ESSAY

PRIVATE DEBT AND THE MISSING LEVER OF CORPORATE GOVERNANCE

DOUGLAS G. BAIRD[†] & ROBERT K. RASMUSSEN[††]

Traditional approaches to corporate governance focus exclusively on shareholders and neglect the large and growing role of creditors. Today's creditors craft elaborate covenants that give them a large role in the affairs of the corporation. While they do not exercise their rights in sunny times when things are going well, these are not the times that matter most. When a business stumbles, creditors typically enjoy powers that public shareholders never have, such as the ability to replace the managers and install those more to their liking. Creditors exercise these powers even when the business is far from being insolvent and continues to pay its debts. Bankruptcy provides no sanctuary, as senior lenders ensure that their powers either go unchecked or are enhanced. The powers that modern lenders wield rival in importance the hostile takeover in disciplining poor or underperforming managers. This Essay explores these powers and begins the task of integrating this lever of corporate governance into the modern account of corporate law.

INTRODUCTION

In 2003, Krispy Kreme was the darling of Wall Street. Its stock had more than quadrupled since first going public only a few years before. Krispy Kreme's CEO also served as chairman of its board, and he had been with the company for more than twenty-five years. No one was more dedicated to the business. His wedding cake was made out of

[†] Harry A. Bigelow Distinguished Service Professor of Law, University of Chicago Law School.

[††] Milton Underwood Professor of Law, Vanderbilt Law School. We thank Ian Ayres, Steve Kaplan, Ed Morrison, Ed Rubin, David Skeel, Cass Sunstein, Randall Thomas, Bob Thompson, Ron Trost, and Christopher Yoo for their help. Earlier versions of this paper were presented at the October 2002 meeting of the National Bankruptcy Conference, and the law schools at Boalt Hall, Chicago, Colorado, Columbia, Florida State, Texas, Vanderbilt, and Virginia. We also thank the Sarah Scaife Foundation and the Russell Baker Scholars Fund for research support.

In the late 1990s, Warnaco invested unsuccessfully in a chain of Calvin Klein jeans outlet stores. Warnaco borrowed heavily to acquire new brands (including $530 million to reacquire Authentic Fitness, maker of Speedo swimwear, which it had spun off in the early 1990s[49]). Warnaco also borrowed to repurchase its own stock. Over the course of a single year, Warnaco's debt grew from $500 million to $1.5 billion. The CEO had stumbled. Neither shareholder action nor the market for corporate control would set matters aright, regardless of how much the business adhered to the conventional canons of good corporate governance. Nevertheless, the CEO was put under a tight rein and then displaced.

The shift in control came about as a result of Warnaco's need to restructure its debt. Warnaco remained solvent,[50] but it was no longer able to borrow on an unsecured basis from twenty different banks. It had to fold this debt into a revolving credit facility controlled by a handful of banks.[51] This transaction gave the banks a security interest in substantially all of Warnaco's assets, including its cash flow. Warnaco would only receive operating funds with the continued blessings of the banks. Once the revolving credit facility was in place, control rights had shifted. From that point forward, the banks that ran the revolving credit facility essentially controlled the corporation.[52] The

---

[49] *See Warnaco To Buy Authentic Fitness for $426.1 Million*, N.Y. TIMES, Nov. 17, 1999, at C4 (reviewing the deal in which Warnaco paid $426.1 million and assumed $105 million in debt to acquire Authentic Fitness).

[50] Although the stock traded for much less than it had in better times, sophisticated investors were still buying it, as was the CEO. *See Bass Raises Stake in Warnaco*, WOMEN'S WEAR DAILY, Oct. 6, 2000, at 2 (reporting that investor Sid Bass had recently acquired 2.5 million shares in Warnaco); Matt Andrejczak, *Warnaco CEO Goes on Buying Spree*, CBS MARKETWATCH.COM, Nov. 14, 2000, 11/14/00 MKTWATCH 22:26:11 (Westlaw) (reporting that Warnaco's CEO had just purchased more than 600,000 shares of Warnaco stock).

