ARTICLE

TAKING CONTROL RIGHTS SERIOUSLY

ROBERT K. RASMUSSEN†

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INTRODUCTION

The Bankruptcy Code deals first and foremost with the cash flow rights of the debtor's various investors. The immediate cause of most corporate bankruptcy filings is a company's pending inability to pay off its obligations that are becoming due. The firm has made promises to pay various parties, and it does not have the financial wherewithal to live up to those obligations. It lacks the liquidity necessary to continue to service its debt and has either defaulted on its obligations or faces imminent default. In short, there is a mismatch between the company's capital structure and its future revenues.

Restructuring the business's balance sheet under Chapter 11 is designed to address this mismatch between obligations and available resources. The goal is to create a capital structure that better reflects the future revenues of the firm. The heart of Chapter 11 is the absolute priority rule. It sets forth the conditions that must be met for an investor to see her cash flow rights changed over her

† J. Thomas McCarthy Trustee Chair in Law and Political Science, University of Southern California Gould School of Law. Many thanks to Marc Heimowitz, Michael Simkovic, and David Skeel for their thoughtful and helpful comments on an earlier draft of this piece.

objection.[1] Those holding secured debt can see their principal reduced, the interest rates on the debt trimmed, and the term of the loan extended. Unsecured debt can be reduced, paid off at pennies to the dollar, or converted to equity. Equity can be drastically diluted or even wiped out in full. Specifying the extent to which the various parties' rights can be adjusted over their objection structures the bargaining process that leads to a plan of reorganization.

Over the decades, much ink has been spilled over the extent to which there are deviations from absolute priority in practice and the extent to which other mechanisms could be implemented that would vindicate the rule.[2] Recently, there has been serious questioning of the wisdom of the Code's strict adherence to absolute priority, with the suggestion that we return to the world of relative priority.[3] Regardless of which flavor of priority one prefers, in every reorganization case the central issue that is the focus of reorganization law is how cash flow rights are adjusted—what claims will the prebankruptcy investors have against the restructured company?

The Code deals with cash flow rights in other ways besides adjusting investors' rights to cash flow at the end of the proceeding via a plan of reorganization. For example, all rights to receive payments based on prepetition debts are stayed by the filing of a bankruptcy petition.[4] Some transfers of money made on the eve of bankruptcy can be undone.[5] Transactions of the last few years can be scrutinized to see whether the debtor received an adequate return for property that it has transferred to others.[6] The debtor can decide

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1 *See* 11 U.S.C. § 1129(b) (2012). The absolute priority rule is invoked when a class of creditors fails to approve their proposed treatment under the plan. If the class agrees, but an individual creditor objects, her rights are measured by the so-called "best interests" test. 11 U.S.C. § 1129(a)(7)(A)(ii) (2012). As a practical matter, in modern reorganization cases, the best interests test does not loom large.

2 For examples of such work, see generally Barry E. Adler & Ian Ayers, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE L.J. 83 (2001); Barry E. Adler, *Game-Theoretic Bankruptcy Valuation*, 41 J. LEGAL STUD. 209 (2012); Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523 (1992); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983).

3 *See* COMM'N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., 2012–2014: FINAL REPORT AND RECOMMENDATIONS 208-09 (2014) (suggesting reducing the absolute rights of various classes to reduce costs); Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 813 (2017) ("Under a regime of relative priority, no one has an incentive to fight many of the battles that currently plague Chapter 11."); *see also* Anthony J. Casey, *The Creditors' Bargain and Option-Preserving Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 806 (2011) (suggesting that the argument for absolute priority actually supports an alternative model).

4 *See* 11 U.S.C. § 362(a) ("A petition filed under . . . this title . . . operates as a stay . . . .").

5 *See id.* § 547 (listing the possible conditions for a return of assets).

6 *Id.* §§ 544(b), 548. Examples of transactions that can be revisited include the granting of intercorporate guarantees and leveraged buyouts. *See, e.g.*, Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors (*In re* TOUSA, Inc.), 680 F.3d 1298, 1311-13 (11th Cir. 2012)

whether to continue with transactions in progress.[7] All of these situations adjust outside parties' legal rights to receive money from the debtor.

Bankruptcy law, in contrast, has little to say about control rights over the running of the business.[8] It by and large allows the existing management to remain in charge of the debtor.[9] State law vests the ultimate authority over a company's operations with the firm's board of directors,[10] and bankruptcy law leaves that structure in place. Boards, in turn, delegate the running of the company to the CEO and the executive team, and the Code takes this allocation of authority as the baseline for operating the debtor, both during the case and afterwards.

To be sure, the Code modestly curtails the board's and managers' sphere of autonomy in some situations. To the extent that the managers want to do something out of the ordinary, they need court approval. A court must grant permission to pay off prepetition suppliers that the managers deem critical to the debtor's continued operations.[11] Borrowing money outside of the ordinary course of business needs court approval.[12] Decisions to sell most or all of the assets of the business require the court's blessing.[13] Yet the Code provides

(invalidating guarantees granted by affiliates of the borrower to the lender as fraudulent conveyances); United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1297 (3d Cir. 1986) (finding a leveraged buyout to be a fraudulent conveyance). The Supreme Court's recent decision in *Merit Management,* which held that shareholders that receive a payment through a financial intermediary are not protected under § 546(e) of the Bankruptcy Code, is likely to cause an increase in such attempts to recover funds. *See* Merit Mgmt. Grp. v. FTI Consulting, Inc., 138 S. Ct. 883, 887 (2018); Plaintiffs-Appellants-Cross-Appellees' Motion to Recall Mandate at 1, *In re* Tribune Co. Fraudulent Conveyance Litig., 818 F.3d. 98, No. 13-3992-cv (2d Cir. Apr. 10, 2018) (requesting that the Second Circuit permit those seeking to recover to pursue their claim from those receiving proceeds from the leveraged buyout of the Tribune Company in light of the Supreme Court's decision in *Merit).*

7 *See* 11 U.S.C. § 365 (2012) ("[T]he trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.").

8 Other countries often give creditors direct control rights. *See* David A. Skeel, Jr., *Corporate Anatomy Lessons,* 113 YALE L.J. 1519, 1555-56 (2004) (reviewing REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (2004)) (noting the increase in creditor protection in creditor-oriented systems like England and Germany). Creditors can protect their rights at the end of the case through voting on the plan of reorganization, though management often retains the exclusive right to propose a plan of reorganization. For an explanation of the role that voting plays in Chapter 11, see *id.* at 1557-59 and see generally David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases,* 78 VA. L. REV. 461 (1992).

9 *See* 11 U.S.C. § 1107 (2012) (preserving most of a debtor's rights to control). Current management can be removed "for cause" and replaced by a trustee. *Id.* § 1104(a). However, such removal is rare in large reorganization cases. *See* Jonathan C. Lipson & Christopher Fiore Marotta, *Examining Success*, AM. BANKR. L.J. 1, 37 (2016) (reporting that trustees are appointed in 3.7% of large reorganization cases).

10 *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2018) (setting all default authority to a board of directors).

11 *See In re* Kmart Corp., 359 F.3d 866, 874 (7th Cir. 2004).

12 11 U.S.C. § 364 (2012).

13 *See id.* § 363(b) (describing the process and requirement for selling assets outside of the "ordinary course of business").

little guidance to the bankruptcy judge on how to assess a request when those in charge seek the requisite permission. Case law suggests that for major transactions, such as the sale of an entire firm, the burden on the managers is to articulate a "business justification" for the proposed action.[14] On its face, this articulation sounds a bit more demanding than the "business judgment rule" that effectively insulates most corporate transactions outside of bankruptcy from judicial questioning. The increase in scrutiny, however, is modest at best. Few cases can be found where the bankruptcy judge rejects the justification that the managers put forward. The upshot is that, at least as a formal legal matter, control of the company prior to the confirmation of a plan of reorganization remains with those who had control prior to the commencement of the case.

There is a change of control rights at the end of the case when a plan of reorganization is confirmed. It is not, however, that lenders receive the legal authority to make decisions with respect to the deployment of the company's assets, as *lenders*. Rather, lenders are given new interests in the reorganized company. In most cases where the debtor is not sold to a new owner,[15] the standard result is that shares in the reorganized company are distributed to the prebankruptcy investors. They do not go to the old shareholders;[16] instead, they go to the former debt holders. Precisely how the securities are distributed depends on where in the waterfall the value of the company runs out.[17] The point is that Chapter 11 does not give control rights to creditors. Rather, it changes the creditors (or at least some of them) into shareholders.[18]

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14 *See* Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1069-70 (2d Cir. 1983) (finding that there must be a business justification beyond appeasing customers to selling property outside the normal course of business).

