ESSAY

PRIVATE DEBT AND THE MISSING LEVER OF CORPORATE GOVERNANCE

DOUGLAS G. BAIRD[†] & ROBERT K. RASMUSSEN[††]

Traditional approaches to corporate governance focus exclusively on shareholders and neglect the large and growing role of creditors. Today's creditors craft elaborate covenants that give them a large role in the affairs of the corporation. While they do not exercise their rights in sunny times when things are going well, these are not the times that matter most. When a business stumbles, creditors typically enjoy powers that public shareholders never have, such as the ability to replace the managers and install those more to their liking. Creditors exercise these powers even when the business is far from being insolvent and continues to pay its debts. Bankruptcy provides no sanctuary, as senior lenders ensure that their powers either go unchecked or are enhanced. The powers that modern lenders wield rival in importance the hostile takeover in disciplining poor or underperforming managers. This Essay explores these powers and begins the task of integrating this lever of corporate governance into the modern account of corporate law.

INTRODUCTION

In 2003, Krispy Kreme was the darling of Wall Street. Its stock had more than quadrupled since first going public only a few years before. Krispy Kreme's CEO also served as chairman of its board, and he had been with the company for more than twenty-five years. No one was more dedicated to the business. His wedding cake was made out of

[†] Harry A. Bigelow Distinguished Service Professor of Law, University of Chicago Law School.

[††] Milton Underwood Professor of Law, Vanderbilt Law School. We thank Ian Ayres, Steve Kaplan, Ed Morrison, Ed Rubin, David Skeel, Cass Sunstein, Randall Thomas, Bob Thompson, Ron Trost, and Christopher Yoo for their help. Earlier versions of this paper were presented at the October 2002 meeting of the National Bankruptcy Conference, and the law schools at Boalt Hall, Chicago, Colorado, Columbia, Florida State, Texas, Vanderbilt, and Virginia. We also thank the Sarah Scaife Foundation and the Russell Baker Scholars Fund for research support.

hundreds of Krispy Kreme doughnuts. His infectious enthusiasm and aggressive growth strategy were going to make the business another Starbucks. The cover story in *Fortune* concluded on a decidedly upbeat note:

> Unless the fat police run riot across this land, Krispy Kreme is here to stay. It isn't some fly-by-night dot-com. There's 66 years of history here. It's a product that people not only love but understand. (Quick, what does InfoSpace do?) The world is always filled with unknowns, never more so than right now. With all that's wrong out there, sometimes it's easy to lose focus on the big picture. So take a second and ask yourself: Is the American dream still alive? Is Krispy Kreme for real? Don't bet against it.[1]

Krispy Kreme's fortunes, however, took a turn for the worse over the next few months. A low-carb craze was dampening growth. News accounts suggested that the company's accounting practices were too aggressive. The stock declined precipitously, and the predictable security class actions and SEC investigations followed shortly thereafter. The board met to take stock. It fired the CEO and replaced him with a complete stranger. This stranger was the CEO of a failed energy business—and not just any failed energy business. Krispy Kreme hired Enron's CEO and allowed him to remain at Enron while serving simultaneously as Krispy Kreme's CEO.[2]

Conventional accounts of corporate governance simply cannot explain how a board that had worked so long with a highly praised and firmly entrenched CEO would dump him within several months of the first signs of trouble and replace him with a part-timer from Enron. This is not to say that the decision was bad or counter to the interests of the shareholders. Indeed, the stock went up in reaction to the news. But boards hand-picked by a CEO are not supposed to lose faith so quickly.[3] Dispersed shareholders have no say over the choice of the CEO, and in any event, Krispy Kreme's shareholders held no meeting and did no voting between the time the bad news first hit and

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[1] Andy Serwer, *The Hole Story: How Krispy Kreme Became the Hottest Brand in America*, FORTUNE, July 7, 2003, at 52, 62.

[2] Krispy Kreme's press release announcing the appointment of Stephen Cooper as CEO can be found at Press Release, Krispy Kreme Doughnuts, Inc., Krispy Kreme Announces Management Changes (Jan. 18, 2005), http://phx.corporate-ir.net/phoenix.zhtml?c=120929&p=irol-newsArticle&ID=663642.

[3] *See* April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275, 286 (1998) (noting that CEO-led boards often focus on "long-term investment and financing decisions"); Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431 (1988) (showing that boards dominated by insiders are less likely to replace the CEO than are boards dominated by outsiders).

the time the CEO was fired. No hostile takeover loomed on the horizon and for good reason. The market for corporate control does little work in an environment in which the books of the business are untrustworthy. Something is missing from standard accounts of corporate governance.[4]

In our Essay, we explore this missing lever of corporate governance: the control that creditors exercise through elaborate loan covenants. Bondholders typically can do little until a corporation defaults on a loan payment. Even then, their remedies are limited. Not so with bank debt or debt issued by nonfinancial institutions. These loans—and their volume now exceeds half a trillion dollars per year—come with elaborate covenants covering everything from minimum cash receipts to timely delivery of audited financial statements. When a business trips one of the wires in a large loan, the lender is able to exercise de facto control rights—such as replacing the CEO of a company—that shareholders of a public company simply do not have.[5]

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[4] We view the primary task of corporate directors as selecting and replacing the CEO and other members of the management team. Boards have the responsibility of hiring not only the CEO but also her top lieutenants, and they focus on the efforts of the management team as a whole. For convenience, when we refer in the Essay to the CEO, we mean in her capacity as the head and most important member of the management team. Replacing underperforming management is generally considered to be the primary task of corporate governance. *See, e.g.*, Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-14 (1965) (articulating ways in which the market for corporate control disciplines managers).

To be sure, corporate governance can entail other aspects of oversight, such as ensuring that the corporation has appropriate financial controls. Other aspects of corporate governance, such as deciding whether to seek buyers for the business, are often initiated by the CEO. Many accounts of corporate governance, however, focus on issues such as executive compensation. Putting the right contract in place matters, of course, but such things are a second order effect. A Jack Welch performs better at the margin the more his contract aligns his incentives with those of General Electric, but the challenge of writing such a contract pales, in terms of difficulty and the stakes involved, in comparison to finding and recruiting a Jack Welch in the first place. Disney's problem with Michael Eisner was not so much that he was paid too much, but that he stayed too long.

[5] George Triantis is among the few who has appreciated this point. He has, for example, recognized in several pioneering and important papers that debt can play a complementary role with hostile takeovers in disciplining a corporation's management. *See* George G. Triantis, *Debt Financing, Corporate Decision Making, and Security Design*, 26 CANADIAN BUS. L.J. 93, 100-02 (1996) (discussing several ways in which lenders can influence the actions of borrowers); George G. Triantis, *The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines*, 16 INT'L REV. L. & ECON. 101, 104-08 (1996) (explaining three ways in which private lenders can exercise control over managers).

Corporate law, and in particular, rules of corporate governance, properly includes all the ways in which investors exercise control over the affairs of the corporation. Hence, one must take into account the rights that creditors acquire through contract. Loan covenants now are the principal mechanism for handling one of the most challenging problems in corporate governance, the one that arises when a once-effective manager needs replacing and the operations of the business must go through a fundamental overhaul. In the case of Krispy Kreme, the failure to deliver third-quarter financial statements violated various bank loan covenants. This was enough to give control to the banks. To maintain its ongoing operations, Krispy Kreme needed to secure waivers from the banks. The price the banks demanded for the waivers included firing the CEO and replacing him with a seasoned turnaround specialist.[6]

This Essay focuses on the ways in which loan covenants now play a central role in corporate governance. We make two central claims about the power of creditors in shaping corporate decision making. The first is a reconceptualization of the dynamics over control of the corporation. When a business enters financial distress, the major decisions—whether the CEO should go, whether the business should search for a suitor, whether the corporation should file for Chapter 11—require the blessing of the banks.[7] We first review in a general fashion the way in which rights of corporate governance are commonly shaped through contract. We then explore how loan covenants work in conjunction with the more familiar instruments of corporate governance, and follow with an examination of the way in which these contractual rights have reshaped the dynamics of Chapter 11. Our

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[6] The press release announcing the hiring of Cooper as Krispy Kreme's new CEO also announced that the lenders had agreed not to call an event of default under the loan agreement. *See* Press Release, *supra* note 2.

[7] We use the word "banks" to include both traditional banks and other private lenders. Nonbank private lending accounts for a substantial portion of lending to those companies with poor credit ratings. *See* David J. Denis & Vassil T. Mihov, The Choice Among Bank Debt, Non-Bank Private Debt and Public Debt: Evidence from New Corporate Borrowings 26 (June 2002) (unpublished manuscript), http://jfe.rochester.edu/02195.pdf (reporting that in 1995 and 1996, for corporations with over $100 million in assets, there were 317 public debt issues, 299 bank borrowings, and 110 nonbank private borrowings, with the private borrowings exhibiting low credit quality). Given the rise of the secondary market for syndicated bank loans, it is often the case that bank loans, at the time of distress, end up being held by institutions that are not banks. Moreover, in today's market for distressed loans, we see competition between banks and nonbanks. In light of these developments, we find it unhelpful for the aims of this Essay to distinguish between bank and nonbanks, and use the term "banks" to include all private lenders.

second claim is that, while there are potential risks associated with this lever of corporate governance, they are not the ones commonly attributed to senior lenders—that they will be biased towards liquidating the business and forego profitable projects. The fear that senior lenders will routinely destroy valuable businesses ignores the multiple options these lenders possess. Indeed, when one compares the role of private lenders to feasible alternatives, it is likely the case that private debt provides an important check on the agents of enterprise.

I. CORPORATE GOVERNANCE AND THE POWER OF CONTRACT

On its face, corporate law vests authority to run a corporation in the board of directors.[8] Shareholders, in turn, elect the directors, approve charter amendments and bylaws, and pass on certain extraordinary actions. Corporate governance debates center on whether and how the law should alter this allocation.[9] Legal constraints are needed at times when exogenous events create a mismatch between the incentives of the individual investors who possess control rights and what is in the best interests of the investors as a whole. Share-

[8] Stephen Bainbridge has put forth a normative conception of the corporation suggesting that nearly absolute authority is and should be vested in a corporation's board of directors. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 605-06 (2003) [hereinafter Bainbridge, *The Means and Ends*] (noting that boards typically have fiat over corporate decisions and asserting that such control can be reconciled with directors' duties to maximize residual profits for the shareholders); Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 818 (2002) ("[U]ndistorted shareholder choice should not be the null hypothesis—preservation of the board's discretionary authority should be."). Margaret Blair and Lynn Stout also have put forth a theory of the firm that places directors "as the final arbitrator[s] in disputes that cannot be resolved at lower levels." Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 279 (1999).

[9] *See, e.g.*, Bainbridge, *The Means and Ends, supra* note 8, at 605 (proposing that the tension between board authority and shareholder oversight should be resolved in favor of the former); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 865 (2005) (advocating that shareholders should be entitled to both propose and adopt changes to their company's corporate charter and state of incorporation); Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 44 (2003) [hereinafter Bebchuk, *Shareholder Access*] ("[I]t would be desirable and important to adopt additional measures to make shareholders' power to replace directors meaningful."); Blair & Stout, *supra* note 8, at 322 (noting that the vast majority of America's large companies are public corporations and commenting that this phenomenon may imply that independent boards of directors tend to make economically prudent decisions); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 67 (2003) ("Allowing shareholders to run an election contest through the company's proxy statement . . . would be a serious mistake.").

holders, as residual claimants, serve as good proxies for all investors when the business is flush. They bear both the costs and benefits of the enterprise, but they do not actually control the day-to-day affairs of the business, ceding decision making over all but a handful of matters to directors and officers. Shareholders nominally have the right to elect directors, but given the dispersion of shares, the board is effectively self-perpetuating.[10]

In such a world, we face the problem that Adolf Berle and Gardiner Means brought to the surface many decades ago: the separation of ownership and control.[11] The challenge of corporate law lies in ensuring that the interests of the shareholders remain foremost in the minds of those in charge of the business.[12] CEOs may place perks above profits.[13] We need well-designed compensation contracts to tie the wealth of the CEO to the well-being of the shareholders.[14] Man-

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[10] *See, e.g.*, Bebchuk, *Shareholder Access*, *supra* note 9, at 45-46 (reporting that, over a seven-year period, there were on average eleven challenges to incumbent directors, with less than two of these challenges occurring at corporations valued at over $200 million).

[11] ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[12] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 36 (1991) ("The role of corporate law . . . is to adopt a background term that prevails unless varied by contract. . . . For most firms the expectation is that the residual risk bearers have contracted for a promise to maximize long-run profits of the firm, which in turn maximizes the value of their stock.").

