A Capital Market, Corporate Law Approach to Creditor Conduct

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Abstract

The problem of creditor conduct in distressed firms — for which policymakers ought to have the economically-sensible repositioning of the distressed firm as a central goal — has vexed courts for decades. Because courts have not come to coherent, stable doctrine to regulate creditor behavior and because they do not focus on using doctrine to facilitate the sensible repositioning of the distressed firm, social costs arise and those costs may be substantial. It's easy to see why developing a good rule here has been hard to achieve: A rule that facilitates creditor operational intervention going beyond ordinary collection on a defaulted loan can induce creditors to intervene perniciously, to shift value to themselves even at the price of mismanaging the debtor. But a rule that confines creditors to no more than collecting their debt can allow failed managers to continue mismanaging the distressed firm, with the only real alternative — the creditor — paralyzed by unclear and inconsistent judicial doctrine.

The doctrinal difficulty and the potential for creditor paralysis arise from inconsistent judicial doctrine. Some courts hold that it's the creditor's inequitable control of the debtor that is the characteristic that leads to creditor liability. Others rule that the creditor contract rights go beyond simply suing and collecting, fully allowing the creditor to condition its own forbearance from suing on the debtor complying with the creditor's wishes, even if the conditions are costly to the firm's other creditors. Worse for encouraging positive creditor engagement, the doctrinal standard via which courts shift from protected contract rights to perniciously-exercised control is obscure. Leading cases have the same basic facts, sometimes even the same court, but sharply differing results. Creditor control is the key doctrinal metric; but the creditor's goal is the better metric for judicial focus

Here we show, first, that there is often no on-the-ground, operational difference between these two standards — pernicious control and free-wheeling contract enforcement — and that this lack of sharp difference helps to explain why the judicial results are vexing, contradictory, and costly. We next show how similar problems are dealt with differently in corporate law settings — by courts evaluating the questioned transaction for business judgment deference to boards of directors . Then we show how putting a layer of basic corporate duties — entire fairness for conflicted transactions and business judgment rule deferential review for non-conflicted transactions — atop the creditor intervention doctrines clarifies the creditor in control problem and shows a conceptual way out from the problem. A safe harbor for creditors is plausible — if courts could reduce the extent of creditor conflict for critical decisions — and would both encourage constructive creditor intervention and discourage detrimental value-shifting creditor intervention. And then we show that modern financial markets yield a practical way out, using this corporate doctrine as the map: Modern capital markets' capacity to build options, credit default swaps, and contracts for equity calls provides new mechanisms that, when combined with the classic corporate doctrine overlay, can better inform courts and parties on how to evaluate and structure creditor entry into managerial decisionmaking. The capital markets and corporate doctrine combination can create a doctrinal conduit to better incentivize capital market players to improve distressed firms than the current doctrines regulating creditor conduct..

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INTRODUCTION

When firms fail, creditors seek to be repaid. Sometimes they do more than simply collect on their breached contract, taking control of the failing firm and dictating the firm's operating decisions and personnel choices, with the aim of ensuring that they will be repaid. When creditors do so, litigation can readily ensue, inside the eventual bankruptcy or before it, with other claimants on the firm asserting that the controlling creditor was liable to those other claimants, or to the firm, if the creditor ran the firm opportunistically, for its own benefit.

We later parse out differences in the more important of the doctrines governing credit conduct, but for now it suffices to understand two premises here that we demonstrate later, namely that, first, courts have treated substantially identical factual settings differently — holding creditors liable for a duty breach but absolving them for nearly identical actions under contractarian thinking — and, second, that the results and inconsistencies matter. They matter because when a firm fails, a large financial creditor is often the corporate player best positioned to make the needed operating and personnel decisions that will minimize the economic losses and reduce the chance that the firm goes bankrupt or closes up unnecessarily. But if (1) the creditor is sharply conflicted, then it cannot be trusted to maximize overall value, and (2) because the applicable doctrines governing a creditor's acts are both uncertain and not aimed at ameliorating the distressed firm's operational efficiency, the creditor's fear of being caught in an unfriendly legal framework may keep even a nonconflicted creditor well away from decisionmaking, for fear of ex post liability. If courts could find, as we believe they can, a doctrinal overlay that encourages constructive creditor engagement while discouraging value-diminishing engagement, it should articulate the doctrine for such a safe harbor.

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Thus we have a substantial economic problem that has not yet settled into a suitable legal framework, with the judicially-built framework that we do have generating both uncertainty and missed opportunities to restructure weakened firms. The uncertainty arises not just from disagreeing courts unable to settle on correct and consistent doctrine, but rather from foundational difficulties embedded in the distressed situation. Courts regularly indicate that creditors can enforce their contract without then bearing much excess fiduciary responsibility. When courts say that creditor enforcement of their contract is fair game, they typically thereby free the

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creditor from liability even if the creditor directs or influences the debtor's decisionmaking on operations and finances. Other courts indicate that the contract bars the creditor from controlling the debtor firm with impunity. When the creditor does take control (or as some courts put it, when it takes day-to-day control), it acquires concomitant fiduciary duties, as if it constituted the firm's board of directors — duties that typically lead the court to find creditor liability for unfairly furthering its own interests. When the court does so, it typically orders the controlling creditor's claims to be subordinated in bankruptcy to other creditors' claims, holds the creditor liable to the debtor or finds it liable to other creditors outside of bankruptcy.

One core doctrinal difficulty is that the doctrine does not seek to maximize total firm value. Rather, both doctrines regulate the fairness or the contractual appropriateness of the creditor's conduct, without a sharp view as to whether the doctrines would incentive better running of the debtor. A second core doctrinal difficulty is that a line separating legitimate contract and pernicious control, the two judicial positions, is difficult to draw. The two positions blur into one another, because creditor power, even the power to control the debtor, emanates from the loan contract.

Take many courts' focus on the creditor having day-to-day control (a characteristic inducing courts to hold the day-to-day controller liable): A creditor can enrich itself at the expense of other creditors by inducing a single debtor action; the creditor need not control the firm day-to-day, but can, say, force the liquidation of the firm's main factory on a single day, before and after which it does not control the debtor. Such a creditor may perniciously favor itself, but lack the day-to-day control that some courts look for as a predicate to creditor liability.

Other courts give creditors carte blanche to enforce their contract, countenancing creditors going beyond suing to collect, permitting creditors to instruct or influence the firm's operational decisions, sometimes at the expense of other players in the firm. If the debtor violates the loan contract in a way that readily allows the creditor to demand, and receive, repayment, it could forego repayment, but condition its waiver of the debtor's default if, but only if, the debtor agrees to a specified action. Courts that support such conditional contractual waivers will not second guess the creditor's leveraging of its contract into influence, or control.

That is, a creditor could want to enforce its contract via selective, conditional waivers that give it de facto day-to-day control and the ability to shift value to itself. It can leverage its weak position, in which the creditor would not be fully repaid, into a strong one, in which it is fully repaid. Courts often say that day-to-day control is pernicious, but that creditor self-protection via the contract is not. But the line separating pernicious creditor control from protected contract enforcement cannot be drawn precisely, or at all. Several court decisions illustrate why the judicially-prevailing control vs. contract dichotomy is a false one.

We then compare the doctrinal overlay for creditor conflict with the doctrinal overly for corporate board conflicts. One contribution of this paper is that we show how business law has two different doctrines governing substantially similar problem — one for board conflicts and decisionmaking and another for creditor conflicts and decisionmaking. We show how the doctrines are consistent in part and how they are not.

While the current control-based doctrinal dichotomy for creditor conduct is a dead-end in addressing the failing firm's operational and managerial difficulties, importing the corporate doctrines would allow courts to escape doctrinally and conceptually from the current creditor conduct predicament, in theory. For most of the 20th century, such a doctrinal transformation would have been theoretical, and not grounded in transactional reality, because the corporate doctrines require a minimally conflicted decisionmaker, a condition that could not be created in credit markets or under typical bank creditor regulation. But we shall show how these good results can now be achieved not just in theory but in transactional reality, by grafting modern capital markets instruments and institutions onto corporate doctrine.

Courts applying corporate law typically defer to boards of directors' business judgment in running their firm, as long as the directors are not financially conflicted in making that business judgment. If the board will, or could, profit from its business decisions, judicial deference to that board will not be forthcoming and courts will, in one major formulation, review the challenged transaction for its entire fairness. In corporate law, judicial doctrine has long aimed to make the board, or a board committee, a neutral, unbiased decisionmaker, without substantial conflicts of interest when making basic business decisions.

Creditor activities, decisions, and influence over the distressed firm resemble board-like strategic decisions. Courts could analyze creditor strategic actions in business judgment terms, as if the creditor had displaced the debtor's board of directors. But courts have had little reason to do so, because it's hard to see that the influential creditor could be anything but conflicted; as such the doctrinal detour would end in the same place: an entire-fairness style review, analyzing whether the creditor's conflicts justified creditor liability.

The creditor wants to be paid. It wants the firm run better and is often well-positioned to second-guess management of failed firms, but it's typically also prepared to induce the firm's managers to liquidate its core operations quickly in a fire sale, even one that destroys long-run value, if that liquidation pays the creditor in full but continued operation would risk that the firm declines further and the creditor left unpaid.

For the moment, let's just see how in the abstract the corporate law concepts could play out in the controlling creditor context: *Even if* courts determined that creditors' assuming board-like control of the debtor firm created corporate-style fiduciary duties running to the firm, its stockholders, and maybe its other creditors, courts would defer to the controlling creditor's business judgment in influencing the firm, if but only if this hypothetical creditor faced no substantial conflicts of interest when exercising that business judgment. The creditor-based standard would parallel the board-based business judgment rule.

The existence of creditors lacking such sharp conflicts would seem to be more hypothetical and theoretical than real, because creditors of distressed firms seem to be *always* conflicted. They want to realize their cash, they want to realize that cash now, not later, and they will destroy firm value to reach their core goal. Hence, the corporate law based approach would seem to be a real-world dead-end.

And, for a long time, searching for such a nonconflicted creditor would have been a real-world dead-end. The archetypal American lender, the bank, simply had to be in conflict with other creditors, with the debtor, and with the debtor's stockholders.

But modern capital markets allow us to make the business judgment possibility real. Our approach is to harness modern capital markets so that the creditor's self-interested biases come to closely parallel the total value of the corporation, with the creditor's slice of that value increasing or decreasing proportionately to value of the entire pie. It would still be deeply self-interested, with much money on the line. But if the creditor's primary goal is to see the firm better managed, it could willingly come under this doctrinal umbrella, which would lead courts to more willingly protect such properly incentivized creditors in the inevitable subsequent lawsuits.

Modern derivatives markets now make it possible for the lender, when involving itself in the firm's most basic strategic decisions, to acquire derivatives or options on the firm's other capital layers that would make it feel their economic and financial pain from loss due to, say, an unwarranted quick, fire-sale liquidation, while simultaneously allowing it to obtain their gains from a sound reorganization, if that was the best disposition of the firm. By offsetting the creditor's inherent conflict with an equal and opposite financial force, courts can reduce the dominant creditor's inherent conflict in the distressed situation, channeling the creditor's influence into enhancing firm value and away from shifting value from other claimants to itself. To the extent that the inherent conflict can be removed via modern capital markets instruments, the creditor's incentives approach that of a board seeking to maximize the firm's value, and, as it approaches those incentives, the court should, while staying alert to persisting conflicts, be more ready than we've previously thought possible to defer to the controlling creditor's business judgment.

Some creditors would be unwilling to pay the cost of taking up these other financial interests in the firm. But some would want the freedom to maneuver operationally in replacing management or inducing the distressed firm to change its strategic direction; such creditors could be willing to pay the costs of taking up these incentivizing financial instruments so as to avoid being second-guessed later by the court if and when the firm's other creditors sue that creditor. Those that did pay would be buying more room to affect firm mismanagement than otherwise, by acquiring a higher level of business judgment deference in the subsequent lawsuits. For creditors unwilling to pay that cost to acquire the safe harbor, the current over-inclusive and under-inclusive lender liability doctrines would continue to govern judicial assessment of their actions.

The Holy Grail of much corporate law is to find a key decisionmaker who is both incentivized and not conflicted. Courts prefer the combination of incentives without conflict, but will accept one of the two, if that's the best can be done. Thus, nonconflicted boards, even if poorly incentivized, receive business judgment deference from courts. Here we put forward the reasons why current creditor-in-control doctrine gets us neither strong creditor incentives for improving the firm nor low conflicts of interest, despite that modern capital markets can, if harnessed with the correct judicial doctrinal overlay, move us closer to that Holy Grail of incentivized, nonconflicted decisionmaking for a wide range of vital business and financial transactions.

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A road-map for this article: In Part I, we define the problem, showing that as a factual matter, courts have long had, and still have, deep difficulties in distinguishing creditor day-to-day control (which typically leads to liability) from creditor invocation and enforcement of their own contract (which typically does not). We show that judicial doctrine has not focused on an operational goal of turning around otherwise viable firms and repositioning the nonviable ones quickly. We show that the long-standing contradictions in the judicial opinions, we show their continuing instability in recent years following the 2008–2009 financial crisis, and we show why no doctrinal solution emanating from current analysis is viable for real-world decisionmaking.

We also show in Part I the importance of getting the judicial framework for creditor intervention right. While policymakers should not want conflicted creditors running failed firms, they also should not want failed management to continue in place, mismanaging the debtor firm, while astute but fearful creditors watch passively, sitting idly on the sidelines. Nor should policymakers want a controlling creditor to put new people in place in the failing firm, one who would overly favor its own narrow interest at the expense of others in the firm and overall value maximization. Until now, policymakers have either traded off one cost for the other, without any real capacity to simultaneously reduce creditor bias and induce better firm management, or ignored ameliorating firm management as a primary goal for the doctrinal overlay here. There seemed to be no way that would keep sharply conflicted creditors away from firm management while at the same time make it easy for creditors without strong conflicts to influence critical decisionmaking in the distressed firm.

