Michigan Law Review

Volume 112 | Issue 1 Article 2

2013

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

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

Here we show, first, that there is often no on-the-ground, operational difference between these two standards—pernicious control and free-wheeling contract enforcement—and that this lack of sharp difference helps explain why the judicial results are vexing, contradictory, and costly. We next show how similar problems are dealt with differently in corporate law settings: courts evaluate the questioned transaction but defer to the business judgment of an

* David Berg Professor of Law, Harvard Law School. We thank Jennifer Arlen, John Coates, Horst Eidenmuller, Jesse Fried, Marcel Kahan, Michael Levine, Adam Levitin, Mark Ramseyer, Dorothy Shapiro, Steven Shavell, Holger Spamann, Fred Tung, and workshop participants at the École Supérieure de Commerce de Paris, Harvard Law School, and NYU School of Law for comments.

** Ph.D. Candidate, Fall 2013, Università degli Studi di Brescia, LLM, 2013, Harvard Law School.

unconflicted board of directors. Then we show how putting a layer of basic corporate duties—entire fairness for conflicted transactions and business-judgment-rule deferential review for nonconflicted transactions—atop the creditor-intervention doctrines clarifies the creditor-in-control problem and shows us a conceptual way out from the problem. A safe harbor for creditors is plausible—if courts could reduce the extent of creditor conflict for critical decisions—and would both encourage constructive creditor intervention and discourage detrimental, value-shifting creditor intervention.

Finally, we show that modern financial markets yield a practical way out, using this corporate doctrine as the map: modern capital markets' capacity to build options, credit default swaps, and contracts for equity calls provides new mechanisms that, when combined with the classic corporate doctrinal overlay, can better inform courts and parties on how to evaluate and structure creditor entry into managerial decisionmaking. The capital market and corporate doctrine combination can create a doctrinal conduit to better incentivize capital market players to improve distressed firms than the current doctrines regulating creditor conduct.

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Introduction

When firms fail, creditors seek to be repaid. Sometimes, however, a creditor does more than simply collect on its breached contract, taking control of the failing firm and dictating the firm's operating decisions and personnel choices with the aim of being repaid, perhaps at the expense of other creditors or of the firm's well-being. When a creditor does so, litigation can readily ensue, after the eventual bankruptcy or before it, with other claimants on the firm asserting that the controlling creditor was liable to those other claimants, or to the firm, if the creditor ran the firm opportunistically for its own benefit.

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

* * *

Thus we have a substantial economic problem that has not yet settled into a suitable legal framework, with the judicially built framework that now exists generating both uncertainty and missed opportunities to restructure weakened firms. This uncertainty arises not just from disagreeing courts unable to settle on correct and consistent doctrine but also from foundational difficulties embedded in the distressed firm's situation. Courts regularly indicate that a creditor can enforce its contract without then bearing much excess fiduciary responsibility, decisions that we examine in Part I. When courts hold that creditor enforcement of its contract is fair game, they typically thereby free the creditor from liability even if the creditor directs or influences the debtor's decisionmaking on operations and finances. Other courts indicate that the contract bars the creditor from controlling the debtor firm with impunity. When the creditor does take control (or as some courts put it, when it takes day-to-day control), it acquires concomitant fiduciary duties, as if it constituted the firm's board of directors—duties that typically lead a court to find creditor liability for unfairly furthering its own interests. When a court does so, it typically orders the controlling creditor's claims to be subordinated in bankruptcy to other creditors' claims, holds the creditor liable to the debtor, or finds the creditor liable to other creditors. We examine instances of these contrasting decisions in Section I.A.

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

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

Other courts give a creditor carte blanche to enforce its contract, countenancing creditor action that goes beyond suing to collect from the debtor—permitting the creditor to instruct or influence the firm's operational decisions, sometimes at the expense of other players in the firm. If the debtor violates the loan contract in a way that allows the creditor to demand and receive repayment, then the creditor could forgo repayment, reason such courts, but condition its waiver of the debtor's default on whether the debtor agrees to a specified action. Courts that support such conditional contractual waivers will not second-guess the creditor's leveraging of its contract into influence or control.

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

This doctrinal overlay for creditor conflict can be usefully compared with the doctrinal overlay for corporate board conflicts. One contribution of this Article is to show that business law has two different doctrines governing substantially similar problems—one for board conflicts and decisionmaking and another for creditor conflicts and decisionmaking. We show how the doctrines are consistent in part and how they are not.

While the current control-based doctrinal dichotomy for creditor conduct is a dead end for addressing the failing firm's operational and managerial difficulties, importing corporate doctrines would in theory allow courts to doctrinally and conceptually escape from the current creditor-conduct predicament. But for most of the twentieth century, such a doctrinal transformation would have been theoretical and not grounded in transactional reality because the corporate doctrines require that the decisionmaker—the board for corporate decisions, the creditor for distressed debtor intervention—not have significant conflicts of interest, a condition that was plausible for boardrooms but that could not be created in credit markets or under bank regulation. But we will show how these results can now be achieved not just in theory but in transactional reality, by grafting modern capital market instruments and institutions onto corporate doctrine.

Courts applying corporate law typically defer to boards of directors' business judgment to run their own firm: as long as a board was operating professionally, without substantial conflicts of interest, courts will not hold the board liable to shareholders for board errors of judgment. If the board will, or could, profit from its business decisions, judicial deference to that board will not be forthcoming and courts will, in one major formulation, review the challenged transaction for its entire fairness, burdening the board with proving that the transaction was "entirely fair." As we see in Section II.B, in corporate law, judicial doctrine has long aimed to make the board a neutral, unbiased decisionmaker, without substantial conflicts of interest when making basic business decisions.

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

Consider the creditor's goals and how they can be channeled into useful or deleterious actions. The creditor wants ultimately to be paid. It wants the firm to be run better and is often well positioned to second-guess management of failed firms. But the creditor is typically also prepared to induce the firm's managers to liquidate its core operations quickly in a fire sale—even one that destroys long-run value—if that liquidation pays the creditor in full but continued operation would risk the firm's further decline and would leave the creditor unpaid.

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

The existence of creditors lacking such sharp conflicts would seem to be more theoretical than real, however, because creditors of distressed firms seem to be *always* conflicted. They want to cash out their loan, they want to cash it out now, not later, and they will destroy firm value to reach that goal. They prefer an operational decision that cashes them out over one that leaves them at risk, even if the risky decision is overall better for the firm and its other creditors. Hence, this creditor conflict-of-interest renders the corporate-law-based approach into a real-world dead end.

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

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

Modern derivatives markets now make it possible for the creditor involved in the firm's most basic strategic decisions to acquire derivatives or options on the firm's other capital layers. This acquisition would make the creditor feel the firm's financial pain from loss, while simultaneously allowing it to obtain the firm's gains from a sound restructuring of its operations. By offsetting the creditor's inherent conflict with an equal and opposite financial force, courts can reduce the dominant creditor's inherent conflict in the distressed firm's situation. This action would channel the creditor's influence into enhancing firm value and away from shifting value from other claimants to itself. To the extent that the inherent conflict can be removed via the instruments of the modern capital market, courts can make the creditor's incentives approach that of a board seeking to maximize the firm's value. Courts that are convinced that the modern capital market instruments have been so used should be more ready than we have previously thought possible to defer to the controlling creditor's business judgment, while staying alert to persisting conflicts.

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

The holy grail of much corporate law is to find a key decisionmaker who is both incentivized and not conflicted. Here we put forward the reasons why current creditor-in-control doctrine gets us neither strong creditor incentives for improving the firm nor few conflicts of interest. This is so, despite the fact that modern capital markets can, if harnessed with the correct judicial doctrinal overlay, move us closer to that holy grail of incentivized, nonconflicted decisionmaking for a wide range of vital business and financial transactions.

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

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

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

In Parts III and IV, we show how capital structure decisions could reduce those creditor conflicts to a manageable magnitude, allowing courts to consider business-judgment deference. We consider in Part III old-style capital market decisions and their sharp limits here. The bank lending syndicate's conflicts could be shaped, and reduced, by the bank syndicate leader taking stock to offset its credit position. While theoretically possible, such results were practically difficult and legally impossible under American bank regulation. Elements of the structure did, however, appear in the classic Japanese main bank system in ways that would have been difficult or impossible to implement under American banking law. But then in Part IV, we show

how modern derivatives and options, as well as the rise of new institutional lenders beyond traditional banks, now make this scenario viable.

