The role and rights of debtholders in corporate governance

A background note for the OECD-Asia Roundtable on Corporate Governance

20- 21 October 2022

Please cite as: OECD (2022), The role and rights of debtholders in Corporate Governance: Background note for the OECD-Asia Roundtable on Corporate Governance (October 2022), https://www.oecd.org/corporate/background-note-Asia-roundtable-role-and-rights-debtholders-corporate-governance.pdf

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Introduction

This background note aims to inform the discussions at the ***OECD-Asia Roundtable on Corporate Governance*** on the main trends and issues related to the longstanding rise in bond financing by the non-financial corporate sector and its implications for corporate governance. Particularly, it serves as a reference to the session discussing the role and right of debtholders in corporate governance. This note focusses on some relevant trends in Asia and highlights some examples in the region. It is a concise version of the working paper *"The role and rights of debtholders in corporate governance"* (De Oliveira, Magnusson and Mulazimoglu, 2022[1]).

The note is structured in three sections. Section 1 presents data on recent developments in corporate bond markets globally, including issuance, credit quality, covenant protection and the intended use of bond proceeds. It then provides information on trends related to insolvency, default and resolution, as well as an overview of temporary insolvency measures in response to the COVID-19 pandemic.

Section 2 covers four broad areas:

- Bondholder rights and how their interests differ from the ones of other stakeholders such as banks and shareholders.
- The duties of directors and senior executives, both under normal circumstances (e.g. excessive risk-taking in the corporate sector) and when the company is under financial stress (e.g. the duty to disclose the risk of not meeting a material covenant).
- How the evolving profile of bondholders may affect bond market efficiency.
- The role played by debtholders during periods of financial distress and insolvency.

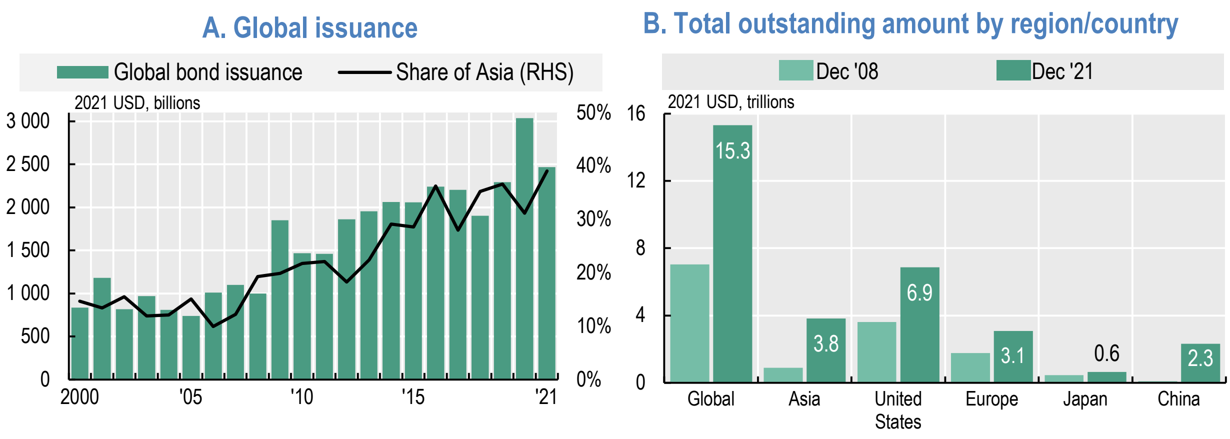
Section 3 provides an overview of measures and guidance related to bondholder rights and corporate disclosure introduced by jurisdictions and international organisations in response to the COVID-19 crisis. It also provides a summary of restructuring regimes in selected countries.

1 Trends

1.1. Developments in corporate bond markets

Corporate bonds typically provide longer-term financing compared to bank loans and serve as an alternative source of capital for companies that want to diversify their capital structure. The past decade has seen a surge in the use of corporate bonds. Globally, annual corporate bond issuance by non-financial companies doubled from an average of USD 939 billion between 2000 and 2008 to an average of USD 2 trillion between 2009 and 2021 (Figure 1.1, Panel A). Similarly, issuances by Asian non-financial companies has grown from a relatively low level of USD 121 billion annually between 2000 and 2008 to USD 602 billion between 2009 and 2021, reaching USD 965 billion in 2021. The share of Asia in global issuances has increased significantly from 14.7% in 2000 to 39.1% in 2021. As a result, global outstanding debt in the form of corporate bonds reached a record level of USD 15.3 trillion at the end of 2021, a 118% increase since 2008. Similarly, the outstanding debt in Asia more than tripled over the same period and reached to USD 3.8 trillion at the end of 2021(Figure 1.1, Panel B). The increase is particularly notable in the People's Republic of China (China), where the bond market has grown from negligible levels in 2005 to a globally significant share in recent years.[1]

Figure 1.1. Global non-financial corporate bond landscape



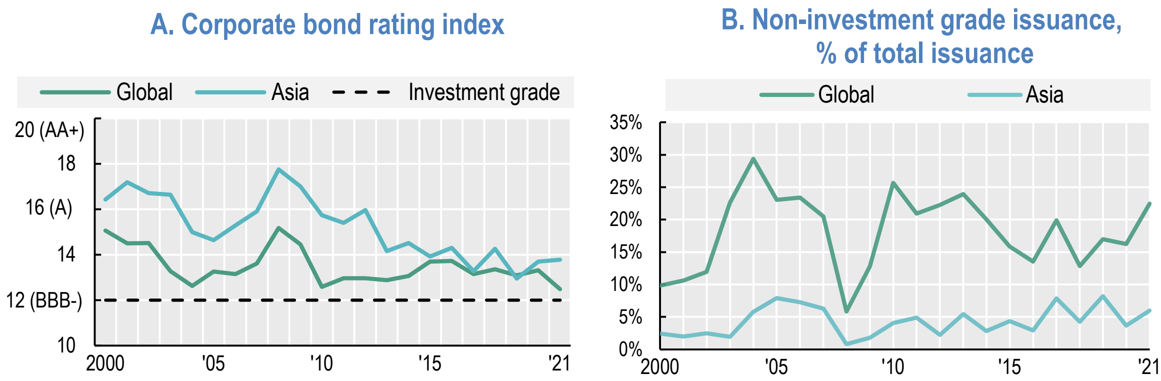
Source: OECD Capital Market Series dataset, Refinitiv.

Simultaneously, the quality of the outstanding debt stock has decreased, both in terms of credit ratings and creditors' contractual protection. The average credit quality of corporate bonds has decreased from the high levels of the early 2000s globally and in Asia (Figure 1.3, Panel A). The value-weighted average

[1] For a detailed discussion on the developments in the corporate bond markets globally over the past two decades, please see OECD's report *Corporate Bond Market Trends, Emerging Risks and Monetary Policy* (Çelik, Demirtaş and Isaksson, 2020[68]).

rating of Asian corporate bonds has decreased from above A in 2000 to slightly below BBB+ in 2021. This is somewhat slightly higher than the average rating globally, towards which Asian issuers have converged since about 2015. Contrary to global trends, in Asia this development has not been driven by a marked increase in non-investment grade issuance. The non-investment grade ("high-yield") corporate bond market has remained at low levels throughout the analysed period, representing only 3.7% of total issuance in the region in 2020 and 6.0% in 2021. This is significantly lower than the share of non-investment grade issuances globally, which stands around 22.5% in 2021(Figure 1.3, Panel B). In addition, globally the portion of BBB rated bonds (the lowest investment grade rating) reached 57.5% of all investment grade issuance, up from 39% during the 2000-07 period. For Asia, the share of BBB rated bonds increased from 5.9% in 2009 to 50% in 2020. In 2021, however the share dropped to 36.8%, making A grades the largest category at 45.8%.

Figure 1.2. Credit quality of corporate bonds

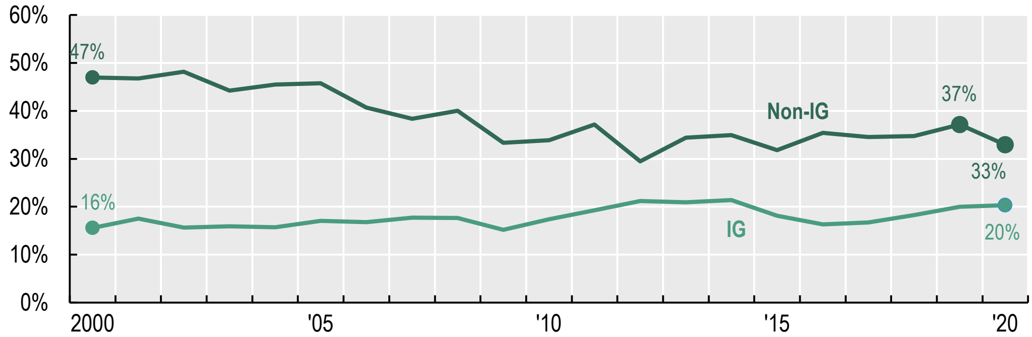


Source: OECD Capital Market Series dataset, Thomson Reuters Eikon.

Bond covenants, outlined in the bond indenture, are contractual obligations that a company commits to abide to in order to reduce the risks of defaulting on the payment schedule, and may include restrictions on its ability to take on additional debt or make new fixed investments (see further discussion in section 2 "Key Issues"). In the low interest rate environment of the past decade, bond investors became increasingly willing to forego some of their contractual protection, agreeing to weaker covenants to achieve higher returns, especially within the non-investment grade category. The covenant protection index for non-investment grade non-financial corporate bonds issued in the United States has been on a downward trend since 2000 and reached 33% in 2020, down from 47% in 2000 (Figure 1.4). In Asia, the covenant protection of non-investment grade bonds have also weakened over the last decade. According to Moody's, the average covenant quality score deteriorated to an all-time low of 3.33 (moderate) in 2020 from 2.36 (good) in 2011.[2] Still, covenant quality in Asian bonds have stayed stronger than bond covenants in EMEA and North America for 2020 (Moody's Investors Service, 2021[2]).

[2] A lower score implies stronger covenant quality on Moody's 1.0 to 5.0 scale.

Figure 1.3. Covenant protection index for bonds issued in the United States by non-financial companies



Note: The covenant protection index shows the presence of covenants in bond contracts of newly issued bonds. It is based on a binary variable (presence or absence) for 27 covenants and does not reflect their effective protection in an individual context. This figure is based on the analysis of 17 898 corporate bonds issued in the United States by companies incorporated there and in 66 other countries. 2020 data covers the January to September period.
Source: OECD (2021[3]), *The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis*, https://doi.org/10.1787/efb2013c-en.

Figure 1.5 offers a more detailed analysis of specific covenants by rating category. In addition to providing general trends with respect to the use of covenants in bond indentures, this analysis also reveals which types of covenants have caused the decrease in the overall quality of the covenant index presented in Figure 1.4.

Fifteen different types of covenants are classified under four groups of covenants (restrictions on financing activities, restrictions on payouts, event-driven covenants, and restrictions on investment activities and asset sales) (Çelik, Demirtaş and Isaksson, 2015[4]). Restrictions on financing activities were used significantly less in non-investment bonds in 2020 than in 2000 (Panel A). This holds for all covenants in the group, and it is particularly notable for stock issuance covenants, which restrict the issuance of additional common or preferred stock by the issuer or by its subsidiaries.

Covenants restricting shareholder payouts (share buybacks and dividends) have also significantly decreased within non-investment grade bonds since 2000 (see Panel B of Figure 1.6. for a more detailed view of these particular covenants over the 2000-20 period). Leverage restriction covenants and sale-and-lease-back limitation covenants have also become less widely used since 2000. Leverage covenants usually impose limits on the dollar amount of debt outstanding or require the firm not to exceed certain pre-defined leverage ratios, while sale-and-lease-back covenants limit a company's ability to raise capital by selling an asset to a counterparty and then leases it back to the company.

