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Private Debt and the Missing Lever of Corporate Governance

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Abstract

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.

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

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more than 25 years. No one was more dedicated to the business. His wedding cake was made out of 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 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.

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 its 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 the CEO of Enron, and allowed him to remain at Enron while serving simultaneously as CEO of Krispy Kreme.

Conventional accounts of corporate governance simply cannot explain how a board that had worked 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. 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 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.

In our essay, we identify 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 a 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.

Corporate law and in particular rules of corporate governance properly include 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, the business needed to secure waivers from the banks. The price the banks demanded for the waivers included the head of the CEO and the installation in his stead of a seasoned turnaround specialist.

This essay focuses on the way in which loan covenants now play a central role in corporate governance. 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.[1] 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. We conclude with a few observations on the potential risks associated with this lever of corporate governance.

[1] We use the word "banks" to include both traditional banks and other private lenders. Non-bank 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,* working paper at 26 (June 2002) (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 non-bank 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 non-banks. In light of these developments, we find it unhelpful for the aims of this paper to distinguish between bank and non-banks, and use the term "banks" to include all private lenders.

I. Corporate Governance and the Power of Contract

On its face, corporate law vests authority to run a corporation in the board of directors. Shareholders, in turn, elect the directors, approve charter amendments and by-laws, and pass on certain extraordinary actions. Corporate governance debates center on whether the law should alter this allocation.[2] Legal processes and rules are needed because exogenous events create a mismatch between the incentives of the individual investors that possess control rights and what is in the best interest of the investors as a whole. Shareholders, as residual claimants, serve as good proxies for all investors when the business is flush. They bear both the costs and benefits of the operation of the enterprise, but they do not actually control the day-to-day affairs of the business and cede decisionmaking over all but a handful of matters to directors and officers. They nominally have the right to elect directors, but, given the dispersion of shares, the board is effectively self-perpetuating.[3]

In such a world, we face the problem that Berle and Means brought to the surface many decades ago—the separation of ownership and control. The challenge of corporate law lies in ensuring that the interests of the shareholders

[2] See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power,* 118 Harv. L. Rev. 833 (2005); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance,* 97 Nw. L. Rev. 547 (2003); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law,* 85 Va. L. Rev. 247 (1999); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come,* 59 Bus. Law. 67 (2003).

[3] See Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot,* 59 Bus. Law. 43, 45-46 (2003) (reporting that, over a seven-year period, there were on average 11 challenges to incumbent directors, with less than two of these challenges occurring at corporations valued at over $200 million).

remain foremost in the minds of those in charge of the business. CEOs may place perks above profits. We need well-designed compensation contracts to tie the wealth of the CEO to the well being of the shareholders.[4] Managers can place their friends on the board.[5] 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.[6] We need independent directors and greater shareholder input to check their incentives to pursue their self-interest to the detriment of the corporation as a whole. Directors enjoy serving on boards. We need to provide incentives that they will sell the business when a buyer appears.[7] While one finds

[4] See Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 Del. J. Corp. L. 540 (1984); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives: It's Not How Much You Pay, but How,* 68 Harv. Bus. Rev. 138 (1990); John E. Core, Wayne Guay & David F. Larcker, *Executive Equity Compensation and Incentives: A Survey,* 9 Econ. Policy Rev. 27 (2003). For an argument that excessive agency cost afflict the current method of setting executive pay, see Lucian Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE (Harvard 2004).

[5] See Anil Shivdasamf & David Yermack, *CEO Involvement in the Selection of New Board Members*, 54 J. Fin. 1829, 1833-34 (1999) (finding direct CEO in appointment of directors in 47% of corporations studied).

[6] The more entrenched managers are of a parent corporation, the more likely they are to provide similar entrenchment to their fellow managers when the parent spins off a subsidiary. See Robert Daines and Michael Klausner, *Agents Protecting Agents: An Empirical Study of Takeover Defenses in Spinoffs,* working paper (Dec. 16, 2004).

[7] The classic formulation of the problem can be found in 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 (1981). For a recent exchange on this topic, compare Martin Lipton, *Pills, Polls, and Professors Redux,* 69 U. Chi. L. Rev. 1037 (2002) with Lucian Ayre Bebchuk, *The Case Against Board Veto in Corporate Takeovers,* 69 U. Chi. L. Rev. 973 (2002).

