EW Barker Centre for Law & Business
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The World Today: Conflicts between Creditor and Debtor, Listed Company and SME

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We believe that many of the biggest challenges facing the world today can be explained largely by a tug of war between creditors and debtors. This includes the high stock prices at a time of poor economic growth, the China-US cold war, and the inter-generational problems seen around the world. There are differences of course as the debtor in the case of the young worried about a mortgaged future are the individuals themselves, whereas with shares it is the company and in the case of nations, a Westphalian state. Behind debtors that are artificial entities, however, are different constituencies that benefit from the preservation of them at the expense of those that lend money to them. We do not question the morality of lending, and perhaps we should forgive our debtors, but only seek to point out the conflict that exists between lenders and borrowers (and the others behind them).

Where stock prices are concerned, Mohamed El-Erian has questioned the "zombie" markets which have seen a V shaped recovery from the lows of March 2020 due to Covid-19. The real economy is still in very bad shape with no end in sight. One reason for this is the fundamental shift in value in a company from creditors to shareholders. This was gradual in the past, with possibly Chapter 11 type debtor-in-possession restructuring provisions leading the way from the US. But in the past 20 years (and especially since the GFC), we have seen insolvency laws further weakened by legislators and the courts. Our Chapter 11 provisions are perhaps even more pro-shareholder than in the US, with there being no shareholder cramdown and need for shareholder approval for most restructurings. The proof of insolvency has become more difficult in the way the courts have raised the bar for proving cash-flow and balance-sheet insolvency. Banks can also in theory no longer become insolvent given bail-in rules that convert debt to equity automatically when they default. Then, with Covid-19, we suspended wrongful trading rules which are intended to stop a company incurring further debts when there is no reasonable prospect of repaying them in full, as was also done in the UK and Australia with comparable legislation.

But it is more subtle than that as on the face of it trading out of insolvency may be the right decision for the company, its employees and the economy as a whole. The constituency that seems, however, to have benefitted the most are shareholders, and today these are not as widely dispersed as in the past. One of the most important rules of company law is that the assets of the company are partitioned in such a way that shareholders cannot reach them while it is a going concern and they can then be committed to creditors. That is termed "capital lock-

in". But again, starting with the US, capital maintenance rules, such as prohibitions against share buybacks, have been weakened over time. They do not exist in the US anymore. There they rely on what are termed fraudulent conveyance rules which prevent transactions that are intended to defraud creditors. On the surface, this seems adequate protection. The reality, however, is that to prove the intent to defraud, there is invariably a need to show that the company became insolvent because of the transaction. But we have seen that insolvency is hard to prove. So a Catch-22 has been set up for creditors which has allowed enormous volumes of share repurchases and dividend payments over the past 10 years.

Shareholders have benefitted when others have suffered as the corporate vehicle has been used as a tool not for generating real wealth and employment from its underlying business, but high share prices from the manipulation of its share prices. Some managers spend more time worrying about what to do with the company's shares rather than its business. But we should not be surprised as we have seen, again in the US, enormous amounts of class action shareholder litigation against corporations which do not proceed to trial but are settled by management. These are ostensibly about poor governance but in reality often about trying to extract value from the corporation and by extension other constituencies within it. In the case of shareholder litigation, those suffering include undiversified shareholders not forming part of the plaintiff class. But with buybacks and dividend payments, most shareholder interests are aligned, and it is largely the weaker creditors like some suppliers who are unable to protect themselves that suffer when external shocks like Covid-19 hit.

All this may be fine. But in the next stage of the game, voluntary creditors like banks will demand greater protection and higher interest rates. This is especially so as, for some reason, possibly again the shift in bargaining power, banks are finding it difficult to obtain floating charges over a company's undertaking. Some suppliers may not deal with the company at all. The trust that has been built up by asset partitioning and capital lock-in has been eroded. We are already seeing renewed talk about permanent debt-relief once Covid-19 passes. While it is perhaps time to consider some form of Jubilee where debt is forgiven for individuals, we are not sure how that would work with corporate debtors given the moral hazards that we see with shareholders now plunging into stock markets at high PE ratios. Perhaps they already know that things will move further in their favour. Of course, we do not want to go back to the days when we jailed our debtors. But we have overshot to the other extreme now when corporate debtors are given so much protection that its shareholders, which are supposed to rank last in terms of priority to repayment, have been able to have its de facto position reassessed. We are not sure of the exact mechanics of this, but Covid-19 seems to have further strengthened their position. The sequence in which they share the company with creditors has been reversed or at least muddied.