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

I. The Problem

The economic problem is that failing firms can often be turned around, but that turnaround can be impeded if a firm's own inside managers and directors are ill-suited for the task. Outside creditors will often be uninterested in a turnaround but will simply seek to collect whatever they can. Yet, sometimes major creditors are well positioned to assess the distressed firm's managerial capacity and business model. These creditors may believe that a differently managed firm would be worth more for all. And they may want to influence or replace the firm's management because they want to maximize their own recovery by making the firm more valuable. But the judicial doctrinal overlay sitting atop this business problem is not well constructed to encourage functional creditor conduct. Doctrine will deter some well-motivated creditors from acting, influencing, and controlling because active creditors will not know how their conduct will be measured.

Courts analyze these activist creditor-in-control situations in differing ways: under doctrines of good faith and gap filling of the creditor's contract with the debtor and its other creditors;[1] under doctrines of instrumentality or alter ego, by which the firm is deemed to be an instrument of the creditor;[2] under similar doctrines with the creditor and firm in a newly created agency relationship (under which a controlling lender is seen as the debtor's principal, responsible for its agent's wrongs);[3] under bankruptcy equitable

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1. *E.g.*, Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990).

2. *See* Krivo Indus. Supply Co. v. Nat'l Distillers & Chem. Corp., 483 F.2d 1098, 1106 (5th Cir. 1973) ("[T]he control required for liability under the 'instrumentality' rule amounts to total domination of the subservient corporation, to the extent that the subservient corporation manifests no separate corporate interests of its own and functions solely to achieve the purposes of the dominant corporation."). *See generally infra* Section I.A.2.

3. *E.g.*, A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 291 (Minn. 1981).

subordination doctrines;[4] via fiduciary duties (which arise from the creditor becoming a de facto or de jure director or controlling shareholder of the failing firm);[5] or under newer tort doctrines of liability for facilitating a deepening insolvency of the firm.[6]

The overall doctrinal problem is as follows: courts dealing with activist creditors in troubled firms often say that (1) creditors who take day-to-day control of their debtors assume board-like duties to the firm's stockholders and its other creditors,[7] and (2) creditors can enforce their loan agreements to protect their own interests.[8] These contradictory standards for judicial decisionmaking confuse creditors and firms, disabling creditors' counsel from being able to advise potentially powerful creditors well because the two standards merge and overlap but lead to opposite outcomes. A creditor may lack day-to-day control but could pressure the debtor to favor the influential creditor over other creditors. The self-interested pressure can induce a single but powerful debtor decision, or the debtor's managers may feel creditor pressure that is short of full creditor control but that influences day-to-day outcomes, from decision to decision. Yet one judicial standard focuses on the differences between day-to-day creditor control, which the standard deems pernicious, and control that is intermittent and more in the nature of influence, which the standard deems to be innocent. Conversely, a creditor may take day-to-day control, directly or by putting a new management team in place, but do so to run the firm more efficiently than failed incumbent management. In that situation, the controlling creditor may never opportunistically favor itself over the firm's other creditors but seek only to maximize firm value (which the controlling creditor expects will allow it to be repaid). But with day-to-day control, the creditor still puts itself at legal risk.

The analogous contractarian thinking is here no better at inducing value-enhancing creditor incentives. The creditor might go beyond suing and collecting on its contract; it might also use its contract to protect its interests by waiving the debtor's loan covenant defaults daily, declining to demand repayment of its loan even though the debtor has failed to maintain

4. *E.g.*, Bergquist v. First Nat'l Bank (*In re* Am. Lumber Co.), 5 B.R. 470, 478 (D. Minn. 1980).

5. *E.g.*, Smith v. Assocs. Commercial Corp. (*In re* Clark Pipe & Supply Co.), 893 F.2d 693, 702 (5th Cir. 1990) [hereinafter *Clark Pipe & Supply II*].

6. *E.g.*, OHC Liquidation Trust v. Credit Suisse First Boston (*In re* Oakwood Homes Corp.), 340 B.R. 510 (Bankr. D. Del. 2006).

7. *E.g.*, Badger Freightways, Inc. v. Cont'l Ill. Nat'l Bank & Trust Co. (*In re* Badger Freightways, Inc.), 106 B.R. 971, 977 (Bankr. N.D. Ill. 1989) ("If the lending institution usurps the power to make business decisions from the customer's board of directors and officers, then it must also undertake the fiduciary obligation that the officers and directors owe the corporation . . . ."); *In re* Beverages Int'l Ltd., 50 B.R. 273, 280–82 (Bankr. D. Mass. 1985) (stating that "where the creditor exercises control over or domination of the debtor, his dealings with the debtor are subject to strict scrutiny. The burden is on an insider claimant to show the inherent fairness and good faith of the challenged transaction" and that "[w]here a creditor has taken control of the debtor, he assumes the fiduciary duties of management and a duty to deal fairly with other creditors").

8. *E.g.*, *Clark Pipe & Supply II*, 893 F.2d at 695.

its part of the bargain. The creditor's decision to waive the debtor's default would, however, be based on whether the debtor is recovering its economic well-being (which could be good for all creditors)—for example, by reducing unnecessary expenses and removing unsuitable managers—or on whether the debtor is enriching the favored creditor each day at the expense of other creditors, such as by converting free, unsecured inventory into accounts receivable pledged to the lender as security. Some contractarian courts say that leveraging the contract into such influence does not entail controlling the corporation, its management, or its operations.[9]

The doctrinal situation is thus operationally contradictory. And here, getting the rules right can make an acute operational difference. When a firm fails, it often takes time to replace incumbent management, often requiring a costly bankruptcy to do so.[10] Creditors may be better positioned than the board and the firm's stockholders to do so efficaciously and quickly, with the creditors sometimes being less conflicted in their decisionmaking than the incumbent managers. Or sometimes a firm could be run most efficiently if a motivated outsider evaluated whether incumbent management is the right team to handle the firm's problems or whether it needs to be replaced. A powerful creditor could know what to do and have the incentive to do it correctly, but if judicial doctrine is uncertain and dangerous for the creditor, with liability potentially substantial, then the creditor could avoid intervention that could tag it with liability. It collects its loan as best it can via the normal machinery of demanding repayment and suing the debtor but does nothing more to influence the firm's decisionmaking or the identity of its decisionmakers. Yet, if the rules against creditor intervention are too weak (e.g., if every creditor intervention colorably connected to the creditor's loan agreement were fair game for creditor action), then excessive creditor intervention of the wrong kind could induce inefficient shutdowns and excessive value shifts to the favored creditor. This risk might affect others' willingness to deal with the failing firm out of fear that the controlling creditor will excessively shift the debtor's value to itself.

A. *The Doctrinal Contradiction: Creditor Control Versus Contractual Self-Protection*

To see how unedifying the doctrinal distinctions governing an activist creditor are, in both providing useful guidance and addressing the operational difficulties of a distressed firm, consider three pairings of cases:

9. *E.g.*, Am. Consol. Transp. Cos. v. RBS Citizens N.A. (*In re* Am. Consol. Transp. Cos.), 433 B.R. 242 (Bankr. N.D. Ill. 2010).

10. On the costs of bankruptcy, see Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. Fin. 1067 (1984); Ben Branch, *The Costs of Bankruptcy: A Review*, 11 Int'l Rev. Fin. Analysis 39 (2002); Arturo Bris et al., *The Costs of Bankruptcy: Chapter 7 Liquidation Versus Chapter 11 Reorganization*, 61 J. Fin. 1253 (2006); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. Fin. Econ. 285 (1990); and Lawrence Summers & David Cutler, *Texaco and Pennzoil Both Lost Big*, N.Y. Times, Feb. 14, 1988, at F3.

American Lumber[11] and *W.T. Grant*;[12] *Clark Pipe & Supply I*[13] and *Clark Pipe & Supply II*;[14] and *American Consolidated*[15] and *Busy Bee*.[16]

The first pairing, *American Lumber* and *W.T. Grant*, juxtaposes the modern judicial classics here, with the two courts dealing with substantially similar facts differently. In the first case, *American Lumber*, the court equitably subordinated the offending creditor—sending it to the end of the creditor queue, to be paid only if the debtor had value left when the bankruptcy process came to it. In the second, *W.T. Grant*, the court extolled the virtue of creditor self-protection via its loan agreement and protected the beleaguered creditor. The second pairing is the extraordinary *Clark Pipe & Supply* sequence, in which the Fifth Circuit examined the creditors' actions one day and concluded that the creditor had perniciously taken control, thereby justifying the creditor's equitable subordination. And then, another day, the same court—indeed, the same panel—examined those creditor actions again but concluded the second time that the creditor had only acted to protect itself on its contract, and as such was free from liability. The last pairing, *American Consolidated* and *Busy Bee*, shows that these contradictions—similar facts, different outcomes—continue today.

