical sense—use junior lender claims as collateral for their own claim. The effect can be that senior lenders are paid for their whole claim while junior lenders get nothing. *See Lauriala* 2010, *passim*.

such as employers and suppliers, and involuntary creditors, such as tort victims and the tax authorities.

Does Finnish company law recognise the shift of residual risk to the creditors? This is determined by two factors: firstly, whether the creditors gain control rights when they become residual risk bearers. No—creditors only get legal control rights when the debtor company enters formal insolvency proceedings. However, contract practice has developed to recognise this shift. Secondly, is the company always run in the interests of the residual risk bearer even if creditors instead of shareholders have become the bearers of residual risk? Again, no—the explanation is in the following.

It is the duty of the directors to promote benefit of the company.[157] The duties of the directors are interpreted in the light of the purpose of the company, which in accordance with FCA, Chapter 1, Section 5 is taken to be creating shareholder value. This means that the directors are seen to owe their duties to the shareholders.[158] There is some tension between the interpretations of Sections 5 and 8, because the benefit of the company could be understood to include the benefit of also some other constituents than just the shareholders. *Simula* argues that the better alternative is to interpret the purpose of the company pursuant to FCA, Chapter 1, Section 5, as maximising net present value, because pursuing this end leads to decision-making that is rational in respect of the interests of all parties.[159] However compelling this interpretation may be, there is no consensus. *Mähönen* and *Villa* seem to suggest alternatively (i) *enlightened value maximisation*, which is seen to include maximising the value of all securities issued by the company, be they debt or equity instruments,[160] and (ii) maximising the earnings of the company, which is (incorrectly, it is submitted) seen to equate maximising shareholder value.[161] *Airaksinen* et al. note that the vagueness of the Section restricts its practical

157. FCA, Chapter 1, Section 8. The section refers to the 'management' of the company. Management means the managing director, the members of the board of directors and the members of the supervisory board, if any. Because of the supervisory board members' non-executive role, normally the relevant actors in interacting with creditors are the directors, and the word director is therefore used in this thesis (*see* FCA, Chapter 6, Section 1). In respect of group companies, the Section is seen to codify the requirement *corporate benefit* instead of group benefit. *See Lindholm – Storå* 2010, 410 *et seq.* on the meaning of the term *corporate benefit* in the interpretation of the FCA.

158. On the interpretation of FCA, Chapter 1, Section 5, *see* e.g. *Airaksinen* et al. 2010a, pp. 26–34 and *Mähönen – Villa* 2006a, pp. 79–86, 120–121. *See* Gov. prop. 109/2005, p. 41, where it is stated that acting for the benefit of the company imposes a duty of loyalty on the directors, owed to the company and ultimately its shareholders as a class.

159. *See Simula* 2007, pp. 35–46.

160. *Cf. Mähönen – Villa* 2006a, p. 84 and *ibid.*, p. 93.

161. *See ibid.*, p. 115, *cf. Simula* 2007, p. 38, especially footnote 106.

applicability.[162] Instead of seeing FCA, Chapter 1, Section 5 as a guideline for the proper course of action in situations which arise in practice, in my opinion, the Section is more better viewed more as the *raison d'être* of the company than a practical guideline against which directors' actions are judged. In this practical sense, the purpose of the company is secondary to the duty of care of the directors pursuant to FCA, Chapter 1, Section 8. The directors are under duty to promote corporate benefit (which necessitates taking into account—at least to some degree—the interests of the company's interest parties), which in turn is intended to translate into creating shareholder value (the ultimate end). Of note is that the purpose of the company can be modified in the articles to be something else than generating shareholder value, and that such a modification does not alter the duties of care and loyalty owed by the directors to the company.

To some extent, the duties owed to the company are altered by an obligation to "pursue operating continuously", which is thought to "secure the rights of also the creditors".[163] Such an obligation was originally recognised in *KKO:2003:33*, where a mutual real estate company failed to levy sufficient fees from its shareholders to ensure the continued solvency of the company (such a company normally has no other sources of income). The purpose of an MREC is not to create shareholder value, but to provide housing services to its shareholders. In this respect, the *dictum* should be understood confined to the facts of the case, and in respect of normal companies, it shall not be understood as creating an obligation to collect fees from the shareholders in order to ensure continued solvency.[164] The obligation is rather undefined and it is unclear when it becomes applicable. In my opinion, in respect of normal companies, if it is accepted that the directors are under obligation to prefer continued operation, such an obligation would require the directors of insolvent companies to choose from optional courses of action the course of action which is most likely to restore the company's solvency instead a course of action whose expected value for the shareholders is higher but is less likely to succeed.[165] The latter course of action would effectively be a wealth transfer from the creditors to the shareholders—the former would bear the downside risk while the latter would receive the upside. Noting that evaluating the expected value[166] of any undertaking of the company is extremely difficult, *Airaksinen* et al. propose that the directors may undertake any project whose expected value is positive.[167] Even

162. *Airaksinen* et al. 2010a, p. 30.
163. *See* Gov. prop. 109/2005, p. 39.
164. *See Villa* 2003a, p. 7.
165. Consider the example at page 30 above.
166. Expected value is calculated as of value times probability, both of which are in practice very difficult to estimate.
167. *Airaksinen* et al. 2010a, pp. 29–30.

undertakings whose expected value is positive may unjustifiably undermine the interests of other interest parties than shareholders, unless constrained by an obligation to pursue continued operation, as especially in case of companies in the vicinity of insolvency or insolvent, undertakings with positive expected value may allow separating downside and upside risk (consider the quote above on p. 30.) Because it is inherently difficult to estimate the expected value of any undertaking, and circumstances where the company nears some sort of an end period, such as insolvency elevates the risk of shareholder opportunism, negotiated creditor protection in the form of creditor control rights allow the creditors to have a 'vote' on the correct course of action—i.e. the course of action that takes into account the interests of all major economic interest parties.

The duty of care of the directors does not include an explicit duty to act in the interests of the interest parties of the company, such as its contracting parties.[168] Conversely, the duty of care includes a duty of loyalty owed to all shareholders,[169] which could be taken to mean the exclusion of other parties as the beneficiaries of such duties. The creditors are not owed fiduciary duties, but are instead protected by specific creditor protection norms and the prohibition of advancing the interests of a specific creditor or a specific class of creditors at the expense of the company.[170] To be sure, the shareholders continue to enjoy the loyalty of the directors despite a shift of residual risk to the creditors when the company is in the vicinity of insolvency or actually insolvent. Sophisticated loan agreements are designed to attack this problem specifically. Consider the financial covenants and the right to accelerate on breach of covenant. The financial covenants establish in clear terms when the creditor believes the debtor is in the vicinity of insolvency, and the right to accelerate ensures the creditor has a voice in such a case. Statutory law can never achieve the clarity of agreed financial covenants which set out the conditions in clear numbers, but would instead have to rely on standards, providing a one-size-fits-all approach leading to difficulty in determining when the company is in the vicinity of insolvency. Because of the difficulty of determining when the shift of residual risk occurs, it would be very hard for legislation to recognise a shift of fiduciary duties that follow the shift of actual residual risk and can be better anticipated through contracts.

To summarise, lending contract practice seems to account for the shift of the residual risk better than company law. Contract practice allows for the shift of control to the actual residual risk bearers while company law does not. There is,

168. *Airaksinen* et al. 2010a, p. 47.
169. Gov. prop. 109/2005, p. 40.
170. *Mähönen – Villa* 2006a, p. 125.

then, tension between the realities recognised by contract practice and the rigidity of company law. Because contract practice has not developed limits to the decision-making by lenders, it is important to ask what governs decision-making by lenders who have actual control. Is there a duty of care and is the standard the same as the directors'? Do they have a duty of loyalty *vis-à-vis* the other constituents, namely the other creditors and the shareholders? These problems will be discussed in the following chapters. Before these questions are addressed, legal strategies for reducing agency costs will be discussed next.

3.3 Reducing agency costs

3.3.1 Generally

Agency costs can be reduced using different strategies. Some of such strategies may require legislative intervention while others are available through contracting. The strategies can be divided into *regulatory strategies*, which work by regulating the principal-agent relationship, and *governance strategies*, which seek to enable the principal to better control the agent's behaviour.[171]

Armour et al. outline ten strategies for reducing agency costs (set out in the table below), intended to illustrate the different approaches, not to provide an all-encompassing list. On the left hand side are regulatory strategies and on the right hand side are governance strategies. Each of these strategies has an *ex ante* and an *ex post* variety.[172] At the outset, it must be noted that the strategies set out in the table below, while suitable to govern any principal-agent relationship, are best suited to more typical principal-agent relationships, for example that of a director and the company. Due to the different nature of the relationship between a borrower and a lender, only a subset of the strategies is applicable to regulating lender control. Secondly, it must be emphasised that it would be exceptional for a creditor to be an agent *vis-à-vis* a debtor—normally the debtor company is to be regarded the agent and the creditors the principals in this principal-agent relationship. This section aims to conclude which strategies, on a general level, may be of use in regulating lenders in control, and to illustrate how lenders try to reduce their agency costs, both with the aid of examples.

171. *Armour* et al. 2009a, pp. 37–38. This thesis follows the terminology established in *ibid.*, pp. 37–51.
172. The table is reprinted from *ibid.*, p. 39.

	regulatory strategies		governance strategies		
	agent constraints	affiliation terms	appointment rights	decision rights	agent incentives
ex ante strategy	rules	entry	selection	initiation	trusteeship
ex post strategy	standards	exit	removal	veto	reward

3.3.2 Governance strategies

Let us first look at governance strategies, set out on the right hand side of the table above. Governance strategies seek to enable the principal to monitor enforce agent compliance.[173]

Firstly, there are *appointment rights*—selection and removal. Principals seek to *select* the best agents available and to *remove* inefficient agents. Appointment rights are a cornerstone of corporate governance, as underperforming or fraudulent directors risk losing their reputational capital when ousted.[174] Similarly, borrowers will try to borrow from lenders who require the least onerous covenants and the lowest interest. The reputation of the bank may play some role, especially when choosing the arranging bank. Also borrowing is a repeat game and borrowers too suffer from having bad reputation.[175] Lenders' choice of clients and right to accelerate are better classified as entry and exit strategies because lenders are free to decide whether to invest or not. Borrowers may not be able to choose whether to borrow or not, the only choice, if any, is between lenders, and is therefore better classified as appointment. To be sure, there is some overlap in the appointment rights and affiliation terms strategies.

Lenders may seek to use *decision rights* strategy[176] to constrain the borrower from making by negotiating a *veto* right over certain business decisions. Further, when the borrower is in default, lenders may require the borrower makes or refrains from making certain decisions as a condition for continuing the facility, effectively *initiating* the decision-making process. However, it is always the borrower, more specifically its board, that formally makes and enforces such decisions.

173. *See Armour* et al. 2009a, pp. 43-45.
174. *See* e.g. *Enriques – Macey* 2001, p. 1171 and *Enriques* et al. 2009, p. 79.
175. *Enriques – Macey* 2001, p. 1170.
176. *See Armour* et al. 2009a, p. 43.

Agent incentive strategies[177] have some use in reducing agency costs relating to lender control. Borrowers cannot *reward* the lenders for efficient use of their controlling powers, which are only used in exceptional circumstances. On the other hand, the lenders can incentivise the borrower to favour decisions that are in the interests of the lenders, e.g. by tying the interest rate to certain financial ratios. *Trusteeship* strategies include using independent gatekeepers to oversee agents' decision-making—a familiar example includes auditors.[178] Keeping in mind that even if creditors have a contractual right or actual power to decide certain matters, it is the company itself, or more precisely its directors, who implement the decisions made by creditors. In this role, the directors serve a gatekeeper function deciding which decisions to implement.

To summarise, in the normal situation that the lenders are to be considered the principals and the company the agent, the governance strategies may allow the lenders to reduce their risk by incentivising or forcing the borrower to make certain decisions deemed favourable by the lenders. From the point on when lenders start to use control powers, the debtor company's directors act as gatekeepers employing the trusteeship strategy in protecting shareholder interests from creditor abuse.

3.3.3 Regulatory strategies

Regulatory strategies involve setting terms governing the principal-agent relationship beforehand, while the governance strategies revolved around constraining agent opportunism once the principal-agent relationship has formed.

Affiliation terms[179] regulate how principals and agents *enter* into a principal-agent relationship, and how principals can *exit*. Entry could be governed by disclosure obligations on the agent, a familiar example being the prospectus requirements on listed companies. Exit rights allow the principal to either withdraw his investment,[180] or to sell his investment.[181]

From a lender point of view, affiliation terms are of central importance. Lenders will only extend credit to creditworthy clients. Here financial disclosure prior to entering into the facility agreement is key. The right to accelerate is a kind of an

177. *See Armour* et al. 2009a, p. 43.
178. *See ibid.*, pp. 43–45.
179. *See ibid.*, pp. 40–42.
180. E.g., in the context of company law, consider mandatory share redemption by an abusing shareholder, *see* FCA, Chapter 23. However, shareholders do not have a right to have their shares redeemed by the company.
181. E.g., consider freely transferable shares in the context of company law. *See* e.g. *Armour* et al. 2009c, pp. 11–12 and *Airaksinen* et al. 2010a, pp. 22–26.

exit right. In an economical sense, it enables the lenders to have their investment immediately paid back, although often there is not enough money to pay back the loan in full. Further, lenders can sell their interest in the facility. Indeed, the LMA was established to enhance tradeability of the loans (and to reduce transaction costs).[182]

Agent constraints can include *rules* and *standards*, each limiting the agent's actions in some way.[183] Rules are norms which establish the limitations *ex ante*, while the breach of standards, which rely on the application of a principle, has to be determined *ex post*. The covenants in loan agreements are in this sense essentially rules prohibiting certain actions by the borrower—consider e.g. the negative pledge, no change of business, and restrictions to disposals. In some respects, the material adverse change is a standard that catches borrower failures that don't fall into any of the categories established by the other covenants, although in many a case material adverse change may be out of control of the borrower.

Normative strategies that try to reduce agency costs arising from misuse of control by creditors by directly attacking that misuse would have to come in the form of either agent constraints or agent incentives. These categories have some overlap and economical constraints, such as recovery to the bankruptcy estate of the debtor, could be placed in either category.

Keeping in mind these general categorisations of strategies for reducing agency costs, the following chapter considers different liability mechanisms which may have elements that reduce agency costs.

4 Safeguards against creditor opportunism

4.1 No regulation of creditor control as such

In the previous chapter I argued that negotiated lender control powers may alter the principal-agent relationship existing between the lender and a debtor company substantially. The lender may become agent of the borrower, who thereby becomes a principal vulnerable to the opportunism of the lender. A key objective of company law is to reduce agency costs by regulating the various principal-agent relationships.[184]

182. *See* e.g. *Wood* 2007b, p. 35.
183. *See Armour* et al. 2009a, pp. 39–40.
184. E.g. *ibid.*, p. 35.

When company law regulates transactions with creditors, its aim is to establish creditor protection and not protection of the company from its creditors.[185] *Armour* et al. find that that corporate lenders routinely negotiate for contractual protection in form of covenants, and that the parties to such transactions face transaction costs arising from these negotiations. Still, company law regulates transactions with creditors quite little. They find three reasons: (i) risk of limiting the debtor company's operations too much, which would be as harmful as too few restrictions, (ii) creditors have too heterogenous time and risk horizons which makes finding a one-size-fits-all solution difficult, and (iii) as time passes, restrictions protective of creditors might need to be altered, which calls for negotiated protection.[186] It should be noted that *Armour* et al. look at the principal-agent relationship of creditor and debtor from the point of view of the normal situation of the creditor as the principal—i.e. placing restrictions on the company. They make a convincing point for negotiated creditor protection in principle instead of emulating its intents and purposes in statutory law, and I do not intend to dispute the advantages of negotiated creditor protection.[187]

However, this does not mean that companies or creditors thereto benefit from company law not regulating creditor use of control powers. As was stated above, both agents and principals benefit from measures which work to align the agent's interests with those of the principal.[188] Why, then, does not company law regulate exercising of control powers by a creditor over a debtor company? One reason could be that creditor control is an exception. It is expected that creditors are at the peril of the debtor's opportunism, not the other way. Therefore there might not seem to be too much need to circumscribe use of control powers by a creditor—indeed, normally he has no control powers.

As there are no restrictions specifically designed to attack the use of controlling powers by creditors, mechanisms imposing such limitations are sporadic and coincidental, and work indirectly by introducing economically relevant negative consequences, not restrictions as such.

185. *See* e.g. *Armour* et al. 2009b, pp. 115 *et seq.* According to *Bergström* and *Samuelsson*, creditor protection can be seen as a *theme* overlapping several branches of law. *See Bergström – Samuelsson* 2009, pp. 177 *et seq.*
186. *Armour* et al. 2009b, pp. 118–119.
187. *See Enriques – Macey* 2001, *passim*, *Ferran* 2006, *passim*, and *Mülbert* 2006, *passim* in favour of negotiated creditor protection.
188. *See Armour* et al. 2009a, p. 37.