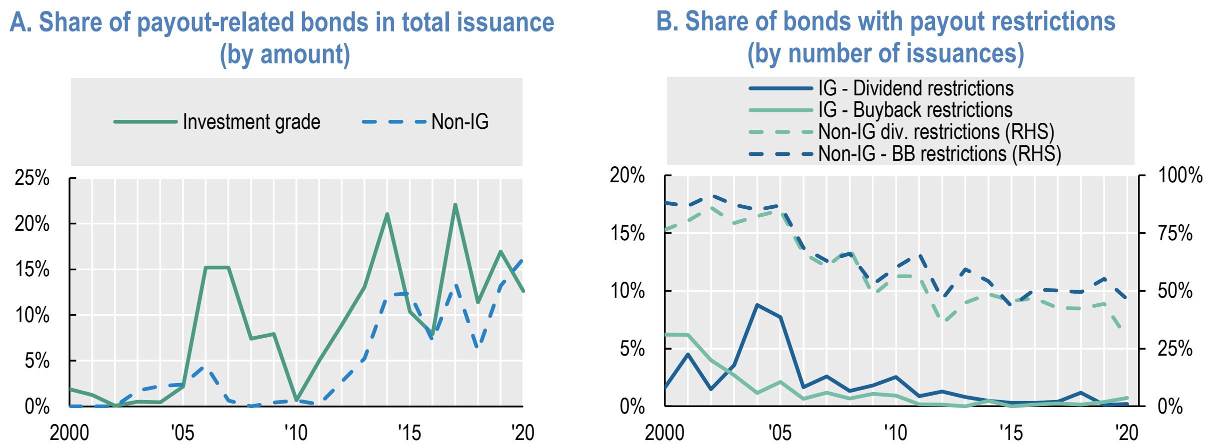
Three of the covenant types in Figure 1.5 are used in approximately 90% of both investment and non-investment grade bond indentures. They are 1) cross-default or cross-acceleration provisions, which trigger default or acceleration of payments when any of the issuer's other debt moves into default or is accelerated, 2) merger restrictions, requiring the combined entity to assume all the outstanding debt and continue to comply with the bond indenture in the case of a merger, and 3) asset sale restrictions, which permit asset sales only up to a certain amount and/or may require that the proceeds be used only for purposes specified in the bond indenture. Two other covenants that are common within both rating categories, albeit to a lesser extent than the three aforementioned, are poison put covenants, which give the bondholders the option to sell back their bonds at a premium when there is a change-in-control event, and secured debt restrictions (i.e. negative pledge covenants), which restrict the issuance of senior debt.

Figure 1.4. The use of covenants in bonds issued in the United States by non-financial companies

Note: Figures are based on the analysis of 17 898 corporate bond issues in the United States by non-financial companies incorporated there and in 66 other countries, and 2020 data covers the January to September period. The presence of covenants in bond contracts of newly issued bonds are taken as a binary variable (presence or absence) and does not reflect their effective protection in an individual context.
Source: OECD Capital Market Series dataset, Refinitiv, Mergent FISD.

Meanwhile, corporate bonds are increasingly used to finance non-investment activities, notably shareholder payouts in the form of dividends and share buybacks. Debt-financed shareholder payouts increase the risk profile of a company, augmenting the leverage ratio by simultaneously decreasing the amount of equity outstanding and increasing the amount of debt. Since 2000, there has been a sharp increase in the share of corporate bond prospectuses that indicate either dividends or share buybacks among the intended use of proceeds (Figure 1.5., Panel A). Similarly, there has been a clear decline in the share of bonds that include covenants restricting such uses, especially for non-investment grade bonds (Figure 1.5., Panel B).

Figure 1.5. Corporate bonds intended for dividend and share buyback financing



Note: The percentages in Panel A are calculated based on the subsample of corporate bond issues which have an explicit intended use for the bond proceeds other than the non-specific reason of "General Corporate Purposes". Data used in these figure covers global data with a higher share of corporate bonds from United States.
Source: OECD (2021[3]), *The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis*, https://doi.org/10.1787/efb2013c-en.

Some companies have recently begun issuing bonds specifically to finance environmental, social and governance (ESG) projects, as well as bonds linked to a company's ESG performance. Currently, there are four distinct types of ESG bonds in corporate bond markets: 1) green bonds, usually defined as bonds where the proceeds are used to invest in a portfolio of projects with positive environmental results; 2) social bonds, used to finance projects with positive social results; 3) sustainability bonds, financing projects targeting positive both environmental and social impacts; (4) sustainability-linked bonds (SLBs), where the proceeds may be used for general corporate purposes, and not for a specific portfolio of projects (ICMA, 2020[5]). For SLBs, the characteristics of the bonds (usually the coupon paid) instead vary depending on the sustainability performance of the company. Typically, the company needs to pay a higher coupon if it did not reach a predefined sustainability performance target.

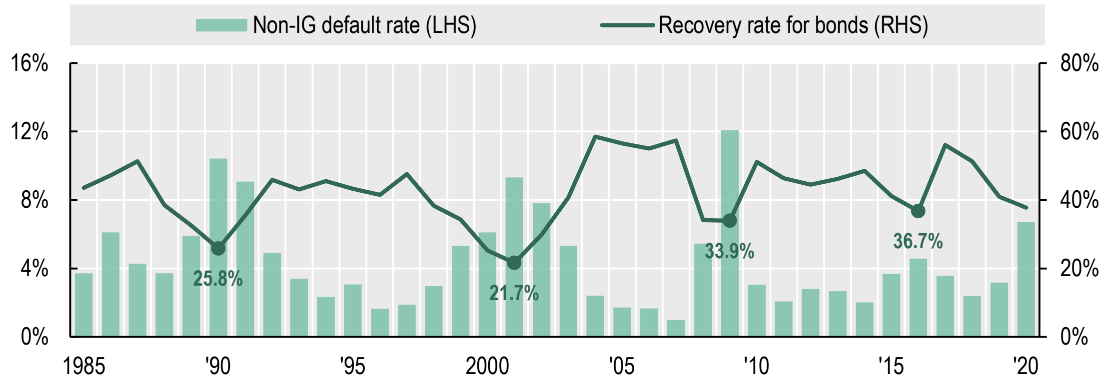
The criteria for determining whether an activity financed by the issuance of a corporate bond is environmentally sustainable, however, can vary. In order to protect investors in corporate bonds and other financial instruments, some jurisdictions have developed taxonomies to classify which economic activities should be considered environmentally sustainable (allowing, for instance, a company to label a bond as "green").[3] There has been a gradual increase in the amount of funds raised via corporate green bonds, reaching USD 378 billion in 2021. The amount of funds raised via sustainability, social and sustainability-linked bonds issued by corporations reached USD 225 billion in 2021 (OECD, 2022[6]).

1.2. Insolvency, default and resolution

During economic crises, the number of defaulting firms typically increases, while the average recovery rate tends to decrease. This negative correlation is illustrated in Figure 1.6. This dynamic is the result of several factors, notably that both variables respond to the same macroeconomic conditions and that real asset value decreases are associated with widespread defaults. Between 1985 and 2020, the average recovery rate for defaulted bonds was 42%.

[3] See, for instance, Regulation EU 2020/852 on the establishment of a framework to facilitate sustainable investment.

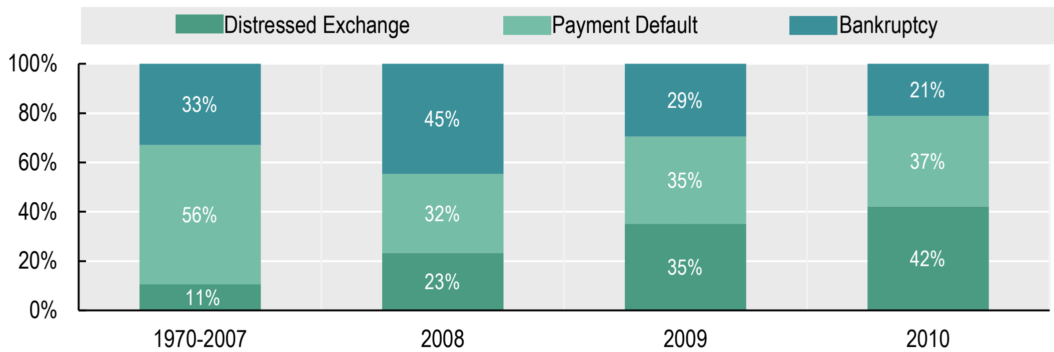
Figure 1.6. Historical non-IG default rate and bond recovery rate



Source: Moody's Investor Services (2021[7]), OECD (2021[3]), *The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis*, https://doi.org/10.1787/efb2013c-en.

Although there is clear cyclicality in both default rates and recovery rates, there is a slight upward structural trend in recovery rates over time. This could partly be an effect of an increase in the use of out-of-court debt restructuring agreements – often called "distressed exchanges" – where an issuer in financial distress offers its creditors a swap between existing debt for equity, new debt securities, cash or other types of assets (or any combination of these). The prevalence of such exchanges has increased almost fourfold from 11% of total default events in the period 1970-2007 to 42% in 2010 (Figure 1.8).

Figure 1.7. Distribution of default event types

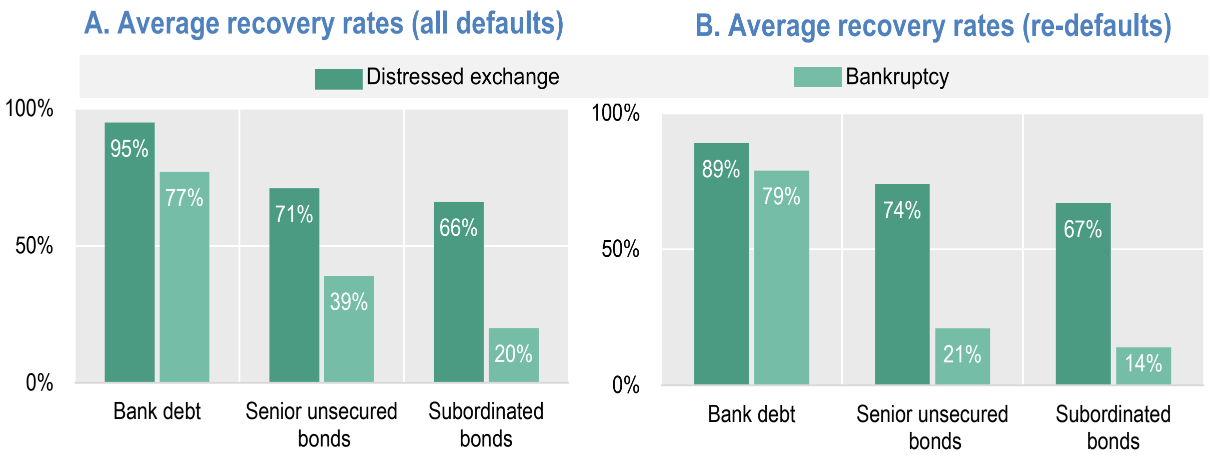


Note: The annual defaults in this figure covers global data with a higher share of defaults from North American region.
Source: Moody's Investor Services (2011[8]), OECD (2021[3]), *The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis*, https://doi.org/10.1787/efb2013c-en.

Compared to bankruptcies, distressed exchanges on average tend to offer significantly higher recovery rates, especially for unsecured and junior debt (Figure 1.9). The INSOL International Statement of Principles for a Global Approach to Multi-Creditor Workouts ("INSOL Principles") explicitly recognises that "there are often material advantages for both creditors and debtors in the expeditious implementation of informal or contract-based rescues or workouts […] compared with the unpredictable costs and uncertainties of a formal insolvency" (2017[7]). During crises and consequent large-scale financial distress, there has historically been a move towards out-of-court debt restructurings, as court involvement often represents the largest cost during insolvency proceedings (Adalet McGowan and Andrews, 2016[8]).

However, it should be noted that a majority (61%) of companies that re-default after a distressed exchange end up going through a bankruptcy proceeding (OECD, 2021[3]).

Figure 1.8. Average recovery rates: distressed exchanges vs. bankruptcies



Note: Recovery rates in this figure are based on ultimate recovery rates, which are primarily available for default resolutions of US non-financial companies.
Source: OECD (2021[3]), *The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis*, https://doi.org/10.1787/efb2013c-en.

In response to the COVID-19 crisis, several countries implemented temporary measures related to their insolvency frameworks to prevent a wave of insolvencies of otherwise viable companies and a possible overload of the court system. Compared to the group of (primarily G20 and OECD) countries presented in Table 1.1, the group of Asian economies included generally implemented fewer temporary measures related to insolvency. The most common type of measure, taken in 23 jurisdictions in Table 1.1, was the temporary suspension of debtors' obligation to file for bankruptcy and/or creditors' right to initiate such procedures – only two out of 18 Asian economies implemented that particular measure. Eleven jurisdictions, three Asian economies, increased the minimum amount of debt required to initiate bankruptcy proceedings. Five jurisdictions, including only Singapore from the covered Asian economies, implemented a temporary suspension of directors' duties regarding wrongful trading, limiting personal liability for continued business trading in an insolvent entity. It bears mentioning that a large number of Asian jurisdictions (and indeed globally) also implemented debt moratoria (not shown in the table), temporal postponement of principal and/or interest payments which effectively amounts to a (temporary) limitation of bankruptcies, albeit not through insolvency regulation. In some economies these measures only applied to certain types of companies. For example, in Sri Lanka, a six-month debt moratorium was extended to SMEs active within certain sectors.