[13] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 313-19 (1976) (putting forth a formal model that demonstrates how managers with less than one-hundred-percent ownership of the corporation have an incentive to consume benefits rather than to maximize the value of the business).

[14] *See* John E. Core, Wayne R. Guay & David F. Larcker, *Executive Equity Compensation and Incentives: A Survey*, ECON. POL'Y REV., Apr. 2003, at 27, 44 (concluding that broad generalizations about executive compensation, such as "more equity ownership . . . is always better than less" are overly simplistic, and that instead such plans must be carefully tailored to the executive and the company (internal quotation marks omitted)); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, but How*, HARV. BUS. REV., May-June 1990, at 138, 141-42 (recommending that CEOs be required to hold substantial quantities of company stock, that cash compensation be designed to reward performance, and that CEOs be motivated to perform by a real threat of dismissal). For an argument that excessive agency costs afflict the current method of setting executive pay, see LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 86 (2004) ("The more power managers have, the more favorable their compensation arrangements are.").

agers can place their friends on the board.[15] These friends do not ask hard questions on a host of issues, ranging from the operation of the business to the compensation of the CEO and her team.[16] We need independent directors and greater shareholder input to check managers' incentives to pursue their self-interest to the detriment of the corporation as a whole.[17] Directors enjoy serving on boards. We need to provide incentives so they will sell the business when a buyer makes an offer that is in the shareholders' best interests.[18] While one finds vehement disagreement over how the law should allocate control between shareholders and directors, the law makes the allocation in the first instance. Any change occurs through the cumbersome process of amending the corporate charter.

According to this conventional account, creditors receive no special rights against the corporation. The creditors' power is limited to suing the debtors when they fail to pay as promised. Creditors do not have their hands on the levers of power. When financial woes strike, the board's fiduciary duties do shift from the shareholders to the creditors.[19] This shift, however, is quite limited.[20] One searches in

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[15] *See* Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829, 1833-34 (1999) (finding direct CEO involvement in the director selection process of 47% of corporations studied).

[16] *See* BEBCHUK & FRIED, *supra* note 14, at 80-82 (documenting that as CEO influence on the board increases, creative pay tends to escalate, while the sensitivity of pay to performance declines).

[17] *See* Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819, 831 (2002) ("Boards that do not 'do the right thing' . . . tend to be those where the independence model is warped by one of any number of factors, such as domination by senior management . . . .").

[18] For a classic formulation of this problem, see Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1175 (1981) (noting that the least effective managers have the greatest incentives to resist the sale of their companies). For a recent exchange on this topic, compare Lucian Ayre Bebchuk, *The Case Against Board Veto in Corporate Takeovers,* 69 U. CHI. L. REV. 973, 1012 (2002) (rejecting the argument that giving corporate boards veto power over hostile bids has a sufficiently positive effect on long-term investment to justify the other costs it creates), with Martin Lipton, *Pills, Polls, and Professors Redux,* 69 U. CHI. L. REV. 1037, 1059 (2002) (contending that rendering public corporations more vulnerable to hostile takeover bids would impose substantial additional costs on them, such as reducing access to credit).

[19] *See, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.").

[20] *See* Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1523 (1993) (concluding that *Credit Lyonnais* represents a mere enforcement of a creditor's preexisting contractual right). For

vain for directors ever being held liable for violating their duties to creditors. Creditors can protect themselves by setting out specific covenants in their loan agreements, but such protection is not a part of corporate governance in all but the most general sense. Under the prevailing view, debt performs a disciplining role only in the sense that the obligation to repay the loan forces the managers to focus on the bottom line. Debt constrains the actions of managers and reduces management waste, but creditors do not play an active role in the governance of the corporation.[21] In the standard model, debt is diversely held among public bondholders who rely on an indenture trustee to guard their interests.[22] The indenture trustee, however, can do no more than insist on rigid compliance with the bond covenants. She cannot exert any active role in the affairs of the corporation, as she lacks the power to alter the essential terms of the loan without the unanimous consent of the bondholders.[23]

The standard account neglects the role that bank and noninstitutional debt plays in the world of corporate finance. There are few lim-

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an argument that the shift in fiduciary duties to creditors is inconsistent with the underpinnings of Delaware corporate law, see Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, J. BUS. & TECH. L. (forthcoming 2006) (manuscript at 32), http://www.law.umaryland.edu/conferences/Twilight/bainbridge.pdf (last visited Mar. 23, 2006) (suggesting that *Credit Lyonnais* is unsound because it "threatens to give bondholders a windfall for which they have not bargained").

[21] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 12, at 68-69 (discussing the various controls creditors may exercise); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986) ("[D]ebt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers."). For evidence that adding leverage can increase the value of the corporation, see Gregor Andrade & Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed*, 53 J. FIN. 1443, 1458-59 (1998) (determining that highly leveraged companies in their study that defaulted earned slightly above-market returns and concluding by implication that when such companies remained solvent, they significantly outperformed the market).

[22] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 12, at 51 (characterizing bond indentures as one way in which debtors limit their ability to act contrary to a creditor's interest, thereby reducing the "risk premium" they must pay). Of course, the differences between public bondholders and private debt has not gone completely unnoticed. *See, e.g.*, Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUD. 393, 405 (1984) (noting that banks, by centralizing the monitoring function, can monitor debtors more efficiently than individuals); Eugene F. Fama, *What's Different About Banks?*, 15 J. MONETARY ECON. 29, 38 (1985) (suggesting that for small businesses, contracting costs for a bank are often lower than they are on the open debt market).

[23] Mark Roe explores this dynamic in Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987).

its on lenders' ability to insert any conditions or covenants into their loan agreements. While corporate charters are relatively short documents, loan contracts routinely exceed one hundred pages. These loan agreements define defaults in ways that give creditors as much control over the board and its decisions as shareholders. Indeed, in the limit, these covenants can obliterate the difference between debt and equity. The line between debt and equity is an entirely permeable one, in terms of both cash flow rights and control rights. Put-call parity tells us that, with the right combination of derivative instruments, one can achieve any configuration of cash flow rights—straight debt, straight equity, or any flavor in between.[24] To a very large extent, the same is true for control rights as well. Rights that we ordinarily associate with shareholders, such as the right to elect members of the board or veto sales of the business, often reside elsewhere.[25]

The role of contracting is readily observable at the time a business is formed. The entrepreneur and the venture capitalists care about the way cash flow rights and control rights are allocated between them, not the formal labels attached to these rights.[26] Whether the venture capitalist formally fits into the pigeonhole of "creditor" or "shareholder" is something she cares about only if something turns on it. Venture capitalists often invest in several different countries, each of which has its own legal system. The details of these legal systems

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[24] The classic work demonstrating put-call parity is Hans R. Stoll's *The Relationship Between Put and Call Option Prices*, 24 J. FIN. 801 (1969).

[25] We have developed these ideas in a series of previous papers. *See* Douglas G. Baird & Robert K. Rasmussen, *Four (or Five) Easy Lessons from Enron*, 55 VAND. L. REV. 1787, 1808 (2002) ("Here, then, is the third lesson of Enron. The basic decisions in a reorganization ought to begin with an examination of the way in which control rights are allocated. Their coherence, or lack of coherence, tells us how much work the bankruptcy judge must do."); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 682 (2003) [hereinafter Baird & Rasmussen, *Chapter 11 at Twilight*] ("Creditors exercise control that investors in nineteenth century railroads could only dream of."); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 779 (2002) [hereinafter Baird & Rasmussen, *The End of Bankruptcy*] ("When things are going poorly, . . . control rights can shift to parties not traditionally viewed as inside the firm."); Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 922 (2001) ("[T]he central focus of corporate reorganizations . . . should remain upon how the firm's assets are used and who controls them.").

[26] *See* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 306-08 (2003) (arguing that standard financial contracting theories fail to account for the practical complexities of the relationships between venture capitalists and entrepreneurs, and providing analytical tools for supplementing formalistic theories with real-life considerations and implications).

are important only insofar as the investment contracts must take them into account.[27] For example, a venture capitalist in the United States may want to prevent a business from filing for Chapter 11, but otherwise enjoy all the usual attributes of a creditor. To achieve this result, the venture capitalist becomes a preferred shareholder and takes steps to ensure that no other creditors of any consequence come into being. The venture capitalist has the same priority rights and the same cash flow rights as a creditor, but the business will not even be eligible for bankruptcy because, as a formal matter, it has no creditors.[28] The same venture capitalist in Sweden does not face the equivalent of Chapter 11.[29] She might do the same deal and enjoy the same control rights and cash flow rights, but formally be a creditor.

More is going on, of course, than merely contracting around such things as bankruptcy law. A venture capital firm invests in only a discrete part of the life cycle of a business. In start-up ventures, the allocation of control rights is a relatively straightforward and prominent problem. The entrepreneur who possesses the idea has the incentives to develop the concept and bring it to market. As long as the endeavor progresses well, she is well positioned to make the decisions. Control rights remain largely vested in her and her management team. The venture capitalist is content to cheer from the sidelines.

Control rights shift, however, when things go poorly for the start-up. When the enterprise cannot find its footing, the principal question becomes whether the project should continue (with either the entrepreneur or someone else in charge), be sold to another entity, or be shut down. More time may be needed to make a final decision on the fate of the venture, the entrepreneur may need to be replaced by

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[27] When we look at venture capital deals across different countries, we find that differences in the legal systems are relatively unimportant. Success turns on the sophistication of the contracts that the venture capitalist writes. *See* Steven Kaplan et al., *How Do Legal Differences and Learning Affect Financial Contracts?* 19 (Nat'l Bureau of Econ. Research, Working Paper No. 10097, 2003), *available at* http://www.nber.org/papers/w10097 (explaining analytic results indicating that "the [venture capital] sophistication variables consistently have significant explanatory power while the legal and institutional variables do not").

[28] Of course, nothing is certain, and sometimes creditors can arise, but such risks are manageable. For torts, insurance provides compensation for all but the most extreme calamities. For suppliers and the like, the cost that an inadvertent creditor can impose is capped by the amount of its claim.

[29] Swedish bankruptcy law provides for a mandatory cash auction of failed corporations. *See* Per Strömberg, *Conflicts of Interest and Market Illiquidity in Bankruptcy Auctions: Theory and Tests*, 55 J. FIN. 2641, 2645-48 (2000) (describing the Swedish cash auction mechanism, as compared to the bargaining procedure exemplified by Chapter 11 in U.S. bankruptcy law).

someone with more managerial experience, or it may be that the once-promising idea simply cannot survive in the marketplace. The venture capital firm is particularly well positioned to make this decision. Successful venture capitalists face a high opportunity cost of continuing projects that will not produce a positive return. It is thus not surprising that the venture capitalist is almost always vested with the shutdown decision when the business struggles. She possesses the power to decide whether to liquidate the business regardless of whether she is formally a preferred stockholder, a creditor, or something else entirely.[30]

Investment contracts, of course, must specify precisely *when* the venture capitalist will acquire control over the company. The vicissitudes of the future mean that these contracts cannot detail every contingency that may arise. Hence, the challenge for contract drafters is to find suitable proxies. Control should shift when it is likely that the entrepreneur may be unduly biased toward continuation—either of the project or her role in it—and when there is little threat of the venture capital firm attempting to appropriate more of the upside gains for itself.

The proxies used tend to be objective "milestones" that can easily be verified by both parties and, if necessary, a court. Typical milestones that transfer control are tied to the failure to meet various goals set out in the business plan, such as whether the venture has met cash flow projections, produced a working prototype, or found a specified number of customers by a fixed date. Control transfers when a milestone is not met, even though the financial instruments that the corporation has issued remain unchanged. The transfer of control, however, does not necessarily mean that the business will be shut down; rather, it means that the decision of how to proceed is placed in the hands of someone perceived as better positioned to make that judg-

[30] *See* Kaplan & Strömberg, *supra* note 26, at 282 (asserting that the practical rights of parties to a financial contract carry more significance than the formal labels assigned to those rights).

ment call.[31] And this person often has the formal legal attribute of a creditor.[32]

The way in which the allocation of control rights departs from the traditional paradigm early in the life cycle of the business is only one illustration of the way in which control rights—and hence the powers of corporate governance—are customized to suit the needs of a business at different times. Different challenges arise at various points in the life cycle of a business. At conception, the open question is the soundness of the business plan.[33] In the first few years, the founder of the business may also be the one developing the technology. The success of her efforts and the business are one and the same. The question for the investors is not one of choosing the CEO, but rather how long to back her before pulling the plug.

