Controlling Tunnelling through Lending Arrangements: The Disciplining Effect of Lending Arrangements on Value-Diversion, Its Limits and Implications

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'If you owe the bank $100, that is your problem.
If you owe the bank $100 million, that is the bank's problem.'
J. Paul Getty

Abstract

The practices of corporate controllers to divert company value to themselves at the expense of (minority) shareholders and creditors (*tunnelling*) present a continuing challenge for lawmakers to address. While there is a variety of ways to control self-dealing in public companies, one less studied and appreciated lever against value-diversion is the role of lenders of such companies. This article examines the lending arrangements and common contractual provisions (undertakings, (non-)financial covenants, restrictions), and argues that such arrangements have considerable potential to monitor, deter and restrain value-diversion via self-dealing in the debtor companies. Likely limits to such a potential, and various important factors are also examined. The study concludes with possible implications of such findings.

Keywords

Tunnelling, self-dealing, related party transactions, value-diversion, creditor protection, lending arrangements, covenants, debtor companies, lenders, creditor discipline

1. Introduction

Tunnelling indicates the practices of corporate insiders[1] in public companies to divert company value to themselves at the expense of (minority) shareholders and creditors.[2]

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[1] The term 'corporate insiders' is used throughout the study to denote insiders that have controlling power over the company such as directors/managers in a dispersedly-owned company or a controlling shareholder in a controlled company.

[2] See generally Simon Johnson et al., *Tunneling* 90 American Economic Review 22, 22 (2000).

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There is a variety of forms corporate insiders use to divert (extract/tunnel) value (wealth) from the company.[3] The primary example is self-dealing transactions (or related party transactions (RPTs)). Taking this further, Atanasov et al. develop a threefold taxonomy: 'cash flow tunnelling', 'asset tunnelling' and 'equity tunnelling'.[4] While cash flow tunnelling refers to practices which 'remove[] a portion of the current year's cash flow, but do[] not affect the remaining stock of long-term productive assets', asset tunnelling means 'the transfer of major long-term (tangible or intangible) assets from (to) the firm for less (more) than market value'.[5] As for equity tunnelling, the controlling shareholder increases his or her share of the company's value at expense of minority shareholders through dilutive equity issuances or freeze-outs.[6]

Tunnelling has been an important and challenging issue for regulators, policy makers and investors alike. While universally the question is how to create a regime that allows value-increasing self-dealing transactions while preventing value-decreasing ones, the most effective and efficient way to this end is often controversial and far from obvious. One less recognized and studied lever against the tunnelling practices remains the influence of creditors, especially bank and non-bank lenders.

Generally, regulating tunnelling has been framed within the context of a (minority) shareholder protection regime as shareholders are residual claimants of any value residing in a company.[7] And corporate law (in its widest sense) mainly leaves it to the creditors to protect themselves from any risk in their relationships with the debtor companies. Creditors in turn negotiate with the companies to place self-help provisions in their contracts. In this line, this article pursues the idea that self-help creditor protection – the contractual arrangement creditors have managed to negotiate with the debtor companies – may work in a way that monitors, deters or curtails value-diversion from the debtor companies.[8] Indeed, a close examination of the lending arrangements reveals that the arrangements creditors may have with the debtor companies in lending to them – securities, undertakings, (non-)financial covenants,

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[3] *Id.*, at 22–23. *See also* Simeon Djankov et al., *The Law and Economics of Self-Dealing* 88 Journal of Financial Economics 430 (2008).

[4] Vladimir Atanasov et al., *Law and Tunneling* 37 Journal of Corporation Law 1, 5 (2011) [hereinafter Atanasov et al., *Law and Tunneling*]. *See also* Vladimir Atanasov et al., *Unbundling and Measuring Tunneling* 2014 University of Illinois Law Review 1697, 1703–08 (2014) [hereinafter Atanasov et al., *Unbundling and Measuring Tunneling*].

[5] Atanasov et al., *Law and Tunneling*, *supra* note 4, at 5; Atanasov et al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1700–01.

[6] Atanasov et al., *Law and Tunneling*, *supra* note 4, at 5–6; Atanasov et al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1701. For examples of cash flow, asset and equity tunnelling, *see id.*, at 1706.

[7] Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law,* 67 (Cambridge, MA: HUP, 1991) ('shareholders are the residual claimants to the firm's income.'). It is however also acknowledged that creditors will also clearly benefit from such a tunnelling regulation as long as the latter prevents value-diversion from the debtor companies.

[8] While creditors of a public company might be composed of diverse groups, one group of the main creditors is bank and non-bank lenders. They are the creditors with which this study is concerned, not bondholders, trade creditors or non-contractual creditors. See also *infra* notes 40–42 and accompanying text.

restrictions etc. – may have disciplining effects in terms of tunnelling/value-diversion. Accordingly, this article rejects the conventional and simple argument that creditors may not be very concerned with value-diversion as long as the debtor company pays its debts as they fall due. While there is certain truth to this argument, it misses the whole picture, and overlooks how creditors regulate their relationships with the debtor companies and the potential effects of contractual provisions on value-diversion. One of the main contributions and key part of this article is the examination of the ways in which creditors may prevent value-diversion from the debtor companies through contractual provisions even though these provisions may not be directly related to tunnelling. Any such effect will also obviously benefit (minority) shareholders.

Although the creditor-shareholder relationship has mainly been observed as a relationship of conflict,[9] there are situations where creditors' interest would overlap with that of (minority) shareholders and where the debt a company incurs or creditors would function as a means to control agency problems in public companies.[10] I similarly argue that the fact that creditors look after their own interest in their dealings with a company may restrain harmful tunnelling practices, thus also creating positive externalities for (minority) shareholders of the company in the same way that a set of rules protecting shareholders (such as RPT regulation) would redound to the benefit of creditors.

In **section 2**, I examine firstly the general interaction between the debt and corporate governance of a public company. Although corporate governance discourse has largely neglected the role of creditors, there are many ways in which creditors or generally debt may help alleviating agency problems in publicly traded companies. In **section 3**, I turn attention to the disciplining effects of self-help creditor protection in terms of controlling tunnelling. The analysis suggests that contractual arrangements

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[9] See Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance* 34 Journal of Corporation Law 641, 641 (2009) (stating that '[d]ebt and equity are like sibling rivals within the traditional agency cost framing of the firm.'); George G. Triantis & Robert J. Daniels, *The Role of Debt in Interactive Corporate Governance* 83 California Law Review 1073, 1111 (1995) (noting the conflict between shareholders and creditors as the financial condition of the firm deteriorates). *See further* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure* 3 Journal of Financial Economics 305, 334–37 (1976); Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants* 7 Journal of Financial Economics 117, 118–19 (1979) (presenting major sources of conflict between bondholders and shareholders).

[10] See generally Douglas G. Baird & Robert K. Rasmussen., *Private Debt and the Missing Lever of Corporate Governance* 154 University of Pennsylvania Law Review 1209 (2004); Triantis & Daniels, *supra* note 9; Charles K. Whitehead, *Debt and Corporate Governance* in *The Oxford Handbook of Corporate Law and Governance* 470 (Oxford: OUP, 2018); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance* 57 UCLA Law Review 115 (2009). *See also* Louise Gullifer & Jennifer Payne, *Corporate Finance Law: Principles and Policy,* 80–88 (Oxford: Hart Publishing, 2011); Paul Davies & Klaus J. Hopt, *Non-Shareholder Voice in Bank Governance: Board Composition, Performance and Liability* (ECGI Law Working Paper No. 413/2018, 2018), <https://www.ssrn.com/abstract=3226244> (discussing the potential role of bondholders in bank governance).

between a creditor and a corporation show good promise as regards monitoring, proscribing and curtailing the ability of corporate insiders to tunnel value.

Clearly, there are limits to the disciplining effects of the lending arrangements on tunnelling in the debtor companies. In **section 4**, I examine such limits. Especially, the self-interest of creditors and the opportunities for risk transfer may mean that creditor influence on the debtor companies will not work in a mutually beneficial way or that creditors will not be concerned with the debtor companies at all.

Lastly, acknowledging the disciplining effect of lending arrangements and its limits as regards the prevention of value-diversion in public companies will offer some implications. There is a puzzling issue with which scholars have wrestled: (1) why in regimes where tunnelling remains unregulated or poorly regulated, contrary to expectations, public investors purchase shares of such companies in the equity market despite the considerable risk of expropriation, and (2) why companies raise finance from equity markets despite the high cost of capital, and corporate insiders in such companies do not expropriate more than they actually do, despite no observable limit provided by capital markets/corporate law or similar rules. A related question in regimes with developed capital markets law and minority shareholder protection has been why corporate insiders do not exploit more certain loopholes and opportunities legal regimes leave behind in the face of some such real examples. In **section 5**, I argue that the potential disciplining effects of a lending relationship with regard to value-diversion may provide an additional answer to both questions. Then, some forward-looking implications in the light of the findings of this article are put forward.

2. The Interaction between Debt and Corporate Governance

There are various ways in which debt alleviates the principal-agency problem between the managers of a company and its shareholders. Although these means are admittedly not perfect tools, they are of (direct or indirect) assistance to a certain extent and form good complements (rather than substitutes for) to more traditional ways of solving agency and moral hazard problems in listed companies.[11]

First of all, contractual provisions entered into between a company and one of its creditors play an important role whether the company is in financial distress or not. For example, fixed obligations (to pay interest and principal) force the company to disgorge free cash which can create otherwise agency problems.[12] Similarly, some

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[11] See similarly Baird & Rasmussen, *supra* note 10, at 1242–43 (arguing that '[c]reditor control can serve as a complement to … more commonly recognized means of reining in managers …' and linking it to the conditions that 'creditor control … loom[s] large enough to be a credible threat to managers' and that 'creditors' self-interest … lead[s] them to exercise control in a way that maximizes the value of the business').

[12] Triantis & Daniels, *supra* note 9, at 1078; Whitehead, *supra* note 10, at 476–78; Michael J. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers* 76 American Economic Review 323, 324 (1986) ('[D]ebt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers.'); René M. Stulz, *Managerial Discretion and*

covenants or provisions in the loan agreements (which will be examined below) may constrain to a certain extent the behaviour of corporate insiders which can again create agency costs.[13] Furthermore, lenders monitor assumptions of large amounts of debt.[14] Lenders are affected if a company attempts further borrowing (which is called 'sharing problem')[15] and would like to control it through certain provisions and covenants in their contracts.[16] This may redound to the benefit of shareholders because they may also be negatively affected by constant borrowing especially if it is underlined by an agency problem (for example if managers use the lent funds for 'empire-building').[17] Lenders may also use their voice to address the observable problems in the debtor companies (leveraged by their threat to exit) (especially for distressed companies). The extreme example of this voice is the well-documented creditor influence and involvement in termination decisions for existing management.[18] Another example of voice is placing a representative in the board of directors in the debtor companies.[19]

There are also indirect ways for the creditor influence to take place. For example, the market for lending provided (and may still provide) funds for hostile takeovers, thus creating a market for corporate control and for leveraged buyout, which would supposedly discipline managers in public corporations.[20] Furthermore, the debtor

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Optimal Financing Policies 26 Journal of Financial Economics 3, 4 (1990) (stating that 'debt payments force managers to pay out cash flow', affecting shareholder wealth positively 'by reducing [the agency cost of over-] investment when it would be too high').

[13] Triantis & Daniels, *supra* note 9, at 1078; Greg Nini et al., *Creditor Control Rights and Firm Investment Policy* 92 Journal of Financial Economics 400, 415–17 (2009) (finding (suggestively) that creditor-imposed capital restriction promotes efficient investment, and observing an increase in both market value and operating performance after the restriction).

[14] Paul H. Edelman et al., *Shareholder Voting in an Age of Intermediary Capitalism* 87 Southern California Law Review 1359, 1379 (2014).

[15] See Hideki Kanda, *Debtholders and Equityholders* 21 Journal of Legal Studies 431, 432–33 (1992).

[16] See *e.g.,* Baird & Rasmussen, *supra* note 10, at 1233.

[17] Empire-building happens 'when managers [or controlling shareholders] have an interest in expanding the firm beyond what is rational, reinvesting the free cash, pursuing pet projects, and so on.' See Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance* 52 Journal of Finance 737, 742 (1997).

[18] See *e.g.,* Sadi Ozelge & Anthony Saunders, *The Role of Lending Banks in Forced CEO Turnovers* 44 Journal of Money, Credit & Banking 631 (2012) (investigating 'the governance role of banks exercised through the replacement of underperforming CEOs in borrowing firms' and finding that for underperforming firms, '[a]n average level of bank loans outstanding implies a 22% to 47% increase in the forced turnover probability of a borrowing firm's CEO'). *See also* Tung, *supra* note 10, at 157–58 (comparing banks' influence in this regard with that of independent board of directors).

[19] See *infra* notes 132 & 133.

[20] See *e.g.,* Sanjai Bhagat et al., *Hostile Takeovers in the 1980s: The Return to Corporate Specialization,* in *Brookings Papers on Economic Activity: Microeconomics,* 1 (Washington, D.C.: Brookings Institution Press, 1990); William Long & David Ravenscraft, *Decade of Debt: Lessons from LBOs in the 1980s* in *The Deal Decade: What Takeovers and Leveraged Buyouts Mean for Corporate Governance,* 205 (Washington, D.C.: Brookings Institution Press, 1993); Ronald J. Gilson, *Catalysing Corporate Governance: The Evolution of the United States System in the 1980s and 1990s* 24 Companies & Securities Law Journal 143 (2006).

company's reputation of sound corporate governance may provide it with access to new credit sources or lower its cost of capital.[21] Conversely, a bank's exit from a lending relationship may constitute a signal for other stakeholders to intervene to correct an objectionable state of affairs in the debtor company.[22] Jensen also refers to debt as 'powerful agents for change', claiming that companies which could not meet their debt payments force themselves to rethink their entire strategy and structure.[23]

Lastly, lenders may hold a substantial number of shares in a debtor company. This would give further incentives to a lender to monitor the management of the company.[24] But, if lenders such as banks and insurance companies own equity in the debtor company to the point of control, they might themselves consume private benefits to the detriment of other shareholders and other creditors. Significant ownership of equity by banks, however, remains rare.[25]

3. The Disciplining Effects of the Lending Arrangements on Value-Diversion

The effects of debt in terms of ameliorating (agency) problems in a public company are not limited to the abovementioned circumstances. In this section, I argue that self-help creditor protection – the position creditors have managed to negotiate with the debtor companies (depending on their bargaining power and risk taste) in general and

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[21] Whitehead, *supra* note 10, at 476.

[22] Triantis & Daniels, *supra* note 9, at 1087. Managers of a company also have a personal stake in avoiding bankruptcy of the company, which can be triggered by a bank's exit from a lending arrangement, because of its repercussions in the labour market for the managers of a bankrupt company. See Stuart C. Gilson, *Management Turnover and Financial Distress* 25 Journal of Financial Economics 241, 242 (1989) (finding that fifty-two percent of the sample firms in financial distress experienced a senior-level management change and none of the departing managers held a senior management position at another exchange-listed firm during the next three years).

[23] Michael C. Jensen, *Eclipse of the Public Corporation* 67 Harvard Business Review 61, 67 (Sept.-Oct. 1989). *See similarly* Whitehead, *supra* note 10, at 477 (arguing that debt financing increases the risk of bankruptcy and incurring the real costs of financial distress and 'in order to reduce those risks, managers are motivated to maximize profitability, including by reducing business expenses, working harder, and investing more carefully.'). See also Gullifer & Payne, *supra* note 10, at 81.

[24] This is because in such a case, lenders would be exposed to agency costs not only as debtholders but also as shareholders. Yet, if lenders do not hold those shares in their own names but rather as fiduciaries, they may prioritize their creditor position to the detriment of the beneficiaries of shares. See Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism* 79 Georgetown Law Journal 445, 470, fn. 81 (1991). Furthermore, where a bank's position as a creditor vis-à-vis the debtor company is weak (for example because liquidity is high and the debtor company may finance itself through other lenders), the bank may hesitate to use any power it may have as a shareholder of the debtor company in order not to antagonize corporate insiders and jeopardize its lending business. See Bernard S. Black, *Shareholder Passivity Reexamined* 89 Michigan Law Review 520, 600 (1990); John C. Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor* 91 Columbia Law Review 1277, 1321 (1991); Rock, *supra*, at 470, fn. 80.

[25] Rafael La Porta et al., *Corporate Ownership around the World* 54 Journal of Finance 471, 502 (1999).

certain provisions in their lending arrangements in particular – has disciplining effects in terms of curbing and controlling tunnelling in the debtor companies.

The consideration that creditors are more interested in the downside risk than the upside risk[26] (together with another consideration that creditors have fixed claims rather than residual claims) has generally led to the view that creditors will not be particularly concerned with self-dealing.[27] Yet, such a view largely ignores how lenders manage any risk with a debtor company in a lending arrangement (by limiting itself to the payment of fixed claims) and the workings of a lending arrangement over the course of the lending relationship. Nor does it appreciate the potential effects of such an arrangement on the ability of corporate insiders to divert value. Furthermore, the sole consideration that creditors have fixed claims does not reflect truly the state of affairs between a lender and the debtor company. For example, for public companies, most of the loans are revolving loans rather than term loans,[28] which means that the debtor company is allowed to draw down any amount it needs (not exceeding the aggregate borrowing limit) and pay at its discretion (as well as making periodic interest payments), and then to re-borrow and re-pay (ultimately until the loan's termination date).[29] This means that the relationship between a debtor company and a lender is not one-off and the lender is constantly carrying the default risk, which in turn means that the lender is also constantly exposed to the risk of value-diversion from the debtor company. It would be perhaps more illuminating to consider the impact tunnelling may have on the cash flow, income statement or balance sheet of the company, or generally its operations and profitability – the primary considerations for the lenders' credit decisions.[30]

Although lending arrangements may primarily be directed towards protecting the interests of the creditor itself and towards handling the default risk, they simultaneously control self-dealing risk in the debtor company, which is also beneficial for the (minority) shareholders of the company. These lending arrangements would affect the self-dealing risk posed by directors/managers and controlling shareholders alike. In the case of controlled companies, their disciplining effect (in terms of value-diversion) might arise in any type of controlled company, for example, whether family-

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[26] *Cf.* Triantis & Daniels, *supra* note 9, at 1101 (arguing that 'banks often do participate in the upside prospects of their borrowers').

[27] See *e.g.,* Luca Enriques, *The Law on Company Directors' Self-Dealing: A Comparative Analysis* 2 International & Comparative Corporate Law Journal 297, 331–32 (2000) (writing that banks, as fixed claimants, will not be particularly concerned with managers' diversion of assets, as long as there is no risk of the company defaulting).

[28] See *e.g.,* Florin P. Vasvari, *Equity Compensation and the Pricing of Syndicated Loans,* 11 (Apr., 2008), <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1128249> (indicating that most of the loans in the sample are revolving).