15 A substantial number of Chapter 11 cases today involve selling the debtor. *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675-76 (2003) (reporting that sales comprised over half of the Chapter 11 cases of large, publicly held companies).

16 Even in cases where the absolute priority was violated in the past, old equity received a very small fraction of the new shares. *See* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 141-43 (1990) (reporting that in a sample of thirty cases, nine cases had no distribution to equity, eleven cases had distributions to equity that were less than or equal to five percent of the distribution to unsecured creditors, eight others had distributions that were between five percent and ten percent, and in only two cases were the distributions more than ten percent).

17 On the challenges of valuing a company in a Chapter 11 proceeding, see generally Kenneth Ayotte & Edward R. Morrison, *Valuation Disputes in Corporate Bankruptcy*, 166 U. PA. L. REV. 1819 (2018).

18 Barry Adler has proposed replacing Chapter 11 with a system that makes such changes automatically upon default. *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323-24 (1993). Along the same lines, bonds that automatically converted to equity upon default have also been proposed. *See generally* Note, *Distress-Contingent Convertible Bonds: A Proposed Solution to the Excess Debt Problem*, 104 HARV. L. REV. 1857 (1991). Both of these proposals have control rights remaining with equity and convert junior debt holders into equity holders. In other words, they adjust cash flow rights rather than control rights.

However, bankruptcy law does one thing in the area of control rights. It abrogates all efforts to parcel out control rights via contract. To the extent that the parties have contracted for the debtor to take certain action, the debtor can reject the contract.[19] Attempts by third parties to exercise control over the assets of the estate, even if these parties are otherwise legally entitled to take such action, are blocked by the Code's automatic stay.[20]

One can question the Code's obsession with cash flow rights and the relative neglect of control rights. From a societal perspective, getting the right decisions as to the deployment of assets matters more than who collects the spoils. Control rights in the end determine the size of the pie. Cash flow rights merely determine how the pie is sliced. The paramount question facing any enterprise is who makes the decisions regarding the future of the business. When scholars look at corporate decisions, they have a tendency to focus on the incentives caused by cash flow rights. It is undoubtedly true that incentives matter. Consider, for example, the issue of executive compensation. Tying a CEO's compensation to the company's stock price will lead to different outcomes than would tying her compensation to the company's market share. But focusing only on incentives elides the question of the quality of the person making the decisions. Some folks have better judgment; some are a better fit with the organization. To look at it another way, it is not that the CEOs who fail necessarily have bad incentives. Tinkering with the terms of a compensation agreement would not turn a mediocre CEO into an outstanding one. The converse is true as well. A poorly structured compensation package will not consign a talented leader to failure.

The bottom line is that giving someone the best incentives does not give them the wisdom to make the right judgments. Having someone in control who makes good decisions matters a lot to investors. For example, it is common in lending agreements to include a change of control covenant. The typical provision provides that a change in a borrower's leadership constitutes a default under the loan. However, it is not that the bank invariably calls the loan when such a change is made. Rather, the bank achieved a level of comfort with the team that was in charge at the time it made the loan; by having a "change of control" provision, the bank can assess whether it has the same level of comfort with the new team or whether it wants to terminate the relationship.

This relative lack of attention to control rights by bankruptcy law has not always been the case. At one point, the formal shift of control rights loomed large in the law of corporate reorganizations. The Bankruptcy Act, the predecessor to today's Code, paid close attention to control rights. The drafters of the Act distinguished between two types of companies: one was the small business. The

19 11 U.S.C. § 365(a) (2012).

20 *Id.* § 362(a)(3).

fate of such an operation, then as now, was tied up with its owner. The company may or may not be able to be reorganized successfully. If it was, however, there was no doubt that it would be under the control of the prebankruptcy owner. Not surprisingly, under the Act's Chapter XI, the owner/manager remained in charge of the business during the restructuring effort. Putting someone else in place would make little sense. Outside of bankruptcy there was little separation between ownership and control, and there was no reason to cleave the two once a bankruptcy petition had been filed.[21]

The Bankruptcy Act treated publicly traded firms differently. Such businesses were run by professional managers rather than the owners of the company. One could easily imagine transferring control over the company to a new set of hands. Chapter X of the Act was to be the home for companies overseen by professional managers. As the law was originally envisioned, the old managers were shown the door when the company filed for reorganization, and the SEC would step in and appoint new people to run the company.[22]

The drafters of the Chandler Act were acutely aware of who exercised control rights. They did not trust the private managers of failed firms (nor their lawyers). They viewed public companies as having a public purpose, and when these businesses encountered financial difficulty, it seemed only right to them to sweep out those who had caused the problem and put in place leadership blessed by the government.

Things did not go as the drafters planned, with small businesses ending up in Chapter XI and large public companies in Chapter X.[23] Rather, businesses large and small sought to reorganize under Chapter XI's provision. The motivation was readily apparent: few managers wanted to sign up for an automatic death sentence. The initial tactic was that they would avoid filing for Chapter X for as long as they could. Eventually, case law developed so that they were able to shoe horn their way into Chapter XI and thus remain in control of the business during the bankruptcy proceeding.[24] Chapter X became something of a relic.

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21 Such businesses still make up a sizable portion of Chapter 11 work, at least when measured by cases. *See* Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 COLUM. L. REV. 2310, 2321-22 (2005) (reporting that in a sample of Chapter 11 cases, there were 104 small business cases and only two cases where the debtor had a separation of ownership and control).

22 *See* Chandler Act, ch. 575, § 189, 52 Stat. 840, 892 (1938) (allowing the trustee to "operate the business").

23 *See* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW 161-66 (2001) (describing the history by which public corporations obtained access to Chapter XI).

24 *See* Benjamin Weintraub & Harris Levin, *A Sequel to Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporation,* 26 FORDHAM L. REV. 292, 292 (1957) (explaining that middle-sized public corporations were able to file for relief under Chapter XI).

The drafters of the Code's Chapter 11 were well aware of this failed attempt to segregate small companies from large ones. Accordingly, they crafted a single chapter for all corporate bankruptcy reorganizations. In terms of who would run the company during the reorganization effort, the drafters adhered to the prevailing practice and selected Chapter XI's rule of allowing current managers to remain in place. Managers embraced this new regime. In the first years of Chapter 11, it was common knowledge that the debtor and its prebankruptcy management remained in full control of both the business and the reorganization effort. Indeed, Chapter 11 was viewed by many as a vehicle by which managers could hide from the consequences of their poor decisions.[25]

While the formal allocation of control over an enterprise that has filed for reorganization has remained the same since the enactment of the Code almost forty years ago, the past two decades have seen an increase in the ability of debt holders to influence the conduct of the business and the course of the Chapter 11 proceeding. It is now commonplace for creditors to be the driving force behind reorganization efforts. Indeed, some have referred to the current state of affairs as "creditor in possession," a reflection of the fact that the creditors—or at least a subset of them—are making the crucial decisions about the future of the business, as opposed to the board of directors and the management.

In this Article, I revisit this state of affairs. Part I assesses how state law and investors allocate control rights over a business prior to the onset of financial distress. Even in financially healthy companies there is potential for tension between the interests of equity holders and debt holders as to the course of the business going forward, and this tension can be resolved through terms in the lending agreement. Part II examines how creditors in today's environment affect the exercise of control. While they are careful not to put their hands directly on the levers of power, these creditors shape the business's future. Part III assesses this state of affairs. While the current balance between the rights and powers of debt holders and equity holders may be optimal, one can question such a Panglossian proposition. Many features of current law shape how the parties allocate control rights. In particular, our legal regime makes it difficult for parties to contract directly on control rights. If these features were altered, it could open up the contracting space and change the lending contracts that now govern the relationship between debtors and their investors.

25 *See, e.g.*, Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1049 (1992) ("We believe that, insofar as corporate bankruptcies are concerned, the principal beneficiaries of Chapter 11 . . . are corporate managers.").

I. THE ALLOCATION OF CONTROL RIGHTS OUTSIDE OF BANKRUPTCY

Corporate law vests control rights over the operation of the business with the board of directors of the company.[26] The board of directors is elected by the shareholders, but it would be a mistake to analogize such elections to political contests. The board formally nominates a candidate for each position that is up for election, often putting the incumbent board members forward. The power to nominate in practice translates to the power to appoint. Shareholders routinely cast their proxies in favor of those put forward by the board. It is rare that the winners of the board election are not those proposed by the board.[27] The recent case of activist investor Nelson Peltz running a successful campaign to gain a seat on the Procter and Gamble Board stands out for its uniqueness.[28]

In most corporations, the board delegates the control rights over the day-to-day operation of the business to the CEO. The CEO, often working with the board, fills out the rest of the management team. The board thus has the ultimate authority in that it selects the CEO, has the power to fire the CEO, and retains final authority over the company's major decisions.[29] The exact nature of which decisions need to be approved by the board varies from firm to firm; generally, the company's bylaws dictate which decisions can be made by management and which need to be made by the board.

