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Secured Lending and Its Uncertain Future

Douglas G. Baird

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INTRODUCTION

The modern conception of secured financing and corporate reorganization revolves around the idea of absolute priority. In many respects, this priority right is more strongly embedded than ever before. Relatively swift auctions of firms are now commonplace in Chapter 11,[1] and the quick division of the spoils vindicates this idea of priority. Equity is usually wiped out when a large corporation is restructured in Chapter 11.[2] But priority is not the whole story. In addition to priority, security interests have at least two other features worth noting: (1) insulation from the bankruptcy process; and (2) control over the debtor, inside of bankruptcy and out. This article focuses on these two themes.

The first Part of this article focuses on the idea of insulation. "Insulation" is a word to describe the ways in which a secured creditor can minimize the indirect costs associated with bankruptcy. Even if you are paid in full at the end of the day, you would rather not have to participate in the process at all. You want to be able to ignore the process and never have to worry about your place in line. The uncertainties involved in receiving repayment in a different coin or at a different time disappear. You want to be insulated and remote from the bankruptcy process. Modern developments in secured financing provide a number of avenues of providing such insulation.[3] Special purpose entities allow investors to pass through bankruptcy as easily as neutrinos pass through the earth and these have generated a great deal of

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[1] Of the large corporations emerging from Chapter 11, fifty-six percent were asset sales of one type or another. *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003).

[2] *See* Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANK. INST. L. REV. (forthcoming 2004).

[3] Steven Schwarcz has done the seminal work here. *See, e.g.*, STEVEN SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (3d ed. 2002).

attention. Part I of this article, however, focuses on other recent practices that allow secured creditors to insulate themselves from bankruptcy even when asset securitization is not involved.

The second Part of this article focuses on the idea of control. We sometimes see large firms in financial distress in which an institutional lender is virtually the firm's only creditor and yet it insists on taking security. As a creditor, it already has priority over equityholders. They are, for all practical purposes, the only other players in the picture. This lender is not after priority, but rather control. When a firm is in financial distress, creditors care about whether the firm takes on new projects or replaces its managers. A security interest gives creditors a voice in these decisions.

Control rights are central to modern secured financing.[4] They matter both when no other creditors are in the picture and when they are. Indeed, control rights are fundamentally different from priority rights. The priority one creditor enjoys necessarily works to the disadvantage of junior creditors. Control rights may disadvantage junior creditors as well, but they do not have to. Junior creditors may be better off when senior lenders have control rights, as they may take steps (such as the replacement of management) that make everyone better off.

After emphasizing these two features of secured financing—insulation and control—the article returns in Part III to the question of priority. I shall suggest that priority is a less important theme in secured financing than usually thought. Priority can be achieved by other means, and in any event priority in the sense of absolute priority may not be what creditors want. Absolute priority destroys the option value of junior claims and interests and this is not always a good idea.

I. INSULATION FROM THE BANKRUPTCY PROCESS

Special purpose entities in asset securitization ensure that investors enjoy a cash flow that will not be interrupted when the debtor files for bankruptcy. But secured creditors insulate themselves from the bankruptcy process in other environments as well. Consider first small firms in Chapter 11. We have an excavating company. An equipment financer has a security interest in its earth-moving equipment. The auto dealer has a security interest in the company car. When such a firm finds itself in Chapter 11, this debtor is likely to make payments on the earth-moving equipment and the car as if the Chapter 11 never

[4] *See* Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921 (2001).

happened.

The debtor is unlikely to have filed for Chapter 11 because of these obligations. An excavation company that does not make enough to pay for the use of heavy equipment has no going-concern value. If the debtor cannot afford to make such payments, modern bankruptcy judges are likely to infer that the firm is not viable. They shut such firms down.

The typical debtor in small cases does not use Chapter 11 to negotiate with its equipment financer, but rather to solve problems with its tax collector, landlord, workers, or suppliers. Under these circumstances, relatively little is lost by continuing to pay the secured creditor under the terms of the security agreement. After all, if the creditor is oversecured, it is entitled to the payments eventually. Even if the creditor is undersecured, it is still entitled to protection for the amount the collateral is depreciating each month. In a world of low inflation rates, the monthly payments under the loan agreement are a decent approximation for the amount that the asset depreciates. Given the small stakes and the debtor's need to solve other problems, continuing payments as if bankruptcy never happened is an approximate form of adequate protection. The secured financer of equipment thus finds itself remote from the bankruptcy process, as are investors in special purpose entities.