[29] For a discussion of term and revolving loans, *see* Tung, *supra* note 10, at 135.

[30] See Atanasov et al., *Law and Tunneling*, *supra* note 4, at 6 (stating that 'cash flow tunnelling primarily affects the income statement and statement of cash flows … asset … tunnelling principally affect[s] items on the balance sheet … In terms of operational impact, asset tunnelling directly affects the company's future operations and profitability …').

owned or state-controlled, although the extent of this disciplining effect would depend on certain other factors in such controlled companies.[31]

In the pages that follow, first (**section 3.1**), an account of how self-help creditor protection can alleviate directly or indirectly the risk of tunnelling in the debtor companies will be given. Lending arrangements reveal that self-help creditor protection may also provide a countervailing power against the risk of tunnelling in the debtor companies, the extent of which may depend on the specific circumstances and some other factors. In **section 3.2**, a summary of main findings and an evaluation are provided.

3.1. How Lending Arrangements May Curb Tunnelling

There are many and various ways whereby corporate lenders may monitor, check and curb tunnelling in the debtor companies. They manifest themselves in the form of security arrangements, (financial or non-financial) covenants, information flow and other miscellaneous provisions. Or, a contractual agreement between the corporate lenders and the debtor company may include a direct RPT provision.[32]

Further, although there seems to be no limit to the imagination of lenders in controlling the debtor company behaviour,[33] not in all lending relationships, all the arrangements that will be examined below will be available. This will depend on the specific relationship between the lender and the company.[34] However, I will predominantly rely on the provisions drawn from the modal agreements provided by the Loan Market Association (LMA)[35] in London and the Loan Syndications and Trading

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[31] See *infra* text and accompanying notes 222–228 (discussing how in the case of wide discrepancies between the cash flow right and voting right of a controller in a company and in non-arm's length lending transactions, the disciplining effect may diminish). Particularly, in family-controlled companies, the discrepancy between the cash flow right and control right (especially through pyramidal structures) may be common. See *e.g.*, Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights,* in *Concentrated Corporate Ownership,* 445 (Chicago: The University of Chicago Press, 2000). The state-controlled companies, on the other hand, may obtain lending easily from other state-controlled financial institutions, creating non-arm's length lending relationships.

[32] See *infra* 'affiliate transactions'.

[33] See Baird & Rasmussen, *supra* note 10, at 1216–17 (arguing that '[t]here are few limits on lenders' ability to insert any conditions or covenants into their loan agreements. … [I]n the limit, these covenants can obliterate the difference between debt and equity.'). Control rights are adjusted to take account of different business types and different economic conditions, and formal legal status (for example being a 'creditor') does not fully reflect what control rights a creditor holds. See *id.*, at 1221 & 1223.

[34] See *e.g.,* Whitehead, *supra* note 9, at 652 (stating that '[c]ovenant levels are determined, in part, by the amount of borrower information that a lender possesses or can cheaply acquire' and lenders may have more relaxed reliance on covenants and monitoring in lending to borrowers with established reputations.). See also *id.*, at 666–67 (relating the decline in covenant levels in loans to private equity borrowers to the role of the reputation of the latter).

[35] See Loan Market Association, <https://www.lma.eu.com/about-us> (last visited 12 October 2021).

Association (LSTA)[36] in New York.[37] These bodies and their documentation have largely dominated the syndicated lending practice across the world.[38] I will also draw on the contractual provisions studied in the financial literature. As a matter of norm, these provisions will feature in lending arrangements concluded in the UK and the US under their respective laws as well as in European, Asian and African jurisdictions.[39]

Lastly, as stated above, I focus on the relationship between the banks and other similar financial institutions as lenders[40] on the one side and companies as debtors on the other side. Banks and other similar institutions are much more able to negotiate stricter terms with the debtor company and to monitor their relationship with the latter than bondholders that buy debt of the company in capital markets.[41] Consequently, bonds include lighter terms than loan contracts and monitoring function is largely assigned to a trustee, which may have few incentives to monitor.[42]

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[36] See Loan Syndications and Trading Association, <https://www.lsta.org/about/> (last visited 12 October 2021).

[37] The documents made available by these bodies to their members are not public, but provisions of loan agreements can be found in practitioner's books. See *e.g.*, Sue Wright, *The Handbook of International Loan Documentation* (London: Palgrave Macmillan, 2nd ed. 2014) (primarily based on the LMA recommended form for an unsecured term loan to an investment grade borrower); Mark Campbell & Christoph Weaver, *Syndicated Lending: Practice and Documentation* (London: Euromoney Institutional Investor, 6th ed. 2013) (based on the recommended form of LMA primary documents); Michael Bellucci & Jerome McCluskey, *The LSTA's Complete Credit Agreement Guide* (New York: McGraw Hill Education, 2nd ed. 2017) (based on the LSTA's model credit agreement provisions).

[38] See *supra* notes 35 & 36.

[39] For example, LMA provides lending documentation for developing markets, some African jurisdictions, Germany, France and Spain. See <https://www.lma.eu.com/documents-guidelines/documents/category/developing-markets#document_index> (last visited 12 October 2021). See *also* Bonelli Erede Pappalardo et al., *Loan Documentation in Europe: Recent Trends and Current Issues* (July 2014), <https://www.uria.com/documentos/publicaciones/4230/documento/BF001.pdf?id=5398> (noting that the LMA's collection of primary documentation is widely and extensively used as a starting point in both the European loan market and elsewhere).

[40] The term 'lender(s)' is used throughout the study to denote not only banks but also similar institutions that lend to companies such as finance companies, insurance companies, investment banks, mutual funds and hedge funds. See in this regard Mark Carey et al., *Does Corporate Lending by Banks and Finance Companies Differ?: Evidence on Specialization in Private Debt Companies* 53 Journal of Finance 845 (1998) (comparing corporate loans made by banks and finance companies, and finding that finance companies lend to riskier borrowers); David J. Denis & Vassil T. Mihov, *The Choice among Bank Debt, Non-Bank Private Debt, and Public Debt: Evidence from New Corporate Borrowings* 70 Journal of Financial Economics 3 (2003) (finding similar results). See also Greg Nini, *How Non-Banks Increased the Supply of Bank Loans: Evidence from Institutional Term Loans,* 2 (Mar. 2008), <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1108818> (stating that 'institutional term loan tranches share the same contractual features as other corporate loans').

[41] See *e.g.,* Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring* 51 Review of Economic Studies 393 (1984); Eugene F. Fama, *What's Different About Banks?* 15 Journal of Monetary Economics 29 (1985).

[42] See Triantis & Daniels, *supra* note 9, at 1088–89; Whitehead, *supra* note 9, at 651; Gullifer & Payne, *supra* note 10, at 82 (stating that '[e]ven where there is a bond trustee, the terms of the trust deed normally exclude all active obligations to monitor and the trustee is only obliged to receive certificates of compliance from the issuer.'); Marcel Kahan & Bruce Tuckman, *Private vs. Public Lending: Evidence*

Security interest. Being a secured creditor enables the creditor to turn to the asset(s) of the debtor company subject to the security interest to satisfy its claim against it in the case of a default on payment.[43] As long as the creditor remains fully collateralized (meaning the (liquidation) value of the asset(s) subject to the security interest is equal to or exceeds the debt owed to the creditor), it would be thought that there is an obviated need to investigate or monitor the borrower on the side of the creditor. While this is partly true,[44] the fact that a creditor has a security interest in the assets of the debtor company effectively prevents the company from dealing with the asset(s) in question without the consent of the (secured) creditor.[45] In such a case, it might be reasonably expected that such a creditor would not agree to the sale of this asset to a related party in an undervalued transaction.[46] If a debtor company has many secured

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from Covenants (July 1993), <https://escholarship.org/uc/item/1xw4w7sk> (comparing the terms of private debt agreements with those of public bonds).

On bond covenants, see Matthew T. Billett et al., *Growth Opportunities and the Choice of Leverage, Debt Maturity, and Covenants* 62 Journal of Finance 697, 699 (2007) (examining the use of restrictive covenants in bonds to control stockholder–bondholder conflicts); Smith & Warner, *supra* note 9 (examining ways in which debt contracts are written to control the conflict between bondholders and stockholders). See also Yakov Amihud et al., *A New Governance Structure for Corporate Bonds* 51 Stanford Law Review 447 (1999) (proposing a new type of bondholder representative, a 'supertrustee' with the authority and incentives to monitor the company actively, instead of conventional indenture trustee); Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights* 103 Northwestern University Law Review 281, 314 (2009) (noting that '[t]raditional investors in corporate bonds – insurance companies and mutual funds – have long taken a hands-off approach to violations of their contractual rights.').

[43] See *e.g.,* Sarah Paterson & Rafal Zakrzewski eds., *McKnight, Paterson, & Zakrzewski On The Law of International Finance,* 815–16 (Oxford: OUP, 2nd ed. 2017); Hugh Beale et al., *The Law of Security and Title-Based Financing,* 17–18 (Oxford: OUP, 3rd ed. 2018).

[44] The secured creditor(s) must still oversee the debtor company to make sure that it does not smuggle the secured assets from the reach of creditors and/or damage the same unless the creditors are in possession of the asset(s). Furthermore, in the case of jurisdictions with badly-functioning judiciary and enforcement organs, secured creditors would still investigate and monitor the borrowers to make sure that they can be paid without having to resort to the enforcement of the security (to the extent that the costs of monitoring would be less than the costs of enforcing the security). Finally, the filing of bankruptcy may bring with itself an automatic stay for any security to be enforced against the property of the debtor company. *See, e.g.,* 11 U.S.C. § 362(a)(5) (2000). Thus, secured creditors may have incentives to oversee the debtor company so that it stays steered off the insolvency.

[45] In a sale of the secured asset without the consent of the secured party, normally a *bona fide* purchaser in an arm's length dealing can acquire the title in the asset without the security interest attached. However, in an RPT, the related party (such as corporate insiders) will be or be deemed aware of the security interest and cannot acquire the title in the asset without the security interest attached. So, it does not make economically sense for those insiders willing to divert value from the company to transact with secured assets. Furthermore, security can take the form of transferring the title in the asset to the counterparty, which in turn means that the transferor (the debtor company) cannot anymore dispose of the asset.

[46] However, creditors may agree to the removal of the security interest over the asset (giving the company the freedom to transact with the asset) in return for another security interest over an asset of the same (or more) value and liquidity.

creditors, the volume, value or scope of assets that may be tunnelled from the company diminishes.[47]

The above explanation deals with a security interest over specific assets of the debtor company. Yet, in commercial world, more usefully, an encompassing security interest over all the assets of the debtor company, but one which allows the company to sell or trade with any of the secured assets without the consent of the secured creditor (unless a certain event occurs), might be available (depending on the legal regime in question) and even be more common.[48] Such a security interest is known as *floating charge* in the UK and is also available under the Uniform Commercial Code Article 9 in the US (known as *floating lien*; but only for assets within the scope of Article 9).[49]

Although such a security interest allows the debtor company to dispose of the assets under the security, the debtor may do so only in the ordinary course of business.[50] This is an important limitation with regard to potentially harmful transactions with related parties. As RPTs that are *not* in the ordinary course of business of the company are

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[47] This is true unless the debtor company grants the security interest to the creditors over the same asset. Furthermore, a (secured or unsecured) creditor may restrict the debtor from granting a security interest over the assets of the debtor that would grant a preferred claim to another creditor in the event of insolvency (except for some cases). Such a provision is generally known as *negative pledge*, and its legal effect does not go beyond being a contractual obligation and thus does not affect an otherwise duly created security interest in breach of this provision. As to the purpose, content and consequences of a breach of a negative pledge clause, see Wright, *supra* note 37, at 197–208. See also Bellucci & McCluskey, *supra* note 37, at 357–61 (calling this covenant 'lien covenant'). For an example clause, see Campbell & Weaver, *supra* note 37, at 414–16. There may also exist a *negative negative pledge clause*, limiting the ability of a borrower to agree to negative pledge clauses with third parties. See Bellucci & McCluskey, *supra* note 37, at 368–70.

There is also an indirect effect of the existence of security interests in the assets of the debtor company. Existing security interests reduce the ability of the company to liquidate assets and thus also the availability of free cash in the company. See Triantis & Daniels, *supra* note 10, at 1078. This would in turn restrict the ability of corporate insiders to divert value from the company without endangering the business of the company. See Jensen, *supra* note 12, at 323 (defining free cash flow as '[…] cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital.'). For a similar argument, see also George G. Triantis, *A Free-Cash Flow Theory of Secured Debt and Creditor Protection* 80 Virginia Law Review 2155, 2158–65 (1994) (contending that security interests by reducing the ability of management to liquidate assets and thus free cash in the company reduce the risk of managerial slack). Another consequence would be forcing the debtor company to raise finance from the capital markets due to the non-availability of internal financing. Lowering the cost of capital in the capital markets requires a credible commitment to the prevention of (value-diverting) self-dealing practices in the debtor company. See also *infra* text accompanying notes 121–123.

[48] See however Gullifer & Payne, *supra* note 10, at 260–61 (discussing the future of floating charge).

[49] See *id.*, at 242–61 (explaining floating charge); Paterson & Zakrzewski, *supra* note 43, at 857–87 (same); Grant Gilmore, *Security Interests In Personal Property,* 359–65 (Boston: Little, Brown & Company, 1965, *reprinted in* New Jersey: The Lawbook Exchange, Ltd. 1999) (explaining 'floating lien' under Uniform Commercial Code Article 9).

[50] However, the interpretation of 'ordinary course of business' by the courts in the UK has been very wide. See Gullifer & Payne, *supra* note 10, at 243; Paterson & Zakrzewski, *supra* note 43, at 866–67.

most susceptible to value-diversion from the company, harmful self-dealing of the corporate insiders is largely curtailed through this security interest.[51]

Finally, security interests in the shares of corporate insiders (for example if the controlling shareholder pledges its shares for obtaining the loan) are especially noteworthy.[52] Generally, such security interests are structured such that if the value of the shares drops below a minimum threshold, the debtor company (or the corporate insider who pledged its shares) has to provide more security or risk the termination of the loan.[53] Among various causes, one reason why the value of shares would drop may be the self-dealing in the company which causes a discount in the share price of the company in the market.[54] This incentivizes the corporate insiders to keep the share value at least above the minimum threshold (agreed in the arrangement providing for the security interest),[55] which may curtail the ability of the corporate insiders to divert value from the company, especially if the stock market incorporates this information immediately into the stock price.

Covenants. Covenants are foremost tools for lenders to control the risk they undertake in their relationship with the debtor company.[56] Covenants can be classified into two categories: (1) non-financial covenants (also called 'undertakings') and (2) financial covenants.

1. Non-financial covenants: These covenants regulate any major decision about the enterprise such as the purchase or sale of any (substantial) assets outside the ordinary course of business (or trading)[57], mergers & acquisi-

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[51] Furthermore, although one should be careful in creating limits to the disposition power of the debtor over the assets under the security if the intended legal nature of the security interest is, for example, a floating charge; a creditor may also prohibit any self-dealing over the secured assets or subject it to its consent if such transactions are not in the ordinary course of business. See Gullifer & Payne, *supra* note 10, at 249–56 (discussing the defining characteristics of a fixed charge and floating charge); Paterson & Zakrzewski, *supra* note 43, at 864–66.

[52] See also María Gutiérrez & Maribel Sáez Lacave, *Strong Shareholders, Weak Outside Investors* 18 Journal of Corporate Law Studies 277, 299, fn. 73 (2018).

[53] See *id.*; Andrew Ewans & Philip Abbott, *Margin Lending: A Brief Introduction* (6 Jun. 2014), <https://www.fieldfisher.com/publications/2013/04/margin-lending-a-brief-introduction>.

[54] The value of the control block may even increase if private benefits which *inter alia* stem from self-dealing are taken into consideration. Yet, what is important here is the value of the share of the company as traded in the stock market, not the value of the shares that would provide control over the company. For the price difference between controlling and non-controlling shares, see Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison* 59 Journal of Finance 537 (2004); Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis* 68 Journal of Financial Economics 325 (2003).

[55] Gutiérrez & Lacave, *supra* note 52, at 299, fn. 73.

[56] Triantis & Daniels, *supra* note 9, at 1093 (stating that '[c]urrent corporate scholarship explains covenants as a means of bonding the commitment of the firm to refrain from behaviour that redistributes wealth from debtholders to shareholders or from investors as a group to managers.').

[57] The terms 'ordinary course of business' and 'ordinary course of trading' have different consequences, the latter being more restrictive than the former. *See* Wright, *supra* note 37, at 205.

tions, and changing the nature of business.[58] They generally prohibit such activities, or require the debtor company to obtain permission from the lenders (while sometimes excluding transactions at fair value from the scope of covenant).[59] These covenants would also catch by definition transactions with related parties (especially practices within the category of asset tunnelling).[60] In such a case, such covenants translate into a direct prohibition on RPTs, or into a requirement of such transactions being at fair value. It might also be reasonably expected that lender(s) would make sure that the transaction is not diverting value from the company to their detriment if they ever consent to such a transaction (which would simultaneously protect the interests of (minority) shareholders).[61] Magnitude of such transactions would also mean that incentives of the lenders to prevent value-diversion from the company are at greatest. Furthermore, lenders may include in the loan agreement a direct undertaking by the debtor company to conduct all transactions at arm's length basis.[62]

2. Financial covenants: such covenants incorporate some financial ratios into the contract, which send different signals to the lenders about the financial health of the company.[63] These covenants are various and pervasive,[64] but

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[58] Tung, *supra* note 10, at 138; Wright, *supra* note 37, at 208–11 (explaining 'no disposals clause' (which restricts major disposals of assets (even if they are at market value) and which is designed to ensure that value is maintained in the debtor company, and to prevent changes in the composition of major assets), 'merger' clause (which restricts mergers and corporate restructuring), and 'change of business' clause (which prohibits change of business)). For some additional restrictions, see *id.*, at 213–20. See also Bellucci & McCluskey, *supra* note 37, at 376–80 (explaining how lenders in the US regulate fundamental changes, asset sales and acquisitions by the borrower). For an example covenant, see further Campbell & Weaver, *supra* note 37, at 416.

[59] For example, the LSTA's modal provision, while generally prohibiting asset sales by the debtor company, allows any disposition at 'fair value', which translates into a requirement of fair value transaction in the case of RPTs. See Bellucci & McCluskey, *supra* note 37, at 378.

[60] However, there might be an exception for intragroup transactions if the other company (party to the pertinent transaction) is included within the scope of 'debtor companies' in the context of the lending arrangement. See Wright, *supra* note 37, at 210. See also Bellucci & McCluskey, *supra* note 37, at 377 (stating that '[i]n terms of intrafamilial mergers, almost universally a credit agreement permits mergers of subsidiaries with the borrower if the borrower is the surviving or continuing corporation.'); *id.*, at 380 (similar as regards the acquisitions).