This sharing of control over the business between the board and management can be immune from shareholder intervention. Current law allows a corporation to adopt structures that insulate a board and incumbent managers in their exercise of control rights. Under Delaware law, a company can, in its charter, retain the right for the board of directors to issue a poison pill in response to a hostile takeover attempt.[30] A poison pill, or shareholder rights plan, allows existing shareholders to buy new discounted shares should

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26 *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2016) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

27 *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 688 (2007) ("[T]he incidence of electoral challenges by a rival team seeking to run the company better is quite small—and successful such challenges are quite rare."); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 311 (1999) ("[S]hareholders in public corporations do not in any realistic sense elect boards. Rather, *boards elect themselves*.").

28 *See* Nick Turner & Beth Jinks, *P&G Names Activist Nelson Peltz to Board After Proxy Battle*, BLOOMBERG (Dec. 15, 2017, 5:31 PM), https://www.bloomberg.com/news/articles/2017-12-15/p-g-names-billionaire-nelson-peltz-to-board-after-proxy-battle [https://perma.cc/UTN7-93S9] (describing Peltz "narrowly" obtaining a "contentious and costly" victory to win a seat on Procter and Gamble's Board of Directors).

29 *See* Douglas G. Baird & Robert K. Rasmussen, *The Prime Directive,* 75 U. CIN. L. REV. 921, 923 (2007) ("[T]he challenge of hiring and firing managers is the single most important job that directors face.").

30 DEL. CODE ANN. tit. 8, §§ 151, 157 (2018). Even absent such a provision, a board can create a poison pill. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1357 (Del. 1985) (upholding a business's use of a poison pill as a legitimate exercise of its judgment).

a potential acquirer obtain a certain level of stockholdings. Crucially, the putative acquirer is not offered the discounted shares. The ability to deploy a pill makes it difficult for an outsider who has determined that the company is not being run effectively to buy the company over the objection of the board. Indeed, the entire point of a poison pill is to defeat a hostile takeover.

But what about replacing the board via elections? If the existing board will not entertain an attractive offer for the company, perhaps a new one would be more amenable. The company can block this move as well. It can structure itself so that its board is staggered. This means that only a minority of directors, typically one-third, stand for election each year. Therefore, a hostile bidder can only replace a minority through a proxy contest in any given year. To the extent that the board unanimously opposes a takeover bid, it would take two election cycles for the hostile bidder to gain control of the board. The effectiveness of this insulation of control rights from outsiders is well established,[31] even if there remains robust debate over the social desirability of the practice.[32]

The market for corporate control, however, is not the only mechanism that affects the ability of managers to exercise control rights. Contracting plays a role in guiding control rights as well. A lending contract's primary purpose is to set forth cash flow rights. The contracts specify when the borrowed money has to be repaid, stipulate the interest rate, and dictate what the effect of default will be on those obligations. But they do more than this. Lending contracts not only set cash flow rights, but also often provide a basis by which the lender can affect and constrain management's exercise of the control that it enjoys over the company. Lending documents, which are far more detailed than corporate charters, often run in excess of 100 pages, and many of these provisions relate directly to decisions regarding corporate action. For example, it is common for a credit agreement to limit how much money a borrower can devote to capital

31 *See* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, & Policy*, 54 STAN. L. REV. 887, 890 (2002) ("A staggered board . . . offers a more powerful antitakeover defense than has previously been recognized.").

32 *Compare* K.J. Martijn Cremers & Simone M. Sepe, *The Shareholder Value of Empowered Boards*, 68 STAN. L. REV. 67, 71 (2016) (documenting empirically the association between staggered boards and significant increases in firm value), *and* K.J. Martijn Cremers et al., *Staggered Boards and Long-Term Firm Value, Revisited*, 126 J. FIN. ECON. 422, 443 (2017) (finding that when a certain subset of firms—namely those in long-term projects—adopt a staggered board, the value of the firm increases), *with* Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1642 (2013) ("[A]n analysis of the long-term effects of board insulation, informed by the relevant theoretical and empirical literature . . . indicates that the overall effect of insulation at current or higher levels is negative rather than positive."), *and* Lucian A. Bebchuk & Alma Cohen, Recent Board Declassifications: A Response to Cremers and Sepe 7 (May 1, 2017) (unpublished response), *available at* https://ssrn.com/abstract=2970629 (concluding that methodological issues in Cremer's and Sepe's studies preclude their papers from drawing valid inferences on the effects of staggered boards).

expenditures. The lender limits what can be spent on new large projects, thereby putting constraints on expansion of the business. The credit agreement can also constrain the ability of borrowers to enter new lines of business, borrow additional funds, and pledge collateral. The lending agreement may also circumscribe the ability of the borrower to make acquisitions or to shift funds to subsidiaries in other countries.

It is important to delineate the legal relationship that the credit agreement creates between the lender and the borrower. It is commonplace in the literature to describe these contracts as vesting control rights in the lenders.[33] As a legal matter, this characterization is not entirely accurate; the contracts do not give lenders direct control rights over the business. The lenders cannot take actions that normally fall within the domain of the board: they cannot put a company up for sale, require a change of management, or veto a new investment that the managers want to make. The formal power over these decisions remains with the company, and the lender has no legal right to block a duly made decision by the board. No court, in looking at the lending contract, would grant a lender's request to enjoin action that the company seeks to take.

This is not to say that the lenders lack power over the borrower—quite the contrary. The point is that the lender has more actual power than legal rights. The covenants in the lending agreement effectively give the lender veto power over certain actions and allow the lender to exert influence on others. The process works as follows: When the borrower violates a covenant in the credit agreement, the lender may declare a default under the terms of the agreement. The effect of declaring a default is to accelerate the principal and make the entire outstanding loan due and owing immediately. The threat of acceleration is a powerful one. Few companies have the ability to pay off

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33 *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 933 (2001) ("The key to the success of the equity receivership lay in the control rights given to the investment bankers and their need to return to the market in the future."); Greg Nini et al., *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 REV. FIN. STUD. 1713, 1758 (2012) ("Given the well-documented set of control rights given to the creditors following a covenant violation, we interpret the evidence as suggesting that creditors serve a corporate governance role that helps increase the value of the firm."); Greg Nini et al., *Creditor Control Rights and Firm Investment Policy*, 92 J. FIN. ECON. 400, 401 (2009) ("Private credit agreements govern the terms of sole-lender and syndicated bank loans to companies, and they contain covenants that are more detailed, comprehensive, and tightly set than public bonds."); Michael R. Roberts & Amir Sufi, *Control Rights and Capital Structure: An Empirical Investigation*, 64 J. FIN. 1657, 1666 (2009) ("Although the allocation of control rights is an important aspect of these models, creditor 'control' does not necessarily entail creditors literally replacing managers as decision-makers."); Mitchell Berlin et al., Concentration of Control Rights in Leveraged Loan Syndicates 4 (Mar. 16, 2018) (unpublished manuscript) *available at* https://ssrn.com/abstract=2960757 ("The purpose of split control rights is not to diminish borrower monitoring but rather to concentrate control rights with the revolving lenders.").

all that they owe in full on short notice. Indeed, in cases where the lender operates the borrower's cash management system, the lender can seize all of the borrower's accounts to recover the money it is owed, thereby depriving the company of working funds.[34] Needless to say, faced with these potential consequences, borrowers do their best not to default.

The way in which lenders have used the covenants in a credit agreement to police the actions of the borrower has evolved over time. Covenants used to be thought of as purely defensive measures, designed to protect the interests of the lenders. The lenders, at the time they extended credit to the borrower, understood the business to which they were loaning money. They knew the risks that they were taking. Of course, they wanted the business to thrive; they expected to get paid out of the revenues that the business earns. On the other hand, there was always the chance that managers could change the risk profile of the company. For this reason, the lenders wanted to make sure that the business did not make fundamental changes without their consent. It was not that they thought that they had better ideas about the appropriate course of action than those running the business. Indeed, part of the decision to make the loan in the first instance was that the lead bank had confidence in the management team and its vision for the company. Rather, the lenders understood the risk profile that they were accepting when they agreed to make the loan, and they wanted to make sure that, if the borrower wanted to take actions that would (or could) change that profile, they were comfortable with those changes. The lenders did not want to wake up one day and find that they had lent money to a very different company than the company they had originally signed on to support.