[51] *See Warnaco Completes $2.56 Billion Financing*, BUS. WIRE, Oct. 6, 2000 (LEXIS, News & Business database) (reporting the new secured credit facility put in place at Warnaco). While debt of this sort is often syndicated among a number of banks, the lead bank typically performs the bulk of the monitoring of the debtor.

[52] Laws that protect junior creditors from transactions that advance the interests of senior lenders at their expense generally have too short a reach-back period to provide them with much protection. The preference period generally runs only ninety days. *See* 11 U.S.C. § 547(b) (2000) ("[T]he trustee may avoid any transfer of an interest of the debtor in property . . . made on or within 90 days before the date of the filing of the petition . . . ."). Senior lenders will generally not be treated as insiders, and even when they are, the preference period runs only a year. *See id.* ("[T]he trustee may avoid any transfer of an interest of the debtor in property . . . made between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider . . . ."). Pledging the assets usually can be done far

revolver gave the banks the ability to veto any extraordinary transaction. Moreover, the business was put on a short leash. The management knew that its continued employment depended on reversing the recent slide.[53] For those beholden to equity, the incentives to engage in unduly risky transactions as the corporation nears insolvency were firmly checked.[54]

The presence of such an institutional lender fundamentally alters corporate governance. The lending agreement contains many affirmative and negative covenants that give the lender de facto control over every aspect of the business. Moreover, the complete control the lender has over the debtor's cash flow gives the lender veto power over every course of action, whether internal to the corporation or outside it. Decisions normally reserved for directors and stockholders—such as whether to sell a division, change the business plan, or replace the managers—require the lender's explicit blessing. Trip wires are tied to the performance of the business and its discrete units, and a general provision gives the lender the ability to call the loan in

---

enough in advance to ensure that none of these problems arise. For example, in the case of Interstate Bakeries, the company had no secured debt as of July 18, 2001. Its unsecured debt was a tad less than $600 million. The next day, Interstate entered into a new credit facility. This facility brought additional liquidity—it was for $800 million. All of the prior debt was paid off. The cost, however, was that the new facility was secured by substantially all of the assets of the business. INTERSTATE BAKERIES CORP., 2001 ANNUAL REPORT 15, 22 (2001).

[53] Replacement of the CEO would more than likely require a bankruptcy filing, as the severance portion of her compensation contract was $43 million. *See* Dan Ackman, *Warnaco Flounders*, FORBES.COM, June 12, 2001, http://www.forbes.com/2001/06/12/0612topnews.html ("A termination agreement dating to 1991 guarantees the CEO $43 million more."). Indeed, she was replaced in bankruptcy, and the company rejected her contract. She sued Warnaco seeking $25 million under the contract, but settled the case for less than $500,000. *See* Soma Biswas, *Wachner Settles Warnaco Severance Fight*, THEDEAL.COM, Nov. 18, 2002, http://www.thedeal.com/NASApp/cs/CS?pagename=TheDeal/TDDArticle/TDStandardArticle&bn=NULL&c=TDDArticle&cid=1037611341406 (reporting that instead of the $25 million she wanted, Wachner received "a $3.5 million general unsecured claim plus an administrative claim of $200,000 in cash").

[54] On the incentives of equity holders to favor risky transactions in situations of financial distress, see Jensen & Meckling, *supra* note 13, at 334-37. Barry Adler has extensively examined how bankruptcy law affects these dynamics. *See* Barry E. Adler, *A Re-examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575, 576 (1995) (asserting that managers of financially distressed firms "have a strong incentive to gamble with the firm's assets" and proposing ways to mitigate such behavior); Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 440-41 (1992) (examining the effects of bankruptcy reallocation on firms' contractual priorities and analyzing risk-sharing theory).

the event of any material adverse change.[55] The purpose of these trip wires is not to force repayment of the loan, but rather to ensure that lenders have control over major decisions and the ability to insist on changes in management when the business encounter reverses.