In large cases, the effect of the bankruptcy process on creditors can be considerably dampened by the way they shape their security agreements.[5] The latest generation of DIP financing agreements provides that the prepetition creditor with a security interest in accounts is deemed to "relend" to the debtor as the account turns over. This "new loan" is given administrative expense priority. Hence, once the account turns over, the secured lender has an administrative claim equal to the amount of its loan, in addition to its lien. These are known as "roll-ups."[6]

Roll-ups insulate the secured creditor from cramdown. By acquiring administrative expense priority for its prepetition claim, the prepetition creditor can insist on being paid in cash upon confirmation of the plan. With respect to this creditor, the debtor no longer can use §1129(b) to impose a plan over its objection. We have a Chapter 11 regime in which the principal secured creditor can veto any plan that pays it less than 100 cents on the dollar in cash at the time of confirmation. The secured creditor in this case participates in the rest of

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[5] *See* David A. Skeel, Jr., *The Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003).

[6] Robert Rasmussen and I discuss these and other control devices in Douglas G. Baird & Robert K. Rasmussen, Corporate Governance, State-Contingent Control Rights and Financial Distress (first draft Oct. 2002) (unpublished manuscript, on file with author).

the bankruptcy process, but has nevertheless insulated itself from much of the dynamics associated with plan confirmation. Its rights are not "bankruptcy remote," but they are "cramdown remote."

II. SECURED CREDIT AND THE IMPORTANCE OF CONTROL

The secured creditor often comes into being at a distinct point in its life cycle. Warnaco provides a good example. A Fortune 500 Company, Warnaco 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, its debt was spread across a number of different banks and it was unsecured. In the late 1990s, however, things started to go wrong. Warnaco invested unsuccessfully in a chain of Calvin Klein jeans outlet stores. Warnaco also 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). Over the course of a single year, Warnaco's debt grew from $500 million to $1.5 billion. It was unable to convert bridge loans used to acquire new divisions into long-term debt.

At this point, it was in default on existing loan covenants and had exhausted other sources of capital. The existing institutional lenders got together. They agreed to provide an additional infusion of cash, but required at the same time that the debt be restructured. Warnaco's debt was restructured and the unsecured debt parceled out among twenty banks became folded into a revolving credit facility controlled by a handful of banks. This facility gave them a security interest in all of the firm's assets. With the security interest comes control over the firm's cash flow.

The loan agreement for the revolving credit facility sets out negative and affirmative covenants and defines events of default. The various covenants require the debtor to seek permission from the lender for any major decision about the firm, such as the purchase or sale of any substantial assets outside the ordinary course of business. The debtor also gives the lender access to its books and records. Covenants also check the ability of the debtor from using its cash collateral or borrowing from other creditors. Violations of the covenants are events of default, as are any "reasonable grounds for insecurity."

In a case such as Warnaco, the priority that the banks enjoyed by virtue of the revolving credit facility was largely irrelevant. There were few other creditors and they were owed much less than the billions secured by the revolver. Getting priority over other creditors was simply not important. In a case such as Warnaco, secured credit is not providing priority, but rather control.

The various covenants give the banks de facto control over how the firm is run. A creditor that exercises too much control exposes itself to various risks. In recent years, however, courts have tended to affirm the right of the creditor to exercise the rights set out under its loan agreement. More to the point, institutional lenders may not need to exercise their rights to enjoy the desired effect.

Once the debtor has defaulted on loan covenants and the lenders have the power to cut off its cash flow, a few hints are all that is needed. Return to Warnaco. Six months after the restructuring, the financial performance was poor and its auditors sounded some ominous warnings. At this point, Warnaco was in default and it needed to keep the lenders at bay. The banks made it known that they thought that Warnaco should hire a suitable Chief Restructuring Officer.

Warnaco's board, which had largely let the CEO run the show, had become active. It took note of the bank's suggestion. It hired Tony Alvarez as Warnaco's CRO. Alvarez 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.

Alvarez is one of the two principals of Alvarez & Marsal. The firm can take on a number of different roles. It sometimes serves as a creditor advisor and enables "bank groups, bondholders and other investors to clearly evaluate the risks and opportunities associated with a distressed company's business plan."[7] The firm also does turnaround management consulting. Wearing this hat, the firm "helps stabilize operations, address liquidity concerns, and position the company for successful financial or operational restructuring."[8] The first line of work gives credibility to the second. As the firm itself puts it, "A&M's involvement reassures creditors that the company is taking important steps to address its problems and maximize its value."[9] Even if the banks did not formally have the right to appoint Alvarez, the effect was the same. And with Alvarez in place, the banks had as their war-time general someone whose loyalties were not tied to the existing managers.