1. *American Lumber* Versus *W.T. Grant*

In *American Lumber*, a creditor controlled the finances and operations of the debtor lumber company to the detriment of the firm's unsecured creditors.[17] The district court found that the bank had undertaken

> a course of liquidation that was designed solely to preempt from general unsecured creditors any portion of the value of the inventory and equipment of [American Lumber] and to thereby enhance the value of [the bank's] previously existing security interest in the accounts receivable and contract rights of [the debtor].[18]

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11. Bergquist v. First Nat'l Bank (*In re* Am. Lumber Co.), 5 B.R. 470 (D. Minn. 1980).

12. Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d 599 (2d Cir. 1983).

13. *E.g.*, Smith v. Assocs. Commercial Corp. (*In re* Clark Pipe & Supply Co.), 870 F.2d 1022, 1030 (5th Cir. 1989) [hereinafter *Clark Pipe & Supply I*], *withdrawn on reh'g*, *Clark Pipe & Supply II*, 893 F.2d 693 (5th Cir. 1990).

14. *Clark Pipe & Supply II*, 893 F.2d 693 (5th Cir. 1990).

15. Am. Consol. Transp. Cos. v. RBS Citizens N.A. (*In re* Am. Consol. Transp. Cos.), 433 B.R. 242 (Bankr. N.D. Ill. 2010).

16. Busy Bee, Inc. v. Wachovia Bank, N.A., No. 97 CV 5078, 2006 Pa. Dist. & Cnty. Dec. LEXIS 238 (Ct. Com. Pl. Feb. 28, 2006), *aff'd*, 932 A.2d 248 (Pa. Super. Ct. 2007).

17. Bergquist v. First Nat'l Bank (*In re* Am. Lumber Co.), 5 B.R. 470, 474 (D. Minn. 1980). The bank's control over the debtor's affairs included taking possession of the debtor's plants, requiring approval for any payment to other creditors, reducing the salaries of the principals, and hiring and firing of employees. *Id.* The bank also misrepresented the debtor's financial condition to potential suppliers. *Id.*

18. *Id.* at 477 (quoting Bergquist v. First Nat'l Bank (*In re* Am. Lumber Co.), 7 B.R. 519, 529 (Bankr. D. Minn. 1979)) (internal quotation marks omitted).

The bank therefore had breached its fiduciary duty to the other creditors, and the court equitably subordinated the bank's claims to the other creditors' claims.[19] The decision became a disdained cause célèbre among large institutional creditors and their legal counsel.[20]

A few years later, in *W.T. Grant*, the Court of Appeals for the Second Circuit confirmed a bankruptcy litigation settlement, notwithstanding the urging of some bondholders that the court equitably subordinate the bankrupt firm's major secured bank lenders.[21] The plaintiff bondholders asserted that a pool of banks manipulated the debtor by forcing it to enter into security agreements favoring the banking pool and refusing to make further loans to the debtor until it executed new security agreements that benefited the banks.[22] When Grant management sought to buy back the bonds at a low price, in a perhaps misguided effort to clean up its balance sheet, the banks prevented Grant from doing so.[23]

The court rejected the dissenting bondholders' view, concluding that a

> "creditor is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim" . . . . [A creditor can] us[e] his bargaining position, including his ability to refuse to make further loans needed by the debtor, to improve the status of his existing claims.[24]

The court said that to establish creditor liability, it is not enough to show that

> the banks kept careful watch on what was going on at Grant . . . . [T]he appellants must show not simply that the banks proffered advice to Grant that was unpalatable to management, even advice gloved with an implicit threat that, unless it were taken, further loans would not be forthcoming. They must show at least that the banks acted solely for their own benefit . . . and adversely to the interest of others.[25]

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

20. *See* Helen Davis Chaitman, *The Equitable Subordination of Bank Claims*, 39 Bus. Law. 1561, 1569–71 (1984) (the author, a lender liability litigator, criticized the decision, noting that "[t]he lesson . . . [from] *American Lumber* is clear: when a bank exposes itself to a finding that it improperly exercised control over a borrower corporation, it risks the subordination of its entire claim against the borrower"); Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 Bus. Law. 417, 436–41 (1985); Werner F. Ebke & James R. Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 Sw. L.J. 775, 794–95 (1986); Jeremy W. Dickens, Note, *Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of "Control"*, 65 Tex. L. Rev. 801, 827–29 (1987).

21. Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d 599 (2d Cir. 1983).

22. *Id.*

23. *Id.* at 605.

24. *Id.* at 609–10 (quoting *In re* W.T. Grant Co., 4 B.R. 53, 75 (Bankr. S.D.N.Y. 1980)).

25. *Id.* at 610–11.

One might be tempted to distinguish *American Lumber* from *W.T. Grant* by viewing the former as the lender actively directing the debtor's liquidation and the latter as the banks just providing advice "gloved with an implicit threat."[26] One reason why such a distinction is unsound is that advice gloved with an implicit threat can be used to control the debtor. Advice from a creditor who can induce a bankruptcy or shut down the debtor is more than gratuitous advice from a sympathetic bystander that the debtor will feel free to ignore. Indeed, the giver of such advice, if it is a large creditor with a loan agreement in default, can de facto control the creditor.

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

A second reason why a simple direction–advice distinction is unsound is that a creditor could induce a controlled liquidation of the corporation without assuming an actively and explicitly controlling position. The next pairing of cases demonstrates this possibility.

2. *Clark Pipe & Supply I* Versus *Clark Pipe & Supply II*

Clark Pipe and Supply Company, Inc. was in the business of buying and selling oil pipe.[27] When its business deteriorated, its main creditor, a finance company, reduced its advances to Clark, leaving the debtor with just enough money to "keep its doors open and to sell the inventory."[28] The finance company knew that the debtor's bankruptcy was inevitable and used the advances "to leverage its recovery at the expense of other creditors."[29] It improved its recovery, and it did so at the expense of the other creditors because "[e]very time Clark sold pipe," the finance company obtained the resulting account receivable as security, which "improved its position to the detriment of the vendor."[30] In the debtor–creditor vernacular, the dominating creditor used its influence to induce the debtor to feed the lien, moving value from where it lacked a security interest into assets that the creditor could seize as security, thereby getting more value out of the enterprise, at the expense of the firm's unsecured creditors.

26. *Id.* at 610.

27. *Clark Pipe & Supply I*, 870 F.2d 1022, 1024 (5th Cir. 1989), *withdrawn on reh'g*, *Clark Pipe & Supply II*, 893 F.2d 693 (5th Cir. 1990).

28. *Id.*

29. *Id.* at 1029.

30. *Id.* at 1030.

The Court of Appeals for the Fifth Circuit held for the other creditors, concluding that "Clark was an instrumentality of [the creditor] for the limited purpose of equitable subordination."[31] The court viewed the creditor as controlling the debtor and running the debtor for its own benefit.

But shortly thereafter came an extraordinary judicial reversal. The court treated a suggestion for rehearing en banc from the losing party as a petition for a panel rehearing of the case.[32] The same panel then reheard the case and reversed itself.[33] The panel, which had condemned the creditor's control the first time it examined its conduct, took a contractarian approach and exonerated it: "Through its loan agreement, every lender effectively exercises 'control' over its borrower to some degree."[34] Control is not the touchstone for liability, it said.[35] The creditor could protect its rights under the contract, even by facilitating a slow liquidation of the debtor.[36] The creditor "was not a fiduciary of Clark, it did not exert improper control over Clark's financial affairs, and it did not act inequitably in exercising its rights under its loan agreement with Clark."[37]

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

3. *Busy Bee* Versus *American Consolidated*

Lest the reader conclude that these two pairings were decades-old doctrinal mishaps that have since been resolved, consider the recent *Busy Bee* and *American Consolidated* decisions. In *Busy Bee*, a Pennsylvania court in 2006 examined a lender's influence over a borrower.[38] The court said that a "confidential or fiduciary relationship" arose "if the lender gains substantial control over the borrower's business affairs by compelling the borrower to engage in unusual transactions or by becoming involved in the actual day-to-day operations of the borrower."[39] Indeed, the offended parties showed that "the Bank compelled [the debtor] to . . . abandon[ ] . . . its retail conversion strategy and . . . liquidat[e] . . . its retail business. The Bank also

31. *Id.*

32. *Clark Pipe & Supply II*, 893 F.2d 693, 695 (5th Cir. 1990).