But when the business succeeds and grows, the investors no longer face the question of shutting down the business, but instead must decide whether the founder is also the person best equipped to lead the business through its adolescence. The entrepreneur with the visionary idea is often replaced by seasoned managers who excel at developing the infrastructure of the business. When the business grows and becomes more stable, close supervision is unnecessary and often counterproductive. Hence, the venture capitalist, someone whose comparative advantage lies in monitoring young companies, exits and is replaced by public shareholders and by public and private debtholders.

The nature of the business often affects its capital structure. A business that makes fashions for teenagers might be set up along the following lines. Because the clothes themselves are made overseas,

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[31] This is not to say, of course, that the venture capital firm will always make the optimal decision. For example, given the high opportunity cost of the time of the venture firm, once it decides to shut down a project, it may not spend much time finding the buyer who will pay the highest possible price. Our point here is only that, as between the parties in whom the shutdown decision could be vested, the venture firm has the better incentives to make the correct decision.

[32] Again, we are not asserting that this person has to be a creditor. The venture capitalist, in this country at least, has the legal status of a preferred stockholder. Our point is that the formal legal status is not itself important when control rights are (as is always the case in venture capital deals) a creature of contract.

[33] Venture-backed businesses that eventually go public retain the same business plan throughout their development. Managers, in contrast, often turn over. Indeed, managers are more likely to leave the corporation than are other capital assets. *See* Steven N. Kaplan et al., *What Are Firms? Evolution from Birth to Public Companies* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 11581, 2005), *available at* http://www.nber.org/papers/w11581 ("While the points of differentiation, alienable assets, customers, and competitors remain relatively constant, the human capital of the sample firms changes more substantially.").

the company's suppliers (or its intermediaries) are likely to insist on a standby letter of credit that insures they will be paid.[34] To obtain such a letter, the corporation will have to have a credit line with a bank. Apart from this credit line, however, the principal challenge facing the owners when designing the capital structure is to find the right CEO, to give that person the right set of incentives, and to put a governance structure in place that removes the CEO if necessary. In such an environment, investors do not need the attributes typically associated with creditors.

While the investors can make judgments about the sort of person most likely to make these decisions well, they cannot know perfectly, nor can they review decisions as the CEO makes them. Quite the contrary, to give any investors the ability to micromanage the CEO's fashion judgment would invite disaster. The CEO is hired precisely because she is supposed to have a comparative advantage on this score over the investors. These investors need a capital structure that gives the CEO slack for a season or two, but still allows the investors to replace her if she has not been successful.[35] Apart from the credit line (which may never be drawn upon), the capital structure may consist largely of equity, but be held by a relatively small number of investors who also sit on the board.[36]

One way to understand how control rights are adjusted to take account of different types of businesses is through the following thought experiments. Consider a business that has a single owner (or, more likely, a consortium of investors that can effectively act as one). Perhaps the business went through a leveraged buyout several years before, or maybe it is a relatively new enterprise that has already found its footing in the marketplace. The business is thriving. The CEO is the driving force behind the business and responsible for much of the success it has enjoyed. The owner now wants to sell the business and must decide on the capital structure and a system of corporate gov-

[34] For an example of litigation growing out of such an arrangement, see P.A. Bergner & Co. v. Bank One, Milwaukee, N.A., 140 F.3d 1111 (7th Cir. 1998).

[35] On the notion of a capital structure providing slack to the managers, see generally George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102 (2004).

[36] *See, e.g.*, Harry DeAngelo et al., *Asset Liquidity, Debt Covenants, and Managerial Discretion in Financial Distress: The Collapse of L.A. Gear*, 64 J. FIN. ECON. 3, 5 (2002) (employing a case study of L.A. Gear to illustrate how highly liquid asset structures can provide managers of public corporations with additional time and discretionary leverage during periods of financial difficulties).

ernance that will maximize its value (and hence the amount the owner can realize in the sale). What about an all-equity capital structure brought about through an initial public offering to a group of passive and widely dispersed shareholders? How well will this mechanism work at the outset? How well will it work going forward? How can it change? How will these changes make things better or worse?

A diversely held, all-equity capital structure gives the CEO enormous freedom. In time, the board will consist largely of those whom she picks. They are not likely to rein her in, and the shareholders will exercise virtually no oversight. Notwithstanding these features, such a capital structure at the time of initial public offering may make sense. Granting the CEO freedom is in the first instance a good idea. The business's success and promising future derive from her skill and the course she has set for the business. Her stock and options align her interests with those of the enterprise. An active board with many layers of oversight may be contrary to the interests of the owners.[37] Second-guessing her acquisition plans and flyspecking her compensation contract do not advance the interests of the enterprise.

Consider now a different kind of business, a mature corporation with steady cash flow. Investors face the danger that those in charge will fail to focus on maximizing cash flow.[38] The investors therefore often put in place a capital structure that requires the people running this business to distribute cash on a continual basis. They can do this by having the corporation issue short-term debt that requires the managers to go to the market repeatedly.[39] Alternatively, they may have the enterprise pay cash dividends to the stockholders.[40] Finally, they can put substantial leverage in the company that requires the payment of periodic interest on the pain of default. Failure to live up to any of these obligations—the ability to turn over short-term debt, the payment of dividends, or the default on long-term debt—can spell

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[37] *See* Jeffrey L. Coles et al., Boards: Does One Size Fit All? 38 (Feb. 9, 2005) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=665746 (providing empirical support for the proposition that the size of the board and the percentage of outside directors turns on the nature of the corporation's business).

[38] *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986) (discussing how managers need mechanisms in place to discourage inefficient investments and inefficient operations).

[39] *See id.* at 324 (proposing that the issuance of debt can produce positive control effects over management).

[40] *See* Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 655 (1984) ("Expected, continuing dividends compel firms to raise new money in order to carry out their activities.").

the beginning of the end for the current managers. The configuration of control rights of a business at any moment turns on the nature of the business it is in, the economic conditions in which it finds itself, and its financial obligations.

There are any number of different ways to parcel out cash flow rights and control rights. No one way is necessarily better than any other. For all these configurations, however, their suitability turns not merely on the business at the moment the rights are put in place, but also on how they will work when things go wrong. Hence, any assessment of a particular governance regime requires taking into account how it will function in bad states of the world.

II. STATE-CONTINGENT CONTROL RIGHTS AND MATURE BUSINESSES

CEOs of once-thriving businesses sometimes lose their touch. They exhaust the fount of ideas that brought their initial success. The business environment changes and the attributes of the CEO that made her the right person to run the business a few years ago are not well suited to the current challenges. Investors as a group need some mechanism to protect them when the person in charge can no longer find the right path. Here the levers of corporate governance need to influence, and when necessary, replace, wayward managers.

Since the 1970s, academics have pointed to the market for corporate control as the mechanism best suited to minimize the costs of the separation between owners and managers.[41] When the CEO no longer deploys the assets of the corporation in a way that maximizes shareholder value, a hostile raider can take over the business and set matters aright. Moreover, the possibility of a hostile takeover ensures that managers keep their more base impulses in check. But in recent years, the weaknesses of the hostile takeover as a disciplining device have become manifest. A staggered board coupled with the unfettered ability of the board of directors to adopt a poison pill largely immunizes most businesses from the market for corporate control.[42]

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[41] Henry Manne did the pioneering work in this area. *See* Manne, *supra* note 4, at 113 ("Only the take-over scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders.").

[42] *See* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 891, 930-31 (2002) [hereinafter Bebchuk et al., *Staggered Boards*] (finding that an effective staggered board increases from 34% to 61% the chances of a corporation remaining independent nine months

Recent reform proposals do not seem to be effective replacements for the market for corporate control. One can find calls to increase the incidence of independent directors, but the available empirical evidence casts doubt on their ability to protect shareholders.[43] Sarbanes-Oxley—even assuming that it is effective[44]—combats fraud, not sloth. It does nothing to replace managers who are honest but inept. The public investors can exit by selling their investments, but they have no ability to rectify matters when a CEO stumbles. Often they lack access to crucial information, such as whether the CEO in fact needs replacing or whether the business is merely going through a rough patch. Shareholders are passive, cannot act quickly, and in any event typically do not hire and fire corporate officers.

The difficulties Warnaco faced several years ago when its CEO faltered provides an illustration of how creditor control can work when the traditional levers of corporate governance do not. Warnaco is a publicly traded Fortune 1000 company that manufactures and distributes intimate apparel, name-brand jeans, and swimwear. A small group of investors acquired it in a leveraged buyout in the late 1980s. Under the leadership of its hard-driving CEO, it shed debt, streamlined operations, and became an effective competitor in the marketplace. Warnaco became a publicly traded corporation once again in 1991, and it flourished in the 1990s as it acquired licenses to sell some highly visible brand names (including Calvin Klein jeans). As Warnaco's fortunes were rising and its CEO was performing well, control rights were largely invested in her. She set the enterprise's strategy. The board was neither independent nor terribly active. She was well compensated for her efforts, receiving more than $158 million in salary, bonuses, and options between 1993 and 1999.[45] Warnaco's debt was spread across twenty different banks and it was unsecured.[46]

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after a hostile bid); *see also* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 418-19 & tbl.1 (reporting that about 60% of the publicly traded corporations examined from 1995 to 2002 had staggered boards).

[43] *See* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 895-900 (2002) (countering the argument that a board with a majority of independent directors will benefit shareholders).

[44] For an argument that it is not, see Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005) (criticizing the prudence behind the enactment of Sarbanes-Oxley and the effectiveness of its substantive corporate governance mandates).

[45] *Warnaco Ousts CEO Amid Its Restructuring*, L.A. TIMES, Nov. 17, 2001, pt. 3, at 1.

[46] On the general tendency of healthy, large companies to not secure their debt, see Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 629

During the time that it flourished, Warnaco seemed a classic example of a business with a firmly entrenched manager.[47] The CEO also served as chair of the board. Half of the six-member staggered board were insiders. The CEO had picked the "independent" directors from her circle of social friends and professional colleagues. They were uninvolved in the activities of the business while it enjoyed good times. Indeed, Warnaco made *Business Week*'s list of "The Worst Boards of Directors" in 1996, largely due to the board's lack of independence.[48] The freedom given the CEO, however, may be not so much the product of lax corporate governance as what made sense for someone with a long and consistent track record. The corporate governance challenge, from the perspective of the investors as a group, was not in corralling the CEO's decisions while she was doing well, but in ensuring that action was taken soon enough when her decisions went astray.

(1997). *See also* Allen N. Berger & Gregory F. Udell, *Collateral, Loan Quality, and Bank Risk*, 25 J. MONETARY ECON. 21, 27-40 (1990) (providing empirical evidence that supports the positive correlation between use of secured loans and the borrower's risk).

[47] Recent corporate law scholarship explores the cost of entrenched managers. *See, e.g.*, Lucian Bebchuk et al., *What Matters in Corporate Governance* 5 (John M. Olin Ctr. for Law, Econ., & Bus., Harvard Law Sch., Discussion Paper No. 491, 2004) [hereinafter Bebchuk et al., *What Matters*] ("We take the view . . . that arrangements that protect incumbents from removal or its consequences are harmful to shareholders. . . . Those concerned about insulation from intervention or removal by shareholders have been most concerned about the adverse effects that entrenchment can have on management behavior and incentives."). Modern indices of corporate governance include things such as whether there is an effective staggered board, *see* Bebchuk et al., *Staggered Boards*, *supra* note 42, at 902-24 (discussing the antitakeover power afforded to companies with effective staggered boards); whether shareholders' voting power on bylaw amendments, charter amendments, and merger is constrained, *see* Bebchuk et al., *What Matters*, *supra*, at 6-7 (evaluating four provisions that limit shareholder voting power in specific ways through use of an entrenchment index); the extent to which boards have adopted protections against hostile takeovers, *see id.* at 8-9 (examining the correlation between corporate governance and the implementation of provisions intended to thwart takeovers); and whether there are a majority of independent directors, *see* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 248-65 (2002) (examining whether increasing the proportion of independent directors on boards achieves improved profitability). The "governance index" created by the Investor Responsibility Research Center (IRRC) and used in a number of recent papers focuses exclusively on the relationship between the board and shareholders. *See* Bebchuk et al., *What Matters*, *supra*, at 6-9 (describing six governance provisions followed by the IRRC in developing an index to measure board entrenchment); Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 109 (2003) (describing the construction of a governance index as an analytical tool for investigating the balance of power between shareholders and managers).