These temporary measures were adapted as the pandemic developed. A number of countries provided extensions of the initial measures, and temporary measures were sometimes been scaled back partially over time. In France, large parts of the exceptional insolvency measures implemented in May 2020 were first extended, and then partly perpetuated in the French Government's transposition of the EU Restructuring and Insolvency Directive (Charles Russell Speechlys, 2020[9]) (Franklin, 2021[10]). In some cases, there have been permanent changes to bankruptcy legislation. For example, in Australia the temporary debt relief measures officially ceased on 1 January 2021, but the minimum debt threshold for triggering bankruptcy procedures was amended in the bankruptcy law, doubling from AUD 5 000 to AUD 10 000 (AFSA, 2021[11]). In the United States, an important measure was to raise the threshold for debt eligible for restructuring under the Small Business Reorganization Act with the COVID-19 Bankruptcy Relief Extension Act of 2021.

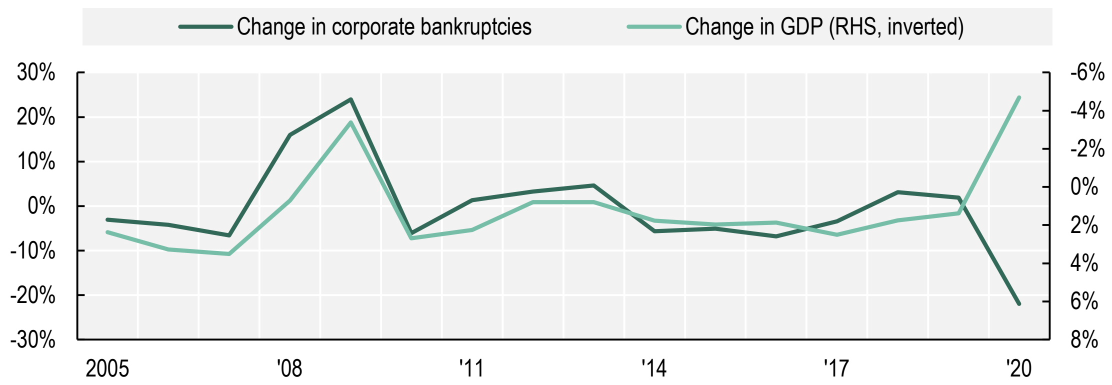
Table 1.1. Bankruptcy and insolvency – temporary regulatory measures in response to COVID-19

Extension of thresholds to respond/ file bankruptcy/insolvency notice	Suspension to file for bankruptcy/insolvency		Temporary relief for directors from duty to prevent insolvent trading
Australia	Belgium	Lithuania	Australia
Austria	Czech Republic	Luxembourg	Germany
France	Estonia	Mexico	New Zealand
Hungary	Finland	Poland	**Singapore**
India	France	Portugal	United Kingdom
Israel	Germany	Russia	
Italy	Hungary	Slovak Republic	
Korea	**India**	Slovenia	
Malaysia	**Indonesia**	Spain	
Singapore	Italy	Switzerland	
Slovak Republic	Latvia	Türkiye	
		United Kingdom	

Source: OECD (2021[3]), *The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis*, https://doi.org/10.1787/efb2013c-en.

Economic crises are generally followed by increases in bankruptcies. However, the COVID-19 crisis, at least up until now, has been an exception. Together with substantial fiscal and monetary support, the temporary insolvency measures summarised above have successfully prevented a surge in bankruptcies. As Figure 1.9 shows, this has temporarily severed the link between the number of corporate bankruptcies and GDP growth in a group of OECD countries. Indicative both of the large economic damage caused by the pandemic and the scale of intervention, between 2005 and 2019 the correlation coefficient between the yearly change in corporate bankruptcies and GDP growth was negative and very strong (-0.88), but when including 2020 in the sample (2005-20) the correlation reduces significantly (-0.12).

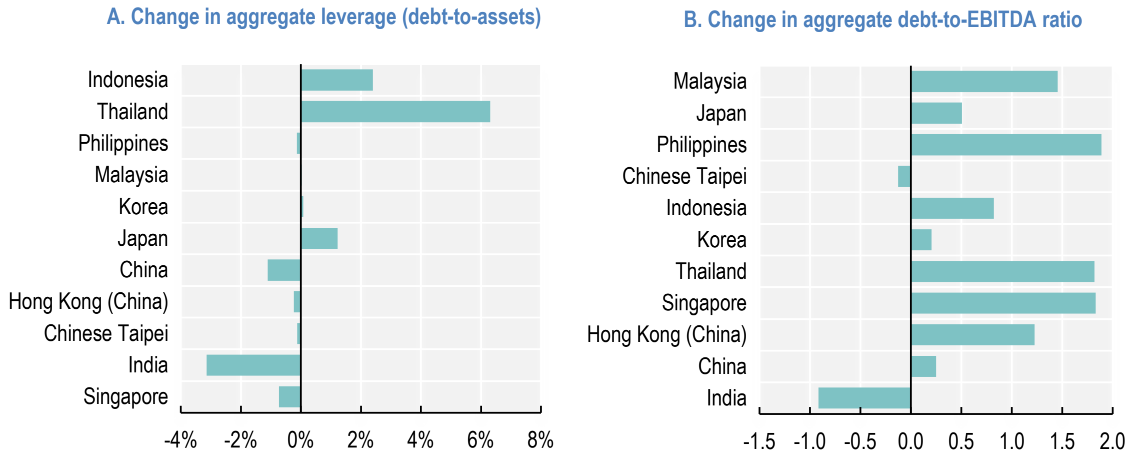
Figure 1.9. GDP growth and yearly change in bankruptcies in a group of OECD economies



Note: The countries included are those with full data coverage over the period: Australia, Belgium, Finland, France, Germany, the Netherlands, Norway, Sweden and the United Kingdom. Both measures use simple unweighted averages.
Source: OECD Statistics.

The main business-related challenge facing governments in the aftermath of the COVID-19 pandemic is that fundamentally viable businesses may exit the crisis with unsustainable levels of financial leverage, making them more vulnerable to future macroeconomic shocks. In Asia, when looking at leverage at the economy level, measured as the debt-to-assets ratio of listed corporations, only a few economies have seen significant increases between 2019 and 2020 (Figure 1.10, Panel A). The most pronounced increase is observed in Thailand and Indonesia, where leverage rose by 6 and 2 percentage points respectively between 2019-20. On the contrary, Indian corporations' aggregate leverage ratio decreased by 3% between 2019-20 as many firms used internal cash flows to cut debt as capital expenditure was deferred (Fortune India, 2021[12]). A larger increase in leverage is observed when looking at the debt-to-EBITDA ratio (Figure 1.10 Panel B). Indeed, most economies in Asia have seen an increase from around 1x to 2x between 2019 and 2020. Specifically, corporations in the Philippines, Thailand and Singapore experienced an increase in this ratio of 2.0x in 2020. In Singapore the ratio rose from 5.1x in 2019 to 6.9x in 2020, and in the Philippines, this number increased from 4.1x in 2019 to 6.0x in 2020.

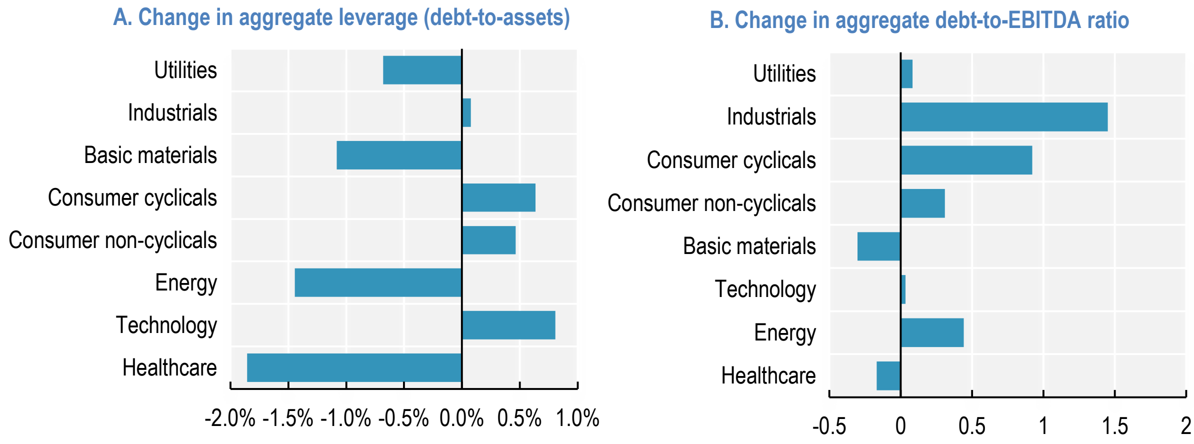
Figure 1.10. Debt ratio of non-financial listed companies between 2019 and 2020, by economy



Source: OECD Capital Market Series dataset, Refinitiv, see Annex for details.

As shown in Figure 1.11, only consumers and technology experienced an increased in their leverage ratio between 2019 and 2020. Contrarily, industries such as basic materials, energy and healthcare decreased tier leverage ratio between 2019 and 2020. When looking at the debt-to-EBITDA ratio, industrials have experienced the largest increase between 2019 and 2020.

Figure 1.11. Debt ratio of non-financial listed companies in Asia between 2019 and 2020, by industries

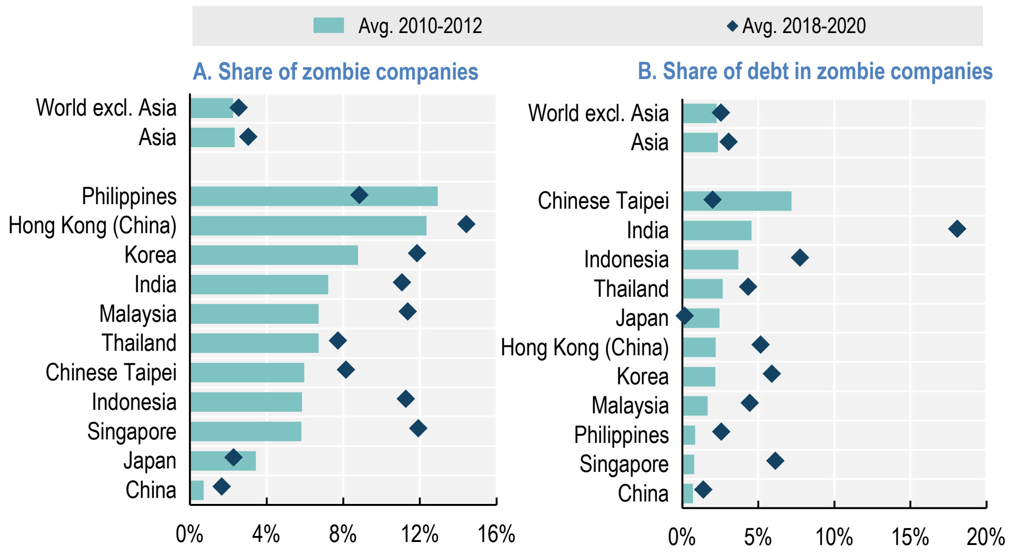


Source: OECD Capital Market Series dataset, Refinitiv, see Annex for details.

Increasing debt levels and a persistent decline in firms' profitability have led to the rise of zombie companies around the world. These non-viable zombie firms are defined as mature firms that are consistently incapable of covering their interest payments with their operating profits (Adalet McGowan, Andrews and Millot, 2017[13]).[4] In Asia, the share of zombie companies has also increased and this rise is especially prominent in Singapore, Korea, Malaysia, Indonesia and India (Figure 1.12 Panel A). In these economies, the average share of zombie companies between 2018 and 2020 has stood at around 12%, which is an increase of approximately 5 percentage points from the average between year 2010 and 2012. In Hong Kong (China) the ratio of zombie companies has been consistently high, with on average over 14% of companies identified as zombie companies between 2018-20. These companies also make up a significant share of the total debt of listed corporations. In India, the share of debt in zombie companies' balance sheets increased significantly and reached almost 20% of total listed companies' debt between 2018 and 2020 (Figure 1.12 Panel B). In Indonesia, Singapore, Korea and Hong Kong (China), zombie companies represent around 5% of total debt. The presence of such non-viable companies is a sign of resource misallocation in the economy, and could deprive promising companies of financing opportunities and deter new entrants in the market.