In Part II, we show that basic corporate law faces a similar problem of judicial review of boards of directors' decisions. Corporate law, however, uses contrasting doctrines, which point to a conceptual way out from the creditor-in-control dilemma. The dominant form of judicial review of board decisionmaking is business judgment deference, if, but only if, the directors were not financially conflicted in their decisionmaking. If conflicted, the court will not give the board business judgment deference and will examine the entire fairness of the challenged transactions. In concept, many courts reviewing *creditor* action typically jump right to a sort of entire fairness review, because the creditor's conflicts were just too deep, extensive, and obvious. The courts need hardly have stopped to assess whether business judgment review and deference would have been plausible, because it's so hard to imagine that it could be. But the business judgment concept nevertheless is conceptually available: *if* one could replicate the nonconflicted board in the creditor's profile, then courts could encourage constructive creditor engagement with the failing firm.

In Parts III and IV, we show how capital structure decisions could reduce those creditor conflicts to a manageable magnitude, allowing courts to consider business judgment deference. We show in Part III how old-style capital market decisions — give the bank syndicate leader stock to offset its credit position — were theoretically possible but both practically difficult and legally impossible under American bank regulation, with elements seen as appearing in the classic Japanese main bank system in ways that would have been difficult or impossible to emerge in the United States. But then in Part IV we show how modern derivatives and options, as well as the rise of new institutional lenders beyond traditional banks, now make this scenario viable.

Thus, we show for the first time, layering corporate law doctrine atop creditor law (in and out of bankruptcy) points to a doctrinal, theoretical way out from the basic contradictions in the doctrines governing creditor conduct. The doctrinal overlay could provide a safe harbor that would lead to some creditors being unconflicted (or less conflicted) by holding proportionate interests in the conflicted capital layers. We then show, again for the first time, that modern capital markets now have both the instruments and the financial players in place that could yield a practical way to turn doctrine and theory into on-the-ground, operational reality. Now is the time for judicial doctrine to emerge that could harness these instruments and financial players to better business ends.

I. THE PROBLEM

The economic problem is this: Failing firms can often enough be turned around, but often the firm's own inside managers and directors are not the ones best fit to turn it around. Outside creditors will often simply seek to collect whatever they can and then exit the firm. Yet, sometimes major creditors are well-positioned to assess the distressed firm's managerial capacity and business model, believe that a differently managed firm would be worth more for all, and want to influence or replace the firm's management. They may want to influence or replace management, because they want to maximize their own recovery. But the judicial doctrinal overlay sitting atop this business problem is not well-constructed to encourage functional creditor conduct. Some well-motivated creditors will be deterred from acting, influencing, and controlling due to the doctrinal uncertainties by which their conduct will be measured.

Sometimes courts analyze these creditor-in-control situations under doctrines of good faith, sometimes under doctrines of instrumentality or alter ego, sometimes as a newly-created agency relationship (under which a controlling lender is seen to be the debtor's principal, responsible for its agent's wrongs), sometimes under bankruptcy equitable subordination doctrines, sometimes via fiduciary duties (that arise from the creditor becoming a de facto or de jure director or controlling shareholder of the failing firm). Other times the situations are analyzed under newer tort doctrines of liability for facilitating a deepening insolvency of the firm;

sometimes they are analyzed in terms of gap-filling of the creditor's contract with the debtor-firm and its other creditors.

The overall doctrinal problem is this: Courts dealing with activist creditors in troubled firms often say both that: (1) creditors who take day-to-day control of their debtor assume board-like duties to the firm's stockholders and its other creditors,[1] and that (2) creditors can enforce their loan agreement to protect their own interests. These contradictory standards for judicial decisionmaking confuse creditors and firms, and disable creditors' counsel from being able to well-advise potentially powerful creditors, because the two standards merge and overlap, but lead to opposite outcomes. A creditor may lack day-to-day control, but can pressure the debtor to favor the influential creditor over the debtor's other creditors. The self-interested pressure can induce a single but powerful debtor decision, or the debtor's managers may feel creditor pressure that's short of full creditor control, but which influences outcomes day-to-day, from decision-to-decision. Yet one standard focuses on the differences between day-to-day control, which the standard locates as pernicious, and control that is intermittent and in the nature of influence, which the standard deems to be innocent. Conversely, a creditor may take day-to-day control, directly or by putting a new management team in place, but do so to run the firm more efficiently than failed incumbent management; the controlling creditor may never opportunistically favor itself over the firm's other creditors, but seek only to maximize firm value (which it expects will allow it to be repaid). But with day-to-day control, it puts itself at legal risk.

The analogous contractarian thinking is here no better in inducing value enhancing creditor incentives. The creditor might go beyond suing and collecting on its contract, using its contract to protect its interests by waiving the debtor's loan covenant defaults daily, based on whether the debtor is recovering its economic well-being (which could be good for all creditors) — for example, by reducing unnecessary expenses and removing unsuitable managers — or based on whether the debtor is enriching the favored creditor each day at the expense of other creditors, such as by converting free, unsecured inventory into accounts receivable pledged to the lender as security. Some contractarian courts say that leveraging the contract into such influence does not entail controlling the corporation, its management, and its operations.

The doctrinal situation is thus contradictory. And getting the rules here right can make an acute operational difference. When a firm fails, it often takes time to replace incumbent management, often requiring a costly bankruptcy to oust incumbent management;[2] creditors may be better positioned than the board and the

[1] E.g., In re Badger Freightways, Inc., 106 B.R. 971, 977 (Bankr. N. D. Ill. 1989) (if the lending institution usurps the power to make business decisions from the customer's board of directors or officers, then it must also undertake the fiduciary obligations that officers and directors owe the corporation"); In re Beverages Intern. Ltd., 50 B.R. 273, 282 (Bankr. D. Mass.1985) ("Where a creditor has taken control of the debtor, he assumes the fiduciary duties of management and a duty to deal fairly with other creditors.").

[2] On the costs of bankruptcy, see Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 10067 (1984); Lawrence Summers & David Cutler, *Texaco and Pennzoil Both Lost Big*, N.Y. TIMES, 14, 1988, at 3; Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990); Ben Branch, *The Costs of*

firm's stockholders to do so efficaciously and quickly, and creditors are sometimes even less conflicted in their decisionmaking than the incumbent managers. Or sometimes a firm could be run most efficiently if a motivated outsider evaluated whether incumbent management is the right team to handle the firm's problems or whether it needs to be replaced. A powerful creditor could know what to do and have the incentive to do it correctly, but if judicial doctrine is uncertain and creditor liability potentially substantial, the creditor could avoid decisions, interventions, and pressure that could tag it with liability. It collects its loan as best it can via the normal machinery of demands and lawsuits, but does nothing more to influence the firm's decisionmaking or the identity of its decisionmakers. Yet, if the rules against creditor intervention are too weak (e.g., if every creditor intervention colorably connected to the creditor's loan agreement were fair game for creditor action), then excessive creditor intervention of the wrong kind could induce inefficient shut-downs and excessive value shifts to the favored creditor, such that others are unwilling to deal with the failing firm, out of fear that the controlling creditor will be excessively favored.

A. The Doctrinal Problems: Creditor Control vs. Creditor Self-Protection via Its Contract

To see how unedifying the doctrinal distinctions governing an activist creditor are either in providing useful guidance or in addressing the operational difficulties of a distressed firm, consider three pairings of cases: *American Lumber* and *WT Grant*; *Clark Pipe & Supply I* and *Clark Pipe & Supply II*; and *American Consol* and *Busy Bee*.

The first pairing of *American Lumber* and *WT Grant* juxtaposes the modern judicial classics covering creditor conduct and equitable subordination, with the court in each case dealing with substantially similar facts to equitably subordinate — sending the offending creditor to end of the creditor queue, to be paid last, if the debtor had any value left when the bankruptcy process came to that last creditor — the creditor in the first instance but to extol the virtue of creditor self-protection via its loan agreement in the second. The second pairing is the extraordinary *Clark Pipe & Supply* sequence, in which the court examined the facts on one day and concluded that the creditor had perniciously taken control, thereby justifying the creditor's equitable subordination. And then, on another day, the same court — indeed, the same panel — looked again at those facts, but concluded that the creditor had only protected itself on its contract, nothing more, and as such was free from liability. The last pairing, of *American Consol* and *Busy Bee*, shows that these contradictions — similar facts, different outcomes — continue today.

1. American Lumber v. WT Grant. In *American Lumber*, a lender controlled all aspects of the finances and operations of the debtor lumber company, to the

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Bankruptcy. A Review, 11 INT'L REV. FIN. ANAL. 39 (2002); Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 61 J. FIN. 1253 (2006).

detriment of the firm's unsecured creditors.[3] The court found that the bank had undertaken "a course of liquidation that was designed solely to preempt from general unsecured creditors any portion of the value of the inventory and equipment of [American Lumber] and to [t]hereby enhance the value of [the bank's] previously existing security interest in the accounts receivable and contract rights of" the debtor.[4] The bank therefore had breached its fiduciary duty to the other creditors and the court equitably subordinated the bank's claims to the other creditors' claims.[5] The decision became a disdained cause célèbre among large institutional creditors and their legal counsel.[6]

A few years later, in *W.T. Grant*,[7] the U.S. Court of Appeals for the Second Circuit confirmed a bankruptcy litigation settlement, notwithstanding the opposition of some bondholders asking for the equitable subordination of the bankrupt firm's major secured bank lenders. The plaintiff bondholders asserted that a pool of banks manipulated the debtor by forcing it to enter into security agreements favoring the banking pool and refusing to make further loans to the debtor until the debtor executed new security agreements that benefited the banks. When Grant management sought to buy back the bonds at a low price, in a perhaps misguided effort to clean up its balance sheet, the banks prevented Grant from doing so.[8]

The court rejected the dissenting bondholders' view, concluding that a "creditor is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim . . . . [A] creditor[can] us[e] his bargaining position, including his ability to refuse to make further loans needed by the debtor, to improve the status of his existing claims."[9] Said the Court: To establish creditor liability, it's not enough to show that "the banks kept careful watch on what was going on at Grant. . . . [T]he appellants must show not simply that the banks proffered advice to Grant that was unpalatable to management, even advice gloved with an implicit threat that, unless it were taken, further loans would not be forthcoming. They must show at least that the banks acted solely for their own benefit . . . and adversely to the interest of others."[10]

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[3] See In re American Lumber Co., 5 B.R. 470 (Bankr. D. Minn. 1980). The bank's control over the debtor's affairs included its taking possession of the debtor's plants, requiring approval for any payment to other creditors, reducing the salaries of the principals, and hiring and firing of employees. The bank also misrepresented the debtor's financial condition to potential suppliers.

[4] *Id.* at 477.

[5] *Id.* at 478. In its defense, the bank "argue[d] that subordination will cause members of the financial community to feel that they cannot give financial assistance to failing companies, but must instead foreclose on their security interests and collect debts swiftly, not leaving any chance for survival, [however] the Court [was] singularly unimpressed."

[6] Helen D. Chaitman, *The Equitable Subordination of Bank Claims*, 39 BUS. LAW. 1561, 1569-1571 (1984); Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 436-41 (1985); Jeremy W. Dickens, *Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of "Control,"* 65 TEX. L. REV. 801, 827-29 (1987); Werner F. Ebke & James R. Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 SW. L.J. 775, 794-95 (1986).

[7] In re W.T. Grant Co., 699 F.2d 599 (2d Cir.1983).

[8] *Id.* at 611.

[9] *Id.* at 609-10.

[10] *Id.* at 610-11.

One might be tempted to distinguish *American Lumber* from *W.T. Grant* by viewing the former as the lender actively directing the debtor's liquidation, while in the latter the banks just provided advice "gloved with an implicit threat," as the court said.[11] Two reasons suggest why such a distinction is unsound. First, advice gloved with an implicit threat can be used to control the debtor. Advice from a creditor who can induce a bankruptcy or shut down the debtor firm is more than gratuitous advice that the debtor will feel free to ignore. Indeed, the giver of such advice, if it's a large creditor with a loan agreement in default, can de facto control the creditor.

What then separates control from gratuitous advice, if the debtor is in default under a major loan from that creditor, a creditor that the debtor cannot afford to offend? The distinction between advice and control becomes one of poise, manners, and the effectiveness of the creditor's lawyers in conveying the creditor's threat and its consequences, but doing so politely and without explicitly directing the debtor, just pointing out the consequences of the debtor's choice of actions.

Moreover, as the next pairing of cases will show, a creditor could conduct a controlled liquidation of the corporation without assuming an actively and explicitly controlling position, for example by limiting the size of its advances.

2. Clark Pipe & Supply I v. Clark Pipe & Supply II. Clark Pipe and Supply Company Inc. was in the business of buying and selling oil pipe. When its business deteriorated, its main creditor, a finance company, reduced its advances to Clark, leaving the debtor with just enough money to keep its doors open and sell the inventory. The finance company knew that the debtor's bankruptcy was inevitable and used the advances "to leverage its recovery at the expense of other creditors." It improved its recovery at the expense of other creditors, because "[e]very time Clark sold pipe, [the finance company obtained the resulting account receivable as security, which] improved its position to the detriment of the vendor."[12] In the debtor-creditor vernacular, the dominating creditor used its influence to induce the debtor to feed the lien, moving value from where it lacked a security interest into assets that the creditor could seize as security, thereby getting more value out of the enterprise, at the expense of the firm's unsecured creditors.

The Fifth Circuit Court of Appeals held for the other creditors, concluding that "Clark was an instrumentality of [the creditor] for the limited purpose of equitable subordination."[13] The court viewed the creditor as controlling the debtor and running the debtor for its own benefit.