The bank's control is not absolute. In the end, Warnaco's new CEO still reported to the Board of Directors. The Board of Directors could replace him. Indeed, the shareholders could replace the Board of Directors. The banks could threaten to call their loans, but such moves are not costless and Warnaco had tough negotiators to press their case. Nevertheless, the new CRO was cut from a different cloth than his predecessor. His compensation and his future employment prospects turned, in no small part, on fixing the firm and finding someone to

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[7] *See* http://www.alvarezandmarsal.com (last visited May 24, 2004) (discussing Alvarez and Marshal's turnaround consulting services).

[8] *Id.*

[9] *Id.*

replace him.

These revolving credit facilities ensure that the banks retain control when and whether the debtor files for Chapter 11. Firms like Warnaco cannot run in Chapter 11 without someone willing to finance their postpetition operations and the Bankruptcy Code imposes substantial hurdles on any postpetition loans that prime prepetition secured claims. Moreover, a debtor in Warnaco's position usually cannot find anyone else to provide a cash infusion subject to the banks' lien.

For this reason, the banks occupy the driver's seat as far as the use of Chapter 11 is concerned.[10] These banks alone can provide postpetition financing. Far from protecting the debtor from its creditors, modern Chapter 11 is often chosen at the behest of the banks that run the revolver. Moreover, the banks are able to dictate in large measure the terms of the postpetition financing and the banks will insist on the same terms as in their revolving credit arrangement (and then some). In WorldCom, for example, the DIP lenders insisted on the appointment of a CRO from their list of three candidates.[11] Within a few months of the Chapter 11 filing, Warnaco's CEO was gone and the CRO took her place.

Sometimes the DIP lender secures the promise not to file "a motion in the bankruptcy case without Lender's prior written consent" and "not to the fil[e] of 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."

The DIP agreements can go even further. The DIP financing agreement in Warnaco, for example, gave the DIP lender a power of attorney. 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.[12] The agreement also stipulated that the DIP lender's exercise of this power of attorney

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[10] Few doubt this dramatic change in Chapter 11 practice. Some, however, believe that the amount of control creditors have come to enjoy is a bad thing. *See, e.g.*, Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 12 (2003). The authors state:

> We have a new form of chapter 11 emerging in the courts. Having invented the DIP (debtor-in-possession), American lawyers are now creating the SPIP (secured-party-in-possession). More and more chapter 11 cases seem to be no more than vehicles through which secured parties may enjoy their Article 9 rights under the umbrella, and protective shield, of the bankruptcy laws.

Id.

[11] *See* Carrick Mollenkamp & Henny Sender, *WorldCom's Turnaround Team to Come from Creditors' List*, WALL ST. J., July 24, 2002, at B8.

[12] *See* Senior Secured Super-Priority Debtor in Possession Revolving Credit Agreement, *In re* Warnaco Group, Inc. §11.8 (June 11, 2001) (on file with author).

does not violate the automatic stay.[13] A creditor empowered to act *as the debtor* is not a creditor in the traditional sense at all.

Given the difficulty of obtaining 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. Such clauses have the effect of waiving the debtor's exclusive right to propose a plan of reorganization. We can assess the current state of secured financing only if we take account of the way in which it now serves not only as a vehicle to ensure priority, but also as a means of exercising control.

In cases such as Warnaco, we do need to have some concerns about whether secured credit is necessarily a good thing. Often the person negotiating the revolving credit facility has interests that do not correspond with those of the firm as a whole. The salient characteristic of these revolving credit facilities comes from the long and largely silent fuse they bring with them. They restore the firm to financial health (or at least the appearance of financial health) for some period of time. But in many cases, they merely put off the day of reckoning. Dispersed bondholders or other holders of long-term obligations of the firm are made worse off when an institutional creditor senses trouble and insists on collateralizing the debt. As long as the security interest is perfected outside of bankruptcy's preference window, everyone else must take a back seat.

The revolving credit arrangement may also compromise the rights of the shareholders. They might be better off if the current management were removed. The revolving credit facility may make it possible for existing managers to continue to make the same mistakes that created the financial mess in the first place.

We also must worry about situations in which the person controlling the revolving credit arrangement or the debtor-in-possession financing has the wrong set of incentives. To the extent that they are not residual claimants, to the extent that those junior to them are not in the money, we have to worry that their decisionmaking is going to run contrary to the interests of the junior owners. They will be inclined to favor liquidation and other courses of action that may systematically work to the disadvantage of junior people.

Here again, however, it is easy to give too much emphasis to the influence of priority. In many cases, control will ensure various steps—such as the appointment of a Tony Alvarez—that put the firm on the right track. Hiring an effective manager of a firm is a goal that is commonly shared among all the investors.