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 creditor's power is limited to suing the debtor when it fails to pay as promised. They 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.[8] This shift, however, provides little recourse. One searches in 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 the consumption of perks, but creditors do not play an active role in the governance of the corporation.[9] In the standard model, debt is diversely held among public bondholders who rely on an indenture trustee to guard their interests.[10] The indenture trustee, however, can do no more than insist on rigid

[8] See Laura Lin, *Shift of Fiduciary Duties Upon Corporate Insolvency: Proper Scope of Director's Duty to Creditors*, 46 Vand. L. Rev. 1485 (1993).

[9] For evidence that adding leverage can increase the value of the corporation, see Gregor Andrade & Steven N. Kaplan, *How Costly is Financial (Note Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J. Fin. 1443 (1998).

[10] Of course, the differences between public bondolders and private debt has not

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.

The standard account neglects the role that bank and noninstitutional debt plays in the world of corporate finance. There are few limits on their ability to insert any conditions or covenants in their loan agreements. While corporate charters are relatively short documents, loan contracts routinely exceed a 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. 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.[11]

gone completely unnoticed. See, e.g., Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring,* 51 Rev. Econ. Stud. 393 (1984) (noting that banks are better monitors than public debt holders); Eugene Fama, *What's Different About Banks?,* 15 J. Monetary Econ. 29 (1985) (same).

[11] 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 (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 tell us how much work the bankruptcy judge must do."); Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 Stan. L. Rev. 651 (2002); Douglas G. Baird & Robert K.

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.[12] Whether the venture capitalist formally fits into the pigeonhole of "creditor" or "shareholder" is something they care about only if something turns on it. Venture capitalists often invest in several different countries, each with its own legal system. The details of the legal system are important only in that the investment contracts must take them into account.[13] 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 cashflow rights as a creditor, but the business will not even be eligible for bankruptcy because, as a formal matter, it has no creditors. [14] The same venture

Rasmussen, Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations, 87 Va. L. Rev. 921 (2001).

[12] 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 (2003).

[13] 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 rights. See Steven N. Kaplan, Frederic Martel & Per Strömberg, *How Do Legal Differences and Learning Affect Financial Contracts?,* (Dec. 2003).

[14] 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

capitalist in Sweden does not face the equivalent of Chapter 11.[15] 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 things progress well, she is well positioned to make the decisions. When things go poorly, the principal question is 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 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. She possesses the power to decide whether to liquidate the business regardless of whether she is formally a preferred stockholder, a creditor,

creditor can impose is capped by the amount of its claim.

[15] 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 (2000).

or something else entirely.[16]

Investment contracts, of course, must specify precisely *when* the venture capitalist will acquire control over the company. These contracts cannot detail every contingency that may arise. Hence, the challenge for contact 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 even though the financial instruments that the corporation has issued remain unchanged. The transfer of control, of course, does not mean that the business will be shut down, only that the decision is placed in the hands of someone better positioned to make that decision.[17] And this person often has the

[16] *See* Kaplan & Strömberg, *supra* note --.

[17] 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. Rather, our point 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.

formal legal attribute of a creditor.[18]

The way in which the allocation of control rights depart 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 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.[19] 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 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 whether the founder is also the person equipped to lead the business through its adolescence. The entrepreneur with the visionary idea may need to be replaced by seasoned managers who excel at developing the infrastructure of the business. While they are successful, close supervision is unnecessary and often counterproductive. The venture capitalist who can closely monitor the young company exits and is replaced by

[18] 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 legal status itself is not itself important when control rights are (as is always the case in venture capital deals) a creature of contract.

[19] 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,* working paper (January 2005).