But then came an extraordinary reversal. The court treated a further motion from the losing party as a petition to rehear the case. The same panel reheard the case and reversed itself. The panel, which had condemned the creditor's control only weeks before, took a contractarian approach and exonerated it: "[t]hrough its loan agreement, every lender effectively exercises 'control' over its borrower to some degree."[14] Control is not the touchstone for liability, it said. The creditor could protect its rights under the contract, even by facilitating a slow liquidation of the

[11] *Id*. at 610.

[12] In re Clark Pipe & Supply Co., Inc., 870 F.2d 1022, 1029-30 (5th Cir. 1989).

[13] *Id.* at 1030.

[14] In re Clark Pipe & Supply Co., Inc., 893 F.2d 693, 701 (5th Cir. 1990) (rehearing).

debtor. The creditor "was not a fiduciary of Clark, it did not exert improper control over Clark's financial affairs, and it did not act inequitably in exercising its rights under its loan agreement with Clark."[15]

In such a doctrinal setting, where the same appellate panel views the facts on one day as supporting creditor liability and views those same facts on another day as just a creditor enforcing its contract, it becomes hard for creditors to know when they are crossing, or even when they approaching, a liability line.

3. Busy Bee v. American Consol. Lest the reader conclude that these two pairings were decades-old doctrinal mishaps that have since been resolved, consider the recent *Busy Bee* and *American Consol* decisions. In the first, *Busy Bee*,[16] a Pennsylvania court in 2006 examined a lender's influence over a borrower. The court said that a "confidential or fiduciary relationship" arose "if the lender gains substantial control over the borrower's business affairs by compelling the borrower to engage in unusual transactions or by becoming involved in the actual day-to-day operations of the borrower."[17] Indeed, the offended parties showed that "the Bank compelled [the debtor] to . . . abandon [one] strategy and . . . liquidat[e] . . . its retail business. The Bank also became involved with the [debtor's] day-to-day operations by, inter alia, directing [management] to retain [a particular entity to serve] as a liquidation consultant."[18] Hence, "the Bank assumed a fiduciary responsibility . . . ."[19]

Soon thereafter, the Illinois courts faced similar facts,[20] but used a contractarian analytic to conclude that pernicious "control is not established when a lender insists on standard loan agreement restrictions, closely monitors the borrower's finances, and makes business recommendations, even if in the context of heated negotiations . . . . Nor is pernicious control established when a borrower hires a management or restructuring consultant selected by the lender."[21] The creditor may well have controlled the debtor, because managers felt compelled to follow the creditor's goals, but, since the creditor exercised that influence and control through its loan contract, that control was not sufficiently pernicious to lead to liability. Management could have rejected the insistent creditor's efforts, but then would have faced the creditor's rights under the loan agreement. Although the debtor complained that "the Bank forced it to enter into [new loan terms] after the Bank declared [the debtor] in default" and although the Bank forced it "to take steps towards selling the business . . . even though [the debtor] wanted to remain in business . . ., none of these actions [perniciously] usurped managerial control from the [debtor's] directors… ."[22]

[15] *Id.* at 702. While the surface interpretation is that the judges looked at the same evidence and changed their minds, it's at least possible that the possibility of the rehearing en banc, perhaps with in-chambers indications of judicial disagreement, induced the original panel to reexamine their earlier thinking.

[16] Busy Bee, Inc. v. Wachovia Bank, N.A., 2006 Pa. Dist. & Cnty. Dec. LEXIS 238 (Pa. C.P. Feb. 28, 2006).

[17] *Id.* at 23.

[18] *Id.* at 22.

[19] *Id.* at 23.

[20] In re American Consol. Transp. Companies, Inc., 433 B.R. 242 (Bankr. N.D. Ill. 2010).

[21] *Id.* at 254.

[22] *Id*.

Bottom line contrasts: In both *Busy Bee* and *American Consol*, the lenders: (1) required the debtor to hire the creditor's preferred restructuring consultant and (2) forced the liquidation of a major part of the debtor's business over the debtor's objections. These were the core facts on controlling creditor liability in both cases, but the *Busy Bee* court held the creditor liable and the *American Consol* court did not.[23]

4. Objective facts v. eye-of-the-beholder. The current doctrines put a premium on creditors being well-behaved, on conforming to shared norms of permissible creditor action, particularly if the deciding court shares those commercial norms. Contrast creditor demeanor in two settings. In the first, the creditor, facing a debtor in default under the loan agreement, demands that the debtor take certain actions. It might demand that the debtor close down a weak factory. It might demand that the board change senior management, hiring the creditor's preferred turnaround firm. Perhaps in negotiations the aggressive creditor slams the conference room table, telling the debtor's management that they're working for the creditor now and they'd better do what the creditor thinks makes business sense. This creditor is at risk, in some courts, of being seen to have taken control of the debtor, managing it, and assuming fiduciary duties to the debtor's other creditors or to the debtor itself.

In the second setting, the creditor, faced with a similar debtor default, makes no demands. Instead, it offers the debtor some observations. It tells the debtor: "You're in default under the loan agreement. We haven't decided yet whether to accelerate, demand repayment in full, and thereby, most likely, induce you to file for bankruptcy. But we will tell you that we'd feel a lot better if you closed down the weak factory. And, we've been in workout situations before. We feel very comfortable working with the people at Turnaround Team X and Consulting Firm Y. We're not telling you what to do, we're not telling you that you must close down that money-losing factory, we're not even telling you with certainty what we will do under the loan agreement, because we haven't decided. But we do want you to know that you have some options here, as there are operational decisions that might salvage a good part of the firm's operations and there are professionals with whom we'd go the extra mile to avoid a bankruptcy."

One set of courts is more likely to interpret the second scenario as not entailing pernicious control, but as simple advice. Those courts might well understand that the arms-length advice comes via a velvet glove wrapped around the loan agreement fist, as the *WT Grant* court suggested. But they could see this advice as appropriate input from an interested creditor, who might offer the advice while reminding the debtor that it is in default under the contract. Such courts could see that advice as not entailing the wrongful, pernicious control that would expose the lender to liability.

But from where does the lender's power come to have its advice be taken seriously by the debtor? It doesn't come from an inherent capacity to control and direct the enterprise — it does not own and vote the company's stock. The doctrinal difficulty is that the lender's power — to have its advice taken or to dictate debtor

[23] *Busy Bee* also involved creditor fraud, which perhaps influenced the court when making its overall decision, but that fraud was not part of its creditor-in-control liability rationale.

actions — comes from its loan agreement and the resulting remedies it would have if the debtor defaults under the loan contract. Polite creditors have enormous leverage over their debtor, making the debtor listen attentively to the creditor's suggestions and, quite likely when the debtor is in default, follow them. They can make an offer, or give advice, that the debtor will not refuse. And, symmetrically, the debtor can tell the impolite, tougher, bullying creditors that seek control of the debtor's operations that their demands will not be followed; the debtor can tell the polite creditor that its suggestions will not be followed. In either instance, the creditor's remedy is to turn to its loan agreement.

A directive, ordering tone and a sensibility of control are associated with creditor liability.[24] In contrast, creditor advice and creditor enforcement and conditional loan waiver in another line of decisions are associated with creditors not being liable.[25] These tonal distinctions make a difference to the courts, but should be less important than they have been. Creditor power comes from the creditor's loan agreement. Creditors can induce debtors to favor themselves over the firm's other creditors who lack the dominating creditor's loan agreement advantages and they can do so without formal control. The question is not whether the creditor's actions constituted control that was continuous and deep, as opposed to being interstitial and merely advisory, without insisted-upon demands. As Douglas Baird and Robert Rasmussen have said, the doctrines in this area are "unsettled enough to cause lenders (or at least their counsel) to make their intentions known without issuing stark commands."[26]

[24] For additional decisions equating the creditor action with pernicious control that produced fiduciary duties or creditor action that the court saw to be a basic breach of good faith and, in the end, liability, see A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981); Melamed v. Lake County Nat. Bank, 727 F.2d 1399 (6th Cir. 1984); K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 759 (6th Cir. 1985); In re Beverages Intern. Ltd., 50 B.R. 273 (Bankr. D. Mass.1985); Sanchez-Corea v. Bank of America, 38 Cal.3d 892 (Cal. 1985); Citibank, N.A. v. Data Lease Fin. Corp. 828 F.2d 686 (11th Cir. 1987); In re KDI Holdings, Inc., 277 B.R. 493 (Bankr. S.D.N.Y. 1999); In re Exide Technologies, Inc., 299 B.R. 732 (Bankr. D. Del. 2003); In re Del-Met Corp., 322 B.R. 781 (Bankr. M.D. Tenn. 2005).

[25] For additional decisions viewing the creditor's action as no more than an effort to enforce its loan agreement, and, hence, as neither creating fiduciary duties nor liability, see Krivo Indus. Supply Co. v. Nat'l Distillers & Chemical Corp., 483 F.2d 1098 (5th Cir. 1973); Spillers v. Five Points Guar. Bank, 335 So.2d 851 (Fla. Dist. Ct. App. 1976); Nat'l Westminster Bank USA v. Century Healthcare Corp., 885 F. Supp. 601 (S.D.N.Y. 1995); In re Lois/USA, Inc., 264 B.R. 69 (Bankr. S.D.N.Y. 2001); In re S.M. Acquisitions Co., 332 B.R. 346 (Bankr. N.D. Ill., 2005); Schwan's Sales Enterp., Inc. v. Commerce Bank & Trust Co., 397 F. Supp.2d 189 (D. Mass. 2005); In re Marketxt Holdings Corp., 361 B.R. 369 (Bankr. S.D.N.Y. 2007); Famm Steel, Inc. v. Sovereign Bank, 571 F.3d 93, 102 (1st Cir. 2009); In re Gluth Bros. Const., Inc., 424 B.R. 379 (Bankr. N.D. Ill. 2009).

[26] Douglas Baird & Robert Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Pa. L. Rev. 1209, 1235-36 (2006); Weil, Gotshal & Manges LLP, Reorganizing Failing Business: a Comprehensive Review and Analysis of Financial Restructuring and Business Reorganization 18-64 (rev. ed. 2006):

> Of late, particularly in the areas of equitable subordination and nonstatutory lender liability based on conduct, the pendulum has swung in favor of lenders, particularly at the appellate level. Nonetheless, lenders should be aware that the more control they have and exert over their borrowers, the more likely it is that they will be held liable under any number of theories.

B. The Conflicts in Play

Three major conflicts can be culled from the case law: a vertical conflict in which the targeted creditor could induce the firm to move value from one business place to another one where the creditor can claim priority over other creditors (as in *American Lumber* and *Clark Pipe & Supply*); a horizontal conflict in which the creditor gets paid while other creditors at the same level do not; and another vertical conflict (as in *Busy Bee* and *American Consol*) in which the creditor manages the firm to provide more value to its layer in the capital structure over, say, the lower-ranking equity layers. These conflicts, illustrated in the balance sheets below, recur in insolvent firms.

First, the controlling creditor that goes beyond collecting its loan can induce the firm to manage itself such that more value appears in the creditor's capital layer.

Time (1)

Assets	**Liabilities**
$1000 inventory	$1000 trade debt
500 accounts receivable	1000 syndicated bank loan
	[The bank loan is secured by the accounts receivable, but the receivables are insufficient to cover the loan]

Time (2)

Assets	**Liabilities**
$ 500 inventory	$1000 trade debt
1000 accounts receivable →	1000 syndicated bank loan, now fully secured

Figure 1. Lien-feeding: vertical distortion

Figure 1 illustrates lien-feeding. The dominant creditor finds itself under-secured. It induces the debtor to sell inventory, which when sold becomes an accounts receivable covered by the lender's security agreement. In the balance sheets above, the firm loses no value due to the creditor's influence, but its value is redistributed in the dominant creditor's favor. Lien-feeding is particularly pernicious socially if the $500 in inventory is used to make sales, but cannot generate the full $500 in additional receivables. The dominant creditor is better off, but the total value of the firm's operations has diminished.

Second, the controlling creditor can induce the firm to pay the controlling creditor back before paying any of the other creditors:

Time (1)

Assets	**Liabilities**
$1000 cash	$1000 syndicated bank loan
500 machinery	1000 trade debt

Time (2) Firm pays all its value to the bank syndicate, leaving nothing for trade creditors

Assets	**Liabilities**
500 machinery	$1000 trade debt

Figure 2. Preferential repayment: horizontal distortion

The scenarios in Figures 1 and 2 are related, because moving firm value into security — as in the first scenario in Figure 1 — is a type of partial repayment, while the second scenario, illustrated in Figure 2, is a full repayment.

Third, the controlling creditor can mismanage the firm, such that the firm is more likely to produce value that will pay the creditor back, at the expense of other capital-providers, such as stockholders. So, if the firm has an expected value of $2,500, from equal chances of being worth 0 or $5,000, the controlling creditor could prefer a lower-value business strategy that produces only $2,000, but does so assuredly. This possibility is captured in the potential for creditors to liquidate firms too quickly. It's also in play in the creditor vs. stockholder conflict at the root of *Farah Manufacturing*, discussed below.

Time (1)

Assets	**Liabilities**	
$2500 [from (.5x0) + (.5x$5000)]	$2000	Banks and other debt
		Stockholders

At time (1), the banks are at risk, because the firm has a 50% chance of being unable to pay the banks back. The stockholders have some value in the firm, from the 50% chance that the firm value will exceed $2000.

Time (2) Bank induces firm to liquidate its factories for $2000

Assets	**Liabilities**	
$2000 cash	$2000	Banks and other debt
	0	Stockholders

At time (2), the banks are no longer at risk, because the firm's value is fixed at $2,000, the amount that the firm owes to the banks. The stockholders no longer have any value in the firm and the firm is worth only $2,000, while at time (1) it had a value of $2,500. Because the banks are paid in full if the firm is liquidated, but risk not being paid if it's continued, the banks' incentive from the capital structure is to induce the firm to liquidate, even though continuance yields a higher-value firm.

