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# **Corporate Governance, State-Contingent Control Rights, and Financial Distress**

Douglas G. Baird  
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**Corporate Governance, State-Contingent Control Rights,  
and Financial Distress**

*Douglas G. Baird\* & Robert K. Rasmussen\*\**

**Abstract**

The fundamental question a firm faces is how to deploy its assets. Traditional accounts of corporate governance focus on how various aspects of this decision are parceled out among the shareholders, the board of directors, and the managers. Creditors do not actively participate in governance and instead protect themselves through narrowly tailored default provisions and specific covenants. This account, however, is no longer apt. In recent years, creditors have learned to craft loan agreements that give them control rights, at least in bad states of the world. Creditors contract for these rights either before or even during the bankruptcy proceeding. When they get control prior to bankruptcy, creditors enjoy such powers as the right to hire and fire the CEO and other officers. They determine when large firms enter Chapter 11 and what happens to them while they are there. Other times, creditors seize control rights as part of the deal to finance the firm while in bankruptcy. At the limit, creditors can force the firm onto the auction block. This paper shows how the emergence of these control rights has dramatically altered the dynamics of corporate reorganizations.

Firms organize economic activity.<sup>1</sup> A firm's activity – both inside the firm

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and in the market – flows from a host of decisions, large and small. These range from how much to produce, to what price to charge, to whether to undertake a new project, to whether to change the firm’s business model to whether to remove assets from or add assets to the corporate structure. How these decisions are made and who makes them depends on the how the control rights over the firm’s assets are divvied up. Control rights include the deployment of human capital as well. Just as a machine that breaks down can be replaced, so can an employee or manager who is not performing adequately. Divisions can be sold; operations can be outsourced. Ultimately, control rights have to be arranged so that investors are willing to part with their money. Few would give money a firm without some legal or extra-legal reason to believe that a return will be forthcoming.<sup>2</sup>

Modern capital structures allocate control rights in a state contingent fashion. These rights are coherently allocated in the sense that those who have the power to make decisions about how the firm’s assets are those most likely to make those decisions sensibly.<sup>3</sup> To be sure, the contracts among investors are

<sup>1</sup> The benefits of the corporate form include the protection of investor assets from the creditors of the firm, and the protection of the firm’s assets from the creditors of the firm’s investors. See Henry Hansmann & Reinier Kraakman,

<sup>2</sup> A burgeoning literature explores the relationship between law and investment. Painting with a broad brush, investors are more willing to cede control to others in legal regimes that constrain opportunism.

<sup>3</sup> 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

never completely specified. Firms experience exogenous shocks. Technological and regulatory environments can change unexpectedly. New competitors can arrive on the scene. Circumstances can arise in which the people who make decisions about how the assets are used lack either the appropriate incentives or the necessary expertise. The Board of Directors may not find it in its own interest to accept a value-maximizing tender offer. The star CEO hired from another firm may not live up to expectations. Even though things do not always go as planned, it is still the case that modern investment contracts are typically the product of careful design.

Contracting over control rights occurs more often when the firm anticipates dramatic changes. For example, a venture capital firm invests only in a discrete part of the life cycle of a firm. 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 firm 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. The members of the firm face a high opportunity cost of continuing projects that will not produce a positive

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

return. It is thus not surprising that the venture capital firm is vested with the shutdown decision in bad states of the world.<sup>4</sup>

The investment contracts, of course, must specify precisely when the venture capitalist will acquire control over the firm. These contracts cannot detail every contingency that may arise. Hence, the challenge for contract drafters is to find suitable proxies. Control should shift where it is likely that the entrepreneur may be unduly biased toward continuation – either of the project or her role in it – and 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 firm has met cash-flow projections, produced a working prototype, or found a specified number of customers by a fixed date. The transfer of control, of course, does not mean that the firm will be shut down, only that the decision is placed in the hands of someone better positioned to make that decision.<sup>5</sup>

The coherence—or lack of coherence—of control rights has important implications for the law of corporate reorganizations. Fifteen years ago,

<sup>4</sup> See Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts 1–2* (Nat’l Bureau of Econ. Research, Working Paper No. 7660, Apr. 2000).

<sup>5</sup> 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.

managers of firms invoked Chapter 11 to retain control rights.<sup>6</sup> The general sentiment was that these managers, on the whole, were responsible for the firm's bankrupt state and not well suited to retain the control rights they exercised when the firm prospered. Nevertheless, Chapter 11 allowed them to postpone the day of reckoning. Times have changed. Large firms in financial distress today often exhibit a distinct configuration of control rights. As the fortunes of the firm decline, control rights often shift before bankruptcy to a subset of the firm's creditors. A single institutional lender or group of investors emerges that has a secured claim over all the assets of the firm. They are owed more than the firm is worth, and have the incentive to make decisions that maximizes the value of the firm.

The vehicle by which the lenders gain such control is a revolving credit facility. In exchange for the ability to get new cash, the firm pledges its assets, primarily its accounts receivables and inventory, to the lender. The firm is able to borrow from the facility based on a set formula. The firm can be required to go back to the lender on as frequent as a daily basis for cash. The lender, however, monitors the firm's progress and has the ability to decline to provide new funds in full or reduce the amount that the firm receives.

The de facto shift in corporate control that arises when a revolving credit facility is put in place has become a common feature of large firms in financial distress. The ability of institutional investors to gain control of firms in this fashion changes the negotiations that take place in the shadow of Chapter 11 and the dynamics of Chapter 11 itself.

<sup>6</sup> cites

To be sure, not every financially distressed firm ends up under the scrutiny of a revolving credit facility. Even when a firm’s capital structure prevents creditors from obtaining control prior to bankruptcy, they often can do so as soon as the bankruptcy proceeding begins. Debtor-in-possession financing agreements today contain terms that drive the Chapter 11 process. The managers must cede much of their discretion afforded by the Bankruptcy Code to those who are financing the reorganization proceeding. Creditors seek to end the proceeding quickly. The firm may be given one chance to turn operations around, or face the auction block.

Financial distress today sees creditors taking a larger role in corporate governance than is commonly understood. In this paper, we begin to take account of these changes.

### **I. The Dynamic Nature of Control Rights**

“Control rights” is a generic term that covers many decisions surrounding the activities of a firm. To illustrate how we are using the term, and the phenomena that we are interested in, it is helpful to start with two recent examples, one where creditors took control prior to the bankruptcy proceeding and one where they gained control immediately upon the bankruptcy filing.