[48] *See* John A. Byrne, *The Best & Worst Boards*, BUS. WK., Nov. 25, 1996, at 82, 85 tbl.

In the late 1990s, Warnaco invested unsuccessfully in a chain of Calvin Klein jeans outlet stores. Warnaco borrowed heavily to acquire new brands (including $530 million to reacquire Authentic Fitness, maker of Speedo swimwear, which it had spun off in the early 1990s[49]). Warnaco also borrowed to repurchase its own stock. Over the course of a single year, Warnaco's debt grew from $500 million to $1.5 billion. The CEO had stumbled. Neither shareholder action nor the market for corporate control would set matters aright, regardless of how much the business adhered to the conventional canons of good corporate governance. Nevertheless, the CEO was put under a tight rein and then displaced.

The shift in control came about as a result of Warnaco's need to restructure its debt. Warnaco remained solvent,[50] but it was no longer able to borrow on an unsecured basis from twenty different banks. It had to fold this debt into a revolving credit facility controlled by a handful of banks.[51] This transaction gave the banks a security interest in substantially all of Warnaco's assets, including its cash flow. Warnaco would only receive operating funds with the continued blessings of the banks. Once the revolving credit facility was in place, control rights had shifted. From that point forward, the banks that ran the revolving credit facility essentially controlled the corporation.[52] The

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[49] *See Warnaco To Buy Authentic Fitness for $426.1 Million*, N.Y. TIMES, Nov. 17, 1999, at C4 (reviewing the deal in which Warnaco paid $426.1 million and assumed $105 million in debt to acquire Authentic Fitness).

[50] Although the stock traded for much less than it had in better times, sophisticated investors were still buying it, as was the CEO. *See Bass Raises Stake in Warnaco*, WOMEN'S WEAR DAILY, Oct. 6, 2000, at 2 (reporting that investor Sid Bass had recently acquired 2.5 million shares in Warnaco); Matt Andrejczak, *Warnaco CEO Goes on Buying Spree*, CBS MARKETWATCH.COM, Nov. 14, 2000, 11/14/00 MKTWATCH 22:26:11 (Westlaw) (reporting that Warnaco's CEO had just purchased more than 600,000 shares of Warnaco stock).

[51] *See Warnaco Completes $2.56 Billion Financing*, BUS. WIRE, Oct. 6, 2000 (LEXIS, News & Business database) (reporting the new secured credit facility put in place at Warnaco). While debt of this sort is often syndicated among a number of banks, the lead bank typically performs the bulk of the monitoring of the debtor.

[52] Laws that protect junior creditors from transactions that advance the interests of senior lenders at their expense generally have too short a reach-back period to provide them with much protection. The preference period generally runs only ninety days. *See* 11 U.S.C. § 547(b) (2000) ("[T]he trustee may avoid any transfer of an interest of the debtor in property . . . made on or within 90 days before the date of the filing of the petition . . . ."). Senior lenders will generally not be treated as insiders, and even when they are, the preference period runs only a year. *See id.* ("[T]he trustee may avoid any transfer of an interest of the debtor in property . . . made between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider . . . ."). Pledging the assets usually can be done far

revolver gave the banks the ability to veto any extraordinary transaction. Moreover, the business was put on a short leash. The management knew that its continued employment depended on reversing the recent slide.[53] For those beholden to equity, the incentives to engage in unduly risky transactions as the corporation nears insolvency were firmly checked.[54]

The presence of such an institutional lender fundamentally alters corporate governance. The lending agreement contains many affirmative and negative covenants that give the lender de facto control over every aspect of the business. Moreover, the complete control the lender has over the debtor's cash flow gives the lender veto power over every course of action, whether internal to the corporation or outside it. Decisions normally reserved for directors and stockholders—such as whether to sell a division, change the business plan, or replace the managers—require the lender's explicit blessing. Trip wires are tied to the performance of the business and its discrete units, and a general provision gives the lender the ability to call the loan in

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enough in advance to ensure that none of these problems arise. For example, in the case of Interstate Bakeries, the company had no secured debt as of July 18, 2001. Its unsecured debt was a tad less than $600 million. The next day, Interstate entered into a new credit facility. This facility brought additional liquidity—it was for $800 million. All of the prior debt was paid off. The cost, however, was that the new facility was secured by substantially all of the assets of the business. INTERSTATE BAKERIES CORP., 2001 ANNUAL REPORT 15, 22 (2001).

[53] Replacement of the CEO would more than likely require a bankruptcy filing, as the severance portion of her compensation contract was $43 million. *See* Dan Ackman, *Warnaco Flounders*, FORBES.COM, June 12, 2001, http://www.forbes.com/2001/06/12/0612topnews.html ("A termination agreement dating to 1991 guarantees the CEO $43 million more."). Indeed, she was replaced in bankruptcy, and the company rejected her contract. She sued Warnaco seeking $25 million under the contract, but settled the case for less than $500,000. *See* Soma Biswas, *Wachner Settles Warnaco Severance Fight*, THEDEAL.COM, Nov. 18, 2002, http://www.thedeal.com/NASApp/cs/CS?pagename=TheDeal/TDDArticle/TDStandardArticle&bn=NULL&c=TDDArticle&cid=1037611341406 (reporting that instead of the $25 million she wanted, Wachner received "a $3.5 million general unsecured claim plus an administrative claim of $200,000 in cash").

[54] On the incentives of equity holders to favor risky transactions in situations of financial distress, see Jensen & Meckling, *supra* note 13, at 334-37. Barry Adler has extensively examined how bankruptcy law affects these dynamics. *See* Barry E. Adler, *A Re-examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575, 576 (1995) (asserting that managers of financially distressed firms "have a strong incentive to gamble with the firm's assets" and proposing ways to mitigate such behavior); Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 440-41 (1992) (examining the effects of bankruptcy reallocation on firms' contractual priorities and analyzing risk-sharing theory).

the event of any material adverse change.[55] The purpose of these trip wires is not to force repayment of the loan, but rather to ensure that lenders have control over major decisions and the ability to insist on changes in management when the business encounter reverses.

Several decades ago, institutional creditors could not exercise this much control. Before Article 9 of the Uniform Commercial Code was enacted, acquiring a security interest in all of a company's property was hard.[56] Each type of collateral had its own legal regime. Moreover, courts viewed with suspicion omnibus clauses that picked up all of the debtor's property and provided no cushion for other creditors.[57] In many instances, secured lending was premised upon the creditor's ability to take possession of discrete assets and sell them in the event that the debtor defaulted. It was not possible to make a secured loan premised upon the corporation's value as a going concern. Article 9, and especially the revised Article 9, have made it possible for lenders to acquire all of a corporation's assets.[58] The modern security interest effectively covers not only a corporation's discrete assets, but also the synergy that each asset has with the others. The expanded security interest not only changes the basis on which the lender extends credit, but also the control that the creditor can exercise over the business.[59]

Modern business practices also enhance a creditor's ability to control a corporation. In many highly competitive industries, successful companies must actively manage their cash flows. The institutional

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[55] The notion of default clauses in lending agreements as trip wires designed to signal to the lender that it needs to step up its monitoring activity is set out in Ronald J. Daniels & George G. Triantis, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1093-94 (1995) ("[Debt covenants] serve as trip wires for the lender's right to accelerate and enforce or to intervene in the borrower's decisions.").

[56] *See* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 197 (1965) ("[A] lender against the security of 'pledgeable intangibles' could perfect his security interest under pre-Code law only by taking possession of the collateral.").

[57] *See, e.g.*, Benedict v. Ratner, 268 U.S. 353, 360 (1925) (holding that under state law, "a transfer of property as security which reserves to the transferor the right to dispose of the [property for his own benefit] is, as to creditors, fraudulent and void").

[58] Perhaps most notably, the revised Article 9 made it possible for a lender to take a security interest in a debtor's deposit accounts. *See* U.C.C. § 9-109 cmt. 16 (2000) ("[D]ebtors who wished to use deposit accounts as collateral sometimes were precluded from doing so as a practical matter.").

[59] For an important and early recognition of the way in which secured credit can give a lender control rights that encourage the firm to pursue promising investments, see Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 904 (1986) (stating that secured financing "ameliorates the conflicts that would otherwise discourage firms from financing investment opportunities with private debt").

lender not only takes a security interest in all of the debtor's assets, but also actively manages the debtor's cash flow through a revolving credit facility. A creditor can now acquire a valid security interest in all of a debtor's assets and ensure that all of the cash coming into the corporation and leaving it passes through its hands. Modern technology enables the lender to know precisely how much cash a borrower has at any given time. By virtue of controlling the business's cash flow, the creditor is less dependent upon the debtor to tell it what is going on. The creditor has experience in the industry, and thus can readily distinguish between cash flow problems related to a general industry downturn and such problems that are unique to the corporation it is funding. When the debtor's cash flow deteriorates, the lender can then invoke the powers for which it has contracted in the lending agreement.

The ability to cut off a debtor's cash flow is a much more potent threat (and gives the creditor much more control over a company) than the threat to repossess the debtor's equipment. Turning off the cash stops a debtor dead in its tracks. In contrast, repossessing collateral is a potent threat only if the creditor can reach the property without breaching the peace.[60] Even then, repossessing collateral other than cash jeopardizes the value of that collateral. A debtor can dispose of its assets—its inventory, its equipment, etc.—much more effectively than can a lender. A lender, therefore, may find that the collateral is worth more in the debtor's hands.[61] Cash, on the other hand, is worth just as much in the lender's hands as in the debtor's.

Yet, precipitously turning off the cash is at some level *too* great a threat. Just as a secured creditor with a security interest in a machine could not credibly threaten to blow up the machine, a secured creditor with a security interest in a corporation's cash flow is unlikely to abruptly shut down the business. Taking all the cash on hand today precludes future activity that would generate additional funds. It destroys the option value of the security interest.[62] Rather, the security interest here serves two roles. At times, it gives the creditor the ability

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[60] *See* U.C.C. § 9-609(b) (2000) ("A secured party may proceed [to repossess collateral] . . . if it proceeds without breach of the peace.").

[61] *See* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 221-22 (1997) (stating that lenders rarely forcibly repossess collateral because they believe that the result of doing so would be "disastrous").

[62] On secured credit as an option, see Robert K. Rasmussen, *Secured Credit, Control Rights and Options*, 25 CARDOZO L. REV. 1935, 1941-50 (2004) (arguing that secured credit is a "real option and a financial option" that provides lenders with significant flexibility and control).

to conduct a controlled liquidation of the corporation. By limiting the amount of the advances, it can ensure that funds are spent only on liquidating the current assets.[63] The lender can limit a debtor's access to cash in a way that it cannot limit its access to a machine. With a machine, the debtor either has access or it does not. As to cash, the lender controls the amount of cash that the debtor can spend. Cash can be a much more nuanced mechanism of control.

The security interest in the debtor's cash flow serves a second function as well. Leaving assets unencumbered would allow the debtor to obtain funds from other sources. The debtor could always attempt to find another lender so as to continue its operations. By taking a security interest in the cash flow, the institutional lender leaves the debtor with no exit strategy. The lender monitors the business's progress and has the right to decline to provide new funds in full or reduce the amount that the corporation receives. To induce the lender to waive loan covenants and otherwise stay its hand, the board takes a more active role in the business. The debtor has to find a common understanding with the lender as to the future of the enterprise.[64]

Institutional creditors do not routinely insist on these revolving credit facilities. Indeed, when the debtor finds itself in robust financial health, it will find multiple sources of credit and competition among these creditors, which limits the terms that creditors can demand. Managers are reluctant to put their fate in the hands of a bank consortium, and lenders have no need to meddle in the affairs of a thriving business. Revolving credit facilities with all the requisite bells and whistles are expensive to set up and to monitor. When times are good, they are unnecessary. A creditor may be content to take a security interest in a discrete asset as long as principal and interest on the loan are less than what the creditor knows it can realize on the collateral, inside of bankruptcy and out.

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[63] *See, e.g.*, *In re* Clark Pipe & Supply Co., 893 F.2d 693, 695 (5th Cir. 1990) ("[The secured lender] began reducing the percentage advance rates so that . . . [the debtor] would have just enough cash to pay its direct operating expenses. [The debtor] used the advances to keep its doors open and to sell inventory, [in order] to pay off the past advances from [the secured lender].").

[64] There are reasons to believe that boards may be overly trusting of the CEOs that they have hired. *See* Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 294 (2004) ("Once it has installed or chosen to retain a CEO, the board is motivated to trust the CEO more than it should."). Lenders, all else being equal, are less likely to suffer from this bias, as they are not responsible for electing and installing the corporation's officers.