[61] See Bellucci & McCluskey, *supra* note 37, at 378 (stating that '[s]ales of revenue-generating assets often raise concerns from lenders as to whether the borrower is selling the asset for what it is worth as well as how the sale proceeds are being reinvested in the business.'). However, conflict of interests might arise and mean that value-diversion is not prevented. *See infra* text accompanying note 165.

[62] Wright, *supra* note 37, at 214.

[63] See Wright, *supra* note 37, at 183–85 (detailing the purposes of financial covenants and what they test).

[64] See *e.g.,* Michael R. Roberts & Amir Sufi, *Control Rights and Capital Structure: An Empirical Investigation* 64 Journal of Finance 1657, 1662 (2009) (finding that in their sample, almost 97% of the credit agreements contain at least one financial covenant); Cem Demiroglu & Christopher M. James, *The Information Content of Bank Loan Covenants* 23 Review of Financial Studies 3700, 3707 (2010)

their existence in a lending arrangement depends on the specific circumstances of that lending relationship.[65] I submit that if companies endeavour to comply with such covenants (and thus look after some financial indicators), the ability of corporate insiders to divert value from the corporation is curtailed as well. Below, an account of a set of common financial covenants and their potential effect is given.[66]

a. *Leverage ratio* is generally expressed with a measure of debt as the numerator and a measure of earnings, cash flow or capitalization as the denominator, and limited by a certain cap ratio.[67] This ratio may affect the scope of value-decreasing RPTs with corporate insiders in several ways. First, it affects financial RPTs through which corporate insiders lend to their company over the market interest rate since otherwise the numerator (a measure of debt) and thereby leverage ratio would increase.[68] Similarly, such a covenant might effectively preclude the company to borrow otherwise to enter into an RPT. Secondly, value-decreasing RPTs may be affected because they may cause a decrease in earnings, cash flow or capitalization,[69] which would again cause an increase in the leverage ratio. Especially, cash flow tunnelling which may impact earnings or cash flow of the company (for example, selling outputs to insiders at below-market prices, or buying inputs from insiders at above-market prices),[70] and asset tunnelling (for example, selling an asset to insiders at less than fair value) which diverts all future cash flows associated with the asset and 'reduce[s] the value of the firm's remaining assets and thus the firm's overall profitability' due to the synergy

(stating that for loans with expected maturity of a year or more, the average loan in their sample includes three financial covenants).

[65] See *e.g.,* Michael Bradley & Michael R. Roberts, *The Structure and Pricing of Corporate Covenants* 5 Quarterly Journal of Finance 1 (2015) (examining the covenant structure of corporate loan agreements and its association with several factors).

[66] For an example contractual clause involving some financial covenants, *see* Campbell & Weaver, *supra* note 37, at 409–12.

[67] See Wright, *supra* note 37, at 186–87; Bellucci & McCluskey, *supra* note 37, at 326–27. See also Roberts & Sufi, *supra* note 64, at 1663 (finding that in their sample, 79% of the agreements contain a covenant of this variety).

[68] However, it is possible that if shareholder loans are by law or contract subordinated to other debts, lenders may exclude such debt from the definition of the measure of debt used in the leverage ratio.

[69] Forms of equity tunnelling may affect capitalization of the company. For example, repurchases of shares from insiders at more than fair value, while diluting the value of minority shares, also reduce capitalization of the company. See Atanasov et al., *Law and Tunneling*, *supra* note 4, at 9; Atanasov et al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1707.

[70] See Atanasov et al., *Law and Tunneling*, *supra* note 4, at 7; Atanasov et al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1703–04.

between the different aspects of a firm's business[71] are closely related to this ratio.

b. *Gearing ratio* compares the total amount borrowed by the debtor company with the balance sheet value of the company, or total equity, or tangible net worth, requiring it to be maintained at a certain ratio.[72] This ratio may affect expropriatory financial RPTs which may increase total debt of the company excessively, and other value-diverting RPTs which may affect retained earnings (thus tangible net worth) or the balance sheet value of the company (like cash flow tunnelling and asset tunnelling).

c. *Cash flow covenant* requires a minimum amount of cash flow over a specified period of time.[73] This covenant may especially affect egregious forms of RPTs that disturb the cash flow of a company. At minimum, corporate insiders will be more careful when buying or selling some assets of the company so as not to affect the cash flow of company.[74]

d. *Coverage ratio* requires the borrower to maintain its cash flow or 'EBITDA'[75] at or above a specified multiple of its total interest expense.[76] An accompanying covenant may require the same to be maintained at or above a specified multiple of total debt.[77] Depending on the exact con-

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[71] Atanasov et al., *Law and Tunneling*, *supra* note 4, at 8; Atanasov et al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1704–05.

[72] Wright, *supra* note 37, at 187; Bellucci & McCluskey, *supra* note 37, at 318 (calling this covenant 'net worth ratio').

[73] See Tung, *supra* note 10, at 136. See also Roberts & Sufi, *supra* note 64, at 1663 (finding that in their sample, 13% of the agreements contain a cash flow covenant).

[74] See also Atanasov et al., *Law and Tunneling*, *supra* note 4, at 8; Atanasov et al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1704–05 (explaining how asset tunnelling may have a negative impact on the cash flow and operating performance of the company). However, from the perspective of this covenant, the issue is not whether the transaction is value-decreasing or not. Corporate insiders may also hesitate to enter into value-increasing or value-neutral RPTs if such transactions may affect the cash flow of the company negatively for a period (unless the company is able to convince the lenders to waive the breach of the covenant). By the same token, however, corporate insiders may also hesitate to enter into value-decreasing transactions that affect the cash flow of the company negatively.

[75] 'EBITDA' is an accounting term denoting 'earnings before interest, taxes, depreciation and amortization'. It is different than 'cash flow' because the latter only includes cash actually received or paid out while the former includes cash yet to be received or to be paid out.

[76] See Tung, *supra* note 10, at 137; Wright, *supra* note 37, at 185; Bellucci & McCluskey, *supra* note 37, at 320–21. See also Roberts & Sufi, *supra* note 64, at 1663 (finding that in their sample, 74% of the agreements contain such a covenant).

[77] See Wright, *supra* note 37, at 185–86; Bellucci & McCluskey, *supra* note 37, at 321–22 (calling this covenant 'debt service coverage ratio'). See also *id.*, at 322–23 (explaining 'fixed charges covenant ratio', which factors in capital expenditures, taxes and dividend payments in addition to total debt).

Another restriction can be imposed upon the aggregate amount of lease payment made by the borrower during a fiscal period. See *id.,* at 323–25. Such a restriction can directly impact value-diversion through a related party lease agreement. For example, in the case of a controlling shareholder leasing land or equipment for the operation of the company, expropriatory charges will be limited in order not to fall foul of this restriction. See also Atanasov et al., *Law and Tunneling*, *supra* note 4, at 8; Atanasov et

figuration of this type of covenants, the potential impact on value-diversion would take shape. They may impact the amount of interest that can be paid within the context of a financial RPT (like shareholder loans). For example, if a company cannot increase its cash flow to the same extent, it cannot also pay an unjustified amount of interest to a controlling shareholder on a loan. Likewise, if a company cannot decrease its total interest expense, it cannot enter into value-diverting RPTs that affect the cash flow of a company or 'EBITDA' negatively (as would happen due to practices that can be sorted under cash flow tunnelling and asset tunnelling).

e. *Net worth covenant* sets a bottom end for the value of borrower's net assets (the difference between the value of the company's assets and its liabilities).[78] Such a covenant usually excludes *intangible* asset (thus mainly referred to as *tangible net worth covenant*).[79] It closely relates to value-diverting RPTs. For example, in the case of asset tunnelling whereby corporate insiders buy significant assets from the company (falling under 'property, plant and equipment' on the balance sheet) at discounts or sell such assets to the company at inflated prices, a debtor company would lower the value of its net assets, thus risking going beyond the floor set by the lenders.[80] Similarly, the company would be

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al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1708 (classifying a lease of company assets from a related party at more than fair value as either cash flow tunnelling or asset tunnelling depending on the lease term being short or long).

[78] See Tung, *supra* note 10, at 137; Roberts & Sufi, *supra* note 64, at 1663 (finding that in their sample, 45% of the agreements contain a net worth covenant).

The net worth covenant can also refer to paid-in capital and retained earnings. See Wright, *supra* note 37, at 188; Campbell & Weaver, *supra* note 37, at 411; Bellucci & McCluskey, *supra* note 37, at 316–18. In such a formulation, too, there might be an impact on the scope of value-diversion. For example, cash flow tunnelling or asset tunnelling may reduce earnings of the company, which may violate the bottom end stipulated in the agreement. Furthermore, equity tunnelling in the form of repurchase of shares of the controlling shareholder at more than fair value (which dilutes the value of minority shares) (see Atanasov et al., *Law and Tunneling*, *supra* note 4, at 9; Atanasov et al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1707) will reduce paid-in capital, which may again violate the bottom end stipulated in the agreement.

[79] See Wright, *supra* note 37, at 188; Campbell & Weaver, *supra* note 37, at 411; Bellucci & McCluskey, *supra* note 37, at 316–18.

[80] There is however a noteworthy caveat to such a claim, stemming from the possibility of different book and market values of assets. If there is a difference between the book value and market value of an asset, the ability of corporate insiders to divert value is greater. For example, assume that the book value of an asset is USD 10 million while its market value is USD 12 million and the corporate insider buys that asset at its book value (USD 10 million). In such a case, the company books will show no difference while in fact there has been USD 2 million value-diversion. Such occasions may exist if there has been no write-up even though the market value of the asset rose above its book value. Such a possibility also diminishes the importance of such a covenant for lenders. *See* Wright, *supra* note 37, at 188. This possibility is, however, a reflection of a more general issue that encourages corporate insiders to transfer wealth, namely, legal and accounting arbitrage opportunities. See Atanasov et al., *Law and Tunneling*, *supra* note 4, at 40. International Accounting Standard 16 regarding 'property, plant

deterred from entering into unfair financial RPTs that increase the liability of the company excessively.

f. *Sweep covenants* require loan prepayments upon the occurrence of certain events which inject money into the company (like asset sales or securities issuances) or if the amount of cash in the company exceeds a certain threshold.[81] Such a covenant barely restrains the ability of corporate insiders to tunnel value because a value-decreasing RPT (such as an asset sale at discount) may still occur, and corporate insiders may be oblivious to the fact that cash flowing to the company from such a transaction has to be used to pay down a loan. Yet, if using the cash from such a transaction to pay down a loan would leave the company in a tight spot (also given that the transaction is undervalued), corporate insiders may be deterred from entering into such a transaction.

g. There may also be some covenants that require the debtor company to maintain a certain ratio of short-term assets to short-term liabilities.[82] Such covenants would have an effect similar to that of *net worth covenant*,[83] albeit a limited one, as they only target short-term assets and liabilities.[84]

h. Lastly, there might be some covenants which restrict the ability of the debtor company to pay dividends and other distributions to shareholders.[85] Company laws already include some restrictions in this regard.[86] But they are narrow as far as their extent is concerned. Creditors may and do negotiate stricter requirements for distributions to shareholders

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and equipment' permits reporting companies to carry the relevant asset either at cost or at a revalued amount (less depreciation and impairment), *see* <https://www.iasplus.com/en/standards/ias/ias16> (last visited 12 October 2021).

[81] See Tung, *supra* note 10, at 138; Wright, *supra* note 37, at 189; Bellucci & McCluskey, *supra* note 37, at 380. See also Bradley & Roberts, *supra* note 65, tbl. 1 (finding that of the corporate loan agreements in their sample, 62.5% included asset sale sweeps, 46.2% included debt sweeps, and 45.9% included equity sweeps (defining asset, debt, and equity sweep covenants as covenants that require early repayment of the loan when, under certain conditions, funds are raised through asset, debt, and equity sales after the inception of the loan)).

[82] See Wright, *supra* note 37, at 18; Bellucci & McCluskey, *supra* note 37, at 318–19. See also Roberts & Sufi, *supra* note 64, at 1663 (finding that in their sample, 15% of the agreements contain a liquidity covenant).

[83] The same caveat as mentioned with regard to 'net worth covenant' (stemming from book value vs. market value) is equally pertinent here. See *supra* note 80.

[84] Short-term assets/liabilities or current assets/liabilities are accounting terms that indicate assets which can be liquidated within one year and liabilities which will become payable within one year.

[85] See Bellucci & McCluskey, *supra* note 37, at 390–92. See also Wright, *supra* note 37, at 215 (stating that 'often dividends are permitted if certain financial tests are met after the dividend is paid and provided there is no default'). Furthermore, clauses that restrict the disposal of assets may include payment of dividends as well because, for the purpose of that clause, assets will include cash. See *id.*, at 208.

[86] See generally John Armour et al., *Transactions with Creditors* in R. Kraakman et al (eds), *The Anatomy of Corporate Law,* 109, 125–26 (Oxford: OUP, 3rd ed. 2017).

> and such distributions would include not only dividends but hidden distributions in the form of undervalued RPTs.[87]

In brief, if the debtor companies would endeavour to comply with the requirements of these financial covenants in loan agreements, the potential for tunnelling is instantaneously curtailed. The issue is then how incentivized the debtor companies are to follow such covenants.[88] First of all, compliance with such covenants is constantly monitored through the information flow from the debtor company to the lenders.[89] Secondly, a breach of such covenants would be an event of default and would give the lenders the right to accelerate the loan and terminate the loan agreement.[90] Yet, for most lenders, this might be the 'nuclear option'.[91] Rather, covenants usually function as 'tripwires',[92] the breach of which gives lenders the chance to evaluate the situation of the borrower and renegotiate stricter terms if necessary.[93] Occasionally, breaches of such covenants are waived.[94]

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[87] See Bellucci & McCluskey, *supra* note 37, at 391 (stating that '… [the definition of dividends] not only picks up the layman's understanding of periodic dividends declared by the borrower's board or management body, but also captures any other device by which money could leave the borrower and be paid to equity holders.').

[88] There is a separate issue of whether corporate insiders would still want to comply with (financial) covenants and thus would not tunnel value from the company in a way that would breach such covenants even though complying with covenants is clearly in the interest of the company. See in this regard *infra* text accompanying notes 140–145.

[89] The debtor company is required to provide the lenders with a 'compliance certificate', confirming that the financial ratios have been met (and there has been no default) and setting out its calculations of the figures. See Wright, *supra* note 37, at 180; Campbell & Weaver, *supra* note 37, at 405 (providing an example clause); Bellucci & McCluskey, *supra* note 37, at 330–32.

[90] Events of default are usually enumerated in loan agreements, including breach and non-breach events. See generally Wright, *supra* note 37, at 220–44; Bellucci & McCluskey, *supra* note 37, at 437–62. One of events of default is the breach of financial and non-financial covenants. *See* Wright, *supra* note 37, at 223–24; Bellucci & McCluskey, *supra* note 37, at 444–46. In the case of an event of default, the lenders are entitled to stop advancing funds, to accelerate the outstanding loan, and to terminate the loan agreement. See Wright, *supra* note 37, at 244–46; Bellucci & McCluskey, *supra* note 37, at 463–67. For an example clause of 'Events of Defaults' and remedies for lenders, see Campbell & Weaver, *supra* note 37, at 417–23.

[91] Preferring this route may trigger cross-default clauses in other loan agreements of the debtor company, ultimately leading to the insolvency of the debtor. See Gullifer & Payne, *supra* note 10, at 82 (stating that accelerating and terminating the loan is 'nuclear weapon which could well send the borrower into insolvency'). As to when banks may not choose to 'exit', see Triantis & Daniels, *supra* note 9, at 1087.

[92] *Id.*, at 1093.

[93] Whitehead, *supra* note 9, at 642. On renegotiation of the loan agreements, see Tung, *supra* note 10, at 141–44; Michael R. Roberts & Amir Sufi, *Renegotiation of Financial Contracts: Evidence from Private Credit Agreements* 93 Journal of Financial Economics 159 (2009).

[94] Lenders also renegotiate covenants that become too restrictive and limit the profitable activity of the company. See Whitehead, *supra* note 9, at 651. See also Nicolae Gârleanu & Jeffrey Zwiebel, *Design and Renegotiation of Debt Covenants* 22 Review of Financial Studies 749, 750 (2009) (finding that covenants are tight at first, however frequently relaxed or waived upon renegotiation following a violation); Ilia D. Dichev & Douglas J. Skinner, *Large-Sample Evidence on the Debt Covenant*

However, covenants themselves and their violations provide lenders with tremendous leverage, giving them power over the financial, investment and operational policy of the debtor company.[95] In this context, if taking a course of action which includes self-dealing will violate one of the covenants, then the company is compelled to negotiate with the lenders over the planned course of action (for a waiver or relaxation of the covenant). This will mean that the debtor company has to make sure that this course of action does not include any value-diversion to corporate insiders despite the self-dealing. In the case of a violation, if lenders are able to understand that such breaches are (partly or fully) due to some (value-diverting) RPTs (through the help of their expertise and superior information access),[96] more serious consequences would await the debtor company and thus corporate insiders. For example, the debtor company would encounter an increased cost of capital due to hesitation of the banks to lend or an increase in the strictness of existing lending arrangement,[97] and suffer

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Hypothesis 40 Journal of Accounting Research 1091, 1122 (2002) (stating that 'private lenders use debt covenant violations as a screening device, and frequently waive violations or reset covenants without imposing serious consequences on borrowing firms.'); Roberts & Sufi, *supra* note 64, at 1668 (reporting that in 63% of the covenant violations in their sample, the creditors granted a waiver, yet the exact terms of the waiver are unknown).

[95] Tung, *supra* note 10, at 153–60; Gullifer & Payne, *supra* note 10, at 81 & 83–84. See also Sudheer Chava & Michael R. Roberts, *How Does Financing Impact Investment? The Role of Debt Covenants* 63 Journal of Finance 2085, 2086 (2008) (stating that '[u]pon breaching a covenant, control rights shift to the creditor, who can use the threat of accelerating the loan to choose her most preferred course of action …').

[96] See also Tung, *supra* note 10, at 151 (stating that a covenant 'violation will trigger the lender's scrutiny, and firm managers may be tasked to justify the firm's strategies and forecasts.').