Several decades ago, institutional creditors could not exercise this much control. Before Article 9 of the Uniform Commercial Code was enacted, acquiring a security interest in all of a company's property was hard.[56] Each type of collateral had its own legal regime. Moreover, courts viewed with suspicion omnibus clauses that picked up all of the debtor's property and provided no cushion for other creditors.[57] In many instances, secured lending was premised upon the creditor's ability to take possession of discrete assets and sell them in the event that the debtor defaulted. It was not possible to make a secured loan premised upon the corporation's value as a going concern. Article 9, and especially the revised Article 9, have made it possible for lenders to acquire all of a corporation's assets.[58] The modern security interest effectively covers not only a corporation's discrete assets, but also the synergy that each asset has with the others. The expanded security interest not only changes the basis on which the lender extends credit, but also the control that the creditor can exercise over the business.[59]

Modern business practices also enhance a creditor's ability to control a corporation. In many highly competitive industries, successful companies must actively manage their cash flows. The institutional

---

[55] The notion of default clauses in lending agreements as trip wires designed to signal to the lender that it needs to step up its monitoring activity is set out in Ronald J. Daniels & George G. Triantis, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1093-94 (1995) ("[Debt covenants] serve as trip wires for the lender's right to accelerate and enforce or to intervene in the borrower's decisions.").

[56] *See* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 197 (1965) ("[A] lender against the security of 'pledgeable intangibles' could perfect his security interest under pre-Code law only by taking possession of the collateral.").

[57] *See, e.g.*, Benedict v. Ratner, 268 U.S. 353, 360 (1925) (holding that under state law, "a transfer of property as security which reserves to the transferor the right to dispose of the [property for his own benefit] is, as to creditors, fraudulent and void").

[58] Perhaps most notably, the revised Article 9 made it possible for a lender to take a security interest in a debtor's deposit accounts. *See* U.C.C. § 9-109 cmt. 16 (2000) ("[D]ebtors who wished to use deposit accounts as collateral sometimes were precluded from doing so as a practical matter.").

[59] For an important and early recognition of the way in which secured credit can give a lender control rights that encourage the firm to pursue promising investments, see Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 904 (1986) (stating that secured financing "ameliorates the conflicts that would otherwise discourage firms from financing investment opportunities with private debt").

lender not only takes a security interest in all of the debtor's assets, but also actively manages the debtor's cash flow through a revolving credit facility. A creditor can now acquire a valid security interest in all of a debtor's assets and ensure that all of the cash coming into the corporation and leaving it passes through its hands. Modern technology enables the lender to know precisely how much cash a borrower has at any given time. By virtue of controlling the business's cash flow, the creditor is less dependent upon the debtor to tell it what is going on. The creditor has experience in the industry, and thus can readily distinguish between cash flow problems related to a general industry downturn and such problems that are unique to the corporation it is funding. When the debtor's cash flow deteriorates, the lender can then invoke the powers for which it has contracted in the lending agreement.

The ability to cut off a debtor's cash flow is a much more potent threat (and gives the creditor much more control over a company) than the threat to repossess the debtor's equipment. Turning off the cash stops a debtor dead in its tracks. In contrast, repossessing collateral is a potent threat only if the creditor can reach the property without breaching the peace.[60] Even then, repossessing collateral other than cash jeopardizes the value of that collateral. A debtor can dispose of its assets—its inventory, its equipment, etc.—much more effectively than can a lender. A lender, therefore, may find that the collateral is worth more in the debtor's hands.[61] Cash, on the other hand, is worth just as much in the lender's hands as in the debtor's.

Yet, precipitously turning off the cash is at some level *too* great a threat. Just as a secured creditor with a security interest in a machine could not credibly threaten to blow up the machine, a secured creditor with a security interest in a corporation's cash flow is unlikely to abruptly shut down the business. Taking all the cash on hand today precludes future activity that would generate additional funds. It destroys the option value of the security interest.[62] Rather, the security interest here serves two roles. At times, it gives the creditor the ability

---

[60] *See* U.C.C. § 9-609(b) (2000) ("A secured party may proceed [to repossess collateral] . . . if it proceeds without breach of the peace.").