33. *Id.*

34. *Id.* at 701.

35. *Id.*

36. *Id.* at 702.

37. *Id.* While the surface interpretation is that the judges looked at the same evidence and changed their minds, the possibility of a rehearing en banc, perhaps with in-chambers indications of judicial disagreement, could have induced the judges to reexamine their earlier thinking.

38. Busy Bee, Inc. v. Wachovia Bank, N.A., No. 97 CV 5078, 2006 Pa. Dist. & Cnty. Dec. LEXIS 238 (Ct. Com. Pl. Feb. 28, 2006), *aff'd*, 932 A.2d 248 (Pa. Super. Ct. 2007).

39. *Id.* at *68.

became involved with [the debtor's] day-to-day operations by, *inter alia*, directing [the debtor] to retain . . . [a particular] liquidation consultant."[40] Hence, "the Bank assumed a fiduciary responsibility."[41]

Soon thereafter, an Illinois court faced similar facts but used a contractarian analysis to conclude that pernicious "control is not established when a lender insists on standard loan agreement restrictions, closely monitors the borrower's finances, and makes business recommendations, even [in] the context of heated negotiations. Nor is [liability-inducing] control established when a borrower hires a management or restructuring consultant selected by the lender."[42] The creditor may well have controlled the debtor because managers felt compelled to follow the creditor's goals, but since the creditor exercised that influence and control through its loan contract, that control was not sufficiently pernicious to lead to liability.[43] Management could in principle have rejected the insistent creditor's efforts but then would have faced the creditor's rights under the loan agreement.[44] Although the debtor complained that "the Bank forced it to enter into [new loan terms] after the Bank declared [the debtor] in default," and although the Bank forced it "to take steps towards selling the business . . . even though [the debtor] wanted to remain in business[,] . . . none of these actions usurped managerial control from the [debtor's] directors and officers."[45]

Thus, here are the bottom line contrasts: in both *Busy Bee* and *American Consolidated*, the lenders (1) required the debtor to hire the creditor's preferred restructuring consultant and (2) forced the liquidation of a major part of the debtor's business over the debtor's objections. These were the core facts on controlling-creditor liability in both cases, but the *Busy Bee* court held the creditor liable and the *American Consolidated* court did not.[46]

4. Objective Facts Versus Eye-of-the-Beholder Viewpoint

The current doctrines put a premium on creditors' being well behaved—that is, on their conforming to shared norms of permissible creditor action, particularly if the deciding court shares those commercial norms. Contrast creditor demeanor in two settings. In the first, the creditor, facing a debtor in default under the loan agreement, demands that the debtor take specified actions. It might demand that the debtor close down a weak factory. It might demand that the board change senior management and hire the creditor's preferred turnaround firm. Perhaps in negotiations the

40. *Id.* at *66–67.

41. *Id.* at *68.

42. Am. Consol. Transp. Cos. v. RBS Citizens N.A. (*In re* Am. Consol. Transp. Cos.), 433 B.R. 242, 254 (Bankr. N.D. Ill. 2010) (citation omitted).

43. *Id.*

44. *Id.*

45. *Id.*

46. *Busy Bee* also involved creditor fraud, which perhaps influenced the court when making its overall decision, but that fraud was not part of its creditor-in-control liability rationale. *See Busy Bee, Inc.*, 2006 Pa. Dist. & Cnty. Dec. LEXIS 238.

workout lawyer for the aggressive creditor slams a fist into the conference room table, telling the debtor's managers that they are working for the creditor now, and they had better do what the creditor thinks makes business sense. This creditor is at risk of being seen as taking control of the debtor, managing it, and assuming fiduciary duties to the debtor's other creditors or to the debtor itself.

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

One set of courts is more likely to interpret the second scenario as not entailing pernicious control but as simple advice. Those courts might well understand that the superficially arm's-length advice comes via a velvet glove wrapped around the loan agreement fist, as the *W.T. Grant* court suggested.[47] But they could see this advice as appropriate input from an interested creditor, one who might offer the advice while reminding the debtor that it is in default under the contract. Such courts could see that advice as not entailing the wrongful, pernicious control that would expose the lender to liability.

But where does the creditor's power come from to have its advice be taken seriously by the debtor? It does not come from an inherent capacity to control and direct the enterprise—the creditor does not own and vote the company's stock. The doctrinal difficulty is that the creditor's power to have its advice taken or to dictate debtor actions comes from its loan agreement and the remedies it would have if the debtor defaulted under the loan contract. A polite creditor has enormous leverage over its debtor, making the debtor listen attentively to the creditor's suggestions and, quite likely when the debtor is in default, follow them. It can make an offer or give advice that the debtor will not refuse. And, symmetrically, the debtor can tell the impolite, tougher, bullying creditor that seeks control of the debtor's operations that its demands will not be followed; the debtor can also tell the *polite* creditor that its suggestions will not be followed. In either instance, the creditor's remedy is to turn to its loan agreement.

47. *See* Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d 599, 610 (2d Cir. 1983).

Directive language, an ordering tone, and a relationship that seems controlling are all associated with creditor liability.[48] In contrast, creditor advice, creditor contract enforcement, and conditional loan waivers in another line of decisions are in contrast associated with creditors not being liable.[49] These tonal distinctions make a difference to courts but should be less important than they have been.

Creditor power comes from the creditor's loan agreement. A creditor can induce a debtor to favor itself over the firm's other creditors if they lack the loan agreement advantages of the dominating creditor, and it can do so without formal control. The question is not whether the creditor's actions constituted control that was continuous and deep, as opposed to being interstitial and merely advisory, without insisted-on demands. As Douglas Baird and Robert Rasmussen state, the doctrines in this area are "unsettled enough to cause lenders (or at least their counsel) to make their intentions known without issuing stark commands."[50]

48. For additional decisions equating the creditor action with pernicious control that produced fiduciary duties or creditor action that the court saw to be a basic breach of good faith and, in the end, liability, see Citibank, N.A. v. Data Lease Fin. Corp. 828 F.2d 686, 691–92 (11th Cir. 1987); K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 759 (6th Cir. 1985); Melamed v. Lake Cnty. Nat'l Bank, 727 F.2d 1399, 1403–04 (6th Cir. 1984); Limor v. Buerger (*In re* Del-Met Corp.), 322 B.R. 781, 811 (Bankr. M.D. Tenn. 2005); Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re* Exide Techs., Inc.), 299 B.R. 732, 743 (Bankr. D. Del. 2003); Official Comm. of Unsecured Creditors of the Debtors v. Austin Fin. Servs., Inc. (*In re* KDI Holdings, Inc.), 277 B.R. 493, 512–13 (Bankr. S.D.N.Y. 1999); *In re* Beverages Int'l Ltd., 50 B.R. 273, 283 (Bankr. D. Mass. 1985); Sanchez-Corea v. Bank of Am., 701 P.2d 826, 837–38 (Cal. 1985); and A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 291 (Minn. 1981).

49. For additional decisions viewing the creditor's action as no more than an effort to enforce its loan agreement, and, hence, as creating neither fiduciary duties nor liability, see Famm Steel, Inc. v. Sovereign Bank, 571 F.3d 93, 102–03 (1st Cir. 2009); Krivo Indus. Supply Co. v. Nat'l Distillers & Chem. Corp., 483 F.2d 1098, 1110 (5th Cir. 1973); Schwan's Sales Enters., Inc. v. Commerce Bank & Trust Co., 397 F. Supp. 2d 189, 196 (D. Mass. 2005); Nat'l Westminster Bank USA v. Century Healthcare Corp., 885 F. Supp. 601, 603 (S.D.N.Y. 1995); Dixon v. Am. Cmty. Bank & Trust (*In re* Gluth Bros. Constr., Inc.), 424 B.R. 379, 390 (Bankr. N.D. Ill. 2009); Nisselson v. Softbank AM Corp. (*In re* MarketXT Holdings Corp.), 361 B.R. 369, 391 (Bankr. S.D.N.Y. 2007); Am. Nat'l Bank & Trust Co. v. Matrix IV, Inc. (*In re* S.M. Acquisitions Co.), 332 B.R. 346, 352 (Bankr. N.D. Ill. 2005), *aff'd in part*, *rev'd in part*, No. 05 C 7076, 2006 WL 2290990 (N.D. Ill. 2006); and Spillers v. Five Points Guar. Bank, 335 So. 2d 851, 852–53 (Fla. Dist. Ct. App. 1976).

50. Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Pa. L. Rev. 1209, 1235–36 (2006); *see also* 2 Weil, Gotshal & Manges LLP, Reorganizing Failing Business: A Comprehensive Review and Analysis of Financial Restructuring and Business Reorganization 18-64, 18-65 (rev. ed. 2006) ("Of late, particularly in the areas of equitable subordination and nonstatutory lender liability based on conduct, the pendulum has swung in favor of lenders, particularly at the appellate level. Nonetheless, lenders should be aware that the more control they have and exert over their borrowers, the more likely it is that they will be held liable under any number of theories.").

B. *The Conflicts in Play*

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

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

Figure 1. Lien Feeding: Vertical Distortion

Time (1)

Assets	*Liabilities*
$1,000 inventory	$1,000 trade debt
$ 500 accounts receivable	$1,000 syndicated bank loan
	[The bank loan is secured by the accounts receivable, but the receivables are insufficient to cover the loan.]

Time (2)

Assets	*Liabilities*
$ 500 inventory	$1,000 trade debt
$1,000 accounts receivable	$1,000 syndicated bank loan
	[The bank loan is now fully secured.]

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

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

Figure 2. Preferential Repayment: Horizontal Distortion

Time (1)

Assets	*Liabilities*
$1,000 cash	$1,000 syndicated bank loan
$ 500 machinery	$1,000 trade debt

Time (2)

Firm pays all its value to the bank syndicate, leaving nothing for trade creditors.

Assets	*Liabilities*
$ 500 machinery	$1,000 trade debt

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

Third, the controlling creditor can mismanage the firm, such that the firm is more likely to produce value that will pay the creditor back at the expense of other capital-providers, such as stockholders. So, if the firm has an expected value of $2,500, from equal chances of being worth $0 or $5,000, the controlling creditor could prefer a lower-value business strategy that produces only $2,000 but does so assuredly. As Figure 3 illustrates, this possibility is captured in the potential for creditors to liquidate firms too quickly. It is also in play in the creditor-versus-stockholder conflict at the root of *State National Bank of El Paso v. Farah Manufacturing Co.*,[51] discussed below.

On these numbers, illustrated in Figure 3, creditor control of this debtor is pernicious. But it would not take much imagination to change the numbers so that the liquidation strategy would be the best for the firm overall (if the market for its products has deteriorated and the firm was no longer a viable business with any continuing going concern value). If a court could readily review and judge the business decisions, then it could itself directly manage the creditor-liability decision, making the creditor liable for inducing a self-interested liquidation but not for inducing a value-maximizing liquidation. If a court cannot review the substance of a business decision accurately, then it needs a different set of tools to manage such a conflict. In the corporate boardroom context, courts generally see themselves as poorly suited for such business review, which they undertake only as a last resort.

51. State Nat'l Bank of El Paso v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984), *appeal dismissed per stipulation*, Mar. 6, 1985.

Figure 3. Creditors Reduce Firm Value to Detriment of Stockholders

Time (1)

Assets	*Liabilities*
$2,500 [from (.5 • 0) + (.5 • $5,000)]	$2,000 banks and other debt $ 500 stockholders

At time (1), the banks are at risk because the firm has a 50 percent chance of being unable to pay the banks back. The stockholders have some value in the firm from the 50 percent chance that the firm value will exceed $2,000.

Time (2)

Bank induces firm to liquidate its factories for $2000.

Assets	*Liabilities*
$2,000 cash	$2,000 banks and other debt $ 0 stockholders

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

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

1. Operational Costs of Deterring Capable Creditors from Intervening in Failing Firms

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

Firm failure is often management failure.[52] Incumbent management might have mistakenly run the company into the ground. Sometimes incumbent management is just unlucky, finding itself running a firm in an industry with declining demand or rising costs, but it is not the management team best positioned to turn the company around. Yet managerial self-

52. *Cf.* Edward I. Altman & Edith Hotchkiss, Corporate Financial Distress and Bankruptcy 221–23 (3d ed. 2006); David J. Denis & Diane K. Denis, *Performance Changes Following Top Management Dismissals*, 50 J. Fin. 1029, 1055 (1995) ("[F]orced top management changes are preceded by large and significant operating performance declines and followed by significant improvements in operating performance."); Mark R. Huson et al., *Managerial Succession and Firm Performance*, 74 J. Fin. Econ. 237, 273 (2004) ("[M]anagerial quality and expected firm operating performance increase after CEO turnover.").

interest could lead managers who are no longer right for the firm to keep themselves in place for too long, with replacement only coming in the firm's bankruptcy, if at all.

Operational costs can thus be visited on the firm if legal doctrine excessively deters creditor entry into influencing the failed firm. Too strict a rule of creditor conduct could induce competent creditors to remain passive, for fear of doctrinal uncertainty and later liability. Yet, a creditor, when managing its loan to a debtor, could have acquired enough knowledge of the debtor and its operational reverses for the creditor to become a good de facto board. The creditor could contribute to managing the firm, may be well positioned to judge whether the business problems were due to bad luck or bad management, and may be able to make an informed judgment as to whether to replace or keep current management. Furthermore, the creditor's active encouragement of the debtor's turnaround may reassure the market about the firm's prospects: the market might see a knowledgeable insider with skin in the game as someone who thinks that the firm is viable. But if judicial doctrine punishes it severely and unpredictably for managerial involvement, the creditor will stay away more than we should want it to.[53]

Randall Kroszner and Philip Strahan investigated American banker board behavior and found it to be consistent with the logic of the negative incentives emanating from these doctrinal uncertainties.[54] They found that one-third of the Forbes 500 firms had a banker on the board.[55] However, American bankers tended to be less active than bankers in other nations, and, in other nations without the American creditor-liability doctrines that motivate this Article's inquiry, banker board representation was denser than here.[56] But Kroszner and Strahan's most telling findings were that American bankers sought stable firms and avoided boards of firms facing financial distress, in contrast to the opposite practice common in other nations.[57] Yet those distressed firms are the ones most likely to need help.[58]

53. *Cf.* Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 Harv. L. Rev. 505, 538–40 (1977) ("[A] preventive rule that insiders' debt claims are subordinated automatically to those of outsiders may be objectionable because it appears unjust as applied to those insiders who do in fact deal honestly, fairly, and nonpreferentially with their corporations. Indeed, there are compelling arguments which suggest that insiders be allowed to participate in their corporations as creditors on the same basis as outsiders.").

54. Randall S. Kroszner & Phillip E. Strahan, *Bankers on Boards: Monitoring, Conflicts of Interest, and Lender Liability*, 62 J. Fin. Econ. 415, 422 (2001).

55. *Id.* at 416–17.

56. *See id.* at 416.

57. *See id.* at 445–47.

58. *See id.* at 422; *cf.* Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 46 (1991).

2. Operational Costs to Allowing Excessive Creditor Distortions in Managing Failed Firms

The converse of the above is true as well. If the rule overly facilitates creditor entry into its debtor's decisionmaking apparatus, then a firm could be needlessly mismanaged. A creditor of an operationally salvageable firm could take control, force the firm's liquidation, and destroy social and economic value—but still profit from that destruction. If the rules facilitate creditor action to foster a check on firm management, those same rules and standards could also thereby facilitate the negatives of hasty creditor-induced liquidations and shifts in value to the controlling creditor. Preference and fraudulent conveyance law control some such transfers,[59] with equitable subordination often thought to round out the setting.[60] But if courts excessively defer to the creditor and inappropriately fail to invoke equitable subordination, then the sharp-eyed creditor could steal the firm.

Kenneth Ayotte and Edward Morrison examined another sample of public and private Chapter 11 filings and found that secured creditors liquidate more quickly when they have adequate security for themselves than when they do not.[61] And three economists, after reviewing their own data, recently concluded that misplaced strengthened creditor rights do, in fact, distort business decisions: "[S]tronger creditor rights induce risk-reducing investments. Strong creditor rights in default may lead to inefficient liquidation, which extinguishes the continuation option of a firm's enterprise and thus hurts shareholder value."[62]

Moreover, the density and frequency of these conflicts and operational difficulties are not minor. In one study, finance researchers examined 7,600 debtor defaults during the past decade and found that creditors obtained benefits not contemplated by their contracts.[63] Creditors used the debtors' loan agreement "violations to apply noncontractual control over the governance of [the debtor] firms," resulting in "a statistically and economically significant increase in CEO [replacement]."[64] As Baird and Rasmussen note,

59. *See* 11 U.S.C. §§ 547–48, 550 (2006).