Warnaco was a publicly traded Fortune 500 firm that filed for Chapter 11 in June 2001 and emerged in February 2003. Warnaco a decades old firm that manufactured and distributed intimate apparel, name-brand jeans, and swimwear.<sup>7</sup> A small group of investors acquired it in a leveraged buyout in the

<sup>7</sup> For a history of Warnaco, see website



late 1980s. Under the leadership of its hard-driving CEO, it shed debt, streamlined operations, and became an effective competitor in the marketplace. Warnaco became a publicly traded firm 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 firm's strategy. The board was neither independent nor terribly active.<sup>8</sup> The debt was spread across a number of different banks and it was unsecured.<sup>9</sup> The corporate governance of Warnaco—a firm run by a CEO and overseen by a Board of Directors—was like that of any other large firm.

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). Warnaco borrowed to repurchase its own stock. It also made a strategic decision to place more of its product in downscale retailers. This last decision led to a highly public fight with Calvin Klein, which objected to its

<sup>8</sup> It is worth noting, however, that Warnaco's corporate governance structure leading up to the institution of the secured credit facility was weak. The board of directors exercised control and the CEO ran the day-to-day operations. It had staggered boards. The CEO was the chair of the board and possessed a \$40 million golden parachute. Few of the directors were independent. Hence, we cannot assume that the creation of the facility was in fact efficient.

<sup>9</sup> 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).

product being sold in such venues. The ensuing litigation both threatened one of its most valuable licenses and publicized some of its marketing practices that undercut its image. 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.

Warnaco remained solvent. Although much lower than it had been, its stock was trading for several dollars a share. Sophisticated investors were still buying, as was the CEO.<sup>10</sup> At this point, however, decisionmaking at the firm changed dramatically, although in a way largely unnoted in conventional accounts of corporate governance. Warnaco's debt was restructured and the unsecured debt parceled out among 20 banks became folded into a revolving credit facility controlled by a handful of banks. 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 firm.

Not every firm that encounters financial distress sees the installation of a revolving credit facility. These facilities are normally put in place for firms that have a steady cash flow. Also, the firm has to have the ability to pledge sufficient collateral to assure those funding the facility that they will receive a return on their investment. When neither of these conditions exists, we see creditors

<sup>10</sup> We do not in fact see venture capitalist start-up ventures in bankruptcy, however. Such firms tend to have little debt in their capital structures. Ownership interests take the form of different flavors of equity.

gaining control of the firm via terms in debtor-in-possession financing.

United Airlines was the second largest airline in the world. With large size came large operational difficulties. During what turned out to be the last few months of the last economic boom, United granted industry-leading salaries to many of its employees.<sup>11</sup> It also had a fleet of airlines that contained a number of different models. This diversity led to higher labor costs and reduced flexibility in changing airplanes. United had a cost structure that allowed it to operate at a profit so long as the economy kept booming the way it had for the past few years.

Like other major carriers, many of the investors in United had security interests in particular planes or owned planes that they in turn leased to United. Other investors owned facilities (such as airport terminals) that were leased to United. These investors were dispersed and overlapping. Moreover, as the economic environment deteriorated, the value of the hard assets fell dramatically. Moreover, as other airlines also worked to shed excess capacity, the assets became more illiquid. Buyers for many of the assets simply did not exist, especially with respect to the older, less efficient aircraft, which were also highly customized and could not be readily used by other airlines. Control rights were not coherently allocated in the sense that no one had anticipated a set of economic conditions that would put these diverse investors in a situation in which they looked beyond the liquidation value of their collateral to the value of

<sup>11</sup> United granted a 23% increase to its pilots in October 2000. Its mechanics used this contract as a basis for insisting that these employees be granted comparable increases as well. In short, between 1998 and 2001, United labor costs measure on a per available seat basis increased by 26%, the highest in the industry. See Informational Brief of United Airlines at 22-25.

the firm as a going concern.

A confluence of factors put United (and all other airlines founded before deregulation) into economic and financial distress. Somewhat ironically, the technology revolution that led to the economic boom of the 1990s turned against United. The major airlines had long offered a myriad of prices for the same flight in an attempt to price discriminate among its passengers. The Internet introduced greater transparency into the pricing system. It became much easier for a would-be passenger to locate the cheapest available fare. Airlines lost some of their ability to extract the highest possible fare from large segments of its customers. In 1999, 41% of United's domestic passengers purchased unrestricted, premium fares. Two years later, that figure had fallen to 22%.<sup>12</sup>

United also faced competition from a new type of airline, the low cost carrier. These carriers, led by Southwest and including JetBlue and Air Trans, operate on a different business model than do the traditional mainline carriers. Their structure results in having a substantially lower cost. On routes where mainline carriers compete with low cost carriers, the mainline carriers have to reduce their prices to that of the low cost carrier in order to attract passengers. By the end of 2001, United competed with low cost carriers on over 70% of its routes.<sup>13</sup>

United's downward spiral began when the economy went into recession in 2001. This economic downturn resulted in substantial reduced travel by business travelers, on which United depended for a substantial portion of its income.

<sup>12</sup> Informational Brief at 39.

<sup>13</sup> Informational Brief at 43.

Added to the general economic troubles was the industry specific downturn caused by the September 11<sup>th</sup> terrorist attacks. By December 2002, United was losing more than \$20 million a day.<sup>14</sup>

United could not access the public credit markets. Its bonds had been lowered to junk status. It began to shop for lenders that would be willing to provide debtor-in-possession financing. While United was able to reach agreement with a consortium of lenders, the money did not come cheap. The lenders insisted on terms that were to be the engine that drove the reorganization process.

## **II. Creditors and Corporate Governance**

The traditional account of corporate law does not explain the shift in control rights that we see in Warnaco, United Airlines and other such cases. This account centers on the relationship between the shareholders and the firm.<sup>15</sup> The shareholders are the owners of the firm. They are the ones who are the first to gain if the firm does well and the first to lose if it does poorly. The law gives them the right to elect members of the board and the power to remove them. Major changes in the firm require their approval. The fiduciary duties of the board run to the shareholders. The major challenge we face in the case of publicly traded firms is the one Adolf Berle and Gardiner Means identified many decades ago: Ensuring that the separation of ownership control does not lead to

<sup>14</sup> Informational Brief at 9.

<sup>15</sup> Recent alternative accounts include focusing on the board of directors, see Bainbridge, and focusing on various constituents, see Blair & Stout.

abuse by the managers.<sup>16</sup> In the case of small firms, we worry about the rights of minority shareholders.<sup>17</sup>

In contrast to the shareholders, workers, lessors, and lenders do not participate in the governance of the firm in this country.<sup>18</sup> The firm is a distinct legal being with whom they must deal at arm's length. The board owes no duty to them beyond what they contract for. There are circumstances under which they can pursue stockholders for actions of the corporation, but the law of veil-piercing turns once again on the relationship between the shareholders and the firm.<sup>19</sup> Moreover, reaching the public shareholders of a large firm through such an action is a nonstarter. When the shareholders properly capitalize the firm and respect corporate forms, everyone else remains outside. Neither the unpaid supplier nor the tort victim have a say in what the firm does or how it conducts its affairs.