A change in business focus was not the only risk that lenders traditionally guarded against via covenants in the credit agreement. Lenders are acutely aware that once cash flow rights are divided among various investors with differing claims, those in control may be tempted to take actions that increase the return to equity holders, even if such actions would place undue risk on the other investors. To use economic language, covenants in this era guarded against asset substitution, claim dilution, and dividend payments.[35] Asset substitution occurs when the managers replace one set of projects with a different set that may have the same expected value but greater variance. In the extreme, the managers of the company could reduce all the assets to cash, fly to Las Vegas, and "put it all on black." More realistically, the risk is that

34 *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1227 (2006) (remarking on the veto power that comes with the lender's complete control of the debtor's cash flow, internal and external to the corporation).

35 For the classic work in this area, see generally Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979), which delineates the risks the debt investors face and how covenants can mitigate these risks.

the company would alter its operations, such as starting a new line of business. It is not uncommon that a company has success in one area, leading the managers to believe that they have found the secret sauce that can be applied to other areas as well. Such expansion can sometimes go well. Other times, it can fail spectacularly.[36] It is not that lenders bar efforts to improve the business; rather, the negative covenants ensure that substantial changes are discussed with the lenders and receive their blessing. If the company could not get the lender to agree to a proposed expansion, the company would be left with the choice of either abandoning the new idea or finding a new lender that would be willing to refinance the business, usually paying off the old lender in full.

As with the risk of asset substitution, the risk that claim dilution presents a lender is also easy to understand. Claim dilution happens when a borrower gets money from a second lender after it has obtained a loan.[37] The new loan dilutes the first lender's claim because the first lender now has to compete with the second lender for repayment from the borrower. The dilution is even more extreme if the second lender is promised to be repaid sooner than the first lender or promised collateral that otherwise could have been used to satisfy the first lender's claim. Covenants aimed at prohibiting new borrowing and pledging collateral to other lenders are designed to ensure that a lender's claim is not diluted in this manner.

Dividend payments are perhaps the quickest way to increase the risk of nonpayment to a lender. Dividends go directly to the shareholders and do not end up in the lenders' pockets. Most lenders think that the best thing to do with available cash that is not needed to run the enterprise is to send it to the lenders in satisfaction of what the debtor owes rather than to funnel it to the shareholders. It is thus not surprising that credit agreements have terms that limit or even prohibit dividend payments.[38]

These attempts to constrain borrower behavior at times picked up what the lender would ultimately conclude were benign transactions. It is difficult to identify in advance with accuracy which future transactions will negatively alter the lender's ability to be repaid. The common approach was to draw covenants on the broad side, with the understanding that the credit

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36 Enron, for example, had success in creating a market in electricity. It believed that this expertise would allow it to create markets in other areas, such as water and broadband. Needless to say, the translation from one area to others did not go as well as the leaders had hoped. *See* Douglas G. Baird & Robert K. Rasmussen, *Four (or Five) Easy Lessons from Enron*, 55 VAND. L. REV. 1787, 1794-1801 (2002) (explaining the problems Enron encountered when trying to extend their energy strategy to other industries).

37 *See* Smith & Warner, *supra* note 35, at 136-38.

38 *See id*. at 131-35 (analyzing the features of payment-restricting bond covenants).

agreement could be tweaked as necessary.[39] Indeed, it was common for the borrower and lender to reach an agreement to amend the credit agreement or agree to waive what would otherwise be a default before a covenant was violated.[40] Lending agreements tend to run for five or six years, and even the best business people, lenders, and their lawyers understand that things can be revisited as necessary.

These negative covenants were not originally designed to give the lender control over the decisions that touch on the covenant. Rather, they were more analogous to a veto, with both parties understanding that the veto would be used judiciously. In terms of setting the constraints, they were broad and intentionally overinclusive. It was impossible to identify with precision the situations where the lender might become uncomfortable with actions that the borrower wished to take. The covenants were meant to identify situations that might be problematic and give the lender an advance warning before action was taken. The possibility that the borrower would trigger a covenant often forced a conversation about the nature of the violation.[41] If the lender was comfortable with the proposed actions of the borrower, it could either waive the default or amend the credit agreement so that the action at issue would not be a default.[42] These terms were by and large effective in achieving the goals of the creditors. As the creditors could not seek an injunction in court to specifically enforce the terms, the covenants created incentives for the parties to reach common ground on how to move forward.

In these situations, the terms of the lending agreement and the lenders' willingness to stand on their rights had a large effect on the actions of the company. Companies that were not on the same page as their lender were in for rocky times. Still, as a matter of positive law, it was the debtor deciding what action to take. Control rights remained in the debtor; the lending agreement influenced how they were exercised.

The empirical evidence reveals that these covenants affect company behavior well before bankruptcy is on the horizon. In any given year, somewhere between

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39 *See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1093-94 (1995) (describing debt covenants as "tripwires for the lender's right to accelerate and enforce or to intervene" well before missed payments or insolvency).

40 *See* Ilia D. Dichev & Douglas J. Skinner, *Large-Sample Evidence on the Debt Covenant Hypothesis*, 40 J. ACCT. RES. 1091, 1093 (2002) (finding frequent covenant violations, many not caused by financial distress).

41 *See* Triantis & Daniels, *supra* note 39, at 1084 (noting that "a borrower usually undertakes to advise the bank of any violations of its covenants").

42 *See* Michael R. Roberts, *The Role of Dynamic Renegotiation and Asymmetric Information in Financial Contracting*, 116 J. FIN. ECON. 61, 62 (2015) (reporting that typical loan has a maturity of four and a half years and is amended five times while it is in force).

ten and twenty percent of companies violate a covenant in a credit agreement.[43] Violating these covenants has consequences for the operations of the business. Violations are followed by decreases in both capital expenditures and cash acquisitions of other companies.[44] Payouts to shareholders decline as well.[45] The chance of a CEO being forced out also increases.[46]

Over time, the use of covenants as a lever to influence borrower behavior has expanded. Covenants have gone from being a shield to a sword. This is not so much a change in the way that the lending agreements have been written but rather represents a fundamental change with regard to who holds the loan. That is, a new type of player has entered the scene. This player has come to realize that some covenants originally designed to make sure that the borrower did not radically change its business could be used to force radical changes—of the lender's choice—on the borrowers.

At the extreme, there are those who view the credit agreement as a vehicle for acquiring a company, the so-called "loan-to-own crowd."[47] These investors arose on the scene in the 1990s and were a result of the change in lending markets. There had always been an active secondary market for the public-issued debt of a corporation, in part due to the fact that public debt tends to have fewer covenants than does private debt. Over the past couple of decades, however, a secondary market for private debt has evolved as well.[48]

Since the lending crisis of the 1980s, most private loans to large companies are no longer made by a single lender.[49] Instead, the lead bank—that is, the

43 Greg Nini et al., *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 REV. FIN. STUD. 1713, 1725-26 (2012).

44 *See id.* at 1736-37 (providing a graph that shows that "financial covenant violations are followed by decreases in capital expenditures and cash acquisitions and sharp reductions in the growth rate of total assets and PPE").

45 *See id.* at 1740-41 (showing that "total shareholder payouts decline sharply in the quarter after the violation and stay low for at least a year post-violation").

46 *See id.* at 1741-46 (providing evidence that while CEO turnover is generally consistent, during the quarter after a violation, "the incidence of forced CEO turnovers increases sharply").

47 *See* Bernard Wysocki, Jr., *New Breed of Hardball Investors Makes Loans, Takes Control*, WALL ST. J. (Dec. 12, 2006), https://www.wsj.com/articles/SB116589200646847241 [https://perma.cc/MQ26-AT4p].

48 *See* Amar Gande & Anthony Saunders, *Are Banks Still Special When There Is a Secondary Market for Loans?,* 67 J. FIN. 1649, 1650 (2012) (reporting an increase of loan trading on the secondary market from about $50 billion to over $300 billion between 1997 and 2008); Kerry Kantin, *US Leveraged Loan Trading Volume Hits Record $628B in 2014,* FORBES (Feb. 5, 2015, 9:13 AM), https://www.forbes.com/sites/spleverage/2015/02/05/us-leveraged-loan-trading-volume-hits-record-628b-in-2014 [https://perma.cc/KCL8-GNK3].