Figure 3. Creditors reduce firm value, to detriment of stockholders

On these numbers, creditor control is pernicious. But it would not take much imagination to change the numbers so that the liquidation strategy would be the best for the firm overall (because the market for its products has deteriorated and it has no continuing going concern value). If courts could readily review and judge the business decisions, then the court could itself directly manage the creditor liability decision, making the creditor liable for a self-interested liquidation, but not for value-maximizing liquidation. If courts cannot review the substance of the business decision well, then they need a different set of tools to manage the conflicts. In corporate contexts we generally see courts as not well-suited for such business review, which it does only as a last resort.

C. The Operational Problems: The Importance of Getting the Judicial Standard Right

1. Operational costs of deterring capable creditors from intervening in failing firms. More than doctrinal niceties are at stake. In a dynamic economy, firms rise, fall, and fail. For those that fail, some could be turned around and rise again. For others that would fail regardless, effective management could dampen the costs of failure. Reducing the costs and frequency of failure could make capital for risky firms less expensive and mute the social costs of jobs lost as firms fail. We should want a doctrinal overlay that encourages constructive creditor engagement with the distressed firm.

Firm failure is often management failure.[27] Incumbent management might have mistakenly run the company into the ground. Sometimes incumbent management was just unlucky in being in an industry with declining demand or rising costs, but is not the team best positioned to turn the company around. Yet managerial self-interest could lead managers who are no longer right for the firm to keep themselves in place for too long, with replacement only coming in the firm's bankruptcy, if at all.

Operational costs thus can be visited on the firm if legal doctrine excessively deters creditor entry into influencing the failed firm. Too strict a rule of creditor conduct could induce competent creditors to remain passive, for fear of doctrinal uncertainty and later liability. Yet, creditors, when managing their loan to the debtor, could have acquired enough knowledge of the debtor and its operational reverses for the creditor to become a good de facto board. The creditor could contribute to managing the firm, may be well-positioned to judge whether the business problems were due to bad luck or bad management, and may have an informed judgment as to whether to replace or keep current management. Furthermore, a creditor's active encouragement of the debtor's turnaround may reassure the market about the firm's

[27] Cf. David J. Denis and Diane K. Denis, *Performance Changes Following Top Management Dismissals*, 50 J. FIN. 1029, 1055 (1995) ("forced top management changes are preceded by large and significant operating performance declines and followed by significant improvements in operating performance"); Mark R. Huson, Paul H. Malatesta & Robert Parrino, *Managerial Succession and Firm Performance*, 74 J. FIN. ECON. 237, 273 (2004) ("managerial quality and expected firm operating performance increase after CEO turnover"); EDWARD I. ALTMAN & EDITH S. HOTCHKISS, CORPORATE FINANCIAL DISTRESS AND BANKRUPTCY FINANCIAL DISTRESS 222 (2005.)

prospects: a knowledgeable insider with skin in the game would be seen to think that the firm is viable. But if judicial doctrine punishes them severely and unpredictably for managerial involvement, creditors will stay away more than we should want them to stay away.[28]

Randall Kroszner and Philip Strahan investigated American banker board behavior and found it to be consistent with the logic of the negative incentives emanating from these doctrinal uncertainties. They found that one-third of the Forbes 500 firms had a banker on the board. However, American bankers tended to be less active than bankers in other nations and, in other nations without the American creditor liability doctrines that motivate this paper's inquiry, banker board representation is denser than it is here. But Kroszner and Strahan's most relevant and most telling findings were that American bankers sought stable firms and avoided boards of firms facing financial stress, in contrast to the opposite practice common in other nations. Yet those stressed firms are the ones most likely to need help.[29]

2. Operational costs to allowing excessive creditor distortions in managing failed firms. The converse of the above is true as well. If the rule overly facilitates creditor entry into their debtors' decisionmaking apparatus, then firms could be needlessly mismanaged. Creditors of an operationally salvageable firm could take control, force the firm's liquidation, and destroy social and economic value — but profit from that destruction. If the rules facilitate creditor action, in order to foster a check on firm management, those same rules and standards could also thereby facilitate the negatives of hasty creditor-induced liquidations and shifts in value to the controlling creditor. Preference and fraudulent conveyance law control some such transfers,[30] with equitable subordination often thought to round out the setting,[31] but if courts excessively defer to the creditor and inappropriately fail to invoke equitable subordination, then the sharp-eyed creditor could steal the firm.

Kenneth Ayotte and Edward Morrison examine another sample of public and private chapter 11 filings and find that secured creditors liquidate more quickly when they have adequate security for themselves than when they do not.[32] And three economists, after reviewing their own data, recently concluded that misplaced strengthened creditor rights do, in fact, distort business decisions:

> [S]tronger creditor rights induce risk-reducing investments. Strong creditor rights in default may lead to inefficient liquidation, which extinguishes the

[28] Cf. Robert C. Clark, *Remedies of Corporate Creditors*, 90 HARV. L. REV. 505, 538-40 (1977):

> [A] preventive rule that insiders' debt claims are subordinated automatically to those of outsiders may be objectionable because it appears unjust as applied to those insiders who do in fact deal honestly, fairly, and nonpreferentially with their corporations. Indeed, there are compelling arguments which suggest that insiders be allowed to participate in their corporations as creditors on the same basis as outsiders.

[29] Randall Kroszner & Phillip E. Strahan, *Bankers on Boards: Monitoring, Financing, and Lender Liability*, 62 J. FIN. ECON. 415, 447 (2001); cf. FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 46 (1991).

[30] Bankruptcy Code, §§ 547, 548, 550.

[31] Bankruptcy Code, § 510(c).

[32] Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANAL. 511, 528-530 (2009).

> continuation option of a firm's enterprise and thus hurts shareholder value. Also, creditor rights that [allow creditors to] dismiss[] management in bankruptcy impose private cost on managers. To avoid these costs, shareholders and managers lower the likelihood of distress by reducing cash flow risk. Such risk reduction can result in value loss due to forgoing profitable investments, or from undertaking value-decreasing diversifying investments; strong creditor rights can thereby result in dead-weight costs to firms and to the economy at large. Further, while strengthening creditor rights increases the propensity to lend, it may reduce the firms' demand for credit, resulting in lower overall level of corporate debt.[33]

Moreover, the density and frequency of these conflicts and operational difficulties are not minor. In one study, finance researchers examined 7,600 debtor defaults during the past decade and found that creditors obtained benefits not contemplated by their contract. Creditors used the debtor's loan agreement "violations to [obtain] control over the governance of [the debtor] firms [via] a statistically and economically significant increase in CEO" replacement.[34] As Baird and Rasmussen note, in distressed situations it is not unusual for creditors to impose the appointment of a chief restructuring officer as a condition for continuing to finance the enterprise. In these situations the chief restructuring officer "may be compensated by the company but her interests are aligned with the lenders."[35]

Finally, with the increasing density of hedge fund and private equity positions in financially-troubled companies, the potential increases for both for distortive management by conflicted financial institutions and improved management by new interventions.[36] Getting this trade-off right has always been important, and increased

[33] Viral Acharya, Yakov Amihud & Lubimor Litov, *Creditor rights and corporate risk-taking*, 102 J. FIN. ECON. 150, 151-52 (2011). See also Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1353-54 (2007).

[34] Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 REV. FIN. STUD. 1713 (2012). An interpretive ambiguity might be in play: even if creditor rights to control CEO turnover were not explicitly stated in the contracts that Nini, Smith, and Sufi examined, creditors might readily see it as a consequence of any forbearance on collecting the loan. See also Sadi Ozelge & Anthony Saunders, *The Role of Lending Banks in Forced CEO Turnovers* (2008), *available at* www.ssrn.com/abstract=1031814; Yili Lian, *Creditor Control Rights, Corporate Governance and Bond Performance: Evidence from Loan Covenant Violation* (2012), *available at* www.ssrn.com/abstract=2135083.

[35] Douglas Baird & Robert Rasmussen, supra note 26, at 1234; Nini, Smith & Sufi, supra note 34 (creditors use loan covenant defaults to force managerial change). The bankrupt's primary lender (the so-called "DIP lender") often has power analogous to that of the controlling creditor outside of bankruptcy. As Baird and Rasmussen show:

> [S]ecured creditors have learned, largely through terms contained in debtor-in-possession (DIP) financing, how to gain control over the debtor during the bankruptcy itself. The increase in control rights, combined with the heterogeneity in the most senior tranche, increases the risk that creditors pursuing their own individual agendas will not advance the interests of creditors as a group.

Douglas Baird & Robert K. Rasmussen, *Anti-Bankruptcy*, 119 YALE L.J. 648, 676 (2010).

[36] Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. L. REV. 281, 282 (2009); *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?*, Hearing Before the House Subcomm. on Commercial and Administrative Law of the House Judiciary Comm., 111th Cong., 1st Sess. (2009) (statement of Harvey R. Miller, senior partner, Weil, Gotshal & Manges LLP), at 14:

> Distressed debt traders and hedge funds have different objectives than those of vendor/suppliers. They are motivated by quick and sizeable return on their investment.

economic volatility and powerful new institutional players make getting it right now more important than ever.

II. THE CORPORATE LAW ANALOGUE

Business law faces similar trade-offs in an equally critical business setting, that of the board of directors' liability for mistaken business decisions. Just like the controlling creditor facing liability, the board controls the firm and could be made liable for mistakes and self-interested decisions, in the board's case with liability running from it to the firm or to its shareholders and in the creditor's case running from the controlling creditor to the firm or to its other creditors. We will get considerable purchase on the creditor-in-control problem by examining the analogous corporate doctrines, seeing how controlling creditors would fare under these doctrines, and then examining the reasons why these corporate doctrines are not invoked in creditor situations.

A. Corporate Law Basics

Boards of directors decide whether to liquidate the firm's factories or to keep the firm's business going. They decide whether to keep or replace senior management. They decide whether to second-guess incumbent management by getting a consulting firm's advice. These are basic decisions that boards commonly make as firms fail.

Yet in the corporate boardroom context, decisions to close factories or change management do not take on the same controversial character that they have in the failing firm, creditor-in-control context. The corporate rules reduce controversy in the decisionmaking and reduce judicial second-guessing of the board's decisions. Judicial rules evaluating board decisions are more functional and better guides for business behavior than judicial rules in the creditor liability context. The board-based corporate decisions lack the creditor-based controversy because the corporate decisions are typically shielded by the business judgment rule: If the board is not conflicted, then the court will defer to the board's business judgment. (Boards must also — not relevant to our inquiry — have informed themselves of the decisional considerations and must have acted in good faith.) But if the board is conflicted, then the court will indeed second-guess the board with an entire fairness review. It may conclude that the conflicted board approved a transaction that was fair to the corporation and thus absolve that board of liability, but, as the Delaware court has said, "the determination of the appropriate standard of judicial review frequently is determinative of the outcome."[37] Indeed, anticipating entire fairness review for conflicted decisions, boards and their legal counsel often can manufacture business

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Because their entry price usually is much lower than the face amount of the acquired debt, they are more apt to favor the sale and dismemberment of a debtor, if it will yield faster and greater recoveries based upon the costs of purchasing claims.

[37] Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1371 (Del. 1995) (Holland, J.).

judgment deference even to a conflicted board by taking the decisionmaking away from the conflicted directors and placing it before a board committee of unconflicted directors.

B. The Creditor Takes Control: Entire Fairness Review for Conflicted Creditor Transactions

The typical creditor-in-control setting helps to explain why this corporate law analogy has not, as far as we know, been previously made. The controlling creditor is *always* making decisions that are self-interested. It wants the firm to take low-risk, liquidation-oriented decisions to collapse the firm's future income distribution so as to pay the creditor off as much as possible. The creditor does not want just any new management team in place, but wants one that will produce cash quickly to pay the creditor off. The creditors' conflicts are so obvious that there seems to have been no reason to consider business judgment deference. Courts quite properly jump to the creditor-type version of full, entire fairness review.

C. The Creditor Takes Control: Business Judgment Deference for Non-conflicted Transactions

But what if the controlling creditor lacked major financial conflicts of interest? Yes, hard to imagine at first that the conflicts could be held to low levels, but consider the abstract possibility. In a low-conflict setting, the court could be satisfied that the creditor was likely to be making judgments that would maximize total firm value and, as such, the court would have little reason to second-guess the creditors' decisions, or at least have no more reason to second-guess the creditor than the court has to second-guess unconflicted boards. Boards and creditors make business mistakes, by taking calculated risks that do not payoff, but when they lack gross conflicts, courts could think that the judiciary is unlikely to systematically do better than the business players, with those business players being the boards directing firms in one setting and major creditors influencing the debtor firms in another.

Indeed, in similar corporate circumstances, the Delaware corporate courts protect corporate decisionmakers. When the firm is nearly insolvent, the courts have in recent years indicated that the board, presumably the nonconflicted board, can make decisions that favor the firm as a whole, even at the expense of shareholders. Such decisions will be accorded business judgment deference, the Delaware courts have emphasized: "Directors," said the court, "would be protected by the business judgment rule if they, in good faith, pursued a less risky business strategy precisely because they feared that a more risky strategy might render the firm unable to meet its legal obligations to creditors and other constituencies.[38]

[38] Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004) (Strine, J.).

Could that analogue of an unconflicted board be constructed for the creditor of the failing firm?

D. Considering a Contractual Trump to Corporate Law Doctrine

Contractual qualifications to the forgoing analysis, and a closer look at several additional contractarian considerations, are now necessary. “[T]he efficient ex ante bargain may include terms that look inefficient ex post. . . . [C]reditors may need to . . . have the ability to engage in self-serving behavior that compromises the value of the business as a whole in order to ensure that the shareholders have the right set of incentives in the previous period.”[39] But one can take a strong contractarian approach,[40] an approach to which we generally subscribe, and still recognize the wide need for a new approach to creditor duties.