4.2 Liability of directors

4.2.1 Directors' duties generally

It was observed above that control powers accorded to creditors mix up the agency problems inherent in limited companies. On the one hand financial difficulties of the company may result, in a practical sense, the realisation of the shareholders' risk, thereby causing the lenders to replace the shareholders as the principal *vis-à-vis* the directors. On the other hand, control powers accorded to creditors mean that the lenders complement the directors as the agent *vis-à-vis* the company. Thus creditor control may, in a meaningful sense, remove the separation of ownership and management as the residual risk bearer becomes involved in the management.[189] Thus it is interesting whether directors' duties respond to this shift, and whether creditors can become subject to directors' duties.

Directors are subject to certain directors's duties, and liabilities arising from breach thereof. From the viewpoint of a majority shareholder, directors' duties are secondary to the ability to change the directors, but they are nevertheless important in protecting the shareholders as a class.[190] From the duties follows, in outline, that the directors must make and implement decisions they believe are for the benefit of the company. This section explores the duties and the gatekeeper function of the directors in circumscribing creditor opportunism. The following section considers whether directors' duties can be extended to *actual* directors, such as creditors.

One topic of discussion is, who should be subject to directors' duties—specifically, should directors' duties extend to creditors wielding significant control? According to *Mähönen* and *Villa*, the duties of directors pursuant to Anglo-American law are "more developed and more clearly based on the agency problem" than their Finnish counterparts and therefore, they say, it is reasonable to use Anglo-American doctrine when construing the corresponding duties under Finnish law.[191] However, they note that every jurisdiction decides who shall owe such duties and foreign law cannot provide guidance on this issue.[192] Keeping this in mind, I will consider whether company law should extend directors' duties to certain other persons than the properly appointed directors. In particular, extending directors' duties to *shadow directors*, recognised by English law, is of interest.[193]

189. *See* e.g. *Enriques* et al. 2009, pp. 56 *et seq.* on the shareholder–management conflict in general.
190. *See ibid.*, p. 79.
191. *Mähönen – Villa* 2006a, p. 111. Translation here.
192. *Ibid.*, p. 111.
193. Shadow directors are "an interesting peculiarity of UK law"—they are not recognised in e.g. Germany and the US (*Cahn – Donald* 2010, p. 342) and it is assumed they are not recognised in

4.2.2 Duties owed to the company

Section 8 of Chapter 1 of the FCA sets out the duty of care. Pursuant to the section, the directors must carefully promote the benefit of the company.[194] The duty to promote corporate benefit includes a duty of loyalty towards the company and all its shareholders.[195]

To be sure, in addition to these open-ended standards, also several rules govern management decision making. From a systemic point of view, such explicit rules supplement and implement the general duties of loyalty and care. From a practical point of view, the opposite is true. For a principle to gain traction in practice, both lawyers and judges will need to feel comfortable with working with open-ended standards, and this is generally not so in civil law countries so much as in common law countries.[196] The rules governing the directors are too numerous to be all discussed individually, but reference will be made to relevant rules in context.

The general duties of directors owed to the company and its creditors were discussed in more detail above in section 3.2. It was concluded that even if the creditors have become bearers of residual risk, the management of the debtor company still owes its duties to the company and ultimately its shareholders. However, there is a rather undefined obligation to pursue continued operation, which is thought to secure the interests of the creditors as well.[197]

Creditors who have contractual decision rights or actual decision power cannot directly control the decision-making of the debtor company. Instead, they can only influence the decision-making process by instructing the debtor's directors to make decisions favoured by the creditors. Here, the management has primarily two choices: compliance and non-compliance. In this role, the hired management's oversight of adoption of creditor-made decisions implements the trusteeship strategy of reducing agency costs.

Finland either. The shadow director is not unique to the UK, though, as at least Australia, Hong Kong, India and New Zealand—all former colonies—recognise it. *See Wood* 2007a, p. 590.

194. To be sure, such persons are subject to the duty only when acting in that capacity. *See* Gov. prop. 109/2005, p. 40.

195. Gov. prop. 109/2005, p. 40. *Mähönen* notes that the duty of loyalty typical of the principal-agent relationship (*Mähönen* 1998, p. 233), but that under Finnish law it is unclear what is the relationship between the duties of care and loyalty and for this reason the duty of care has received little attention. (*Ibid.*, p. 240, also *Mähönen – Villa* 2006a, p. 112).

196. *Kanda – Curtis* 2003, p. 15 and *Mikkola* 2010, p. 828.

197. *See* the pre-FCA case *KKO:2003:33*, and Gov. prop. 109/2005, p. 39, where it is stated that such an obligation exists under the FCA as well.

When creditors instruct the company to adopt certain decisions, the directors must weigh the options the company has. On the one hand, the implications of complying with the creditors' instructions must be assessed. On the other hand, these must be weighed against the implications of not complying, i.e. the sanctions likely imposed by the creditors on the company. If not complying is the better bargain for the company, the directors must choose that alternative. In practice, there may be no choice. If not complying with the creditors' directions leads to the penalty of acceleration and insolvency, shareholders (to whom the duty of loyalty is owed) normally receive nothing. Therefore complying with the creditors' demands may well be the only option in so far as the interests of the shareholders are concerned, thus undermining the managements' ability to act as a gatekeeper for opportunistic use of control powers by creditors.

4.2.3 Remedies

The FCA, Chapter 22, lays out the rules concerning directors' liability for damages caused in office for breach of the FCA or the articles of association.[198] Pursuant to Section 1(1), directors are liable for damages caused *to the company* by intentionally or negligently breaching the duty of care pursuant to Chapter 1, Section 8. As the duty is owed to the company, it is the company who has the right to sue for damages and it is the board who makes the decision whether to sue.[199] Because it is anticipated that the board may neglect making such a decision, shareholders have a right to a derivative claim. If the derivative claim succeeds, the proceeds go to the company and not the shareholders who decided to sue.[200] Therefore, in line with the proposition that the duties set out in FCA, Chapter 1, Section 8 are owed to the company and ultimately its shareholders even if creditors have become residual risk bearers, the company alone is entitled to damages and only the shareholders may file a derivative claim.

The directors are also liable for damages caused *to the company, its shareholder or a third person* (this includes creditors) intentionally or negligently and arising out of breach of any other provision in the FCA or the company's articles (Section 1(2)). In practice, the plaintiff would have to show a specific legal rule that has

198. Liability may also arise out of breach of certain other statutes, perhaps most importantly the FAccA and the FAudA. *See Savela* 2006, pp. 134–135. The FCA also contains provisions regarding liability of shareholders, the chairman of a general meeting and the auditor for such breaches, but these are not of interest here.

199. FCA, Chapter 22, Section 6.

200. *See* FCA, Chapter 22, Section 7. Such shareholders must either (i) hold at least one tenth of all shares at the time of suing, or (ii) as a preliminary matter show that not allowing the claim would be in breach of the equality principle as set out in FCA, Chapter 1, Section 7.

been breached to cause liability.[201] Another limiting factor is the requirement that damages can only be awarded if the head of liability is intended to protect the class of claimants the plaintiff belongs to and not only some other interest party. [202] In other words, a shareholder would have to show that the invoked rule is intended to protect shareholders (either individually or as a class), and a creditor would have to show that the invoked rule is intended to protect creditors.

Directors' negligence is assumed in case of breach of a provision in the articles or the act, save for the general provisions in Chapter 1 (Chapter 22, Section 1(3)). Negligence is assumed even if the claim is based on a general provision in Chapter 1 of the act if the damage arose out of a transaction for the benefit of a *related party* as defined in the FCA, Chapter 8, Section 6(2), which is intended to incorporate the definition of the IAS 24 standard and should be interpreted accordingly.[203] Pursuant to the Section, one party is a related party of the other party if it, "may exercise control over the other party or significantly influence the financial and business decision-making of the other party." The wording is thus quite open ended and therefore at what point a creditor giving instructions becomes a related party depends on how strictly the requirement of 'significance' is interpreted,[204] but it seems clear that at least a creditor who actively partakes in the management of the debtor company should be regarded as a related party.

The standards of care and loyalty of these general duties are objective, but acknowledge the facts that business decisions are made based on incomplete information and that risk is a necessary element of business.[205] Because of the inherent riskiness of business activities and the difficulty of making business decisions, negligence is excluded if the directors (i) procure adequate information for the basis of decision-making, (ii) make rational decisions based on the acquired information, (iii) which

201. *Airaksinen* et al. 2010b, p. 760.
202. *Savela* 2006, pp. 280–281, also *Airaksinen* et al. 2010b, p. 753. *C.f.* e.g. *Kyläkallio* et al. 2008, p. 663.
203. *See* Gov. prop. 109/2005, p. 95. Further, loans from or debts to related parties worth over 20 000 euro or 5% of the company's equity must be separately listed in the annual report. (FCA, Chapter 8, Section 6(1)).
204. In accordance with IAS 24.9, *significant influence* means "the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significant influence may be gained by share ownership, statute or agreement." Two questions outside the scope of this thesis remain relating to standard loan agreements: how rigorous monitoring of covenants fulfils the definition of significant influence, and at what point a lender becomes a related party—possible choices include the point in time the loan agreement is made, the point in time the borrower enters default, and the point in time the lender actually starts to influence the decision-making of the borrower.
205. *See* e.g. *Airaksinen* et al. 2010a, p. 47, *Airaksinen* et al. 2010b, p. 758 and Gov. prop. 109/2005, p. 40.

are not prejudiced by interest conflicts on the part of the directors.[206] The standard of care under the FCA is therefore materially the same as under the *business judgement rule*.[207]

To establish liability, the usual requirements of (i) quantifiable damage (ii) which has been caused by breach of a legal rule that establishes liability, (iii) adequate causation, and (iv) remoteness (ie. foreseeability) of damage must be met.[208] There are no limitations as to the kind of damages, i.e., pure economic loss is recoverable.[209]

The directors' liability regime under Finnish law traces its roots to the agency problem and the presumption that the directors are always the agent of the company and by extension its shareholders. This explains why only the shareholders have at their disposal the derivative claim, even though directors' liability to the company also protects the creditors as a class by increasing the funds available for debt service. Therefore the exclusive availability of the derivative claim to the shareholders reflects the idea that they are the only recognised residual risk bearers and thus the party to whom the duties of care and loyalty are owed.

Liability to the company primarily attaches to breach of the duties of care and loyalty, which are to be interpreted in the light of the purpose of the company, i.e., creating shareholder value. Two issues arise. Firstly, as a starting point, only directors can be liable. Therefore *prima facie* the company has no recourse against controlling creditors under this head of liability for advice which has caused the directors to implement decisions that are for the benefit of the company only in averting acceleration by such creditors. This means decisions which would be in breach of the directors' duties if there was no pressure from creditors. If one wants the creditors to be forced to follow the same standard as the directors, the duties of loyalty and care and the liability regime would have to be extended to creditors. However, as stated above, if the creditors have become the residual risk bearers instead of the shareholders, there seems to be no justification for putting the shareholders' interests before those of the creditors'.

Secondly, because the directors owe their duties to the company, the creditors do not have recourse against the directors for breach these duties. This means that even when the creditors have become the residual risk bearers, the law does

206. *See* Gov. prop. 109/2005, p. 41.
207. *See Mähönen – Villa* 2006a, pp. 112–114 and *Airaksinen* et al. 2010b, p. 758.
208. *See* eg. *ibid.*, pp. 751–752 and *Savela* 2006, pp. 273 ff.
209. E.g. *Mähönen – Villa* 2010, p. 437.

not recognise the change of principal and therefore fiduciary duties of directors continue to be owed to parties who have now lost that status. Thus the liability regime does not in such a case incentivise acting for the benefit of the party who has the most appropriate incentives to ensure the profitable operation of the company.

4.3 Applying directors' and shareholders' duties to creditors

4.3.1 Extension mechanisms in general

Because directors' duties are designed to protect the interests of the company, extending the duties to creditors seems on the surface a good way of thwarting opportunistic behaviour by creditors. However, as seen above, under Finnish law the duties do not account for the shift in the bearer of residual risk when the company nears insolvency. On the other hand, as long as the creditors have not become residual risk bearers, extending directors' duties to them would make their interests better aligned with the those of the company.

Circumscribing creditor opportunism is not the only and perhaps not even the most important scenario where a perceived need for extension mechanisms may surface. In fact, the typical scenario relates to attempts at circumventing the directors' liability and directors' disqualification regimes and abuse of the corporate form in general by installing façade directors with the intention of hiding the actual directors. Therefore it is conceivable that developed jurisdictions recognise some mechanisms of extension.

There are primarily two mechanisms which must be considered in so far as imposing liability attaching to breach of directors' duties to persons not properly appointed as directors is concerned: recognition of *de facto* directors and extension of duties to shadow directors. In the following, persons who have taken the post of a director without having been properly appointed as such are called *de facto* directors. Persons who influence decision-making, or even indirectly make decisions, by advising or instructing the properly appointed directors will be called shadow directors. These will next be discussed first from the point of view of Finnish law, and subsequently from the point of view of English law.

Shareholders' duties are much more limited in scope. However, shareholders may become liable for contributing to the breach of the FCA or the articles of association of the company. Because a controlling creditor's position *vis-à-vis* the company may in many respects be compared to that of a majority shareholder's, one must consider whether such creditors might be considered *de facto* shareholders for liability purposes.

4.3.2 *De facto* directors under Finnish law

The FCA does not contain provisions regarding *de facto* or shadow directors. As a starting point, only properly elected directors are to be held liable, but exceptionally the liabilities pursuant to the FCA may be extended to certain other persons by way of expansive interpretation.[210] According to the *travaux*, the assesment whether a person is to be regarded a director in the meaning of FCA, Chapter 22, Section 1, is to be made based on whether the person has actually been chosen to perform the duties of a director. Whether the person has been formally elected is not conclusive, neither are Trade Register entries.[211] *Mähönen* and *Villa* conclude that it is key whether the person is involved in the daily management of the company and whether he is able to make such decisions that belong to a properly appointed director.[212]

De facto directors have been recognised in practice, although case law is very sparse. In *KKO:2001:86*, criminal liability attached to a person who was not a properly appointed director, but was held by the court to have become subject to certain obligations of directors.[213] The obligations were such that criminal sanctions attached to breach thereof. The *dictum* is very light on the facts of the case, but it is stated that the convicted had "in practice taken total care of operating the business and had used actual control." Therefore, he had "as a *de facto* director become subject to the legal obligations of directors" (translation here). This is a criminal case, but there is no reason why such extension of duties would be recognised in criminal law but not in respect of liability questions.[214]

There does not seem to be a clear standard for determining whether a person is to be regarded as a *de facto* director. It seems a high level of engagement in the management of the company is required, but details remain open. The language of the cited case suggests the determinations were made *in casu*, and there is no attempt to discuss whether e.g. the relative long time the person was engaged in the management of the company (one and a half year) or how third parties perceived the role of the person, played any role. This is a practical decision: if

210. *Savela* 2006, p. 213.
211. Gov. prop. 109/2005, p. 194.
212. *Mähönen – Villa* 2006a, p. 294. Similarly *Savela* 2006, p. 216.
213. This case concerned the interpretation of FPenalC, not FCA.
214. *Savela* 2006, p. 215.

liability were not imposed, liability could be escaped by installing façade directors. This argument does not apply to creditors using control rights, as there remain the properly appointed directors who are liable for the decisions they make under pressure.

It seems to be clear that under Finnish law the role of a *de facto* director is reserved for natural persons who as a matter of fact assume upon themselves the decision-making that belongs to directors. It seems that the level of engagement required is too high to allow imposing the duties of directors on persons who instruct or advice the board, at least so long as the properly appointed board makes independently the decision whether to follow such advice or not. Intention to escape liability seems to be a factor. Thus the recognition of *de facto* directors does not seem to extend directors' duties to creditors wielding control in the debtor company. Certainly, normal monitoring of covenants would not be enough, and it is quite unlikely that sophisticated lenders, party to an LMA style loan agreement, would so intrusively engage in the daily management of the borrower as to make them *de facto* directors.

4.3.3 *De facto* shareholders under Finnish law

In an economical sense, equity and debt investors can be identified by the characteristics of their risk positions. Primary characteristics of equity include the residual position, the permanence of equity, and that the investment is unsecured. Primary characteristics of debt include its contractual nature, its fixed-term nature, and a senior position in comparison with equity. Secondary characteristics of equity include its distributive nature, control rights, and perpetuity.[215] Control rights and the right to residual earnings is arguably the most decisive of these characteristics, as it is these characteristics which makes the shareholders the owners of the firm.[216]

In a company in the vicinity of insolvency, creditors become residual risk holders instead of the shareholders and LMA lenders have control rights and current information. Thus LMA lenders' position in a company in the vicinity of insolvency can be compared to that of a controlling majority shareholder in a solvent company. However, the economic similarities do not turn a creditor into a shareholder, but instead their rights and obligations continue to flow from the instrument they own—their position is determined by the the loan agreement and the law relevant to such agreements, not the rules which govern shareholder's rights and obligations.