The law of corporations qualifies these ideas when the firm is in financial distress. If the firm is insolvent, the shareholders are no longer the sole residual

<sup>16</sup> Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* 51 (1932).

<sup>17</sup> See Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 228-52 (Harvard University Press 1991).

<sup>18</sup> This paper discusses how lenders can acquire control rights through contract. The same avenue is open to others as well. For a discussion of why we rarely see firms in which workers or others acquire these rights, see Henry Hansmann, *The Ownership of Enterprise* (Harvard University Press 1996).

<sup>19</sup> See Robert C. Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 *Harv. L. Rev.* 505 (1977); Robert B. Thompson, *Piercing the Veil: An Empirical Study*, 76 *Cornell L. Rev.* 1036 (1991).

owners. When there is not enough to pay the creditors in full, shareholders no longer stand to bear the full consequences from the decisions of the corporation. Hence, corporate law provides that the fiduciary duties of the directors shift when the firm is insolvent.<sup>20</sup> Moreover, the firm is no longer able to issue dividends.<sup>21</sup> Transfers of firm assets can be set aside when the firm does not receive reasonably equivalent value in return. When the firm is insolvent, the money flowing out of the firm belongs not to the shareholders, but rather the creditors.

Much of Chapter 11 follows a similar theme. In most cases, the same managers continue to run the firm.<sup>22</sup> The debtor is charged with running the firm and putting forward a plan of reorganization.<sup>23</sup> The automatic stay keeps creditors and others at a distance from the firm.<sup>24</sup> But the financial condition of the firm requires limits on the powers that those controlling the debtor would otherwise enjoy. The debtor in possession still decides whether to sell assets or borrow, but it cannot act outside the ordinary course without giving creditors

<sup>20</sup> See, e.g., *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No.Civ.A 12150, 1991 Del. Ch. LEXIS 215 (1991); *Angelo, Gordon & Co. v. Allied Riser Communs. Corp.*, 2002 Del. Ch. LEXIS 11 (Del. Ch. Jan. 30, 2002); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992); *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976–77 (4th Cir. 1982) (“[W]hen the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors.”).

<sup>21</sup> See, e.g., Model Business Corporation Act §6.40.

<sup>22</sup> See 11 U.S.C. 1107.

<sup>23</sup> See 11 U.S.C. 1107 & 1121.

<sup>24</sup> See 11 U.S.C. 362(a).

time to object.<sup>25</sup> Moreover, a creditor's committee can review the debtor's affairs. To the extent that the debtor uses cash collateral, it must ensure that the rights of the creditors are adequately protected. The substantive contours of the plan of reorganization must respect the absolute priority rule.<sup>26</sup>

Seen from this perspective, the problem of corporate governance in Chapter 11 is often one of asking what checks are necessary over the decisions of the debtor in possession, given that the firm is in financial distress. We need to reshape the obligations of the Board in light of the conditions in which the firm finds itself. Do we still have a business judgment rule? Under what conditions should the court approve a sale of assets under §363?<sup>27</sup> These questions may not

<sup>25</sup> See 11 U.S.C. 363(b) (requirement of court approval for use of assets outside of the ordinary course of business) & 11 U.S.C. 364 (debtor required to obtain court approval for obtaining credit outside of the ordinary course of business).

<sup>26</sup> See §1129(b). It should be noted, however, that as a matter of first principle a strong case can be made for adopting the rule of relative priority that was prevalent before Justice Douglas created the absolute priority rule (largely out of whole cloth) in *Case v. Los Angeles Lumber Products*, 308 U.S. 106 (1939). See Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 Va. L. Rev. 921 (2001).

<sup>27</sup> The Second Circuit set out a standard for the sale of a major asset under §363 in *Committee of Equity Security Holders v. Lionel Corporation*, 722 F.2d 1063 (2d Cir. 1983), where it found that a sale of a subsidiary could go forward in the face of an objection only if a “good business reason” justified the sale. *Id.* at 1071. The general standard put forth in *Lionel* has generated widespread approval. See, e.g., *Stephens Industries v. McClung*, 789 F.2d 386 (6th Cir. 1986); *In re Abbotts Dairies*, 788 F.2d 143 (3d Cir. 1986). *Lionel* is sometimes read to suggest that a sale of all the assets of a firm outside of a formal plan process is inappropriate. In modern Chapter 11 practice, however, sales of all the firm's



be easy to answer, but the basic inquiry, like the basic structure of Chapter 11, begins with traditional notions of corporate governance, one in which control over the affairs of the firm lie with the directors—and the shareholders are the ones who put them in their positions and have the power to remove them.<sup>28</sup> Creditors deal with the firm and its managers at arm's length.

The rapaciousness of creditors needs to be constrained. Left to their own devices, creditors have an incentive to grab assets from the firm. This narrow focus raises the potential of having creditors destroy much of the value that resides within the firm. Each creditor, protecting its own interest, will seek to get paid even if such repayment would lessen the total amount that would be available for all. Hence bankruptcy law has to restrain creditors and mediate their demands through the collective proceeding of bankruptcy to ensure that the assets of the firm are put to their highest valued use.<sup>29</sup>

This traditional account, however, oversimplifies matters in an important respect. Creditors can obtain control over a firm's governance through the

assets are permitted, as long as the bankruptcy judge is confident that the best price has been obtained and that the sale does not itself affects claims or rights or other matters properly left to the confirmation process. See *Licensing by Paolo v. Sinatra* (In re Gucci), 126 F. 3d 380 (2d Cir. 1997) (“A sale of a substantial part of a Chapter 11 estate may be conducted if a good business reason exists to support it”); *In re RSL COM Primecall, Inc.*, 2002 Bankr. LEXIS 367 (Bankr. S.D.N.Y. April 11, 2002).

<sup>28</sup> See David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 Va. L. Rev. 461 (1992).