First contractarian commonalities underlie even aggressive judicial implication of fiduciary duties. Courts invoking duties for controlling creditors do not deny creditors their contract right to sue and collect their loan. The courts are not according the same contractarian deference when the lender uses its loan to leverage up influence on the firm, which need not be part of the contract. A full-throated contractarian still might protect the behavior, seeing a creditor’s waiver on condition that the debtor take this or that action as a lesser included offense to suing and collecting. But critics of this approach could see the creditor’s and the debtor’s actions as not fully worthy of the same contractarian deference they would give to straight collection activity, if that conditional waiver transferred value from other creditors to the activist creditor. If the debtor and dominant creditor manipulate the firm or its finances in ways that deeply affect third-parties — namely the firm’s other creditors — contractarian deference may well not be warranted.

A second related consideration is obvious: contracts are often incomplete. Even heavily negotiated loan agreements have open-ended terms or fail to anticipate the consequences of the full range of operational outcomes over the life of the loan. The loan may have a financial covenant that’s been violated and, although the creditor’s remedies may well include the right to declare the debtor to be in default, to accelerate the loan’s maturity, and to be repaid quickly, those remedies may not

[39] Douglas G. Baird & M. Todd Henderson, *Other People’s Money*, 60 STAN. L. REV. 1309, 1314-16 (2008); cf. Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967 (2006); Frederick Tung, *Gap Filling in the Zone of Insolvency*, 1 J. BUS. & TECH. L. 607, 618-19 (2007):

> The possibility of draconian remedies upon default reduces adverse selection *ex ante* and may induce good behavior on the borrower’s part *ex post*. Because the borrower has private information about the condition of the business, it is important that upon default, the lender have significant bargaining power in order to be able to extract as much value as possible in a workout. The lender’s ability to shut down the business provides such leverage. This arrangement inures to borrowers’ benefit as well. In the competitive lending markets in which banks operate, reducing banks’ losses translates into lower borrowing costs for firms.

[40] See Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 140-42 (1989); Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L. J. 808, 856-57 (2007).

explicitly include the right to name new management or to direct the firm's operations.[41] Indeed, strong contractarians recognize this possibility when they propose

> to interpret the duty of good faith as equivalent to a prohibition of opportunistic behavior. Under this view, lenders are entitled to the benefit of their bargain but are precluded from using contractual terms as a pretense for extracting benefits for which they have not bargained.[42]

Even in a strong contractarian view of debtor-creditor relations, courts will need to assess the extent to which the controlling creditor's behavior was opportunistic and went beyond what the contract terms permitted. If the contract is clear or if the creditor just did not negotiate for rights to control future firm investments, the case for implying fiduciary duties is not a strong one in our usual business jurisprudence and recent erosions, analysts argue, should be cut back.[43]

But consider the possibility that the loan agreement is specific and explicit: "In the event of a default, the creditor may liquidate the firm immediately in a value-destroying fire-sale." Or, "in the event of a default, the creditor may name new management, in its sole discretion, to run the company in the creditor's interest." As between that creditor and the debtor, the contractarian view would be that even value-destroying creditor actions are permitted to the creditor. (A contractarian, aiming also to maximize social wealth ex post, might hope that merger markets are strong enough that the creditor or the stockholder can sell the firm for a higher value to capture what would be lost in any creditor mismanagement or fire-sale, but that's another matter. A contractarian might also hope that in the face of such a contract, the stockholders and the creditors would negotiate a Coasian deal to deploy the firm most efficiently. The doctrinal and business structures we propose in the next Parts are designed in part to facilitate that Coasian efficient deployment of the distressed firm, even in the face of an ex ante value-destroying contract.)

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[41] Frederick Tung, supra note 39, at 617:

> Upon the borrower's default, the lender's remedies ordinarily enable it to severely damage or destroy the borrower's business. …. But the harshness of the agreement belies the reality of how things ordinarily go between bank and borrower…. What the contract specifies is almost never what ultimately occurs; instead, renegotiation ensues. Clearly, what is going on here differs from the standard aspiring-fully-state-contingent contract of theory. Loan agreements are not trying to "get it right." Instead, the loan agreement [is] a strategic device for structuring renegotiation in the event of default. The agreement sets the parties' leverage … [for the later] renegotiation should it later be required.

[42] Fischel, supra note 40, at 141. Cf. Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990) (Easterbrook, J.):

> "Good faith" is … an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties. When the contract is silent, principles of good faith — such as the UCC's standard of honesty in fact, UCC § 1–201(19), and the reasonable expectations of the trade, UCC § 2–103(b)…—fill the gap. They do not block use of terms that actually appear in the contract.

Again, even in a contractarian framework, we need to assess whether creditor action is primarily opportunistic or contract-based.

[43] Tung, supra note 39, at 815-16.

The difficulty in the full contractarian view even here, in an unusual setting of contractual explicitness on control, is not that it would permit the creditor to liquidate and/or name new management, *against the debtor's objections*, but whether it could be enabled to do so in the face of objections from the firm's *other* creditors. True, if another financial creditor lent to the debtor after examining the loan agreement with the control and liquidate covenants — if they were themselves fully contracting creditors, with knowledge of the prior deals — then the contractarian view would bind those informed, subsequent creditors. But vis-à-vis a wide range of other creditors — some preexisting creditors, tax claimants, many trade creditors, tort claimants, and consumer creditors — the explicit contractarian framework fits badly. These small creditors can be substantial in the aggregate for a firm. Think of many small tort claimants in the mass tort cases that drove firm after firm dealing with asbestos into bankruptcy. Think of tax, consumer, and supplier claims on typical businesses. Such claims have figured prominently in the major cases, such as *American Lumber*, *Clark Pipe & Supply*, and *WT Grant*.[44]

In these three settings, pure deference to an incomplete contract, or to waivers of defaults in exchange for operational concessions, would work erratically in maximizing value. Too many creditors are not party to the relevant contract. But, regardless, for the reasons already discussed, the current state of judicial doctrine — contrasting day-to-day control with creditor enforcement of its contract protections via conditional waivers and hoping that that distinction is real — provides poor guidance. A new approach is needed.

III. A CAPITAL MARKET APPROACH TO REDUCING DISTORTIVE CREDITOR SELF-INTEREST: OLD STYLE

The theory is clear: if we could find an unconflicted creditor, we could accord business judgment deference to the creditor's business decisions in influencing the failing firm. The problem is practical, in that such a lack of conflict, or even a substantial lowering of conflict, seems hard to achieve. Traditional financial structures and traditional bank regulation largely impeded such structures from emerging in the United States.

But the unconflicted creditor-in-control is not as far-fetched as it might at first seem, in light of the new finance and the rise of new financial players. First, though, let's see how old-style finance could have been adapted, with much transactional and regulatory difficulty, to the theory.

[44] This multilateral bargain seems implicit in Jonathan Lipson's review of the creditor duty problem, when he suggests that the duty of good faith in such contractual relationships should require that powerful creditors dealing with distressed firms consider the interests of all parties that the workout affects. Jonathan C. Lipson, *Governance in the Breach: Controlling Creditor Opportunism*, 84 S. CAL. L. REV. 1035, 1073 (2011).

A. The Syndicate Leader

Consider a firm with a traditional lending syndicate and stockholder-managers, but with no other major players in the capital structure. Trade creditors are few, back taxes have been paid. The firm's capital structure initially consists of just the lenders and stockholders.

The firm defaults and creditors do more than declare a default and seek to be repaid. They seek to replace management and to influence operating decisions, as occurred in the well-known *Farah* controversy,[45] whose setting is instructive. There, the lending syndicate forced out old management after a bitter labor strike and secondary boycott of the debtor, put a managerial change clause into its loan agreement (i.e., no managerial change to which the creditors object), used the managerial change clause to wedge its preferred managers into place, and induced management to liquidate major parts of the firm's operations.[46] The bank-placed managers made disastrous operating decisions that cost everyone in the firm dearly. When the original equity holders regained control of the firm, they had better operating results and they sued the banks on several theories of lender liability.[47]

If the firm had a bleak future when the creditors originally seized control, a liquidation sale of the useless machinery was operationally sensible. If the bank-appointed managers intended their decisions to be profit-maximizing, and *if* the controlling creditors who appointed those managers lacked conflicts, then business judgment deference to the decisions could have been appropriate. But given the deep creditor conflicts of interest, no such thinking emerged in the *Farah* litigation. Nor, given the lending syndicate's structure, should it have.

How then could the Farah creditors have not been conflicted? If they owned equity to the same extent that they were owed on their loans, then the debtor-creditor conflict would have approached zero. But the lenders were just about the firm's only creditors, so a proportional equity interest for them would have required them to have *all* of the firm's equity. This was not possible short of a full-scale bankruptcy and reorganization.

But consider this alternative scenario. El Paso National Bank was the syndicate leader and made a slice of the total loan to Farah Manufacturing. What if El Paso, the lead bank, with (say) 10% of the lending syndicate's take-down owned 10% of the debtor's stock? If it then made managerial decisions that lowered the long-term value of Farah Manufacturing's operations (by liquidating too much, too soon, at fire-sale prices), it would have been giving up value that it could have

[45] State Nat'l Bank of El Paso v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984).

[46] *Id.* at 678.

[47] The full facts are more complex, but the text summarizes what's important. In the fuller version, the board itself forced out William Farah because "he was the cause of [Farah Manufacturing's] management problems and poor financial condition." *Id.* at 670. After Farah resigned, there was a managerial revolving door, with the banks eventually putting their people in place, when they leveraged a loan agreement clause that allowed them to call a default if there was change in management that they disliked. Although the Farah family had a controlling stock interest in the firm, several family members opposed William Farah's return to management, leading to intra-family litigation. Eventually Farah prevailed in the family litigation and gained voting control of enough family stock to put himself back in control of the manufacturing company. When he regained control, he had the company sue the banks.

captured through its equity holding. As such, it lacked the incentive for such value-diminishing action, which would have damaged its own total investment. It might do so mistakenly — just as boards making managerial decisions sometimes misjudge the business situation — but not intentionally to further its self-interest.

The potential way out here now is obvious: If El Paso had proportionate debt and equity interests, if it had been entitled to make all important decisions for the lending syndicate and, if the syndicate's inter-creditor contract had allowed El Paso National to recognize the value to itself of its stock interests when making operating and managerial decisions, then the reviewing court could have judged whether the remaining conflicts were really so strong as to trump business judgment deference. The central conflict for the creditor would have been largely mitigated. And if, in the court's view, the residual conflicts were real but weak, or were offset by other factors,[48] then a business judgment review and deference could have been something for the court to consider. Figure 4 illustrates.

Assets	**Liabilities**	
$2000 cash	$2000	Bank and other debt. Syndicate leader owns 10%, or $200, of the debt
	Stockholders	Syndicate leader takes 10% of stock

Scenario 1. Firm is better off continued, as in the first scenario in Figure 3. The syndicate leader has a 50% chance of its $200 portion of the syndicate's loan being fully repaid and a 50% chance of having $300 in equity from the firm's continuance, for an expected value of $250. Hence, even if the liquidation value of the firm is $2000, enough to pay the lenders in full, the syndicate leader's incentives from its ownership interests are to push for the higher value continuance. Liquidation will yield the syndicate leader only $200, less than the $250 from continuance.

Scenario 2. Alternatively, consider the possibility that the firm is better off liquidated, because the top scenario in Figure 3 changes to a lower value, at [(.5x0) + (.5x$3000)] = $1500. The syndicate leader gets $150 from continuance, but $200 from liquidation. Again, the syndicate leader's incentives from its positions in the firm's capital structure are to push for the higher value liquidation.

Figure 4. The syndicate leader, with stock ownership

B. Other Old-Style Ways to Reduce Controlling Creditor Conflicts

1. Warrants at the time of lending. When the creditors and the debtor negotiate their loan, they may reduce the creditors' conflict of interest by having the syndicate leader take stock warrants proportionate to its portion of the loan.

[48] For example, El Paso National Bank's incentive from its equity interest would be offset in part by its interest in protecting the other members of the syndicate so that bankers would in the future have confidence that El Paso as syndicate leader would protect the banks first and foremost, so that banks would willingly join a syndicate that El Paso led.

The warrants' exercise price cannot be immediately fixed and exercisable, because when the loan is granted the firm is usually solvent and profitable; therefore the stock price reflects the current value of the company. The warrants' value in reducing conflict comes later, if and only if the firm declines and bank intervention become appropriate. A formula would be needed, which could take this format: If the syndicate loaned $1 billion and the syndicate leader loaned, and retained in its loan portfolio, $100 million of that $1 billion, then it would get warrants to purchase 10% of the company's stock. The warrants would be exercisable at a price of (say) $2/share, even though the stock price was then $25/share. The warrant contract would specify that the warrants would become exercisable if and only if the company's stock price declined to (say) $3 per share and did not rise above (say) $5/share for 2 months. That setting would indicate the firm was in decline, that bank intervention could be appropriate, and, at that time the warrants would go "live" and be exercisable, thereby dampening the syndicate leader's equity–debt conflicts. The situation might not justify full business judgment deference to the syndicate leader's business interventions, but could lead the reviewing court to be less suspicious, more deferential, and more willing to take on business judgment deference to an unconflicted, or only weakly conflicted, creditor acting like an unconflicted board.[49]

The central problem with this solution is that when the loan is made neither party particularly wants to sell, buy, or hold warrants. It's just a structural reserve for a rainy day. The second problem is that the terms under which the warrants "go live" have to be written before the firm enters financial stress; the parties will surely write terms then that will be off from the ideal terms when the stress arises later.

2. Convertible debt. Another way to reduce the controlling creditors' conflict of interests is for the debtor and the creditors, or at least for the lead bank, to use convertible debt. The syndicate leader could convert its debt into equity during the firm's financial stress, under terms that would dampen the creditor's conflicts.