[4] Zombie companies' definition here follows Adalet McGowan, Andrews and Millot (2017). Zombie companies are defined as firms older than 10 years that during three consecutive years are not able to cover their interest payments with their operating income. The age restriction is imposed to differentiate between real zombie firms and young innovative firms.

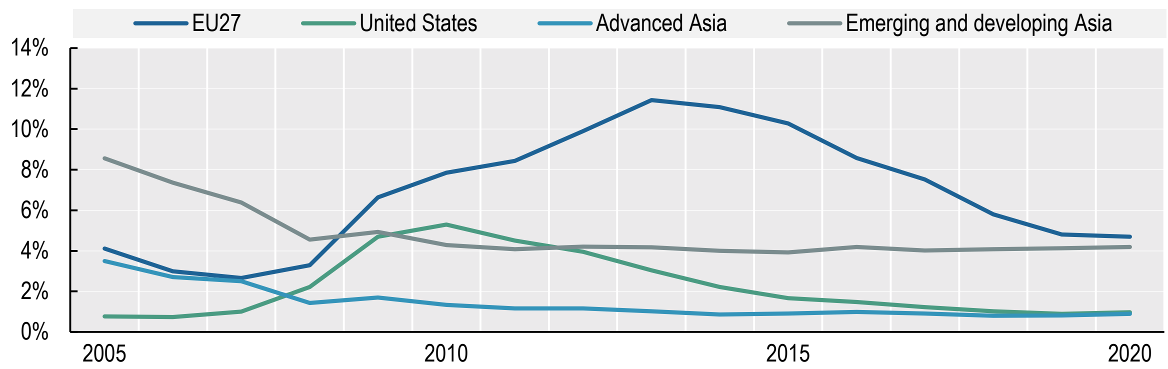
Figure 1.12. Zombie companies by economy / region



Source: OECD Capital Market Series dataset, Refinitiv, see Annex for details.

Importantly, the non-performing loans (NPL) ratio in the region more broadly has been stable and relatively low in the past decade, with no notable increase after the 2008 financial crisis (Figure 1.13). This trend holds for both advanced and emerging Asian economies. This is in sharp contrast to the European Union, which is also heavily bank-dependent, where the share of NPLs rose sharply after the financial crisis and remained elevated during the subsequent euro crisis with significant negative impact on economic performance and financial stability.

Figure 1.13. Non-performing loans ratio in selected regions



Note: Simple averages. United States data are annual averages based on quarterly figures.

Source: IMF Financial Soundness Indicators, Bank of Japan, Federal Reserve Bank of St. Louis FRED.

2 Key issues

The G20/OECD Principles of Corporate Governance state that the corporate governance framework "should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights" (Principle IV.F). The annotation accompanying this Principle contains the only reference to bonds in the G20/OECD Principles of Corporate Governance in their current form, clarifying that creditor rights may vary, "ranging from secured bond holders to unsecured creditors". The important role bondholders currently play in the governance of listed companies, however, suggests that a more comprehensive view of key issues related to bondholder rights may be warranted.

The majority of companies using corporate bond markets are listed on public equity markets or are subsidiaries of publicly listed companies (OECD, 2015[14]). As outlined in the previous section, bond markets have recently gone through a number of changes, such as increased borrowing by non-financial companies, lower credit ratings, the increased prevalence of debt-financed shareholder payouts and the reduction in covenant protection for non-investment grade bonds. The sharp increase in leverage and the temporary suspension of regular insolvency proceedings in a number of jurisdictions following the COVID-19 crisis raise further issues for corporate bond markets. This section provides some key considerations in this regard, notably related to the interplay between creditors and shareholders, the structure and disclosure of covenants, corporate disclosure, the responsibilities of corporate boards, participants in the corporate bond markets and insolvency.

2.1. Creditors' and shareholders' conflicting interests

Corporations have two distinctive characteristics that have made them central to thriving market economies: legal personality and limited liability. For entrepreneurs, this effectively means they can invest their capital in risky ventures knowing how much they might lose in each. This allows for both diversification of investors' portfolios and for investment in enterprises with high risk but potentially large payoffs.

For creditors, the corporate form provides clarity with respect to which pool of assets will be available to support their claims (the claims of corporate creditors have priority over those of shareholders). This permits creditors to focus their analysis on a restricted pool of assets and on a specific line of business, instead of having to understand all assets and liabilities of a group of entrepreneurs. However, there are clear agency costs in this structure because, under normal circumstances, the shareholders – not creditors – control the corporation.

There are three typical ways in which shareholders can benefit at the expense of corporate creditors (for simplicity, assuming here shareholders exercise strong control over management). First, shareholders may divert corporate assets for their personal benefit (e.g. paying above-market remuneration to themselves as executives), therefore reducing the value of assets available for creditors' claims. Second, shareholders may decide in some circumstances to replace low-risk with high-risk assets because they enjoy the upside potential but their losses are limited to the value they invested in equity, while creditors' claims are commonly fixed. Third, new creditors might dilute previous ones when lending money to a company for a project that would not be financially viable without the lower rates charged by the older lenders when financial leverage was lower. This dilution of previous creditors benefits shareholders because they have access to finance from the older lenders that, in light of the more recent higher leverage, is now cheaper than the market would be willing to offer.5

The possibility of the three events above may reduce a company's total value (the sum of its equity and debt calculated by a discounted cash flow valuation method) due to an increase in the cost of debt financing creditors would require to be compensated for assumed risks. This is the reason why shareholders and creditors often agree on contractual provisions to limit the possibility of those events. Creditors may, for instance, take security interests in some major corporate assets, which would limit the possibility of asset substitution that is not in their interest (creditors would need to approve the transfer of those assets) and the dilution of creditors' claims (there would be a segregated pool of assets to support their claims). There are also a number of "debt covenants" that aim at regulating the scope of management's business decisions in order to reduce the risks posed by the misalignment between shareholders' and creditors' interests and, therefore, to create long term sustainable value in companies.

As discussed in Section 1.1 and as detailed further below, covenants may, for instance: limit dividend payouts to avoid asset diversion; require creditors' approval for the divestment of major assets to restrict the possibility of asset substitution (one of the most commonly used debt covenants, as shown in Figure 1.4) or establish that debt repayment would be accelerated if financial leverage exceeds a predetermined threshold to prevent creditors' dilution (a common covenant in non-investment grade bond indentures). While not common, these same provisions could be set by the company law to all companies or in a company's articles of association. In some jurisdictions, for instance, a company may not distribute dividends nor buy back shares if its book value is smaller than its legal capital (Kraakman et al., 2017, pp. 125-126[15]). However, leaving the terms of creditors' protection to loan contracts and bond indentures allows greater flexibility across time and between creditors. Jurisdictions deal with shareholder-creditor agency costs in their legislation mostly in relation to companies that are financially distressed. This is because in such cases the incentives for shareholders – who often see the value of their equity come close to zero – to accept a risky and possibly value-decreasing bet become more significant, and covenants negotiated during normal circumstances may not be enough to protect creditors' interests. A common legal provision is therefore "to encourage managers of distressed corporations – who are, by and large, well-placed to assess the firm's financial situation – to act in the interest of creditors, rather than shareholders, and to initiate, if appropriate, a transition to informal debt restructuring or formal bankruptcy proceedings" (Kraakman et al., 2017, p. 114[15]). With a similar goal, as discussed in Section 1.2 a number of jurisdictions also give creditors the right to initiate a bankruptcy proceeding if a company is unable to pay debts as they fall due.

Policy-making and contract negotiation will, in any circumstance, depend on the business context. In the discussion above, it was assumed that shareholders exert considerable influence over directors, which will often be the case where equity ownership is concentrated. However, if directors' and shareholders' incentives are not closely aligned, directors may not necessarily make decisions that favour shareholders and, in some circumstances, may even be overly conservative in order to avoid a bankruptcy that would negatively impact their reputation and job security (i.e. the shareholder-creditor agency costs will be smaller).

The number of creditors of a company and in a market is also relevant for policy making and contract negotiation. Where debt finance is concentrated, the few existing creditors will often be able to cost-effectively monitor management and renegotiate a company's debt when needed, which facilitates creditors' response to the misalignment between shareholders' and creditors' interests (for instance, out-

5 The discussion in this paragraph is focused on individual companies and assumes all else being equal. Changing market conditions, such as greater liquidity, however, could mean that a second round of debt issuance may be less costly despite more financial leverage. The analysis on conflicts of interest, nevertheless, would still be relevant. In this example of increasing liquidity, debt became more valuable to old creditors because of lowering basic interest rates, but at least part of this gain would be lost due to the higher credit risk caused by more financial leverage.

of-court debt restructuring may be easier). Contrarily, if debt finance is dispersed, creditors may need to rely more heavily on bond trustees, require stringent covenants and use formal bankruptcy proceedings to restructure debt, with all the associated costs (Armour, Cheffins and Skeel Jr., 2003, pp. 1763-1767[16]).

2.2. Bondholders and covenants

Bondholders have certain characteristics that differentiate them from other creditors, notably banks. Firstly, bondholders are typically more dispersed than other creditors. Whereas a bank loan is provided by a single bank, or a syndicate of banks in some cases, a corporate bond is issued to a wider group of investors in the public market. In addition to the monitoring and co-ordination challenges highlighted in the previous paragraph, this makes for a more complex holding structure. In addition, bonds are usually issued in so-called “global form”, meaning all bondholders’ debt is owned either as one single security or as a small number of securities that are held by a depository (typically a bank) or by an international central securities depository (“ICSD”). The actual legal claim is often held by the depository on behalf of the bondholder itself or of a custodian, which is in turn holding it on behalf of the beneficial bondholder. The custodian structure can make the communication between bondholders and issuers challenging, because information needs to flow through a complex network involving custodians and clearing systems (Brodie, 2017[17]).

Another difference relates to the secondary trading of the debt obligation after the borrowing has taken place. While syndicated bank loans can trade in the secondary market, and bank loans can be securitised and traded, as a base case a company taking out a bank loan could expect the bank to remain its creditor until the debt’s maturity (and in particular to remain its point of contact in case of financial distress). Contrarily, the base case for corporate bonds is secondary market trading, meaning the original creditor at the time of issuance is not necessarily the same as the bondholder at some future point, even when there is limited liquidity in the market. Neither the seller nor the buyer of a bond traded in the secondary market is typically under any obligation to inform the issuer that a trade has taken place. Because of this, it is often difficult for issuers to keep an accurate record of the owners of their debt. This can create complications during insolvency procedures, for instance, and issuers may need to undertake a bondholder identification process, typically issuing a press release requesting bondholders to identify themselves. It is also possible to request information on holders from the depository institution, but as bonds are often held by custodians such a process may be unable to identify bondholders in a timely manner (Brodie, 2017[17]).

2.2.1. Covenant structure

Covenants are bondholders’ main corporate governance tool. As mentioned in Section 1.1, covenants act as restrictions on certain actions by the debtor in order to maintain the desired risk profile and reduce the agency costs related to the shareholder-creditor relationship. They are stipulated in the bond indenture at the time of issuance. While both investment grade and non-investment grade bond contracts contain covenants, for investment grade bonds they are typically restricted to issues such as limiting the amount of secured debt an issuer can incur. Non-investment grade bonds, however, will have more extensive covenants, owing to their higher risk of default (Miller, Denaro and Cunningham, 2014[18]).Figure 1.5 provides an overview of covenants used by rating category for bonds issued in the United States.

Violation of covenants results in so-called “technical default” (as opposed to “payment default”) and may lead to an increase in interest rates or the obligation to immediately repay the debt (acceleration). The governance rights provided by covenants have value, illustrated by the fact that bonds trade at a premium to their synthetic (CDS-based) equivalents which cannot be explained by liquidity differences. Further, the premium increases for lower-rated companies (i.e. with higher probability of default) and close to default events, indicating that it is an effect of creditor rights (Feldhütter, Hotchkiss and Karakaş, 2016[19]).

In order to facilitate the enforcement of bond covenants, an independent trustee is typically assigned to represent bondholders and review instances of covenant default. While the specifics of how the trustee will perform this duty can vary according to the individual contract, a general framework is provided by regulatory and legal authorities. For instance, the US Trust Indenture Act has provisions regarding the eligibility and disqualifications of a trustee, the obligations of an issuer, and duties of trustees prior to and during the default.6 However, the independent trustees (often banks) may have little incentive to actively engage to enforce bondholder rights, owing to their fixed fee structure (typically paid by the issuer) and lack of obligations towards bondholders before a covenant breach has taken place, meaning monitoring may suffer. In certain jurisdictions, the appointment of an independent trustee is optional (including in the United States, for transactions where the Trust Indenture Act does not apply). Owing to professional liability concerns, their action is commonly limited to administrative tasks and taking instructions from bondholders. The primary tool available to trustees is the annual compliance certificate supplied to them by the issuer. However, these documents are simple statements of compliance and the trustee is not typically expected to make an assessment of the accuracy of the report (Çelik, Demirtaş and Isaksson, 2015[4]).