<sup>29</sup> The classic work articulating this vision of bankruptcy law remains Thomas H. Jackson, *The Logic and Limits of Bankruptcy* (Harvard 1986).

covenants that they include in their loan agreements.<sup>30</sup> While this has always been possible, it has become increasingly important in recent years. Institutional investors especially reshape the debtor-creditor relationship to provide themselves with enhanced powers. Particularly when a firm is in financial distress (whether outside of bankruptcy or in), creditors (more specifically, the firm's principal institutional lenders) acquire for themselves a set of powers that gives them the ability to control the inner workings of the firm. Far from a scenario where the creditors have an incentive to destroy the firm through individual collection efforts, the creditors in essence gain a real option over the operations of the firm.<sup>31</sup>

#### A. Small Firms

The traditional account of corporate governance is most apt in small cases. About a third of all closely held firms have no institutional debt.<sup>32</sup> Their creditors consist of trade creditors, workers, and tax collectors. There is no elaborate agreement setting out the rights of these creditors. They must rely on their ability to keep the debtor on a short leash and take care that their exposure does not grow too large. If extra-legal avenues of relief fail, they must sue the firm just as they would sue a flesh-and-blood person. The few doctrines that protect

<sup>30</sup> Economists have long recognized the empirical importance of these covenants. See Clifford W. Smith, Jr. & Jerold B. Warner, On Financial Contracts and Optimal Capital Structure: An Analysis of Bond Covenants, 7 J. Fin. Econ. 117 (1979).

<sup>31</sup> For a further elaboration of this point, see Robert K. Rasmussen, Control Rights and Secured Creditor, -- Cardozo L. Rev. – (2004).

<sup>32</sup> See Michell A. Peterson & Raghuram G. Rajan Trade Credit: Theories and Evidence, 10 Review of Financial Studies, 661 (1997).

creditors who lack dickered agreements (such as a prohibition on dividends when the firm is insolvent and the ability to attack transfers for less than reasonably equivalent value) give them no power over the inner workings of the firm. The deal that the debtor strikes with landlords and equipment financiers focuses on the duties that the firm has with respect to the tenancy or the collateral. The principal remedy in both cases is the recovery of the asset in question.

The costs of finely tuning control rights for such firms are large, and these firms are generally not well positioned to weather unexpected change. One cannot assume that the control rights are sensibly allocated when the firm is in financial distress. Consider a building subcontractor who has been successful for many years that dramatically misestimates the costs of a large project. Suddenly, it cannot pay its suppliers, tax collectors, or employees. These creditors have the ability to sue, reduce their claim to judgment, and seize the assets of the firm. They have the ability to exercise control rights. But they are hardly in the same position as a venture capital firm or a large institutional lender. The question of removing the subcontractor and putting new management in place is simply not on the table. To the extent that the firm is worth more than assets that it holds, this value comes from the firm-specific efforts of the subcontractor. The firm should live or die depending on this value. This is a determination, however, this creditor has little experience in making. The small firm enters Chapter 11 because one of these creditors (whether it is a landlord, the tax collector, or the workers' union) is poised to seize the firm's assets under nonbankruptcy law.

Indeed, what distinguishes the handful of small firms in Chapter 11 from similar firms in financial distress that remain outside may be the way in which

control rights tend to be coherently allocated in the latter case, but not the former.<sup>33</sup> A firm that is financed completely by the manager and a close cadre of family and friends will be shut down when they decide that further investments of time and effort do not make sense. If the firm has a single institutional lender – its local bank – the bank can decide when enough is enough.<sup>34</sup> It is only when another creditor who is not adept at making these decisions arrives on the scene that Chapter 11 becomes a viable option. Many small firms enter bankruptcy and turn to the bankruptcy judge to make decisions about the fate of the firm. No one is positioned outside of bankruptcy to make the decision sensibly, but the bankruptcy judge may well be.<sup>35</sup>

When a firm enters Chapter 11 without a large institutional creditor—and many small firms do<sup>36</sup>—the process takes much the shape we expect. Here the basic rules such as the automatic stay, the debtor’s exclusivity period, and the

<sup>33</sup> A study of Chapter 11 cases filed in the Northern District of Illinois Eastern Division, in 1998 Ed Morrison and one of us (Baird) are doing provides some support for this conjecture. About 500,000 firms fail each year, but only 10,000 file for Chapter 11. Put more concretely, in the area the sample covers, hundreds of restaurants fail each year, but fewer than 20 end up in Chapter 11. Disputes with tax collectors, landlords, and victims of employment discrimination characterize the claims of the largest creditors, something that we might not see of restaurants that fail outside of bankruptcy.

<sup>34</sup> Data on number of firms with one lender.

<sup>35</sup> Edward Morrison has conjectured that make these decisions in a way that is consistent with the way a market actor would make the same decision. Morrison musters empirical support for his conjecture in Edward R. Morrison, *Bankruptcy Decisionmaking: An Empirical Study* (Nov. 2002) (manuscript, Columbia University).

<sup>36</sup> See Morrison, *supra* note ?.

absolute priority rule, dominate the landscape. In these cases, creditors have no role in corporate governance. Indeed, the creditors may play a small role in the case.<sup>37</sup> Often there is no creditors' committee. Trade creditors usually do not have enough at stake to exercise any serious control over the enterprise. The equipment financier is typically content to receive its regular installment payments. The landlord often figures large in the reorganization, but rarely will the landlord be pursuing some goal other than trying to shut the firm down and evicting the debtor from the premises.<sup>38</sup> The tax collector has little ability to influence the inner workings of the firm and rarely any inclination to do so. The challenge the law faces is these cases in once again one of ensuring that those who control the firm (who are typically the shareholders) behave responsibly given that gains and losses fall in the first instance on third parties, many of whom cannot protect themselves.

## B. Large Firms

The picture, however, is altogether different for firms like Warnaco that have an institutional lender (or frequently a consortium of lenders) that controls a revolving credit facility and has a first-priority lien over all of the firm's property.<sup>39</sup> Most importantly, the lender has a first position in the firm's account

<sup>37</sup> For an early recognition of this state of affairs, see Lynn M. LoPucki, *The Debtor in Full Control*, 57 Am. Bankr. L.J. 99 (1983).

<sup>38</sup> [Douglas, do you and Ed really find this in your study? Why is the equipment lessor willing to be satisfied with installment payments but the landlord not willing to be satisfied with rent payments?]

<sup>39</sup> Revolving credit facilities are most often seen in firms with significant cash flow. It is the ability to control the cash flow that is the prime attribute of

receivables. As these are collected, the funds go to the lender and not to the firm. Fresh money returns to the firm only if the lender decides that such a continued investment is warranted.

The presence of this institutional lender fundamentally alters corporate governance outside of bankruptcy and, if the firm's fortunes fail to improve, in bankruptcy as well. 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 firm 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 focusing on the performance of the firm and its discrete units are commonplace, as are general provisions that allow the lender to call the loan in the event of any material adverse change.

Several decades ago, institutional creditors could not exercise this much control. Before Article 9 was enacted, acquiring a security interest in all of a firm's property was hard.<sup>40</sup> Each type of collateral had its own legal regime. Moreover, courts viewed with suspicion omnibus clauses that picked up all of the debtor's property and provided no cushion for other creditors.<sup>41</sup> In many instances, secured lending was premised upon the creditor's ability to take the facility.