Instead, we tend to see industrial-strength revolving credit agreements in environments such as Warnaco. In this situation, the debtor is in default on existing loan covenants and has exhausted other sources of capital. Its lender is owed more than any discrete asset the corporation owns, and thus must depend upon the value of the business as a going concern in order to ensure repayment.

The desire of a lender to gain control when a business becomes financially distressed should come as no surprise. Much of the literature on corporate governance is aimed at reducing agency costs when times are good.[65] In that situation, managers may have an incentive to pursue private benefits rather than maximize shareholder wealth. Things change when distress occurs. Distress often foreshadows the replacement of managers and directors.[66] They know that they are in the end game. Final-period problems tend to reduce the efficacy of controls designed to bind managers over the long term. Left unchecked, managers are even more likely to put their interests ahead of those of the company. Lenders thus institute a new set of controls in order to protect their interests.

The loan agreements for these revolving credit facilities have evolved over time, but the basic structure remains the same. The agreement sets out negative and affirmative covenants and defines events of default.[67] The various covenants require the debtor to seek permission from the lender for any major decision about the enterprise, such as the purchase or sale of any substantial assets outside the

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[65] *See, e.g.*, Jensen, *supra* note 21, at 323 ("Corporate managers are the agents of shareholders, a relationship fraught with conflicting interests. Agency theory, the analysis of such conflicts, is now a major part of the economics literature."); Jensen & Meckling, *supra* note 13, at 308-10 (identifying agency costs in modern corporations).

[66] Even in the 1980s, few senior managers survived financial distress. *See* Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241, 247 tbl.3 (1989) (noting that, during the period of 1979-1984, 29% of senior managers remained at least two years after their firms filed for bankruptcy); *see also* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 723 (1993) (observing that 91% of CEOs were replaced among the financially distressed companies examined and that this turnover rate was much higher than that typical of most large, publicly held companies). Turnover has increased over time. *See* Baird & Rasmussen, *Chapter 11 at Twilight*, *supra* note 25, at 697-99 (discussing the pervasiveness of director turnover in the modern corporate bankruptcy context).

[67] If a debtor insists on there being no covenants, the loan will be callable on demand. *See* GUIDE TO ASSET BASED LENDING, GENERAL ELECTRIC CAPITAL COMMERCIAL FINANCE 16 (1999) (noting that, in the absence of a covenant, and in the event that "the borrower's financial condition deteriorates markedly, the lender may decide to cut off cash availability to the borrower and terminate the loan without notice").

ordinary course of business. The debtor also gives the lender access to its books and records—information not routinely available even to shareholders.[68] Loan covenants also check the ability of the debtor to use its cash collateral or to borrow from other creditors. Violations of the covenants are events of default. A default entitles the creditor to demand repayment of the loan and to take possession of all of the borrower's assets.

Having a lender declare a default even without seizing collateral creates consequences for the debtor. A default signals to the rest of the world that the debtor is in financial difficulty and is at loggerheads with its creditors.[69] Change may well be in the offing. Lenders have virtually unimpeded access to the books of the corporation. If the lender signals that it has lost confidence in the business by declaring a default, other investors in the corporation take note. Indeed, a declaration of default may spur a race to collect from the debtor, which in turn makes a bankruptcy filing inevitable. Debtors will often grant concessions to lenders to avoid these consequences. It is not uncommon for a lender to receive an advanced payment, an increase in interest rate, or more sweeping powers in exchange for not declaring a default.

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[68] On the limits of shareholder access to a corporation's financial records, see Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331, 333 (1996) ("[Inspection] statutes could authorize a court to give a shareholder any document that the corporation possesses, although typically courts limit this access to corporate minutes and accounting records.").

[69] This is the converse of the well-documented phenomenon that a bank's decision to extend credit is taken as a positive signal by the stock market. *See* Ronald Best & Hang Zhang, *Alternative Information Sources and the Information Content of Bank Loans*, 48 J. FIN. 1507, 1507 (1993) (citing a 1987 study showing "a significantly positive" impact from "the announcement of bank credit agreements and reports"); Matthew T. Billet et al., *The Effect of Lender Identity on a Borrowing Firm's Equity Return*, 50 J. FIN. 699, 699 (1995) (discussing prior studies suggesting "that certain types of loan announcements generate significantly positive abnormal returns to the average borrower's equity"); Scott L. Lummer & John J. McConnell, *Further Evidence on the Bank Lending Process and the Capital-Market Response to Bank Loan Agreements*, 25 J. FIN. ECON. 99, 100 (1989) (concluding "that the positive announcement-period return" following banks' "revisions to existing agreements" accounts for a greater percentage of returns than "new credit agreements"). Such gains exist even when bank loans trade on the secondary market. *See* Amar Gande & Anthony Saunders, Are Banks Still Special when There Is a Secondary Market for Loans? 3 (Oct. 2005) (unpublished manuscript), http://ssrn.com/abstract=873353 ("[N]ew loan announcements are associated with a positive announcement effect on the borrower's stock price even when a borrower's loans trade on the secondary market.").

Changes in the underlying economy alter the relative positions of the borrower and the lender in another way. A creditor's threat to exercise its rights and exert control over the business is credible only if the creditor can make use of the assets. Hence, even if a creditor in fact has a security interest that covers the entire business and extended credit on the basis of the corporation's value as a going concern, the threat to repossess is credible only to the extent that the secured creditor has the ability to realize the going concern value of the business without the debtor's cooperation. Fifty years ago, small businesses were often indistinguishable from the owner-managers who ran the companies on a day-to-day basis. Today, fewer corporations depend upon the firm-specific skills of the managers.[70]

The ability to replace existing managers has led to what may be the biggest change in the governance of the corporation in recent times. It is now possible to bring in turnaround specialists to take over the business. Both large and small corporations are routinely sold in the marketplace. Institutional lenders bargain for the implicit (and sometimes explicit) power to change the managers.[71] A change in managers or directors without the banks' explicit blessing is often an event of default under the loan covenants. The appointment of a new manager, a Chief Restructuring Officer (CRO), may be a condition of the loan.[72] More commonly, if the business continues to fare badly, the banks may condition the waiver of loan covenants on the appointment of a CRO. Other times, their influence is more subtle. With a sophisticated board of directors, the lenders may need to do no more than make it understood that they will look more kindly on future waivers of loan covenants if a CRO with whom they have worked before is in place and cleaning shop.[73]

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[70] We make this point in greater detail in Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 25, at 774-77 (discussing how "[h]uman capital today is increasingly industry-specific, rather than firm-specific").

[71] The existing managers may need to stay for a few weeks after the turnaround specialist arrives. If they have expertise with respect to the firm's technology or its markets, they may survive even longer, but the turnaround specialist calls the shots.

[72] The phrase "CRO" first appeared in a reported opinion in 2004. Anderson v. Crossroads Capital Partners, L.L.C., No. 01-2000 ADM/SRN, 2004 U.S. Dist. LEXIS 1867, at *2 (D. Minn. Feb. 10, 2004); *see also In re* LTV Steel Co., 333 B.R. 397, 405 (Bankr. N.D. Ohio 2005) (discussing the appointment of a CRO during a company's bankruptcy reorganization and restructuring efforts); *In re* Balt. Emergency Servs. II, LLC, 334 B.R. 164, 168 (Bankr. D. Md. 2005) (same).

[73] By being oblique, they minimize the risk of lender-liability actions outside of bankruptcy and equitable subordination inside. For boards sensitive to Sarbanes-Oxley and potential shortfalls in directors and officers insurance, however, hints are usually

The arrival of a CRO alters the terrain of corporate governance. The CRO is not a typical member of the management team. Unlike other officers of the corporation, she does not report to the CEO. Rather, she reports directly to the board. Whereas the CEO tends to choose other members of her management team, the CEO has little role in the selection of the CRO. The CRO is often tasked with passing judgment on which members of the management team add value and which ones need to be replaced. Indeed, the Chapter 11 filing may take place only after the CRO has had a chance to resolve the operational problems and the business has settled on a plan to restructure its finances. The CRO may be compensated by the company, but her interests are aligned with the lenders.

To get a flavor of this dynamic, recall the case of Warnaco. By the spring of 2001, Warnaco's fortunes had not improved. At that point, the banks insisted that Warnaco hire a turnaround specialist as a CRO.[74] At least initially, this person was to straighten out the finances of the enterprise and pay attention to its operations, while the CEO would remain in control of Warnaco's products and strategic direction. The turnaround specialist hired was Tony Alvarez, who had previously served as CEO of Phar-Mor and Coleco Industries. He had been president and COO of Republic Health and restructuring advisor of Resorts International.

Tony Alvarez is one of the most respected turnaround specialists in the country. Alvarez is one of the two principals of Alvarez & Marsal. The firm provides a number of services. It sometimes serves as a creditor advisor and "enables creditors to evaluate risks and opportunities, and develop solutions that maximize recoveries."[75] The firm also does turnaround management consulting. Wearing this hat, the firm "helps stabilize financial and operational performance by developing and implementing comprehensive profitability and working

sufficient. Boards, of course, are nominally the ones who make the decision, and creditors stop short of insisting on a particular named individual. But only just short. In the WorldCom situation, for example, the creditors conditioned the bankruptcy financing upon the appointment of a CRO and gave the board freedom to choose any restructuring officer it pleased—as long as she was acceptable to the lenders. Senior Secured Superpriority Debtor-In-Possession Credit Agreement, WorldCom, Inc. 62 (July 21, 2002) (on file with the University of Pennsylvania Law Review).

[74] To be precise, the banks did not "insist" on a CRO. They merely "suggested" it. Members of the board, while long-time social friends and business colleagues of the CEO, were sufficiently sophisticated to take the hint.

[75] Alvarez & Marsal, Creditor Advisory, http://www.alvarezandmarsal.com/en/creditor-advisory.asp (last visited Mar. 23, 2006).

capital plans."[76] The first line of work gives credibility to the second. As the firm itself puts it, "[Alvarez & Marsal's] involvement reassures creditors that the company is taking important steps to address its problems and maximize its value."[77] When Alvarez is in place, the banks have as their wartime general someone whose loyalties are not tied to the existing managers. Alvarez does not plan on staying with companies long. His loyalties do not run to the shareholders. His future employment prospects turn on lenders believing that he will maximize the value of the enterprise.[78]

Existing legal doctrines force lenders to exercise their control indirectly. Such doctrines impose risks to lenders whom courts, after the fact, view as exercising direct control over the enterprise. To be sure, concerns over lender liability have eased over the past decade.[79] Courts regularly affirm the right of the creditor to exercise the rights set out under its loan agreement. As long as it cuts square corners, it has no duty to look out for the interests of other creditors.[80] Still, concerns remain. In Chapter 11, other creditors could seek equitable subordination.[81] They could claim that the creditor had so much control over the debtor that it was able to manipulate its affairs in a way

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[76] Alvarez & Marsal, Turnaround Management Consulting, http://www.alvarezandmarsal.com/en/turnaround-consulting.asp (last visited Mar. 23, 2006).

[77] *Id.*

[78] The role that restructuring advisors play in American corporate governance can be compared to the role that insolvency experts play in the Canadian system. *See, e.g.*, George G. Triantis, *The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines*, 16 INT'L REV. L. & ECON. 101, 111-12 (1996) (describing the function of insolvency experts in Canada). While both systems have developed individuals who specialize in assisting distressed companies, there are differences. Restructuring experts in the United States can, as in the cases of Warnaco and Krispy Kreme, be brought in before a Chapter 11 petition is filed. In Canada, traditional insolvency experts are selected by the debtor after it has decided to file for bankruptcy. *Id.*

[79] *See, e.g.*, *In re* Castletons, Inc., 990 F.2d 551, 556 (10th Cir. 1993) (refusing to impose liability on a lender following bankruptcy); Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1358 (7th Cir. 1990) ("Although Debtor contends . . . that Bank's termination of advances frustrated Debtor's efforts to secure credit from other sources, and so propelled it down hill, this is legally irrelevant so long as Bank kept its promises.").

[80] *See, e.g.*, *In re* Clark Pipe and Supply Co., 893 F.2d 693, 702 (5th Cir. 1990) (noting that "a creditor is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim" (quoting *In re* W.T. Grant Co., 699 F.2d 599, 609 (2d Cir. 1983))).