49 On the decline of traditional banks in the area of private loans, see generally Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 666-71 (2010), which discusses the rise of the "syndicated loan," where "[s]ingle banks no longer make loans to large businesses" and instead one bank acts as the leader that "monitor[s] the debtor and oversee[s] the interests of the creditor as a group." For a detailed evolution of syndicated loans, see Yener Altunbaş et al., *The Evolution of Syndicated Loan Markets,* 26 SERV. INDUSTRIES J. 689, 690 (2006). For a general overview of the syndicated loan market, see generally STANDARD & POOR'S, A GUIDE TO THE LOAN MARKET (2011),

bank that has negotiated the basic framework of the loan with the borrowers—puts together a group, or "syndicate," of banks to make the loan. The pieces of the loan are, in effect, parceled out to a number of lenders, with each lender funding a portion of the overall borrowing. These lenders can include not only traditional banks but also insurance companies and hedge funds. Moreover, the initial members of the syndicate can sell their participations to any willing buyer.[50]

The market in private debt has facilitated the emergence of new investors seeking to take control of a distressed firm. These investors buy the debt of a distressed company with the aim of using their position as creditors to ultimately take over the firm. The investors buy the debt, anticipating that they will eventually be able to turn it into equity via a Chapter 11 reorganization. If the equity of the company becomes highly concentrated after the balance sheet is restructured, the distressed investor will end up with control of the company.[51]

One response to the rise of nonbank players in the commercial loan space has been to differentiate between the term loan and the revolver. Many credit agreements consist of a term loan and a revolving credit facility.[52] Nonbank investors tend to participate in the term portion of the loan, whereas the revolver portion of the agreement is funded almost exclusively by banks. A central reason for this trend relates to institutional capability: banks are better equipped to advance funds quickly when the borrower makes a call on the revolver. Most distressed investors, on the other hand, do not have the back-office capabilities necessary to be part of the revolver.

In recent years, it has become increasingly common for the covenants of the term loan and the revolver to diverge. Moreover, the holders of the

https://www.lcdcomps.com/d/pdf/LoanMarketguide.pdf [https://perma.cc/2HRX-LK4A]. *See also* Berlin et al., *supra* note 33, at 2 ("One striking development in the $4 trillion syndicated loan market has been the marketing of bank-originated loans to nonbank intermediaries such as hedge funds, collateralized loan obligations (CLOs), and mutual funds.").

50 One notable exception to this right is the presence of a disqualified-institutions list within certain credit agreements. This list comprises potential buyers who have been deemed ineligible to own the debt. The types of institutions that appear on these lists are often particularly aggressive hedge funds and direct competitors of the borrower. Normally, these restrictions only come into force when the borrower is not in default on the loan. *See* David Griffiths, *Barbarians at the Gate: Loan Syndications and Trading Association Issues Market Advisory Regarding Disqualified Institutions Provisions for Blacklisted Lenders,* BANKR. BLOG (Feb. 25, 2015), https://business-finance-restructuring.weil.com/financial-markets/barbarians-at-the-gate-loan-syndications-and-trading-association-issues-market-advisory-regarding-disqualified-institutions-provisions-for-blacklisted-lenders [https://perma.cc/KCS6-FMU5]; Loan Syndications & Trading Ass'n, *Glossary of Syndicated Loan Market Terms*, PRACTICAL L. (Mar. 30, 2017), https://www.lsta.org/document/default/download/file/a9092950-f706-11e3-a545-5254003c8ea2 [https://perma.cc/83ZA-Z3BS].

51 For a discussion of this dynamic, see Baird & Rasmussen, *supra* note 49, at 659-86.

52 *See* Berlin et al., *supra* note 33, at 2 n.4 (reporting that in a sample of leveraged loans, 95% of borrowers with a term loan also have a line of credit).

revolver have been allowed to both amend its terms without the consent of the term loan holders and waive defaults. This structure has prevented the holdout game that some investors play in the term loan.[53]

Loan-to-own situations, however, are not the only way in which investors today seek to gather control rights. Even without engineering a complete takeover of a company, new investors can look to make changes, such as blocking proposed amendments to the credit agreement. Alternatively, they can insist that the company take certain actions before they will agree to an amendment. For example, they can engineer the appointment of a chief restructuring officer.

The chief restructuring officer (CRO) is a relatively new player in the corporate landscape. To get a sense of the rise and growth of the CRO, it is helpful to look at the milestones of the Turnaround Management Association, a group of professionals dedicated to working with companies in financial distress. The Association did not exist until 1986, and its first seven chapters were created in 1991. Membership soon exceeded 1000 by 1992 and passed 5000 by 2002.[54] The first reported mention of a CRO in a published opinion was 2004.[55]

The extent to which a CRO has her hands on the levers of control depends on the CRO's engagement letter. In some situations, the CRO can hire or fire employees of the company without the prior approval of the CEO. Regardless of whether the CRO reports to the CEO or to the Board, the CRO is a repeat player in the world of restructurings and reorganizations. She knows that her future employment rests with the lender's decision to recommend her for future gigs. To the extent that she is seen as someone who does not adequately prioritize the interests of creditors in exercising control rights, she will not get more work.

The recent increase in the use of covenants to influence company action when an enterprise encounters financial distress is not an isolated phenomenon. Rather, it is part of a broader trend of investor activism across the American economy. Investors now look for companies that they believe are not being run as well as they could be. Even in cases where financial distress is not on the horizon, activist investors buy stock in what they view as underperforming companies and agitate for change.[56] While the merits of

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53 For a discussion of the rise of differentiation between the covenants in the term loan and those in the revolver, see *id.* at 9-13.

54 *See Our History*, TURNAROUND MGMT. ASS'N, https://turnaround.org/about/our-history [https://perma.cc/C87K-DF7J] (last visited May 7, 2018).

55 Baird & Rasmussen, *supra* note 34, at 1233 n.72.

56 For a discussion of hedge fund activism outside of the distress context, see Marcel Kahan & Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 3 CORP. GOVERNANCE L. REV. 134, 139-50 (2007), which attempts to "illustrate[] the potential bright side of hedge fund activism" through avenues such as corporate governance and corporate control activism. On the same subject, see Frank Partnoy, *US Hedge Fund Activism*, *in* RESEARCH HANDBOOK ON SHAREHOLDER

such interventions remain the subject of debate, no one doubts that activist investors have changed the landscape of corporate governance.[57]

II. CONTROL RIGHTS INSIDE BANKRUPTCY

The Bankruptcy Code by and large does not change the formal allocation of control rights. Chapter 11 creates a "debtor in possession."[58] Under this regime, the current managers run the day-to-day operations of the business, subject to the oversight of the board of directors. At the end of the bankruptcy proceeding, new securities are issued in the reorganized company and new shareholders—often the former debt holders—appear, along with new board members—often put in place by the new shareholders.[59] As a formal legal matter, however, things remain in large part the same. The board and the managers retain control of the company, with the board being subject to removal by the shareholders.[60]

The Bankruptcy Code does, however, provide a modest contraction in the free reign that the board and management normally enjoy in running the company. Under the Bankruptcy Code, various actions that a company could have taken on its own outside of bankruptcy require court approval. For example, a company does not need judicial authorization or shareholder approval outside of bankruptcy to borrow funds. Such a decision rests solely with the board and the managers of the company. Once the company invokes Chapter 11, however, the debtor needs court approval to borrow funds outside of the ordinary course of business.[61] Along the same lines, a company outside of bankruptcy does not have to present its case to a judge or its stockholders if it wishes to sell some of its assets outside the ordinary course of business. To be sure, when the company wishes to sell all or substantially all of its assets

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POWER 101-09 (Jennifer Hill & Randall S. Thomas eds., 2015), which summarizes the history of hedge fund activism as well as its approach to the separation of voting and economic interests.

57 The evidence to date generally supports the claim that hedge fund activism leads to shareholder gains. *See* Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism,* 115 COLUM. L. REV. 1085, 1155 (2015) (noting that evidence suggests that activism is "followed by long-term improvements, rather than declines, in performance"); Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1730 (2008) (finding, among other evidence, that "the market reacts favorably to activism, consistent with the view that it creates value"); C.N.V. Krishnan et al., *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296, 297-98 (2016) (enumerating scenarios in which hedge funds gain a positive reputation, primarily due to their financial resources and expertise).

58 11 U.S.C. § 1107(a) (2012).

59 *See* Baird & Rasmussen, *supra* note 15, at 697-99 (describing Chapter 11 cases where old directors were replaced by new directors who were appointed by the new shareholders).

60 *See* Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 801 F.2d 60, 64 (2d Cir. 1986) ("[T]he right to compel a shareholders' meeting for the purpose of electing a new board subsists during reorganization proceedings.").