Further, the structure of covenants in a bond indenture differs from those typically used in other debt contracts. Loan agreements normally use so-called maintenance covenants where compliance is tested at fixed time intervals, whereas bonds (and high-yield bonds in particular) normally use incurrence covenants that are only tested when an issuer engages in a certain action (Brodie, 2017[17]). Nevertheless, there is, as just mentioned, often an element of periodical compliance testing for bonds since issuers must generally supply the trustee with a certificate of compliance annually. However, these compliance tests differ significantly in rigour from those of bank loans, in that they require no supporting calculations or background document, leaving the issuer great freedom to interpret its own compliance with the covenants. Contrarily, bank loan covenants are usually tested quarterly and require detailed calculations, and creditors are often allowed to require additional information from the issuer (Kahan and Rock, 2009[20]).

The effect of this may be that restructurings are initiated later than they would have been had the covenants in the bond contract been subject to regular compliance testing. The increase in passive investor ownership, as discussed further below, may have similar effects. In addition, the extent to which covenants are used at all has declined significantly, as shown in Figure 1.3. However, it bears mentioning that there is a class of specialised hedge funds which focuses on identifying covenant breaches in order to profit from accelerated payments, acting as a form of check on covenant compliance (Çelik, Demirtaş and Isaksson, 2015[4]).

While bondholders can act directly on a covenant breach themselves by informing the trustee, to do so they may be legally required to represent a certain share of bondholders. Taking into consideration the large median issue size of corporate bonds (see e.g. (OECD, 2021[3])) and the dominance of diversified portfolio strategies among bond investors, exceeding the required share may be a challenge. However, since corporate bonds are mainly held by institutional investors, co-operation among them may solve this problem if they have adequate incentives to actively protect the financial interests of their beneficiaries and monitor companies. However, for instance activism by hedge funds has also been accused of causing issuers to create more lenient covenant formulations and, to a certain extent, driving the decrease in the quality of the covenants set out in Figure 1.3 (Kahan and Rock, 2009[20]).

While some indentures offer equal opportunities for all bondholders, it is also possible for a majority of bondholders to structure consent solicitations7 with issuers and exchange offers that maximise the value only for themselves, usually at the expense of minority bondholders. In such a situation, consent solicitations allow the issuer to get majority bondholders' approval to make amendments to the indenture

6 Under the terms of the US Trust Indenture Act, certain securities and transactions are exempt from the provisions of the Act.

7 A "consent solicitation" is a process by which a security issuer proposes changes to the terms of the security contract.

or to waive actual or possible defaults. In exchange, the issuer offers the consenting bondholders attractive fees. Another way that the issuer can amend the indenture or have defaults waivered is by making an exclusive exchange offer where a majority of bondholders tender their bonds for new bonds and in return give consent to the issuer for the desired changes in the bonds that they are trading out (Çelik, Demirtaş and Isaksson, 2015[4]). The trustee, who is supposed to represent all bondholders, may refrain from following the majority's directions by arguing that minority holders would be harmed. However, the trustee may have little incentive to go against the majority decision if they do not face any significant civil or criminal liability risks.

2.2.2. Disclosure and shareholder approval of covenants

Corporate governance policy making and scholarship have traditionally focused on the ability of shareholders to influence management, and on the conflicts of interest between controlling and minority shareholders. Creditors have often been treated as passive bystanders until companies go into bankruptcy. However, as discussed, companies may issue bonds with covenants that considerably restrict the discretion of management (more strongly for companies with low credit ratings, as seen in Figure 1.4) and, under financial stress but well before bankruptcy, companies may choose to renegotiate their debt conditions with existing creditors (for instance, to agree on a waiver of compliance with a covenant). During a debt renegotiation, existing creditors may require changes in the business, such as the replacement of top executives or a reduction in planned capital expenditure (Nini, Smith and Sufi, 2011[21]).

Despite the importance of covenants in the corporate governance of a company, and the fact that shareholders' residual claims are affected by changes related to debt securities, shareholders do not typically have the right to approve the issuance of bonds and the specific terms of their trust indentures. In fact, as is the case with many other relevant business decisions, shareholders typically rely on management's expertise to negotiate new debt financing on behalf of the company and, if managers prove to be incompetent, shareholders would replace them. Since directors' fiduciary duties are also commonly towards shareholders under normal circumstances, shareholders may also be assured by the deterrence effect of a possible enforcement action.8 However, a prerequisite for shareholders to be able to effectively supervise management's performance in managing a company's debt is that there is adequate, publicly available information about debt contracts and related developments. This is also a precondition for the broader objective of maintaining transparent markets as stated in the G20/OECD Principles of Corporate Governance (V.A.7), which make clear that "[t]he Principles envision the disclosure of sufficient and comprehensive information to fully inform investors of the material and foreseeable risks of the enterprise".

Securities regulation requires public companies to file at least an annual report (e.g. Form 10-K in the US), to prepare and make available a prospectus when making a public offer of securities (e.g. Regulation 2019/980 in the EU and Securities Act of 1933 in the US), and, whenever certain material events occur, promptly inform the market about such an event (e.g. Form 8-K in the US). This might represent an obligation for issuers to disclose information on existing material bond covenants or the risk of violating one of those. For instance, the European Securities and Markets Authority's (ESMA) guidelines on disclosure requirements under the Prospectus Regulation state that the issuer should disclose whether it "has entered into covenants with lenders which could materially restrict the use of credit facilities" (ESMA, 2021, p. 15[22]). Likewise, these guidelines state that "where a breach of a covenant has occurred or there is a substantial risk it may occur, information should be disclosed in the prospectus on the impact of the breach and how the issuer will remedy the situation". Non-listed companies and foreign companies that issue a bond in the public markets may face less strict reporting requirements, but, even in those cases, bond indentures might establish some contractual reporting obligations (Christie et al., 2018[23]).

8 For a more nuanced and complete discussion on director fiduciary duties, please see OECD's report *Climate Change and Corporate Governance* (OECD, 2022, pp. 37-39[66]).

Companies may also need to disclose information on existing “externally imposed capital requirements” (some debt covenants may be classified as such) in their financial reports and, when they have not complied with these capital requirements, they may have to report “the consequences of such non-compliance” (paragraph 135 of IAS 1). Moreover, a company would need to provide details of any technical defaults resulting from the violation of a debt covenant and inform whether the default was remedied or the terms of the debt contract were renegotiated (paragraphs 18 and 19 of IFRS 7).

All the aforementioned disclosure requirements are in line with the G20/OECD Principles, which state that “[w]here stakeholders [which include creditors] participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis” (Principle IV.D). There is always the risk, however, of a company not disclosing all material information on debt covenants in a timely manner or, when doing so, the danger of using boilerplate language that would not allow investors to effectively assess a company’s risks. For example, a Chinese manufacturer failed to repay a bank acceptance bill on 4 November 2016 and disclosed the default only two weeks later, whereas a cross-default covenant in one of the company’s bond series provided that the company should publicly disclose any default within two working days (the company was later granted a grace period by the bondholders but the cross-default was eventually triggered in January 2017).[9] Especially for unconventional debt covenants (see the following section for further detail and examples), even well-intentioned executives may find it difficult to understand and communicate the risks posed by some covenants.

2.2.3. Recent developments in covenant design

Following extended expansionary monetary policy in a number of large economies both after the 2008 crisis and in response to the pandemic-induced crisis and the consequent widespread fall in yields, many investors have been willing to invest in bonds with a smaller covenant protection in search of higher returns, as illustrated in Figure 1.3. For example, there have been a number of cases, primarily involving private equity groups, where covenants allow for so-called “asset stripping” through moving valuable assets from restricted subsidiaries – the assets of which are used as guarantees for secured bondholders – to unrestricted subsidiaries, where they have no such claim. Once the assets are moved out of reach from secured bondholders, they can be used to negotiate, for example, distressed exchanges with subordinated creditors. Such deals have primarily been carried out in US bond markets (Rennison and Indap, 2020[24]).This has led to conflicts between creditor representatives and issuers, even resulting in lawsuits (Wells, 2017[25]). In 2017, an attempt to include similar provisions for a euro-denominated issuance was rejected by investors (Smith, 2017[26]).

For non-investment grade bonds, there are typically covenants stipulating an upper limit on “restricted payments” that would reduce collateral (e.g. shareholder dividends). However, opaque definitions of what counts as a restricted payment (and whether for example equity contributions may increase that limit) have led to cases where it is unclear to what extent the issuer is able to move collateral out of reach from creditors. Adding an additional layer of uncertainty, the limit on restricted payments can also be governed by “excluded contributions” covenants. Excluded contributions enable shareholders to receive their equity contribution as a restricted payment, subject to a certificate by the issuer’s principal financial officer specifically designating the contribution as excluded. There have been instances of back-dating definitions of excluded contributions, resulting in significant uncertainty for bondholders about the actual amount of collateral they have access to (Scaggs, 2018[27]). In one case, the value of a company’s outstanding bonds fell sharply as previously unaware bondholders were informed that management did not control the amount of cash that flowed to its owners. Instead, the central treasury, which sent money to its controlling shareholder, was controlled by the board of directors, in turn primarily representing the same controlling

[9] See (Fitch Ratings, 2019, pp. 28-29[63]) and (Reuters, 2017[64]).

shareholder. In addition, the treasury was funded by drawing from the company's revolving credit facility. According to some bondholders, such dividend payments had not been expected, but they were technically allowed under existing covenants, allowing payouts outside of the ring-fenced group (Smith, 2018[28]).

Another example of the loosening of covenant standards is the attempted inclusion of wide-ranging exceptions for covenants stipulating debt limits. Leverage restriction covenants are very common for non-investment grade bonds (see Figure 1.4), setting out restrictions against excessive borrowing by defining for example a maximum debt-to-EBITDA level.10 However, sometimes a "designated commitment" covenant is used to ensure that e.g. credit facilities can be used even if the debt limit is surpassed, which would otherwise result in a technical default. For example, if a company has reached its maximum leverage ratio and the denominator falls (i.e. an EBITDA reduction in the case of a debt-to-EBITDA covenant), a designated commitment covenant would allow the company to continue drawing on the credit facility, subject to it being designated as committed. It has occurred, however, that a bond indenture allows a designated commitment to exclude the committed credit facility from the leverage ratio altogether, effectively increasing the company's borrowing capabilities beyond the debt restriction defined in the bond indenture (Scaggs, 2018[29]).

Two final cases of dubious covenants bear mentioning. The first is so-called "shrinking guarantees", where the share of debt instruments guaranteed by collateral may decrease as borrowing increases, resulting in creditor uncertainty (Scaggs, 2018[30]). The second is the increased prevalence of exceptions ("step-downs") from the standard assumption that 100% of proceeds from asset sales outside of ordinary course of business should go towards prepayment of debt, and the possibility of debt ratios activating such step-down clauses being defined at the issuer's discretion. This discretion could mean, for example, that the issuer may be able to use self-adjusted EBITDA as the basis for the leverage ratio (Scaggs, 2018[31]).

Covenants structured in an opaque way with unconventional exceptions hamper bondholders' ability to properly exercise their rights and governance function. Disclosure of whether covenant breaches are imminent, as well as conditions that may affect future financing arrangements or workouts, are therefore pertinent to both to creditors and to shareholders. This is particularly relevant during times of financial distress when uncertainty is heightened.

Investors have raised concerns about the loosening of covenant standards and inadequate disclosure. In 2015, a group of prominent investors wrote a letter to the Association for Financial Markets in Europe ("AFME") expressing worry about issues on the European non-investment grade bond market and asking for a revision of the Association's best practices. The letter asked for greater disclosure standards on equal terms for all investors, both of different creditor agreements and of financial results. It also raised grievances regarding the increased prevalence of exceptions to covenants ("carve-outs"), such as more liberal indebtedness covenants allowing for increases in leverage ratios, and the inclusion of anticipated synergy costs as EBITDA add-backs (as discussed above). Further, the investor group underlined the expansion and loosening of portability provisions (providing the ability of transferring beneficial ownership without triggering a change in control, subject to certain criteria such as leverage ratios), effective dilution of collateral for secured debt, as well as the shortening of non-call periods (the time from issuance during which a bond cannot be redeemed) and expansion of equity clawback provisions (providing issuers the right to early redemption of part a bond using proceeds from equity offerings) (Wigglesworth and Bolger, 2015[32]).