215. *Mähönen – Villa* 2006a, p. 180. *Mähönen* and *Villa* note that classification of equity and debt is value-bound, and this is thus not an authoritative taxonomy.
216. *See Armour* et al. 2009c, p. 14.

Still, the similarity of the characteristics of the positions of lenders and majority shareholders gives rise to the question whether lender could be considered *de facto* shareholders for the purposes of liability rules.

The FCA, Chapter 22, Section 2, sets out the rules concerning shareholders' liability:

> Shareholders shall be liable for damages they have intentionally or negligently caused to the company, another shareholder or a third person by contributing to the breach of this act or the articles of association.
>
> Damages arising out of acts for the benefit of a related party as defined in Chapter 8, Section 6(2) shall be considered negligently caused unless the defendant shareholder proves having acted carefully.

As a starting point, shareholders have the right to act in their own interests, and are not under a general obligation to consider the interests of the company, other shareholders or third parties. They are, in any case, obliged to comply with the FCA and the articles of association.[217] Further, expansive interpretation may *in casu* allow extending fiduciary duties to controlling shareholders.[218] Pursuant to the FCA, Chapter 22, Section 2, liability attaches to shareholders who intentionally or negligently *contribute* to the breach of the FCA or the articles of association. Because liability attaches to shareholders who *contribute* to the breach of the FCA, liability attaches to shareholders who contribute to the breach of directors' duties of loyalty and care pursuant to the FCA, Chapter 1, Section 8 and the shareholder equality principle pursuant to FCA, Chapter 1, Section 7. In many respects, the negligence of majority shareholders should be assessed in the same way as the directors'.[219] To be sure, the directors would make and implement the necessary decisions, and would be liable themselves under the FCA, Chapter 22, Section 1.

In accordance with the government proposition, what constitutes negligence is influenced by the type of shareholding. Passive minority shareholders would almost never be considered to have negligently contributed to the breach of the act or the article of associations, but controlling majority shareholders' (such as group parent companies') negligence is to be assessed more strictly than that of minority

217. *Mähönen – Villa* 2010, pp. 466–467 and *Airaksinen* et al. 2010b, pp. 766–767.

218. *See Mähönen – Villa* 2006a, pp. 144–145. *Mähönen* and *Villa* suggest that the FCA, Chapter 1, Section 7, which establishes a shareholder equality principle and prohibits the general meeting and the directors from making or implementing decisions which are likely to unjustifiably benefit a shareholder or a third party, prejudicing the company or a shareholder, establish an inter-shareholder duty of loyalty.

219. *Airaksinen* et al. 2010b, p. 768.

shareholders', due to the ability of majority shareholders to significantly influence the decision-making process in the company.[220] According to *Savela*, the standard of care demanded from shareholders should not be that of a professional, but that of a reasonable man. This means that the standard of care is lower than in respect of directors.[221] A shareholder may only become liable for his actions *as a shareholder*, i.e., by using the rights which flow from the shares.[222]

The main mechanism making shareholders liable would be contributing to an unlawful decision in the general meeting, but *contributing* means that also influencing the directors' decision-making in informal ways could bring about liability.[223] Thus the functions of this Section are twofold: to (i) sanction direct breach of the FCA or the articles of association by the shareholders, and to (ii) disincentivise the majority shareholders from inducing the directors to breach their fiduciary duties. As majority shareholders are able to change the directors, they are able to tell the directors to comply or to be ousted. Thus the directors have strong personal incentives to comply. Directors owe their duties to the shareholders as class, and by reducing majority shareholder incentives to extort favours from the directors, this Section is a building block of the practical prerequisites for directors to realise their fiduciary duties.

Calling back a substantial loan may lead to the debtor's bankruptcy, and on bankruptcy the directors lose their jobs. Thus creditors with such substantial claims may be able to extort favourable decisions from the directors, who by making such decisions breach their fiduciary duties. The agency problem suggests that companies should seek to maximise the wealth of the residual risk holder. From this follows that a solvent company should seek to maximise shareholder value, and an insolvent company should seek to maximise the value of creditors' claims. This means that creditors of insolvent companies should be allowed to demand decisions which benefit the creditors *as a class*, while they should not be allowed to do so in respect of solvent companies. The legislator has chosen that the purpose of the company is invariably to maximise shareholder value and thus there is no shift of fiduciary duties. Thus extending the shareholders' liability regime in accordance with the Section to creditors would act as a prophylactic liability protecting the company's purpose pursuant to the FCA, Chapter 1, Section 5.

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220. *See* Gov. prop. 109/2005, p. 196. *See Airaksinen* et al. 2010b, p. 768.
221. *Savela* 2006, p. 187.
222. *Ibid.*, p. 190.
223. *Ibid.*, p. 190, *Mähönen – Villa* 2010, p. 476, and *Airaksinen* et al. 2010b, p. 767.

However, extending shareholders' liability to creditors would require expansive, *contra legem* interpretation. It is a choice of the legislator that external parties are not liable for contributing to the breach of the FCA and the articles of association of companies. The reasoning is simple: the general possibility of such liability would make transaction costs prohibitively high.[224] Moreover, directors' liability was extended in *KKO:2001:86* to *de facto* directors because non-extension would facilitate the abuse of the corporate form for fraudulent conduct, but these grounds do not apply to creditors of companies with properly appointed directors. Contractual parties are subject to contractual liability doctrines and other parties may become liable in tort. If shareholders' liability were to be extended to third parties contributing to the breach of the FCA or the articles of association, there would need to be exceptional reasons *in casu*.

4.3.4 *De facto* and shadow directors under English law

4.3.4.1 Generally

Unlike Finland, English law explicitly recognises both *de facto* directors and shadow directors, providing rules which on the surface clearly extend directors' duties and liabilities to persons who assume those duties and liabilities. A distinction must be made between *de facto* directors and shadow directors. In outline, a *de facto* director is someone who performs the duties of a director without being properly appointed a director,[225] while a shadow director is a puppetmaster—someone who gives instructions to the properly appointed directors who in turn act on the instructions.

4.3.4.2 *De facto* directors

There is no all-encompassing legal test to determine whether a person has become a *de facto* director. Instead, several tests have been formulated in practice. The tests look at the facts: whether the purported director acted in relation to the company in a way only a director could, or whether he acted on equal footing with the appointed directors. The bottom line is that a person who assumes the responsibilities of a director, even if not properly appointed as one, owes fiduciary duties to the company.[226] The liabilities of the *de facto* directors are in all respects identical to those of properly appointed directors.[227]

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224. *See Savela* 2006, p. 225.
225. *See* e.g. *Ferran* 1999, p. 155 or *French* et al. 2010, p. 431. Pursuant to CA 2006, Section 250, "'director' includes any person occupying the position of director, by whatever name called."
226. *See Ferran* 1999, p. 155 for relevant case law.
227. *See* CA 2006, Section 250, reprinted above at footnote 225.

Rules governing *de facto* directors are not of too much interest in so far as lender governance goes. Sophisticated lenders are unlikely to assume the position of a director—be it that of a legally appointed director or that of a *de facto* director.

4.3.4.3 Shadow directors

Pursuant to CA 2006, Section 251(1), *shadow director* means "a person in accordance with whose directions or instructions the directors of the company are accustomed to act." Subsection (2) provides that "a person is not to be regarded as a shadow director by reason only that the directors act on advice given by him in a professional capacity." Subsection (3) excludes parent companies. The definition of a shadow director is thus open to interpretation and whether somebody becomes a shadow director depends on the facts of the matter.

For a person to become a shadow director, a "governing majority" of the directors must be accustomed to act in accordance with his instructions or advice.[228] In *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*, a bank was able to nominate two out of five directors. *Held*, that the bank did not become a shadow director because the the board—i.e., the directors as a class—were not accustomed to act in accordance with the directions of the bank.[229] "Accustomed to act" is to be taken to mean that it is required that the directors act on the instruction of the purported shadow director "over a period of time and as a regular course of conduct."[230]

There is no clear test on when a creditor protecting its own interests becomes a shadow director. In *Re PFTZM Ltd (in liquidation)*, the debtor company fell behind on payments. Officers of the creditor started to attend regular management meetings of the company, setting conditions for continuing to provide credit, and even having the power to veto payments to other creditors.[231] The creditors were not treated as shadow directors. *Per* Judge Baker QC: "The central point, as I see it, is that they were not acting as directors of the company; *they were acting in defence of their own interests*. This is not a case where the directors of the company, [. . .] were accustomed to act in accordance with the directions of others i.e. [the creditor]. It is a case here where *the creditor made terms for the continuation of credit in the light of threatened default. The directors of the company were quite free*

228. *Ultraframe (UK) Ltd v Fielding*, at [1272].
229. *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*, p. 587. This is a New Zealand case, but the test of shadow director was the same under NZ statutory law.
230. *Re Unisoft Group Ltd (No. 2)*, p. 775.
231. *Re PFTZM Ltd (in liquidation)*, pp. 280, 285.

to take the offer or leave it"[232] (emphasis here). In other words: a creditor who sets out his requirements as conditions for continuing a credit facility, and not instructions, is not a shadow director.[233]

However, the possibility that a bank would become a shadow director cannot be ruled out. It is noted, though, that the interference in the management of the borrower would need to be exceptionally intrusive, effectively taking over the management. Normal enforcement of covenants would not be enough.[234]

4.3.4.4 Fiduciary duties

Under Finnish law, there is no established, all-encompassing definition of fiduciary duties. In the context of company law, the duties of loyalty and care owed by the directors to the shareholders may be sometimes called fiduciary duties,[235] but it must be made clear that the meaning of fiduciary duties is entirely different under English law,[236] due to both the scope and content of the duties themselves, especially because of differences in the remedies available for breach.

Under English law, fiduciary duties are the creation of equity, and the remedies recognised by equity for breach of fiduciary duties are more wide-ranging than the remedies normally available for tort or contract law claims. Moreover, the principal of the fiduciary benefits from additional obligations imposed on the fiduciary.[237] There are some established categories of fiduciary relationships, including company directors and the company.[238] A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty.[239] The duty of fiduciary loyalty should be understood as acting as a prophylactic, subsidiary protection seeking to ensure the performance of non-fiduciary duties.[240]

Directors owe fiduciary duties to the company, but not to its shareholders, its creditors, or other directors. Further, the company does not owe fiduciary duties to

232. *Re PFTZM Ltd (in liquidation)*, p. 292. In the case, the definition of *shadow director* was that of IA 1986, Section 251, but also found in CA 2006, Section 251.
233. *Wood* 2007a, p. 591.
234. *Wood* 2007b, p. 71.
235. E.g. *Mähönen – Villa* 2006a, p. 107.
236. *See Mikkola* 2006, especially pp. 25–80, where fiduciary law as it is known in common law jurisdictions is considered from a Finnish standpoint.
237. *Hudson* 2009, p. 616.
238. *Ibid.*, p. 617 and *French* et al. 2010, p. 471.
239. *Bristol and West Building Society v Mothew*, p. 18.
240. *Conaglen* 2005, p. 453.

its shareholders.[241] Whether the foregoing fiduciary duties are applied to shadow directors is important because of the remedies available for breach thereof. If the fiduciary receives property in breach of any of the fiduciary duties, he is considered to hold the property on trust on for the beneficiary. This means that the beneficiary has a property right to that property, its substitute and any income generated by that property. Moreover, the fiduciary will be liable for any loss suffered by the beneficiary, such loss not being limited to contractually anticipated forms of loss or the tests of causation and remoteness (foreseeability) of damage under tort law.[242]

CA 2006 codifies, sometimes with slight modification, the equitable principles imposing fiduciary duties on directors as well as common law of negligence.[243] Directors' duties are divided into seven duties, namely the duty to act within powers (Section 171), the duty to promote the success of the company (Section 172), the duty to exercise independent judgment (Section 173), the duty to exercise reasonable care, skill and diligence (Section 174), the duty to avoid conflicts of interest (Section 175), the duty not to accept benefits from third parties (Section 176), and the duty to declare interest in proposed transaction or arrangement (Section 177).

Pursuant to CA 2006, Section 170, "the general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles apply." Thus, it is left for the courts to decide what fiduciary duties shall be imposed on shadow directors and there is as of yet very little case law.[244] According to *Ultraframe (UK) Ltd v Fielding* imposing fiduciary duties on a person requires more than only that he has become a shadow director,[245] but if the shadow director does something more than just use indirect influence, it may be possible to find a fiduciary relationship to exist between the shadow director and the company, but the shadow director would not necessarily become subject to all fiduciary duties.[246] However, it is submitted that *Ultraframe* does not necessarily represent good law and fiduciary duties might be imposed on shadow directors.[247]

On the whole, the liabilities which attach to shadow directors are too unclear to be evaluated here in detail. To summarise, English law would deal with creditors using actual control powers by instructing *de jure* directors as *shadow directors* rather

241. *See French* et al. 2010, p. 472 and the case law cited there.
242. *Hudson* 2009, pp. 619, 621–622.
243. *French* et al. 2010, p. 470. *See* CA Explanatory Notes, pp. 50–54.
244. *French* et al. 2010, p. 473.
245. *Ultraframe (UK) Ltd v Fielding*, at [1284] and [1289].
246. *Ibid.*, at [1289]–[1291].
247. *Prentice – Payne* 2006, p. 562.

than *de facto* directors under the CA 2006. It is possible, but by no means certain that a lender would be considered a shadow director. *Ultraframe* leaves it quite unclear when fiduciary duties attach to shadow directors and to what extent, but the possibility that repayments, received by creditors who fall within the definition of shadow director, would be considered to be held in trust for the debtor, cannot be completely ruled out.

4.3.5 Conclusions

Creditors with contractual control rights are not able to make decisions which would bind the company internally, but must instead ask the directors to implement their decisions. The directors, for their part, owe duties of loyalty and care to the company, and must act for the benefit of the company. At all times, benefit of the company invariably means the benefit of the shareholders, despite the change of residual risk bearers when the company nears insolvency. Therefore the directors act as important gatekeepers: they owe their fiduciary duties to the shareholders and must thus make and implement the decisions which are for the benefit of the shareholders. To be sure, in practice significant lenders have a lot of leverage because they have the ability to bring the house down by accelerating the loan facility.

A liability regime exists to ensure the directors are incentivised to comply with their duties of loyalty and care. Shareholders are subject to a similar liability regime, and controlling majority shareholders are subject to materially the same standard of care as are the directors. In many respects, the position of controlling creditors can be compared to that of alternatively directors or majority shareholders, and thus it is relevant to consider whether controlling creditors might become subject to the liability regime concerning either directors or shareholders.

In respect of the directors' liability regime, it was concluded that Finland does recognise *de facto* directors, but that due to the way how creditors only influence decision-making indirectly, they would unlikely be considered *de facto* directors. Extending the shareholders' liability regime to creditors was considered even more unlikely.

If extending directors' duties to third parties were to be considered preferable, the English model of recognising shadow directors could be considered. Under the CA 2006, persons in accordance with whose directions or instructions the directors of the company are accustomed to act, are shadow directors. A brief analysis of the shadow director doctrine reveals that it English courts are reluctant to (i) regard controlling creditors as shadow directors, and (ii) the liabilities of shadow directors are not clear.

4.4 Liability for breach of contract and in tort

4.4.1 Introduction

Surely, extension of directors' duties to creditors is not the only conceivable remedy and its exclusion does not mean other heads of liability were not available. The creditors may face liability in contract of tort regardless of whether they are liable under the FCA which does not exclude *parallel liability* under other heads of liability.[248]

The effectiveness of negotiated creditor protection may be hindered by such broad legal principles as fairness or good faith. It was noted above that the LMA documentation was drafted to operate under English law, and that in Finland, loan agreements are regularly made to operate under Finnish law. English law of contracts has not traditionally recognised a duty of good faith.[249] Under English law of contract, there are no *good faith* duties limiting the right to accelerate.[250] The idea is that it is presumed that contractual parties prefer predictability and therefore the wording of the contract is crucial.[251]

Finnish law of obligations, on the other hand, recognises—to some extent—a *duty of loyalty* owed by contracting parties, and a principle close to the duty of loyalty, namely *prohibition of abuse of rights*.[252] These doctrines may restrict the use of contractual control powers by creditors, and the right to accelerate. These doctrines

248. *See Mähönen – Villa* 2010, p. 434 and *Savela* 2006, pp. 342–343.