Setting the conversion price will be hit-and-miss for structuring good incentives during a subsequent workout if the firm faces failure. The lead bank needs to acquire a right to participate in the share capital of the debtor that is proportionate to its interest in the loan agreement. The conversion price has to be chosen to reflect likely financial stress, but a low conversion price, if immediately exercisable, becomes a windfall for the lead bank, without reducing later conflicts of interests. The conversion feature has to be unusable until the firm enters financial stress, which would presumably be indicated by a sharp fall in the firm's stock price. Getting the terms right up-front, when the firm is not in trouble, is not going to be easy.

And, again, the convertible debt solution has the problem that when the loan is originally made, neither the debtor nor the lead bank is otherwise interested in using this kind of convertible debt.

3. Buying up proportionate interests. When the firm enters stress and the bank wants to intervene, the lead bank could buy in the market enough shares so that its debt and equity positions are proportionate. This alternative has the advantage that

[49] Financial instruments can have a self-adjusting price. WILLIAM W. BRATTON, CORPORATE FINANCE 556 (6th ed. 2008). See also Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107, 1110 (1994) (chameleon equity).

it does not require the lead bank to have warrants or conversion rights from the beginning of the lending relationship, when these rights may have no use to the parties, since most firms don't fail and induce lender intervention.

However, if the lead bank must buy a big equity position, and if the market is illiquid or if the creditor has actionable inside information, this eve-of- or upon-intervention effort may not be easy to accomplish quickly.

And, while this possibility of buying up proportionate interests — "strips" in the finance vernacular — has more promise than the other traditional possibilities, it faces other difficulties. The syndicate leader may see its incentives changed by holding proportionate interests, but it's unclear whether its interests would change enough. The syndicate leader, as a repeat player in the lending market, may prefer to make the rest of the syndicate whole and could be willing to give up some value elsewhere in the vertical strip it obtains.

Some interests may be difficult to buy — tax claims, tort claims, and consumer products claims come to mind. In a complex corporate group with multiple subsidiaries, the proportionate claims on all the related enterprises will not be easy to create. Creative finance may be able to mimic some, but not all of the incentives from these existing nonmarket layers in the capital structure. But even without a full mimicking, the proportionate interest possibility still has potential: First, the court could use it to vary the intensity of its scrutiny, in that to the extent the court thinks the conflicts are lowered, the court could lower its scrutiny. Second, if the proportionate interest purchases are incomplete, the court could use them to vary its deference to those who are complaining. If the complainants' claims were not proportionately owned by the syndicate leader, then no deference to the leader's business judgment might be made. But if another complainant's claims were proportionately owned by the syndicate leader, then the court could be more likely to defer to the syndicate leader's business judgment, knowing that the complainant, lacking the proportionate claim that the syndicate leader had, was more conflicted than the syndicate leader.

C. The Classic Main Bank System and Its Relevance

Several of these conflict-reducing features have been present in the Japanese main bank system.

1. How the classic main bank system resembles the capital markets, corporate law approach. In the immediate postwar decades, Japan's main banks were active in their debtors' decisionmaking, especially when the debtors became distressed. The main bank provided significant credit to the borrower and led a syndicate of major banks in the lending to the debtor firm. It the debtor firm began to fail, it was said, the main bank would take over the firm, sending in personnel to make, or review, basic business decisions. The main bank lent to the debtor and it owned stock of the debtor.

The classic main bank system has been described as a system of contingent control: The main bank was typically inactive in corporate governance when the firm did well, but became active if the firm entered distress.[50] One might wonder why Japanese banks were more active in distressed firm decisionmaking, with the overlay of creditor duties that prevails in the United States. The operating firms' capital structure may explain why.[51]

The classic main bank typically owned a major stake of the debtor-firm's equity.[52] It was said to have acquired expertise about the debtors' business. By owning both debt and equity layers of the operating firm's capital structure, it had reduced conflicts of interest in workouts and was pushed toward maximizing overall enterprise value. When the firm needed special assistance, main banks "had their own executives [transferred] to help the[] [debtor] out of difficulty…." And the ongoing relationships were close outside of bankruptcy: Bank personnel, it's been said, "move frequently between banks and companies as part of an on-going relationship that involves training, consulting, and monitoring." Debtor chief financial officers frequently came from the main bank. "Japanese banks allow companies to enter formal bankruptcy only when liquidation makes economic sense — that is, when a company is worth more dead than alive.[53]

The capital markets, corporate law approach we use here mimics the classic main bank role for distressed debtors. A nonconflicted creditor, with a proportionate interest in all layers of the debtor's capital structure, will have the same incentive to maximize the firm's value in the workout as the Japanese main bank was said to have had. Moreover, the fact that the creditor lacks large conflicts of interest will reassure market players that a professional investor is participating in the debtor's turnaround or liquidation process. The German banking and corporate structure was similar, with major banks owning and controlling equity in their debtor firms.

2. How it differs. Before Japan's deregulation of the 1980s, the Japanese main banks represented a stable power center in the Japanese *keiretsu* business groups. The classic main banks were thought to have been able to extract rents from their clients and to have unwisely influenced the operating firms when no financial

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[50] Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LIT. 1, 14 (1990). Classic main bank theory has been criticized as far from main bank reality. Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 L. & SOCIAL INQUIRY 401 (2002).

[51] It was this contrast between main bank ownership in the 1990s and weak overlying duties that set one of the authors here to considering the overall problem then.

[52] See Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 J. ECON. BEHAVIOR & ORG. 399, 402-03 (1989).

[53] Michael C. Jensen, Eclipse of the Public Corporation, 67 HARV. BUS. REV. 61, 73 (1989); Ronald J. Gilson & Mark J. Roe, Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization, 102 YALE L.J. 871, 881 (1993); Jun-Koo Kang & Anil Shivdani, Corporate restructuring during performance declines in Japan, 46 J. FIN. ECON. 29, 30-33 (1997); MASAHIKO AOKI & HUGH PATRICK, THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES 190-91 (1995):

> A feature of the main bank system is that, unlike formal bankruptcy, the process is handled informally without recourse to the courts and without a change in the legal standing of the firm: in effect, the main bank replaces the judge and the court-appointed receiver; but like bankruptcy a range of asset reorganization outcomes is possible, not just restructuring of the enterprise and continuation as a going concern—as the popular term 'bank rescues' connotes — but also varying degrees of liquidation.

stress was present.[54] Overall, some thought the main banks represented more of a burden than a benefit for Japanese firms.[55] And whatever it did in aligning banker incentives with the incentives of others in the enterprise, the main bank system did not prevent corporate decay in Japan.

Unlike the main bank system, the capital market, corporate law approach directly affects corporate governance only when firms are in distress. In such situations, lenders' leverage to affect debtors' decisions rises dramatically. The capital market, corporate law approach would put in place good incentives to minimize lenders' self-serving behavior without permanently modifying the debtors' corporate governance structure during non-stress, normal financial times.

3. Why American banks could not have become main banks. Due to the Glass-Steagall Act, the National Bank Act, and the Bank Holding Company Act, American banks — as well as bank holding companies — are generally barred from taking the relevant equity positions in non-bank companies.[56] There are, however, considerable exceptions to these constraints for stocks acquired in the ordinary course of collecting a debt previously contracted (DPC).[57] The United States also has a long history from back deep into the nineteenth century of keeping banks small in ways that made them unable in more modern times to participate powerfully in corporate governance[58] and of investors being more generally barred from being active investors,[59] despite evidence that when they could participate (before being ousted), they created value.[60]

Banks are allowed to negotiate with borrowers in distress to exchange nonperforming loans for otherwise bank-banned equity, but only "to resolve a troubled credit situation in which the bank otherwise would face credit losses."[61] The banks must then dispose of the instruments acquired within five years.[62]

Since the 1999 Graham-Leach-Bliley Act, American banking law expanded authority for the banks' affiliates to own equity. But the banking law, even after the

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[54] Jonathan R. Macey & Geoffrey P. Miller, Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States, 48 STAN. L. REV. 73, 96 (1995).

[55] See Aoki & Patrick, supra note 54, at 209-10, Xueping Wu & Jung Yao, *Understanding the rise and decline of the Japanese main bank system: The changing effects of bank rent extraction*, 36 J. BANKING & FIN. 36 (2012); Miguel A. Ferreira & Pedro P. Matos, *Universal Banks and Corporate Control: Evidence from the Global Syndicated Loan Market,* 25 REV. FIN. STUD. 2703 (2012).

[56] 12 U.S.C. § 24 (seventh); 12 U.S.C. § 335; 12 U.S.C. § 1843(c)(6), 1843(c)(8); see Laura Lin, *The information content of a bank's involvement in private workouts*, 3 GEO. MASON INDEP. L. REV. 97, 118-19 (1994).

[57] 12 U.S.C. § 29 (Third); U.S.C. § 1843(c)(ii)(2).

[58] Mark J. Roe, Strong Managers, Weak Owners: A Political Theory of American Corporate Finance (1994).

[59] See Michael C. Jensen, *Active Investors, LBOs, and the Privatization of Bankruptcy*, 2 J. APP. CORP. FIN. 35, 36 (1989).

[60] Bradford De Long, *Did J.P. Morgan's men add value? An economist's perspective on financial capitalism*, *in* INSIDE THE BUSINESS ENTERPRISE: HISTORICAL PERSPECTIVES ON THE USE OF INFORMATION 205 (Peter Temin, ed., 1991):

> [in that period] investment banker representation on boards allowed bankers to assess the performance of firm managers, quickly replace managers whose performance was unsatisfactory, and signal to investors that a company was fundamentally sound.

[61] OCC Interpretative Letter No. 1007 (Sep. 7, 2004).

[62] 12 C.F.R. 1.7(b)-(d).

1999 Act, still requires that the equity holdings be for "investment purposes" only, and it prohibits the bank from "routinely mana[ging]"[63] non-financial firms.

IV. A CAPITAL MARKET APPROACH TO REDUCING DISTORTIVE CREDITOR SELF-INTEREST: NEW STYLE DERIVATIVES

What once was hard to accomplish via old-style financial instruments or impossible to accomplish due to bank regulation is now easier to accomplish via new-style derivatives handled by new-style activist hedge funds. While extensive academic work now shows the potential pernicious conflicts that the new-style financial instruments can create, we can turn this thinking inside out to see how the new finance presents opportunities as well as challenges. Empty voting, for example, has captured reformers' attention, as the new finance facilitates stockholders' commanding decisive votes but without any underlying economic stake in the enterprise.

There is now a considerable literature, and considerable real world experience, on how the new finance of derivatives and options can mask a creditor's conflicting financial positions in firms, to the detriment of sound corporate decisionmaking. These analytics are correct to show the dangers of the new finance for sound corporate decisionmaking.[64] Here, we show how courts could harness the

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[63] 12 U.S.C. § 1843(k)(4)(H). See João A.C. Santos & Adrienne S. Rumble, *The American keiretsu and universal banks: Investing, voting and sitting on nonfinancials' corporate boards*, 80 J. FIN. ECON. 419, 427 (2006); Paul J. Polking & Scott A. Cammarn, *Overview of the Gramm-Leach-Bliley Act*, 4 N.C. BANKING INST. 1, 4-5 (2000); FEDERAL RESERVE BOARD, 2003 REPORT TO THE CONGRESS ON FINANCIAL HOLDING COMPANIES UNDER THE GRAMM-LEACH-BLILEY ACT (2003):

> [The Gramm-Leach-Bliley Act] permits an FHC [Financial Holding Company] to routinely manage or operate a portfolio company when, and for the period, necessary or required to obtain a reasonable return on the FHC's investment in the portfolio company. ... However, to ensure that an FHC does not routinely manage or operate a portfolio company for an extended period time, the rule requires that an FHC notify the [Federal Reserve] Board if it routinely manages or operates a portfolio company for more than nine months.

[64] Professors Hu and Black have some of the more widely cited analytics here. Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006); Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008) (empty creditors may force a bankruptcy, rather than agree to a restructuring, because the bankruptcy filing would trigger a contractual payoff on its derivative position). And the pernicious impact has been more widely analyzed: Viral V. Acharya & Timothy C. Johnson, *Insider Trading in Credit Derivatives*, 84 J. FIN. ECON. 110 (2007); Donald D. Bernstein, *Toward a New Corporate Reorganization Paradigm*, 19 J. APP. CORP. FIN. 9, 11-12 (2007); Andras Danis, Do Empty Creditors Matter? Evidence from Distressed Exchange Offers (2012), *available at* www.ssrn.com/abstract=2001467 (data indicates that firms subject to extensive credit default guarantees of its debt are less able to effectuate an effective out-of-court workout to avoid bankruptcy); Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609 (2009); Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 427-30 (2007); Frank Partnoy & David A. Skeel, *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1035 (2007) ("a lender that has purchased credit default swaps may have an incentive to use its position as a lender to affirmatively destroy value"); Marti G. Subrahmanyam, Dragon Yongjun Tang & Sarah Qian Wang, *Does the Tail Wag the Dog? The Effect of Credit Default Swaps on Credit Risk* (2012), *available at* http://people.stern.nyu.edu/msubrahm/papers/EmptyCreditor.pdf ("lenders holding [credit default swap, guarantee-like] protection can push borrowers into bankruptcy in order to trigger … payments

new finance to better ends, of more sturdily aligning strong financial interests in firms with their firms' overall health.

Potential positives are less frequently seen.[65] Here we show the potential to harness these new instruments to reduce conflicts of interest and construct a more functional set of judicial doctrines on lender liability. We do not deny the serious design problems that would need to be overcome to make the doctrinal safe harbor viable and verifiable by the judiciary as substantially eviscerating serious conflict. But, we maintain, what was once impossible is now possible.

A. Equity options

A problem in using old-style equity to reduce creditor conflict is that the creditors do not want it, and stockholders may well not wish to issue equity to the creditors or syndicate leader. Each side, at the time of the lending, may recognize the efficiency at a later time of the firm having an influential creditor with reduced conflicts. But the costs to the lender of holding equity, when most firms do not fail, can readily exceed the expected value of anticipating an unconflicted structure.