With respect to covenant disclosure, AFME's 2018 guidelines for the high-yield primary market state that the offering memorandum "should disclose the key terms of the issuer's material debt facilities and other financings […] and, with respect to each material facility or instrument: […] financial covenants […] in

[10] EBITDA is not defined in International Financial Reporting Standards (IFRS). When EBITDA is in a debt covenant, the debt agreement defines how this measure is calculated. Therefore, it may not be comparable to other measures referred to as EBITDA.

sufficient detail to enable investors to understand the issuer's obligations under the covenants" (emphasis added) (AFME, 2018[33]).

Greater investor focus on climate change has also resulted in the design of new covenants. One example is the bond issuance by an Italian utility company in 2019. According to a covenant in the indenture, the bond's coupon is linked to the company's goal of making 55% of its overall installed capacity renewable by the end of 2021. If the target is not met (as reported by an independent auditor), the interest rate on the bond increases by 25 basis points (Taylor, 2020[34]).

2.3. Excessive risk taking in the non-financial corporate sector

Management, together with the board, is best placed to decide on the optimal capital structure of a company that would maximise its market value. This decision will depend, for instance, on the costs of issuing securities, the current equity risk premium, and the tax treatment for different types of funding (e.g. distribution of dividends and payment of interest to bondholders). Therefore, managers need to frequently adjust their funding decisions according to a number of different factors and dynamic market conditions in order to maximise enterprise value. There are, however, some conflicts of interest that may prevent managers from reaching a decision on a capital structure that would be ideal for both creditors and shareholders.

One conflict that may cause excessive risk taking, as discussed in Section 2.1, is that managers acting in line with shareholders' interests may decide to increase financial leverage (and therefore augment the risk for creditors) to fund a project that would not be financially viable without the lower rates charged by the older lenders when financial leverage was smaller.11 In a mature, investment grade corporation, this risk may be negligible because the company often explores a number of well-known business lines (as a result, as shown in Figure 1.4 "leverage restriction" covenants are uncommon for investment grade bonds). However, for growth companies that are still testing new market niches, conflicts of interest may be more significant (for this reason and possibility others, non-investment grade companies often include "leverage restriction" covenants in their bonds).

There are also agency costs in the relationship between shareholders and managers. Firstly, because the time horizon of managers may be shorter than the one of shareholders. If this is the case, managers may, for instance, choose a more leveraged capital structure if this would represent lower total financing costs in the short term (assuming the equity risk premium is relatively high), despite the higher risks in case a major economic crisis takes place. Evidently, shareholders would not be indifferent to excessive financial leverage, but, in a market with a shrinking number of listed companies and significant liquidity, equity investors may not have many alternatives for where to invest. Moreover, shareholders' lack of capacity to co-ordinate may make an intervention regarding management's decisions on capital structure unlikely. The second shareholder-management agency costs would be that directors may have simply lacked the necessary diligence to establish a proper risk assessment system to consider different uncommon scenarios, such as a pandemic or a disruptive development in global geopolitics. This absence of diligence could represent a violation of executives' and directors' duty of care, but, in many circumstances, it may be challenging for shareholders to prove negligence of management in a business decision as complex as managing the capital structure of a public company.

There may also be agency costs between controlling and minority shareholders. This is especially important where dual class shares are not permitted, as controlling shareholders may be unwilling to raise equity funds for fear of ceding control of the corporation. Therefore, controlling shareholders may be willing

[11] As discussed in footnote 3, the discussion on conflicts of interest in this paper is focused on individual companies and assumes all else being equal.

to accept financial leverage that does not maximise the enterprise value (i.e. destroying value for existing minority shareholders).

All conflicts of interest listed above are as old as the corporate form. It is an open question, therefore, how recent trends in capital markets may have increased the relevance of some of these conflicts of interest and, therefore, at least partially worsened the credit quality in bond markets (see Figure 1.2). For instance, the movement in some major markets towards passive equity investment may have increased shareholder-manager agency costs. Likewise, the increasing relevance of Asian capital markets, where many companies have defined controlling shareholders, may have made majority-minority shareholders conflicts of interest more prevalent.

2.4. Statutory duties in distressed companies

As mentioned in Section 2.1, legislation in many jurisdictions encourage directors of distressed corporations to act in the interest of the company's creditors rather than solely to the shareholders' benefit. In a similar line, the G20/OECD Principles of Corporate Governance state – with respect to any corporation – that "[t]he board is not only accountable to the company and its shareholders but also has a duty to act in their best interests. In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities" (annotation to Principle VI).

The standards applicable to directors in distressed companies vary in intensity: from less strict ones triggered only if directors do not act in good faith to more intensive standards that impose liability for negligence in worsening the financial situation of an insolvent company (Kraakman et al., 2017, pp. 128-129[15]). In technical terms, those standards could be merely a shift in the content of directors' fiduciary duties (e.g. in most US states) or the imposition of additional negligence-based liability for "wrongful trading" once bankruptcy proceedings have become inevitable (e.g. in the UK[12]).

While directors' duty not to trade when insolvent is often reasonable for the protection of creditors' interest, this halt in trading may not be the best solution economy-wide during the start of a crisis when many businesses are facing financial difficulties simultaneously and there is still significant uncertainty regarding how the situation will evolve. The beginning of the COVID-19 pandemic is an example of this, because both the health challenges and governments' response were extremely unclear in early 2020, and in many cases, directors did not have the minimum information needed to assess the prospects of their companies in the following months. That is why, as shown in Table 1.1 a number of jurisdictions suspended the effect of wrongful trading laws in response to the COVID-19 pandemic.

Another important policy decision is whether public authorities may enforce the standards of pro-creditor conduct in distressed companies, for instance banning directors who failed to meet those standards from being managers of a company (this is the case in e.g. Brazil, France, Italy, Japan, the UK and the US). This public enforcement – together with criminal liability for the breach of directors' statutory duties – may add a deterrence effect if civil liability is not sufficient to effectively change directors' behaviour, for instance in circumstances where directors have limited wealth and are closely influenced by shareholders' interests (Kraakman et al., 2017, p. 130[15]).

Considering the strong influence controlling shareholders may have over management, some jurisdictions have adopted the doctrine of "shadow directors" (e.g. in the UK), extending the liabilities of directors to a person – typically a controlling shareholder – who acts as a member of the board without formally being a director. This may include in some circumstances liability due to a failure to meet a pro-creditor standard in distressed companies.

[12] See Section 214 of the UK 1986 Insolvency Act.

In a complementary way, some jurisdictions also adopt standards applicable to creditors and other third parties who trade with a corporate debtor that is near insolvency. If these transactions are to the manifest disadvantage of the debtor, they are often set aside ex post in a bankruptcy proceeding and the benefits received by the third party must then be returned to the debtor (Kraakman et al., 2017, p. 134[15]). Since the third parties will only be able to rely on the transactions if they can prove they had assessed the transactions to be likely advantageous to the debtor ex ante, those third parties may prevent directors from worsening the debtor's financial position.

2.5. Company groups

Company groups are important owners of listed companies. At the end of 2020, they held 11% of global market capitalisation. This structure is particularly prominent in certain jurisdictions, notably Chile, Türkiye and Indonesia, where companies are the largest single owner in more than 60% of listed companies (OECD, 2021[3]). The prevalence of company groups and complex ownership structures carry their own corporate governance implications, as outlined in earlier OECD work (OECD, 2020[35]).13 However, it also has implications for bondholder rights, specifically related to subordination.

Structural subordination seeks to establish creditor rankings based on where an issuer is placed within a corporate group structure. Creditors of the subsidiaries rank higher, because they hold a claim against their assets, whereas the parent company's creditors rank lower in the structural subordination because they only have a residual claim of the subsidiaries' assets (the equity owned by the parent company). This type of subordination is common for example in many European countries, as opposed to contractual subordination which is more common in the United States (Miller et al., 2014[36]).

In markets where creditors are reliant on structural subordination, senior secured lenders will typically require that their debt is incurred directly by the subsidiary whereas unsecured (and possibly non-investment grade bonds) are issued by the parent company. In response to this, bondholders of the parent company may require the adoption of covenants to limit some risks that arise from structural subordination, such as: subsidiary guarantees of the bonds; limitations on subsidiaries' ability to take on additional debt; and limitations on subsidiaries' ability to restrict their dividend payments (as a way to ensure upstream payments) (Miller et al., 2014[36]).

In any circumstance, bond indentures (as any other contract) cannot account for all events that may take place in the future, and there may be some opportunities for whoever controls the group to move assets, costs and business opportunities between companies in the group, favouring, for instance, subsidiaries that are planning to issue new bonds to the detriment of existing bondholders of other subsidiaries. There are some legal remedies for those situations, however, such as the action de confusion de patrimoine in France (article L621-2 of the Commercial Code), where creditors of a subsidiary could enforce their claims against assets of another company in the same group if they can prove the companies engaged in "abnormal financial transactions".

2.6. Institutional investors and passive investment

With respect to corporate governance engagement, bondholders, like shareholders, have the possibility to engage through both exit and voice. However, unlike shareholders who can influence the company on an ongoing basis, bondholders typically use their voice only at specific events at the establishment of the bond contract and in the case of imminent or actual default. While the regulatory, legal and contractual framework for corporate bonds set out the basis for bondholders' rights, the degree of bondholder

[13] Please see for more information (De la Cruz, Medina and Tang, 2022[67]).

engagement in exercising their rights is influenced mostly by their business models with respect to issues such as investment strategy, portfolio composition and liability structures.

During the past two decades, the investor landscape has seen an increasing dominance of institutional investors as retail investments have shifted from direct ownership to holdings through large institutional investors. For instance, in OECD economies institutional investors owned 54% of total listed market capitalisation at the end of 2020 (OECD, 2021[3]). Together with the move towards funded pension systems, one important reason for the growth in institutional investor dominance is the increasing popularity of passive investment strategies, both through growth in indexed investment vehicles such as mutual funds and ETFs, as well as through considerable amounts of “buy and hold” investments by pension funds and insurance corporations.

Mutual funds and exchange traded funds are characterised by liquid liability structures, highly diversified portfolios, flat fee structures and the use of passive strategies in order to decrease their costs. Since the investment strategy underpinning highly diversified portfolios is to take on non-diversifiable risk only, engaging with any single firm, even if value-improving at the firm-level, would fall outside of the strategy. In addition, as other diversified fund competitors may be holding the same company, an investor that engaged with a company would share the value increase with its competitors while carrying the cost alone, worsening its relative performance. Therefore, concentration of ownership in such portfolios has effectively reduced the incentive to engage in traditional corporate governance procedures (Gordon, 2021[37]). This makes this type of investor unlikely agents for enforcing bondholder rights. Moreover, a number of central banks undertaking significant corporate bond purchasing programmes (or expanding existing ones) during the COVID-19 pandemic have added additional concern regarding the exercise of bondholder rights.

Traditional institutional investors, such as pension funds and insurance corporations, generally buy a security that they hold for a long time in line with their liability structures, thereby avoiding costs associated with frequent trading. Rather than monitoring individual bonds in their portfolio, they typically invest in well-diversified bond portfolios, aiming for default rates that are similar to broad market indices. These traditional institutional investors may therefore be more reluctant to actively pursue their rights as bondholders.

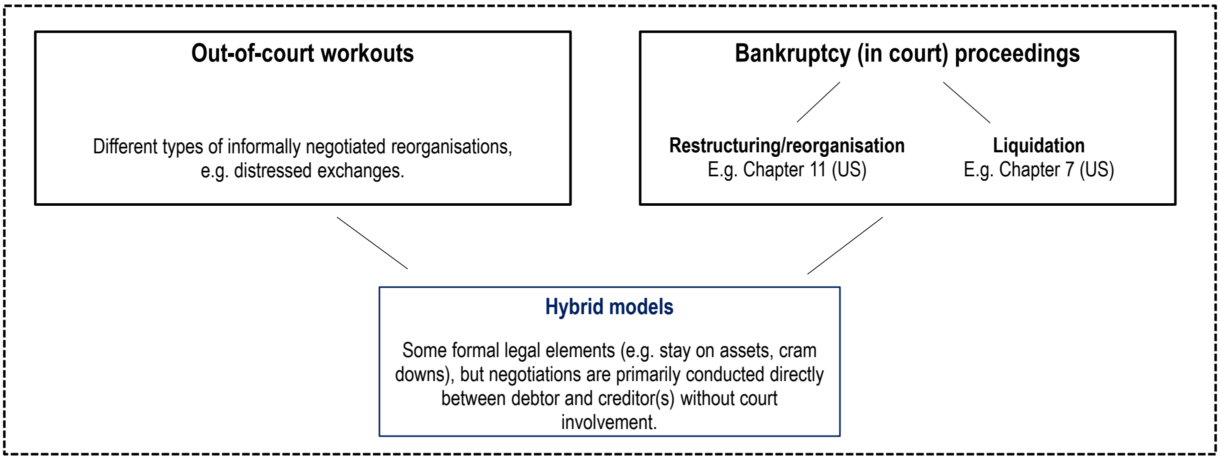
However, as mentioned in Section 2.2.1, the hedge funds that specialise in indenture enforcement and profitable settlements with issuers are more interested in taking action for any violation of bond covenants. This kind of engagement is different from the engagement by the traditional large institutional bondholders which, as already explained, usually limit their engagement to governing their overall portfolio risk and participating in restructurings and recovery of losses.