[97] See Nini et al., *supra* note 13, at 410 (finding that 'the renegotiated agreement after the violation [of a covenant] is 51% more likely to contain a restriction on capital expenditures.'); Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights, Corporate Governance, and Firm Value* 25 Review of Financial Studies 1713 (2012) (showing that 'violations [of credit agreements] are followed immediately by a decline in acquisitions and capital expenditures, a sharp reduction in leverage and shareholder payouts, and an increase in CEO turnover.'); Roberts & Sufi, *supra* note 64, at 1666 (referring to prior research that finds that defaults are used 'to extract amendment fees, reduce unused credit availability, increase interest rates, increase reporting requirements, increase collateral requirements, and restrict corporate investment.'); *id.*, at 1688 (finding that in a random sample of 500 covenant violations, in 32% of the cases, existing creditor took some action and the most common action was a reduction in the size of the credit facility (24%) while creditors also increased the interest spread (15%) and required additional collateral (7%)); Whitehead, *supra* note 10, at 475 (stating that 'the violations are often waived by the lenders, but can be costly to borrower because renegotiations may prompt closer scrutiny of the borrower's credit quality and tighter covenant restrictions in both the renegotiated and future loans.'); Tung, *supra* note 10, at 151 (noting that '[t]he second most likely lender response [after granting a waiver] is to impose additional constraints on the borrower.'); Baird & Rasmussen, *supra* note 10, at 1232 (stating that '[i]t is not uncommon for a lender to receive an advanced payment, an increase in interest rate, or more sweeping powers in exchange for not declaring a default [following a covenant violation].'); Gullifer & Payne, *supra* note 10, at 84 (writing that the 'price' for waiving a breach of covenant 'could be a change in strategy by the directors' or 'extra protection for the lender, such as the grant of additional security, a partial repayment of indebtedness, an increase in the cost of loan or the imposition of more restrictive covenants.').

reputational damage.[98] Or, lenders may refuse to advance further funds unless the breach is rectified.[99] Such *ex post* consequences may give the debtor companies (and corporate insiders) *ex ante* incentives not to breach such covenants in a way that may be (partly or fully) attributable to RPTs.[100] Even if such covenants are violated for reasons unrelated to tunnelling, lenders' monitoring over the financial situation of the debtor company and terms with which the company needs to comply might become tighter. This may reduce the scope for value-diversion from the company further in ways that are explained above and below. When such covenants are violated for reasons related to tunnelling, tighter monitoring and terms reduce again the scope for further value-diversion. Lenders may even demand that such mechanisms as to prevent (value-diverting) self-dealing are put in place in the debtor company.[101]

Restrictions on capital expenditures. Such contractual provisions express a certain amount or a percentage of earnings or revenues as a limit on capital expenditures[102] for a certain period.[103] By significantly curtailing the discretion of corporate insiders

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[98] See *e.g.,* Whitehead, *supra* note 9, at 652 (higher cost of capital manifesting itself in the increased level of covenants due to 'bad' reputation); Douglas W. Diamond, *Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt* 99 Journal of Political Economy 689, 690 (1991) (stating that '[r]eputation effects eliminate the need for monitoring when the value of future profits lost because of information revealed by defaulting on debt is large.'). *Cf.* William W. Bratton Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring* 1989 Duke Law Journal 92, 142 (1989) (noting 'the limited force of reputation', and stating that '[m]anagers' and stockholders' incentives to maintain good reputations in the capital markets do not have the staying power of contract promises').

[99] Gullifer & Payne, *supra* note 10, at 83 (stating that '[w]here the loan is a revolving facility, the threat of a refusal to extend any further credit is often enough for the borrower to comply with the wishes of the lender.').

[100] Whitehead, *supra* note 10, at 475 ('[m]anagers … have a strong incentive to ensure the firm complies with the loan's original terms.'); Tung, *supra* note 10, at 125 & 146–47 ('[t]he borrower's management … has strong incentives to comply with its covenants.'); Gullifer & Payne, *supra* note 10, at 82 ('[d]irectors will, in general, wish to comply with the obligations and to avoid breach.'). *See also* Dichev & Skinner, *supra* note 94, at 1121 (reporting strong evidence that managers take action to avoid covenant violations).

Furthermore, rather than being really concerned with the operations and financial situation of the borrower, lenders may use a covenant violation to get out of the loan to re-lend the same amount to another borrower at higher spreads when interest rates have increased in the market. In such cases, the incentives not to violate covenants (due to RPTs or otherwise) are greater in order not to give lenders an excuse to call the loan.

[101] See also Baird & Rasmussen, *supra* note 10, at 1211 (stating that '[w]hen a business trips one of the wires in a large loan, the lender is able to exercise de facto control rights–such as replacing the CEO of a company–that shareholders of a public company simply do not have.'); Tung, *supra* note 10, at 134 (noting that '[t]o the extent it feels that certain changes should be made, the lender has strong leverage to effect the change.').

[102] 'Capital Expenditures' indicate expenditures made to acquire or construct fixed assets, plant, and equipment (including renewals, improvements, and replacements, but excluding repairs).

[103] See Tung, *supra* note 10, at 137–38; Wright, *supra* note 37, at 189; Bellucci & McCluskey, *supra* note 37, at 325–26. See also Nini et al., *supra* note 13, at 405 (noting that '42% of the firms in our sample have a capital expenditure restriction at some point between 1996 and 2005.').

to make such expenditures,[104] the ability to enter into (value-decreasing) RPTs (such as buying an overvalued asset from a related party – a type of asset tunnelling) is also contained.

Restrictions on investments. Along with restricting capital expenditures, loan agreements may also restrict other investments in the form of acquisition of stock or bonds, making loans and entering into guarantees in relation to affiliated or non-affiliated parties (also called 'investment covenant').[105] Such a restriction may closely affect RPTs.[106] For example, loans to corporate insiders at a below-market interest rate, which is a type of cash flow tunnelling,[107] would fall under such a restriction. Similarly, a loan from the debtor company to a subsidiary at below-market terms, thus expropriatory from the perspective of minority shareholders of the debtor company but beneficial for the controlling shareholder who has shares both in the debtor company and its subsidiary, may be constrained through an investment restriction in the lending agreement.[108]

Furthermore, while such provisions would also encompass restriction of guarantees for the benefit of third parties (which would also include related parties), lenders may include a direct provision restricting guarantees by the debtor company.[109] This provision would impact the activities of corporate insiders in directing the company in their control to guarantee their debt or to engage in guarantee-like arrangements to their benefit.[110]

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[104] See Nini et al., *supra* note 13, at 412–13 (finding that companies with a capital expenditure restriction experience a 15 to 20% decline in capital expenditures in comparison to companies without a capital expenditure restriction); *id.*, at 413–15 (presenting evidence that restrictions constrain borrower investment below the contractual limit).

[105] Bellucci & McCluskey, *supra* note 37, at 382–86; Wright, *supra* note 37, at 214–15 (stating that lenders may restrict lending money or giving guarantees).

[106] Such an effect may be even more encompassing than a rule in laws addressing loans to corporate insiders. For example, the Sarbanes-Oxley Act bans corporate loans to directors and executive officers, but does not limit loans to other insiders and affiliates. *See* Sarbanes-Oxley Act § 402(a) (codified at 15 U.S.C. § 78m(k) (2006)).

[107] Atanasov et al., *Law and Tunneling*, *supra* note 4, at 7; Atanasov et al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1704. Loans to corporate insiders that are large enough to significantly affect the company's cash resources are classified as 'asset tunnelling', and loans to corporate insiders that will not be repaid in bad economic times are labelled as 'equity tunnelling'. See Atanasov et al., *Law and Tunneling*, *supra* note 4, at 7; Atanasov et al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1707–08.

[108] See Bellucci & McCluskey, *supra* note 37, at 383 (stating that '[b]y restricting investments in non-guarantor subsidiaries for example, the investments covenant overlaps with the restricted payments covenant in restricting potentially detrimental value extraction from the credit group.'). See further Atanasov et al., *Law and Tunneling*, *supra* note 4, at 8; Atanasov et al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1704 (labelling 'investing in an affiliate on terms the affiliate could not obtain from outside investors' as asset tunnelling). Equity investments in affiliate companies may also be a form of asset tunnelling. See Atanasov et al., *Law and Tunneling*, *supra* note 4, at 8; Atanasov et al., *Unbundling and Measuring Tunneling*, *supra* note 4, at 1704.

[109] See Bellucci & McCluskey, *supra* note 37, at 388–90.

[110] See Atanasov et al., *Law and Tunneling*, *supra* note 4, at 7 (analysing guarantees of loans by third parties to insiders under 'cash flow tunnelling').

Contingency provisions. Loan agreements also build-in some provisions that control for contingencies over the life of the loan.[111] For example, *performance pricing* ties interest rate on the outstanding borrowing to changes in some financial performance metrics (e.g. credit ratings or a ratio with a cash-flow measure (i.e. a measure of credit risk)).[112] Performance pricing (with the accompanying financial covenant)[113] rewards improved performance while punishing and catching faltering performance.[114] Such an arrangement presents corporate insiders with incentives to improve performance and lower the cost of capital (by the way of lower interest rates). This will in turn improve the profitability of the debtor company and its share price. On the other hand, inferior performance will mean higher cost of capital (by the way of higher interest rates), less profitability and a likely decrease in share price. In this context, a value-decreasing RPT which affects the financial performance of the company and the ratio upon which the performance pricing grid is based will mean higher cost of capital and hinder the profitability of the company, giving corporate insiders a reason to hesitate when entering into such a transaction in the first place.[115]

Another relevant contingency provision is *build up* provisions which cause a covenant to become stringent over the time of the loan based on a fixed schedule or upon the occurrence of a prespecified event.[116] Such provisions further contain the ability of corporate insiders to tunnel value in that they tighten the covenants.

Miscellaneous. Contractual provisions that require the debtor company to make periodic specified payments and at the same time to meet some minimum financial criteria (as explained above) reduce the amount of 'free cash flow' that can be used in tunnelling.[117] As long as corporate insiders avoid jeopardizing the business of the company, they would hesitate to enter into value-decreasing RPTs unless some cushion as regards the financial health of the company exists.[118] Committing to long-term debt finance reduces the scope of this cushion.

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[111] See Tung, *supra* note 10, at 147–50.

[112] *Id.*, at 148; Roberts & Sufi, *supra* note 93, at 165 (stating that '[t]he two most common measures on which pricing grids are written are debt to cash flow and credit ratings' and '[a]pproximately 73% of the contracts in our sample contain a pricing grid.'). See also Anne Beatty et al., *The Role and Characteristics of Accounting-Based Performance Pricing in Private Debt Contracts* (Jun. 2002), <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=318399> (investigating performance pricing grids).

[113] There is usually an accompanying covenant, using the same financial ratio as the performance pricing grid and setting a limit just beyond the top of the pricing grid. *See* Beatty et al., *supra* note 112, at 14.

[114] Pricing grids that incorporate deterioration in credit quality as well as improvement are more prevalent in financially stronger companies. See *id.*, at 23.

[115] See also Roberts & Sufi, *supra* note 93, at 161 (noting that 'pricing grids can subject borrowers to a doubling of interest rate spreads as their credit quality deteriorates.').

[116] Tung, *supra* note 10, at 149; Demiroglu & James, *supra* note 64, at 3710, fn. 8; Dichev & Skinner, *supra* note 94, at 1103.

[117] See also *supra* note 12 and accompanying text.

[118] See also *supra* note 47. Free cash flow means cash flow in excess of the amount required to fund all the projects that have a positive net present value for the company. Therefore, unless free cash

Lenders may also have a representative in the board of directors of the debtor company, which provides a pair of monitoring eye[119] and might be expected to be less captured by corporate insiders than other directors.[120]

In addition, the lending arrangement between the lenders and the debtor company may limit the access of the debtor company to further finance in private lending or in the debt market.[121] In such a case, the debtor company may be forced to raise finance in equity markets.[122] To lower its cost of capital in the equity market, the debtor company has to curb value-diversion by self-dealing (or put in place mechanisms to this end), and signal it to the market sufficiently.[123]

Affiliate transactions. Along with all the above-mentioned restrictions on tunnelling in the debtor company, there might be even a direct prohibition on RPTs in the lending arrangement. Although in the form of direct prohibition, such a provision closely resembles a provision in a common RPT regulation within the context of capital markets law/corporate law in a jurisdiction. It allows transactions in the ordinary course of business at prices and on terms and conditions not less favourable to the debtor company than could be obtained on an arm's-length basis from unrelated third parties. It also permits transactions between the debtor company and the wholly-owned subsidiary. For example, LSTA's modal provision provides as follows:

> The Borrower will not, and will not permit any Subsidiary to, sell, lease, or otherwise transfer any property or assets to, or purchase, lease, or otherwise

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flow exists, using corporate funds by the way of entering into value-diverting RPTs has the potential of damaging the business of the company.

[119] See *infra* note 132.

[120] There are reasons to doubt that outside and/or independent directors will effectively conduct their monitoring role vis-à-vis managers and/or controlling shareholders. See *e.g.,* Wolf-Georg Ringe, *Independent Directors: After the Crisis* 14 European Business Organization Law Review 401 (2013); James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel* 48 Villanova Law Review 1077 (2003). As to bias in the boardroom, *see* Antony Page, *Unconscious Bias and the Limits of Director Independence* 2009 University of Illinois Law Review 237 (2009); Julian Velasco, *Structural Bias and the Need for Substantive Review* 82 Washington University Law Quarterly 821 (2004). For a critique regarding the monitoring role of disinterested/independent directors in screening RPTs, see Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal)* 16 European Business Organization Law Review 1, 18–20 (2015).

[121] See Wright, *supra* note 37, at 215; Bellucci & McCluskey, *supra* note 37, at 370–74. See also Roberts & Sufi, *supra* note 64, at 1663 (stating that 'almost 90% of the credit agreements [in their sample] contain either an explicit or implicit restriction on the borrower's total debt').

[122] However, lending agreements may also restrict the issuance of new shares. See Wright, *supra* note 37, at 215. Or, lending arrangements may control the issuance of stock that has debt-like features/provisions (*e.g.* mandatory redemption or mandatory dividends). See Bellucci & McCluskey, *supra* note 37, at 374–75.

[123] Similarly, as long as the lending arrangement reduces the scope of free cash in the debtor company (through fixed payment obligations or covenants), internal funds available to finance projects the debtor company plans to undertake shirk, meaning that the company may be forced to raise finance from capital markets. This in turn implies that the company has to put in place mechanisms signalling good corporate governance to lower its cost of capital.

> acquire any property or assets from, or otherwise engage in any other transactions with, any of its Affiliates, except (a) in the ordinary course of business at prices and on terms and conditions not less favorable to the Borrower or such Subsidiary than could be obtained on an arm's-length basis from unrelated third parties, (b) transactions between or among the Borrower and its [wholly owned] Subsidiaries not involving any other Affiliate …[124]

The definition of the 'affiliate' however seems narrower than the definition of related party normally employed in RPT regulations.[125] The rationale behind such a provision, on the other hand, is the same as in the protection of (minority) shareholders: preventing value-diversion from the debtor company.[126]

Information Access and Expertise. Lenders have tremendous access to information on the debtor company and sufficient expertise to be able monitor self-dealing by corporate insiders in the debtor company.[127] This claim is attributable to several factors:

1. The debtor company gives the lender(s) access to its books and records – an access which is not routinely available to shareholders.[128] Access to the books and records of the company gives the banks the ability to detect any suspicious transaction by the company and assess it fully.

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[124] Bellucci & McCluskey, *supra* note 37, at 398. See also Wright, *supra* note 37, at 101 (in relation to LMA based lending arrangements, stating that lenders may include restrictions on transactions with affiliates). See further *id.*, at 220 (explaining that 'separateness undertakings', designed to reduce the risk of 'substantive consolidation' in the case of a winding up, may include an undertaking to only transact business with affiliates on arm's length terms).

[125] 'Affiliate' is defined as follows: '"Affiliate" means, with respect to a specified Person, another Person that directly, or indirectly through one or more intermediaries, Controls or is Controlled by or is under common Control with the Person specified. For purposes hereof, "Control" means the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of a Person, whether through the ability to exercise voting power, by contract or otherwise.' See Bellucci & McCluskey, *supra* note 37, at 398–400 (commenting that from the perspective of the debtor company, controlling shareholders, sister companies and subsidiaries will be affiliate, while '[o]fficers and directors may not per se qualify as affiliates without the presence of the additional control relationship.').

[126] *Id.* Lenders may also limit amendments to material agreements (including waiving rights) entered into by the debtor company with third parties (including also related parties) that may adversely affect the rights of the borrower under such agreements. See *id.*, at 401–02. Such restrictions may also impact material RPTs which the controlling shareholder attempts to modify to his or her benefit but to the detriment of the debtor company.

[127] This information access and expertise may be even greater than that of other constituencies tasked with monitoring such as (independent) directors. See also Douglas G. Baird & Robert K. Rasmussen, *The Prime Directive* 75 University of Cincinnati Law Review 921, 938 (2007) (stating that 'banks have better information than do directors.'); Tung, *supra* note 10, at 132–33 (noting that '[p]rivate lenders enjoy important informational advantages over directors generally.'); Gullifer & Payne, *supra* note 10, at 82 (agreeing with Tung).

[128] Wright, *supra* note 37, at 215; Bellucci & McCluskey, *supra* note 37, at 337–38.

2. The debtor company commits in its lending arrangement to provide the lender(s) with a steady line of information in the form of periodic financial and operating statements, and with the certifications of compliance with covenants and other provisions in the loan agreement.[129] While this enables the lender(s) to verify the compliance with the loan agreement (*inter alia* with covenants and other provisions), it also facilitates the monitoring of RPTs and cements *ex ante* incentives of the debtor companies and corporate insiders not to engage in tunnelling.
3. The lender(s) may be able to monitor the cash flow of the debtor fully if the lender(s) also provide(s) cash management services to the debtor company.[130] In this way, they would be able to screen and oversee the cash flow of the company that may involve transferring value from the company to corporate insiders to the detriment of the banks (but also (minority) shareholders).
4. The lender(s) also 'enjoy[s] direct access to the firm's management and independent accountants to address any concerns it may have.'[131] In the case of an RPT, in this way, the lenders can make sure that the transaction with the related party does not tunnel value from the company, and thus does not jeopardize the financial well-being of the company (and increase the credit risk).
5. As mentioned above, lender(s) may place a representative on the board of the debtor company.[132] Such a representative would be another source of information flow for the lender(s).[133]

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[129] Wright, *supra* note 37, at 179–80 (stating that the debtor company generally agrees to provide the lenders with annual audited financial statements, half-yearly unaudited statements and in the case of sub-investment borrowers, monthly management accounts); Bellucci & McCluskey, *supra* note 37, at 328–32 (stating that 'credit agreements … require at a minimum that the borrower deliver [sic] annual audited and quarterly unaudited financial statements.'). Furthermore, the debtor company may be required to provide the lenders with copies of all documents which the borrower sends to its shareholders, and such further information about its business (or that of any group member) as any lender may reasonably request. See Wright, *supra* note 37, at 181–82; Bellucci & McCluskey, *supra* note 37, at 334–35. For an example of information undertakings by the borrower, see Campbell & Weaver, *supra* note 37, at 404–09. *See also* Triantis & Daniels, *supra* note 9, at 1084; Tung, *supra* note 10, at 138–40.

[130] Gullifer & Payne, *supra* note 10, at 81–82.