60. *See id.* § 510(c).

61. Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. Legal Anal. 511, 528–30 (2009).

62. Viral V. Acharya et al., *Creditor Rights and Corporate Risk-Taking*, 102 J. Fin. Econ. 150, 151–52 (2011); *see also* Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 Colum. L. Rev. 1321, 1353–54 (2007).

63. Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 Rev. Fin. Stud. 1713 (2012).

64. *Id.* at 1716. An interpretive ambiguity might be in play: even if creditor rights to control CEO turnover were not explicitly stated in the contracts that Nini, Smith, and Sufi examined, creditors might readily see them as a consequence of any forbearance on collecting the loan. *See* Sadi Ozelge & Anthony Saunders, *The Role of Lending Banks in Forced CEO Turnovers*, 44 J. Money Credit & Banking 631 (2012); Yili Lian, *Creditor Control Rights, Corporate Governance and Bond Performance: Evidence from Loan Covenant Violation* (July 9, 2012) (unpublished manuscript), *available at* www.ssrn.com/abstract=2135083.

in distressed situations it is not unusual for creditors to condition their continuing to finance the enterprise on the debtor appointing a chief restructuring officer to the creditor's liking.[65] In these situations, the chief restructuring officer "may be compensated by the company, but her interests are aligned with the lenders."[66]

Finally, with the growing number of hedge fund and private equity positions in financially troubled companies, the potential increases for either distortive management by conflicted financial institutions or improved management by new interventions.[67] Getting this trade-off right has always been important—and is now more important than ever—with increased economic volatility inducing more business and with powerful new institutional players active in restructurings.

II. The Corporate Law Analogue

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

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65. Baird & Rasmussen, *supra* note 50, at 1233.

66. *Id.* at 1234; *see also* Nini et al., *supra* note 63, at 1715 (explaining how creditors use loan covenant defaults to force managerial change). The bankrupt's primary lender (the so-called "DIP lender") often has power analogous to that of the controlling creditor outside of bankruptcy. As Baird and Rasmussen show,

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

Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 Yale L.J. 648, 676 (2010) (footnote omitted).

67. *See Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary*, 111th Cong. 22 (2009) (statement of Harvey R. Miller, senior partner, Weil, Gotshal & Manges LLP) ("Distressed debt traders and hedge funds have different objectives than those of vendor/suppliers. They are motivated by quick and sizeable returns on their investment. Because their entry price usually is much lower than the face amount of the acquired debt, they are more apt to favor the sale and dismemberment of a debtor, if it will yield faster and greater recoveries based upon the costs of purchasing claims."); Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 Nw. U. L. Rev. 281, 282 (2009).

A. *Corporate Law Basics*

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

Yet in the corporate boardroom context, decisions to close factories or change management do not take on the same controversial character that they do in the failing-firm, creditor-in-control context. The corporate rules reduce controversy in the decisionmaking and reduce judicial second-guessing of the board's decisions. Judicial rules evaluating board decisions are more functional and serve as better guides for business behavior than the judicial rules evaluating creditor conduct.

Board-based corporate decisions lack the creditor-based controversy, because corporate decisions are typically shielded by the business-judgment rule: if the board is not conflicted, then the court will defer to the board's business judgment. "The business judgment rule [is a standard of judicial review that] presumes that in making a business decision, independent and disinterested directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation."[68]

But if the board is conflicted, then the court will indeed second-guess the board with an entire fairness review. As three of the country's leading business judges stated, if the plaintiff shows that the directors have an interest in the transaction, the burden to prove that the transaction was "entirely fair" to the corporation switches over to the defendants. "[T]he basic rationale for entire fairness review [is] the difficulty in ascertaining, in non-arm's-length transactions, the price at which the deal would have been effected in the market."[69] The court may conclude that the conflicted board approved a transaction that was fair to the corporation and thus absolve that board of liability. As the Delaware chancery court has said, however, "[T]he determination of the appropriate standard of judicial review frequently is determinative of the outcome."[70] Indeed, anticipating entire fairness review for conflicted decisions, boards and their legal counsel can often manufacture business-judgment deference even with a conflicted board, by taking the decisionmaking away from the conflicted directors and placing it before a board committee of unconflicted directors.

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68. American Bar Association, Corporate Director's Guidebook 27 (6th ed. 2011).

69. *See* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 Nw. U. L. Rev. 449, 461 (2002).

70. Unitrin, Inc. v. Am. Gen. Corp. (*In re* Unitrin, Inc.), 651 A.2d 1361, 1371 (Del. 1995) (quoting Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1989)) (internal quotation marks omitted).

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

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

C. *The Creditor Takes Control: Business-Judgment Deference for Nonconflicted Transactions*

But what if the controlling creditor lacked major financial conflicts of interest? Yes, it is hard to imagine at first that the conflicts could be only minor, but consider the abstract possibility. In a low-conflict setting, the court could be satisfied that the creditor was likely to be making judgments that would maximize total firm value. If this were the case, the court would have little reason to second-guess the creditor's decisions, or at least have no more reason to second-guess the creditor than the court has to second-guess an unconflicted board. Boards and creditors make business mistakes—by taking calculated risks that do not pay off, for example. But when they lack gross conflicts, courts could think that the judiciary is unlikely to systematically do better than the business players. Those business players are the boards directing firms in one setting and the firm's major creditors influencing the debtor firms in another.

Indeed, in similar corporate circumstances, the Delaware courts protect corporate decisionmakers. When the firm is nearly insolvent, courts in recent years have considered the possibility that the board, presumably the nonconflicted board, can make decisions that favor the firm as a whole, without considering only the interests of the shareholders.[71] As one Delaware court emphasized, such decisions will be accorded business-judgment deference: "[D]irectors would be protected by the business judgment rule if they, in good faith, pursued a less risky business strategy precisely because they feared that a more risky strategy might render the firm unable to meet

71. *See* Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 788 (Del. Ch. 2004); Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991); E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. Pa. L. Rev. 1399, 1430 (2005). *But cf.* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).

its legal obligations to creditors and other constituencies."[72] Could that analogue of an unconflicted board be constructed for the creditor of the failing firm?

D. *Considering a Contractual Trump to Corporate Law Doctrine*

Contractual qualifications to the foregoing analysis, along with a closer look at several additional contractarian considerations, are now necessary. Does the loan contract's terms determine the range of judicial action as to the controlling creditor?

> [T]he efficient ex ante bargain may include terms that look inefficient ex post. . . . [C]reditors may need to . . . have the ability to engage in self-serving behavior that compromises the value of the business as a whole in order to ensure that the shareholders have the right set of incentives in the previous period.[73]

But one can take a strong contractarian stance,[74] an approach to which the authors here generally subscribe, and still recognize the great need for a new approach to creditor duties.

First, contractarian characteristics underlie even aggressive judicial implication of fiduciary duties. Courts that impose duties on controlling creditors still do not deny creditors their contract right to sue and collect on their loan. They rather evaluate a creditor's behavior that is not basic collection activity. The fiduciary-duty courts, however, do not conclude that contractarian deference to straight collection action should extend to when the creditor uses its loan to leverage influence on the firm. That added action, a fiduciary-oriented court could conclude, is not part of the contract.[75] But a

72. Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 788 (Del. Ch. 2004).

73. Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 Stan. L. Rev. 1309, 1314 (2008) (footnote omitted); *see also* Frederick Tung, *Gap Filling in the Zone of Insolvency*, 1 J. Bus. & Tech. L. 607, 618–19 (2007) ("The possibility of draconian remedies upon default reduces adverse selection *ex ante* and may induce good behavior on the borrower's part *ex post*. Because the borrower has private information about the condition of the business, it is important that upon default, the lender have significant bargaining power in order to be able to extract as much value as possible in a workout. The lender's ability to shut down the business provides such leverage. This arrangement inures to borrowers' benefit as well. In the competitive lending markets in which banks operate, reducing banks' losses translates into lower borrowing costs for firms." (footnotes omitted)); *cf.* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. Rev. 967, 983 (2006) (explaining how venture capital startups' capital structures can be part of an efficient ex ante bargain but lead to ex post inefficiencies).