249. McKendrick argues that international convergence will sooner or later result in the adoption of the doctrine of good faith in English law (*see McKendrick* 2003, pp. 552 *et seq.*) and some argue that English law already covertly recognises it as a part of several other contract law doctrines (*see Burrows* 2009, p. 299). For a comparison of English law and Nordic law (specifically Swedish law) on this point, *see Munukka* 2007, pp. 33–42, especially pp. 35 *et seq*. Space and the purpose of this thesis do not allow for further comparison here of Finnish and English law on this issue.

250. *See Ferran* 2006, p. 189 and *Wood* 2007b, p. 114.

251. *Ibid.*, p. 116. There are many shipping law cases relating to termination rights exemplifying the strictness of contractual interpretation. In *The Laconia*, the hire in accordance with a charterparty fell due on a Sunday. As there were no means to effect payment on a Sunday, the charterer paid on Monday. The shipowner was able to withdraw because the late payment constituted breach of charther. There are other such cases. The reasoning for invoking technicalities is to be able to subsequently charter the vessel at a higher rate, i.e., contracting parties are allowed to interpret and enforce contracts harshly for their own benefit. *See Wood* 2007b, pp. 115–116 for case law relating to the right to accelerate a loan agreement. *See* e.g. *Baughen* 2009, 254 *et seq*. for case law relating to this question in the field of maritime law.

252. *See* e.g. *Hemmo* 2003a, pp. 53–56.

do not by any means render LMA style loan agreements inoperable, but the parties must take them into account when negotiating and enforcing loan agreements, pricing in the effects—the restricted acceleration right and uncertainty. Liability in tort must also be considered.

4.4.2 Contractual duty of loyalty

4.4.2.1 Generally

The analysis of limitations to creditor control imposed by general contract law is based on the following hypotheses: (i) creditors exercise control by threatening to accelerate if the debtor does not implement the creditors' decisions, (ii) the loan agreement provides for an unlimited right of acceleration when the debtor is in default, and (iii) acceleration thus does not constitute breach of contract, but general contract law may limit the right to accelerate. Contract law could limit creditor control by making acceleration ineffective in some cases, and possibly sanctioning unlawful acceleration by liability for damages. The idea is that even if a contracting party formally has at his disposal a contractual right (e.g. acceleration), the contractual duty of loyalty limits to some extent the use of such a right in certain ways harmful to the counterparty.[253] This subsection explores doctrines which impose varying degrees of a duty of loyalty on contracting parties, thereby possibly limiting the right to accelerate and thus circumscribing creditor control.

The law of property[254] allows individual actors great freedom to exercise their rights as they please. Nevertheless, law does not permit benefiting from dishonourable abuse of such rights to the detriment of other parties. FContractsA, Section 33 denies legal force from dishonourable and unworthy acts. The uncodified prohibitions of abuse of rights[255] and unethical legal acts[256] cover an area wider than the Section,[257] and are an integral part of Finnish law recognised without statutory support.[258] Further, the FContractsA, Section 36, allows for adjustment of unreasonable contractual provisions.

Legal rights shall not be enforced solely with the intention of injuring one's counterparty (prohibition of *chicanery*).[259] Neither may two parties act in concert to

253. *See Hemmo* 1996, p. 333.
254. Finnish: *varallisuusoikeus*.
255. Finnish: *oikeuksien väärinkäytön kielto*.
256. Finnish: *hyvän tavan vastaisten oikeustoimien kielto*.
257. *Tammi-Salminen* 2001, p. 249.
258. *Pöyhönen* 2003, p. 87.
259. *Tammi-Salminen* 2001, p. 251.

injure a third (prohibition of *collusive acts*).[260] Such intentional and purposeful injuring of one's counterparty is rarely realised in the relationship of a creditor and a debtor. To be sure, covenants are not written or monitored with the intention of causing damage, but with the intention of securing loan service. Nevertheless, it is wise to ask whether aggressive enforcement of covenants, knowing that the enforcement measures cause damage to the borrower, are covered by such general principles—whether they are covered by the controversial doctrine of *contractual duty of loyalty* or whether adjustment of an acceleration provision is possible.

4.4.2.2 Origins and meaning of the duty

The contractual duty of loyalty is in the process of becoming one of the central legal principles in contract law. It does not, however, have as great an effect as many other legal principles central to that area of law, such as freedom of contract.[261] There has been debate on whether it should be regarded as an independent principle, but most writers now agree that it is best seen as an independent legal principle, not only an influence in interpreting other norms, although it may help in defining other norms such as the statutory rule allowing adjustment of unfair contract terms in accordance with FContractsA, Section 36.[262] Thus, the duty has a dual role: it is sometimes an independent norm with independent legal effects, sometimes it aids in the interpretation of some other norm, such as a statutory rule or a contract provision. Some writers show eagerness to use the duty of loyalty as an umbrella term, placing different duties, arising out of either statutory provisions or out of general principles, and connected with the notion of loyalty under that heading. Identifying proper sources of law calls for more clarity.[263] Thus in the following, the duty of loyalty is to be taken to mean the principle in the law of contracts under Finnish law, to the exclusion of statutory rules which may be understood as manifestations of the duty.

The contractual duty of loyalty escapes a clear definition, but the general idea is well established.[264] *Taxell* originally defined the contractual duty of loyalty (or, loyalty rule, *lojalitetsregeln*) as an expression of the idea that (i) "the parties to a contractual relationship may not unilaterally promote their own interests to

260. *Tammi-Salminen* 2001, pp. 252 *et seq*.

261. *See Karhu* 2008, p. 130.

262. *See Häyhä* 1996, p. 320, *Mähönen* 2000b, p. 10 and *Karhu* 2008, p. 101. The term *legal principle* can be attract various definitions. This thesis follows *Mielityinen's* definition: "legal principles [are] openly value-bound legal norms, which are relatively general as regards their content" (translation here). *Mielityinen* 2006, p. 104.

263. *See* on the critique e.g. *Hemmo* 2003a, p. 55.

264. *Karhu* argues that attempts at defining the contractual duty of loyalty constrain perceiving the features and effects of the duty in modern contract law. *See Karhu* 2008, pp. 101,116.

the impairment of each other", and that (ii) "the parties are, to a certain extent, responsible for taking into account the rights and interests of their counterparty."[265] The first part of the citation sets out the *passive side of the duty of loyalty*, and the second party sets out its *active side*.[266] This is a standard definition of the duty, but it is necessary to add, that the duty does not require the parties to unreasonably endanger their own rights arising out of the contract in question.[267]

The contractual duty of loyalty exists to some extent due to the tension between the realities of evolving circumstances affecting long-term contracts and the principle of *pacta sunt servanda*. As a general proposition, each contracting party bears the risk of changing circumstances, but the contractual duty of loyalty may circumscribe taking advantage by a party of unforeseen changed circumstances which affect adversely his counterparty.[268] There is no duty of loyalty owed to parties who intentionally or through gross negligence breach their contractual obligations, or themselves act disloyally.[269] The more cooperation between parties a contractual relationship calls for, the stricter the interpretation of their duty of loyalty. Long term and personal nature of the contract in question also add to the duty of loyalty.[270] Agency calls for strong duties of loyalty.[271]

Legal norms have to be clear and specific to be able to affect the behaviour of the public and to act as rules in resolving legal disputes. Therefore the contractual duty of loyalty is problematic as a legal norm: it is perhaps not specific enough to fulfil such criteria.[272] Another aspect of the ambiguity of the contractual duty of loyalty is that the extent of the duty depends on the nature of the contractual relationship which gives rise to the duty.[273] An agent owes a duty of loyalty to his principal. In the case of business parties party to the same contractual arrangement, their duty of loyalty is owed to the other parties of the same arrangement, imposing an obligation on the parties to aim for the realisation of the agreed goals and the purpose of the contractual arrangement.[274] Understood in the context of a contractual arrangement with several contracts and several parties, contracting

265. *See Taxell* 1972, pp. 81 *et seq.* Translation here. The original passage is: "Lojalitetsregeln *är ett uttryck för tanken att parterna i avtalsförhållanden inte ensidigt få driva sina intressen till förfång för varandra. Part är inom vissa gränser skyldig att beakta sin motparts rätt och intresse.*"
266. *See Lehtinen* 2007, p. 211.
267. *See Mähönen* 2000b, p. 10 and *Mähönen* 2000a, p. 129.
268. *See Häyhä* 1996, pp. 317–318.
269. *Lehtinen* 2007, p. 213.
270. *See Mähönen* 2000a, p. 131 and *Hemmo* 2003a, pp. 54–55.
271. *Mähönen* 2000b, p. 11.
272. *See Häyhä* 1996, p. 321.
273. *Karhu* 2008, p. 114.
274. *Ibid.*, p. 115.

parties to such a *nexus of contracts* owe their duty of loyalty to the nexus itself.[275] This line of thought traces back to the idea that a contract is an instrument of cooperation of the parties.[276]

Häyhä appears to give the contractual duty of loyalty only a supplementary and secondary role: to fill holes in contracts and in law.[277] After the publication of *Häyhä's* article, the law has become more clearly stated, and it seems clear that today's understanding of the contractual duty of loyalty allows it to modify express contractual provisions. According to *Karhu*, the contractual duty of loyalty is imposed on business parties as well, and it cannot be excluded by contract. Further, contractual limitations to liability for damages caused intentionally or through gross negligence are void. At the minimum, the contractual duty of loyalty prohibits causing damage to the counterparty by "grossly demeritable means."[278]

In respect of Swedish law, *Munukka* has categorised three facets of the contractual duty of loyalty arising in three typical relationships. These are (i) relationships characterised by trust, (ii) the relationship of a weaker and a stronger party, and (iii) the relationship of participants to a project. The first type arises in the relationship between a principal and his agent, which includes actual agency as well as property dealers, attorneys and other middlemen. The second relationship is normally that of a professional business and a consumer. The third category comprises business relationships between business parties who engage in a common undertaking.[279] *Munukka's* categorisation of the contractual duty of loyalty helps in understanding the typical circumstances giving rise to the duty.

Contractual duty of loyalty has rarely been explicitly invoked in Supreme Court cases, but it is in more regular use in the lower courts.[280] In the following I will discuss four Surpreme Court cases which in my view state the law relating to the contractual duty of loyalty.

> *KKO:1993:130* is the first Supreme Court case where the contractual duty of loyalty was invoked in the *dictum* of the supreme court. Certain constructors and the City of Hanko had agreed on building new piers to the city's deep-water harbour. Originally the piers were to have rubber

275. *Lehtinen* 2007, pp. 211–212.
276. *See Ämmälä* 1994, p. 3 on contracts as an instrument of cooperation.
277. *See Häyhä* 1996, p. 327.
278. *Karhu* 2008, p. 106.
279. *See Munukka* 2007, *passim. See Karhu* 2008, pp. 109 *et seq.* summarising *Munukka's* work.
280. *Mähönen* 2000b, p. 10.

fenders, but because of lack of funds, the city asked the constructors to use inferior, cheaper wooden fenders instead. The wooden fenders insufficiently attenuated approaching ships' impact energy, damaging the piers. In accordance with the parties' agreement, the constructors were under obligation to notify the City of errors or discrepancies in the information given by the City, which might endanger fulfilling the construction agreement. The Supreme Court held that the *contractual duty of loyalty* extended the temporal applicability of the notification obligation to time before starting the construction works. The constructors were liable for damages arising out of repairing the piers and modifying them to withstand the impact energy levels pursuant to the construction agreement. *Karhu* finds all three of *Munukka's* categories in the case. The least important category in respect of the case is the relationship between a weak and a strong party. Even so, it is noteworthy that even if the City was not a weak party *per se*, the constructors had, because of their expertise, a duty of care to properly take into account the interests of the City, who did not understand the requested change of design rendered the piers unusable. The leading category giving rise to a duty of loyalty in this case is the relationship between participants to a project. Because the constructors failed to notify the City, the goal of their common project was not met.[281]

KKO:2007:72 is the first case where the contractual duty of loyalty has been listed as a keyword for the case.[282] A bank had extended a loan to a property owner, who had pledged the property as collateral for the loan. Subsequently, the property was sold to a party who did not know of the security pledge. The bank financed the purchase, whereby the buyer pledged his personal property as collateral for the purchase loan. It was clear that the buyer would not have bought the property had he known of the security pledge, and that he had incurred damage from not being able to subsequently sell the property. The bank benefited from added security in form of the additional security pledges by the buyer. The Supreme Court found that the contractual duty of loyalty imposed an obligation on the bank, who was the beneficiary of the original pledge, to remind the buyer to acquire necessary information for the basis of his decision-making in respect of the property sale. In

281. *See Karhu* 2008, pp. 111 *et seq.*
282. *Ibid.*, p. 112.

other words, the bank had an obligation to take into account the *key* interests of its counterparty in the financing transaction. In *Munukka's* typology, the case exhibits characteristics which are best understood as an example of participants' loyalty obligation.[283]

The contractual duty of loyalty may also allow one party to refrain from fulfilling the contract if the other party is acting in breach of the duty of loyalty.

KKO:1992:145 does not explicitly invoke the contractual duty of loyalty, but the prohibition of abuse of rights instead. However, the case can be understood in terms of the duty of loyalty as well and I do not regard the two doctrines as clearly distinct.[284] A Finnish bank, the defendant, had given a *demand guarantee* to two Iranian banks which had subsequently been nationalised by merger to a state-owned bank, the plaintiff. The two Iranian banks had for their part given an Iranian ministry a demand guarantee, which had been cashed by the ministry. The Supreme Court concluded that at the time the plaintiff demanded payment from the defendant in accordance with the guarantee, (i) the Iranian ministry's claim underlying the demand guarantee had ceased to exist, and that (ii) the plaintiff was able to invoke against the bank all the defences it was able to invoke against the ministry as the nationalisation had effectively made them part of the same entity. *Held*, dismissing the claim, that invoking the demand guarantee thus constituted *abuse of rights*. The prohibition of abuse of rights could be seen as the lower boundary of the duty of loyalty: at least clearly disloyal abuse of counterparties in contract is proscribed.

The Supreme Court has only explicitly invoked the duty of loyalty in cases which concern *negotiation loyalty*. Indeed, both of the cases where the contractual duty of loyalty was expressly invoked involved a disclosure obligation which was by the contractual duty of loyalty either founded or extended to the time before entering into the agreement. Even so, the duty of loyalty is not confined to providing one's counterparty with proper information.

In this respect, the recent case *KKO:2010:69* is interesting, because damages could have been based on breach of the duty of loyalty had

283. *Karhu* 2008, p. 113.
284. Also *Hemmo* 2003a, p. 56 draws parallels between the doctrines.

the Court so decided, but it didn't. A gas station chain and a franchisee were parties to long-running franchise agreements (which the court calls cooperation agreements). The chain had terminated the agreements on the grounds that its new strategy was to operate gas stations not through franchisees, but through a joint venture with a grocery retailer. The agreements included a termination clause which can be seen to express the parties' parallel interests at the outset of the contractual relationship: the parties would be able to terminate only when there no longer were possibilities for the realisation of the purpose of the contract. The Supreme Court noted that each party shall bear the risk of change to circumstances. Further, the termination provision in the agreement could not be interpreted expansively when invoked by the stronger party to the detriment of the weaker party. *Held*, that termination thus constituted breach of contract.

Karhu has argued that protection of the weaker party is giving way to the notion of establishing a *level playing field*,[285] apparently meaning that the duty of loyalty would be allowed more independence as a decision criterion. This Supreme Court decision seems to be a departure from such development, and it seems the Supreme Court is not ready—or willing—to base damages awards on the contractual duty of loyalty (outside of *culpa in contrahendo*). This case could alternatively be, in *Munukka's* typology, explained in terms of participation loyalty, but it wasn't. The parties' parallel interests at the time of entering into the agreement, the disparity in the strength of the parties and the type of contract (long-running cooperation agreement) could be seen to add to the duty of loyalty. In fact, the plaintiff tried to invoke breach of the duty as explanation to the liability of the defendant, but the Supreme Court decided to base its argument solely on the effect the disproportionate strength of the parties has on the interpretation of contracts.

All these cases show a degree of moral disapproval. The cases also show that the notion of loyalty underlies decisions which do not expressly invoke it, but at the same time do not clarify the role of the duty of loyalty as an independent legal rule. However, literature unanimously agrees the duty exists with requisite institutional support.

285. *Karhu* 2008, p. 113.