<sup>40</sup> See 1 Grant Gilmore, *Security Interests in Personal Property* 1-286 (Little, Brown 1965).

<sup>41</sup> See, e.g., *Benedict v. Ratner*, 268 U.S. 353 (1925).

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 firm's value as a going concern. Article 9 and especially revised Article 9 have made it possible for lenders to acquire all of a firm's assets.<sup>42</sup> The modern security interest effectively covers not only a firm'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 firm.<sup>43</sup>

Modern business practices also enhance a creditor's ability to control a firm. In many highly competitive industries, successful firms 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 acquire a valid security interest in all of a debtor's assets and ensure that all the cash coming into the firm and leaving it passes through its hands. By virtue of controlling the firm'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

<sup>42</sup> 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.”)

<sup>43</sup> 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).

are unique to the firm. 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 firm) than is 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.<sup>44</sup> Even then, repossessing collateral that is not cash threatens much of 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.<sup>45</sup> Cash, on the other hand, is worth just as much in the lenders' hands as is the debtor's.

Yet, turning off the cash is at some level too great a threat. Just as a secured creditor with a security interest in a machine could not credibly threaten to blow up the machine, a secured creditor with a security interest a firm's cash flow is unlikely to abruptly shut down the firm. Taking all the cash on hand today precludes future activity that would generate additional funds. Rather, the security interest here serves two roles. At times, it gives the creditor the ability to conduct a controlled liquidation of the firm. By limiting the amount of the advances, it can ensure that funds are only spent on liquidating the current

<sup>44</sup> See UCC 9-609.

<sup>45</sup> See Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 Mich. L. Rev. 159 (1997).



assets.<sup>46</sup>

The security interest, however, is also a way of ensuring that the institutional lender retains control. 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. It has to find a common understanding with the lender as to the future of the enterprise.

Institutional creditors do not routinely insist on these revolving credit facilities. Indeed, when the debtor finds itself in robust financial health, it will also 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. 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. Moreover, 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 and it needs a lender that must depend upon the value of the firm as a going concern in order to ensure repayment.

The loan agreements for these revolving credit facilities have evolved over

<sup>46</sup> Clark Supply

time, but the basic structure remains the same. The agreement sets out negative and affirmative covenants and defines events of default.<sup>47</sup> 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—information not available to ordinary shareholders.<sup>48</sup> Loan 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.” A default entitles the creditor to demand repayment of the loan and to take possession of all the assets of the firm.

A change in the underlying economy alters the relative position of the borrower and the lender in another way. Fifty years ago small firms were often indistinguishable from the owner-manager who ran the firm on a day-to-day basis.<sup>49</sup> A creditor could threaten to exercise its rights and exert control over the firm, 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 firm and extended credit on the basis of the firm’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 firm without the

<sup>47</sup> If a debtor insists on there being no covenants, the loan will be callable on demand. See GE Capital document

<sup>48</sup> 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).

<sup>49</sup> We see a similar structure in emerging economies such as Poland. See cite.

debtor's cooperation. Today fewer firms depend upon the firm-specific skills of the manager.<sup>50</sup> It is possible to bring in turnaround specialists to take over the firm and it is more possible to sell both large and small firms in the marketplace.

Institutional lenders now bargain for the implicit (and sometimes the explicit) power to change the managers.<sup>51</sup> 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 firm continues to fare badly, the banks may condition the waiver of loan covenants on the appointment of a CRO. Indeed, the Chapter 11 may take place only after the CRO has had a chance to straighten out the firm's operational problems of the firm have been fixed and the firm has settled on a plan to straighten out the firm's finances.

Return to Warnaco. By spring of 2001, Warnaco had resolved its litigation with Calvin Klein, but its financial performance was poor and its auditors sounded some ominous warnings. At this point, the banks insisted that Warnaco hire a turn-around specialist as a Chief Restructuring Officer. At least initially, this person would straighten out the finances of the firm 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

<sup>50</sup> We make this point in greater detail in Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 *Stan. L. Rev.* 651 (2002).

<sup>51</sup> 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.

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 most respected turnaround specialists in the country. 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.” 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.<sup>52</sup> 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 firm.

A creditor that exercises too much control exposes itself to various risks. Other creditors, for example, may seek to subordinate the claim of a 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. In recent years, however, courts have tended to affirm the right of the creditor to exercise the rights set out under its loan

<sup>52</sup> The firm’s web site is <http://www.alvarezandmarsal.com>.

agreement. As long as it cuts square corners, it has no duty to look out for the interests of other creditors. As the Fifth Circuit noted in *Smith v. Associates Commercial Corporation*, however, creditors acting within the scope of the ordinary powers given to them in their original loan agreements are safe:

[A] creditor is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim. . . . The permissible parameters of a creditor's efforts to seek collection from a debtor are generally those with respect to voidable preferences and fraudulent conveyances proscribed by the Bankruptcy Act; apart from these there is generally no objection to a creditor's using his bargaining position, including his ability to refuse to make further loans needed by the debtor, to improve the status of his existing claims.<sup>53</sup>

Some obligations arise not from legal status, but from control. A creditor that is too closely involved in a debtor's ongoing operations might find itself liable under CERCLA for environmental damage for which the debtor is responsible,<sup>54</sup> but creditors who do not actually participate in on-the-ground decisionmaking ordinarily find themselves within a statutory safe harbor.<sup>55</sup>

<sup>53</sup> 893 F.2d 693, 702 (5th Cir. 1990), quoting *Cosoff v. Rodman*, 699 F.2d 599, 609–10 (2d Cir. 1983). See also *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.”).

<sup>54</sup> *United States v. Fleet Factors*, 901 F.2d 1550 (11th Cir. 1990).

<sup>55</sup> As the court observed in *Monarch Tile, Inc. v. City of Florence*, 212 F.3d 1219, 1221 n.2 (11th Cir. 2000), “[w]hile much of *Fleet Factor's* reasoning and holding remain intact, Congress has abrogated the part of *Fleet Factors'* holding that deals with the liability of lenders who participate in the management of properties operated by polluting firms. *Fleet Factors* held that lenders and other

What are we to make of this state of affairs? Some agreements that take this form could be a good thing. Assume that we have a closely held firm with a single shareholder (or a small number of shareholders who act in concert). This shareholder shops around among competing financial institutions.<sup>56</sup> The revolving credit facility put in place displaces all the other outstanding extensions of credit to the firm. In such a case, there are no externalities. The parties to the agreement are bearing all its costs and enjoying its benefits. To be sure, the owner-manager may be entering into the agreement because she is an optimist. She is willing to cede so much power to the lender, because she is convinced that the firm's fortunes will turn and that the lender will be repaid and leave the scene before it has a chance to interfere with the firm. As a general matter, however, courts and other legal institutions have little ability to improve matters by trying to control excessive optimism here or elsewhere.