[81] *See* 11 U.S.C. § 510(c) (2000) (allowing the court to subordinate claims or interests).

that worked to its own benefit.[82] The law on this score is unsettled enough to cause lenders (or at least their counsel) to make their intentions known without issuing stark commands. Similarly, the new and ill-defined tort known as "deepening insolvency," which might hold a senior lender liable for propping up the business while it is insolvent, creates incentives for lenders not to be seen as directly taking control of the business.[83]

These doctrines may induce lenders to become coy. Even fending off claims of equitable subordination and deepening insolvency has its costs. Discretion is thus the watchword. Yet few in the boardroom misread the signs. If anything, new corporate reforms that empower boards and make them more active and independent may increase the responsiveness of the board of directors. The more sophisticated and sensible the board of directors, the more attuned it will be to the levers of power that private creditors exercise in tough times. As long as legal doctrines such as the risk of equitable subordination matter, creditor control works most effectively with boards that understand the hints that are being dropped. Today's savvy independent board member rarely worries about the distant threat of a hostile takeover, but pays attention when the business's banks come calling.

III. CREDITOR CONTROL IN CHAPTER 11

Chapter 11 provides no respite for beleaguered managers. Senior creditors keep their hands on the levers of corporate governance even after the corporation enters Chapter 11. Lenders have devised various strategies to ensure that their control rights persist (and are even enhanced) after the debtor files for bankruptcy. Most commonly, creditors do this through their control over postpetition financing.[84] War-

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[82] *See, e.g.*, *In re* Exide Techs., Inc., 299 B.R. 732, 743-46 (Bankr. D. Del. 2003) (holding that a cause of action for equitable subordination was stated where banks were alleged to have used their position to gain "control" over the debtor).

[83] *See, e.g.*, *id.* at 750-51 (holding that other creditors had successfully pleaded the tort where they alleged that the lenders caused the debtors to acquire another company with borrowed funds "so that they could obtain the control necessary to force the Debtors fraudulently to continue its business for nearly two years at ever-increasing levels of insolvency," and where "the conduct by the Lenders caused the Debtors to suffer massive losses and become more deeply insolvent, costing creditors substantial value" (citation omitted)).

[84] Of the ninety-three large, publicly held corporations that concluded reorganization proceedings in 2002, fifty-one of them (55%) had debtor-in-possession (DIP) financing. *See* Web BRD, http://lopucki.law.ucla.edu (last visited Mar. 23, 2006) (listing, in a searchable bankruptcy research database maintained by Lynn LoPucki, the public companies that concluded proceedings in 2002); BankruptcyData.com, http://

naco again illustrates the modern dynamic. By June 2001, Warnaco was in default to its bank lenders. It needed additional cash to maintain its operations, and the banks that controlled the revolver were under no obligation to provide it. The next step no longer was in the hands of the managers or the board. The banks could shut down Warnaco instantly outside of bankruptcy if they chose to do so. Instead, the banks steered Warnaco towards Chapter 11.

That a senior lender would press for bankruptcy stands conventional wisdom on its head. It might seem that the directors could hold off the banks by filing a Chapter 11 petition.[85] The Bankruptcy Code and appellate decisions appear to paint a rather bleak picture for the senior lender seeking to influence the operation of the business. A Chapter 11 filing puts in place an automatic stay that prevents lenders from seizing their collateral.[86] They have to wait until a plan of reorganization is confirmed. Until then, they can insist only on adequate protection of the value of their collateral.[87] The time value of their secured claims is not even protected to the extent they are undersecured.[88] At confirmation, they can insist only on a promise of a stream of future payments, the present value of which equals the value of the collateral, with both the value of the collateral and the

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bankruptcydata.com (last visited Mar. 23, 2006) (noting, in the information provided for those companies, whether a DIP financing order had been issued). This is generally consistent with lending practices from the mid-1990s. *See* Sandeep Dahiya et al., *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. FIN. ECON. 259, 266 (2003) (reporting that in 1995-1997, over 40% of firms in their sample received DIP financing). Focusing on DIP financing most likely understates creditor control to the extent that it does not include cash collateral orders, which can be the functional equivalent of DIP financing orders. *See* 1 WEIL, GOTSHAL & MANGES LLP, REORGANIZING FAILING BUSINESSES 9-31 (1998) ("In circumstances where the amount of cash collateral in the debtor's possession is sufficient to finance the debtor and its operations, cash collateral use may be preferable to a traditional debtor in possession credit facility.").

[85] *See* Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1050 (1992) ("Chapter 11, like many takeover defensive measures, is justified by its supporters as a mechanism to preserve and protect valuable corporate assets."); LoPucki & Whitford, *supra* note 66, at 757 (suggesting that Chapter 11 may provide a "soft landing" for managers).

[86] *See* 11 U.S.C. § 362(a)(5) (2000) (providing for an automatic stay applicable to "any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim").

[87] *See id.* § 363(e) (allowing the court to "prohibit or condition such use, sale, or lease as is necessary to provide adequate protection").

[88] *See, e.g.*, United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 382 (1988) (denying interest on the collateral to an undersecured creditor of a bankrupt debtor).

discount rate being issues for judicial determination.[89] After all, Chapter 11 is supposed to provide "breathing space" to a struggling business from the collection efforts of its creditors.

In practice, however, modern Chapter 11 provides managers with little sanctuary from sophisticated lenders. When firms like Warnaco need an infusion of cash to continue their operations, they must find a postpetition lender. The market for postpetition lending is quite robust. There are a number of institutional lenders that specialize in postpetition financing.[90] These alternative sources may ensure that the debtor pays a competitive rate for its fresh money; they do not, however, offer the debtor's management the ability to roam free of creditor control. A new lender tends to enter the scene only with the blessings of the existing one.[91] The debtor is going to need to use the cash collateral of the existing lender,[92] and the new lender will generally insist on a lien that primes that of the existing lenders. Such arrangements can be put in place with the consent of the existing lender.[93] To be sure, cash collateral orders can be sought over the objection of the existing lender. But litigation over such matters could imperil the reorganization effort at an early stage. More importantly, courts are unlikely to grant such orders over vigorous opposition.[94]

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[89] *See* 11 U.S.C. § 1129(b)(2)(A) (2000) (setting forth fairness requirements with respect to secured claims). On valuation disputes, see Assocs. Commercial Corp. v. Rash, 520 U.S. 953 *passim* (1997) (discussing the value of collateral in the context of a Chapter 13 plan). On interest rate disputes, see Till v. SCS Credit Corp., 541 U.S. 465, 479-80 (2004) (showing a fragmented court putting forth three different approaches to calculating the appropriate interest rate, with no approach garnering a majority).

[90] Leaders in the area include JP Morgan Chase, Citibank, Wachovia, General Electric Credit, CIT, Foothill, and Cerberus.

[91] Alternatively, the new lender can buy out the interest of the prior lender. For example, Winn-Dixie had a $600 million credit facility in place prior to its filing for bankruptcy. When it filed for Chapter 11, Winn-Dixie obtained $800 million in debtor-in-possession financing, the first $600 million of which went to pay off the prepetition borrowing in full. Emergency Motion Pursuant to 11 U.S.C. §§ 105, 361, 362, 363 and 364 for Interim and Final Financing Orders, *In re* Winn-Dixie Stores, Inc., No. 05-11063, at 3-11 (Bankr. S.D.N.Y. Feb. 21, 2005).

[92] *See* 11 U.S.C. § 363(c)(2) (2000) (requiring consent or court approval for the debtor to use cash collateral); *id.* § 363(e) (requiring adequate protection as a predicate for court approval where a party in interest has made a request).

[93] For example, the prepetition lenders in the Polaroid case had a $333 million credit facility in place at the time Polaroid filed. They consented to Polaroid's procuring a new credit facility for $50 million, even though the new facility contained liens that primed their liens. *See* Motion for Interim and Final Order, *In re* Polaroid Corp., No. 01-10864 (Bankr. D. Del. Oct. 12, 2001) (conveying the debtor's belief that the prepetition secured creditors would consent to postpetition financing).

[94] *See* DEBRA GRASSGREEN, FIRST-DAY MOTIONS MANUAL: A PRACTICAL GUIDE TO THE CRITICAL FIRST DAYS OF A BANKRUPTCY CASE 48 (2003) ("Counsel should attempt

The typical debtor-in-possession (DIP) loan grants the lender virtually complete control over the reorganization process. The DIP financing agreement will have many financial covenants, the violation of any of which gives the DIP lender the ability to terminate the financing. The DIP loan also limits the reach of bankruptcy's automatic stay. The DIP lender in the Winn-Dixie bankruptcy insisted that it could seize any of its collateral upon default, so long as it provided the debtor with five days notice.[95] The DIP financer provides only limited degrees of freedom for the business while it remains in Chapter 11. One provision typically waives the right of the debtor to seek to use the lender's cash collateral over the lender's objection, while another waives the right of the debtor to seek a priming lien on the secured creditor's collateral.[96] Moreover, the DIP financing agreement can provide that the loan terminates if the debtor fails to arrange for a sale of some or all of its assets by a specific date.[97]

The DIP financer can control both how long the debtor takes to form a plan and the form the plan ultimately takes. The credit agreement often provides that the debtor defaults if a plan is not filed within a certain period of time.[98] Such a provision has the de facto effect of putting the decision about the length of the exclusivity period in the hands of the DIP lender rather than the court.[99] The debtor's freedom to shape a plan of reorganization is limited as well. The DIP credit agreement may include among many covenants the promise

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to negotiate the [cash collateral] order with the creditor and present an agreed order because a cash collateral dispute may give the court an unfavorable impression of the debtor's reorganization prospects.").

[95] Other provisions, such as a waiver of the right to seek reimbursement under 11 U.S.C. § 506(c) (2000), the waiver of avoidance actions, and the agreement to pay all of the secured creditor's expenses go not so much to control as they do to ensuring the lender is paid in full.

[96] *See id.* § 364(d) (authorizing primary liens "after notice and a hearing" before the court).

[97] *See* Senior Secured Super-Priority Debtor in Possession Revolving Credit Agreement, Warnaco Inc. § 7.16 (June 11, 2001) (on file with the University of Pennsylvania Law Review) [hereinafter Warnaco Credit Agreement] (creating affirmative covenants requiring "true and complete copies of sale and purchase agreements" to be executed by a certain time).

[98] *See id.* § 7.14 (setting forth the affirmative covenant that the DIP file a plan of reorganization by a specified date).

[99] Much of the concern with the operation of the Bankruptcy Code in the 1980s and early 1990s stemmed from the bankruptcy courts' willingness to continue indefinitely the debtor's exclusive right to file a plan of reorganization. *See* Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11, 31 (linking choice of venue to "courts' policies toward extensions of exclusivity").

not to file "a plan of reorganization in the bankruptcy case without Lender's prior written consent that provides for any treatment of the obligations owing to Lender other than payment in full in cash on the effective date of such plan."[100] Provisions such as these effectively remove the debtor's power to "cram down" a plan over creditor dissent.

DIP loans also nullify the rights of shareholders.[101] Any change in control, defined to include a new majority of the board, will be a default on the loan.[102] Similarly, the DIP lending agreement can provide that an event of default exists if the CRO is replaced.[103] Provisions can go further still. The DIP financing agreement in Warnaco gave the DIP lender the power of attorney.[104] In the event of any default, the DIP lender was entitled "to take any and all appropriate action . . . which may be necessary and desirable to accomplish the purposes of [the] Agreement" including, but not limited to, the sale of any of the debtor's assets.[105] The agreement also stipulated that the DIP lender's exercise of this power of attorney does not violate the automatic stay.[106] To put this in the language of corporate governance, a creditor empowered to act *as the debtor* is not a creditor in the traditional sense at all.

To be sure, not all courts approve all of these provisions. Yet, by cobbling together those provisions that a secured lender knows will pass judicial muster in the chosen venue (a choice in which the se-

[100] *See, e.g.*, Credit Agreement, Winn-Dixie Stores, Inc. § 7.2.20(e) (Feb. 2005) (on file with the University of Pennsylvania Law Review) [hereinafter Winn-Dixie Credit Agreement] (requiring that the plan of reorganization pay all DIP loans in full in cash); Warnaco Credit Agreement, *supra* note 97, § 7.14 (same).

[101] In theory, shareholders still retain the right to replace the board of directors while the corporation is in bankruptcy. *See In re* Johns-Manville Corp., 801 F.2d 60, 64 (2d Cir. 1986) ("[T]he right to compel a shareholders' meeting for the purpose of electing a new board subsists during reorganization proceedings."); *In re* Marvel Entm't Group, Inc., 209 B.R. 832, 838 (D. Del. 1997) (holding that shareholders may elect a new board of directors while reorganization proceedings are ongoing).