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, the company's suppliers (or their intermediaries) are likely to insist on a standby letter of credit that insures they will be paid.[20] 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 invites 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 dump her if she has not been successful. Apart from the credit line (which may never be drawn upon), the capital structure may consist largely of equity, but held by a relatively small number of investors who also sit on the

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

board.[21]

One way to understand how control rights shift over the life cycle of a business 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 governance 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 derives from her skill and the course she has set for the business. Her stock and options aligns

[21]. See Harry DeAngelo, Linda DeAngelo & Karen H Wruck, Asset Liquidity, Debt Covenants, and Managerial Discretion in Financial Distress: The Collapse of L.A. Gear, 64 J. FIN. ECON. 3 (2002).

her interests with those of the enterprise. An active board with many layers of oversight may be contrary to the interests of the owners. Second-guessing her acquisition plans and fly-specking her compensation contract does not advance the interests of the enterprise.

Consider now a different kind of business, a mature corporation with steady cash flows. Investors face the danger that those in charge will fail to focus on maximizing cash flow.[22] 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.[23] Alternatively, they may have the enterprise pay cash dividends to the stockholders.[24] 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 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 cashflow rights and control rights. No one is necessarily better than any other. For all these

22. See Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 AM. ECON. REV. 323 (1986).

23 See id.

24 See Frank H. Easterbrook, Two Agency-Cost Explanations of Dividends, 74 Am. Econ. Rev. 650, 654 (1984).

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. 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.[25]

[25] See Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 Stan.

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.[26] Sarbanes-Oxley—even assuming that it is effective[27]—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 500 company that that manufactured and distributed 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

L. Rev. 887, 890 (2002) (having an effective staggered board increases chances of corporation remaining independent 12 months after a hostile bid from 31% to 64%); Lucian Arye Bebchuk & Alma Cohen, *The Costs of Entrenched Boards,* working paper at 14 (reporting that 60% of the publicly traded corporations they examined had staggered boards).

[26] See Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants,* 55 Stan. L. Rev. 885, 895-900 (2002).

[27] For an argument that it is not, see Roberto Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance,* working paper.

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 $158 million in salary and bonuses between 1993 and 1998. Warnaco's debt was spread across twenty different banks and it was unsecured.[28]

During the time that it flourished, Warnaco seemed a classic example of a business with a firmly entrenched manager.[29] The CEO also served as chair of the

[28] On the general tendency of health, large companies not to secure their debt, see Ronald J. Mann, *Explaining the Pattern of Secured Credit,* 110 Harv. L. Rev. 625, 629 (1997); Allen N. Berger & Gregory F. Udell, *Collateral, Loan Quality, and Bank Risk,* 25 J. Monetary Econ. 21, 27-40 (1990).

[29] Entrenchment of existing managers is the central focus of modern corporate law scholarship. See, e.g., Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance,* working paper at 5 (Nov. 2004) ("We take the view * * * that arrangements that protect incumbent 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., *supra* note --, whether shareholders' voting power on by-law amendments, charter amendments and merger is constrained, Bebchuk, et al, *What Matters,* at 6-7, the extent to which boards have adopted protections against hostile takeovers, see *id.* at 8-9, and whether there are a majority of independent directors, see Sanjai Bhagat & Bernard S. Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance,* 27 J. Corp. L. 231 (2002). The "governance index"

board. Half of the six-member staggered board were insiders. The CEO had picked her "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. Warnaco made *Business Week*'s list of "The Worst Board of Directors" in 1996, largely due to the Board's lack of independence.[30] 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 ensuring that action was taken soon enough when she went bad.

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). 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

created by the Investor Responsibility Research Center and used in a number of recent papers focus exclusively on the relationship between the board and shareholders. See Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices,* 118 Q.J. Econ. 107 (2003); Bebchuk, et al., *What Matters, supra.*

[30] See The Worst Board of Directors, available at http//:www.businessweek.com/1996/48/b35035.htm

displaced.

The shift in control came about as a result of Warnaco's need to restructure its debt. Warnaco remained solvent,[31] 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.[32] 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.[33] The 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

[31] Although the stock traded for much less than it had in better times, sophisticated investors were still buying it, as was the CEO.

[32] While debt of this sort is often syndicated among a number of banks, the general understanding is that the lead bank will perform the bulk of the monitoring of the debtor.