Matters are more complicated when a large, publicly held firm puts a revolving credit facility in place. Here, as elsewhere in corporate law, one has to be attentive for possible agency costs. Often the person negotiating the revolving credit facility has interests that do not correspond with those of the firm as a

parties who participated 'in the financial management of a facility to a degree indicating a capacity to influence the corporation's treatment of hazardous wastes' could be liable for cleaning up pollution created by an operator's activities. Largely in response to the perceived overbreadth of the *Fleet Factors* rule, Congress amended CERCLA in 1996, narrowing somewhat the sweep of lender liability under CERCLA. See, e.g., 42 U.S.C. §9601(F)(i)(II) (noting that the term 'participate in management' does not include 'merely having the capacity to influence . . . facility operations.')."

<sup>56</sup> Just as the Internet has brought transparency to the market for airline tickets, it is bringing transparency to the market for capital. For example, a company of any size can get a quote on a loan online from GE Capital.

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. For some creditors, the arrival of a revolving credit facility is a benefit. When a revolving credit facility comes into place, it is only because the firm is in trouble. Sure, the creditors would rather that the firm not be in financial distress, but this is not an option. The relevant comparison is whether the creditors as a group would do better from some other course of action, such as an earlier filing for Chapter 11. To the extent that the inflow of cash allows the firm to regain its competitive footing and avoid Chapter 11, all are better off.

But in many cases, a revolving credit facility merely puts off the day of reckoning. Dispersed bondholders or other holders of long-term obligations of the firm may be 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. Yet this may not be a cause for concern. After all, if the bondholders expected to be able to look to the assets that the firm has on hand, they could have either taken these assets as collateral or insisted on a negative pledge clause. Bondholders, however, recognize that they are not well situated to monitor the affairs of the debtor. If the firm reaches financial distress, the interests of bondholders may be better served by the actions of the institutional lender to maximize the value of the firm than they would be by the existing managers.

The revolving credit arrangement may also compromise the rights of the shareholders. They might be better off if the current management were removed. Even if the revolving credit facility may make it possible for existing managers to

be removed more quickly than they otherwise would have been, this removal comes at a cost. The new managers are going to focus on maximizing the recovery to the lender rather than to the shareholders. Indeed, the facility may be the first step toward a Chapter 11. Once in Chapter 11, the managers put in place by the lenders are less likely to cut a favorable deal for the shareholders than the replaced managers would have been. They may be more likely to sell the firm for cash, which will have the effect of wiping out the shareholders' investment, or proposing a plan of reorganization that gives little or nothing to the equity holders.

To say that there is a cost to shareholders, however, is not necessarily to say that there is a cost to social welfare. It is well known that managers of an insolvent firm that acted as faithful agents of the shareholders would have an incentive to invest in projects that benefit the shareholders but have a negative net present value. Whether or not the change of control rights that accompanies the arrival of revolving credit facility promotes social welfare depends on a host of factors. The more insolvent the firm, the more likely the lender will act like the residual claimant and maximize the overall value of the firm. Those making the decisions for the lender may prefer decisions that entail less risk.

But whether the revolving credit facility is a good or a bad thing, it undoubtedly changes the dynamics of Chapter 11. Indeed, the increase we have seen in the Chapter 11 filings of large firms over the past several years, even before the general worsening of the economy, reflects the control that the institutional lender has outside of bankruptcy. A firm will not find it in its interest to enter Chapter 11 without this creditor's blessing. This creditor often wants to use the bankruptcy process merely because it provides the best means



to sell its collateral free and clear of the claims of others. Chapter 11 is no longer a place where diverse creditors come together and collectively decide upon the future of the firm.<sup>57</sup> Moreover, the way in which those controlling the revolving credit agreements reappear as debtor-in-possession (“DIP”) financiers fundamentally alters the Chapter 11 process itself. We turn to it in the next Part.

### **III. DIP Lending and Creditor Control in Chapter 11**

Much of the dynamic of the bankruptcy proceeding turns on the need that the debtor has for financing once in Chapter 11. Many of the provisions we see in modern DIP lending agreements have been around for two decades. In the early 1980s when they first appeared, many bankruptcy judges might not scrutinize the provisions or understand them if they did. With the institutionalization of these various practices, however, has also come an increasing judicial awareness of them. The Southern District of New York has issued explicit guidelines for cash collateral and financing requests.<sup>58</sup> Bankruptcy judges refuse to approve financing orders unless the motion describes the debtor’s efforts to obtain financing and the basis on which the debtor believes that it has secured financing on the best terms available.<sup>59</sup>

The most common ways of exercising control through the DIP financing order (such as roll-ups, termination and default provisions) must be disclosed

<sup>57</sup> See Baird & Rasmussen

<sup>58</sup> See Guidelines for Financing Requests, General Order No. M-274 (Bank. S.D.N.Y. September 9, 2002).

<sup>59</sup> See *id.* at I.A.5.

conspicuously.<sup>60</sup> Courts typically may grant an interim order that protects the DIP lender to the extent of the new funds that it advances, but the broader powers await a final order that is not granted until a later hearing that ordinarily does not commence until the creditors committee has been formed and has a chance to review its provisions.<sup>61</sup>

The power that the DIP lender enjoys in the modern Chapter 11 is not gained from advantage-taking by the sophisticated against the weak and ignorant. The DIP financiers enjoy the protection that they do because other alternatives are not available. Given the security interests in place and given the unwillingness of bankruptcy judges to approve DIP financing orders that prime secured lenders, alternatives (other than the liquidation of the debtor) do not exist. When a senior lender is in place and is owed more than the value of the firm, the decisionmaking does not seem skewed. A case such as *Warnaco* suggests that the existing rules work well. If anything, the small return that the junior creditors received and the amount of time the old chief executive remained in place suggests that the existing rules still give too much power to people who are out of the money.

When the firm has a revolving credit facility in place and needs an additional infusion of cash, its options are limited. 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.

<sup>60</sup> *See id.* at II.A.2 & II.A.8.

<sup>61</sup> *See id.* at I.B.3. Judge Walsh suggests that even for a case on a fast track, the period to challenge the creditor's prepetition position should at least be 60 days from the time the committee is appointed. Walsh Letter ¶13

The next step no longer was in the hands of the managers or the board. The banks could shut down the firm instantly outside of bankruptcy if they choose to do so. [Can we get a copy of this agreement? What powers short of destruction did the lenders have?]