[102] *See* Winn-Dixie Credit Agreement, *supra* note 100, § 8.1.8 (listing as an event causing default "[a]ny Change in Control").

[103] *See* Summary of Terms and Conditions for Revolving Credit and Letter of Credit Facility in the Amount of $200 Million, Interstate Bakeries Corp., at 15, subdiv. (o) (Sept. 20, 2004) (requiring that the debtors retain their current restructuring advisor or another advisor satisfactory to the administrative agent).

[104] *See, e.g.*, Warnaco Credit Agreement, *supra* note 97, § 11.8(a) (appointing the administrative agent and its agents or officers as DIP's "lawful attorney-in-fact").

[105] *Id.*

[106] *Id.* § 11.8(b) ("Exercise . . . of the power granted hereunder is not a violation of the automatic stay . . . .").

cured lender has considerable influence),[107] the DIP lender can ensure that no major decision is made in a way that it finds objectionable.[108] Given the difficulty of finding another DIP lender, the effect of these provisions (coupled with the DIP financer's unwillingness to waive them) is to give the DIP financer the ability to control the Chapter 11 case.[109]

With the creditors in control, the reorganization of Warnaco proceeded smoothly.[110] Within six months of entering bankruptcy, the CEO was dismissed and Alvarez became the new CEO. An investment bank shopped all of the company's assets, though no bids for the entire business emerged that were satisfactory to the senior lenders.[111] Instead, some assets were sold and the company left Chapter 11 less than two years after the case began. The senior lenders, who were owed more than $2.4 billion, received a cash payment of $104 million, $200 million in new notes, and 96% of the new equity.[112] The rest of the equity went to the unsecured creditors and Tony Alvarez, while the erstwhile shareholders received nothing.[113] Less than two months

[107] *See* Marcus Cole, *"Delaware is Not a State": Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 VAND. L. REV. 1845, 1869 (2002) ("Secured creditors, through the power afforded them by their collateral, can influence . . . venue selection.").

[108] Cash collateral orders often contain similar provisions. Agreements on the part of the lender for the debtor to use cash collateral often include an acknowledgement of the validity of the lender's lien, the promise that the debtor will not seek to charge the collateral under § 506(c), the requirement that the debtor receive the lender's consent before granting any future postpetition liens, and payment of all of the lender's expenses.

[109] Creditors once had to demand the appointment of a trustee if they wanted to displace the management. Under modern Chapter 11 practice, however, they have no reason to ask the court to order the appointment of the trustee. Indeed, it is an event of default if such a trustee is appointed. *See* Winn-Dixie Credit Agreement, *supra* note 100, § 8.1.10(h) ("[A] trustee or an examiner with expanded powers relating to the operations of the business of the Borrowers and the Guarantors is appointed in the Chapter 11 Cases pursuant to Section 1104 of the Bankruptcy Code or other applicable law.").

[110] *See* Ben Fidler, *Back in Fashion*, THE DEAL.COM, Feb. 18, 2005, http://www.thedeal.com/servlet/ContentServer?cid=1107993062628&pagename=BI%2FBIArticle&c=TDDArticle (discussing the Warnaco reorganization).

[111] *See* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. (forthcoming 2006) (manuscript at 20), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=813085 (explaining why senior lenders will sometimes prefer a negotiated reorganization to a market sale).

[112] Fidler, *supra* note 110.

[113] Such elimination of equity is common in modern reorganization practice, Baird & Rasmussen, *Chapter 11 at Twilight*, *supra* note 25, at 692 n.65, as is the allocation of a small number of shares to unsecured creditors, Baird & Bernstein, *supra* note

later, the former President and CEO of Brooks Brothers took over for Alvarez. Warnaco is once again a publicly traded company.[114] As for Alvarez, he has moved on and now serves as the CEO for the maker of Wonder Bread and Twinkies, Interstate Bakeries. Interstate is currently in Chapter 11.[115]

IV. THE COSTS AND BENEFITS OF PRIVATE DEBT AS A LEVER OF CORPORATE GOVERNANCE

Even while creditor control has yet to hit the radar screen of the general corporate governance literature, it has become the central issue in bankruptcy scholarship. One can already find academics bemoaning the power that senior creditors exercise in reorganizations today.[116] These critiques neglect the connection between creditor control and corporate governance as a general matter. The control that creditors exercise in bankruptcy is simply the final stage of a process that begins well outside of bankruptcy. Limiting creditor control in bankruptcy should not be done in a vacuum. Such changes also affect creditor control and corporate governance outside of bankruptcy and these effects must be taken into account.

Increased creditor control may be, on balance, a salutary development. The market for corporate control does not function well for all corporations in all states of the world. Shareholders cannot often galvanize quickly when misfortune strikes. Creditor control can serve

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111 (manuscript at 29). This latter result is not a violation of absolute priority, but rather the predictable outcome of negotiations when the value of the business is uncertain. Baird & Bernstein, *supra* note 111 (manuscript at 29).

[114] *See* Fidler, *supra* note 110 (discussing how some investment houses have initiated coverage on Warnaco stock at a "buy" rating).

[115] Twinkies' Maker Files Bankruptcy, CNNMONEY.COM, Sept. 22, 2004, http://money.cnn.com/2004/09/22/news/fortune500/interstate_bankruptcy (last visited Mar. 23, 2006).

[116] *See* George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 24-25 (2004) ("[S]ecured creditors capitalizing upon agency problems to gain the help of insiders and insolvency professionals [have] effectively take[n] over—or 'hijack[ed]'—the chapter 11 process and essentially create[d] a federal unified foreclosure process." (citations omitted)); Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 KY. L.J. 839, 841-42 (2004) ("[I]t is not clear that this development promotes social welfare. Rather, lender control may only benefit lenders."); Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases*, 21 BANKR. STRATEGIST 1, 2 (2003) ("The exercise . . . of remedial rights given secured creditors upon the occurrence of default, in effect, puts those creditors in control of the debtor/borrower."); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 860 (2004) ("[A] takeover of the Chapter 11 process by one group of creditors would seem to be the occasion for concern, not celebration.").

as a complement to these more commonly recognized means of reining in managers who lose their touch. For this to be the case, however, at least two things have to be true. First, creditor control must loom large enough to be a credible threat to managers. Short sticks do not cast long shadows. Second, creditors' self-interest must lead them to exercise control in a way that maximizes the value of the business. Levers of power can do bad as well as good, and there is little reason to think that creditors with control rights will advance anyone else's interest except to the extent it advances their own.

A. *The Influence of Private Debt*

We can gain some purchase on the power of private debt as a lever of corporate governance by using hostile takeovers as a benchmark. By common account, the possibility of a hostile takeover is one of the most important ways of keeping managers in line. Nevertheless, there are only about twenty hostile takeovers a year.[117] A publicly traded corporation is five times more likely to file a Chapter 11 petition than to be subject to a hostile takeover,[118] and, as Krispy Kreme's experience illustrates, the businesses that enter Chapter 11 are only a fraction of those subject to the discipline of creditor control.[119]

The possibility of creditor control exists any time a business takes on a substantial loan, which is commonplace in the life of a publicly traded corporation. For example, one study reports that in 1995 and 1996, there were over four hundred large private loans to public cor-

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[117] In their path-breaking piece on the effect of staggered boards, Bebchuk, Coates, and Subramanian's comprehensive search uncovered only ninety-two hostile bids over the five-year period from 1996 to 2000. Bebchuk et al., *supra* note 42, at 925.

[118] During the same time period as Bebchuk, Coates, and Subramanian's comprehensive search found ninety-two hostile takeovers (1996-2000), 612 publicly traded corporations filed for bankruptcy. NEW GENERATION RESEARCH, THE 2004 BANKRUPTCY YEARBOOK AND ALMANAC 36 (2004). Of these, 286 had assets that exceeded $100 million. *Id.* at 67. It might seem that hostile takeovers are only the tip of the iceberg, as they now represent only a small part of mergers and acquisitions activity, and some negotiated mergers may be hostile takeovers by another name. But anecdotes from those engaged in the takeover business and empirical evidence suggest that the possibility of a hostile offer has little impact on negotiated mergers. *See* Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621, 685 (2003) (concluding that "the hostile bid threat is in the distant background in many deals," and, "[a]s a result, the bargaining power benefits of takeover defenses in negotiated acquisitions recede, and the costs of takeover defenses in the hostile bid context come to the fore").

[119] In a previous article, we documented the extent of creditor control for all large businesses that exited Chapter 11 in 2002. Baird & Rasmussen, *Chapter 11 at Twilight*, *supra* note 25, at 675-85.

porations owning more than $100 million in assets.[120] Another study estimates that public debt represents only 17% of all outstanding debt, and that the majority of corporations rely solely on institutional debt.[121] The sources of private debt include both traditional banks and companies, such as General Electric Capital and Cerberus, that specialize in lending to corporations that are facing financial difficulties.

The secondary market for distressed debt provides further evidence of the importance of creditor control. Creditor control is likely to manifest itself when a loan becomes distressed. Most large loans are arranged by a lead bank, but financed by a syndicate of banks. This allows banks to spread their risk. The norm is for the lead bank to hold the largest share of the loan and to perform most of the monitoring, for which it receives a fee. The lead bank does not typically sell its interest. There is, however, a secondary market for those portions of the loan held by other members of the syndicate. If one defines "distressed debt" as those loans that trade at less than 90% of face value, over $40 billion in distressed debt changed hands in 2002. This represented 42% of all trading in the secondary loan market for that year.[122]

The *possibility* of creditor control may matter as much as whether it is actually exercised, and even more than the threat of a hostile takeover. Staggered boards drastically reduce the threat of a hostile takeover, but there is no comparable device to limit creditors. Managers have no way to protect themselves against creditor control once they take on debt. In theory, a business can rid itself of a creditor who presses too hard by repaying the loan, but a business that encounters difficulty with a private creditor is likely to have trouble replacing it with another. Any new lender has to worry about the private information held by the existing lender. The existing lender may want to withdraw for reasons that are not yet plain to outsiders. Any new lender is in any event bound to insist upon its own control rights to protect itself.

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[120] These are the only loans large enough to have a material effect on the finances of the business and thus trigger an SEC filing. Denis & Mihov, *supra* note 7, at 26.

[121] *See* Joel Houston & Christopher James, *Bank Information Monopolies and the Mix of Private and Public Debt Claims*, 51 J. FIN. 1863, 1871 (1996) (detailing the results of a study of 250 randomly selected publicly traded firms that show that in 1990, public debt accounted for 17% of the firms' total debt, and that only 46% of the surveyed firms had any public debt at all).

[122] Gande & Saunders, *supra* note 69, at 6-7.

Private debt is thus a widely used lever of corporate control. Moreover, it can be useful in situations where the other levers have little effect. The threat of a hostile takeover looms larger over an all-equity corporation than creditor control.[123] On the other hand, in the presence of fraud or, as in the case of Krispy Kreme, uncertainty about the bookkeeping and the financial affairs of the business, hostile takeovers cannot be depended upon. Potential outside buyers need to be able to trust the books. Creditor control is the mechanism of choice, as they can force the replacement of the CFO and get to the bottom of things. Indeed, the hostile takeover may do some work in this environment only because the lenders act first. Their insistences on a CRO and a new CFO, along with the filing of a Chapter 11 petition, may create an environment in which the market for corporate control can once again operate effectively.[124]

B. *Private Debt, Self-Interest, and Investor Welfare*

Private lenders are not charitable institutions. They will act to maximize their rate of return when they engineer the appointment of a CRO or otherwise exercise their influence. The crucial question is the extent to which private lenders' self-interest is aligned with the interests of all the investors in the corporation. The lenders who wield control are typically also the most senior. Conventional wisdom suggests that they have an incentive to steer companies away from risky projects, even when such projects promise to increase the value of the enterprise.[125] Moreover, private lenders acquired their powers from managers whose own interests do not correspond with those of the investors as a group. To gain breathing space for themselves, old managers will do nothing to stop the controlling lender from acting in a way that disadvantages those not present. They will readily agree to covenants that give them breathing space today even if these terms

[123] Even here, however, the possibility of creditor control casts some shadow. Any step a manager takes (whether it is empire building or excessive consumption of perks) that might force her to credit markets is one that she takes knowing that creditors will not sit idly by when things start going wrong.

[124] Indeed, more than half of all large Chapter 11s are sales. Baird & Rasmussen, *Chapter 11 at Twilight*, *supra* note 25, at 675-76.