61 11 U.S.C. § 364(a)–(d).

outside of bankruptcy, it needs shareholder approval.[62] However, decisions such as closing down a division and focusing on core aspects of the business fall within the board's domain. The Bankruptcy Code, in contrast, requires that all sales outside of the ordinary course of business have to be blessed by the court.[63]

When a court decides whether to approve the transactions that the managers wish to execute, it requires the managers to articulate a business justification for the proposed transaction.[64] One may be tempted to think that this requirement lessens the board's and management's control rights of the firm in two ways. First, it opens up more transactions to judicial oversight than can be scrutinized outside of bankruptcy. Second, the requirement of articulating a business justification is a bit more intrusive than the normal business judgment rule that guides most corporate governance decisions.[65]

Just as is the case outside of bankruptcy, focusing solely on the legal assignment of control rights inside of bankruptcy fails to capture the dynamic on the ground. Formal rules provide a modest check at best. While one consequence is the slight increase in judicial oversight of managerial decisionmaking, there is also the benefit of tighter constraints on outsiders who wish to influence the exercise of control. Perhaps most notably, filing for bankruptcy results in the imposition of an automatic stay, which prevents all attempts to collect money from the debtor. To the extent that part of the leverage that the lender had outside of bankruptcy was the threat to declare a default, this power is removed. Moreover, the stay prevents any effort to exercise control over property of the estate.[66]

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62 There is often extensive litigation surrounding the sale of a company outside of bankruptcy. Shareholders who believe that the sales price undervalues the company can seek appraisal rights. *See, e.g.*, Charles Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. 1551, 1558-59 (2014) (elaborating on the role of appraisal in U.S. corporate law, along with its statutory structure); *see also* Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd., 177 A.3d 1 (Del. 2017) (discussing the role that deal price should play in appraisal suits). Such appraisal suits do not affect whether or not the sale ultimately occurs. Alternatively, shareholders who are unhappy with the deal price can file a class action lawsuit against the board and allege that the directors violated their fiduciary duties. Such class actions occur in only about ten percent of takeover cases. C.N.V. Krishnan et al., *Shareholder Litigation in Mergers and Acquisitions*, 18 J. CORP. FIN. 1248, 1249 (2012).

63 11 U.S.C. § 363(b).

64 *See, e.g.*, Institutional Creditors of Cont'l Airlines, Inc. v. Cont'l Air Lines, Inc. (*In re* Cont'l Air Lines, Inc.), 780 F.2d 1223, 1226-27 (5th Cir. 1986) ("[F]or the debtor-in-possession or trustee to satisfy its fiduciary duty to the debtor, creditors and equity holders, there must be some articulated business justification for using, selling, or leasing the property outside the ordinary course of business."); Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1066 (2d Cir. 1983) (advocating for a middle ground in bankruptcy court that "gives the bankruptcy judge considerable discretion yet requires him to articulate sound business justifications for his decisions").

65 *See* Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 675 (2002) ("The business judgment rule is perhaps best summarized as a ban against courts second-guessing the substantive quality of disinterested corporate directors' decisions.").

66 11 U.S.C. § 362(a)(3).

At the end of the reorganization proceeding, at least as traditionally envisioned, control rights do shift. The plan of reorganization restructures the balance sheet of the company. To the extent that claims against the company are exchanged for equity claims, such an exchange could result in the former creditors gaining control of the company. It is the rare case where the initial shareholders retain a controlling equity interest in the reorganized firm.

Over the years, however, creditors have devised ways to influence the debtor's exercise of control rights even after the company has entered the Chapter 11 forum. As discussed above, one way that lenders exercise their influence over a borrower is to engineer the appointment of a CRO. The officer may report to the CEO or to the board. Either way, the CRO is positioned on the inside as an officer of the company. The automatic stay and other bankruptcy provisions that limit the effort of creditors therefore do not affect her. The automatic stay applies to outsiders, and she is an insider. Despite her status as part of the extant management team, the CRO's authority and her loyalty remain intact even after a bankruptcy petition is filed.

Another way lenders have been able to maintain their ability to influence the control rights of the debtor is through debtor-in-possession (DIP) financing.[67] Just as the need for financing outside of bankruptcy enables lenders to insist on lending terms that allow them to exert power over the debtor, the need for financing inside of bankruptcy gives lenders, if anything, even greater power. Chapter 11 is an expensive affair, and many of the company's normal financing needs remain throughout the process. Workers must be paid, inventory must be purchased, advertisements must be run, and rent must be paid. Added to these normal costs are the extraordinary costs of the restructuring process, namely the expenses accrued through hiring lawyers, investment bankers, accountants, and other professionals who contribute their expertise to the reorganization effort. Few companies that encounter financial distress have sufficient unencumbered assets to fund a Chapter 11 proceeding. Whatever cash they do have is often subject to lien of a senior creditor. The most likely source of new funds or the ability to use cash on hand that is part of the lenders' collateral package therefore lies with the existing lenders.[68]

The financing agreement for the DIP loan is negotiated before the company files for bankruptcy. The terms of the financing agreement can very well limit the board's and management's exercise of control rights. The agreement can limit the capital expenditures that the debtor can make. Indeed, it can go much

67 *See* Baird & Rasmussen, *supra* note 34, at 1238-41 (summarizing the procedural elements of a DIP loan).

68 *See* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 523 (2009) (finding that seventy-six percent of firms studied received either DIP financing or cash collateral orders).

further than the terms that we typically observe in credit agreements negotiated outside of bankruptcy. DIP financing agreements can actually mandate that the debtor take certain action; for example, the credit agreement may require that the debtor adhere to a strict budget.[69] The agreement may also specify milestones for when a plan of reorganization has to be proposed. Actions that the secured lender views as problematic, such as the debtor losing the exclusive right to propose a plan of reorganization, can constitute a default under the DIP lending agreement. In some cases, the financing agreement can specify that if certain benchmarks are not met, the company will be put up for auction. Through these various provisions, the DIP lenders shape the pace and the path of the Chapter 11 proceeding.

Recent years have seen continued evolution in the ways in which lenders can influence a company's exercise of control rights in its transition into the bankruptcy forum. Most notable is the rise of plan support agreements and restructuring support agreements.[70] These agreements delineate the way in which the Chapter 11 proceeding will progress. Major decisions as to how a case will proceed are made before the case is filed. The agreements are contracts among the debtor and various creditor constituencies entered into in advance of, and in contemplation of, a bankruptcy filing. The major parties—usually the secured creditors and, if they are not the holders of the fulcrum security, then the fulcrum security holder, and the debtor—negotiate the contours of a plan of restructuring in advance of a bankruptcy filing. Lenders have substantial leverage in these negotiations, and the outcome is an agreement whereby the signing parties agree to support a plan. The agreement specifies the jurisdiction where the petition is going to be filed, the timetable for the reorganization, and the terms of the reorganization.

A recent example is Cumulus Media, one of the largest owners and operators of AM and FM stations in the United States.[71] The company had over $2.3 billion in debt.[72] While it was generating sufficient revenues to fund

69 *See id.* at 525 (finding that seventy-two percent of loans "impose specific line-item budgets . . . [which] obligate the firm to submit detailed evidence of cash receipts and expenditures").

70 *See* Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593, 603 (2017) ("Over the last decade, secured creditors have also discovered that they could increase their control over the debtor in a different fashion—through the use of restructuring support agreements. Restructuring support agreements are a natural outgrowth of the Bankruptcy Code's affirmative commitment to prepackaged bankruptcies."); David Skeel & George Triantis, *Bankruptcy's Uneasy Shift to a Contract Paradigm*, 166 U. PA. L. REV. 1777 (2018).

71 *See* Declaration of John F. Abbot in Support of Chapter 11 Petitions and First Day Motions at 3, *In re* Cumulus Media, Inc., No. 17-13381 (Bankr. S.D.N.Y. Nov. 30, 2017) [hereinafter Declaration of John Abbot] ("Cumulus Media is a leader in the radio broadcasting industry, reaching 245 million people each week through their owned-and-operated stations . . . .").

72 *Id.* at 12.

its operations, it could not service its debt.[73] The cash that it generated was subject to the senior lenders' security interest. Cumulus attempted to restructure its debt outside of bankruptcy, but the efforts failed.[74] It then turned to the bankruptcy system as an alternative way to adjust its obligations. Cumulus, along with an ad hoc group of senior lenders, crafted a plan to reduce its outstanding debt by roughly $1 billion and transfer the bulk of the stock in the new entity to the senior lenders.[75] The agreement specified when and where the bankruptcy petition would be filed.[76] The agreement also stipulated that the debtor would be allowed to use the lenders' cash collateral to fund itself, the plan that would be proposed, the date on which the plan and the disclosure statement would be filed, the date by which the plan would be confirmed, and the method by which a new board of directors would be selected.[77] While junior creditors who were not part of the Restructuring Support Agreement challenged some aspects of the plan—looking, in essence, to increase the payout that the proposed plan gave them—the Restructuring Support Agreement dictated the timing and the pace of the Chapter 11 proceeding. Cumulus followed the prescribed script, reduced its debt, and left Chapter 11 less than six months after it filed its bankruptcy petition.[78]

III. CONTRACTING FOR CONTROL

It is thus clear that lenders can use the provisions of their credit agreements to greatly influence the exercise of the control rights that rest with a borrower's board and managers. This power exists both inside and outside of Chapter 11 bankruptcy proceedings. Given that lenders have this power, why do we not see contracts that expressly transfer control rights to the lender? Such a transfer could take many forms. A default could allow a lender to place a representative on the board, give the lender the legal right to replace a majority of the board, give the lender the power to remove the CEO, or give the lender the right to initiate the sale of parts or all of the

73 *Id.* at 19.