[33] 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 90 days. Senior lenders will generally not be treated as insiders, and even here the preference period runs only a year. Pledging the assets usually can be done far enough in advance to ensure that none of these problems arise. For example, in the case of Interstate Bakeries, Interstate had no secured debt as of July 18, 2001. Its unsecured debt was a tad less than $600 million. The next, 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. See 2001 Annual Report at 22.

depended on reversing the recent slide.[34] The incentives for those beholden to equity to engage in unduly risky transactions as the corporation nears insolvency were firmly checked.

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 flows 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 allows the lender to call the loan in the event of any material adverse change.[35]

Several decades ago, institutional creditors could not exercise this much control. Before Article 9 was enacted, acquiring a security interest in all of a company's property was hard.[36] Each type of collateral had its own legal regime.

[34] Replacement of the CEO would more than likely require a bankruptcy filing. The severance portion of her compensation contract was $43 million. 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.

[35] 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 was first set out in Ronald J. Daniels & George Triantis, *The Role of Debt in Interactive Corporate Governance*, 83 Cal. L. Rev. 1073, 1093-94 (1995).

[36] See 1 Grant Gilmore, Security Interests in Personal Property 1-286 (Little,

Moreover, courts viewed with suspicion omnibus clauses that picked up all of the debtor's property and provided no cushion for other creditors.[37] 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 revised Article 9 have made it possible for lenders to acquire all of a corporation's assets.[38] The modern security interest effectively covers not only a corporation's discrete assets, but also the synergy that each asset has with the other. The expanded security interest not only changes the basis on which the lender extend credit, but also the control that the creditor can exercise over the business.[39]

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 lender not only takes a security interest in all of the debtor's assets, but also actively manages the debtor's cash flows through a revolving credit facility. A creditor can now

Brown 1965).

[37] See, e.g., Benedict v. Ratner, 268 U.S. 353 (1925).

[38] Perhaps most notably, revised Article 9 made it possible for a lender to take a security interest in a debtor's deposit accounts. See 9-104(l) of Old Article 9. See also Comment 16 to 9-109 of new 9 ("[D]ebtors who wished to use deposit accounts as collateral sometimes were precluded from doing so as a practical matter.")

[39] 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 (1986).

acquire a valid security interest in all of a debtor's assets and ensure that all 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 flows, 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 down turn 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 that it has contracted for in the lending agreement.

The ability to cut off a debtor's cash flows 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. Repossessing collateral is a potent threat only if the creditor can reach the property without breaching the peace.[40] 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 may find that the collateral is worth more in the debtor's hands.[41] Cash, on the other hand, is worth just as much in the lenders' hands as is 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

[40] See UCC 9-609.

[41] See Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt,* 96 Mich. L. Rev. 159 (1997).

threaten to blow up the machine, a secured creditor with a security interest 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.[42] Rather, the security interest here serves two roles. At times, it gives the creditor the ability to conduct a controlled liquidation of the corporation. By limiting the amount of the advances, it can ensure that funds are only spent on liquidating the current assets.[43] The lender can limit a debtor's access to cash in a way that it cannot limit its access to a machine. With the 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

[42] On secured credit as an option, see Robert K. Rasmussen, *Secured Credit, Control Rights, and Options,* 25 Cardozo L. Rev. 1935 (2004).

[43] See, e.g., In re Clark Pipe & Supply Co., 893 F.2d 693, --- (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, the proceeds of which were used to pay off the past advances from [the secured lender].")

role in the business. The debtor has to find a common understanding with the lender as to the future of the enterprise.[44]

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 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, these 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.

Instead, we tend to see industrial strength revolving credit agreements in environments such as Warnaco. 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. Here,

[44] There are reasons to believe that Boards may be overly trusting of the CEO that they have hired. See Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals about Agency Costs, Self-Deception and Deceiving Others*, draft. Lenders, all else being equal, are less likely to suffer from this bias.

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.[45] They know that they are in an end-game situation. Final-period problems tend to reduce the efficacy of controls designed to bind 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 interest.

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.[46] 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 ordinary course of business. The debtor also gives the lender access to its books and records—information not routinely available even to shareholders.[47] Loan covenants also check the ability of the debtor from using its cash collateral or borrowing from other creditors. Violations of the covenants are

[45] In the 1980s, few senior managers survived financial distress. See Stuart C. Gilson, *Management Turnover and Financial Distress,* 25 J. Fin. Econ. 241, 247 (1989) (29% of senior managers remain after financial distress); 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) (91% of CEOs replaced during financial distress).