[131] Tung, *supra* note 10, at 139. *See also* Bellucci & McCluskey, *supra* note 37, at 337–38. Corporate insiders may also be more willing to reveal inside information to the banks than to the market (especially institutional shareholders) thanks to the duty of confidentiality of banks against the debtors. See Triantis & Daniels, *supra* note 9, at 1084. On the duty of confidentiality, *see* Paterson & Zakrzewski, *supra* note 43, at 707–09. Furthermore, (given the increased participation of non-bank lenders in syndicates), there might be confidentiality undertakings in the loan. *See* Wright, *supra* note 37, at 287–88; Bellucci & McCluskey, *supra* note 37, at 625–36. For an example 'confidentiality' clause, *see* Campbell & Weaver, *supra* note 37, at 454–58.

[132] Gullifer & Payne, *supra* note 10, at 82. See also Randall S. Krozner & Philip E. Strahan, *Bankers on Boards: Monitoring, Conflicts of Interest, and Lender Liability* 62 Journal of Financial Economics 415, tbl. 1 (2001) (displaying the frequency of commercial bankers on the boards of large non-financial firms in Germany, Japan, and the United States).

[133] Tung, *supra* note 10, at 139. Lenders would not also have illiquidity or insider trading liability concerns as opposed to (minority) shareholders who would try to place a representative on the board.

6. The lender(s) may have special expertise in evaluating the fairness of RPTs as there may be some staff who have necessary skills and proficiency in this regard or an investment bank within the own body of a lender.[134]
7. Moreover, lenders tend to specialize in lending to particular industries or industry segments.[135] This also provides another type of expertise in evaluating the fairness of RPTs, meaning that they could make a situation-specific analysis of an RPT.[136]

Financial distress. When a company enters into a financially distressed phase, self-help creditor protection reaches its peak.[137] Restructuring existing debts is a common phenomenon, which leads to a lending arrangement that provides creditors with far-reaching protections and an all-encompassing security interest (if they do not already exist). Such an arrangement may even lead to a *de facto* control by a few creditors.[138] In such cases where debt owed to the creditors cannot be fully satisfied by the assets of the debtor company, and creditors depend on the value of the company as a going-concern, value-decreasing RPTs are out of question.

3.2. A Summary of Findings and Evaluation

I have so far argued that lenders have tremendous influence on self-dealing in the debtor companies and preventing value-diversion through the provisions they negotiate in their lending arrangements. This influence can be divided into two categories: (1) direct influence and (2) indirect influence. Direct influence takes the form of provisions on disposal of assets, mergers & acquisitions, distribution to shareholders, and affiliate transactions. Such provisions either proscribe transactions that can tunnel value or require the lenders' consent for the relevant transaction to take place. A requirement of lenders' consent to an RPT may also arise if a security interest exists in the asset(s) subject to the transaction. Furthermore, in negotiations with lenders over a course of action which includes self-dealing and is such as to violate a covenant, lenders again have a direct say (in that they need to waive the violation or relax the covenant for the debtor company to carry out its intentions without breaching the relevant covenant). In all these cases, direct lender influence may translate into less value-diversion from the company, thus creating a *disciplining effect*.

Indirect influence similarly stems from various sources. First, an encompassing security interest over all the assets of the debtor company bars transactions outside

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[134] In such a case, however, a conflict of interest might arise. *See infra* text accompanying note 165.

[135] Tung, *supra* note 10, at 140. *See also id.*, at 133 (comparing outside directors' industry expertise with that of a private lender).

[136] Moreover, if banks encounter similar RPTs in different debtor companies, they can make use of the expertise acquired in one transaction for other transactions and compare transactions to evaluate their fairness.

[137] See Gullifer & Payne, *supra* note 10, at 87 (stating that '[t]here is a far greater incentive for a creditor to protect its own interests' in the twilight period before insolvency).

[138] Baird & Rasmussen, *supra* note 10, at 1227.

the ordinary course of business. Second, lending arrangements may effectively compel the debtor companies not to harbour any self-dealing in order not to increase their cost of capital, reduce their profitability, or peril their financial well-being. Last but not least, there is the effect of the provisions that require the debtor companies to comply with some financial requirements and restrictions. As long as companies endeavour to abide by these provisions, there will be less room for value-diversion from the company.

One can still argue that corporate insiders may still not hesitate to divert value and trip one of the wires, even at the expense of heightened lender scrutiny and stricter requirements which fall on the debtor company in the first place, not directly on the corporate insiders.[139] Yet, covenants may still affect the incentives of corporate insiders to a certain extent. For example, assume that there is a controlling shareholder in the debtor company, owning 50% of the shares of the company. Further assume that this shareholder enters into a transaction with the company which is valued at USD 6 million while the true value is USD 10 million. The *net* gain for the controlling shareholder is USD 2 million.[140] If this transaction causes the company to violate one (or some) of the provisions of the lending arrangement, the violation may translate into further costs for the company for the existing loan or subsequent loans (for example, in the form of increased interest rate, collateral, fees, covenant or reporting requirements or reduced credit availability and corporate investment).[141] Further, such stricter requirements may mean less capital to buy productive assets or invest in positive net value projects or less ability to make such investments, which means less operating performance and profitability, generating further costs. In addition, tunnelling itself may negatively impact the operating performance or profitability of the company.[142] There may be even costs outside the lending relationship such as an increase in the risk premiums demanded by trade creditors (or suppliers).[143] If the overall notional amount of all these costs of the breach for the company amounts to

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[139] See also *infra* text accompanying notes 222–228.

[140] The gain for the controlling shareholder is USD 4 million; however, he or she will also bear half of the loss for the company, which is USD 2 million.

[141] One can expect the violations of loan agreement (*e.g.* covenants or other restrictions) to be low-cost events for companies of good financial health. Yet, they can still be costly (in the form of review of the company's operations, the need to produce updated financial reports and to explain and justify to the lenders the strategy as well as reduced managerial time, and waiver or modification fees for the banks), giving incentives to avoid them as far as possible. See Dichev & Skinner, *supra* note 94, at 1096. Furthermore, a study finds that companies switch from private debt (bank) to public debt (junk bonds) for financing, not due to deteriorating financial health, but to avoid constraints and monitoring bank financing involves, supporting the idea that bank financing, and constraints/monitoring it brings are costly to companies even if they are in good financial health. See Stuart C. Gilson & Jerold B. Warner, *Private Versus Public Debt: Evidence from Firms that Replace Bank Loans with Junk Bonds* (Oct., 1998), <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=140093>.

[142] See Atanasov et al., *Law and Tunneling*, *supra* note 4, at 7–8. See also *id.*, at 36–37 ('[T]he bottom line impact on earnings or the damage to shareholder perceptions about the firm could reduce the value of the controller's shares').

[143] See also Baird & Rasmussen, *supra* note 10, at 1232 (stating that '[a] default signals to the rest of the world that the debtor is in financial difficulty and is at loggerheads with its creditors.').

or exceeds USD 4 million in total, any net gain for the controlling shareholder entering into RPT will be cancelled out.[144] Furthermore, if the RPT in question falls foul of the provisions directly regulating an RPT (such as 'no disposals' or 'affiliate transactions' provisions), as well as the normal consequences of a breach (triggering an event of default, giving the lenders the right to accelerate and terminate the loan), lenders may ask for specific performance, thus rectifying the breach, or an injunction to prevent the transaction from being completed.[145]

It is also possible that although a corporate insider diverts value from the debtor company, the latter is still able to abide by the lending arrangement.[146] As regards financial covenants/provisions, this is especially likely in the case of large and financially healthy companies.[147] Still, in such a case, the ability of corporate insiders to self-deal is curtailed to a certain degree because it may not be possible to constantly divert value from the company while remaining in compliance with the loan agreement, especially given that covenants are tight.[148] Secondly, if there is a performance pricing grid in the loan agreement which also takes account of credit deterioration in the form of some financial ratio, value diversion may affect the latter and cause more costs for the company (in the form of increased interest rate) and thus also a cost for corporate insiders to consider.[149] Lastly, although lenders may not have leverage against the debtor company or may even be oblivious to the value-diversion as the company has still remained in compliance with the agreement, such a behaviour,

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[144] Because the controlling shareholder will bear USD 2 million of these costs.

[145] However, in common law countries which the loan agreements examined in this study stem from, specific performance as a remedy will be an exceptional remedy. *See* Wright, *supra* note 37, at 317.

[146] This may be possible for example because the corporate insider is also propping up the company for the latter to remain in compliance with the loan. This might be especially likely in corporate groups where tunnelling is also more likely to occur. For 'propping', see Curtis J. Milhaupt & Mariana Pargendler, *Related Party Transactions in State-Owned Enterprises: Tunneling, Propping, and Policy Channeling,* in *The Law and Finance of Related Party Transactions,* 245 (Cambridge: CUP, 2019). Although propping may cancel out tunnelling, sister companies in the corporate group will in turn be harmed, and there is a great chance that propping will be reversed after the loan has been terminated.

It may also be that despite diverting value, corporate insiders endeavour to make the company more profitable and efficient so that the company is still able to abide by the loan agreement. This means that although there will still be value diversion, it may be cancelled out by more value-production in the company.

[147] In terms of non-financial covenants/provisions that may relate to RPTs, certain exceptions or the limited scope of the provisions may let value-diverting RPTs occur without breaching the lending agreement.

[148] See Dichev & Skinner, *supra* note 94, at 1093. Similarly, using accounting tricks to be able to stay in compliance with the loan agreement (despite value-diversion) is not sustainable on the long-term. See Tung, *supra* note 10, at 147, fn. 146. Furthermore, a study, examining company performance, finds that an unusually large number of companies cluster just shy of a covenant violation point and this pattern becomes more pronounced over the loan's later years, suggesting real management in response to covenant constraints. See Dichev & Skinner, *supra* note 94, at 1093.

[149] Performance pricing grids which also take account of credit deterioration along with credit enhancement are more common in large and healthy companies where it would also be expected that some value-decreasing RPTs do not bring about a violation of the lending agreement. See *supra* note 114.

which they will still be able to detect thanks to their superior information access and expertise, constitutes a signal for the lenders that there are some, and may be further, actions in the company that put them at risk.[150]

Corporate groups present other issues in relation to (financial or non-financial) covenants and complying with them. For example, in the case of a loan to a subsidiary guaranteed by the parent company, it is possible that financial covenants are tested at the group level, and any debt relationship between the parent and the subsidiary is disregarded in the definition of relevant measures.[151] In such a case, value-diverting shareholder loans (from the parent to the subsidiary above the market rate) will not be exposed in financial covenants. Yet, even there will exist an ultimate limit to value-diversion, because otherwise, the parent company to where value has been diverted will be liable for any default by the subsidiary as a guarantor. Furthermore, when a loan facility is provided to a number of companies within a corporate group, intra-group transactions may be permitted among the debtor companies under the 'no disposals clause' (but not with group companies that are not debtors).[152] For such a loan, however, financial ratios may be tested at both group level and a particular debtor company level.[153] When this is the case, financial covenants may still affect certain value-diversion from individual debtor companies within the group, and lenders will still be concerned about transactions with other group companies excluded from the scope of financial covenants.[154]

4. The Limits to Disciplining Effects of the Lending Arrangements on Value-Diversion

4.1. Lender Liability

The leverage of lenders over the debtor companies mostly stems from their rights in a lending relationship. But, if lenders are not able to exercise what they have bargained for due to restrictions imposed upon by a court, their leverage weakens. Yet, courts

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[150] Furthermore, loans to public companies mostly have short-term maturities. See Roberts & Sufi, *supra* note 93, tbl.1, Panel B. In rolling over the loan or granting a new loan, lenders may take account of risks they have observed, and reflect them in the increased cost of capital. *See* Whitehead, *supra* note 10, at 478. See also Michael J. Barclay & Clifford W. Smith, *The Maturity Structure of Corporate Debt* 50 Journal of Finance 609, 612 (1995) (noting that through short-term loans, 'the bank maintains a stronger bargaining position').

[151] See *e.g.,* Campbell & Weaver, *supra* note 37, at 410–12.

[152] Wright, *supra* note 37, at 32. A similar exception may exist as regards the 'affiliate transactions' provision in the credit agreement. See Bellucci & McCluskey, *supra* note 37, at 400 (stating that '[t]ransactions between and among the borrower and its subsidiaries are allowed at least in facilities where the lenders are looking to the consolidated group to support loans made available to the borrower, although in a credit agreement in which not all of the subsidiaries are guarantors, only transactions between and among the borrower and its guarantor subsidiaries may be permitted.').

[153] Wright, *supra* note 37, at 32.

[154] *Id*.

do refrain from meddling with the lending contracts as long as creditors duly used their contractual rights negotiated with a sophisticated party (like a publicly listed company).[155]

A few legal doctrines, however, that come into play in the case of insolvent companies might make lenders warier of using their power over the company when it is still solvent.[156] Equitable subordination, for example, may cause a lender's claim against the debtor company to be subordinated to the claims of other creditors.[157] Yet, the reach of these doctrines is limited, especially if lenders cannot be deemed as having control over the debtor company, and conditions are demanding (for example, requiring an inequitable conduct).[158] In most cases, lenders will make sure that they are not perceived as controllers of the debtor company, and lenders' conduct during the lending relationship will not trigger such doctrines. Therefore, the effect of such doctrines to deter lenders from using their power over the company is not very significant.[159]

4.2. Self-Interest of Lenders

Lenders are not saints or charitable organisations. It is reasonable to expect that in their relationships with the debtor companies, they will only look after their own interests.[160] It has been argued above that in doing so, they may curtail tunnelling in the debtor companies to a certain extent, and thus benefit also (minority) shareholders that are vulnerable to value-diversion.[161] Yet, self-interest of the lenders may not always translate into a mutually beneficial situation.

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[155] See Baird & Rasmussen, *supra* note 10, at 1235.

[156] See also Gullifer & Payne, *supra* note 10, at 84–85 (indicating the risk of being classified as a 'de facto director' or 'shadow director' if a lender becomes too involved in the operation of a company). The risk of such a classification for lenders is slight as long as lenders do not step outside the usual lender-borrower relationship where lenders are deemed to be entitled to keep a close eye on the borrower's operations and to impose conditions on the company. *See id.*

[157] Other doctrines include 'voidable preference' or 'transaction avoidance', which basically reverses payments made to the creditor within a certain period before the bankruptcy when the debtor company was insolvent. To be deemed as having control over the company may make the conditions to be fulfilled lighter.

[158] See Triantis & Daniels, *supra* note 9, at 1091–1103.

[159] See similarly *id.*, at 1102 (arguing that '[t]he risk of lender liability is probably insufficient to deter intervention by banks who have otherwise both the incentive and expertise to take steps to correct managerial slack.'). Tung also argues that the design of creditor-debtor law should consider corporate governance spillovers of lender influence because the shadow of liability may overdeter lenders from exercising their contractual leverage. *See supra* note 10, at 174.

[160] See Baird & Rasmussen, *supra* note 10, at 1243 (stating that 'there is little reason to think that creditors with control rights will advance any one else's interest except to the extent it advances their own.').

[161] See also in relation to lender activities in financially distressed firms, *id.*, at 1245–47 (arguing that 'senior lenders can promote their own economic well-being by maximizing the value of the business.').

First of all, self-interest of the banks may dictate reputational constraints, especially when the liquidity in the market for lending is high and money is cheap.[162] In such cases, banks may be averse to be seen as over-intrusive, which might also mean that they overlook some self-dealing practices and value-diversion in their debtor companies, especially in large and financially healthy companies where there seems no imminent default risk. One offsetting consideration comes from the growth of secondary credit market.[163] The buyers of loans in these markets have less concern about their reputation in their dealings with the debtor companies. Therefore, they might be less willing to let the debtor companies go unchecked and more disposed to take action.[164]

Banks' reliability as a gatekeeper can also be questioned. Conflicts of interest may arise.[165] For example, as well as being a large lender, a bank (or an investment bank within its own body) can assume the role of the transaction manager in the case of a material RPT. To put it mildly, fee earnings from such a role may alleviate any concern such a transaction may cause for the lending arrangement. There are also similarly some offsetting considerations. The typical loan is today syndicated, meaning that there is more than one lender against a debtor company.[166] Decisions in a syndicate require either a unanimous decision or a (simple or qualified) majority.[167] This means that even if one bank is conflicted, other lenders may not be. They may not be willing to leave any room for manoeuvre to corporate insiders or to tolerate value-diversion. Similarly, companies, particularly large ones, may have more than one lender, especially to prevent hold-up problem by relying only on one lender.[168] In such a case, each lender monitors its own relationship, and not all lenders will be conflicted. In addition, there may be an effect of the lender liability doctrines. As well as limiting the ultimate power of the lender over the company, they also constrain the power of a lender to benefit at the expense of other stakeholders.[169] For example, a

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[162] Tung, *supra* note 10, at 134 (stating that '[w]hen market conditions favour borrowers over lenders … lenders may feel constrained by market competition from pressing managers so aggressively that they refinance with a different lender.'); Dichev & Skinner, *supra* note 94, at 1096–97.

[163] See *e.g.,* Steven Drucker & Manju Puri, *On Loan Sales, Loan Contracting, and Lending Relationships* 22 Review of Financial Studies 2835, 2835 (2009) (indicating that loan trading grew from USD 8 billion in 1991 to USD 238.6 billion in 2006 in the US).

[164] See Tung, *supra* note 10, at 161, fn. 220.

[165] See further Triantis & Daniels, *supra* note 9, at 1111, fn. 145.

[166] See also Amir Sufi, *Information Asymmetry and Financing Arrangements: Evidence from Syndicated Loans* 62 Journal of Finance 629, 629 (2007) (describing the growth of syndicated loans in the US).

[167] See *e.g.,* Paterson & Zakrzewski, *supra* note 43, at 456–59. *See further* Wright, *supra* note 37, at 285–87 (explaining the LMA clause that regulates the level of consent between the lenders required for an amendment or a waiver of provisions of the documents); Bellucci & McCluskey, *supra* note 37, at 510–20 (explaining the LSTA voting provision).

[168] See Whitehead, *supra* note 10, at 473–74 (explaining the hold-up problem); Joel Houston & Christopher James, *Bank Information Monopolies and the Mix of Private and Public Debt Claims* 51 Journal of Finance 1863, 1888 (1996) (suggesting that multiple lending relationships mitigate hold-up problems).

[169] See similarly Triantis & Daniels, *supra* note 9, at 1102.

large lender that consents to a value-diverting RPT in return for other business or a security interest risks its claim being subordinated to other creditors (in the case of insolvency).

Lastly, although lenders' self-interest may directly or indirectly restrict tunnelling, the same may also restrict value-increasing self-dealing. Using the leverage given to them through the lending arrangement, they may object to value-increasing projects that include RPTs but seem risky. Another reason for objection might be that a value-increasing RPT will substitute a liquid asset with an illiquid one. Except for a few restrictions, lenders' discretion remains unfettered in using their rights granted by the lending agreement, and thus they are able to assert their own preference over a policy that might benefit the company and thus shareholders.