74 *Id.* at 19-20.

75 *See Case Profile: Cumulus Media RSA Hands 83.5% of Equity to TL Holders*, DEBTWIRE (Nov. 30, 2017), https://www.debtwire.com/info/case-profile-cumulus-media-rsa-hands-835-equity-tl-holders [https://perma.cc/XB8R-59KN] ("Under the proposed treatment, the term loan lenders would get a USD 1.3bn first lien term loan and 83.5% of the company's reorganized equity.").

76 The Restructuring Support Agreement can be found as an attachment to the first day declaration of John F. Abbot. *See* Declaration of John Abbot, *supra* note 71, at 64-92.

77 *See id.* at 66-67.

78 *Emerging from Chapter 11, Cumulus Turns Page on a New Chapter*, INSIDERADIO (June 5, 2018), www.insideradio.com/emerging-from-chapter-cumulus-turns-page-on-new-chapter/article_b6193d3c-6882-11e8-85d1-0b7d91a4acdb.html [https://perma.cc/382U-RZGE] (reporting the company "did pretty much what it first said it would" when it filed and emerged from bankruptcy "a few weeks ahead of schedule").

company. Credit agreements are complex and creative documents. Over the years the drafters of these documents have developed a myriad of ways to protect the lenders' investment in the debtor. There is no end to the innovation that one could imagine when it comes to creating provisions that shift control, but lending agreements lack such arrangements.[79]

It is not that such terms are beyond the imagination of today's lawyers and investors. In the venture capital context, we do see contracts providing that, if the borrower fails to meet certain targets, the private equity sponsor has the right to appoint a certain number of directors to the board and thus gain control of the company.[80] Yet we do not see such explicit transfer of control in the public company world. Control rights remain formally vested in the board and the managers while investors are left seeking to influence the exercise of these rights.[81] Lenders contract expressly over cash flow rights but act indirectly when it comes to control rights.

One explanation for this difference between cash flow rights and control rights may simply be that the parties do not want deals that contract expressly over control rights. Perhaps the optimal allocation of such rights is for the board and the management team to always retain formal control of the company and for the lenders to act on a more indirect basis. The reason for being circumspect over control could be that giving formal control rights to lenders upon certain triggering events would raise the specter of opportunistic behavior. Recent experience has demonstrated that activist investors consider buying debt and exerting leverage as part of their business plan.[82] A board and management team could therefore legitimately be concerned that if a debt contract contained various control rights that could be exercised directly by the lending group in certain circumstances, these

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79 At least two prominent reform proposals tie cash flow rights to control rights by having a default trigger that converts the lowest priority of debt. *See* Adler, *supra* note 18, at 325 ("If . . . a default were sufficiently significant or prolonged to trigger a transformation, the firm would automatically extinguish both the equity class and the fixed claims of at least the class with the next lowest priority."); Note, *supra* note 18, at 1858 ("[C]ontracts should automatically rearrange troubled capital structures by providing for a mandatory conversion of debt to equity as debtors reach specified distress thresholds.").

80 *See* Baird & Rasmussen, *supra* note 34, at 1218-19 ("Control rights shift, however, when things go poorly for the start-up. When the enterprise cannot find its footing, the principal question becomes whether the project should continue . . . , be sold . . . , or be shut down . . . . [T]he venture capitalist is almost always vested with the shutdown decision when the business struggles.").

81 Anthony Casey identifies one exception to this typical pattern. He notes that when the stock of the enterprise's subsidiaries is held in a holding company, the lender can take a pledge of the stock and, if there is a default, have the stock transferred to them, giving them de jure control over the subsidiaries. Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement,* 124 YALE L.J. 2680, 2721-23 (2015).

82 *See An Introduction to Distressed Debt and Credit Investing*, CAIS (Mar. 29, 2017), https://www.caisgroup.com/blog/an-introduction-to-distressed-debt-and-credit-investing [https://perma.cc/S53C-4V52].

aggressive investors could well buy a sufficient amount of the debt and attempt to trigger the ability to exercise control. Any attempt to specify when control shifts ex ante could well be inefficient ex post. Getting matters precisely right is difficult. The current environment allows for broad covenants that specify default, with default triggering a conversation rather than an automatic shift in control. Given the inability to perfectly tailor control rights contracts in advance, one could speculate that the current allocation—of debt contracts formally setting out cash flow rights and only creating the power to influence control rights externally—is optimal.[83]

To illustrate the point, consider a firm that has assets of $100 and debt of $80. Assume that there is a provision in the lending agreement stipulating that if the value of the company decreases to $85, the lender gains the right to replace the board with directors of its own choosing. If this provision is exercised and the lender retains the same debt claim, it has control but may now be in favor of an inefficient liquidation. The liquidation bias of those holding debt claims is well known.[84] To ensure that bias does not exist, the lender needs both to gain control of the company and to either cash out or dilute the existing shareholders. One could imagine a contract that provides both that the lender exercises control and that this exercise in and of itself automatically changes cash flow rights. Nonetheless, such transfer of cash flow rights along with the contractual shift in control would heighten the threat of opportunism, in which control rights are exercised with the simple aim of wiping out the equity and transferring value to the debt holder. It takes little imagination to posit a hedge fund whose investment thesis would be to search for investments where the governing documents allow for a change of control and shift in cash flow rights. Indeed, to the extent that such a shift can extract value from the shareholders, so much the better from the fund's vantage point.

Perhaps the balance between borrowers and lenders has reached an acceptable compromise. Creditors have developed ways, though often cumbersome, to affect the exercise of control rights. By not allowing creditors to grab formal control too quickly and making it expensive for lenders to assert their rights under the lending agreement in full, the current landscape guards against creditor opportunism. Such a Panglossian take on the current state of affairs would suggest that parties might hesitate to write contracts on control rights.

83 The point in text is similar to the observation of Professors Scott and Triantis that, in drafting contracts, there is a tradeoff between clear terms ex ante and litigation ex post. *See* Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design,* 115 YALE L.J. 814, 822-39 (2006).

84 Ayotte and Morrison present evidence suggesting that senior lenders with control tend to favor liquidation. *See* Ayotte & Morrison, *supra* note 68, at 520-21, 538 (finding that traditional reorganization occurred in only thirty-two percent of cases and that the entire firm was sold off in sixty-six percent of cases).

Yet there are other reasons that explain the absence of control right contracts. There are both agency-cost reasons and legal reasons that suggest a hesitancy in contracting directly on control. Agency-cost reasons often lead current management to disfavor such contracts, whereas legal landmines suggest why a lender may well hesitate before negotiating for such provisions.

First, most people on a company's management team derive private benefits from their continued employment with the firm. They enjoy both future salary as well as psychic benefits from their jobs. All things being equal, they would not endorse a course of action that could increase the risk of them losing their jobs.[85] Under the current regime, when a company agrees to a covenant that grants cash flow rights to a lender, the company leaders know that there is a chance that the company will violate the covenant and thus be forced into negotiations with the lender about either getting a waiver of the default or an amendment to the credit agreement. The lender, however, does not have the direct power to replace the management team with one more to its own liking. This dynamic would change were the lender and the company to contract on control rights. Running afoul of such provisions could well lead to a quick exit from the company for the extant managers. For this reason, when choosing between contractual provisions tied to cash flow rights and those tied to control rights, the borrower's management would prefer the former to the latter.

It is not just management and its understandable fear of removal that may explain the lack of contracting on control. Lenders have their own reason to shy away from such terms. At first blush, one may think that lenders would value contractually based control rights as an effective means of protecting their investment. Rather than having to use the sword of Damocles in the form of a threatened declaration of default to nudge a company to move in the direction they wish, lenders could issue such orders directly.

As attractive as this may be in theory, in practice lenders worry that exercising too much control over the borrower raises the risks of lender liability and equitable subordination. If the lender takes actual control of the company and runs the company to further the lender's interest, it risks being hit with a lender liability law suit. In the past, lenders have been held liable for exercising too much control over the debtor. For example, in *State National Bank of El Paso v. Farah Manufacturing Co.*,[86] a court affirmed a judgment of roughly $19 million

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85 *See* Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277, 282 (1991) ("[M]anagers equate firm liquidation with financial 'ruin.' Since liquidation is harmful to managers' job prospects, reputation, and self-respect, they seek to minimize the probability of its occurrence . . . .").