[46] If a debtor insists on there being no covenants, the loan will be callable on demand. See Guide to Asset Based Lending, GE Capital Commercial Finance 16 (1999).

[47] 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 (1996).

events of default. A default entitles the creditor to demand repayment of the loan and to take possession of all the assets of the borrower.

Even declaring a default without seizing collateral has 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. 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.

A change in the underlying economy alters the relative position of the borrower and the lender in another way. Fifty years ago small businesses were often indistinguishable from the owner-manager who ran the company on a day-to-day basis. A creditor could threaten to exercise its rights and exert control over the business, but such a threat is credible only if the creditor could make use of the assets. Hence, even if a creditor in fact had a security interest that covered the entire business and extended credit on the basis of the corporation's value as a going concern, the threat to repossess was credible only to the extent that the secured creditor had the ability to realize the going concern value of the business without the debtor's cooperation. Today fewer corporations depend upon the firm-specific skills of the manager.[48]

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 firm. Both large and small corporations are routinely sold in the marketplace. Institutional lenders bargain for the implicit (and sometimes the explicit) power to change the managers.[49] 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. 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.[50]

[48] We make this point in greater detail in Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 Stan. L. Rev. 651 (2002).

[49] 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 turn-around specialist calls the shots.

[50] 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 D&O insurance, however, hints are usually 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 WorldCom, for example, the creditors conditioned the dip financing upon the appointment of a chief restructuring officer and gave the board

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, he does not report to the CEO. Rather, he reports directly to the board. Whereas the CEO tends to choose other members of his management team, the CEO has little role into this selection. 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 may take place only after the CRO has had a chance to straighten out the operational problems and the business has settled on a plan to straighten out its finances.

To get a flavor of this dynamic, return to Warnaco. By spring of 2001, Warnaco's fortunes had not improved. At this point, the banks insisted that Warnaco hire a turn-around specialist as a Chief Restructuring Officer.[51] At least initially, this person would 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

freedom to choose any restructuring officer they pleased—as long as he was one of the three on a list they provided.

[51] 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.

provides a number of services. 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." 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." 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." When Alvarez is in place, the banks have as their war-time general someone whose loyalties are not tied to the existing managers.[52] Alvarez does not plan on staying with companies long. His loyalties do not run to the shareholders. His future employment prospects turn on maintaining the confidence of lenders that he can maximize the value of the enterprise.

Existing legal doctrines force lenders to exercise their control indirectly. Such doctrines impose risks to lenders who 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.[53] Courts regularly affirm the right of the creditor to exercise the rights set out under its loan agreement. As long as it

[52] The firm's web site is http://www.alvarezandmarsal.com.

[53] See Sloan v. Zions First National Bank, 990 F.2d 551 (10th Cir. 1993); Kham & Nate's Shoes No. 2 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.").

cuts square corners, it has no duty to look out for the interests of other creditors.[54] Still, concerns remain. In Chapter 11, other creditors could seek equitable subordination. They could claim that the creditor that had so much control over the debtor that it was able to manipulate its affairs in a way that worked to its own benefit.[55] 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 know as "deepening insolvency," which can 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.[56]

III. Creditor Control in Chapter 11

Senior creditors retain 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

[54] See, e.g., Smith v. Associates Commercial Corporation, 893 F.2d 693, 702 (5th Cir. 1990).

[55] See, e.g., In re Excide Technologies, Inc., 299 B.R. 732, 743-46 (Bkrtcy.D.Del 2003) (holding that cause of action for equitable subordination stated where banks were alleged to have used their position to gain "control" over debtor).

[56] See, In re Excide Technologies, 299 B.R. at 750-52 (holding that other creditors had successfully plead 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. The conduct by the Lenders caused the Debtors to suffer massive losses and become more deeply insolvent, costing creditors substantial value.")

control over postpetition financing.[57] Warnaco 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 choose 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.[58] 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.[59] They have to wait until a plan of reorganization was confirmed. Until then, they can insist only on

[57] Of the 93 large, publicly held corporations that concluded reorganization proceeding in 2002, 51 (55%) of them had debtor-in-possession financing. 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 may understate creditor control to the extent that it does not include cash collateral orders, which can be the functional equivalent of DIP financing orders.