4.3. Opportunities for Risk Transfer and Developments in the Market for Lending

In the traditional framework, contractual protections and monitoring have been the principal means for lenders to manage credit risk. A liquid credit market was close to non-existent, and the benefits of diversification only inured to equity holders.[170] Yet, there has been a significant change in this regard brought about by a growing secondary credit market and the emergence of new ways for the lenders to manage their credit exposure (i.e. transfer or diversify away their credit risk).[171] Such a change may limit their reliance on contractual protections and monitoring, which in turn implies a limited role for the debt to play within corporate governance.[172]

There are various ways for lenders to transfer or diversify away the credit risk incurred in a lending relationship: (1) syndication, (2) loan sales in the secondary market, (3) using securitization and derivatives. In a syndicated loan, one or a few lead bank(s) negotiate(s) the lending arrangement with the borrower, followed by a participation of the other banks in the loan. In such a case, each bank caps its credit exposure by its participation.[173] In loan sales, a lender transfers its interest in a loan to investors in the secondary market through one of various legal mechanisms.[174] In securitization, the sponsoring bank sells a loan portfolio to a special purpose vehicle that in turn issues securities (the so-called 'collateralized loan obligations' or 'CLOs') to public investors to finance the purchase of loans.[175] Finally, lenders may hedge the

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[170] Whitehead, *supra* note 9, at 653.

[171] For an account of the evolution of the credit market, see *id*., at 654–61.

[172] *Id.*, at 651 ('[s]ubsequent changes in the lending business have introduced the possibility of lower cost alternatives, prompting an evolution in the role of debt within corporate governance.'). See also Whitehead, *supra* note 10, at 471–72.

[173] See Paterson & Zakrzewski, *supra* note 43, at 452.

[174] Mechanisms used to transfer an interest in the loan are various, producing different legal results, and depend on the law governing the transfer. For the mechanisms used under English law, see Wright, *supra* note 37, at 249–57; for those used in the US, see Bellucci & McCluskey, *supra* note 37, at 541–72.

[175] See Paterson & Zakrzewski, *supra* note 43, at 747 ff.

credit risk through derivatives, mainly through credit default swaps ('CDS').[176] In such an arrangement, the counterparty undertakes to reimburse the lender for any losses incurred as a result of the occurrence of one of the 'credit events' agreed in the derivative agreement (for example, a default in the payment of principal or interest on a loan). In return, the lender pays a premium over an agreed period.[177]

A common point in all these arrangements is that lenders reduce or dispose of the credit risk, which implies less need for monitoring the borrower and using self-help creditor protection (through covenants and other contractual arrangements). A corollary is the 'decoupling of economic interest and control':[178] a lender who has reduced or disposed of the credit risk but still in control of the loan may not be (or be less) interested in monitoring the borrower (to the detriment of those who bear the economic interest).[179] Even if the counterparties (buyers of the credit risk) are in control of the loan, they may prefer to manage their risk by diversifying or may be less able to oversee the borrower (in comparison to sellers of the credit risk).[180]

During or in the aftermath of the last financial crisis, such arrangements have been said to cause agency and moral hazard problems, and have gone through a sort of turbulence, receiving heightened regulatory attention. Nevertheless, they seem to be here to stay, changing the traditional framework of lender monitoring fundamentally.[181]

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[176] For a discussion of the risks and benefits of credit derivatives, see Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives* 75 University of Cincinnati Law Review 1019, 1032–50 (2007). For their use and function, *see* Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation* 12 Fordham Journal of Corporate & Financial Law 167 (2007).

[177] See Paterson & Zakrzewski *supra* note 43, at 664.

[178] See Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions* 156 University of Pennsylvania Law Review 625, 728–35 (2008).

[179] In addition, as with shareholders, hedging economic risk (*e.g.* through a credit default swap) may give perverse incentives. In our context, for instance, a creditor which is over-insured through a CDS stands to profit from value-diversion from the debtor company that ultimately leads to a default. See Tung, *supra* note 10, at 168 (stating that 'credit default swaps might not only weaken private lenders' monitoring incentives, but might also encourage them to pursue value-destroying strategies to maximize their private profits.'); Hu & Black, *supra* note 178, at 731.

[180] See Whitehead, *supra* note 10, at 482; Gullifer & Payne, *supra* note 10, at 86 (stating that loan transfers, participations, securitization and credit derivatives 'potentially weaken the role of debt in corporate governance, as the person with the right to pull the levers of governance may not be the person who is exposed to the risk which incentivises the monitoring and governance.'). For example, in a securitization, the purchaser of a portfolio of loans from the sponsoring bank is managed by a trustee who may have little incentive to get involved in the loans. See Henry T.C. Hu & Bernard Black, *Debt and Hybrid Decoupling: An Overview* 12 The M&A Lawyer 3, 8 (2008). See also Hu & Black, *supra* note 178, at 729 (stating that in loan participations whereby a bank transfers some, most or all of the economic stake to other lenders, while in some cases, the seller bank agrees to exercise rights stemming from the loan as instructed by the buyer, in other cases, the seller bank is left with control rights). Lack of action or oversight by banks that lent billions of dollars to Enron (either while it was thought to be healthy or during financial deterioration) was linked to credit derivates the banks entered into. See Partnoy & Skeel, Jr., *supra* note 176, at 1032–33.

[181] See Whitehead, *supra* note 9, at 673 (arguing that 'increased regulatory and market focus suggest that, rather than halting growth, the current downturn may lead to a healthier financial system and further expansion of private credit.'). See also *id.*, at 650 (arguing that 'significant differences between

Yet, there are still reasons why the debt may still function as one of the levers in corporate governance.[182] These reasons also suggest that we may still expect a certain degree of restriction on tunnelling in the debtor companies along the lines of the traditional framework explained above, or differently.

In loan sales, although the seller bank disposes of the credit risk, the buyer now carries it. And the buyer generally acquires, alongside the cash flow rights from the loan, the contractual rights (such as undertakings to provide financial information, to obey covenants etc.).[183] This means that there is nothing more than a change of the identity of the lender. On the contrary, in the case of distressed debt, vulture funds that buy such debts (at a discount) in the secondary market usually assume an active monitoring of the debtor, and would provide 'another pair of eyes' over the debtor company in distressed times where tunnelling may be of concern.[184]

Furthermore, there are cases where the seller bank retains an economic risk (albeit a limited one), and for this reason may still continue to monitor the borrower.[185] For example, depending on the arrangement, the buyer may require the seller bank to hold

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subprime and corporate loans suggest that the agency problems that sparked the current crisis may not apply equally to corporate credit.').

[182] See generally *id.*, at 654–61. See also Whitehead, *supra* note 10, at 479–87; Tung, *supra* note 10, at 163 (stating that 'offsetting considerations in loan syndication and secondary loan trading tend to bond lenders as faithful monitors.'); Gullifer & Payne, *supra* note 10, at 85–86 (arguing that although 'the most effective and economically efficient monitoring and influence is exercised by a single bank lender', '[e]ven where finance is provided from a number of sources [as in a syndication] … it appears that the influence of a bank lender is still significant.').

[183] For example, *see* the effects of 'assignment' and 'novation', two of the main methods used under English law, Wright, *supra* note 37, at 250–55. In sub-participations, parties will make provisions in their contract regarding the exercise of lender's rights. *See* Paterson & Zakrzewski, *supra* note 43, at 719.

Moreover, loans for resale have been found to have significantly more covenants than other loans. See Drucker & Puri, *supra* note 163, at 2837 ('Our results show that sold loans have significantly more covenants than loans that are not sold.'); *id.* at 2856 (finding that loans to the borrowers with mixed reputations (receiving different credit ratings) are more likely to be sold when they include more restrictive covenants), and *id.*, at 2858 (finding that including more restrictive covenants and more covenants increases the likelihood of the sale when the reputation of lead lenders is not high).

[184] Whitehead, *supra* note 9, at 665. See also Michelle M. Marner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing* 77 Fordham Law Review 703, 706 (2008) ('An investor can purchase the debt of a financially troubled company and then try to influence corporate matters by exercising or threating to exercise its contractual and statutory rights as a debtholder.'); *id.*, at 708–09 ('Institutional investors increasingly are looking to the distressed debt market not only to make a quick profit, but also to create value by proactively influencing corporate governance.').

[185] See Whitehead, *supra* note 9, at 663–64 and cited sources therein. In the US, this condition became mandatory for most securitizations in the aftermath of the financial crisis through an amendment to the Securities Exchange Act of 1934 by the section 941 of the Dodd-Frank Act of 2010. Securitizers are required to retain at least five percent of the credit risk associated with any such securitization (known as 'risk retention'). There is a similar rule in the EU. Article 6 of the Securitisation Regulation, directly applicable in the Member States, requires a material net economic interest in the securitisation of not less than 5%. *See* Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework

a portion of the loan until its maturity. Or, the seller bank by itself may decide to hold a portion of the loan until its maturity to assure the buyers of the quality of the loan and its continuing stake in monitoring the borrower.[186] In addition, the seller bank may still have other lending relationship with the same borrower even though a loan has been transferred. Similarly, if obligations arising from the loan agreement (e.g. to lend money) have not been transferred along with the rights, and the borrower can still draw down funds under the loan agreement (e.g. in a revolving facility), the seller bank is still exposed to the borrower despite transferring the credit risk for already drawn down money.[187]

Loan sales are also constrained in their scope because lending arrangements generally contain some restrictions concerning the transfer of the loan to another party.[188] For various reasons,[189] borrowers require in the lending agreement their consent to be obtained for loan transfers or otherwise specify other conditions to be fulfilled for the loan to be transferred.[190]

Reputational issues are also largely relevant in incentivizing monitoring. In a syndication, for example, if the lead bank syndicates bad loans or shirks in its monitoring duties[191] (especially after selling or hedging its stake in the credit market[192]), it may

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for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012, 2017 O.J. (L 347) 35.

[186] Tung, *supra* note 10, at 165; Gary B. Gorton & George G. Pennacchi, *Banks and Loan Sales: Marketing Nonmarketable Assets* 35 Journal of Monetary Economics 389, 409–10 (1995) (stating that their empirical tests strongly support that in a resale, a bank will retain a greater proportion of more risky loans). As to syndication, *see further* Sufi, *supra* note 166, at 630 (finding that '[w]hen borrowing firms require more intense due diligence and monitoring (by a variety of measures), the lead arranger (informed lender) retains a larger share of the loan and forms a more concentrated syndicate.'); Steven A. Dennis & Donald J. Mullineaux, *Syndicated Loans* 9 Journal of Financial Intermediation 404, 407 (2007) (finding that 'the lead manager in the syndicate holds larger proportions of information-problematic loans in its own portfolio.').

[187] See *e.g.,* Gary B. Gorton & Joseph G. Haubrich, *Loan Sales, Recourse, and Reputation: An Analysis of Secondary Loan Participations,* 37 (Rodney L. White Ctr. Fin. Research, Working Paper No. 14-87, 1987) (stating that banks often sold the front end of a longer loan or commitment).

[188] On the other hand, lenders are reluctant to agree to provisions that restrict their ability to enter into credit default swaps. See Wright, *supra* note 37, at 262.

[189] *Id.*, at 263.

[190] *Id.*, at 263–64 (explaining the default position in the LMA modal agreement and other certain parameters within which the right to transfer must be exercised); Bellucci & McCluskey, *supra* note 37, at 544–54 (explaining the default position in the LSTA's modal provision). For an example of 'changes to lenders' clause, see Campbell & Weaver, *supra* note 37, at 424. Loan transfers might also be subject to the consent of the lead bank in a syndication, which is the position under the LSTA's modal provision (referring to the consent of administrative agent). See Bellucci & McCluskey, *supra* note 37, at 544. See also Sang Whi Lee & Donald J. Mullineaux, *Monitoring, Financial Distress, and the Structure of Commercial Lending Syndicates* 33 Financial Management 107, 111 (2004) (stating that in their sample, 'about 44% of the transactions require lead bank consent for loan resales.').

[191] In a syndicate, the lead bank takes on the duty of administering the loan (including communication and information dissemination) and monitoring the borrower for a fee. See Sufi, *supra* note 166, at 622–23 (detailing syndication process and responsibilities of the lead bank(s)).

[192] *Cf.* Baird & Rasmussen, *supra* note 10, at 1244 (stating that 'the lead bank does not typically sell its interest.'). Furthermore, both the borrower and the other syndicate members would expect and

suffer a reputational damage, jeopardizing further syndications (and also underwriting business which flows from being the lead bank). If a lead bank desires to be able to syndicate loans further, concerns over the reputation may induce it to continue to monitor the borrower (when initiating the loan and over the course of the loan).[193] In a loan sale, similarly, selling a bad loan or stopping monitoring the borrower after transferring the credit risk[194] may damage the reputation of the seller bank and impact further sales in the secondary market. If a lender desires to be able to sell continuously its loans in the secondary market, concerns over the reputation may likewise induce it to continue to monitor the debtor company.[195] On the other side, a borrower with good reputation will obtain funds at a lower cost of capital if its reputation enables the initial lenders to sell the loans in the secondary market to the buyers without an enhancement in the covenant level.[196]

Alongside reputational reasons, relational considerations induce self-compliance. For example, a debtor company may comply with its lending arrangement just because, given the availability of liquid secondary market itself, the lender may sell otherwise its stake in the loan. The relationship with the lender it is familiar with is important to a debtor company, and it may want to avoid hostile vulture funds in the secondary market.[197] In addition, the decline in the exposure to a borrower through transferring credit risk enables a creditor to enforce its covenant protections more

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prefer the lead bank to have a durable and continuing involvement in the syndicated loan. Lead banks, too, may have a reputational stake in preserving their relationship with their borrowers.

[193] Tung, *supra* note 10, at 164–65 (stating that '[e]xisting studies strongly suggest … that lead banks have reputational stakes in their treatment of syndicate members' and '[t]hese findings suggest that lead banks value their reputations, which should induce them to monitor conscientiously despite the risk diversification from syndication.'); Dianna Preece & Donald J. Mullineaux, *Monitoring, Loan Renegotiability, and Firm Value: The Role of Lending Syndicates* 20 Journal of Banking & Finance 577, 580–81 (1996) (indicating that in a syndication, 'the lead bank is presumably motivated primarily by reputation effects in carrying out its duties.'); Dennis & Mullineaux, *supra* note 186, at 407 (finding that '[a] loan is more likely to be syndicated … as the reputation of the syndicate's managing agent improves'). *See* also *supra* note 186 (citing studies that show that the lead banks retain a larger share of the loan when there are issues related to monitoring the borrower).

The move towards more transparency in the CDS market post-financial crisis increases the likelihood of a reputational damage as lead banks cannot covertly hedge their stake in the loan. See Tung, *supra* note 10, at 176; Gullifer & Payne, *supra* note 10, at 87.

[194] For example, the seller bank may have hedged its remaining economic stake in its relationship with the borrower (in the same loan which is partially sold, or in other lending relations with the same borrower).

[195] Whitehead, *supra* note 9, at 665; Raghuram G. Rajan, *The Past and Future of Commercial Banking Viewed Through an Incomplete Contract Lens* 30 Journal of Money, Credit & Banking 524, 540 (1998) (arguing that in the loan sales market, '[b]uyers do not inspect what they buy very closely, [i]nstead they trust sellers', which is possible through the frequently repeated transactions any single market participant undertakes); Drucker & Puri, *supra* note 163, at 2856–58 (examining the relationship between loan saleability, covenant levels and reputation).

[196] Whitehead, *supra* note 9, at 665–66. See also Diamond, *supra* note 98, at 690. *Cf.* Bratton, *supra* note 98, at 142.

[197] Similarly, borrowers might want to avoid lenders hedging their interests through CDSs for various reasons. See Tung *supra* note 10, at 176–77.

effectively (and proactively) since it enhances the relative bargaining power of the lender which does not need to fear anymore triggering the financial demise of the borrower, ultimately enabling it to more easily refuse to renegotiate a loan.[198] This will in turn make the debtor company more hesitant to breach a covenant in the first place. A similar consideration is pertinent with regard to syndication. In a syndicate, decisions (such as waiving a breach of covenant) are taken by unanimity or (simple or qualified) majority depending on the issue,[199] and it is more difficult to negotiate with a syndicate than with a single lender. This difficulty creates more incentives to comply with the loan agreement in the first place and means less action that attracts lenders' scrutiny.[200]

Last but not least, the pricing of the credit instruments (loan sales or derivatives in the secondary market) increasingly depends on the actions of the relevant borrower that change its credit quality (i.e. increase/decrease the credit risk).[201] This pricing will in turn influence the price and non-price terms of the existing loans and subsequent loans made to the borrower.[202] If borrowers want to lower their cost of capital, they need to refrain from actions that change their credit quality or increase the credit risk, which in turn influences the prices at which loans made to them and other credit instruments relating to their borrowing trade. Therefore, as Whitehead aptly states, 'by directly affecting a firm's cost of capital, private credit may provide a more efficient alternative [to covenants and monitoring] that penalizes actions that increase credit risk as or shortly after they occur.'[203] Furthermore, more costly debt capital

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[198] See Whitehead, *supra* note 10, fn. 32 & 484. See also Patrick Bolton & Martin Oehmke, *Credit Default Swaps and the Empty Creditor Problem* 24 Review of Financial Studies 2617 (2011) (noting that credit default swaps strengthen creditors' bargaining power).

[199] See *supra* note 167 and accompanying text.

[200] See Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors* 104 Journal of Political Economy 1, 1 (1996) (stating that '[d]ebt structures that lead to inefficient renegotiation are beneficial in that they deter default').

[201] Whitehead, *supra* note 10, at 486 (stating that 'as the private credit market becomes more liquid, one would expect actions that affect a firm's credit quality increasingly to be reflected in changes in price at which a firm's loans and other credit instruments trade.'); Tung *supra* note 10, at 177 (noting that exchange trading of CDS contracts will result in 'more accurate CDS market pricing' and 'better pricing information to reflect the quality of the underlying loans'). See also Francis A. Longstaff et al., *Corporate Yield Spreads: Default Risk or Liquidity? New Evidence from the Credit Default Swap Market* 60 Journal of Finance 2213 (2005) (using the credit default swap premium directly as a measure of the default component in corporate spreads).

[202] See Whitehead, *supra* note 9, at 669. Existing loans with floating interest rates may have their interest rate tied to the changes in the price of the credit instruments relating to the borrower. See *e.g.,* Pierre Paulden & Caroline Hyde, *Citigroup, Credit Suisse Link Loans to Swaps in Shift* (Bloomberg, 29 Oct. 2008), <https://www.bloomberg.com/news/articles/2008-10-29/citigroup-credit-suisse-link-loans-to-swaps-as-power-shifts>. See also Lars Norden & Wolf Wagner, *Credit Derivatives and Loan Pricing* 32 Journal of Banking & Finance 2560 (2008) (finding that changes in credit default swaps spreads are the most dominant determinant of loan spreads).

[203] Whitehead, *supra* note 9, at 669. Furthermore, post-financial crisis efforts (towards greater transparency, less complexity and more rigorous processes) may have increased the ability to assess and manage credit exposure (either directly through contractual provisions or indirectly through pricing). See also *id.*, at 674–75.