86 678 S.W.2d 661, 666-67 (Tex. App. 1984), *appeal dismissed per stipulation*. *See also* K.M.C. Co. v. Irving Tr. Co., 757 F.2d 752, 759 (6th Cir. 1985) (affirming that the implied obligation of good

against a bank that was the lead bank on the loan to the borrower. The bank had lost confidence in the company's prior CEO, and the CEO was replaced. When the company ran into financial distress, the old CEO sought to reclaim his position. The bank vetoed such efforts, putting its allies on the board.[87] The court affirmed a jury finding that the bank had not acted in good faith and that, had the former CEO rather than his bank-selected replacement been in charge, the company would have been worth about $19 million more than it was at the time of suit.[88]

There are, of course, cases that provide some comfort to lenders. Many courts have held that if the lender cuts square corners and adheres to the terms of its credit agreement, it cannot be held liable.[89] While the cases where a lender has been held liable for its treatment of the borrower are rare, it remains standard practice for law firms to remind their clients to avoid situations that could lead to a lender liability suit.[90]

Lender liability is not the only risk a lender who contracts directly for control could face. Looming perhaps even larger is the doctrine of equitable subordination. Under this line of cases, if a creditor exerts undue influence over the debtor, the court can lower the priority status of the creditor's claim should the borrower end up in a bankruptcy proceeding.[91] The effect of such

faith may have required the lender to give notice to the borrower before it exercised its discretion under a lending agreement to not advance funds).

87 *See Farah*, 678 S.W.2d at 667-68.

88 *See id.* at 685 ("Acceleration clauses are not to be used offensively such as for the commercial advantage of the creditor. They do not permit acceleration when the facts make its use unjust or oppressive.").

89 *See, e.g.*, Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990) ("Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of 'good faith.'").

90 *See, e.g.*, Eugene C. Kim & Gina Giang, *Lender Liability: Taking Stock in an Uncertain Time*, ABA COM. L. NEWSL. (A.B.A. Section of Bus. Law, Chicago, Ill.), Spring 2009, at 9, *available at* https://www.sheppardmullin.com/media/article/713_Lender%20Liability%20Article%20-%20Eugene%20Kim.pdf [https://perma.cc/J37Q-EJE4] (warning clients that it is "difficult to predict which path lender liability law will take in the future").

91 *See* 11 U.S.C. § 510(c) (2012) ("[T]he court may . . . under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest . . . ."); Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 322 (1939) ("[T]he court, in approving a plan, was authorized and required . . . to recognize the rights and the status of the preferred stockholders arising out of Standard's wrongful and injurious conduct in the mismanagement of Deep Rock's affairs."); Helen Davis Chaitman, *The Equitable Subordination of Bank Claims*, 39 BUS. LAW. 1561, 1562 (1984) ("[C]ourts have subordinated bank claims in two situations: first, where the bank has participated in . . . fraudulent conduct; and second, where the bank has taken control of the debtor, thus assuming the fiduciary duties of a controlling shareholder, and then breached those duties to the injury of general creditors."); Allan L. Hill & Nickolas Karavolas, *Equitable Subordination Considerations for Creditors*, LAW 360 (July 2015, 10:19 AM), https://www.law360.com/articles/674223/equitable-subordination-considerations-for-creditors [https://perma.cc/G8NB-3SRJ] (listing the conditions for equitable subordination as "(1) the creditor must have engaged in . . . inequitable conduct; (2) the misconduct must have resulted in injury to other creditors of the bankrupt party or conferred an unfair advantage on the creditor; and (3) equitable subordination must not be inconsistent with the provisions of the Bankruptcy Code").

subordination can be extreme. A subordinated lender can go from having its claim paid in full to a position where it receives only a fraction of what it is owed.

The message of these two doctrines is clear: vigorous efforts on the part of lenders to take formal control over the affairs of the borrower entail substantial risks. In light of this, it is no surprise that lenders tend not to contract directly for control rights. Moreover, when trying to use terms of the lending agreement as leverage to influence the debtor's exercise of control rights, lenders endeavor to stick as closely as possible to the terms of their agreement.[92]

There is yet another constraint on lenders exercising control that derives directly from the Bankruptcy Code. Some provisions of the Code have special provisions for "insiders." Most notably, the reach-back period for preference law is extended from ninety days to one year for insiders.[93] In the *Winstar* bankruptcy, a creditor who exercised power under its lending agreement was treated as an insider, even though it did not exercise actual control over the debtor.[94] Existence of formal control would almost assuredly turn an outside creditor into an insider for the purposes of the Bankruptcy Code. Lenders understandably pause before taking actions that would put an extra nine months of payments at risk of being set aside as preferential.

In total, the legal impediments to contracting on control rights are formidable. Coordination costs also inhibit contracting on control. When a creditor seeks to lend money to a company, the Article 9 filing system and real estate filing systems alert the putative lender to prior lenders who may have already staked their claim to priority. Searching these systems is relatively easy. As of now, however, there is no analogous system whereby a lender can alert third parties that it has a claim for contingent control rights. Ensuring that the borrower has not promised to give multiple lenders the same right of control is no small matter.

That said, we cannot state with any degree of confidence what contracts would be written if the various impediments to contracting on control were removed. Few, if any, would have predicted at the outset of the syndicated lending market that we would see the type of provisions that we see today. One way to take tentative steps toward contracts over control rights would be to allow borrowers and lenders to remove some of the hurdles in their way. One

92 *See, e.g.*, Smith v. Assocs. Commercial Corp. (*In re* Clark Pipe & Supply Co.), 893 F.2d 693, 699-700 (5th Cir. 1990) (finding that the control used by Associates over Clark's finances did not "rise[] to the level of unconscionable conduct necessary to justify the application of the doctrine of equitable subordination . . . because . . . pursuant to its loan agreement with Clark, Associates had the right to reduce funding, just as it did, as Clark's sales slowed").

93 11 U.S.C. § 547(b)(4)(B).

94 Schubert v. Lucent Techs. Inc. (*In re* Winstar Commc'ns, Inc.), 554 F.3d 382, 396-97 (3d Cir. 2009) ("[I]t is not necessary that a non-statutory insider have actual control; rather, the question is whether there is a close relationship [between debtor and creditor] and . . . anything other than closeness to suggest that any transactions were not conducted at arm's length." (internal quotation marks omitted)).

could imagine allowing companies to specify, in their charters, that they waive their ability to bring lender liability lawsuits. Along the same lines, a lender could insist that all of the borrower's contracts with other creditors contain a provision whereby the creditor waives its right to attempt to equitably subordinate the first lender's claim should the borrower end up in Chapter 11.

Allowing a company to include in its charter a provision that would limit future lawsuits is by no means unprecedented. In 2000, Delaware amended its corporate law so that a company could, in its charter, waive the corporate opportunity doctrine.[95] That doctrine, as a part of the duty of loyalty, forbade corporate fiduciaries from taking new business projects without first offering them to the company. Other states followed Delaware's lead. Presented with this new degree of freedom, hundreds of companies adopted such waivers.[96] While there has been only one empirical study of the efficiency effects of such adoptions, the preliminary results demonstrate that the waivers are positive for the investors in the company. The fact that companies are willing to embrace new contracts when legal prohibitions are lifted and the fact that such innovations seem to have a positive effect suggests that lenders and borrowers should be allowed to contract around those legal prohibitions that today discourage contracting over control rights.

CONCLUSION

We live in a bifurcated world. Credit agreements contract directly on cash flow rights. While credit agreements can constrain the actions that a borrower can take, they do not give control rights to the lenders. Lenders, however, have been able to find various and sundry ways to draft contracts that allow them to exercise power over the decisions that the company makes. Like much of corporate law, this state of affairs is the result of history, economics, and politics.[97] Were one to build a financing system from the ground up, it is unclear that one would insist on restricting the contracting space in such ways as it is limited today. It is, of course, often perilous to replace an extant system with a new one out of whole cloth. The costs incurred in the transition from the old system to the new one could exceed the gains that the new system would generate. Yet one need not make wholesale changes. Instead, the introduction of incremental ways for opening up the contracting space in lending agreements, allowing firms to opt out of the constraints that inhibit

95 DEL. CODE ANN. tit. 8, § 122(17) (2018).

96 Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers,* 117 COLUM. L. REV. 1075, 1078-79 (2017).

97 *See generally* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 283-87 (1994) (discussing how these factors have shaped the general contours of American corporate law).

contracting on control rights, could lead to innovations that would benefit borrowers and lenders alike.