[58] See Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11,* 101 Yale L.J. 1043, 1050-52 (1992); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies,* 141 U. Pa. L. Rev. 669, 756-58 (1993) (suggesting that Chapter 11 may provide "soft landing" for managers).

[59] See 11 U.S.C. § 362.

adequate protection of the value of their collateral.[60] The time value of their secured claims is not even protected to the extent they are undersecured.[61] At confirmation, they can only insist on a promise stream of future payments, the present value of which equals the value of the collateral, with both the value of the collateral and the discount rate being issues for judicial determination.[62] After all, Chapter 11 is supposed to give a "breathing space" to a beleaguered 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.[63] These alternative sources may insure 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.[64] The debtor is going to need to use the cash collateral of the

[60] See 11 U.S.C. § 363(e).

[61] See United Savings Assoc. v. Timbers of Inwood Forest Assoc., 484 U.S. 365 (1988).

[62] See 11 U.S.C. 1129(b)(2)(A). On valuation disputes, see *Associates Commercial Corp. v. Rash,* 520 U.S. 953 (1997). On interest rate disputes, see Till v. SCS Credit Corp., 541 U.S. 465 (2004).

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

[64] Alternatively, the new lender can buy out the interest of the prior lender.

existing lender,[65] 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. 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.

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.[66] 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.[67] Moreover, the DIP financing agreement can provide that the loan terminates if the debtor fails to

[65] See 11 USC 362(c)(2) (requiring consent or court approval for the debtor to use cash collateral) & (e) (requiring adequate protection as a predicate for court approval).

[66] Other provisions, such as a waiver of the right to seek reimbursement under Section 506(c), 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 ensure that the lender is paid in full.

[67] Such liens are authorized by Section 364(d) of the Code. See 11 U.S.C. 364(d).

arrange for a sale of some or all of its assets by a specific date.[68]

The DIP financier 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 it is an event of default if a plan is not filed within a certain period of time.[69] 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.[70] The debtor's freedom to shape a plan of reorganization is limited as well. The DIP may include among many covenants the promise not to file "of 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." 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.[71] Any change in control,

[68] See Warnaco Revolving Credit Agreement §7.16.

[69] See Warnaco Revolving Credit Agreement §7.14.

[70] Much of the concern with 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 Wisc. L. Rev. 11.

[71] In theory, shareholders still retain the right to replace the board of directors while the corporation is in bankruptcy. See In re Johns-Manville, 801 F.2d 60 (2d Cir. 1986); Official Bondholders Committee v. Chase Manhattan Bank, 209 Bankr. 832 (D. Del. 1997).

defined to include a new majority of the board, will be a default on the loan.[72] Similarly, the DIP can provide that it is an event of default if its CRO is replaced.[73] Provisions can go further still. The DIP financing agreement in Warnaco gave the DIP lender a power of attorney.[74] 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. The agreement also stipulated that the DIP lender's exercise of this power of attorney does not violate the automatic stay. 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 these provisions. Yet, by cobbling together those provisions that a secured lender knows will pass judicial muster in the chosen venue (a venue into which the secured lender had considerable influence),[75] the DIP lender can insure that no major decision is made in a way that it finds objectionable.[76] Given the difficulty of obtaining another DIP lender,

[72] See Winn-Dixie Credit Agreement § 8.1.8 (Feb. 21, 2005).

[73] See Interstate Summary of Terms and Conditions for Revolving Credit and Letter of Credit Facility, Affirmative Covenants (o) (Sept. 20, 2004).

[74] See, e.g., Senior Secured Super-Priority Debtor in Possession Revolving Credit Agreement, In re Warnaco Group, Inc. §11.8 (June 11, 2001).

[75] See Marcus Cole, *"Delaware is Not a State": Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 Vand. L. Rev. 1845, 1869 (2002).