Terminating a longterm agreement requires the existence of acceptable grounds and such factors as the type of the agreement and especially the confidence the parties put into the continuity of the contractual relationship contribute to the assessment of the acceptability of termination. However, freedom to terminate contracts is an important starting point and thus the requirement of acceptable reasons should not be set too high.[286] Interest conflicts between the parties play a role. If the parties' interests are parallel, the limitations posed by the duty of loyalty are less strict than when the parties have conflicting interests.[287] The duty of loyalty can be seen to restrict reactions to breaches of contract and such restrictions to apply especially to creditors. According to *Häyhä*, when a debtor is in default, the creditor must plan his reactions so that they cause no or as little harm as possible to the debtor.[288]

Taking into account the interests of the debtor cannot, however, require the creditor to unjustifiably endanger his own interests. A strong counterargument for allowing loyalty duties to restrict acceleration rights is that acceleration is a key instrument lenders use to protect themselves from risk.[289] The risk perceived by the lenders is priced into the loan agreement in the form of interest rates and security pledge requirements. Thus uncertainty over the ability of using the right to accelerate might cause creditors to overprice their loans (e.g. by demanding too high interest or too comprehensive security pledges). Economic efficiency suggests that the duty of loyalty should restrict acceleration when the injury caused to the debtor is clearly greater than the benefit enjoyed by the creditor, but this cannot be the only rule determining when acceleration is acceptable as it is not the intention of credit agreements on the whole that creditors should take on operational risk of the debtor. The acceleration right is a part of a contractual machinery which exists for the purpose of enabling cheaper credit to the debtor—something the debtor himself has benefited from up until the point of acceleration. However, accelerating a facility on a technicality, e.g. due to a broken financial covenant of no material significance, for selfish motives such as being able to relend the money at a higher interest, nears abuse of rights and cannot be allowed.

To conclude, it is clear that the law of contracts prohibits actions whose sole purpose is to injure other parties (*chicanery*). This applies to creditors as well. The duty of loyalty, on the other hand, is considerably more complicated and whether it restricts acceleration must be determined *in casu*. On a very general level, elements

286. *See Hemmo* 1996, pp. 331–332.
287. *Hemmo* 2003a, p. 54.
288. *Häyhä* 1996, p. 317.
289. *Hemmo* 2001, p. 330.

of a relationship of trust and a common project between the creditor and the debtor add to the requirement of loyalty—continuing use of control to impose austerity measures on the debtor which the debtor complies with increases the level of cooperation and trust between the parties, and must thus restrict subsequent acceleration by the creditor in case the austerity measures demanded by the creditor fail to keep the debtor buoyant. *Hemmo* has argued that the duty of loyalty may prevent a party from terminating an agreement especially when the agreement is vital to the continued business of the counterparty, and the party wishing to terminate has through its own actions created justified expectations that it will not terminate (by e.g. encouraging the counterparty to take up investments which are rational only if the agreement stays in place over a longer period). Termination would be possible, though, if grounds for cancelling the agreement exist.[290] Applied to loan agreements, this means that the lenders cannot accelerate at least when it is the austerity measures demanded by the lenders that have worsened the borrower's ability to service its loans.

Parties to a loan agreement are typically sophisticated parties who have carefully priced the value of all contractual provisions in the agreement. The right to accelerate is a key means of reducing the creditors' risk and thereby the price of the borrowed money. The contractual duty of loyalty should only prohibit accelerating when the creditors have at their disposal optional courses of action which are materially as favourable as accelerating. This may mean that if accelerating would gravely injure the debtor, and it is possible without jeopardising their own interest, the creditors should consider e.g. giving the debtor more time (e.g. to find additional financing), selling their interest in the loan (to someone who is willing to refrain from accelerating), or even extending more credit (especially if there is a deep relationship of trust due to austerity measures demanded by the creditors and carried out by the debtor). Because the right to accelerate is specifically designed to protect creditor interests and the duty of loyalty only prohibits invoking the right when their interests are not at stake, the duty of loyalty does not in normal circumstances circumscribe invoking the right.

4.4.2.3 Remedies for breach of loyalty

In *Mähönen's* view, breach of negotiation loyalty (i.e., *culpa in contrahendo*) is the only case where breach of the duty gives rise to a claim for damages. According to *Mähönen*, outside of contractual negotiations, the effects of the duty are primarily indirect. Breach of the duty by one party may allow his counterparty to (i) terminate

290. *Hemmo* 2003b, p. 386. *See* also *Hemmo* 1996, p. 337.

the contract, (ii) disregard the contract or the invoking of a right arising out of that contract (including termination) in accordance with FContractsA, Sections 31 or 33, or (iii) adjust the contract or ignore a provision in accordance with FContractsA, Section 36.[291]

Hemmo adds that the duty of loyalty may restrict the parties' right to terminate a longterm contract if the continuity of the business of the counterparty is at stake and the contract is of material worth,[292] and that breaches of the duty of loyalty should be sanctioned in the same way other breaches of contract are sanctioned, given that the extent of the duty is clear.[293]

Unlawful termination is ineffective and the contract stays in place unaffected in spite of the termination.[294] Thus the borrower may ignore the acceleration—of course given that the lenders cannot, e.g., freeze the borrower's bank account, in which case the borrower's only recourse is to sue for a declaratory judgement[295]—an injunction[296] may also be available. In case of wrongful acceleration, the lenders are liable for damages. The damages are to be calculated based on the borrower's positive interest.[297]

4.4.3 Liability in tort

The FTortLiaA applies to *extra-contractual* liability only, i.e. liability for breach of contract cannot be based on the act, but on the liability principles of the law of contracts alone.[298] In the context of creditor control, this means that liability in tort *vis-à-vis* the debtor will not attach to creditors who use contractual control powers over the debtor. Also inter-creditor liability between creditors party to the same contractual relationship is excluded on this basis. However, one must ask whether creditors in control might be liable in tort *vis-à-vis* such other creditors of the debtor who are not the controlling creditor's contracting parties.

Creditors of a common debtor share an interest in the same asset, namely the solvency of the debtor. Thus when one of the creditors demands the debtor implements some disadvantageous decisions made by the creditor, or when one

291. *See Mähönen* 2000a, p. 141.
292. *Hemmo* 2003a, p. 54.
293. *Hemmo* 1996, p. 334.
294. *Ibid.*, p. 342.
295. Finnish: *vahvistuskanne*.
296. Finnish: *turvaamistoimi*.
297. *See Hemmo* 1996, p. 343 and *Hemmo* 2003b, pp. 386–388.
298. The scope of the act is stated at Chapter 1, Section 1. *See* e.g. *KKO:1992:165* and the cases listed at *Mähönen – Villa* 2010, pp. 442 *et seq.*

of the creditors accelerates, the debtor and the other creditors of the debtor face losses arising out of reduced solvency of the debtor. Such losses faced by a debtor and its interest parties are *pure economic losses*, i.e., losses not consequent from property damage or personal injury. The FTortLiaA, Chapter 5, Section 1, limits recoverable pure economic losses to those which are caused (i) by criminal acts or (ii) in exercising public authority. Additionally, outside of losses caused by criminal acts or in exercising public authority, pure economic loss is recoverable (iii) when especially weighty reasons exist. From the point of view of creditor control, the third point is of interest. The creditors who use control powers are usually private entities, and enforcing loan agreements is not criminal in any normal circumstances. Thus whether creditors in control may become liable in tort depends on the interpretation of *especially weighty reasons* in this context.

It is not coincidental that pure economic loss is generally not recoverable in extra-contractual relationships. In business, different actors often have contradicting interests, and losses to other actors are a natural and necessary corollary of business activity—consider competitors. Thus non-recoverability of pure economic loss is a necessary precondition for realising *freedom of occupation*,[299] but that especially weighty reasons allow subsiding this assumption shows that not all conduct which belongs to a class of activities normally beneficial for the society must be allowed. The requirement of especially weighty reasons was introduced in the parliament and thus the bill does not explain when such reasons might exist.[300] There is institutional support for finding especially weighty reasons in unethical conduct.[301] In line with this proposition, acts with the intention of causing damage to other parties would fulfil the requirement of especially weighty reasons. Additionally knowing, but not purposeful, causing of loss to other parties could constitute unethical conduct *if the manner in which the damage is caused is considered disloyal*. However, one must note that unethical conduct has not always constituted an especially weighty reason in court *praxis*.[302] *Hemmo* has argued that FTortLiaA, Chapter 5, Section 1, should be amended to expressly include unethical conduct as grounds for liability for pure economic loss as such amendment would codify case law.[303]

299. *See* e.g. *Routamo* et al. 2006, pp. 303–304.
300. *See* e.g. *Hemmo* 2002, pp. 5 *et seq*.
301. *Tammi-Salminen* 2001, p. 311.
302. *See ibid.*, p. 312, who recommends *de sententia ferenda* finding unethical conduct to always constitute an especially weighty reason.
303. *See Hemmo* 2002, pp. 22–23.

> Subsequent case law expressly attaches liability for pure economic loss to unethical conduct. In *KKO:2005:105*, the holder of a design right had sent resellers of a competitor's product letters stating that the competitor's product violated the design right, demanding the resellers cease selling the product. Subsequently it was found that the competitor's product did not violate the design right. The Supreme Court found especially weighty reasons for allowing a claim for pure economic loss. The Court concluded that "[I]f someone in the course of his business activities engages in such conduct which is contrary to business ethics or otherwise inappropriate and thus unlawful, knowing that his conduct characteristically risks causing losses to the business of another, in so far as regards the requirement of [especially weighty reasons], such actions provide a starting point of finding liability in tort. In such a case, liability could be removed if particular counterarguments exist."[304]

Tammi-Salminen argues that a duty of loyalty may exist between parties whose interests are dependant on the same asset. This means e.g. parties who are not contracting parties of each other, but are creditors of a common debtor.[305] If we accept *Tammi-Salminen's* general proposition, loss arising out of creditor enforcement actions which breach inter-creditor loyalty could constitute recoverable pure economic loss if breach of loyalty constitutes unethical conduct and a duty of loyalty is found between creditors.

It is not clear whether creditors of a common debtor owe a duty of loyalty to each other. Firstly it must be noted that the law knows no general duty to protect the interests of one's counterparty or one's counterparty's counterparty,[306] and that the duty of loyalty remains a very controversial topic in literature.[307] The Supreme Court has shown reluctance to expressly invoke the duty in cases where it could act as an independent rule.[308] Still, the duty of loyalty seems to be a necessary

304. *KKO:2005:105*, at 18. Translation here.
305. *See Tammi-Salminen* 2001, p. 267.
306. *Ibid.*, p. 268.
307. *Karhu* 2008, p. 116.
308. Consider *KKO:2010:69*, where the duty of loyalty could have been invoked as an alternate or parallel rule should the Supreme Court have wanted to instil more institutional support for the duty of loyalty.

element in protecting parties to a nexus of contracts from abuse by other parties to the nexus,[309] and it is important in establishing a level playing field.[310]

A duty of loyalty between creditors does not seem to fit any of the categories recognised by *Munukka's* typology. The class of creditors consists of a constantly evolving mass of actors with widely differentiating risk profiles. The class includes voluntary, adjusting creditors and involuntary, non-adjusting creditors such as tort claimants. Such a diverse class of individual actors, who normally do not know each other's identity, interests or risk profiles, cannot be described in terms of participants to a common project. Neither does the relationship between creditors show characteristics of a relationship of trust or elements of disproportionate strength of parties, especially as they are not each other's counterparties.

As regards syndicate lending, the lenders would not be liable in tort to each other as they are each others' contracting parties. Therefore, in the context of syndicate lending, controlling lenders could therefore only be liable in tort to a constantly evolving mass of e.g. tort claimants, employees and suppliers. It is impossible to estimate the possible damages the class might face. Imposing a duty of loyalty on all creditors would make the creditor who happens to cause insolvency of the debtor by accelerating randomly liable for other creditors' damages arising out of the debtor's insolvency.

It must be noted that mere reduced solvency of the debtor does not constitute quantifiable damage to its creditors. The creditors only face losses if the debtor becomes *insolvent*. Preferential treatment of creditors, be it instigated by the debtor or a creditor, is better addressed with recovery to the bankruptcy estate of the debtor. Recovery to the bankruptcy estate is better able to protect the interests of the creditors *as a class* than tort claims filed by individual creditors. Of course, other creditors face quantifiable damages arising out of a controlling creditor's abusive conduct if the post-recovery assets of the bankruptcy estate of the debtor do not cover their claims. In such a case the damage caused by unethical conduct would be the difference between the value of a creditor's claim were the actions causing the damage never taken, and the creditor's distributive proportion in the estate.

Controlling creditors are thus able to cause losses to other creditors which could be recovered if a duty of loyalty were to exist between creditors. However, a

309. *See Lehtinen* 2007, pp. 210 *et seq.*
310. *See Karhu* 2008, p. 113, who argues that the notion of establishing a level playing field is superseding protection of the weaker party.

generalised duty of loyalty imposed on all creditors and owed to all other creditors would make it impossible to enforce contracts as it would be impossible to estimate what causes damage to other interest parties and what is the worth of that damage. Because any given business debtor's creditors are normally quite numerous, a generalised duty of loyalty whose breach is sanctioned with liability for damages would open the *floodgates of litigation*.

Thus recoverability of pure economic loss in inter-creditor relationships can not and does not provide a starting point, and something more is needed to establish a duty of loyalty owed by creditor to creditor. In the context of syndicate lending, a creditor who demands austerity measures from the debtor thereby deepens the duty of loyalty he owes to the debtor. By extension, the duty of loyalty could be seen as owed to the enterprise as a whole—not only the debtor but also its creditors. Use of controlling power by a creditor contains elements of a relationship of trust in having characteristics of an agent-principle relationship. Thus if the austerity measures deepen the insolvency of the debtor and are the cause of the other creditors' losses, the breach of assumed duty of loyalty could result in pure economic loss being recoverable by the other creditors.[311] The more effectively the creditor has taken over the control of the management of the debtor, the deeper the duty of loyalty should be. At least gross breach of inter-creditor loyalty could be understood in terms of unethical conduct.

In conclusion, it seems conceivable, but rather unlikely that a duty of loyalty were found to exist between creditors of a common debtor in future case law. The issue whether such a duty exists would normally only arise in the insolvency of the debtor, and in that case recovery to the debtor's bankruptcy estate provides well-established rules legal actors are familiar with, leaving little space for open-ended standards such as the duty of loyalty to act as legal norms. Secondly, recovery may be favoured because objective recovery grounds reduce discretion and thereby doubt, and the need for evidence. If breach of inter-creditor duty of loyalty is accepted as a head of liability, there would still be left major difficulties for establishing a controlling creditor's liability, especially as regards causation, i.e. whether the damage was actually caused by the controlling creditor.

4.4.4 Conclusions

The contractual duty of loyalty is one of the most polemic doctrines discussed in the last couple of decades, and its exact impact continues to elude researchers.

311. However, liability for damages to the debtor would be determined by contract law principles.

The contemporary material notion of the contract does, however, prohibit acts which are in compliance with the contract but so clearly disloyal they near abuse of rights. In respect of the contractual relationship of a creditor and a debtor, it was concluded that creditors would be prohibited from accelerating on a technicality if the acceleration were to cause significant damage to the debtor. Furthermore, creditors who take over the effective management of the debtor, would not be able to accelerate as such conduct would create justified exceptions deepening the loyalty between the creditor and the debtor. As regards inter-creditor liability in tort, it was concluded that such liability would be quite unlikely.

Such general duties as a contractual duty of loyalty reduce certainty of the parties' position, thereby adding to the price of loans. Such an effect would be unfortunate as it would add to the financing costs of all debtors, reducing their efficiency. It is from this perspective fortunate that the contractual duty of loyalty only appears to prohibit clearly abusive conduct, and risk transfers from controlling creditors to the debtor.

4.5 Recovery to the bankruptcy estate of the debtor

4.5.1 Generally

A single syndicated loan may form the bulk of a borrower's financing. Thus acceleration may, and often does, lead to actual and legal insolvency and ensuing bankruptcy. To be sure, the debtor normally is already insolvent at the time of acceleration. Lenders who accelerate early enough are maybe fully repaid while on bankruptcy they would receive a small fraction of their claim. Thus it is of key importance whether syndicate loan repayments due to lender acceleration may be subjected to recovery to the bankruptcy estate of the borrower. The FRA is the central piece of insolvency law relating to the requirement of corporate benefit. Its purpose is to catch payments which prejudice creditors,[312] thereby, in addition to economic reasons, stemming from notions of morality and fairness. However, under the FRA, most of the recovery categories are *objective in criteria*. The recovery categories target payments which *typically prejudice creditors*, and the objective nature of their criteria reduces the need for evidence.[313] To supplement the objective categories, the act includes (at Section 5) a subjective catch-all rule which encapsulates the purpose of the act: to recover transactions which "inappropriately favour a creditor to the prejudice of other creditors." Because of

312. Gov. prop. 103/1990, p. 17.
313. *See* Gov. prop. 103/1990, p. 18.

the mostly objective criteria, transactions which do not in fact favour a creditor and prejudice other creditors, but share relevant characteristics with transactions that typically do so, may be caught too.

The act catches payment made during a *suspect period*[314], which is a period starting a certain amount of time before the *critical date*[315], i.e. the date on which the bankruptcy application was filed with the court.[316] The suspect period continues to run after the critical date.[317] The length of the suspect period before the critical date depends on the recovery grounds, and some preferential payments are recoverable without temporal limitations. The different recovery grounds which may apply to syndicate loans are below discussed in context.