(following a change in the credit quality and reflected either in the existing loans or in the subsequent loans) may impact the profitability of the debtor company and thus also the share price, providing another mechanism of discipline for corporate insiders.[204] On the understanding that tunnelling affects a borrower's credit quality, and it is reflected in the price at which the credit instruments (relating to that borrower) are valued in the secondary loan or derivatives market,[205] the debtor company's cost of capital in raising finance from the lenders, and thus also its profitability and share price will be affected by tunnelling. This provides corporate insiders with incentives to engage in less tunnelling (as in the traditional framework explained above).

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Along with this transformation in the private credit market, another noticeable and relevant change is the move from private debt to public debt.[206] If more companies rely on raising finance from the capital markets by issuing debt instruments, there will be a reduced role for bank (and non-bank) lenders to play. A corollary of this development would be a lesser influence of debt within corporate governance, because, as noted above, private debt fares much better than public debt in monitoring borrowers and restricting their discretion.[207] Nevertheless, private debt will remain as an important source of capital and can still provide benefits in terms of controlling agency costs.[208]

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[204] *Id.*, at 669–70.

[205] Tunnelling may affect a borrower's credit quality in two ways: (1) tunnelling may have an impact on the operating performance and profitability of the company and (2) tunnelling will mean less corporate wealth for the claims of the lenders to be satisfied. Both situations can be reflected in pricing in the secondary loan and derivatives market. Participants in such markets may have quasi-public information about the debtor companies if they are, for example, banks, or they may benefit from the disclosure obligations of publicly-listed companies within the framework of capital markets laws and regulations. See *e.g.,* Mark J. Flannery et al., *Credit Default Swap Spreads As Viable Substitutes for Credit Ratings* 158 University of Pennsylvania Law Review 2085 (2010) (showing that 'CDS spreads incorporate new information about as quickly as equity prices and significantly more quickly than credit ratings.').

[206] See *e.g.,* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks* 2002 University of Illinois Law Review 215, 231–39.

[207] See *supra* text accompanying notes 40–42.

[208] See Whitehead, *supra* note 9, at 652 (stating that 'borrowers, for whom, there is less publicly available information … are more likely to rely on banks than the public market.'); Triantis & Daniels, *supra* note 9, at 1083 (noting this trend and detailing the role of banks). See also Joshua D. Rauh & Amir Sufi, *Capital Structure and Debt Structure* 23 Review of Financial Studies 4242, 4243–44 (2010) (documenting how debt structure varies across the credit-quality); *id.*, at 4250 (presenting summary statistics on debt composition in a sample of randomly selected 305 companies); Nini et al., *supra* note 13, at 401 and cited sources therein (writing that 'roughly 80% of all public firms maintain private credit agreements, compared with only 15–20% that have public debt.'); Bradley & Roberts, *supra* note 65, at 9–10 (stating that '[b]etween 1993 and 2001, the total amount of public corporate debt issued was less than one half of the amount of private corporate debt issued …'); Roberts & Sufi, *supra* note 93, at 160 (stating that 'the loans that are governed by private credit agreements represent the largest

Secondly, dynamics in the market for bank and non-bank loans (e.g. liquidity and strong competition among the lenders) are another (changeable) factor to consider. They may affect the negotiation power of the lenders against the debtor companies, which may translate into less restrains and covenants in the lending arrangements (also called covenant-light or cov-lite loans[209]), and thus may render private debt like public debt.[210] However, in our context, even such loans are capable of curtailing tunnelling.[211]

4.4. Evaluation

There are various limits to the role of lenders in curbing value-diversion from the debtor companies. As one can see, while some of these limits such as 'lender liability' are less consequential, others like 'self-interest' or 'transformation of debt' are more pronounced. Yet, there are also many offsetting considerations which enable the debt to play its usual role or to find new ways to affect corporate governance. The possibility remains that the creditor control will thwart value-diversion from the debtor companies and will inure to the benefit of all stakeholders (including (minority)

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source of external finance for corporations – in terms of flows – larger than public debt and equity combined.') (citations omitted).

International trade also makes banks essential. Payments in international trade are ensured through 'letter of credit'. This requires a corporation engaging in international trade to have a credit line with a bank. See Baird & Rasmussen, *supra* note 10, at 1221.

[209] Such loans indicate loans where there are less covenants than normally observed and/or where covenants are tested less frequently than normal. After the last financial crisis, attitude towards such loans may have changed. See Whitehead, *supra* note 9, at 676 (arguing that 'the credit crisis has reinforced the importance of covenants to lenders'). Such loans, however, seem to have made a comeback in syndicated loans of low credit quality (also called 'leveraged loan market'), passing their previous peak pre-financial crisis. See Bo Becker & Victoria Ivashina, *Covenant-Light Contracts and Creditor Coordination* (Swedish House of Fin. Research Paper No. 16-09, 2016), <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2871887> (finding that in 2015, 70% of newly-issued *leveraged* loans were covenant-light or 'cov-lite' loans). See also Wright, *supra* 37, at 177–78 (explaining various features of covenant lite loans); Bellucci & McCluskey, *supra* note 37, at 406–09.

[210] See Tung, *supra* note 47, at 161–62; Whitehead, *supra* note 9, at 661–63. See also Becker & Ivashina, *supra* note 209, at 2–8 (attributing the rise in cov-lite loans in leveraged loan market to changes in the size and composition of the investor base in such loans that seems like the investor base in high-yield bonds (rather than attributing it to the borrower demand hypothesis), based on the idea that the presence of coordination costs between different investors may reduce the usefulness of covenants).

[211] In comparison to traditional loans where companies are expected to comply with covenants at all times and/or such compliance is tested every certain period (generally every fiscal quarter) (called 'maintenance covenants'), in covenant-light loans, companies are required to obey the covenants when the company pursues an active event, such as issuance of additional financing, sale of assets, or merger (called 'incurrence covenants'). See Becker & Ivashina, *supra* note 209, at 1; Bellucci & McCluskey, *supra* note 37, at 407 (stating that '[t]he hallmark of covenant lite transactions is the replacement of financial covenants that constitute "maintenance" tests with covenants constituting "incurrence" tests.'). In the case of a self-dealing in the form of such events, the ability to divert value may be curtailed to remain in compliance with covenants. Otherwise, consequences that follow a covenant violation may ensue.

shareholders) generally. Acknowledging this disciplining effect or 'countervailing power',[212] one should attempt to tackle and isolate the situations that can cause harm or where banks remain simply ineffective.[213]

It is also important to note the limitations of other tools most jurisdictions employ to control self-dealing in public companies before giving a definitive judgement on the creditors' role. The relevant benchmarks, for example, a (disinterested) shareholder vote on RPTs or screening by independent directors, suffer similar or their own limitations.[214] Shareholders can also be conflicted and may have incentives not necessarily aligned with that of corporation when voting on RPTs.[215] Similarly, directors, although 'independent', may be beholden to controlling shareholders who have appointed them in the first place.[216] Banks would also fare better than most institutional and almost all retail shareholders, and independent directors in terms of information and expertise in evaluating an RPT.[217]

Empirical evidence also suggests that banks' impact on the debtor companies may be beneficial.[218] Studies show that positive abnormal stock returns follow companies'

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[212] Cheffins identifies 'three "external" accountability mechanisms that can operate as significant constraints on managerial discretion, namely governmental regulation of corporate activity, competitive pressure from rival firms and organized labor', unifying them under the term of 'countervailing power'. See Brian R. Cheffins, *Corporate Governance and Countervailing Power* (ECGI Law Working Paper No. 448/2019, 2019), <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3225801>. In this line, creditor control is also a countervailing power against corporate insiders in the debtor companies.

[213] Baird & Rasmussen, *supra* note 10, at 1250.

[214] See generally Enriques, *supra* note 120.

[215] For conflicts of interest affecting institutional shareholders, see Black, *supra* note 24, at 595–608; Coffee, *supra* note 24, at 1321–22; Rock, *supra* note 24, at 469–72. For the phenomenon of empty voting by shareholders, see Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership* 79 Southern California Law Review 811 (2016). See also Alessio M. Pacces, *Procedural and Substantive Review of Related Party Transactions: The Case for Noncontrolling Shareholder-Dependent Directors,* in *The Law and Finance of Related Party Transactions,* 181, 201–05 (Cambridge: CUP, 2019) (explaining potential harms and benefits of activist hedge funds in screening RPTs).

[216] See generally María Gutiérrez & Maribel Sáez, *Deconstructing Independent Directors* 13 Journal of Corporate Law Studies 63 (2013); Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders* 165 University of Pennsylvania Law Review 1271 (2017).

[217] Institutional and retail shareholders may have weak incentives to cast an informed vote. See Black, *supra* note 24, at 526–29 (explaining the classic rendition of shareholder passivity); Edward Rock, *Institutional Investors in Corporate Governance* in *The Oxford Handbook of Corporate Law and Governance,* 363, 373–74 (Oxford: OUP, 2018) (explaining the inadequate incentives hypothesis for institutional investor passivity). See also Tung, *supra* note 47, at 132–34 (comparing bank's expertise and information flow with those of independent directors).

[218] See *e.g.,* Joanna M. Shepherd et al., *What Else Matters for Corporate Governance?: The Case of Bank Monitoring* 88 Boston University Law Review 991 (2008) (finding evidence that bank monitoring improves firm value, especially where agency costs are high).

public announcement of bank loans.[219] There are also similar findings for non-bank loans.[220] Studies also confirm monitoring benefits of private debt.[221]

On the other hand, some financial literature, especially ones examining developing countries where controlled companies are the norm and capital market institutions have been rather weak, demonstrate that the disciplining effect of debt on value-diversion can be limited and debt can be used rather as an instrument for value-diversion (to acquire more resources to tunnel).[222] It is important to note however the particulars of the context where such an outcome arises.

This scenario mostly occurs where banks, providing finance to a company, are associated with the latter and/or where corporate insiders do not bear much of the

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[219] See *e.g.,* Christopher James, *Some Evidence on the Uniqueness of Bank Loans* 19 Journal of Financial Economics 217, 218–19 (1987) (finding a positive stock price response to the announcement of new bank credit agreements and significantly negative returns for announcements of private placements and straight debt issues used to repay bank loans); Myron B. Slovin et al., *Firm Size and the Information Content of Bank Loan Announcements* 16 Journal of Banking & Finance 1057 (1992) (examining share price responses to the announcements of bank credit agreements for listed companies, and finding that for small firms, both renewals and initiations of loan agreements generate significantly positive share price effects in contrast to large firms); Matthew T. Billett et al., *The Effect of Lender Identity on a Borrowing Firm's Equity Return* 50 Journal of Finance 699, 699–700 (1995) (citing previous studies which find that loan announcements generate significantly positive abnormal returns to the average borrower's equity, and finding that the borrower's abnormal return increases with the lender's credit quality); Demiroglu & James, *supra* note 64, at 3727–28 (finding a larger stock price reaction to the announcement of loans with tight covenants).

[220] See *e.g.,* Billett et al., *supra* note 219, at 700 (finding that 'the borrower returns associated with nonbank loans (e.g., from commercial finance companies) are positive and statistically indistinguishable from the returns associated with bank loans.'); Dianna C. Preece & Donald J. Mullineaux, *Monitoring by Financial Intermediaries: Banks Versus Non-Banks* 8 Journal of Financial Services Research 193 (1994) (finding evidence that 'borrowing firms experience positive abnormal returns upon announcing conclusions of loan agreements with nonbank firms.').

[221] See *e.g.*, Sudha Krishnaswami et al., *Information Asymmetry, Monitoring, and the Placement of Structure of Corporate Debt* 51 Journal of Financial Economics 407, 409 (1999) (finding that firms with more growth options –thus with greater debt-related moral hazard problems– use higher proportions of private debt (rather than public debt), benefitting from greater monitoring and restrictive covenants associated with private debt); Sudip Datta et al., *Bank Monitoring and the Pricing of Corporate Public Debt* 51 Journal of Financial Economics 435 (1999) (confirming cross-monitoring benefits of bank debt for bondholders); Nini et al., *supra* note 13, at 415–17 (finding (suggestively) that creditor-imposed capital restriction promotes efficient investment, observing an increase in both market value and operating performance after the restriction). See also Tobias H. Tröger, *Germany's Reluctance to Regulate Related Party Transactions: An Industrial Organization Perspective,* in *The Law and Finance of Related Party Transactions,* 426, 434–38 (Cambridge: CUP, 2019) (remarking banks' involvement in controlling RPTs in Germany while noting that they may also have consumed simultaneously some private benefits to compensate their monitoring efforts).

[222] See *e.g.,* Mara Faccio et al., *Debt and Corporate Governance* (10 Jan. 2001), <https://www.researchgate.net/publication/228419088_Debt_and_Corporate_Governance> (examining Continental European and East Asian countries); Jayati Sarkar & Subrata Sarkar, *Debt and Corporate Governance in Emerging Economies: Evidence from India* 16 Economics of Transition 293 (2008) (examining India over a certain period of advancement in capital market institutions); Pramuan Bunkanwanicha et al., *Debt and Entrenchment: Evidence from Thailand and Indonesia* 185 European Journal of Operational Research 1587 (2008) (examining Thailand and Indonesia).

costs related to troubles in a lending relationship or bank monitoring. In pyramidal corporate structures, for example, there is a great discrepancy between the control and cash flow rights. Assume that a controlling shareholder owns 100% of X, which owns in turn 60% of Y, which owns in turn 30% of Z. This controlling shareholder has a 18% economic stake in Z, which is however enough to control it through his or her ownership in X and Y. While tunnelling in Z may put Z into trouble in its lending relationship, the costs of this trouble would affect the controlling shareholder only to the extent of his or her 18% economic stake, which is unlikely to incentivize him or her not to expropriate value from Z. Reputational costs would also be small as the controlling shareholder hides behind a pyramidal ownership and has no concerns on his or her employability in labour market.[223]

Furthermore, in such structures, the lender is generally a group bank which can reasonably be excepted not to be as meticulous in its monitoring as external banks, and would be left to be bailed out by taxpayers after the value from the borrower companies had been siphoned off.[224] This is actually how East Asian crisis in late nineties had been precipitated.[225] So, related party lending and a lower ratio of cash flow rights to control rights (for instance through a corporate pyramid) may transform the possible disciplining role of debt into an instrumental role for value-diversion.[226] In this line, a study, examining listed companies in France, also finds that when the discrepancy between cash flow and control rights of the controlling shareholder is low, debt constrains expropriation. However, when it is high, it is expected that debt would increase tunnelling as the corporate insider would not incur a substantial portion of the costs of his or her misbehaviour.[227] Similarly, highlighting the importance of an arm's length lending relationship, another study, examining 18 emerging markets, finds that *international* syndicated loan mitigates agency costs and creates value for companies where pyramid ownership structures create potentially extreme agency costs.[228]

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[223] Faccio et al., *supra* note 222, at 2–3.

[224] *Id.*, at 4.

[225] See Michael Backman, *Asian Eclipse: Exposing the Dark Side of Business in Asia* (Singapore, New York: J. Wiley, 1999).

[226] See Mara Faccio et al., *Debt and Expropriation* (Purdue CIBER Working Paper No. 50, 2007), <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=239724>. See also Yunxia Bai et al., *Corporate Ownership, Debt, and Expropriation: Evidence from China* 1 China Journal of Accounting Studies 13 (2013) (describing how bank loans on favourable terms secured through close ties to local or central government facilitate expropriation).

[227] Sabri Boubaker, *On the Relationship between Ownership-Control Structure and Debt Financing: New Evidence from France* 5 Corporate Ownership & Control 139, 145–46 (2007).

[228] Campbell R. Harvey et al., *The Effect of Capital Structure When Expected Agency Costs are Extreme* 74 Journal of Financial Economics 3 (2004).

5. The Implications of Disciplining Effects of the Lending Arrangements on Value-Diversion

It has been argued that the debt (or a lending relationship) can have disciplining effects in terms of curbing tunnelling to a certain extent. This finding has some past- and forward-looking implications. In this section, such implications will be explained and examined.

5.1. Gilson's Riddle and Possible Explanations

There has been a puzzling phenomenon that occupied the minds of legal and finance scholars: why do we observe companies raising finance from the equity market and public investors subscribing to those shares even if there is a weak or ineffective (minority) shareholder protection regime in place, which would supposedly increase the cost of capital in the equity market (and would deter companies from raising finance there) and leave public investors expropriated (which would in turn deter these investors from investing in public companies)?[229] In addition, the question arises why in such regimes controlling shareholders do not expropriate more than they actually do in spite of there being no effective barriers. This puzzle has been called as Gilson's riddle.[230]

There have been various explanations in the literature in this regard.[231] Professor Gilson explains this phenomenon with an eye to poor commercial law which generally co-exists with poor shareholder protection in capital markets.[232] Gilson argues that in an environment of poor commercial law, commercial transactions must be self-enforcing and a corporation's business depends on its capacity to engage in self-enforcing exchange based on its reputation as a means to assure the performance of contractual obligations.[233] This role of reputation in the product market may in turn explain the existence of publicly held minority shares in the capital market despite the lack of a formal limit on the expropriation of minority shareholders.[234] Gilson

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[229] Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange* 60 Stanford Law Review 633, 647 (2007).

[230] Sang Yop Kang, *Re-Envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Often Embrace* 16 University of Pennsylvania Journal of Business Law 843, 846–47 (2014).

[231] Such explanations should not be confused with a number of accounts of why controlled companies would want to have public investors (i.e. minority shareholders) in regimes with *efficient capital markets and strong shareholder protection*. See in this regard Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders* 152 University of Pennsylvania of Law Review 785, 791 (2003). See also Pacces, *supra* note 215, at 187–89 (seeing the existence of minority shareholders in corporate groups as a commitment device for RPTs to support an efficient governance structure).

[232] Gilson, *supra* note 229, at 635. Poor commercial law denotes both substantively bad law regardless of the quality of enforcement and substantively good law but with poor enforcement. *See id.*, at 635, fn. 6.

[233] *Id.*, at 635–36.

[234] *Id.*, at 636.

contends that bad behaviour toward minority shareholders can affect the corporation's reputation in the product market, and concerns over the success in the product market may lead to self-imposed limits on controlling shareholders' extraction of private benefits.[235] Similarly, a corporation may prefer to have minority shareholders despite the high cost of capital due to poor minority shareholder protection as a support to its reputation in the product market.[236] Professor Gilson does not claim that reputation-based product market account fully explains the abovementioned puzzle, rather discusses other explanations[237] and acknowledges that a range of explanations may be at work.[238]

Professor Kang, on the other hand, challenges Professor Gilson's product market based account[239] and proposes new answers to the abovementioned puzzle.[240] He argues that companies in jurisdictions with poor capital market laws raise equity finance for several other reasons,[241] and controlling shareholders voluntarily limit the expropriation because of a long-term goal of maximising their private benefits.[242] Further, he explains the seemingly irrational behaviour of public investors in purchasing shares in spite of the absence of a limit on the expropriation by controlling shareholders on several intertwined grounds.[243]

Yet, although both scholars note the pecking order theory of corporate finance, referring to the role of equity finance as a last resort finance under the condition of information asymmetry as in jurisdictions with poor capital market laws, and would expect corporations to resort to debt finance before equity finance,[244] a discussion of

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[235] *Id.* Gilson also explains the observability of minority shareholder treatment to trade partners in product markets and whether the fair treatment of minority shareholders (net of its costs) adds anything to the operation of the product market's direct transmission of information concerning the reputation of the corporation. See *id.*, at 649–50.