In many cases we do not have a residual owner who internalizes

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13 *Id.*

the costs of her decisionmaking. But for many decisions, complete internalization is not important. Enron provides a particularly vivid example. Massive fraud prevented anyone from knowing who was entitled to what, but there was general agreement on the course that needed to be taken—the speedy sale of its assets, especially its trading operation.[14]

Understanding control requires us to understand how much the control rights are allocated (by a security agreement or otherwise) in a way that reflects conscious design and to ensure that those who make the decisions are likely to make decisions that benefit the firm as a whole.

III. REVISITING PRIORITY

Up to this point, I have emphasized how security serves functions different from merely vindicating the absolute priority rule. At the same time, it is it also worth noting that priority itself has contours that are themselves less clear than they might at first seem. The familiar characteristics of hierarchical capital structures and cut-and-dried notions such as the difference between debt and equity are much less clear than they used to be. We live in a world that understands the lessons of Black-Scholes, and this changes everything.[15] Take a simple example. How would you characterize this transaction?

Firm wants to obtain $100 from Investor. To do this, Firm gives $100 in stock to Investor. At the same time, one of Firm's subsidiaries enters into an arrangement with a subsidiary of Investor in which Firm's subsidiary acquires the right to buy the stock back for $100 at a specified time. Another subsidiary gives a different subsidiary of Investor the right to sell the share of stock to it for $100.

What is the relationship between Firm and Investor? Investor is an equityholder and some of its related firms are counterparties to some transactions involving derivatives. But this is not the right way to think about it. Step all these transactions together and you see that Investor has the same economic position vis á vis Firm as an ordinary creditor. It gave $100 and received in exchange a right to get back $100 at some

[14] *See* PETER C. FUSARO & ROSS M. MILLER, WHAT WENT WRONG AT ENRON 178 (2002); Press Release, Enron Corp., Enron Commences Auction Process to Maximize Value of Core Assets (Aug. 27, 2002), *available at* http://www.enron.com/corp/pressroom/releases/-2002/ene/29-082702ReleaseLtr.html.

[15] For a general introduction to these ideas, see Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460, 465–70 (1993). For a formal treatment, see Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 649–54 (1973); Robert C. Merton, *Theory of Rational Option Pricing*, 4 BELL J. ECON. & MGMT. SCI. 141, 141–42 (1973).

time in the future. The amount it would receive from Firm would be the same whether Firm fared well or poorly. It enjoys neither the upside nor the downside we associate with equity. But outsiders will know this only if they can step these transactions together. It is hard to imagine how you craft transparent rules of accounting if Firm and Investor have many subsidiaries and many interactions.

Moreover, just as you can use the principle of put-call parity to create virtual debt, the holder of debt can engage in various transactions that create an entirely new breed of cat. But let us say you care about only one, such as priority. There is no need to take a security interest at all. If you care only about priority, you can have the debtor set up a subsidiary and drop down all of its existing assets into the subsidiary. Once this happens, you make a simple unsecured loan to the subsidiary. You are a simple general creditor of the subsidiary, but your interest now primes the claims of all the creditors of the parent. The only asset of the parent corporation is stock of the subsidiary and owners of the stock are entitled to be paid only after creditors such as you have been paid in full. One has to be careful. There are some fraudulent transfer issues here. But the possibilities are endless.[16]

This returns me to the absolute priority rule. Absolute priority seems the most straightforward interpretation of the relevant investment contract: debt should be paid before equity. It has the virtues of a simple rule. Any investor who wants an investment contract that provides for a different priority can create it by combining the right mixture of puts and calls.[17] Shareholders who want protection in bad states of the world can purchase a debt instrument, a convertible instrument, or a derivative.

Even if creditors are better off with an investment contract that provides for something other than absolute priority, secondary markets allow investors to enjoy any priority scheme they want. Nevertheless, absolute priority has a significant and largely unappreciated weakness that makes it possibly not the best default rule in some environments. The equity of an insolvent firm trades for a positive price as long as there is no recognition event. There is a firm that has $20 in debt and a lottery ticket with a one-in-ten chance of paying $100. What is the equity worth? It all depends on whether the creditors can force a sale of the ticket and receive a distribution before the drawing. If they can, the ticket will be sold for $10, and the creditor will receive everything. There will be nothing left. But if the recognition event takes place after the lottery drawing, the story is altogether different. The equity in the

[16] The equivalence between the priority through secured credit and structural priority through parent and subsidiary corporations is, of course, well known. *See, e.g.*, David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1648 (1991).