74. *See* Daniel R. Fischel, *The Economics of Lender Liability*, 99 Yale L.J. 131, 140–42, 147 (1989) ("Optimal fiduciary rules approximate the bargain that the parties would have reached if the costs of contracting were zero."); Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 Emory L.J. 809, 817, 856–57 (2008) ("Private contracting alone should be effective to shift managers' loyalties in favor of creditors. Additional legal constraints are both unnecessary and costly.").

75. *E.g.*, State Nat'l Bank of El Paso v. Farah Mfg. Co., 678 S.W.2d 661, 686 (Tex. Ct. App. 1984), *appeal dismissed per stipulation*, Mar. 6, 1985 (stating that "it was the legitimate option of the lenders to determine whether or not [the appointment of a particular CEO]

full-throated contractarian still might protect the added action (of conditioning waiver on debtor action not explicitly covered by the loan agreement), seeing a creditor's waiver on condition that the debtor take this or that action as a lesser included offense to suing and collecting. But critics of this approach could see the creditor's and debtor's actions as not fully worthy of the same contractarian deference that they would give to straight collection activity, if that conditional waiver transferred value from other creditors to the activist creditor. If the debtor and dominant creditor manipulate the firm or its finances in ways that deeply affect third parties—namely the firm's other creditors—contractarian deference may well not be warranted.

A second, related consideration is obvious: contracts are often incomplete. Even heavily negotiated loan agreements have open-ended terms or fail to anticipate the consequences of the full range of operational outcomes over the life of the loan. The loan may have a financial covenant that has been violated, and the available remedies may not explicitly include the right to name new management or direct the firm's operations.[76] Indeed, strong contractarians recognize this possibility when they propose "to interpret the duty of good faith as equivalent to a prohibition of opportunistic behavior. Under this view, lenders are entitled to the benefit of their bargain but are precluded from using contractual terms as a pretense for extracting benefits for which they have not bargained."[77]

Thus, even courts holding the strongest contractarian view of debtor–creditor relations will need to assess the extent to which the controlling creditor's behavior was opportunistic and went beyond what the contract terms permitted. If the contract was clear or if the creditor just did not negotiate for formal rights to control future firm investments in the event of the debtor's default, the case for implying fiduciary duties is not a strong one in our usual business jurisprudence, and recent erosions, analysts argue, should be cut back.[78]

But consider the possibility that the loan agreement is specific and explicit: "In the event of a default, the creditor may liquidate the firm immediately in a value-destroying fire sale." Or, "in the event of a default, the

should be viewed as a default," but it was not fair game "to issue warnings designed to force the board to elect someone other than" that person).

76. *See generally* Tung, *supra* note 73, at 617–18.

77. Fischel, *supra* note 74, at 141 (footnote omitted); *see also* Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990) ("'Good faith' is . . . an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties. When the contract is silent, principles of good faith—such as the UCC's standard of honesty in fact, UCC § 1-201(19), and the reasonable expectations of the trade, UCC § 2-103(b) . . . fill the gap. They do not block use of terms that actually appear in the contract."). Again, even in a contractarian framework, we need to assess whether creditor action is primarily opportunistic or contract-based.

78. Tung, *supra* note 74, at 815–16.

creditor may name new management, in its sole discretion, to run the company in the creditor's interest." As between that creditor and the debtor, the contractarian view would be that the creditor can engage in even value-destroying creditor actions. (A contractarian, aiming also to maximize social wealth ex post, might hope that merger markets are strong enough that the creditor or the stockholder can sell the firm for a higher value to capture what would be lost in any creditor mismanagement or fire sale, but that is another matter. A contractarian might also hope that, in the face of such a contract, the stockholders and creditors would negotiate a Coasian deal[79] to deploy the firm most efficiently. The doctrinal and business structures we propose in the next Parts are designed in part to facilitate such a Coasian efficient deployment of the distressed firm, even in the face of an ex ante value-destroying contract.)

The difficulty of the full contractarian view even here, in an unusual setting of contractual explicitness on control, is not that it would permit the creditor to liquidate or name new management, *against the debtor's objections*, but that the creditor could be enabled to do so in the face of objections from the firm's *other* creditors. True, if other financial creditors lent to the debtor after examining the loan agreement with the control-and-liquidate covenants—that is, if they were themselves fully contracting creditors, with knowledge of the prior deals—then the contractarian view would bind those informed, subsequent creditors. But vis-à-vis a wide range of other creditors—many preexisting creditors and most tax claimants, as well as many trade creditors, tort claimants, and consumer creditors—the explicit contractarian framework fits poorly. These creditors in the aggregate can be substantial for a firm. Think of many small tort claimants in the mass tort cases that drove firm after firm that dealt with asbestos into bankruptcy. Think of tax, consumer, and supplier claims on typical businesses. Such claims have figured prominently in major cases, such as *American Lumber*,[80] *Clark Pipe & Supply II*,[81] and *W.T. Grant*.[82]

In these three settings, pure deference to an incomplete contract, or to waivers of defaults in exchange for operational concessions, would work erratically in maximizing value. Too many creditors are not party to the relevant contract.

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79. The Coase Theorem indicates that, in the absence of transaction costs, parties will bargain to efficiently use their resources, regardless of which party is liable to the other. R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

80. Bergquist v. First Nat'l Bank (*In re* Am. Lumber Co.), 5 B.R. 470, 475 (D. Minn. 1980).

81. *Clark Pipe & Supply II*, 893 F.2d 693, 695–96 (5th Cir. 1990).

82. Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d 599, 601 (2d Cir. 1983). This multilateral bargain seems implicit in Jonathan Lipson's review of the creditor duty problem, when he suggests that the duty of good faith in such contractual relationships should require that powerful creditors dealing with distressed firms consider the interests of all parties that the workout affects. Jonathan C. Lipson, *Governance in the Breach: Controlling Creditor Opportunism*, 84 S. CAL. L. REV. 1035, 1073 (2011).

In principle, these contractarian issues could arise elsewhere in the life cycle of the firm—contracts are always incomplete, some creditors do not fully negotiate contracts, bilateral contracts have third-party effects on other creditors. But these difficulties are more acute when the firm is insolvent or nearly so.

Regardless, for the reasons already discussed, the current state of judicial doctrine—contrasting day-to-day control against creditor enforcement of its contract protections via conditional waivers and hoping that such a distinction is real—provides poor guidance. We need a new approach.

III. A Capital Market Approach to Reducing Distortive Creditor Self-Interest: Old Style

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

But the unconflicted creditor-in-control is not as far-fetched as it might at first seem, in light of the new finance of options and derivatives, and against the background of the concomitant rise of new financial players. First, though, we will consider how old-style finance could have been adapted, albeit with much transactional and regulatory difficulty, to the theory.

A. *The Syndicate Leader*

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

The firm defaults, and creditors do more than seek to be repaid: they seek to replace management and influence operating decisions. This setting occurred in the well-known *Farah Manufacturing* controversy[83] and is instructive here. There, the lending syndicate forced out old management after a bitter labor strike and secondary boycott of the debtor, put a managerial change clause into its loan agreement (i.e., barring any managerial change to which the creditors objected), used the managerial change clause to wedge its preferred managers into place, and induced managers to liquidate major parts of the firm's operations.[84] The new managers made disastrous operating decisions that cost everyone in the firm dearly.[85] When the original equity holders eventually regained control of the firm, they had better

83. State Nat'l Bank of El Paso v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984), *appeal dismissed by agreement*, Mar. 6, 1985.

84. *Id.* at 667–68, 672, 678.

85. *Id.* at 668–69.

operating results, and they sued the banks on several theories of lender liability.[86]

If the firm had a bleak future when the creditors originally seized control, a liquidation sale of the useless machinery was operationally sensible. If the bank-appointed managers intended their decisions to be profit maximizing, however, and *if* the controlling creditors who appointed those managers lacked conflicts, then business-judgment judicial deference to the decisions could have been appropriate. But given the deep conflicts of interest of the creditors, no such thinking emerged in the *Farah Manufacturing* litigation.[87] Nor, given the lending syndicate's structure, should it have.