2.7. Insolvency frameworks

A corporate insolvency framework has two main goals. First, to help creditors better co-ordinate their interests under imperfect market conditions and to provide opportunities for restructuring of viable companies under financial stress to continue their operations. Second, an insolvency framework aims at ensuring an orderly liquidation of assets and payment to creditors (instead of asset fire sales through bilateral debt enforcement), maximising the value of a company’s assets and their deployment to their most productive use. In order to fulfil these goals, legislators need to find a balance between debtors’ and creditors’ protection. On the one hand, a system that excessively favours the incumbent management and the reorganisation of debt may increase credit risk and, therefore, increase financing costs for companies. On the other hand, a framework that is friendlier to creditors may startle venture capital and force companies that would be viable in the long-term into liquidation.

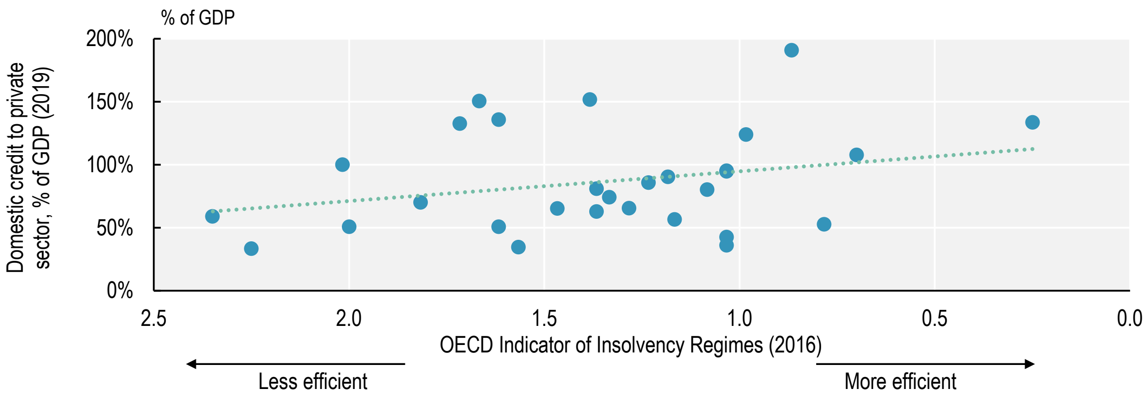
In order to give a broad overview of the structure and terminology used in this section, Figure 2.1 provides a taxonomy of the three primary elements of an insolvency framework (out-of-court workouts, bankruptcy proceedings and hybrid models).

Figure 2.1. The taxonomy of an insolvency framework



Insolvency frameworks that adequately fulfil the aforementioned goals will likely increase the productivity of an economy at large, improving access to credit and better allocating capital. Creditors will be more willing to provide credit if they know that their rights are enforceable and that a potential future bankruptcy process will be predictable, cost-effective and provide a high expected recovery rate. Empirical studies show that effective insolvency regimes are associated with not just increased general availability of credit, but also lower cost of credit and increased returns to creditors in cases of loan default (World Bank, 2014, pp. 4-5[38]). Lack of access to credit has been found to be a significant constraint on corporate growth (Ayyagari, Demirgüç-Kunt and Maksimovic, 2008[39]). As further supporting evidence of the link between insolvency regimes and credit availability, Figure 2.2 establishes a similar correlation when using the insolvency indicators developed by Adalet McGowan and Andrews (2018[40]). A well-functioning insolvency system incentivises cheap credit in this manner without disincentivising monitoring by creditors, while also discouraging imprudent borrowing. Such an insolvency system would be in line with the G20/OECD Principles of Corporate Governance (I.A), which states that "[t]he corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and well-functioning markets".

Figure 2.2. Efficiency of insolvency regimes and domestic credit to the private sector



Note: The sample includes the same countries as in Adalet McGowan and Andrews (2018[40]) , but excludes Canada and Switzerland due to lack of domestic credit data in the World Bank dataset.
Source: (McGowan and Andrews, 2018[40]) (x-axis), World Bank (y-axis).

The improvement in credit access and the range of different types of credit available as an effect of a better bankruptcy regime may be particularly strong for certain types of companies. Becker and Josephson (2016[41]) provide evidence that the development of bond markets, in particular for riskier companies, is directly dependent on the strength of the bankruptcy procedures. This is an effect of bondholders requiring higher interest rates in countries with inefficient bankruptcy regimes to compensate for the fact that they are more likely to have to resort to out-of-court workouts, where banks typically have an advantage due to, among other reasons, their relative size.

In terms of capital allocation, strong insolvency regimes contribute to improvements in a number of ways. For example, more efficient exit of failing firms allows for a stronger market selection mechanism and reduces the share of scarce resources consumed or held up in unviable firms (Adalet McGowan and Andrews, 2016[8]). Similarly, empirical studies suggest a well-functioning insolvency framework can help reduce the share of non-performing loans (World Bank, 2021[42]). This is particularly pertinent given the extended period of high NPL ratios seen in some European countries after the euro crisis.

Regimes that facilitate and encourage restructuring rather than liquidation of fundamentally economically viable firms are able to reduce excessive leverage in an economy while protecting economic value in the shape of, for example, relations with suppliers and by maintaining employment. More broadly, insolvency systems influence economic productivity through the dynamics of both firm creation and destruction in an economy by altering the barriers both for exit and entry. A well-functioning insolvency system facilitates expedient exit of unviable firms without erecting high barriers for firm creation by penalising business failure too harshly which would stymie entrepreneurship.

In practice, discriminating between firms that are viable in the long-term – and should therefore have their debts restructured – and those that are unviable – and should by implication be liquidated – is a complex and costly task. It often requires specific industry knowledge, and an individual analysis of a company's management and long-term business prospects. Creditors might be willing to invest their time to conduct such an analysis in an out-of-court workout if the amounts involved are high, or may be obliged to do so in a bankruptcy proceeding. However, a sound analysis of a company's viability may not be economically feasible for small businesses, especially when it comes to formal restructurings. In the case of SMEs, therefore, it is particularly important that the bankruptcy procedures are proportional in cost and complexity to the size of the insolvent company even if it means that there will be a less sophisticated assessment of business viability.

In addition to the size of the enterprise, a number of other characteristics of the individual company and the institutional context may alter the ideal solution for a specific case. Overall, however, some international best practices have been outlined in a number of studies, including early warnings that a company is under financial stress, adoption of a mechanism that prevents a "hold-out" by a minority of creditors in a restructuring process and an option of out-of-court workouts ("OCW") (McGowan and Andrews, 2016, pp. 15-16[43]).

Delays in the initiation of restructuring procedures may increase the costs of the reorganisation and make it less likely that viable companies are successfully restructured. There are two main policy instruments to allow for the early initiation of restructuring proceedings. First, creditors may have the right to initiate a bankruptcy proceeding if a clear trigger has been pulled, such as a default by the corporate debtors exceeding a legally specified value. Second, debtors' officers may face civil or criminal liability if they do not initiate a bankruptcy proceeding soon after there is enough evidence the company is insolvent or on the path to become insolvent as discussed in Section 2.4.

In some contexts, a small group of holdout creditors may have the incentive to hold back the restructuring proceeding expecting to extract a benefit for themselves, even if it means delaying a solution that would maximise all creditors' wealth. Therefore, requiring unanimity to approve a restructuring plan may delay the solution to financial distress, or even make it impossible. This is why some jurisdictions allow restructuring plans to be approved by a majority of creditors in each class (known as "cram down" provisions) and, in some circumstances, for one class to prevail over other dissenting class (a “cross-class cram down”). In any case, in order to protect creditors’ expectations, a “cram down” is typically possible only if creditors within the same class receive equal treatment and in cases where what creditors will receive under the restructuring plan is expected to be at least as much as they would receive if the company were wound-up.

As shown in Figure 1.8., recovery rates in OCW (often called “distressed exchanges” in public markets) have been considerably higher than in bankruptcy proceedings, especially for unsecured and subordinated bonds. OCWs have a number of advantages, such as not incurring the higher legal costs typically associated with court involvement and potentially shortening the period of distress through a quick consensual agreement. Moreover, during economic crises, OCWs provide an important alternative to potentially clogged courts. Probably the two most relevant drawbacks of OCWs are that dissenting creditors cannot be overruled by a majority (enabling a hold-out by a minority of creditors) and that bilateral debt enforcement actions would still be possible in the courts (which might mean a disruption in business if key productive assets are foreclosed by secured creditors). As a solution to the latter problem, some jurisdictions (e.g. France, Italy, Spain and the UK) have adopted hybrid regimes where creditors have considerable freedom to negotiate an agreement with the corporate debtor and the court would intervene only at critical points (perhaps most importantly, to declare a stay of creditor actions) (J. Díez et al, 2021, p. 25[44]). In general, owing to the costliness of court procedures, there are possible efficiency gains from promoting OCWs and limiting court involvement only to cases where it is an absolute necessity. When insolvency practitioners are appointed by courts, it is important to ensure that their remuneration structure does not provide skewed incentives resulting in inefficient outcomes (e.g. keeping unviable firms alive) (Adalet McGowan and Andrews, 2016[8]).

An interesting question on the frontier between insolvency and corporate governance frameworks is whether incumbent management should be protected or removed during a bankruptcy proceeding (e.g. through the nomination of an insolvency administrator with wide powers). On the one hand, directors and officers may have firm or sector-specific knowledge and relationships that are rarely found and, therefore, which may make it better for the business to keep the same individuals in their positions. In addition, if managers anticipate being replaced after the initiation of a bankruptcy proceeding, they may try to postpone the insolvency recognition by hiding losses or forsaking necessary operational costs such as factory maintenance. On the other hand, the financial stress may be a result of the incompetence or excessive risk-taking attitude of the existing management team and part of the solution to the crisis may be to replace those key executives. Moreover, if there is no expected turnover, management may choose to strategically default, benefiting from the protections associated with a restructuring proceeding (such as a stay of creditors actions) without necessarily needing court intervention to keep the company afloat (McGowan and Andrews, 2016, pp. 23-24[43]).

2.7.1. Bondholders during insolvency procedures

The unique characteristics of corporate bonds have implications for the role bondholders may be able to play during OCW and bankruptcy procedures. As discussed in detail in Section 2.2, ownership is often more dispersed for bondholders and ownership records of bonds more difficult to obtain compared to bank loans, which creates difficulties in identifying the parties that should be participating in the debt restructuring negotiations.

The legal form of a corporate bond also affects the restructuring process, since they are debt securities and therefore regulated under laws concerning insider trading and market abuse. That means that during a restructuring procedure bondholders may be in possession of sensitive information and, as a consequence, restricted from trading the bond. This creates a tension between the willingness of bondholders to maintain the ability to buy and sell their holdings, which can be ensured by not receiving any private information related to the restructuring, and the need for some bondholders to receive private information in order to work out a satisfactory restructuring deal. This is typically solved by forming a group of bondholders which participates in the restructuring negotiations (appointed either formally or informally – known as an “ad hoc committee” in the latter case). That group then engages financial and legal advisors who negotiate on their behalf with the issuer’s advisors. As they progress, the proposal (which is private information) is communicated to the bondholder group, which considers it. The information is then made public, allowing the previously restricted group to trade in the securities again. This process may be repeated several times (Brodie, 2017[17]).

3 Views from regulators

Some jurisdictions and organisations have recently provided guidance related to bondholder rights and corporate disclosure, primarily as a response to the COVID-19 crisis. This section provides an overview of some of these initiatives as well as a summary of the World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes and selected country restructuring regimes.