[236] *Id.* See also *id.*, at 648–49.

[237] He mentions two other explanations – which he calls 'informal ceiling account' and 'vanity stock market account'. The former is that even in a jurisdiction with poor shareholder protection regime, some actor in authority will not tolerate too greedy or too blatant expropriation of the minority shareholders, creating an informal ceiling on private benefit extraction. *See id.*, at 647. The latter relates the existence of minority shareholders to a political economy story. *See id.*, at 651.

[238] *Id.*, at 651.

[239] Kang, *supra* note 230, at 859–66.

[240] *Id.*, at 848.

[241] For these reasons, *see id.*, at 848. See also *id.*, at 866–84.

[242] *Id.*, at 849 & 881–84. In this regard, see also Sang Yop Kang, *"Generous Thieves": The Puzzle of Controlling Shareholder Arrangements in Bad-Law Jurisdictions* 21 Stanford Journal of Law, Business & Finance 57 (2015).

[243] Kang, *supra* note 230, at 849–50. *See also id.*, at 884–94.

[244] Gilson, *supra* note 229, at 647; Kang, *supra* note 230, at 856. Under the pecking order theory of corporate finance, the choice of which type of finance a company resorts to turns on the information asymmetry in the market, and this asymmetry becomes more significant when the financing option is riskier (from the perspective of prospective investors). As a result, in a poor shareholder protection regime where the information asymmetry in the equity market would be huge, a company will use first retained earnings to finance its activities, then will turn to debt finance and as a last resort to equity finance. Especially, banks will not suffer under information asymmetry as much as prospective investors in the equity market, and any information asymmetry will be less significant for banks in comparison to

the possible implications of debt finance is missing (especially among the possible explanations for the Gilson's riddle).

I submit that the role of the lending arrangements in curbing tunnelling may provide another explanation: by curtailing the ability of corporate insiders to divert value from a company and monitoring the company in this regard, lenders of the company set a limit on the divertible value. As explained above, the disciplining effects of lending arrangements with regard to self-dealing are not perfect or self-sufficient. Yet, they provide a certain limit on tunnelling, which would also be observable by public investors in the stock market.[245]

The line of reasoning is as follows: the high cost of capital in the stock market would supposedly make companies turn to the banks. But, raising finance from the banks comes with its own restrictions, which *inter alia* contain tunnelling. This would in turn enable the companies to turn to the equity market with less discounts applied to their share price by public investors who would now discern that the self-dealing risk is ameliorated through lending arrangements.[246] Thus, an explanation for the puzzle of why companies raise finance from equity markets and public investors buy shares of such companies in the absence of (effective) (minority) shareholder protection regime might be that the control by bank lenders provides a limited but a sufficient substitute for (minority) shareholders to get a fair return on their investments, and for companies to lower their cost of capital in the equity market. It also explains why controlling shareholders do not expropriate more than they actually do despite no observable limit on expropriation provided by the (minority) shareholder protection regime.

I do not claim that such an explanation may have been at work in every jurisdiction as it depends on the context and particularities of a jurisdiction. Yet, such an explanation remains plausible and is also at least consistent with the empirical evidence.[247] Event studies that find positive abnormal stock returns accompanying the announcement of bank and non-bank loans show that shareholders value bank monitoring.[248]

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prospective investors in the equity market as debt will carry less risk because it has priority over equity. For a more detailed account of this theory, see *e.g.,* Richard A. Brealey et al., *Principles of Corporate Finance,* 460–65 (New York: McGraw-Hill Education, 10th ed. 2011).

[245] See also Triantis & Daniels, *supra* note 9, at 1079 ('through their observable reactions, stakeholders convey signals and information regarding the corporation to each other.').

[246] See Triantis & Daniels, *supra* note 9, at 1090 ('the existence of a bank lender is a signal … that restrictive covenants are in place and that the firm's activities are being monitored.'). Existence of a bank lender is also a positive signal for other stakeholders. See Fama, *supra* note 41, at 36–37 (explaining the signals from a bank about the creditworthiness of an organization's higher-priority fixed payoff contracts); Eugene Fama, *Contract Costs and Financing Decisions* 63 Journal of Business S71, S84–86 (1990) (same); Bradley & Roberts, *supra* note 65, at 3–4 (showing that the cost of capital is lower in *bond* market when firms include covenants in their *loan* agreements).

[247] See also Tröger, *supra* note 221 (explaining Germany's reluctance of regulating related party transactions based on the idea of German banks (as lenders and shareholders) controlling tunnelling in German companies to a certain extent in the shadow of few existing legal provisions).

[248] See *supra* notes 219 & 220.

Studies also find that banks transmit information to capital markets,[249] that bank debt alleviates adverse selection problems,[250] and that lenders take precautions against the expropriation of their wealth.[251] Moreover, especially for small/medium-sized companies that may not otherwise be able to signal to the market the absence of (current or future) value-diversion in the company,[252] the existence of bank loans may help such companies to enter the stock market, and public investors to consider investing in such companies.[253] Notably, the single bank lender, which exercises the most effective and economically efficient monitoring and influence as opposed to other types of debt finance, is the most common for small/medium sized companies.[254]

There are, however, observable limitations to such a theory. If one assumes that countries with poor capital market laws will also have poor commercial laws, it may mean less leverage power for banks.[255] Yet, *international* loans which are not uncommon for large corporations in developing countries, and which subject the loan to the law and jurisdiction of a country with advanced laws would not suffer under such a limitation. Furthermore, as explained above, if related party lending and controlling minority structures (where controlling shareholders have little economic stake (or

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[249] See *e.g.,* Scott L. Lummer & John J. McConnell, *Further Evidence on the Bank Lending Process and the Capital-Market Response to Bank Loan Agreements* 25 Journal of Financial Economics 99 (1989) (stating that 'banks play an important role as transmitters of information in capital markets', and attributing it to favourable and unfavourable loan revisions, rather than new loans); Ronald Best & Hang Zhang, *Alternative Information Sources and the Information Content of Bank Loans* 48 Journal of Finance 1507 (1993) (noting the information production role of banks when other sources provide noisy signals).

[250] See *e.g.,* Charles J. Hadlock & Christopher M. James, *Do Banks Provide Financial Slack?* 57 Journal of Finance 1383 (2002).

[251] See generally Vasvari, *supra* note 28 (finding that managerial equity compensation which motivates managers to expropriate lenders' wealth and engage in aggressive investment behaviour is associated with larger risk premiums in syndicated loan spreads, and that loan agreements are structured to facilitate better bank monitoring *ex post* in that loan contracts require more restrictive covenants and the lead arranging banks retain larger shares in the loans).

[252] For example, 'financial analysts have the tools to recognize and assess the impacts of tunnelling transactions [or propensities]', and may have incentives to monitor tunnelling by corporate insiders. See Atanasov et al., *Law and Tunneling*, *supra* note 4, at 38. However, in developing countries, the number of such skilled analysts may be limited and their coverage would be devoted to large firms, leaving small/medium-sized companies with no analyst coverage, and thus creating a need to convey information to the market otherwise.

[253] Slovin et al., *supra* note 219 (suggesting that bank credits convey more information to capital markets for small firms).

[254] See Gullifer & Payne, *supra* note 10, at 85–86.

[255] See also Judy Day & Peter Taylor, *Institutional Change and Debt-based Corporate Governance: A Comparative Analysis of Four Transition Economies* 8 Journal of Management & Governance 73 (2004) (arguing that in transition economies during an interim stage in moving towards market-based systems, debt finance has a useful role to play in corporate governance, analysing the institutional requirements for debt to function as an effective corporate governance devise, and finding that significant process towards this end has been made in four selected transition economies).

cash flow rights) in the company[256]) are common in a jurisdiction, the disciplining effect of debt disappears.[257]

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Such a theory should not be understood as only relating to jurisdictions with poor capital market laws to protect investors. In relation to jurisdictions with developed capital market laws, another but a similar question arises: why tunnelling in such countries is neither severe nor widespread even though there are gaps in the laws and some corporate insiders do indeed take advantage of them to tunnel value from the company.[258] The general answer to this question of why tunnelling opportunities have not been more widely exploited is informal mechanisms that complement the law and limit tunnelling.[259] I submit that a lending relationship (with its restrictions, monitoring and sanctions) is another complementary mechanism that prevents corporate insiders from exploiting more any opportunities law may leave behind, and from tunnelling more wealth from the companies.[260]

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[256] A controlling shareholder may achieve its controlling position while having non-equivalent or little cash flow rights through three mechanisms: (1) dual-class share structures, (2) stock pyramids, and (3) cross-ownership ties. See Bebchuk et al., *supra* note 31, at 297–301.

[257] For an argument that Professor Gilson's product market-based account also does not hold in the case of controlling minority structures, see Kang, *supra* note 230, at 863–66. Kang argues that under a controlling minority structure where a controlling shareholder has little economic stake in a company, when the company raises equity finance despite the very high cost of capital in countries with poor capital markets law, the controlling shareholder's personal cost of equity financing is minimal. So, according to Kang, the decision to raise equity finance by the controlling shareholder does not seem too irrational. Yet, Kang's argument ignores the phase where the controlling minority structure had been formed in the first place. Prior to that phase, the controlling shareholder contributes entire (equity) capital of the company, and then offers the company shares to the public investors while retaining control with limited cash flow rights. In this phase, the controlling shareholder's personal cost of equity finance is not minimal, and his decision to raise finance from stock markets would seem irrational.

[258] See Atanasov et al., *Law and Tunneling*, *supra* note 4, at 36. See also Vladimir Atanasov, Audra Boone & David Haushalter, *Is There Shareholder Expropriation in the United States? An Analysis of Publicly Traded Subsidiaries* 45 Journal of Financial & Quantitative Analysis 1 (2010) (indicating that some parent companies in the US behave opportunistically toward their publicly traded subsidiaries).

[259] Atanasov et al., *Law and Tunneling*, *supra* note 4, at 36–39 (counting 'equity ownership of the tunneler', 'the controller's reputational concerns', 'actions by other shareholders', 'organizational transparency', 'liquid stock markets' among such informal mechanisms).

[260] In countries with developed capital market laws, bank finance is still a significant source of finance. See Gary Gorton & Andrew Winton, *Financial Intermediation,* in *Handbook of The Economics of Finance: Volume 1A Corporate Finance,* 433 (Amsterdam: Elsevier, 2003) (finding that '[b]ank loans are the predominant source of external funding in … [Canada, Finland, France, Germany, Italy, Japan, the UK, and US] and in none of the[se] countries are capital markets a significant source of financing.'). *See also* Franklin Allen et al., *Financial Intermediation, Markets, and Alternative Financial Sectors,* in *Handbook of The Economics of Finance: Volume 2A,* 759 (Amsterdam: Elsevier, 2013) (arguing that 'while traditional financing channels, including financial markets and banks, provide significant sources of funds for firms in developed countries, alternative financing channels provide an equally important source of funds in both developed and developing countries.').

5.2. Forward-Looking Implications

The considerations discussed above about the role of lending arrangements in curbing tunnelling and its limitations lead to some forward-looking reflections in terms of how relevant laws should be further designed and shaped.

First of all, with great power comes great responsibility. Banks are able to monitor and exert great influence on the debtor companies. Arguably, there should be some mechanisms that channel this clout into a mutually beneficial situation for all the stakeholders in a debtor company. It may be too far-fetched to expect lenders to scrutinize every self-dealing that may drop into their radar.[261] However, when they do detect value-diversion but use it to their advantage and to the detriment of shareholders and other creditors, there should be some legal repercussions. Equitable subordination is one means; but, it comes into play in insolvency and its conditions may be difficult to fulfil.

Secondly, acknowledging that lenders may play a positive monitoring and governance role in the debtor companies has led some commentators to inquire whether financial regulation should consider the repercussions of any regulatory change in terms of this role.[262] I submit that such an approach may not be sound. Of course, it is clearly pleasant to have a regulatory option that addresses the problems concerning financial regulation as well as providing positive spillovers for the lenders' monitoring role in the debtor companies.[263] Or, in the case of competing regulatory alternatives, one that strengthens the lenders' monitoring role can be preferred. However, making reforms in the field of financial regulation too sensitive to their corporate governance implications is not helpful. Financial regulation has its own ambitions to achieve (e.g. maintaining market integrity and controlling systemic risk). Taking account of corporate governance considerations alongside will unnecessarily complicate matters. Corporate and capital markets laws have already their own to tools to handle conflicts in a corporation, and creditor control is only a supplementary power against agents that may pursue their own interests rather than the interest of corporation. Otherwise, running after two hares will result in catching neither.

Nevertheless, one should note the widespread efforts in other fields that may affect the role of debt in curbing tunnelling and its limitations. The supervision of related

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[261] See also Tung, *supra* note 10, at 170–73 (finding generalized fiduciary duties for lenders unnecessary and counterproductive); Gullifer & Payne, *supra* note 10, at 86 (stating that there is no need to impose extra duties on creditors).

[262] See *e.g.,* Whitehead, *supra* note 9, at 677 (asking '[t]o the extent that change in the capital market affects corporate governance, should we begin to consider the impact of that regulation – beyond its traditional focus on market integrity and systemic risk – on how firms are governed?', and giving the examples of banks' regulatory capital requirements and regulating the credit derivatives market); Whitehead, *supra* note 10, at 487–88; Tung, *supra* note 10, at 170 (arguing that '[r]eform [in financial regulation] should … be sensitive to potential spillovers that might affect lenders' monitoring incentives and governance role.'); *id.*, at 175–78.

[263] See *e.g.,* Tung, *supra* note 10, at 176 (explaining how post-financial crisis regulation of CDSs may strengthen lender influence on corporate governance).

party lending and relevant capital adequacy requirements for banks may hinder related party lending as a means to expropriation.[264] More generally, as long as prudential authorities keep tabs on banks and other similar financial institutions, they will be more diligent in their relationships with borrowers, which should benefit the interaction between the debt and corporate governance in general and the role of lending arrangements in curbing tunnelling in particular.[265] Likewise, tax rules which disincentivise corporate pyramids will reduce the occurrence of large divergence between the cash flow and control rights of corporate insiders which otherwise diminishes the disciplining effects of debt in relation to value-diversion.[266]

6. Conclusion

This study aims to join the series of scholarship that has reflected on the likely (and beneficial) creditor influence on controlling agency costs of any kind in public companies. It does so by examining the disciplining effects of several contractual provisions found in lending arrangements as regards the value-diversion from public companies through self-dealing. The assertion is not that contractual arrangements with creditors are full-fledged mechanisms to prevent tunnelling, rather they will constitute a complementary tool to avert value-diversion.

While it seems that a lending arrangement may create the potential to monitor, deter and contain value-diversion through self-dealing, whether this potential will realize depends on various factors and context.[267] For example, a non-arm's length dealing with the banks or a corporate insider with very low economic stake in the company may thwart potential restraints on self-dealing or even turn debt into an

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[264] For example, Basel Committee on Banking Supervision's Core Principles for Effective Banking Supervision include a 'core principle' on related party lending (Principle 20), which states the following: 'in order to prevent abuses arising in transactions with related parties and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties on an arm's length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes.' These principles are available at <https://www.bis.org/basel_framework/standard/BCP.htm> (last visited 12 October 2021). Furthermore, Basel Committee on Banking Supervision's Guidelines on Corporate Governance Principles for Banks include further principles that may impact related party lending (see paras 27, 83, and 154; available at <https://www.bis.org/bcbs/publ/d328.htm> (last visited 12 October 2021)).

[265] For example, regulators have become increasingly worried about covenant-lite leveraged lending (see *supra* note 209) and took some action. See John Armour et al., *Principles of Financial Regulation,* 627–28 (Oxford: OUP, 2016).

[266] See *e.g.,* Randall Morck, *How to Eliminate Pyramidal Business Groups – The Double Taxation of Inter- Corporate Dividends and Other Incisive Uses of Tax Policy* 19 Tax Policy & The Economy 135 (2005).

[267] As Judge Easterbrook said, '[w]hether a debt-induced effect on monitoring is superior is a though question, but it is a question for the particular firm, no different in principle from the question "should this firm hire private detectives to monitor employees' theft?"'. See Frank H. Easterbrook, *High-Yield Debt as An Incentive Device* 11 International Review of Law & Economics 183, 184 (1991).

instrumental tool for further expropriation. Another consideration is how the developments and changes in the dynamics in the private credit market will impact this potential. Such developments or changes may also affect the weight of the above-mentioned limits to the potential disciplining effects of a lending relationship. For example, one might expect the self-interest of lenders to play a lesser role while hedging becomes an important concern. The regulation of financial markets, which is primarily concerned with systemic risk and market integrity, and legal rules from other fields will also have a bearing on the lenders' governance role.

In assessing the lenders' role, one should consider how it pans out in comparison to other conventional ways of controlling agency costs in public companies.[268] A full comparison with various tools in different contexts is outside the scope of this study, but some examples – also given in above text – may suffice. For instance, although it is conceivable that in a financially healthy, large and profitable company, limits on value-diversion by the way of restrictions imposed by lenders might be lower in comparison to other companies, it is also documented that shareholders will not veto excessive remuneration of corporate managers (one of the primary forms of value-diversion) as long as the company performs well.[269] Furthermore, the lender influence on corporate governance in general and on value-diverting self-dealing in particular may fare better than other *complementary* tools that are supposed to deter agency costs. For example, while corporate insiders who may otherwise fear hostile takeovers and limit tunnelling in the company to prevent further decreases in the value of company shares might implement poison pills against such a threat, there is a limited exit from bank monitoring. Unless market conditions favour the borrower side of the transaction, corporate insiders cannot take measures against the countervailing power of the lenders.

Whatever one makes of the potential effect of lending arrangements on tunnelling and the limits to such an effect, one should consider its implications. Acknowledging lender influence on preventing self-dealing, as this study does, turns one's attention to the role it may play in providing answers to some questions that have been dealt with in other related studies. A more forward-looking aspect is how to best channel this lender influence into a mutually beneficial situation by tackling its possible limitations, and how to maximise this influence alongside the pursuit of other goals. On the other hand, a negative viewpoint on the role of lenders in controlling value-diversion in the debtor companies must mean more work to strengthen the efficacy of existing RPT regulations given that an important stakeholder group in the company is left out.

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[268] See similarly Tung, *supra* note 10, at 133 & 162.

[269] See Jill Fisch et al., *Is Say on Pay All About Pay? The Impact of Firm Performance* 8 Harvard Business Law Review 101 (2018).