There is a crucial case before the UK Supreme Court currently that will indicate which direction we are heading. The lower courts there had set aside a lawful dividend paid from retained earnings on the basis that it was made with intent to defraud creditors as the company had a material contingent liability at the time that was undervalued. The company was not insolvent then, and only became so 10 years later. So even though the creditor's interests had not come to the fore yet, the payment was seen to have jeopardised the position of the creditors in favour of the shareholders. If the Supreme Court reverses this last holding, it will mean that the UK will move closer to the US where insolvency rules replace company law rules. But we have seen that insolvency is hard to prove and so this will strengthen the hands of shareholders (and the managers who largely represent their interests on an increasingly short-term basis).

We have to acknowledge US exceptionalism given that it can export US dollars. Even so, we believe that what lit the fires of the China-US cold war was the unwillingness of the former to accept any more of the latter's debt in exchange for goods it produced. The rest of the world should, however, oscillate around the middle. The corporation, although maligned, has been a vehicle that has created tremendous real wealth that has led to the standards of living that we see today. Many business risks that came to fruition would not have been undertaken if not for this artificial entity which pooled together funds from shareholders and creditors to be managed by professional managers. The risk that its structure has been destabilized is now very real. In the short-term, it appears that they are doing well because of high share prices. But it could be that those share prices are a reflection of value being shifted from other constituencies in the company in a way which means that it will create less real growth growing forward.

One study has shown, for example, that 'in 2018, only 43% of companies in the S&P 500 Index recorded any R&D expenses, with just 38 companies accounting for 75% of the R&D spending of all 500 companies'.[1]

We believe a line should be drawn in the sand so that we do not reach a state where governments have to dampen the stock market so that the real economy can do well. In this regard, it pays to recall that Lee Kuan Yew in 1972/3 warned of the overvaluation of the stock market which some think ended the bull run of the early 70s. It was fortunate that he did as Singapore's economy would have suffered even more from the oil shock later caused by the fourth Arab-Israeli war. This contrasts with the way that US and Chinese politicians today talk about keeping share prices up. The interesting thing is that John Kenneth Galbraith was labelled a communist whose 'activism took the very practical form of destroying stock market values' when he appeared as a witness at a stock market inquiry of the Senate Banking and Currency Committee in 1955 and warned that the market then bore similarities to what happened in 1929. We only hope that this is not the case again.

But the world that we have described above is one for listed companies, not SMEs. SMEs provide most of the employment and job diversity in the world (72% in Singapore itself) even if they do not generate the greatest profit for shareholders. As we have said, the Global Financial Crisis and Covid-19 have shown us the fragility of a system that focuses too much on shareholder primacy, which then, in the words of some, end up "over-financialised". If it is true that global supply chains will be disrupted going forward, we will need our SMEs to make many of the things that we have imported over the years. Yet many of them still have problems obtaining financing with almost half obtaining no or inadequate bank financing. Their bargaining powers are far weaker as the controlling shareholders and an SME itself is not seen as "too big to fail". So they have to give floating charges over their assets, their controllers guarantees to banks, and there is no market price for the shares of a private company to manipulate through buybacks. Worse, the increasing use of the "oppression" action in Singapore by minority shareholders against majority shareholders drains SMEs of future funding for growth.

Getting things right requires serious domain knowledge and not the chest beating forms of leadership described by the Singapore International Chamber of Commerce and American Chamber of Commerce (Straits Times, 6 Sept 2020) when they described the weakness of the Singaporean worker. Our strength was discipline and obedience which allowed the Government to lead us in a way impossible in a Western society with its divided preferences (which admittedly allows greater creativity). Every society has its own strengths and weaknesses and it is diversity whether at a State, business entity and individual level that will give us the best chance of surviving the difficulties the world faces now. After all, it was less than 20 years ago when we were all told that a company was only there for its shareholders. We saw the havoc that that has wreaked when taken to an extreme. So there is nothing binary, there are trade-offs to consider and in the end what is required is temperate decision making through the use of empirical evidence and proper cost-benefit analysis. Coming back to the story here, we need to make sure we get the creditor and shareholder balance right so that businesses, good businesses, can thrive. We believe that focusing on that is more workable then talk of corporate purposes, much in vogue now, which will lead to too much indeterminacy as all stakeholders vie for a share of the pie. The moral of the story is that we cannot afford to be either too pragmatic or idealistic.

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[1] W Lazonick, M Erdem Sakinç and M Hopkins, 'Why Stock Buybacks Are Dangerous for the Economy' Harvard Business Review January 7 2020.