3.1. Developments in Asia

In **Viet Nam** the Prime Minister issued four directives between September 2021 and April 2022 targeting the stock and corporate bond markets. The main purpose of the directives were to strengthen the management, supervision, inspection and examination in these markets by enforcing greater transparency and ensuring investor protection. On April 18 2022, the government office issued a notice on the implementation of these directives, and then on April 25 2022, the Ministry of Finance issued a directive- (Directive No: 01/CT-BTC- (Ministry of Finance of Viet Nam, 2022[45]) specifically targeting the corporate bond market in order to strengthen the inspection, supervision and development of issuance, investment and service provision in the market.

Aiming to improve bondholders' rights, **China** revised its Securities Law in 2019. The updated law recognised the importance of the bond administrator structure by requiring that an issuer shall retain a bond administrator for bondholders. The administrator could be either the underwriter of the issuance or any other institution recognised by the CSRC. The updates also specifies the bond administrator's roles in cases of default. Moreover, it set out a procedure where the bond administrator will be the one in charge to file or participate in civil lawsuits or liquidation procedures on behalf of bondholders to avoid reckless accelerated liquidation processes that could be triggered by one single bondholder. Besides, the collective action mechanism has been updated to incorporate and extraordinary resolution, which can be used to modify substantial terms of the bond for a successful restructuring. The method of calculating votes in the bondholder's meeting has also been revised to better represent the will of all bondholders, rather than the attendees at the meeting (Fu, 2021[46]).

In **India,** SEBI issued a public consultation paper to strengthen the regulatory framework for corporate bonds and trustees of debentures in 2020. The proposed framework mandates minimum disclosure requirements in order to enhance transparency. Debenture trustees are required to make disclosures on the issuer's compliance status of each covenant, ensure adequate asset cover and monitor defaults and status of proceedings of cases under defaults. It also proposes the creation of a recovery fund at the time of the issuance of debt that shall be used by the debenture trustee towards recovery proceedings expenses. The fund aim to ensure timely enforcement proceedings by adequately funding the debenture trustees in advance (SEBI, 2020[47]). Additionally, SEBI issued a directive and guidelines to monitor security and covenants of non-convertible securities by using distributed ledger technology.

In **Indonesia,** the Financial Services Authority (OJK) issued a new rule on debt securities and sukuk that requires the submission of all transaction documentation of private placements of debt securities to OJK. This is the first time OJK regulates private placements and it aimed to increase oversight through tightening regulatory supervision. Under the new rule, securities can only be sold via private placement to professional investors, defined by OJK as those having the capacity to perform a risk analysis on their investments. Importantly, the rule requires investors to provide a statement that it qualifies as a professional investor-Rule No. 30/POJK.04/2019- (ADB, 2021[48]).

3.2. Global Developments

3.2.1. International Accounting Standard Board

In November 2021, the International Accounting Standards Board (IASB) proposed amendments to the IAS 1 Presentation of Financial Statements to improve the information companies provide about their long-term debt with covenants (IFRS Foundation, 2021[49]). Currently, IAS 1 requires a company to classify a liability as non-current only if the company has a right to defer settlement of the liability for at least 12 months after the reporting date. However, such a right is often subject to the company complying with covenants after the reporting date. For example, a company might have long-term debt that could become repayable within 12 months if the company fails to comply with covenants after the reporting date.

In June 2022, IASB tentatively decided to finalise the proposed amendments, which would specify that, when an entity classifies liabilities arising from loan arrangements as non-current and those liabilities are subject to covenants, the entity is required to disclose information that enables investors to assess the risk that the liabilities could become repayable within 12 months, including: (1) information about the covenants with which the entity is required to comply (such as the nature of the covenants and the date on which the entity must comply with them); (2) facts and circumstances that indicate the entity may have difficulty complying with covenants when it is required to do so (IFRS Foundation, 2022[50])The amendments are expected to become effective for annual reporting periods beginning on or after 1 January 2024.

3.2.2. The US Securities and Exchange Commission

In June 2020, the Division of Corporation Finance of the US Securities and Exchange Commission ("SEC Division") published guidance to provide additional views of the SEC Division regarding operations, liquidity, and capital resources disclosures companies should consider with respect to business and market disruptions related to COVID-19. With the guidance, the SEC Division continues to encourage companies to provide disclosures to allow investors to evaluate the current and expected impact of COVID-19 through the eyes of management and to proactively revise and update disclosures as facts and circumstances change. In this guidance, the SEC Division encouraged companies to consider a broad range of questions including whether they are at material risk of not meeting their covenants. Furthermore, companies were also encouraged to consider whether their financing arrangements contained terms that would limit their ability to obtain additional funding and whether these terms could result in liquidity challenges that would make the company unable to maintain current operations (SEC, 2020[51]).

3.2.3. Irish Auditing & Accounting Supervisory Authority

The Irish Auditing & Accounting Supervisory Authority ("IAASA") examines the annual financial statements of certain equity and debt issuers to ensure reports are compliant with the relevant financial report framework. The authority also publishes the main conclusions from these examinations and priorities for its future examinations in order to assist all issuers' management in the preparation of their financial reports (these are called "observations paper"). In the observations papers published in 2020 and 2021, reporting on loan covenants were highlighted as an important consideration for issuers' management during the COVID-19 pandemic. Specifically, IAASA recommended in 2021 that "the impact [of the health crisis] on loan covenants should be explained in annual reports with disclosure of (i) re-negotiation of waivers of loan covenant conditions with lenders, including an explanation of the terms of the waiver; (ii) explanation of the impact of any non-compliance with the loan covenant waiver terms; and (iii) potential failure of the loan covenant waiver terms and the possibility of obtaining another waiver in the future" (IAASA, 2021, p. 8[52]).

3.2.4. The UK Financial Reporting Council's Stewardship Code

In October 2019, the UK Financial Reporting Council ("FRC") published an updated version of its 2010 Stewardship Code which outlines how institutional investors should engage with their investee companies. Along with a number of other changes, the revised version requires signatories to explain their stewardship activities with respect to asset classes beyond public equity, which was the original scope, including fixed income. This is a response to the fact that "[t]here has been significant growth [since 2010] in investment in assets other than listed equity, such as fixed income bonds, real estate and infrastructure" (FRC, 2020[53]). This is in line with the figures presented in the trends section in this paper.

Principle 12 of the revised Stewardship Code states that signatories should actively exercise their rights and responsibilities. For fixed income assets, such as corporate bonds, they are to explain their approach to: seeking amendments to terms and conditions in indentures or contracts; seeking access to information provided in trust deeds; impairment rights; and reviewing prospectus and transaction documents (FRC, 2020[53]). While traditionally an issue discussed in the context of institutional investors' equity holdings, the expansion of the UK Stewardship Code to include fixed income is relevant to the issues related to passive bond investments discussed in Section 2.6. It bears mentioning that the FRC has seen few investors reporting on how they exercise their rights in corporate debt since the introduction of this addition.

3.2.5. World Bank: Principles for Effective Insolvency and Creditor/Debtor Regimes

The World Bank Principles for Insolvency and Creditor/Debtor Regimes ("WB Principles") include recommendations under four main areas: the credit environment; risk management and informal workout systems; insolvency law systems; and the implementation of insolvency systems (World Bank, 2016[54]). Principles related to the credit environment focus mainly on the efficiency, transparency, and reliability of the methods for recovering debt. Secondly, within a well-functioning credit system, existence and efficiency of collateral management and enforcement systems (with different mechanisms for secured and unsecured debt) are mentioned as necessary. In addition, to have a sound insolvency system (as well as procedures outside of the insolvency system), the predictability, transparency and affordability of enforcement systems are stressed as core aspects. The informal corporate workouts part of the World Bank Principles focuses on restoring enterprises to financial viability and includes recommendations on (1) incentivising lending to, investment in, or recapitalisation of viable distressed enterprises, (2) supporting a broad range of restructuring activities, such as debt write-offs, rescheduling, restructurings, and debt-equity conversions; and (3) providing favourable or neutral tax treatment for restructurings. The risk management component of the recommendations calls for complete, accurate and reliable credit information systems.

Importantly, the WB Principles provide guidance on procedures regarding commercial insolvency. Insolvency, specifically liquidation or reorganisation (whichever chosen to maximise the value of the firm's assets and recoveries for creditors) is expected to be conducted in a timely, efficient and impartial (by providing equitable treatment of similarly situated creditors) manner. As pointed out in the WB Principles, this requires existence of strong institutional and regulatory frameworks. On top of these four areas of recommendations, as an overarching consideration for promoting sound investment climates that will create a solid foundation for efficient framework to resolve debts, the World Bank Principles emphasise the importance of corporate governance and transparency.

3.3. Restructuring regimes – Selected country examples

Standardised out-of-court restructuring processes are centralised frameworks designed for large numbers of restructurings where the debtors have common characteristics. Typically, those restructuring regimes do not involve the judiciary. A number of countries, such as Korea and Iceland, have already included this kind of procedure in their insolvency systems. In the case of Iceland, the government supported – following a severe crisis in its financial system in 2010 – the schemes through various tax incentives aiming to reduce tax barriers to restructuring, for instance by applying tax exemptions for debtors on debt write-downs. An arbitration committee was also integrated to the scheme to resolve disputes among parties without the need for courts to intervene (Menezes and Akvile, 2021[55]).

Some countries, such as France, the Netherlands, Germany, Spain and Italy, apply informal workout procedures that combine contractual workouts with limited court intervention. These structures are known as hybrid procedures and are supported by the European Union in its 2019 European Restructuring Directive following the experiences of France, Italy, and Spain during the euro area crisis, and by the United Kingdom in its recent insolvency reform as part of the 2020 Corporate Insolvency and Governance Act (Diez et al., 2021[56]). Additionally, many countries chose to temporarily adopt similar procedures as a response to the COVID-19 pandemic, such as Germany, Colombia and Poland.

The Netherlands adopted a new hybrid out-of-court restructuring mechanism that entered into force in January 2021. The mechanism enables debtors to negotiate a restructuring plan with their creditors outside the formal insolvency procedure, which would be only later confirmed by a court in a formal proceeding (Menezes and Akvile, 2021[55]). The debtor can pair the initial plan proceedings with a court-order stay up to a maximum of eight months that will stop creditors enforcing their rights, including the right to invoke termination clauses in contracts (Houthoff, 2020[57]). The court's acceptance of the plan relies on all creditors and shareholders (whose rights are affected by the plan) approving it. For class acceptance, a two-thirds majority of all class participants who have cast a vote is required. The court could refuse the restructuring plan for instance if certain creditors or shareholders would be worse off under the plan than in the event of liquidation. When one or more classes of creditors reject the plan, the court can still approve it with a condition of partial distribution to the opposing creditors in the event of liquidation. During the process, the debtor will remain in possession of its assets and can continue to conduct business as usual.

In **Viet Nam,** the insolvency regime is rarely used as it requires significant time and resources and creates an impediment for formal bankruptcy procedures (IMF, 2021[58]). In this respect, the IMF has recommended that the Vietnamese insolvency regime should the survival prospects of viable businesses and streamline the liquidation process for the non-viable companies by including: (i) a specialised SME bankruptcy regime to fast-track reorganisation and liquidation; (ii) improved out-of-court restructuring frameworks, especially for SMEs; and (iii) mechanism that allows firms to initiate bankruptcy proceedings before becoming insolvent. Viet Nam did improve temporarily via *Resolution 42* bad debt settlement which empowers banks in terms of debt collection procedures (Viet Nam News, 2022[59]).

China has not implemented changes in insolvency laws, however during the COVID-19 crisis the authorities issued new bankruptcy guidance. Bankruptcy courts are now expected to encourage restructuring and settlement processes before liquidating a company. They are supposed to actively guide negotiation between creditors and debtors by means of instalment payments, extensions of the performance period for liabilities and changes of contract price, among others (Squire Patton Boggs, 2021[60]) .

Korea enacted the Corporate Restructuring Promotion Act in 2001 as a temporal act that should have expired in 2005. The act ended up being extended several times and further revised. The revised version of the insolvency regime enacted in 2004 already included shorter deadlines, allowed debtor-in-possession structures, and permitted shareholders to repurchase converted equity (Bergthaler et al., 2015[61]). In 2018, the act was amended intending to further facilitate out-of-court restructuring procedures (The Korean Law Blog, 2019[62]).

Singapore after making amendments to the Companies Act that updated and strengthened the restructuring regime, enacted a single act called "*Insolvency, Restructuring and Dissolution Act*" that consolidates all existing laws related to individual and corporate insolvency. Among many other aspects, the restructuring framework implements a system of rescue financing similar to the regime of DIP financing existing in the United States. Additionally, directors are allowed to keep running the company during the reorganisation procedure. This restructuring framework provides debtors with most of the tools existing in formal reorganisation procedures while allowing the debtor to remain in possession – something uncommon in reorganisation procedures outside the United States.

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