A prerequisite of recovery is that the initial state of matters can be restored. In other words it is only possible to negate positive acts—omission to act cannot be 'recovered' into a positive act.[318] This means that if the lenders have wrongfully stopped payments to the borrower e.g. under the conditions precedent clause, the payments which were never made cannot be 'recovered' to the estate of the borrower. The creditor who has received payments subjected to recovery does not lose his status as a creditor and is not subordinated to other creditors. Instead, the practical corollary of recovery is that the assets of the estate are increased by the recovered amount, and the creditor will need to give to the estate notice of his claim as if the repayment never occurred.[319]

Another prerequisite of recovery is that the act to be recovered had the capability of injuring the other creditors.[320] Acts which typically either alone or with other acts reduce the amount available to satisfy other creditors' claims on bankruptcy, may be recovered. It is not required that the acts in the matter at hand in fact did so. If the act cannot have caused injury to the other creditors, it cannot be recovered.[321] This requirement concerns all recovery grounds, including the objective recovery grounds.[322]

314. Finnish: *takaisinsaantiaika* or *kriittinen aika*.
315. Finnish: *määräpäivä*.
316. *See* FRA, Section 2.
317. *Tuomisto* 2002, pp. 16–17.
318. *See* e.g. *KKO:2003:33*.
319. *Huhtamäki* 1993, p. 186.
320. *Tuomisto* 2002, p. 77.
321. *Ibid.*, p. 82.
322. *See KKO:2011:24*.

4.5.2 Related parties under the FRA

4.5.2.1 Generally

The FRA treats transactions with related parties much more strictly than transactions with unrelated parties. The recovery periods for related party transactions are materially longer, and the requirements for recovery are less onerous. Thus it is important to know whether a controlling creditor may become a related party in the meaning of the FRA. The relationship of a creditor and a debtor does not in itself make them related parties,[323] but syndicate lending brings upon such intrusive elements of control whose significance requires attention. It is decisive whether the party was a related party *at the time of the transaction*, and subsequent changes to the relationship of the parties carry no meaning.[324]

Relevantly,[325] in accordance with FRA, Section 3(2), related parties of a company include

(i) parties who either alone or with their related parties through shareholding or partnership *or comparable economic circumstances* share materially linked interests with the company,

(ii) parties who through a managerial position exercise substantial influence on the operation of the company, and

(iii) related parties of parties described in items (i) and (ii).

4.5.2.2 Economic interest criterion

Thus there are two alternative criteria: economic interest and control. Item (i) is an expression of the former, and it can be divided into three requirements: (a) a relationship in economic respects comparable to shareholding or partnership, and (b) materially (c) linked interests. According to the government proposal, a shareholder has materially linked interests with the company at least when the shareholding exceeds half of the company's shares. Materially linked interests also exist between a company and a shareholder if the company is a 50/50 joint venture and when a shareholder holds a significant minority stake in a company with dispersed ownership.[326] Thus, although this is not said in the government proposal,

323. Gov. prop. 103/1990, p. 45.
324. *Miettinen* 2011, p. 32.
325. The class of related parties also includes certain relatives of physical persons. These are not of interest here.
326. Gov. prop. 103/1990, p. 46.

the *level of control* the shareholder is able to exercise is important. In respect of third parties, comparable economic circumstances may exist if the creditor has a "share in the debtor's earnings *and* losses."[327] This requirement seems peculiar, because as shareholders have limited liability, they do not take part in the debtor's losses and thus a share in the debtor's losses does not bring the economic qualifications of the relationship closer to that of a shareholder's. Creditors do not have a share in the debtor's losses—unless they are also guarantors, which would be exceptional. Thus this statement is better understood as meaning to include guarantors and general partners in a partnership, than to exclude creditors. Conducting business through another company using actual control arising out of contractual arrangements is given as an example of comparable economic circumstances in the government proposition, but it is not explained how profits and losses would be channeled to the beneficiary in such arrangements.[328]

The government proposal has been interpreted by some to introduce as a central criterion the question whether the creditor is entitled to a share of the debtor's earnings or takes part in its losses. *Tuomisto* argues that credit risk alone is not sufficient—otherwise the government proposal could not state that creditors are not related parties only for being creditors.[329] *Villa* has countered this view, arguing that for a creditor to become a related party, sharing profits or losses is not necessary, but using actual economic control in the debtor for the creditor's own interests may suffice.[330] There would be no clear rule when a creditor has enough control to make it a related party, but determinations would have to be made *in casu*. The more closely the creditor's investment resembles an equity investment, the more likely the creditor would be a related party under the FRA. The fewer the creditors, the more control a single creditor has and thus would be more the likely a related party.[331] *Tuomisto's* view seems to have been accepted at face value in cases of the Court of Appeal in Helsinki. Thus it appears that the statutory test of *comparable economic circumstances* is routinely equated with the singular criterion of a share in profits and losses, expressed in the *travaux*.[332]

A categorical statement that fixed debt claims are in economic respects not comparable to equity investments seems wrong and deserves attention. Firstly, understanding literally the government proposal view that a relationship is in economic respects comparable to shareholding normally when one party has *a share in the*

327. Gov. prop. 103/1990, p. 45.
328. Gov. prop. 103/1990, p. 45.
329. Gov. prop. 103/1990, p. 45, *cf. Tuomisto* 2002, p. 31.
330. *Villa* 1997, p. 372.
331. *Ibid.*, p. 373.
332. *See Tuomisto* 2002, pp. 31–36 and *Miettinen* 2011, p. 73.

the other party's earnings and losses and such a share is a necessary precondition for finding economic grounds for a related party relationship seems highly formalistic. Statutory law must necessarily have preference to its *travaux*. According to the FRA, the criterion is that the parties' relationship is in economic respects comparable to shareholding of partnership, not that one party has a share in the other's losses. The passage expresses one example what might constitute an economically comparable relationship, but it cannot replace the statutory test. Thus the economic realities of the relationship must be assessed as a whole, not based on a single criterion.

Secondly, the whole statement seems economically false. It is true that creditors normally have a fixed claim and thus limited upside, while shareholders' upside is unlimited. Importantly, however, neither shareholders nor creditors are liable for the debtor's losses beyond their investment, and do not therefore have a *share in the debtor's losses*. As long as the debtor is solvent, the value of the creditors' claims are mostly influenced by factors external to the company (such as interest rate developments). But if the debtor is clearly overindebted, the shareholders' interest in the debtor is due to their subordinated position on liquidation worthless, and the creditors' claim follows the debtor's net present value.[333] The *nominal value* of the claim stays the same fixed amount, but its marketable, *fair value* follows its proportional share to the debtor's assets on liquidation. Thus increases and decreases in net present value of the debtor increase or decrease the *value* of a creditor's claim. It is worth noting that the fact that participations in LMA loans are freely transferrable and there is a secondary market brings their characteristics closer to those of shares. The fact that the value of the lenders' investment is linked to the debtor's net value creates a material link between the interests of a creditor and a debtor in the vicinity of insolvency.

Thus LMA lenders' position is comparable to shareholders in those respects that it is a transferable investment with downside risk, and sometimes upside risk. Moreover, lenders have current information on the finances of the debtor and means to influence the inter-company decision-making which affects their risk position. This is clearly comparable to shareholders as a class. Indeed, it is the control and the information that separates lenders from other creditors and brings their investment's characteristics closer to that of the shareholders'. In assessing whether the economic characteristics are comparable to that of a shareholder or a partner, one must look at the characteristics as a whole. Such determinations would have to be made *in casu*, but it seems clear that the typical lender should

333. *See* e.g. *Gilson – Vetsuypens* 1994, pp. 1005–1006.

be seen as having an economically comparable position with the shareholders and therefore held a related party.

4.5.2.3 Managerial position criterion

Item (ii) concerns (*de facto*) managers, i.e., control. Above the rules regarding *de facto* directors under the FCA were explained.[334] It was discovered that the concept of shadow directors is unknown to Finnish law, but *de facto* directors are treated identically to properly appointed directors. This gives rise to the question whether syndicate lenders could be treated as *de facto* directors, and I argued that the level of interference with a company's management required for a party to become a *de facto* director under Finnish law is almost certainly too high to allow for the treatment of syndicate lenders as directors in the meaning of the FCA. However, the test under the FRA is independent from those considerations. The test in accordance with the subsection is twofold: the party must be able to substantially influence the operation of the company. Substantial influence is to be taken to mean the ability to influence company decision-making in respect of transactions between himself and the company.[335] This requirement would be met if the loan was of substantial financial importance to the borrower due to the ability to accelerate.

Ovaska has argued that it would be unsystematic to not regard controlling creditors as related parties as creditors are often able to exercise very intrusive or even total control over a debtor.[336] *Villa* agrees with *Ovaska* at least in respect of work-out proceedings whereby managerial decision-making is by contract transferred to creditors.[337]

The proposition that creditors who employ control have a managerial position in the meaning of the FRA can be criticised. The influence the party is able to exercise must be resultant from a managerial position, which does not have to be that of a formally appointed director. However, *position* implies a level of permanence in the person's managerial activities and thus only continuous interference with a debtor's management could possibly make a creditor its related party. Further, Court of Appeal case law suggests that the influence must be *internal* to the company, and outside pressure would not constitute a managerial position.[338] Persons in

334. At subsection 4.3.2.
335. Gov. prop. 103/1990, p. 46.
336. *See Ovaska* 1991, p. 155.
337. *See Villa* 1997, pp. 370–371.
338. *See HHO 25.3.1997 t. n:o 1016 S 95/1367*.

managerial positions has sometimes included corporate doctors.[339] In conclusion, a creditor would likely not merely by pressuring a debtor into certain courses of action become a related party under this head. However, if a creditor's employee were to be appointed as a director, the creditor would become a related party by extension.[340] Creditor partaking in debtor board meetings or other managerial meetings brings about a grey area. It seems unclear whether e.g. being able to veto decisions in such meetings would make the creditor a related party. *Villa* argues that a mere veto right would not be sufficient without a possibility to actively influence the debtor's decision-making.[341]

4.5.2.4 Conclusions

Ovaska has emphasised the control criterion and argued that banks or other financial institutions wielding control over a debtor should be seen as having a *de facto* managerial position, because it would be unsystematic not to allow their recognition as *de facto* managers.[342] *Tuomisto* has emphasised the economic interest criterion and argued that creditors with a fixed claim do not fulfil the criterion. The cases cited by *Tuomisto* and *Miettinen* suggest that even if a creditor has at its disposal contractual control powers, the criterion of *managerial position* is not fulfilled and neither is the criterion of *economic interest* if the creditor has a fixed claim.[343]

The test of related parties under the FRA and the interpretation thereof can be criticised for being too formalistic. Strict interpretation of the wording of the Section and its *travaux* leads to the conclusion that creditors cannot be related parties because (i) they do not *take part* in the debtor's *losses*, and because (ii) they do not have a managerial *position*. Such a formalistic interpretation leads to the result that parties who have the incentive and the means to influence the debtor's payments are not caught by the definition of related parties. Assessing as a whole *in casu* the interests, the level of information available to the creditor, and especially the possibilities of influencing the decision-making of the debtor, would lead to a better result in respect of averting wealth transfers which prejudice the debtor's creditors.

Finally, it is worth noting that the definition of related parties under the FCA is considerably different. Under the FCA, *control* is the singular criterion for

339. *See* cases cited at *Tuomisto* 2002, pp. 37–38.
340. Gov. prop. 103/1990, p. 46.
341. *Villa* 1997, p. 374.
342. *See Ovaska* 1991, p. 155.
343. *See Tuomisto* 2002, pp. 31–36 *Miettinen* 2011, p. 73.

determining whether a related party relation exists.[344] Thus emphasising control as an element of economic similarity of circumstances meant in the FRA would bring the definition closer to that of the FCA.

4.5.3 Recovery of debt repayment

Repayment of debt is subject to three alternative and one cumulative criteria. In accordance with the FRA, Section 10, repayment is recovered if it is paid during a *three month* suspect period either

(i) with exceptional means of payment,

(ii) prematurely, *or*

(iii) in an amount which is to be considered substantial in proportion to the assets of the estate,

and the repayment cannot be considered ordinary in the circumstances. Furthermore, the repayment must be such that it would typically injure other creditors by reducing the amount of funds available to satisfy their claims on bankruptcy.[345]

In respect of related parties, the suspect period is *two years*. Repayment to a related party is recovered unless it is proved the debtor was not insolvent at the time of repayment and that the repayment did not make the debtor insolvent.

In respect of related party lenders pursuant to an LMA style loan agreement, the requirement that the debtor was insolvent at the time of payment, or that the payment rendered the debtor insolvent, would in normal circumstances be fulfilled as such loans regularly form the bulk of a borrower's financing, and could thus be subjected to recovery. As it is somewhat uncertain whether and when controlling creditors are considered related parties under the FRA, it is crucial to know whether repayments of accelerated loans fulfil the criteria for recovery during the three month period under the stricter criteria. It is assumed that lenders would normally demand cash payment and thus the first alternative criterion is not discussed here.

Whether the repaid amount is to be considered *substantial* depends on the circumstances. The repaid amount shall be compared to the *gross assets less pledged assets*

344. Pursuant to the FCA, Chapter 8, Section 6(2), one party is a related party of the other party if it "may exercise control over the other party or significantly influence the financial and business decision-making of the other party." *See* page 45 above on the interpretation of the Section.
345. *See KKO:2011:24*.

of the estate *at the time of entering into bankruptcy*.[346] In assessing the substantiality of a payment, all payments made to the same creditor are summed up.[347] As regards the practice of funnelling repayments to syndicate lenders through the agent bank, *KKO:1999:38* is interesting.

> A consolidated group of two insurance companies had a practice of realising debt collection of both companies through a single entity through which debt payments would be funnelled. The debtor was sent a debt collection letter which did not state how the payment would be distributed to the two companies. The payments were made to the companies' joint bank account. In these circumstances, the substantiality of the payments to the two insurance companies (through their common debt collection entity) was assessed as a whole.

The brevity of the arguments of the Court prevent concluding whether these are meant to be alternative or cumulative criteria and the decision appears to have been made *in casu*. It is clear, however, that such an arrangement shares key characteristics with the practice of having the agent bank receive all payments.

What constitutes a substantial amount has been left to develop in court *praxis*. A rule of thumb is that objectively suspicious payments, i.e., payments which appear to having been made for the purposes of avoiding the effects of bankruptcy, are considered substantial.[348] Payments between 10–15% of the gross assets less pledged assets have been routinely subjected to recovery.[349] Given the often significant role syndicate lending has in a debtor's financing, this requirement would normally be easily met, even on a per-lender basis.

In assessing whether the payment was made *prematurely*, the due date is not decisive. Instead, it is decisive whether the payment is to be objectively considered premature taking into account when the payment would have been made had the debtor been solvent.[350] In these determinations, the due date does, however, provide a strong starting point. Payments made after the original due date are rarely premature, while payments prior to the due date almost always are.[351] A loan

346. *Tuomisto* 2002, pp. 198–200.
347. *See KKO:1997:138*.
348. Gov. prop. 103/1990, pp. 55–56.
349. According to *Tuomisto*, in Court of Appeal case law, 10% is an established threshold. *See Tuomisto* 2002, p. 205. *Koulu* lists two Supreme Court cases where the threshold was 15%. *See Koulu* 2009b, p. 323.
350. Gov. prop. 103/1990, p. 14.
351. *Koulu* 2009b, p. 323 and *Tuomisto* 2002, p. 188.

which has been called back due to e.g. default on repayments is thus considered *premature*.[352] It is critical that the acceleration is due to the intent of avoiding the effects of insolvency. If the calling back of the loan is due to some other reason than impending insolvency of the debtor, recovery is not possible.[353] In respect of term loans, also LMA style term loans, accelerating the loan is always exceptional. The ratio of acceleration is to avoid becoming victim of the debtor's deteriorating financial standing. In summary, accelerating a term loan makes its repayment premature in the language of the FRA.