[76] Cash collateral orders often contain similar provisions. Agreement on the part of the lender for the debtor to use cash collateral often include an

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.[77]

With the creditors in control, the reorganization of Warnaco proceeded smoothly. 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. 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 96.26% of the equity. The rest of the equity went to the unsecured creditors and Tony Alvarez, while the erstwhile shareholders received nothing. Less than two months later, the former President and CEO of Brooks Brothers took over for Alvarez. Warnaco is once again a publicly traded company. As to Alvarez, he has moved on and serves as the CEO for the maker of Wonder Bread and Twinkies, Interstate Bakeries. Interstate is currently in Chapter 11.

acknowledgement of the validity of the lender's lien, the promise that the debtor will not seek to charge the collateral under Section 506(c), the requirement that debtor receive the lender's consent before granting any future postpetition liens, and payment of all of the lender's expenses.

[77] 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 § 8.1.10(h).

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.[78] 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 must be taken into account.

Increased creditor control may be, on balance, a salutary development. 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's interest except to the extent it advances

[78] See George W. Kuney, *Hijacking Chapter 11,* 21 Emory Bankr. Dev. J. 19, 24-25 (2004) ("secured 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 created a federal unified foreclosure process"); Stephen Lubben, *The New and Improved Chapter 11,* working paper; Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases,* 21 Bankr. Strategist 1, 2 (2003); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 Tex. L. Rev. 795 (2004).

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.[79] A publicly traded corporation is five times more likely to file a Chapter 11 petition than be subject to a hostile takeover,[80] and, as Krispy Kreme illustrates, the businesses that enter Chapter 11 are only a fraction of those subject to the discipline of creditor control.[81]

The possibility of creditor control exists any time a business takes on a substantial loan, and these are commonplace in the life on a publicly traded

[79] In their path-breaking piece on the effect of staggered boards, Bebchuk, Coates and Subramanian's comprehensive search uncovered only 92 hostile bids over a five-year period.

[80] During the same time period as Bebchuk, Coates and Subramanian's comprehensive search (1996-2000) found 92 hostile takeovers, 622 publicly traded corporations filed for bankruptcy. Of these, 186 had assets that exceed $100 million, measured in 1980 dollars. See The 2004 Bankruptcy Yearbook & Almanac 70 (New Generations Research). It might seem that hostile takeovers are only a tip of the iceberg, as they now represent only a small part of M&A activitiy 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 (2003).

[81] In a previous paper, we document the extent of creditor control for all large businesses that exited Chapter 11 in 2002. See Baird & Rasmussen, supra note x.

corporation. For example, one study reports that in the two years 1995 and 1996, there were over four hundred large private loans to public corporations owning more than $100 million in assets.[82] The sources of private debt include both traditional banks and companies such as GE 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 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, in 2002, over $40 billion in loans changed hands. This represented 42% of all of the trading in the secondary loan market for that year.

The *possibility* of creditor control may matter as much as whether it is actually exercised 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, but a business that encounters

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

difficulty with a private creditor is likely to have trouble replacing it with another. Any new lender has to worry about private information. The existing lender may want out 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.

Private debt is thus a widely used lever of corporate control. Moreover, it can do work 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.[83] 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. Outsiders 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.[84]

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

[83] Even here, however, the possibility of creditor control casts some shadow. Any step a manager (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.

[84] Indeed, more than half of all large Chapter 11s are sales. See Baird & Rasmussen, supra note x.

exercise their influence. The crucial question is the extent to which private lenders act in a way that is consistent with the interests of all the investors in the corporation. The lenders who wield control are typically also the most senior. Conventional wisdom suggests they have an incentive to steer companies away from risky projects, even when such projects promise to increase the value of the enterprise. 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.

The self-interested action of senior lenders that imposes the largest risks as a theoretical matter comes from the liquidation bias of senior lenders. 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 its way. Even if they do, the senior lender is likely to be as eager as anyone else to take advantage of them. Senior creditors now use the bankruptcy process to transform their debt into equity expeditiously. A prepackaged bankruptcy, lasting perhaps two months, can recapitalize the corporation. As long as the senior creditor anticipates this transformation, it effectively enjoys the long-term upside of the business and will therefore have no liquidation bias.[85] We see such dynamics in non-prepackaged

[85] The senior lender's control of the process can, of course, lead to plans of reorganization in which it gets a large share of the pie than it is otherwise entitled, but this exercise of power has, in the first instance, only distributional consequences. For an exploration of these dynamics, see Douglas G. Baird & Donald S. Bernstein, xxxxx.

cases as well. The lenders in Warnaco explored the possibility of a sale, but in the end decided to retain the core business.