It might seem that the directors could hold off the banks by filing a Chapter 11 petition.<sup>62</sup> After all, a Chapter 11 filing would put in place an automatic stay. The banks would have to wait until a plan of reorganization was confirmed. Until then, they could insist only on adequate protection of the value of their collateral. The time value of their secured claims would not even be protected to the extent they were undersecured.<sup>63</sup> Indeed, the oft-repeated phrase, if not wisdom, holds that Chapter 11 is designed to give a breathing space to a firm 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. A postpetition lender would be easy to find if it could be given a security interest that primed the interest of the existing secured creditors and the Bankruptcy Code gives the judge the power to grant such liens.<sup>64</sup> But the statute imposes substantial hurdles, and modern bankruptcy judges rarely find that the debtor

<sup>62</sup> cite to stuff from the 1990s

<sup>63</sup> See Timbers

<sup>64</sup> See 11 U.S.C. §364(d)(1).

has surmounted them.<sup>65</sup>

Once a debtor cannot find anyone else to provide a cash infusion subject to the banks' lien, the banks occupy the driver's seat. They alone can provide the postpetition financing. A Chapter 11 makes sense for the firm only if it has their blessing. Moreover, they 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). For example, the latest generation of DIP financing agreements in the large cases provides that the prepetition creditor with a security interest in accounts "relends" to the debtor as the account turns over. Hence, it receives an administrative expense priority for the amount of the "new" loan (perhaps subject to a cap).<sup>66</sup> These are known as "roll-ups."

When adequate protection takes the form of administrative expense priority, the secured creditor insulates itself from the debtor's ability to cram down a plan.<sup>67</sup> By acquiring administrative expense priority for its prepetition claim, the prepetition creditor can insist on being paid in cash upon confirmation

<sup>65</sup> Look at DIP orders in Delaware and SDNY. A recent empirical study finds that for those firms where courts grant priming liens, they have a lower chance of reorganizing than when the DIP financing is done without a priming lien. See Maria Carpeto, *Does Debtor-in-possession Financing Add Value?*, draft Jan. 15, 2003

<sup>66</sup> See, e.g., Final Order (I) Authorizing Debtors in Possession to enter into Post-petition Credit Agreement etc. ¶13, *In re The Warnaco Group, Inc.* (Bankr. S.D.N.Y. 2001).

<sup>67</sup> Cite to Klee

of the plan.<sup>68</sup> With respect to this creditor, the debtor no longer has the power to cramdown a plan over its objections.<sup>69</sup> 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. Clauses such as these in “new technology” debtor-in-possession financing orders have the effect of transforming the rules in Chapter 11 as they appear in the Bankruptcy Code and reported decisions into something else entirely.

The DIP financing agreement will have many financial covenants, the violation of any of which give the DIP lender the ability to terminate the financing. The DIP financier can also control both how long the debtor takes to form a plan and the form the plan ultimately takes. The DIP financing agreement typically provides if a plan is not filed within a certain period of time.<sup>70</sup> Such a provision in the DIP financing agreement has the de facto effect of putting the decision about the length of the exclusivity period in the hands of the DIP financier rather than the court. Moreover, the DIP financing agreement can provide that the loan terminates if the debtor fails to arrange for a sale of some or all of its assets by a specific date.<sup>71</sup>

For example, the DIP lender in the Interliant reorganization included

<sup>68</sup> See 11 U.S.C. §1129(a)(9)(A).

<sup>69</sup> Blackletter bankruptcy law gives the debtor the power to propose a plan of reorganization over the objection of a class of creditors, if it complies with the absolute priority rule and the other requirements of 11 U.S.C. §1129(b).

<sup>70</sup> See Warnaco Revolving Credit Agreement §7.14.

<sup>71</sup> See Warnaco Revolving Credit Agreement §7.16.

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.” Given the difficulty of obtaining another DIP lender, the effect of these provisions (coupled with the DIP financier’s unwillingness to waive them) is to give the DIP financier 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.<sup>72</sup>

The DIP agreements can go even further. The DIP financing agreement in Warnaco, for example, gave the DIP lender a power of attorney.<sup>73</sup> 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.

Once the banks have this power, they do not need to invoke it to wield their influence. Creditors once had to demand the appointment of a trustee if they wanted to displace the management. Under modern Chapter 11 practice, however, DIP lenders can use their power to appoint new managers. Because

<sup>72</sup> See 11 U.S.C. §1121.

<sup>73</sup> See, e.g., Senior Secured Super-Priority Debtor in Possession Revolving Credit Agreement, In re Warnaco Group, Inc. §11.8 (June 11, 2001).

they can name them, they have no reason to ask the court to order the appointment of the trustee. In WorldCom, for example, the DIP lenders insisted on the appointment of a CRO from their list of three candidates.<sup>74</sup> Within a few months of the Chapter 11 filing, Warnaco's CEO was gone and the CRO took her place. 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 CEO was cut from a different cloth than his predecessor. His compensation and his future employment prospects turned, in no small part, to fix the firm and find someone to replace him.

Even in cases where there is no revolving credit agreement put in place before the bankruptcy petition is filed, it will often be the case that the Debtor has to cede substantial control to the lenders in order to obtain DIP financing. In United, no revolving credit facility was put in place. This was not because the managers wanted to remain free from the control of creditors; rather, it was because United did not have sufficient collateral to obtain a loan of the size it needed. United was unable to secure any substantial financing after September 11, 2001.

Before it filed for bankruptcy, United shopped around for DIP financing. There were few options. United was hemorrhaging money. It was losing in excess of ten million dollars a day. United received two bids to provide DIP

<sup>74</sup> See Carrick Mollenkamp & Henny Sender, WorldCom's Turnaround Team to Come from Creditors' List, Wall Street Journal B8 (July 24, 2002).

financing. It ultimately cobbled together a DIP financing package with a reported value of \$1.5 billion. In truth, little new money was put on the table. The DIP financing package consisted of two loans. The first was a \$300 million loan from Bank One. Bank One issued United's loyalty credit card that allows holders to accrue frequent flier miles based on the amount of purchased made with the card. Bank One purchased these miles from UAL Loyalty Services, the United subsidiary that operates United's frequent flier program. One of the conditions of the loan was that Bank One could apply any debt that it owes for miles against the DIP loan.<sup>75</sup> In effect, this \$300 million was simply an advanced purchase of miles by Bank One.<sup>76</sup>

The second DIP loan was provided by four lenders – JP Morgan Chase, Citicorp, CIT Group, and, again, Bank One. The total amount of this loan was \$1.2 billion. However, only \$500 million of this amount was available to United when it first filed for bankruptcy. The remaining amount would only be available after United's EBITDAR – earnings before interest, taxes, depreciation, amortization and restructuring costs – measured from the beginning of the bankruptcy case was positive. In other words, the second portion of the loan would only be available was United was cash-flow positive on an operational level.