Thus repayment of an accelerated term loan fulfils always at least one and usually two of the alternative criteria. For recovery to be possible, also the final cumulative criterion must be met, *viz.* that the *payment cannot be considered ordinary in the circumstances*. The requirement that the payment is not ordinary in the circumstances is intended to employ the principle that only objectively suspicious payments are recovered.[354] In accordance with the government proposition, payments which are objectively assessed not connected to the debtor's bankruptcy would be considered ordinary.[355] This means that payments which are made for the reason of avoiding bankruptcy are not ordinary in respect of the debtor's business. The circumstances shall not be such that according to an objective assessment, the creditor must have known of the impending insolvency, and therefore sought payment before other creditors.[356] Thus payments which would be made regardless of impending bankruptcy, e.g. out-of-pocket expenses to suppliers etc. are usually ordinary.[357] If there is established payment practice between the parties, such practice offers a benchmark for determining whether the payment is ordinary in that type of business relationship. In the absence of such practice, established practice of the relevant industry may be considered.[358] In this respect it must be kept in mind that acceleration is always exceptional. According to *Immonen*, if a term loan is repaid voluntarily, without debt collection actions on the part of the creditor and at the end of the term—i.e., on the original due date—the repayment is to be considered ordinary and thus recovery is precluded.[359] *Tuomisto* argues that even such repayment could be considered not ordinary in case the debtor has

352. Gov. prop. 103/1990, pp. 14–15.
353. *See Tuomisto* 2002, p. 194 and *KKO:1998:24*.
354. Gov. prop. 103/1990, p. 15.
355. Gov. prop. 103/1990, p. 56.
356. *Lennander* 2004, p. 247. Because the criterion is objective, it does not matter whether the creditor actually knew of the debtor's standing. This statement is in respect of Swedish law, which is in material respects identical to Finnish law on this issue. *See* konkurslag (1987:672), Chapter 4, Section 10.
357. *See Koulu* 2009b, p. 324.
358. *See Tuomisto* 2002, p. 212.
359. *Immonen* 1994, p. 74.

had to default on other payments in order to repay the term loan.[360] In Supreme Court case law, especially payments which are linked to the debtor's impending insolvency and bankruptcy have been considered not ordinary.[361]

To summarise, repayment of an accelerated term loan is considered premature (and often substantial in proportion to the estate's assets). Such repayments are also not ordinary in the language of the Section. Therefore recovery is possible if the repayment is made during the suspect period, which starts three months prior to the critical date. If the creditor is a related party under the FRA, repayments of debt made later than *two years* before the critical date are recovered, *unless* the creditor proves the debtor was not insolvent at the time of repayment and did not become insolvent due to the repayment. If lenders are not considered related parties, they are incentivised to prefer early acceleration as there would be a possibility of escaping the rather short three month suspect period. Thus lenders are incentivised to prefer early acceleration because if they accelerate early enough, they might evade recovery. Thus if lenders are not considered related parties, they have thanks to the flow of information and the ability to accelerate at any time after the debtor has defaulted, often means to escape recovery under FRA, Section 10.

4.5.4 General recovery grounds

The FRA, Section 5, sets out the general recovery grounds.[362] Section 5 is independent from the other recovery grounds and may become applicable without prejudice to whether some of the other grounds apply. Thus whether or not a repayment tranche is caught by Section 10, recovery may be possible under Section 5.

> Legal acts which by themselves or along with other measures inappropriately favour one creditor prejudicing other creditors, transfer assets from the reach of creditors, or increase liabilities to the detriment of creditors, shall be recovered.
>
> Recovery requires that the debtor was at the time of the legal act insolvent or that the legal act contributed to the insolvency of the debtor. It shall additionally be required that the counterparty knew or ought to have known of the debtor's insolvency or the implications of the legal act on the financial standing of the debtor, and of the matters which make the legal act inappropriate.

360. *Tuomisto* 2002, p. 219.
361. *See Kuusiluoma* 2011, pp. 104 *et seq.* for an analysis of all 20 Supreme Court cases in respect of FRA, Section 10.
362. Passages concerning gifts are excluded from this translation.

> If the counterparty of the legal act pursuant to Subsection (1) was a related party of the debtor, his knowledge of the circumstances pursuant to the Subsection shall be assumed, unless proven likely that he did not have the knowledge and ought not to have the knowledge.
>
> Legal acts made earlier than five years before the critical date shall be recovered only in case the counterparty was a related party of the debtor.

Thus the requirements in respect of unrelated parties can be divided into four distinct, cumulative requirements:

(i) Inappropriateness,

(ii) reduced funds of the bankruptcy estate,

(iii) the debtor was insolvent at the time of the act, or the act contributed to the debtor becoming insolvent, *and*

(iv) creditor's knowledge of debtor's finances and of the act's inappropriateness

Acceleration of a significant loan would typically reduce the funds available for satisfying the claims of the other creditors of the bankruptcy estate, and would usually at least *contribute* to the debtor becoming insolvent, if it isn't already. Moreover, because of information covenants, the lenders would normally very well know the financial standing of the debtor and the effects of acceleration. Thus the criteria in items (ii)–(iv) are easily met in respect of syndicate loans, and *inappropriateness* remains the decisive criterion in determining whether recovery is possible under the FRA, Section 5.

According to the government proposal, legal acts are *inappropriate* only if they are made "judging from the circumstances, for the purpose of averting the effects of potential bankruptcy." Further, inappropriateness is clear especially when "a prerequisite of recovery has been met in a striking way." This would especially be so if the counterparty of the debtor was well aware of the debtor's bad financial situation, or if the legal act was made shortly before bankruptcy,[363] but these factors alone would not make the act inappropriate.[364] Other factors which speak for inappropriateness include underpriced disposals of assets, and disposals at

363. Gov. prop. 103/1990, p. 48.
364. *Tuomisto* 2002, p. 100.

fair value but subject to otherwise unfavourable conditions, with a view of using the proceeds towards satisfying the claim of the creditor who is trying to avert the effects of bankruptcy.[365] Prepayment of debt and repayment of debt with exceptional means of payment speak for inappropriateness,[366] and so do forceful, possibly unlawful, debt collection actions.[367] Large wealth transfers, inflicting great damage on the other creditors, are more likely inappropriate than small wealth transfers.[368]

Arguments against inappropriateness include security pledges held by the creditor, because due to the priority on bankruptcy the damage to other creditors may be fairly limited, that the transaction was made in an effort to rehabilitate the debtor's business, and that the creditor *bona fide* believed that the finances of the debtor would improve despite knowing of the insolvency.[369] In any case, inappropriateness must be assessed on the whole.

Syndicate lenders would usually only accelerate as a last resort, hoping to be averting the effects of impending bankruptcy. Lenders would know very well the debtor's situation and acceleration would normally be made shortly before bankruptcy—to be sure, bankruptcy would usually be a direct consequence of acceleration due to the often substantial significance of the loan. Austerity measures demanded by lenders could be counted against them if the measures seek to accumulate funds for debt service through disposals. Further, acceleration amounts to prepayment. Because a syndicate loan would usually be accelerated only when the situation is hopeless in the lenders view, and because in any case repayment of such debt is not due to rehabilitation efforts, the counterarguments relating to turnaround hopes do not apply. However, if the loan is secured, recovery could be averted due to lack of injury to other creditors. In summary, everything speaks for inappropriateness, which could be cured if the lender is secured. Thus recovery would normally be available under the FRA, Section 5.

The critical period is *five years*. In respect of related parties, there is no limit. Further, related parties' knowledge of the debtor's financial standing and other material facts is assumed.

365. *See Tuomisto* 2002, p. 103.
366. *See* Gov. prop. 103/1990, p. 49.
367. *Tuomisto* 2002, p. 105.
368. *Ibid.*, p. 109.
369. *Ibid.*, pp. 112, 115, 118.

4.5.5 Conclusions

According to the positive analysis above, recovery of repayments due to acceleration would be possible both under the FRA, Section 10, whereby the critical period is three months, and Section 5, whereby the critical period is five years. In respect of related parties, the critical periods are two years and unlimited, respectively.

Whether controlling creditors, such as major syndicate lenders, are considered related parties, is not certain. Formalistic interpretation of the criteria prohibits regarding controlling creditors as related parties because of the claimed lack of a managerial position and similarity economic interests.

I have above criticised such a view, arguing that the qualities of the relationship should be assessed as a whole *in casu* from the point of view of the purpose of the notion of related parties, and that the interests, the level of information available to the creditor, and especially the possibilities of influencing the decision-making of the debtor, should be able to make a controlling creditor a related party under the FRA.

4.6 Other mechanisms in cases of exceptional abuse

4.6.1 Illegal distribution of funds

Pursuant to FCA, Chapter 13, Section 1, any transaction which reduces the company's funds or increases its debts *without economic grounds* constitutes illegal distribution of funds. The requirement of economic grounds means that based on the knowledge available at the time of the transaction, in respect of the company, the transaction shall be regarded as increasing earning capacity.[370] Pursuant to Section 4, if the recipient of the funds knew or ought to have known that the transaction constituted illegal distribution of funds, he must return the funds to the company, added with interest. Examples include overpriced purchases and underpriced sales, along with borrowing money at too high interest.

A strong starting point is that repayment of due debt would not constitute illegal distribution of funds, as economic grounds exist for complying with the company's legal obligations. However, for debt which is not due, there might be no economic reasons from the point of view of the company to repay such debt. Thus if e.g. a

370. *See Lindholm – Storå* 2010, pp. 411–412.

duty of loyalty restricts calling back a loan, repayment of such loan could constitute illegal distribution of funds as there would not necessarily be no economic grounds for repayment. The recipient would only have to return the funds if he knew or ought to have known that the transaction constituted illegal distribution of funds. In respect of the duty of loyalty, because there is very much discretion concerning what constitutes a breach of the duty of loyalty, a return obligation would only arise in exceptional cases of abuse.

4.6.2 Subordination of a creditor's claim

Mähönen and *Villa* suggest that exceptionally gross abuse of the debtor by a creditor might be dealt with in the terms of *subordination*, whereby the creditor would lose its status as a creditor (its investment would be regarded as an equity investment) and would become jointly liable for the liabilities of the debtor. There would be two criteria, an objective one and a subjective one, both to be met. The objective criterion would be shift of control to the creditor, and the subjective criterion would be opportunistic, inappropriate use of such control powers by the creditor.[371] According to *Villa*, a creditor would for subordination purposes be regarded as the controlling, if (i) the creditor has discretion to decide on the preferred course of action case-by-case,[372] (ii) the creditor uses this discretion to disloyally advance its own ends, (iii) thereby causing damage to the other constituents of the debtor company.[373]

5 Synthesis

5.1 Recognising the change of residual risk bearer

5.1.1 Agent mix

During its lifetime, a company may and must choose to interact with various agents. A company's agents will necessarily include its *directors*, but may also include *majority shareholders*, and as seen above, *creditors*.[374] The balance of power between the shareholders and the directors depends on whether there is

371. *Mähönen – Villa* 2006a, p. 243 and *Villa* 2003b, pp. 186–187.
372. The idea is that simply enforcing contracts is not use of control in the sense making decisions as the situation develops and demanding the implementation of such decisions is. *See Lauriala* 2001, p. 126.
373. *Villa* 2003b, p. 187.
374. For a more comprehensive list and discussion of possible agents during the lifetime of a company, *see Mäntysaari* 2010, pp. 209 *et seq.*, especially pp. 217–224.

a majority shareholder. Dispersed ownership and inactive shareholders empower the directors, while a majority shareholder would be able to efficiently control the directors, becoming the agent of the other shareholders.[375] Creditors become agents when they have the ability to influence director decision-making levying a significant economic sanction on the company in case of non-compliance.

Above it was stated that economic efficiency suggests that companies should be managed in the interests of the residual risk bearer. In a solvent company, this is the shareholders, in an insolvent company the creditors and in a bankrupt company the claimants as a whole. Should company law account for such changes, i.e., should the fiduciary duties of the directors shift according to the shifts of residual risk? In respect of Finnish companies, in so far as the company remains a going concern, the directors owe their fiduciary duties invariably to the shareholders regardless of the financial state of the company.[376] Bankruptcy brings about the only recognised change of principal: bankruptcy estates shall seek to maximise creditor value, and it is the creditors who have residual control powers in the estate.[377]

5.1.2 Excursion: Delaware

If residual control rights should always lay with the residual risk bearer, could the law recognise the change of residual risk bearer? *Campbell* and *Frost* have found that Delaware courts have recognised a change in directors' fiduciary duties when firms enter and move through deepening financial distress. The directors are obliged to maximise the value of the company's residual risk bearer, but who is the residual risk bearer, changes according to the company's solvency. Four stages of deepening distress are recognised: (i) the normal situation, i.e. solvency, (ii) the vicinity of insolvency before actual insolvency, (iii) actual insolvency before entering into bankruptcy proceedings, (iv) legal bankruptcy after having filed for bankruptcy.[378]

While the company is solvent, the directors owe their fiduciary duties to the shareholders and only them—not to creditors or any other constituents. In summary, the duty is to maximise the shareholder value of the shareholders as a class.[379]

Vicinity of insolvency means that the company nears insolvency but has not quite become insolvent. With reference to *Credit Lyonnais Bank Nederland, N.V. v. Pathe*

375. *See Enriques* et al. 2009, pp. 62 *et seq.*
376. *See* section 3.2 above.
377. *See Koulu* 2009a, pp. 50–51 and *ibid.*, pp. 59 *et seq.*
378. *See Campbell – Frost* 2007, p. 493.
379. *Ibid.*, pp. 495–497.

Communications Corp. (unreported), *Campbell* and *Frost* find that in vicinity of insolvency, the directors owe their fiduciary duties to the corporate enterprise as a whole, i.e., all its stakeholders. There are two inherent difficulties: firstly, it is impossible to know when the company is in the 'vicinity' of insolvency. Secondly, there is the difficulty of defining the stakeholders to whom fiduciary duties would be owed.[380]

If the company's financial standing further deteriorates, it becomes insolvent. When the company is insolvent, under Delaware law its directors owe their fiduciary duties to the company's *creditors*.[381] Insolvency is defined alternatively as "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof" and "an inability to meet recurring obligations as they fall due in the usual course of business."[382] Thus there is less ambiguity to what constitutes insolvency than there is to what constitutes vicinity of insolvency. There is, however, ambiguity in what the content of the fiduciary duties owed to creditors in such circumstances is. There are three options: (i) swapping creditors for shareholders as principals—maximising creditor value, (ii) considering the interests of creditors and shareholders as a whole, and (iii) retaining shareholders as the primary principals of the directors, but giving more space to consider the interests of the creditors.[383]

Finally, insolvency may lead to bankruptcy. In a Chapter 11 bankruptcy, the management of the bankrupt debtor company stays in place, but their fiduciary duties change. In bankruptcy, the fiduciary duties are owed to shareholders and creditors of the estate as a whole—it is the duty of the directors to pursue maximising the value of the estate.[384]

It is clear whether a company is bankrupt or not, but the distinctions between the periods of solvency, vicinity of insolvency and insolvency are vague. Thus it is very difficult for the directors to know the contents of their fiduciary duties and to whom the duties are owed, creating inefficiency. Therefore *Campbell* and *Frost* argue that entering into bankruptcy should mark the only shift in fiduciary duties.[385] If the fiduciary duties change according to the financial standing of the company while it is not bankrupt, it is difficult to price the value of one's investment if it is not clear in whose interests the company is run. Thus e.g. negotiating contractual creditor

380. *Campbell – Frost* 2007, pp. 503–505.
381. *See Geyer v. Ingersoll Publications Co.*
382. *See Campbell – Frost* 2007, p. 500 and the cases referred therein.
383. *Ibid.*, p. 501.
384. *Ibid.*, p. 509.
385. *Ibid.*, pp. 511–512, 522 *et seq.*

protection suffers a blow from this uncertainty.[386] Finally, ambiguities in who the fiduciary duties are owed creates possibilities of abuse for the directors, as it is difficult to enforce unclear duties.[387]

5.1.3 Residual risk bearer rule

Campbell and *Frost's* critique of the Delaware suggests that directors' fiduciary duties should only change upon bankruptcy—which is the current Finnish law model—because constantly shifting duties would introduce costly uncertainty. Because company law cannot efficiently ensure that a distressed company is operated in the interests of its residual risk bearers, creditors need negotiated creditor protection, i.e., contractual control powers, to ensure debtor companies do not act opportunistically in the interests of the shareholders. How then, do the three mechanisms which were taken into consideration as possible limiting factors to creditor control, respond to the agency problem? Do they let the creditors rule when the debtor company is insolvent and the creditors have become its residual risk bearers, and prohibit creditor control when the company is solvent?

5.2 Limitations to creditor control in light of the agency problem

5.2.1 Assessing the mechanisms

One purpose of the legal system as a whole is to reduce economic inefficiency.[388] This is the case for institutions in the sphere of the law of property especially. Company law exists to promote economic activity and the efficiency thereof by reducing transaction costs through reducing the need for negotiation by providing model rules. Secondly, company law separates ownership and management, thus allowing actors with excess funds but limited management resources to act as owners, and actors with limited funds but management skills to act as managers. Thus company law must efficiently control the agency relationship between the owners and the management, i.e., reduce agency costs. Indeed, the FCA is strongly influenced by the *law and economics* arguments especially as regards the agency relationship between the owners and the management.[389]

386. *See Campbell – Frost* 2007, p. 521.
387. *Ibid.*, p. 522.
388. E.g. *Hemmo* 1996, p. 333.
389. *Mähönen – Villa* 2006a, pp. 44–49.