[17] *See* Baird & Rasmussen, *supra* note 4, at 940-41.

firm should trade for $8 (reflecting the one chance in ten that the firm will win the lottery, get $100, pay $20 to the senior creditor, and have $80 left over).

We do not recognize this option value in Chapter 11. The absolute priority rule not only tells us that debt gets paid first, but also that the option value of junior interests is ignored as well. The crucial feature of an absolute priority rule is the way it collapses all future possibilities to the present and thereby extinguishes the option value that equity would otherwise have. This discontinuity (which exists not only for the absolute priority, but most variations on it) introduces costs that alternative priority schemes do not.[18]

Consider the following. Firm owes Senior Lender $100. We are the junior investors. Firm's only asset is a project. The value of this project changes a lot from day to day. We need to straighten out the capital structure as soon as possible. We need to bring in new investors and hire new employees. We can't do it in this environment. But the valuation issue is messy. The dust will not settle for sure for several years.

Let me tell you what I know about how much the project is worth today. There is a 90% chance that two years from now it will be worth somewhere between $50 and $150. Between these two points, the probabilities are uniform. There is a five percent chance it will turn out to be worth more than $150 and a five percent chance it will be worth less than $50. Nothing is known about how the probabilities are distributed in these regions. I just don't know. If we were to research the question at large cost, we would know more. We could also wait and see how things change.

We are now negotiating with Senior Lender. She knows as much as we know or maybe a little more or a little less. She makes the following argument. We live in a world of absolute priority. Valuations are never certain, but everything seems to suggest the firm is worth $100. It could be lower or it could be higher, but based on what we know about the probability distribution between $150 and $50—and what we don't know about the value of the tails of the distribution, $100 is a decent estimate. Under the absolute priority rule, Senior Lender is entitled to everything and we are entitled to nothing.

We have the incentive to delay and hope the value will rise. We might also spend money to see if we can get a better valuation. Both courses are inefficient. The first delays a needed reorganization and keeps assets in inefficient use. The second incurs deadweight costs and brings no social benefit.

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18 Donald Bernstein was the first to develop the idea of using relative priority to facilitate Chapter 11 negotiations in the context of such valuation disputes. *See* Donald S. Bernstein, Presentation to the American College of Bankruptcy Lawyers, Washington, D.C. (Mar. 28, 2003).

But there is an alternative. Instead of doing more valuations or waiting, we do the following: we give the entire firm to Senior Lender, but we acquire an option to buy the firm for $150 in two year's time. At the same time, we sell a put. We give Senior Lender the right to sell the firm to us for $50 in two years' time. Senior Lender has no grounds to object. She is getting a package of rights worth $100. We are getting something that in expectation is worth $0, but we are both better off because we remove from the table both the potential for strategic behavior and the costs of valuations.

To the extent this deal makes sense at the time of the bargaining, it also makes sense before the fact. We should not be surprised to see such a deal as part of a pre-bargain arrangement. Such an arrangement illustrates one of the pervasive deficiencies of the absolute priority—its insistence that any recapitalization also be a day of reckoning that collapses all future liabilities and assets to their present value.

Apologists for absolute priority (and indeed virtually everyone who has proposed alternatives or pointed out its inefficiencies) have ignored the possibility of radically changing a firm's capital structure without changing the relative value of any investor's interest in the firm. Absolute priority is in fact an invention of academics that was not mentioned in any judicial opinion until 1939 and took hold only because a willful law professor turned judge thought it was a good idea.[19] In at least two environments with a norm of freedom of contract (venture capital contracts today[20] and equity receiverships in the late 19th century[21]), investors have recognized option values when firms are restructured. The absolute priority rule is a product of legislation, not freedom of contract.

CONCLUSION

How then do we assess this new shape of secured financing? What matters to investors is whether their investment instruments dispersed among the investors as a group maximize the value of those assets. Answering this question turns not on whether they enjoy perfected security interests, but rather on the substantive characteristics that work to their mutual benefit. We are a long way from being able to make this

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[19] The law-professor-turned-justice was, of course, William O. Douglas. *See* Douglas G. Baird & Robert K. Rasmussen, Boyd*'s Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393, 412-17.

[20] *See* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: Evidence from Venture Capital Contracts*, 71 REV. ECON. STUD. (forthcoming 2004); *see also* Steven N. Kaplan & Per Strömberg, *Venture Capitalists As Principals: Contracting, Screening, and Monitoring*, AMER. ECON. REV., May 2001, at 426.

[21] *See* Baird & Rasmussen, *supra* note 4, at 931-32, 956.

assessment. In the case of secured financing, this task requires us to incorporate ideas of remoteness and control into our understanding and the need for caution in assessing the role played by priority and in particular the absolute priority rule.