Another problem is that while the debt-equity holding may make sense as the firm fails, for the creditor and the firm to negotiate that equity issuance during financial stress could prove daunting. If the lender and debtor wait until stress arises to negotiate the creditor's purchase of the conflict-reducing equity, the equity transaction will most likely be bundled with the creditor's collection efforts and operational goals. The debtor firm and its management may well wish to neutralize the creditor's actions and, thus, would not issue the equity. The creditor, not yet with its incentives aligned, may use its muscle perniciously to extract equity on terms that disfavor the other creditors and equity-holders.

But options on equity could be easier to use. If the syndicate leader has, say, 10% of the firm's debt, then it could buy from third parties options on equity in an amount roughly equal to 10% of the firm's equity, at a strike price approximating the then-current price of the equity, with an expiration date at around when the crisis is expected to be resolved one way or the other. One big advantage of such options is that the firm's management (presumably representing stockholders) and the creditor need not make a crisis-infected agreement, one which they would find hard to reach. Instead the creditor can buy the right level of options from other, third-party market players and then can take an aggressive activist stance vis-à-vis the firm, confident that courts would be likely to accord the creditor business judgment deference.[66]

[under the guarantee contract], even though restructuring may be a better choice for the firm from [other] lenders' perspective").

[65] For two articles seeing positives see Frank H. Easterbrook, *Derivative Securities and Corporate Governance*, 69 U. CHI. L. REV. 733 (2002); Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231 (2008).

[66] The option mechanism when perfectly implemented tells the court that the controlling creditor has no direct financial incentive to reduce firm value, because doing so would reduce the value of its overall investment in the firm. Even if there are equally valued alternatives, with one favoring one layer

B. Options on Other Debt Layers

Thus far, we have focused for simplicity on creditor–stockholder conflict. In a complex firm, there will be more than one creditor layer and it's here where the most pernicious creditor difficulties arise. Banks may have short-term secured debt, while bondholders have long-term subordinated debt, and trade creditors short-term unsecured but not subordinated debt. The activist creditor could have reason to squeeze out these other layers to its own benefit.

To reduce such conflicts, the syndicate leader could take proportionate interests in each of the other major layers or it could take out options on those layers, so that it pays proportionately if it squeezes these layers out.

C. Credit Default Swaps

The activist creditor could similarly reduce intercreditor conflict by writing credit default swaps on the other major credit layers. That is, if the activist creditor has 10% of one credit layer, it could write swaps on 10% of the bond layer, such that if the bonds fall below a price of X, the activist would have to pay off the difference. Thus motivated, the activist would have less reason to shift value to itself from the bond layer.

D. Implementation Limits

The activist creditor could face implementation problems in buying options on multiple layers. Some layers may be hard to value, so the costs of an options writer assessing, pricing, and then selling the options may be prohibitive. Untraded debt (say, from the debtor's suppliers) may be hard to assess, and further difficulties can arise if the firm has substantial hard-to-define debt, such as mass tort claims from asbestos or other major tort liability exposure, from tax claims, from customers' claims for breach of warranty, or even from soft claims not generally recognized in bankruptcy, such as from employees' or customers' noncontractual expectations of future dealings. Worse, some strong creditors will game the system by taking on derivatives positions that appear to make it interested in the overall health of the firm, but whose fine print terms do not give it those incentives. Courts will, as always, need to be alert.

1. Transaction costs of the activist creditor. These problems neither are assuredly insurmountable nor, even when they cannot be surmounted, do they render the capital markets approach valueless. First, sometimes these hard-to-value and nonfinancial soft claims are small. Second, the court could accord business judgment deference to the strong creditor if and to the extent it takes proportionate interests, but only that far. That is, if it obtains proportionate interests in the subordinated

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and another favoring another layer, the controlling creditor with appropriately-sized options has no direct, incentive-based financial reason to favor one over the other.

debentures and equity, the court should be inclined to give the strong creditor business judgment deference if those players complain. If the dominant creditor has not taken a proportionate interest in the company's asbestos mass tort liability, however, the court should be ready to hear the tort claimants (but not the bondholders or equity holders) without according the creditor a business judgment defense, as to dealings that affected the tort claimants.

Corporate business judgment decisions tend to be binary — if the decisionmaker is sufficiently unbiased, it gets full business judgment deference. Importing the business judgment concept into the creditor liability area must be more nuanced, as the capital markets opportunities outlined here can go a long way to eliminating some conflicts with some creditors, but not all conflicts with all creditors.

2. Creditor fallback from the safe harbor. For some creditors, in some jurisdictions, the cost-benefit trade-off may be unfavorable. They may find it too expensive to pick up proportionate interests in the firm's other creditor layers, just to facilitate protecting their managerial activism with the safe harbor we propose. Some creditors may prefer to take their chances on the old-style current rules, hoping that no one will complain or that they will find their conduct evaluated by a sympathetic court.

3. Judicial limits in verifying the quality of the safe harbor. A law review paper can set forth the concept, but a court would have to verify the actual on-the-ground terms, some of which will be difficult to assess. Some creditors may not really take on the proportionate risks; others may take them on but off-load them surreptitiously.

Courts will often find it easier to verify that a credit default swap is a real risk for the dominant creditor than to evaluate the business value of the creditor's actions. In the boardroom context, courts have been dealing for decades with the problem of assessing the real independence of the decisionmaking subcommittee to see whether to apply the business judgment rule and thereby avoid the difficulty of assessing the business sense of the underlying decision. The capital markets incentive approach here is not without difficulties, but difficulties in assessing the bona fide structure of the transaction for which creditors are seeking business judgment deference will be easier for courts than the difficulties of assessing the entire fairness of the underlying business transaction.

4. The safe harbor as infectious agent. We have proposed the corporate law analogue as a safe harbor for activist creditors, because it channels creditor incentives into improving the firm and away from grabbing value from other creditors. If the safe harbor did not prove valuable enough, the creditor would not seek it and the court would evaluate the creditor under the current standards.

But once the safe harbor is introduced, it stands as an alternative to the current (muddied) standards governing activist creditor conduct. Some courts may be unhappy if active, dominant creditors damage the debtor and get a free-pass under the jurisdiction's existing doctrine if the creditor has influenced but not taken control of the firm. Such courts may adopt the safe harbor standard and look for proportionate interests to validate the actions of every activist creditor, in effect replacing the current standard with our proposed safe harbor. But if such courts looked for vertical strips owned by the activist creditor and too many creditors found it too expensive to acquire those vertical strips, then a safe harbor that became a de facto minimal entry expense for the activist creditor would do damage. Potentially activist creditors would stay quiet if (a) the vertical strip were too expensive, and (b) courts abandoned the old doctrines and required activist creditors to have the (expensive) vertical strip or submit to heavy liability. Although it's a realistic possibility that a safe harbor could turn into a requirement, we do hope it would occur only after enough experience with the proposed safe harbor, with courts and activist creditors finding that it provided more low-cost incentive alignment than even the current authors predict it will have.

E. Hedge Fund Activism

In today's restructuring world, banking syndicate leaders do not loom as large as they once did. Bankers often lend and then sell off their loans to other market participants.[67] Even if they do not, banks are still not well-positioned in the regulatory framework to take multiple positions in the failing firm's capital structure when those positions involve equity stakes.

Yet modern capital markets offer an opportunity here. Oftentimes when the operating firm weakens, hedge funds, which do not face the same regulatory hurdles that traditional bank lenders face here,[68] acquire distressed debt and, with their industry and operating expertise,[69] their negotiating skills, and a taste for financial combat,[70] induce operating and financing decisions in the target firm that favor the

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[67] Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, (2010) ("[t]he creation of a market in bankruptcy claims is the single most important development in the bankruptcy world since the Bankruptcy Code's enactment in 1978"); Bernstein, supra note 1, at 11-12; Paul M. Goldschmid, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191, 200-09. With regard to the growth of assets managed by hedge funds see: Juliet Chung, *Hedge-Fund Assets Rise to Record Level*, WALL ST. J., Apr. 19, 2012**;** Kahan & Rock, supra note 36, at 282.

[68] For now, at least. See WACHTELL, LIPTON, ROSEN & KATZ, *Petition for Rulemaking under Section 13 of the Securities Exchange Act of 1934* (March 7, 2011)), which proposed disclosure rules for hedge fund acquisitions of a kind that could impede hedge funds from acquiring multiple financial layers at an attractive cost. Lucian A. Bebchuk & Robert J. Jackson, *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. __ (forthcoming, 2012), describe the costs of the proposal in deterring useful investor checks on management.

[69] Steven N. Kaplan & Per Strömberg, *Leveraged buyouts and private equity*, 23 J. ECON. PER. 121, 132 (2009):

> Today, most large private equity firms have … industry and operating expertise that they can use to add value to their investments. Indeed, most top private equity firms are now organized around industries. … [P]rivate equity firms now often hire professionals with operating backgrounds and an industry focus … [and they] also make use of internal or external consulting groups.

See also Viral V. Acharya, Oliver F. Gottschalg & Conor Kehoe, *Corporate Governance and Value Creation: Evidence from Private Equity*, __ REV. FIN. STUD. __ (forthcoming, 2012) (MS at 4).

[70] See Kahan & Rock, supra note 36, at 282:

> [H]edge fund activism is strategic: Hedge funds invest *in order to* become active, and the activism is designed to generate gains rather than reduce loses…. By contrast, activism by traditional institutions is incidental to their investment activities. Traditional

hedge fund, either by shifting value to the hedge fund or by inducing the firm to operate better than before.[71]

Three economists examining a sample of 474 Chapter 11 cases from 1996 to 2007 found evidence that is

> more supportive of efficiency gains brought by hedge funds than of value extraction from other claims. The presence of hedge fund unsecured creditors is associated with both higher total debt (including secured and unsecured) recovery and a more positive stock market response at the time of a bankruptcy filing, suggesting a positive effect of hedge fund creditors on the firm's total value…. Similarly, [they] show that hedge funds participating in bankruptcy do not have as short a horizon as their counterparts specialized in pure trading. These hedge funds benefit more from companies' emergence, where the long-term prospects of the firm are important.[72]

Hedge funds can create value in distress situations by overcoming a dominant secured creditors' liquidation bias, thereby increasing the likelihood that the firm emerges from bankruptcy, reassuring the market that the firm will survive, signaling that sophisticated financiers think the firm is survivable, removing some managers while retaining others,[73] reducing the time spent in chapter 11, and providing liquidity for companies that cannot find other lenders.[74] But the most important finding is that according to recent studies hedge funds' investment strategy privileges

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> institutions tend to become active when an investment they hold for different reasons suffers a significant decline in value, and their activism is designed to recoup some of these losses.

On hedge fund activism, also see William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1381 (2007); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 2 J. CORP. L. 681 (2007); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 225 (2009); Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51 (2011); Christopher P. Clifford, *Value creation or destruction? Hedge funds as shareholder activist*, 14 J. CORP. FIN. 323, 325 (2008).

[71] Lipson, supra note 1, at 1638; April Klein & Emanuel Zur, *The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders* 24 REV. FIN. STUD. 1735, 1766 (2011) (activist hedge funds with equity positions damage bondholders).

[72] Wei Jiang, Kai Li & Wei Wang, *Hedge Funds and Chapter 11*, 67 J. FIN. 513, 515 (2012). For similar conclusions, see Brav Alon, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge fund activism, corporate governance, and firm performance*, 63 J. FIN. 1729, 1773-74 (2008); Edith S. Hotchkiss & Robert M. Mooradian, *Vulture investors and the market for control of distressed firms*, 43 J. FIN. ECON. 401, 404 (1997); Jongha Lim, The Role of Activist Hedge Funds in Distressed Firms (Ohio State working paper, 2011) (reporting that in a sample of 184 financially distressed firms for the period from 1998 to 2009, hedge funds often shortened the time needed to alleviate financial distress).

[73] Jiang, Li & Wang, supra note 72, at 555.

[74] Goldschmid, supra note 67, at 249-255; Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703, 753 (2008); Suniati Yap, *Investing in Chapter 11 Companies: Vultures or White Knights?*, 2 Sw. J. L. & Trade Am. 153, 158-161 (1995) ("when investors infuse new capital in the debtor, it often serves as a 'catalyst for a restructuring' and may be the debtor's only chance for survival"); David J. Brophy, Paige P. Ouimet & Clemens Sialm, *Hedge funds as investors of last resort*, 22 REV. FIN. STUD. 541, 543 (2009).

the long-term prospects of the firms.[75] The purpose here is to find judicial doctrines that will encourage this constructive action and discourage destructive activity.

Indeed, the increased volatility in creditor instruments, trading, and control have heightened problems of, and potential for, creditor control. But while the creditor control capacity has increased, judicial doctrine has not adapted to the new business reality and has not yet found ways to channel the increasing creditor activity into the positive value-enhancing mechanisms and away from the value-diminishing negative.[76] Lenders have become more active than they were before.[77] "The crucial question [then becomes] the extent to which private lenders' self-interest is aligned with the interests of all the investors in the corporation."[78] We propose here theory, doctrine, and mechanisms to facilitate that alignment.

A court could be more satisfied with the hedge fund's business judgment if the hedge fund bought up not just one strategic layer of debt with which it would be active but also proportionate interests in, or options on, or credit default swaps on, analogous portions of the target firm's other debt and equity. The new finance of derivatives, options, and credit default swaps makes it possible to construct a creditor that is sufficiently free from conflict that business judgment deference is possible.