Even the first \$500 million came with financial strings attached. The banks received a first lien on all of United's unencumbered assets, and a second

<sup>75</sup> See Bank One DIP at 9.

<sup>76</sup> [If we assume that Bank One pays 2 cents a mile, this would be the equivalent of 15 billion miles. Try to get data to estimate the amount of charges Bank One sees on its United cards]



position on all assets already pledged as collateral. The loan agreement also set forth stringent financial targets that, if not met, would put the loan in default. United could not sell assets worth more than \$5 million without the lenders' consent. It agreed to limits on its capital expenditures. It had to have at least \$200 million in cash and cash reserves on hand. Most prominently, targets were established for the cumulative EBITDAR starting from the beginning of the proceeding. These targets declined on a monthly basis. The cap began at losses of \$964 million by the end of February 2003, and required a positive total by the end of October 2003. Failure to hit these targets would put the loan in default.

United's DIP lenders do have an interest beyond the recovery of the amount it lends. BankOne's credit card business depends on its ability to award United frequent flier miles. J.P. Morgan has investments in United whose value depends in some measure on United's surviving as a going concern. At a first approximation, however, United's DIP financiers are interested in recovering the new money they extended at the time of the bankruptcy filing. The collateral they acquired (essentially all of United's unencumbered assets, including its lucrative Pacific routes for which it paid \$750 million) is enough to protect them as long as United's condition did not deteriorate beyond a specific point. In other words, United's DIP lenders made no investment in United as a going concern.

There was no need to replace current management; it had been brought in precisely to steer the firm through its financial distress. Indeed, United put in place a retention plan to insure that its senior management would stay on board during the reorganization proceeding.

The structure of the DIP financing arrangement sent a clear message. Unless the unions and the aircraft lessors agreed to substantial reductions in the

promises that they had extracted from United in good times, United was going on the auction block. The DIP lenders in essence gave United four months to shape up. If it had not begun to right its affairs by then, the game would be over.

This pressure succeeded. The unions agreed to substantial changes, both in work rules and wage rates. The pilots cut their wages by 30%, the machinists by 13%, and the flight attendants by 9%. United put the total labor savings at \$2.5 billion annually. United also renegotiated many of the lease obligations on its aircraft.

One can paint a positive picture of modern DIP financing. The banks that ran the revolver before the Chapter 11 may be well equipped to oversee the restructuring of the firm in bankruptcy. In many cases, this lender will know more about the firm and how it works than anyone else. It can monitor the firm on an ongoing basis. If the firm's fortunes have taken a dramatic turn for the worse, the firm's assets may no longer be enough to pay the institutional lender in full. Given the absolute priority rule, the other creditors and the shareholders are out of the money. The senior lender should be calling the shots. It is the one who stands to gain or lose from the decisions that are made.

Indeed, from this perspective, the deficiencies of existing Chapter 11 stem from the rents that the other players are still able to extract as a result of the powers that they enjoy under the Bankruptcy Code. In the case of Warnaco, the shareholders were wiped out completely, but unsecured creditors were given a 2.5% share of the stock of the reorganized firm. The banks that decide to use Chapter 11, however, may regard such distributions merely as part of the cost of using the bankruptcy process. Using the bankruptcy courts requires paying a toll, and the toll includes the professional fees of the debtor and the official

committees. These are typically “carved out” of the DIP loan.<sup>77</sup> The amount of stock that all the unsecured creditors received is in the same order of magnitude as the equity Warnaco’s CRO/CEO received (0.5%) as part of his compensation package.

We also see DIP financiers enjoy enormous power in environments where the firm does not have a senior lender in place at the time the firm files for Chapter 11. United’s DIP lenders put the issue of liquidation squarely on the table. The presence of the DIP financiers, however, introduces a liquidation bias only if no one is willing to buy out their position. If United defaulted on its loan, and the DIP lenders threatened liquidation, United could search for a new lender to buy out the old loan. As long as one is willing to entrust this decision to the marketplace, no inefficiency arises. We infer the presence of value that the firm has over and above the liquidation value of its assets from the existence of investors in the marketplace willing to pay a positive price for it. If, on the other hand, United cannot meet its targets and the assets of the firm are sold, this represents what happens to firms that cannot turn a profit.

#### **IV. Conclusion**

Decisions made in bankruptcy court correspond with the wishes of those who ultimately are entitled to the assets. One of the most important mechanisms

<sup>77</sup> See Richard B. Levin, *Almost all you Ever Wanted to Know About Carve Out*, 76 Am. Bankr. L.J. 445 (2002). Bankruptcy Judge Peter Walsh describes such carve outs as “the price of admission to the bankruptcy court.” See Letter of Peter J. Walsh, *Re: First Day DIP Financing Orders* ¶12 (April 2, 1998). The professional fees of creditors that are out of the money are sometimes included in the carve out as well.

that investors use is debtor-in-possession financing. The investors in control of a firm outside of bankruptcy commonly craft provisions in the debtor-in-possession financing orders to ensure that they remain in control even after the firm files for bankruptcy. Far from being a collective proceeding in which diverse owners meet to fix a common pool problem, large Chapter 11s now serve the interests of the investors who control the assets outside of bankruptcy. The firm may enter Chapter 11 as the behest of the senior lenders so that the bankruptcy judge can conduct an auction. The firm may enter Chapter 11 in order that a buyer of the firm can ensure that it will acquire clean title. In other cases, bond covenants of junior creditors may need to be rewritten and, given it is beyond the reach of the Trust Indenture Act, Chapter 11 may be the best place to do it.<sup>78</sup> In all these cases and others, the investors in control outside of bankruptcy use their ability to craft terms in the debtor-in-possession financing order to ensure that Chapter 11 follows the course that they have set for it.

The way in which creditors use loan covenants to control a firm in financial distress often fail to hit the radar screen of those who study corporate governance. They appear nowhere in the provisions of any statute. Moreover, the control rights that creditors enjoy are contingent. The creditor is often a sleeping giant. They do not exercise their powers often because they do not need to. Creditors can work their will without litigation. Even if creditors resort to legal process, it rarely ends in a reported decision. The violation of the covenant is not in doubt and the creditor, rather than seeking damages from the violation of the loan, calls the loan or exercises the other powers it has secured for itself. Rarely

<sup>78</sup> See Trust Indenture Act, 15 U.S.C. § 77ppp(b) (West 2002). Its importance is the theme of Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 Yale L.J. 232 (1987).

can the debtor or any other creditor litigate the case long enough to generate an appellate decision. The case becomes moot.<sup>79</sup> Nevertheless, the allocation of control rights is a central question of corporate governance both inside of bankruptcy and out.

<sup>79</sup> *In re Tempo Technology Corp.*, 202 Bankr. 363 (D. Del. 1996).