[125] *See* Adler, *Bankruptcy and Risk Allocation*, *supra* note 54, at 440 (describing the "risk-sharing" theory of bankruptcy allocation); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 158-59 (1989) (presenting the different incentives of senior and junior creditors as a firm approaches bankruptcy); Jensen & Meckling, *supra* note 13, at 308 (explaining the problem of agency cost).

promise to deliver the business to the creditors should current efforts not pan out.

The self-interested action of senior lenders that imposes the largest risks as a theoretical matter comes from the liquidation bias of senior lenders.[126] But this liquidation bias is not likely to be at work when large businesses are reorganized. To be sure, there is room for slippage. Lenders, in some cases, may pass on projects that offer positive returns. But financially distressed businesses are unlikely to have such projects come their way. Even if they do, the senior lender is likely to be as eager as anyone else to take advantage of them.

A senior creditor will disfavor risky projects that are worth doing only if the returns from the projects will be realized while it is still a senior creditor. This is increasingly unlikely. Projects take some time to implement, and the Chapter 11 process now moves more quickly. Often the assets are sold off relatively quickly. In such cases, senior lenders have no reason to disfavor risky projects. They will want to maximize the sale prices, and doing this requires taking on the projects with the highest expected values, regardless of the uncertainty associated with their cash flows.

When no sale is in sight, senior creditors have even more reason to favor the projects with the highest expected returns, regardless of the variance in the returns associated with them. In modern large Chapter 11 practice, senior claims typically are converted into equity. As long as the conversion takes place before the returns from the project come in, the senior creditor will act as a residual owner and will enjoy both the upside as well as the downside. As senior creditors can anticipate this transformation, they will have no liquidation bias.[127]

This lack of bias towards a value-decreasing liquidation can be seen as well in the decisions that senior lenders make. When we survey the decisions that senior lenders make with the control rights they enjoy, many of them involve actions that work to the benefit of the creditors as a group. These include straightening out the books and

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[126] *See* Mark J. Roe, *Bankruptcy and Debt: A New Model of Corporate Reorganization*, 83 COLUM. L. REV. 527, 542-43 (1983) (postulating why senior lenders might prefer a long, drawn-out liquidation to a stake in a highly viable form); Westbrook, *supra* note 116, at 843-45 (illustrating incentive problems among senior lenders, including the risks of the "free-rider" problem).

[127] The senior lender's control of the process can, of course, lead to plans of reorganization in which it gets a larger share of the pie than that to which it is otherwise entitled, but this exercise of power has, in the first instance, only distributional consequences. For an exploration of these dynamics, see Baird & Bernstein, *supra* note 111 (manuscript at 41-47).

putting in place managers who will shut down inefficient plants and otherwise put the business back on course. Most managers in an organization hone their skills during times of plenty. Distress often calls for a change in focus. To the extent that the changes wrought by CROs and their like improve the operation of the business, all parties benefit. In short, senior lenders can promote their own economic well-being by maximizing the value of the business.

A relatively new technique for structuring lending transactions reinforces the idea that senior lenders take actions that also advance the interests of those junior to them. In these transactions, junior lenders take a second position in all of the senior's collateral. They agree, however, that, should a bankruptcy petition be filed, they will vote as the senior lender directs. Typical clauses prevent these lienholders from opposing DIP financing endorsed by the senior lienholders or objecting to asset sales the seniors bless. They even give the senior creditor the authority to vote the junior's claim on any proposed plan of reorganization.[128] The investors who buy these instruments are content to have cash flow rights that are junior to senior lenders and to cede all potential influence that they could wield in a subsequent reorganization to the senior lenders.

What type of investor purchases what would seem to many as mismatched control rights and cash flow rights? The exclusive buyers of these instruments are hedge funds, private finance companies, and wealthy individuals. Sophisticated professional investors are thus willing to acquire these "silent second liens" and bind themselves to the wishes of the senior lender, even though they know that the senior creditor's interests do not correspond to their own.

We can draw at least two inferences from the market demand for these investments. One is that these transactions show that the interests of the seniors are not necessarily averse to the interests of the juniors. Rational parties can find it in their mutual interest for senior creditors to call the shots when in bad states of the world. We cannot simply assume that the interests of different investor classes result in conflicts over all reorganization decisions.

A second lesson resonates with the theme of this Essay. Silent second liens demonstrate that even when Chapter 11 is far away, parties pay attention to the way in which control rights will be exercised over

[128] *See* Howard Seife, *Silent Second Liens*, 121 BANKING L.J. 771, 772-73 (2004) (discussing the structure of second liens); *Completing the Capital Structure with a Second Lien Loan*, CAPITALEYES, Apr. 2003, *available at* http://www.bofabusinesscapital.com/resources/capeyes/a04-03-158.html (same).

the entire life cycle of the business. Financial distress is a foreseeable event for almost all public corporations. Just as parties establish priority positions at every stage of investment, so too do they focus on which investor group has its hands on the levers of control as the business deteriorates.

In today's environment, we see little need for judicial doctrines designed to promote investor welfare. For example, courts in recent years have taken more seriously the notion that the board's allegiance should shift to the creditors when the business finds itself in the "zone of insolvency."[129] In the absence of such a shift of priorities, the argument goes, the board may incline too much toward imprudent gambles designed to get them back into the money. Such a shift of fiduciary duties may be unnecessary, however. Lenders, as we have seen, are quite capable of taking care of themselves. Rather than adding ill-defined fiduciary duties to the contracts that they write, a better course may be to ensure that such duties do not impede the exercise of contractual rights for which creditors have bargained.

This, we take it, is the true lesson of *Credit Lyonnais*. The case is often cited as establishing the idea of shifting fiduciary duties in the zone of insolvency.[130] The essential facts, however, are that lenders to the corporation wanted to enforce the control rights for which they had bargained, and the board resisted, pointing out that it owed fealty to the shareholders. The court opined on the shifting nature of fiduciary duties so as to undermine the board's argument. The court's instinct was undoubtedly sound, but we would push it further. The easier it becomes to enforce control rights (and it is already quite easy), the less one must depend upon judge-made definitions of fiduciary duty to do the heavy lifting.[131]

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[129] *See, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) ("[W]here a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.").

[130] *See, e.g.*, Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 645 n.128 (1997) (discussing *Credit Lyonnais* and arguing that management should remain faithful to stockholders until the point of a bankruptcy filing); Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813, 1824-25 (2002) (further interpreting the *Credit Lyonnais* decision); Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 669-72 (1996) (discussing the facts of *Credit Lyonnais* and arguing against "substitut[ing] formulas for basic business judgment").

[131] In the same vein, we view with deep skepticism efforts to override the contractual assignment of control rights through doctrines such as equitable subordination or the tort of deepening insolvency.

We thus are cautiously optimistic about the new state of affairs. That said, we also acknowledge that this new world of increased creditor control certainly contains the potential for abuse.[132] Again, we use a prominent Chapter 11 case to illustrate our point. Trans World Airlines (TWA) filed its first Chapter 11 petition in 1992, and its second in 1995.[133] Even after these two attempts at restructuring, the outlook remained bleak for the nation's eighth-largest airline.[134] By early 2000, its managers concluded it could no longer survive on its own. American Airlines entered an agreement to buy TWA, and Chapter 11 was chosen as the vehicle to implement the deal. The original terms of the agreement were that American would assume $3 billion in debt associated with airplane leases and pay an additional $500 million. Also, there was a breakup fee of $65 million. In addition to looking for a suitor, TWA needed an immediate infusion of cash. American filled the role here as well and provided the bankruptcy financing. It made a DIP loan of $200 million at an interest rate of 10%.[135]

American may well have been the highest valued user of the TWA assets. The structure of the transaction, however, points to the possibility of abuse. American was both a lender to TWA and a bidder for its assets.[136] As a lender, American had access to TWA's books. It could delve into TWA's financial condition to a greater degree than any potential bidding rival. This structure creates a situation where one party to an auction has an informational advantage over the other bidders. This informational advantage itself chills bidding from others. Few want to win when bidding against a party that has better information about the true value of the asset.

To be sure, the DIP loan/bid structure in the TWA auction did not completely deter competition. Another bidder appeared, as did a late bid by TWA's former chairman, Carl Icahn. In the end, American prevailed, but only after it raised the cash portion of its offer by $242

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[132] David Skeel has also noted the potential abuse of what he nicely labels "loan-and-control transactions." David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905, 1929-32 (2004).

[133] *In re* Trans World Airlines, Inc., 322 F.3d 283, 286 n.2 (3d Cir. 2003).

[134] *Id.* at 286.

[135] Susan Carey, *American Airlines' TWA Financing Plan Is Approved, Although Rivals Cry Foul*, WALL ST. J., Jan. 29, 2001, at A3.

[136] We see this pattern in other cases as well, such as the Chapter 11 proceedings of IT Group, Inc., and Rhythms NetConnections, Inc. *See* NEW GENERATION RESEARCH, INC., THE 2003 BANKRUPTCY YEARBOOK & ALMANAC 280 (Christopher M. McHugh ed., 2003); George A. Chidi, Jr., *WorldCom Bids $40M for Rhythms' Assets*, ITWORLD.COM, Sept. 25, 2001, http://www.itworld.com/Net/2574/IDG010925Worldcom/.

million. It may well be the case that American could make the most of TWA's assets and that they paid a competitive price for them. Still, the structure of the deal offers the potential for future misuse. Courts, when faced with a case where the plan is to sell the business at the outset, should be skeptical of DIP loans made by the leading bidder. They should, when faced with such a proposal, ensure that there was no alternative source of funding.

Offering the best deal on the financing should itself not be sufficient. A party intent on purchasing the business may well find it profitable to lend money at less-than-competitive rates. Money lost on the financing could be more than recouped by the pall that its informational advantage can cast over the ensuing auction.

We have no doubt overlooked other potential hazards that can arise from creditor control. The potential costs associated with increased creditor control inside of bankruptcy and out, however, do not undermine the possibility that the lever of creditor control may inure to the benefit of all investors as a general matter. Replacing managers sooner than they otherwise would be may increase the value of the business. Isolating situations that can cause harm and subjecting those situations to scrutiny is a better strategy than attempting to vitiate creditor control across the board.

We end on a cautionary note. Even if one were to conclude that creditor control, on balance, decreases the value of the business, one must keep in mind that the most obvious ways of checking creditor control are likely to be counterproductive. For example, a number of bankruptcy scholars have called for limiting lender control inside of Chapter 11 and preserving the benefits of the process for junior creditors.[137] But such changes will surely have unintended consequences. Lenders take control well in advance of a bankruptcy proceeding. To the extent reforms would allow them to enjoy substantial freedom outside of bankruptcy but little inside of bankruptcy, they will take steps to keep businesses outside of Chapter 11, even if Chapter 11 would bring the highest benefits to investors as a group. In the worst

[137] *See* Kuney, *supra* note 116, at 110-12 (concluding that current developments in bankruptcy law signify a "hijacking of [C]hapter 11" to the detriment of its intended beneficiaries, secured creditors); Lubben, *supra* note 116, at 865 (concluding that the control rights approach to bankruptcy where control cedes to a controlling lender "is likely only efficient from the perspective of the controlling lender"); Westbrook, *supra* note 116, at 856 (emphasizing the importance of a neutral manager in order to avoid conflicts of interest that may damage the interests of some creditors).

case scenario, such "reforms" might lead to the piecemeal sale of assets outside of bankruptcy.[138]

CONCLUSION

We view cautiously the new landscape in which creditor control has become a significant lever of corporate governance. Inside the corporation, no one person has the incentive to maximize the value of the business across all states of the world. One cannot simply put everyone in a room and charge them to do good. Decision-making authority has to be lodged somewhere. Vague prescriptions touting the value of negotiations among the various parties obscure the fact that one needs to identify who is making the actual decision, and then identify both the interest and the skill of that person. Our cautious optimism about the benefits of creditor control, however, should not obscure a more basic lesson. Traditional accounts of corporate governance are at a loss to explain cases like Krispy Kreme, Interstate Baking, or Warnaco. Many of the dominant figures—such as the CRO—are unknown. A large part of modern corporate governance, at least in the contexts where the most is at stake, has been neglected for far too long.

[138] Chapter 11 allows assets to be sold together and at the same time ensures clean title. Claims of employees are dealt with in the reorganization and do not follow the assets. *See, e.g.*, *In re Trans World Airlines*, 322 F.3d at 288-90 (discussing how employees' discrimination claims should be treated in bankruptcy proceedings). Similar assurances are harder to provide outside of bankruptcy. To be sure, Chapter 11 was never intended to be a forum for senior lenders to sell assets and ensure buyers that they would receive clean title. Nevertheless, having some such forum seems a sensible idea.