And the new finance of hedge funds acquiring debt instead of banks holding loans makes it possible that creditors can emerge in bankruptcy that are not limited in their portfolio choice — as the Glass-Steagall, the National Bank Act, and the Bank Holding Company Act have traditionally limited deposit-taking banks, but do not limit the new deposit-free hedge funds.[79] With portfolio choice of the powerful

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[75] Jiang, Li & Wang, supra note 72, at 554; Goldschmid, supra note 67, at 267-74. But see, for their negative potential, Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarian at the Gate?* 89 WASH. U. L. REV. 155, 158 (2011); Hu & Black, supra note 1, at 821-22; Kahan & Rock, supra note 36, at 1083-87; Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth,* 55 VAND. L. REV. 1987, 2016 (2002).

[76] See Hu & Westbrook, supra note 33, at 1354; Kahan & Rock, supra note 36, at 282. Lipson, supra note 44, at 1038-39, states:

> Unlike heavily regulated banks and institutional lenders of the past, today's creditors are professional distress investors (e.g. hedge funds, private equity funds, investment banks) which are largely unregulated for these purposes. Being unregulated, they have far greater latitude in what they can do for-or-to distressed firms and their stakeholders… . [They] can hold complex, heterogeneous sets of claims against, or affecting, a distressed firm. They can, for example, hold debt and equity of various tranches, as well as derivative securities, such as credit default swaps and equity short sales. Such complex holdings may … reflect a desire to obtain the so-called "fulcrum" position: the maximum control for the minimum investment in the firm…. [Furthermore] private investors are not a firm's original lenders, but instead purchase debt claims at a discount on a secondary market.

[77] Baird & Rasmussen, supra note 35, at 676; Nini, Smith & Sufi, supra note 34.

[78] Baird & Rasmussen, supra note 26, at 1245-46.

[79] See Jiang, Li & Wang, supra note 73 at 516; Jongha, supra note 73 at 36:

> [H]edge funds have great … flexibility as to the securities they can hold and investments they can make. [U]nlike conventional financial institutions, hedge funds are not burdened by regulatory schemes, oversight, or reporting requirements due to the fact that they [are] open to only a limited range of "accredited" or "qualified" investors. For example, unlike other investment advisers, hedge funds do not have diversification requirements.… . Moreover, unlike other financial institutions, especially banks that are required to keep their balance sheet [at a] high quality and set aside additional capital for risky assets, hedge funds have no restriction on the "riskiness" of their portfolios.

new finance lender no longer circumscribed by bank regulation, it becomes possible to use the new finance of derivatives to construct the nonconflicted (or, more realistically, only weakly conflicted) creditor-in-control.

A bank could not take active positions such as those that Figure 5 illustrates. A modern hedge fund, however, could.

Time (1)

Assets	**Liabilities**	
$1000 value	$1000	Secured debt (but security is less than $1000)
	$1000	Trade debt and bonds
		Stockholders

Time (2) Hedge fund buys 10% of secured debt and seeks to influence the failing firm's strategic direction.

Assets	**Liabilities**		
$1000 value	$100	Hedge fund	$900 other secured
			1000 trade and bonds
			Stockholders

Time (3) Hedge fund acquires a vertical strip

Assets	**Liabilities**		
$1000 value	$100	Hedge fund debt	$900 other secured
	100	Hedge owns credit default swap on unsecured debt. (It will pay $100 to a third party if and when trade not paid.)	1000 trade and bonds
	10%	Hedge fund buys options on 10% of firm's stock	Stockholders

At time (2), the activist hedge fund acquires a single layer in the capital structure but has incentives at odds with raising the firm's overall value. By time (3), the hedge fund has obtained proportionate interests in each of the three capital layers. Its incentives emanating from its capital positions are consistent with maximizing the firm's value.

Figure 5. Hedge fund activism, with credit default swaps and equity options: a "vertical strip"

F. Similar Situational Conflicts and Solutions

While we believe we are the first to show how corporate law doctrine points toward a way to reduce the creditor conflict difficulties in theory, and that modern financial instruments and institutions provide the potential for a practical application, we have seen similar observations of how corporate players can hold multiple financial instruments and thereby reduce their conflicts.

Fredrick Tung and Xue Wang showed that, during the recent financial crisis, bank managers who owned debt-like claims on their financial institution steered their institutions through the financial storms more safely than managers who did not.[80] In a complementary fashion, Lucian Bebchuk and Holger Spamann showed that bank executives with substantial equity investments had reason to, and did, take socially excessive risks with the bank, with the potential systemic impact of that excessive risk-taking borne by others outside the bank.[81] Presumably if such managers held debt-like claims as well equity, their interests would better align with the public interest. To achieve this result, Sallie Krawcheck, a well-known bank executive, recently proposed to structure of bank managers' compensation to align their incentives with the bank overall. In particular, according to the author:

> A simple but powerful way for boards to alter the risk appetite of senior bank executives would be to add fixed-income instruments to the compensation equation. Any shift in this direction would have an impact, *but the most logical end point would be a compensation mix that mirrors the bank's capital structure*. Thus, as bank financial leverage (and therefore financial risk) increased, senior executives would be motivated to become more risk-averse.[82]

And Yair Listokin proposed that bankruptcy trustees get unsecured debt to align the trustee's incentives with the overall value of the firm:[83]

> Debt compensation in bankruptcy improves the incentives of managers to make efficient decisions before bankruptcy. The plan accomplishes this goal by effectively granting the creditors some over-sight of the manager. With debt compensation, decisions that hurt the value of debt potentially hurt the manager. Any given percentage of debt will be worth less if the manager makes inefficient decisions before bankruptcy. In addition, the manager knows that the creditors will decide whether or not to adopt debt compensation, as

[80] Frederick Tung & Xue Wang, *Bank CEOs, Inside Debt Compensation, and the Global Financial Crisis* 26-27 (July 22, 2010) (Boston Univ. School of Law Working Paper No. 10-25):

> Giving managers a stake in the value of the firm's debt makes them less willing to sacrifice its value to benefit shareholders. This is especially important when the firm is in distress. Debt compensation can improve managerial effort and firm value in distress situations because unlike equity, debt is sensitive to the firm's liquidation value. That is, debt holders may still recover value when the firm is in distress. By contrast, equity is worthless once the firm is insolvent. Managers holding inside debt may therefore be less inclined to make risky bets when the firm gets into trouble.

[81] Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010).

[82] Sallie Krawcheck, *Four ways to fix banks*, 90 HARV. BUS. REV. 107, 109 (2012) (emphasis supplied). For a careful academic analysis of the possibility, see Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205 (2011).

[83] Yair Listokin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with Debt*, 155 U. PA. L. REV. 777, 783 (2007); Alex Edmans & Qi Liu, *Inside Debt*, 15 REV. FIN. 75, 92 (2010). But see criticism of this kind of compensation inside bankruptcy, as unnecessary inside bankruptcy, given other protections, and as hard to implement, in Adam J. Levitin, *The problematic case for incentive compensation in bankruptcy*, 156 U. PA. L. REV. 88 (2007).

> well as the appropriate percentage award. Creditors are unlikely to award debt compensation if they feel that the manager has made inefficient decisions in the pre-bankruptcy period.[84]

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We have sought safe harbor principles that could only improve on the incentives governing creditor conduct, because safe harbored players who do not like the rules that would emerge, or who find them expensive to use, could fall-back on the current rules. But we concede that some configuration of possibilities could undermine this goal. If creditors will only lend initially if they can liquidate the company upon default, with no questions asked of them; and if they cannot fall-back on the current rules (because the safe harbor erodes the vitality of the existing rules); and if suing on their contract for repayment (without taking control of the debtor) is not good enough to get the creditor its contracted-for liquidation value; and if the acquisition of vertical strips in the debtor is prohibitively expensive, then, if all of the foregoing come to pass, our rule would fail to improve the status quo ante. But this required simultaneous confluence of difficulties is not something we should expect to be likely. And there remains the possibility ─ which we do not here push forward ─ that replacing the current rules with the incentivized alternative we propose as a safe harbor may eventually overall improve lending practices and restructuring results.

CONCLUSION

The business world is as financially volatile as ever. Yet the doctrines that courts use to evaluate creditor activity that goes beyond basic loan collection have not been updated either for the riskier world we live in or for the 21st century's new capital markets instruments. The new instruments and the new institutions provide the opportunity to better guide creditor action inside troubled firms.

The first step is to recognize that the existing doctrines do not address themselves to facilitating efficacious management of the failing firm. Yet with corporate and economic volatility as important as ever, doctrine should seek to be more functional.

The second step in updating these creditor conduct doctrines is to recognize that the existing doctrines are deeply contradictory. Courts pose the alternative of the creditor perniciously taking day-to-day control of the firm (and thereby acquiring easy-to-breach fiduciary duties to other creditors or to the firm itself) against the alternative of the creditor simply protecting its previously-negotiated contract rights (and thereby owing no duties to other creditors). The difficulty is that the permitted contract could lead to pernicious day-to-day control. And even without day-to-day control, the creditor could push the firm to self-liquidate and destroy value, even if the creditor stayed at an arms-length position away from day-to-day control.

[84] Listokin, supra note 83, at 830.

While deference to contract could trump all judicial decisionmaking here, in most settings that are of interest, the contract is silent, with the specific creditor action just not fully contemplated by the contract, or the creditor action affects other creditors that were not party to the contract. For example, the debtor may be in default under a financial ratio and the creditor offers to forbear, if but only if the debtor liquidates its major facility, to the detriment of trade, tort, and governmental creditors. Moreover, even if contract gives the creditor carte blanche, we should want mechanisms that would facilitate a Coasian ex post rebargaining to deploy the firm as efficiently as possible. Our proposal is for a safe harbor that would internalize enough of the Coasian incentives into a single player, so that the Coasian results would be achieved more often than they are now.

The third step is to recognize that corporate law has long dealt with similar situations when articulating board-based fiduciary duties. The stripped-down version of the corporate law's fiduciary duty rule is that the court will defer to the board's business judgment if the board is not substantially conflicted in its decisionmaking. If the board has serious conflicts of interest and cannot extricate itself from those conflicts by delegating decisionmaking to a subcommittee, then the court will take over the decision from the board and evaluate the board's actions for their entire fairness. Until now, there has been little reason to assess the severity of conflicts in the creditor setting for a deferential judicial review, because the conflicts were obvious, pernicious, and irremediable. Hence, courts rightly jumped to the creditor-in-control equivalent of entire fairness review.

The last step is to recognize that modern capital markets can substantially reduce controlling creditor conflicts to the point that business judgment deference becomes plausible to consider. The controlling creditor could, more easily than ever, obtain options, credit default swaps, and other investments that give it incentives to maximize the value of the firm overall and not the value of just one credit layer in the firm (at the expense of overall firm value).

True, the controlling creditor may not be able to use old-style conflict-reducing mechanisms of simultaneously holding proportionate interests in all of the firm's important credit and equity layers. It is too expensive to do so when the loan is made, costly for a creditor to hold when the firm is doing fine, and barred for many institutional creditors. Yet it is too complicated to negotiate such a deal between the debtor and the creditor when stress befalls the firm. But with modern options and credit default swaps, the creditor need not hold these parallel instruments from the time of loan origination and need not negotiate for them with the debtor firm itself. Rather, the activist creditor, in particular the activist hedge fund that buys up a slice of debt in the distressed firm, can take options on or write credit default swaps on the firm's other debt and equity layers, so that the activist creditor limits its own conflicts that might lead it to prefer value-destroying liquidations and transfers. When the activist creditor does so, the court can be more confident that the activist creditor's actions were intended to raise the total value of the firm, in the activist's best business judgment.

We can consider this reformulation as either a safe harbor for creditors that comply or a screen to help induce healthy creditor action. We cannot be sure how much creditor activity today benefits the enterprise and how much of it shifts value inside the enterprise, although we now have some data indicative of both being in play. Moreover, even if the behavior were now good overall, a bright line permission for creditors would bring forward more negative behavior. And a bright line ban, if we thought that current creditor activity was largely negative, would stymie potential innovation. The beauty of the rule we propose is that we need not know right now the relative weight of good and bad creditor behavior. The overlay of corporate law duties on the creditor control problem gives us a doctrinal solution and the new finance in capital markets gives us the possibility of on-the-ground practical implementation. Creditors who use the offered safe harbor could intervene to improve firm value. If there are no such creditors, or no such creditors willing to pay the capital costs of doing so, then the ongoing, muddy rules will govern their actions.

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We have here re-analyzed a longstanding, difficult, and still unresolved problem of the proper standard for governing creditor action inside distressed firms. We have shown why the transactional problem persists, is severe, and is still doctrinally unresolved. The doctrines are not just messy and contradictory, but they also fail to address themselves to the critical problem of encouraging the best management of distressed firms in volatile markets. We believe we have shown for the first time how corporate law conceptualizations deal with a similar problem, deal with it differently, and can be used to better analyze the problems of creditor intervention in debtor affairs. And we believe we have also shown for the first time how such conceptualizations can be made real by using modern capital market instruments to channel the incentives of new players in financial markets.

A long history of boardroom corporate law doctrine aims to make the boardroom a neutral, unbiased decisionmaker, one that can balance the interests of all affected by the corporation. Delaware corporate courts have made strong efforts during the past decades to make board duties, liabilities, and business judgment deference facilitate better decisionmaking when the firm is in stress.[85] In our approach, the critical decisionmaker is deeply interested, with much money, investment, and value on the line and, hence, may have an advantage over the neutral board when the firm is distress. But that advantage has long been thought to be countered by the creditor's undeniable and irremediable conflicts of interest. Our structural goals here are to make its interest correspond as much as possible to the total value of the corporation, a goal that is now viable. We can reduce the persistent doctrinal and fairness problems of the actions of a controlling creditor in a distressed firm, while simultaneously increasing the chance that the distressed firm will be better run. We have outlined how this could be done, by using core corporate law doctrine to bring forth the correct usage of modern capital markets to reduce creditor conflict and enhance creditor incentives in managing distressed firms.

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[85] See Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation, 1991 Del.Ch. LEXIS 215 at n.55 (Dec. 30, 1991), and the follow-on decisions.