[61] *See* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 221-22 (1997) (stating that lenders rarely forcibly repossess collateral because they believe that the result of doing so would be "disastrous").

[62] On secured credit as an option, see Robert K. Rasmussen, *Secured Credit, Control Rights and Options*, 25 CARDOZO L. REV. 1935, 1941-50 (2004) (arguing that secured credit is a "real option and a financial option" that provides lenders with significant flexibility and control).

to conduct a controlled liquidation of the corporation. By limiting the amount of the advances, it can ensure that funds are spent only on liquidating the current assets.[63] The lender can limit a debtor's access to cash in a way that it cannot limit its access to a machine. With a machine, the debtor either has access or it does not. As to cash, the lender controls the amount of cash that the debtor can spend. Cash can be a much more nuanced mechanism of control.

The security interest in the debtor's cash flow serves a second function as well. Leaving assets unencumbered would allow the debtor to obtain funds from other sources. The debtor could always attempt to find another lender so as to continue its operations. By taking a security interest in the cash flow, the institutional lender leaves the debtor with no exit strategy. The lender monitors the business's progress and has the right to decline to provide new funds in full or reduce the amount that the corporation receives. To induce the lender to waive loan covenants and otherwise stay its hand, the board takes a more active role in the business. The debtor has to find a common understanding with the lender as to the future of the enterprise.[64]

Institutional creditors do not routinely insist on these revolving credit facilities. Indeed, when the debtor finds itself in robust financial health, it will find multiple sources of credit and competition among these creditors, which limits the terms that creditors can demand. Managers are reluctant to put their fate in the hands of a bank consortium, and lenders have no need to meddle in the affairs of a thriving business. Revolving credit facilities with all the requisite bells and whistles are expensive to set up and to monitor. When times are good, they are unnecessary. A creditor may be content to take a security interest in a discrete asset as long as principal and interest on the loan are less than what the creditor knows it can realize on the collateral, inside of bankruptcy and out.

---

[63] *See, e.g.*, *In re* Clark Pipe & Supply Co., 893 F.2d 693, 695 (5th Cir. 1990) ("[The secured lender] began reducing the percentage advance rates so that . . . [the debtor] would have just enough cash to pay its direct operating expenses. [The debtor] used the advances to keep its doors open and to sell inventory, [in order] to pay off the past advances from [the secured lender].").

[64] There are reasons to believe that boards may be overly trusting of the CEOs that they have hired. *See* Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 294 (2004) ("Once it has installed or chosen to retain a CEO, the board is motivated to trust the CEO more than it should."). Lenders, all else being equal, are less likely to suffer from this bias, as they are not responsible for electing and installing the corporation's officers.

Instead, we tend to see industrial-strength revolving credit agreements in environments such as Warnaco. In this situation, the debtor is in default on existing loan covenants and has exhausted other sources of capital. Its lender is owed more than any discrete asset the corporation owns, and thus must depend upon the value of the business as a going concern in order to ensure repayment.

The desire of a lender to gain control when a business becomes financially distressed should come as no surprise. Much of the literature on corporate governance is aimed at reducing agency costs when times are good.[65] In that situation, managers may have an incentive to pursue private benefits rather than maximize shareholder wealth. Things change when distress occurs. Distress often foreshadows the replacement of managers and directors.[66] They know that they are in the end game. Final-period problems tend to reduce the efficacy of controls designed to bind managers over the long term. Left unchecked, managers are even more likely to put their interests ahead of those of the company. Lenders thus institute a new set of controls in order to protect their interests.