This thesis supports the hypothesis that residual control rights should lie with the residual risk bearer, because the residual risk bearer is the most incentivised to ensure the profitable operation of the company. The residual risk bearer is thus also the most incentivised to properly monitor the agents of the company. In the following, the mechanisms which limit or could possibly limit creditor control are assessed on the criteria how well they let the residual risk bearer control the company through its different stages of solvency, and whether they incentivise the company's agents to act in the interests of the residual risk bearer. Because of monitoring costs, creditors would be most willing to control companies in the vicinity of insolvency. In such circumstances, according to the agency problem, the company should seek to maximise the value of the investments of the creditors as a class.

5.2.2 Directors' duties

Directors' duties can constrict creditor control in two ways. Firstly, as outside creditors do not have formal intra-company decision power, but must instead demand the properly appointed directors implement creditor-made decisions, the directors act as gatekeepers whose role is to only implement such decisions when it is in the best interest of the party to whom the directors owe their fiduciary duties. Because breach of the fiduciary duties is sanctioned, the directors are personally incentivised to act in the interest of their principals. Secondly, there may be mechanisms which *extend* these duties to parties who are not properly appointed directors, but assume the role of such. Such an extension would make the party with actual control of the company directly liable for the breach of the duties which guard the interests of the principal recognised by law.

Under the FCA, the directors' fiduciary obligations continue to flow from the interests of the shareholders until the moment the company files for bankruptcy. The standard of care is defined by the business judgement rule. Thus in implementing creditor-made decisions, they must always consider whether implementing such decisions would be in the interests of the shareholders, and not comply if it isn't. To be sure, there might rarely be choice, as major creditors with the ability to demand repayment could force the company into liquidation, which would normally lead to immediate wiping out of all upside risk of the shareholders. If the shareholders' claim is underwater, this would effectively mean the immediate and complete realisation of their downside risk. Because the directors invariably owe their fiduciary duties to the shareholder regardless of whether they have lost the status of the residual risk bearer, they are not properly incentivised to take into account the interests of the creditors when residual risk has shifted to the creditors.

Thus wholesale extension of the directors' duties regime to creditors would force them to act in the interests of the shareholders even when the company should act in the interests of the creditors as a class, i.e., when the company is insolvent. Further, a general risk of becoming liable for breach of directors' duties would result in prohibitively high transaction costs as creditors in general would have to spend time and effort in assessing debtor companies' standing. On the other hand, in a solvent company the shareholders are exactly the party in whose interests the creditors who have become agents should act. Above the positive analysis of extension mechanisms of directors' duties revealed that under Finnish law, directors' fiduciary duties would not be likely extended to third parties such as creditors. Three possible mechanisms where considered. It was found that the level of interference required for a third party to be considered a *de facto* director is too high to allow for considering creditors *de facto* directors. In respect of shareholders' liability, it was concluded that despite economic similarities of the positions of a controlling creditor and a majority shareholder, *contra legem* extension of shareholders' liability to creditors would be quite unlikely. Moreover, the FCA does not recognise the concept of shadow directors. For the purposes of expanding horizons, the English concept of shadow directors was considered as a possible extension mechanism.

On the surface it would seem that the fiduciary obligations of directors should always flow from the residual risk holder's interests. However, due to the inherent impossibility of decisively determining the residual risk bearer as the company moves through deepening stages of financial distress, the directors would not be able to know who they owe their fiduciary duties, and would thus be unable to determine the correct course of action. Thus bankruptcy must act as the singular white line defining a change of the fiduciary duties' principal. However, in respect of creditors with control powers, the practical ability to effect bankruptcy alleviates the problem that the directors' fiduciary obligations do not account for creditor interests in insolvent companies. Of course, creditors without control powers have no recourse against shareholder opportunism in insolvent companies.

Monitoring agent performance is costly, and therefore creditors with control powers would normally only be interested in controlling companies in the vicinity of insolvency. Borrower companies are reluctant to hand over effective management to lenders. Thus covenants would be negotiated so that they act as a warning signal informing the lenders of possibly approaching insolvency, and allow the lenders to react. Thus the nature of negotiated creditor protection forces the directors to consider the interests of the creditors when the company nears insolvency, but allows the directors of solvent companies to act in the interests of the shareholders in so far as they do not risk the company's solvency, which would flip control to the creditors.

5.2.3 Contractual duty of loyalty

The contractual duty of loyalty was found to limit termination rights mainly in two ways. Firstly, calling back a loan would be prohibited when the damage to the debtor significantly surpasses the benefit of the creditor. Secondly, controlling creditors who have taken over effective management of the debtor would face restricted termination rights due to assuming a role which deepens the duty of loyalty.

The contractual duty of loyalty can be seen as having part of its justification come from, in addition to moral arguments, economic efficiency.[390] Proscribing acts which injure one party more than they benefit the other increases overall efficiency. However, in principle, imposing on a legal person a duty of loyalty owed to the legal person's counterparties complicates the fiduciary duties owed by its management. On the one hand, the management must seek to advance the interests of the legal person's residual risk holders, the shareholders. On the other hand, they would have to loyally take into account the interests of the legal person's counterparties. Thus the management would owe general duties to at least two parties, in other words, they would have dual principals and a difficult balancing act to perform. The management would not be able to maximise the interests of either of these constituents, especially because the duty of loyalty remains undesirably undefined.

Contractual parties subject to the contractual duty of loyalty owe the duty to the counterparty company, i.e. to the corporate enterprise as a whole. Thus the duty protects creditors and shareholders as a class by thwarting the use of negotiated control power for private gains.

5.2.4 Recovery to bankruptcy estate

Above two recovery grounds under the FRA were identified to have the ability to recover repayment of debt to controlling creditors: Section 10 (repayment of debt) and Section 5 (general recovery grounds). As regards controlling creditors' related

390. *Hemmo* 1996, p. 333.

party status, it was concluded that the requirements have been construed rather formalistically, denying the imposition of such a status on controlling creditors. This view was criticised, arguing that a purpose-oriented assessment would lead to results more consistent with the systemic purpose of the act.

The criteria of Section 10 are more easily met than those of Section 5 as no evidence of improperness of the act—or the knowledge of improperness by the creditor—is required. While recovery under Section 5 could sometimes be barred for lack of improperness, Section 10 could still apply. The critical period in accordance with the FRA, Section 10 is three months in respect of unrelated parties. Thus if controlling creditors are not considered related parties, they are incentivised to prefer early acceleration as recovery under Section 10 would be escaped (and recovery altogether, should evidence of improperness and the knowledge thereof lack, thereby barring the applicability of Section 5) if the company files for bankruptcy later than three months after the acceleration. Thus too formalistic interpretation of the criteria leads to results which are contrary to the act's purpose of establishing creditor equality.

Whether creditor knowledge of the debtor's financial standing and the calling back of loans for the purposes of cutting exposure to the debtor's deteriorating situation leads to recovery is a balancing act between favouring diligent creditors and non-adjusting creditors. In so far as repayments to controlling creditors are caught by the act, the cost of monitoring the debtor is not paid for—the benefits of monitoring the status of the debtor are lost if acceleration leads to recovery. This is likely to translate into higher interest rates and more onerous security requirements *in lieu* of control rights. Thus in effect sanctioning acceleration is an indirect wealth transfer from the company (and by extension its shareholders) to the company's non-adjusting creditors, which reduces the company's overall efficiency.

The FRA promotes secured lending in more direct ways also. In respect of creditors who hold sufficient security, recovery under the FRA is prevented because of lack of injury to other creditors due to the super-priority of secured lenders on bankruptcy. This rule incentivises taking security as secured lenders avert the risk of recovery altogether. Security requirements add to transaction costs, as drafting security agreements and perfecting the security pledges is costly. Further, the flexibility of the debtors' business is reduced as it needs to ask for creditor consent for disposal of pledged assets. Further, in respect of pledged shares, security agreements often allow creditors to exercise the rights pertaining to the pledged shares when the debtor is in default, which brings about loyalty issues. However, due to space constraints only unsecured lenders were considered in this thesis. In summary, the act works to reduce the benefits of monitoring debtor's financial standing and providing guidance in the face of deterioration, and promotes secured lending.

The FRA regulates the inter-creditor relationship of bankrupt companies' creditors, but it does not regulate the relationship of a going concern and its creditors. Legal acts may be recovered if they inappropriately prejudice *creditors*, and the interests of the company are not considered, and no behavioural standard in respect of the interests of the company is established. Thus the FRA does not respond to the agency relationship existing between controlling creditors as agents and shareholders as principals.

5.3 Importance of mechanisms limiting creditor control

Europe has traditionally sought creditor protection in rigid legal capital rules, an approach which has attracted increasing criticism[391] but is entrenched by the Second Directive. The alternative, negotiated contractual creditor protection flourishes because of the shortcomings of the legislator's approach. Among the core arguments of the criticism against legal capital rules is that such rules are inefficient and not really protective of creditors, yet are costly to the debtor.[392] Indeed, (sophisticated) creditors routinely negotiate for contractual protection,[393] some forms of which are explained below. So-called non-adjusting creditors cannot negotiate for protection (consider tort victims),[394] who may suffer from further deterioration of the debtors' situation due to enforcement of negotiated creditor protection (consider the financial implications of accelerating a major term loan).[395] However, the decreased volatility provided by restrictions on the business of the debtor negotiated by sophisticated voluntary creditors benefits non-adjusting creditors as well by way of reducing the overall riskiness. The incentives of monitoring the riskiness of the debtor's business is reduced if the monitoring costs are not paid for.

Negotiated creditor protection often includes elements which allow the creditor to use some degree of control over the debtor.[396] While legislation relies on legal

391. E.g. *Ferran* 2006, pp. 180 *et seq.*
392. *See* e.g. *Enriques – Macey* 2001, p. 1185.
393. *See* e.g. *Armour* et al. 2009b, pp. 118, 120.
394. *Ferran* 2006, p. 197, notes that the legal capital rules are not even designed to protect e.g. tort victims.
395. *See Mülbert* 2006, pp. 376–377.
396. To be sure, demanding a higher interest rate or collateral are also forms of negotiated creditor protection. *See Enriques – Macey* 2001, p. 1188.

capital rules for creditor protection, creditors have, in a meaningful sense, virtually replaced such rules by introducing sophisticated loan agreements and the protective provisions therein. This change is unaccounted for in the law. The emergence of creditor control powers in contract practice calls for an assessment of related interest conflicts and the mitigation methods available. Further, if legal capital rules are ever abolished on a European level,[397] thereby ever increasing the need for negotiated creditor protection, the mechanisms for maintaining a balance between the risk profiles of company interest parties should be clear.[398]

6 Conclusions

This thesis was based on the hypothesis that companies should be controlled by their residual risk bearers. Shareholders are the only residual risk bearers recognised by company law in respect of companies operating as going concern, and bankruptcy is the only recognised change of residual risk bearer. Because distressed companies' finances often deteriorate slowly, in reality creditors may become residual risk bearers long before the company enters bankruptcy proceedings.

Against this background market practice loan agreements, which grant lenders various mechanisms to control borrower companies, were considered. It was noted that the contractual control rights would usually be available to creditors when the debtor company nears insolvency and breaches predefined financial requirements. Two main questions arise. Firstly, from a legal dogmatics viewpoint, what limits creditor control? Secondly, from a functional viewpoint, do these limitations promote or restrict residual risk bearer rule?

The mechanisms limiting creditor control were chosen so that they apply generally to debtor-creditor relationships solely on the basis of that relationship. Thus lender liability problems arising out of e.g. lender-appointed board members were excluded. Three primary mechanisms possibly attaching sanctions to creditor control were identified: (i) extension of directors' liability regime, (ii) liability for breach of contract and liability in tort, and (iii) recovery to the bankruptcy estate of the debtor. These mechanisms would be considered from two sides: whether and how they limit creditor control, and how well they respond to the agency problem.

397. Which many argue should be done. *See Ferran* 2006, pp. 183 *et seq.*

398. Too much creditor control can be harmful too. Creditors benefit from reduced risk, which in turn may harm the shareholders. Too little risk can lead to an underperforming company—apply this to companies as a class and the result is an underperforming economy.

Directors' duties and the *directors' liability regime* was found to possibly constrict creditor control in two ways. Firstly, because creditors cannot directly make decisions which would bind a debtor company internally, they must ask the company's directors to implement their decisions. As directors owe their fiduciary duties to the shareholders in the company, they must only implement such decisions when it is in the interests of the company. Thus directors act as a gatekeeper—although only in theory if the creditors are able to cause bankruptcy by calling back their loan. Secondly, the directors' duties and liability regimes could be extended to controlling creditors. Three mechanisms of extension were considered: recognising *de facto* directors, recognising shadow directors, and identifying controlling creditors as controlling shareholders. It was found that the FCA does recognise *de facto* directors, but that the level of interference with a company's management required to threat an outside party as a *de facto* director is probably too high to allow for the treatment of controlling creditors as *de facto* directors. The concept of shadow directors was found to be unknown to the FCA. Because shareholders, especially controlling majority shareholders may become liable for *contributing* to the breach of directors' duties, whether controlling creditors could be treated as controlling majority shareholders was considered. It was found that despite certain economic similarities, such *contra legem* extension would be quite unlikely. In summary, directors' duties and liabilities do not extend to controlling creditors under the FCA.

Liability for breach of contract was considered mainly within the terms of the contractual duty of loyalty, which is one of the most polemic doctrines discussed in the last couple of decades. The duty is still moulding, and is rarely expressly invoked in Supreme Court cases. It was found that law prohibits acts which constitute abuse of rights, and that while the duty of loyalty does not require a party to endanger its own interests, the party's behaviour may increase the duty's preponderance. It was concluded that terminating a term facility would be prohibited at least when creditors wish to terminate the facility due to a default which amounts to a mere technicality (e.g. for the reason of being able to relend at a higher interest rate), when the damage to the debtor would materially surpass the creditor's benefit. Creditors' behaviour was seen to limit the right to call back a loan when the creditors have conditioned the continuance of the loan on the execution of austerity measures by the debtor, which the debtor has executed. If the debtor has executed the austerity measures, the creditors' termination right could be constricted even if the outcome of such measures does not satisfy the creditors, because conditioning the continuance of the facility on the execution of such measures creates justified expectations to the debtor, deepening the creditors' duty of loyalty. Because the creditor and the debtor are in a contractual relationship, *liability of controlling creditors in tort vis-à-vis* the debtor would be excluded. For the same reason, tort liability eludes many inter-creditor relationships also. Controlling creditors' tort liability to other constituents of the company was considered unlikely for several reasons, perhaps most importantly due to the lack of foreseeability of damage and because it would open the floodgates of litigation.

Recovery to the bankruptcy estate of the debtor intends to catch wealth transfers which favour one creditor to the detriment of other creditors of a company. As the FRA treats transactions with related parties (as defined in the FRA) much more onerously, it was first considered whether controlling creditors would be considered related parties under the FRA. It was found that the requirements have been often interpreted rather formalistically, giving much weight to certain phrases in the government proposal behind the act, denying the related party status from controlling creditors. However, this study argues that the criteria should be assessed as a whole, giving more weight to the flow of information and the control rights available to the creditor. Thus major creditors with current information in respect of the the financial standing of the debtor and a means of calling back their loan in effort to try to avoid the effects of bankruptcy, should be considered related parties. The FRA catches repayment of debt, subject to certain criteria which the position of a controlling creditor was found to meet. Thus repayment of debt could be recovered, if it is effected during the critical period, which is three months in respect of unrelated parties and two years in respect of related parties. The act also contains a catch-all provision (at Section 5), which was also seen to catch payments to controlling creditors. The critical period is five years in respect of unrelated parties and in respect of related parties, there is no limit.

In the final chapter, the ideas presented earlier in the thesis where considered together. The three limiting mechanisms were considered from the point of view whether they allow the residual risk bearer exercise residual control. It was found that director's duties cannot shift according to the financial standing of the company because of the uncertainty such shifting duties would bring. Directors' duties under Finnish law were found to be invariably owed to the shareholder, and only when a company enters bankruptcy are the creditors recognised as residual risk holders. Because of the contradictory interests of creditors and shareholders in insolvent companies, extending directors' duties to creditors was found undesirable. Contractual creditor control is normally only used when the debtor is financially distressed, and generally speaking, the creditors should be allowed control in such circumstances. The contractual duty of loyalty was found to protect the interests of the shareholders and the creditors as a class from creditor control measures which disloyally favour one creditor and prejudice the other constituents. Finally, it was found that recovery to the bankruptcy estate significantly reduces the effectiveness and usability of negotiated creditor control unless the creditor holds security pledges. In summary, because attempts at averting the effects of bankruptcy are a prime argument for recovery, accelerated loans could normally be recovered. Further, the FRA precludes recovery from secured creditors, which gives strong incentives to creditors to demand sufficient security pledges. In the absence of sufficient security pledges, acceleration rights are useless to the creditor as the repayment could be recovered.