When we survey the types of decisions that senior lenders make with the control rights they enjoy, most of them involve actions that work to the benefit of the creditors as a group. These include straightening out the books and putting in place managers who will shut down inefficient plants and otherwise put the business back on course. Most managers in 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 benefit.

A relatively new lending transaction reinforces the idea that senior lenders take actions that also advance the interests of those junior to them. In these transactions, 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 lien holders from opposing debtor-in-possession financing endorsed by the senior lien holders 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.[86] These instruments are issued by public companies and bought by hedge funds, private finance companies, and wealthy individuals. Sophisticated professionals investors are thus willing to acquire these “silent second liens” and bind themselves to wishes of the senior lender, even though they know that the senior

[86] See Howard Seife, *Silent Second Liens,* 121 Banking L.J. 771 (2004); *Completing the Capital Structure with a Second Lien Loan,* CapitalEyes, Bank of America Business Capital Newsletter (April 2003).

creditor's interests do not correspond with their own. These transactions show that the interests of the seniors are not necessarily averse to the interest of the juniors. Rational parties can find it in their mutual interest for senior creditors to call the shots in bad states of the world. Moreover, such transactions show that even at the time of the initial transaction when Chapter 11 is far away, parties pay attention to the way in which control rights will be exercised over the entire life cycle of the business.

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." In the absence of such a shift, 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 add 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. Indeed, *Credit Lyonnaise*, the case that put forward the idea of shifting fiduciary duties in the zone of insolvency, involved a dispute between creditors that wanted to enforce their control rights and a board that resisted. 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. To the extent that the law does work here, it is to ensure that directors pay attention when senior lenders air their concerns.[87] In the same vein,

[87] See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. Rev. 1009 (1997) (suggesting that the importance of Delaware case law is not that it imposes liability but rather that it establishes norms of behavior for directors).

the decline of lender liability may be a positive development, while the emergence of the tort of deepening insolvency way well not be. Those courts that refuse to apply equitable subordination when the lender is exercising the rights it has under it lending agreement should be applauded.

Finally, new corporate reforms that empower boards and make them more active and independent may improve corporate governance for a reason its advocates have yet to identify. The more sophisticated and sensible the board of directors, they more attuned they 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 understands 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.

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. Again, we use another Chapter 11 case to illustrate. TWA filed its first Chapter 11 petition in 1992 and its second in 1995. Even after these two attempts at restructuring, the outlook remained bleak for the nation's eighth largest airline. By early 2002, its managers concluded it could no longer survive on its own. American Airlines entered an agreement to buy TWA. Chapter 11 was chosen as the vehicle to implement the deal. The original terms of the agreement were that American would assume $3.5 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 provided the bankruptcy financing. It made a DIP loan of $200 million, at a rate of 10%.

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.[88] 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.

To be sure, the DIP loan/bid structure in TWA 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 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.

Other types of hazards can arise from creditor control, especially because of the private information they possess that outsiders do not. The potential costs associated with increased creditor control inside of bankruptcy and out, however, does not undermine the possibility that the lever of creditor control

[88] We see this pattern in other cases as well, such as the Chapter 11 proceedings of IT Group and Rhythms Communications.

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 them to scrutiny is a better strategy than attempting to vitiate creditor control across the board.

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. 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 it would bring the highest benefits to investors as a group. In the worst case scenario, such "reforms" might lead to the piecemeal sale of assets outside of bankruptcy.[89]

V. Conclusion

We view cautiously the new landscape in which creditor control has now become a significant lever of corporate governance. Inside the corporation, no

[89] Chapter 11 allows assets to be sold together and at the same time ensure 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 283 (3d Cir. 2003). 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.

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. Decisionmaking 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.[90] 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.

[90] The phrase "CRO" has yet to appear in a reported decision. The title "chief restructuring officer" first appeared in late 2000. There have been 17 references since, all but five in 2004. Casebooks lag even further behind.