The loan agreements for these revolving credit facilities have evolved over time, but the basic structure remains the same. The agreement sets out negative and affirmative covenants and defines events of default.[67] The various covenants require the debtor to seek permission from the lender for any major decision about the enterprise, such as the purchase or sale of any substantial assets outside the

---

[65] *See, e.g.*, Jensen, *supra* note 21, at 323 ("Corporate managers are the agents of shareholders, a relationship fraught with conflicting interests. Agency theory, the analysis of such conflicts, is now a major part of the economics literature."); Jensen & Meckling, *supra* note 13, at 308-10 (identifying agency costs in modern corporations).

[66] Even in the 1980s, few senior managers survived financial distress. *See* Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241, 247 tbl.3 (1989) (noting that, during the period of 1979-1984, 29% of senior managers remained at least two years after their firms filed for bankruptcy); *see also* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 723 (1993) (observing that 91% of CEOs were replaced among the financially distressed companies examined and that this turnover rate was much higher than that typical of most large, publicly held companies). Turnover has increased over time. *See* Baird & Rasmussen, *Chapter 11 at Twilight*, *supra* note 25, at 697-99 (discussing the pervasiveness of director turnover in the modern corporate bankruptcy context).

[67] If a debtor insists on there being no covenants, the loan will be callable on demand. *See* GUIDE TO ASSET BASED LENDING, GENERAL ELECTRIC CAPITAL COMMERCIAL FINANCE 16 (1999) (noting that, in the absence of a covenant, and in the event that "the borrower's financial condition deteriorates markedly, the lender may decide to cut off cash availability to the borrower and terminate the loan without notice").

ordinary course of business. The debtor also gives the lender access to its books and records—information not routinely available even to shareholders.[68] Loan covenants also check the ability of the debtor to use its cash collateral or to borrow from other creditors. Violations of the covenants are events of default. A default entitles the creditor to demand repayment of the loan and to take possession of all of the borrower's assets.

Having a lender declare a default even without seizing collateral creates consequences for the debtor. A default signals to the rest of the world that the debtor is in financial difficulty and is at loggerheads with its creditors.[69] Change may well be in the offing. Lenders have virtually unimpeded access to the books of the corporation. If the lender signals that it has lost confidence in the business by declaring a default, other investors in the corporation take note. Indeed, a declaration of default may spur a race to collect from the debtor, which in turn makes a bankruptcy filing inevitable. Debtors will often grant concessions to lenders to avoid these consequences. It is not uncommon for a lender to receive an advanced payment, an increase in interest rate, or more sweeping powers in exchange for not declaring a default.

---

[68] On the limits of shareholder access to a corporation's financial records, see Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331, 333 (1996) ("[Inspection] statutes could authorize a court to give a shareholder any document that the corporation possesses, although typically courts limit this access to corporate minutes and accounting records.").

[69] This is the converse of the well-documented phenomenon that a bank's decision to extend credit is taken as a positive signal by the stock market. *See* Ronald Best & Hang Zhang, *Alternative Information Sources and the Information Content of Bank Loans*, 48 J. FIN. 1507, 1507 (1993) (citing a 1987 study showing "a significantly positive" impact from "the announcement of bank credit agreements and reports"); Matthew T. Billet et al., *The Effect of Lender Identity on a Borrowing Firm's Equity Return*, 50 J. FIN. 699, 699 (1995) (discussing prior studies suggesting "that certain types of loan announcements generate significantly positive abnormal returns to the average borrower's equity"); Scott L. Lummer & John J. McConnell, *Further Evidence on the Bank Lending Process and the Capital-Market Response to Bank Loan Agreements*, 25 J. FIN. ECON. 99, 100 (1989) (concluding "that the positive announcement-period return" following banks' "revisions to existing agreements" accounts for a greater percentage of returns than "new credit agreements"). Such gains exist even when bank loans trade on the secondary market. *See* Amar Gande & Anthony Saunders, Are Banks Still Special when There Is a Secondary Market for Loans? 3 (Oct. 2005) (unpublished manuscript), http://ssrn.com/abstract=873353 ("[N]ew loan announcements are associated with a positive announcement effect on the borrower's stock price even when a borrower's loans trade on the secondary market.").