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

But consider this alternative scenario: El Paso National Bank was the syndicate leader and made a slice of the total loan to Farah Manufacturing. What if El Paso, the lead bank, with, say, 10 percent of the lending syndicate's take-down also owned 10 percent of the debtor's stock, as Figure 4 illustrates? If it then made managerial decisions that lowered the long-term value of Farah Manufacturing's operations (by liquidating too much, too soon, at fire-sale prices), it would have given up value that it could have captured through its equity holding. As such, it would have lacked the incentive for such value-diminishing action, which would have damaged its own total investment. It might have done so mistakenly—just as boards making managerial decisions sometimes misjudge the business situation—but not intentionally to further its self-interest.

The potential way out here is now obvious: if El Paso had proportionate debt and equity interests, if it had been entitled to make all important decisions for the lending syndicate, and if the syndicate's intercreditor contract had allowed El Paso to recognize the value to itself of its stock interests when making operational and managerial decisions, then the reviewing court could have judged whether the remaining conflicts were really so strong as to trump business-judgment deference. The central conflict for the creditor

86. *Id.* at 669. The full facts are more complex, but the text summarizes what is important. In the fuller version, the board itself forced out William Farah because "he was the cause of [Farah Manufacturing's] management problems and poor financial condition." *Id.* at 670. After Farah resigned, there was a managerial revolving door, with the banks eventually putting their people in place when they leveraged a loan agreement clause that allowed them to call a default if there was change in management that they disliked. *See id.* at 668, 670. Although the Farah family had a controlling stock interest in the firm, several family members opposed William Farah's return to management, leading to intrafamily litigation. *See id.* at 667–68. Eventually Farah prevailed in the family litigation and gained voting control of enough family stock to put himself back in control of the manufacturing company. *See id.* at 668. When he regained control, he had the company sue the banks. *Id.*

87. *See id.* at 668–70.

would have been largely mitigated. And if, in the court's view, the residual conflicts were weaker or were offset by other factors,[88] then a business-judgment review and deference could have been something for the court to consider. Figure 4 illustrates this point.

Figure 4. The Syndicate Leader with Stock Ownership

Assets	*Liabilities*
$2,000 cash	$2,000 banks and other debt [Syndicate leader owns 10 percent, or $200, of the debt.] Stockholders [Syndicate leader takes 10 percent of the stock.]

Scenario 1. The firm is better off continued, as in the first scenario in Figure 3. The syndicate leader has a 50 percent chance of having its $200 portion of the syndicate's loan fully repaid and a 50 percent chance of having $300 in equity from the firm's continuance, for an expected value of $250. Hence, even if the liquidation value of the firm is $2,000—enough to pay the lenders in full—the syndicate leader's incentives from its ownership interests are to push for the higher value continuance. Liquidation will yield the syndicate leader only $200—less than the $250 from continuance.

Scenario 2. Alternatively, consider the possibility that the firm is better off liquidated because the top scenario in Figure 3 changes to a lower value at [(.5 · 0) + (.5 · $3,000)] = $1,500. The syndicate leader gets $150 from continuance, but $200 from liquidation. Again, the syndicate leader's incentives from its position in the firm's capital structure are to push for the higher value liquidation.

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

The syndicate leader taking a proportionate interest in the other layers in the firm's capital structure is not the only way to implement a corporate law, capital market approach to creditor conduct.

1. Warrants at the Time of Lending

When the creditors and the debtor negotiate their loan, they may reduce the creditors' conflicts of interest by having the syndicate leader take stock warrants proportionate to its portion of the loan.

The warrants' exercise price cannot be immediately fixed and exercisable because when the creditor grants the loan, the firm is usually solvent and profitable; therefore, the stock price reflects the current value of the company. The warrants' value in reducing conflict comes later, only if the firm declines and bank intervention becomes appropriate.

The central problem with this solution is that when the creditor makes the loan, neither party particularly wants to sell, buy, or hold warrants. It is

88. For example, El Paso National Bank's incentive from its equity interest would be offset in part by its interest in protecting the other members of the syndicate. In this way, bankers would have confidence that El Paso as syndicate leader would protect the banks first and foremost so that banks would willingly join a syndicate that El Paso led. This conflict could deter El Paso National from maximizing the value of its own direct holding in Farah.

just a structural reserve for a rainy day that may never come. The second problem is that the parties have to write the terms under which the warrants "go live" before the firm enters financial stress; the parties will surely write terms then that will not be ideal later when the stress arises.

2. Convertible Debt

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

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

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

3. Buying up Proportionate Interests

When the firm enters stress and the bank wants to intervene, the lead bank could buy enough shares in the market so that its debt position is proportionate to its newly acquired equity holding. This alternative has the advantage of not requiring the lead bank to have warrants or conversion rights from the beginning of the lending relationship because these rights may be of no use to the parties since most firms do not fail and induce lender intervention.

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

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

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

C. *The Classic Main Bank System and Its Relevance*

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

1. How the Classic Main Bank System Resembles the Capital Market, Corporate Law Approach

In the immediate post–World War II decades, Japan's main banks were active in their debtors' decisionmaking, especially when the debtors became distressed.[89] The main bank provided significant credit to the borrower and led a syndicate of major banks in lending to the debtor firm.[90] If the debtor firm began to fail, the main bank would take over the firm, sending in personnel to make or review basic business decisions.[91] The main bank lent to the debtor and owned the debtor's stock.[92]

The classic main bank system has been described as a system of contingent control: the main bank was typically inactive in corporate governance

89. Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 J. Econ. Behav. & Org. 399, 407 (1989) (arguing that the main "bank will often intervene in . . . the management of the firm when it is not performing adequately or is in need of some kind of restructuring").

90. Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. Econ. Literature 1, 14 (1990).

91. *Id.*

92. *See* Sheard, *supra* note 89, at 401–02 (presenting the main bank as "maintain[ing] the largest share among private financial institutions of loans to a particular firm" and as "typically [being] a principal shareholder in the firm").

when the firm did well but became active if the firm entered distress.[93] One might wonder why Japanese banks were more active in distressed firm decisionmaking. The operating firms' capital structure may explain why.[94]

The classic main bank typically owned a major stake of the debtor-firm's equity.[95] It also was said to have acquired expertise about the debtor's business.[96] By owning both debt and equity layers of the operating firm's capital structure, it reduced conflicts of interest in workouts and had incentives to maximize overall enterprise value. When the firm needed special assistance, main banks had "their own executives help [the debtor] out of difficulty."[97] And the ongoing relationships were close outside of bankruptcy: bank personnel "move[d] frequently between banks and companies as part of an on-going relationship that involves training, consulting, and monitoring."[98] Debtor chief financial officers frequently came from the main bank. "Japanese banks allow companies to enter formal bankruptcy only when liquidation makes economic sense—that is, when a company is worth more dead than alive."[99]

The capital market, corporate law approach we use here mimics the classic main bank role for distressed debtors. A nonconflicted creditor, with a proportionate interest in all layers of the debtor's capital structure, will have the same incentive to maximize the firm's value in the workout as the Japanese main bank was said to have had. Moreover, the fact that the creditor lacked large conflicts of interest should have reassured market players that a professional investor was participating in the debtor's turnaround or

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93. *Id.* at 407–08. Classic main bank theory has been criticized as far from main bank reality. *See* Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 L. & Soc. Inquiry 401 (2002).

94. It was this contrast between main bank ownership in the 1990s and weak overlying duties with the American banking structure and overlying duties that set one of the authors at that time to begin to consider the problem of creditor conduct, ownership, and creditor duties impediments to constructive creditor activism.

95. Sheard, *supra* note 89, at 401–02.

96. *See id.* at 403 ("The cornerstone of the main bank system is the close information-sharing relationship that exists between the bank and the firm.").

97. Michael C. Jensen, *Eclipse of the Public Corporation*, Harv. Bus. Rev., Sept.–Oct. 1989 (revised 1997), at 26, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=146149.

98. *Id.*

99. *Id.*; Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 Yale L.J. 871, 881 (1993) (examining the informational and incentive mechanisms that facilitate nonjudicial restructurings in the main bank system); *see also* The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies 190 (Masahiko Aoki & Hugh Patrick eds., 1994) ("A feature of the main bank system is that, unlike formal bankruptcy, the process is handled informally without recourse to the courts and without a change in the legal standing of the firm: in effect, the main bank replaces the judge and the court-appointed receiver; but like bankruptcy a range of asset reorganization outcomes is possible, not just restructuring of the enterprise and continuation as a going concern—as the popular term 'bank rescues' connotes—but also varying degrees of liquidation.").

liquidation process. The German banking and corporate structure was similar: major banks owned and controlled equity in their debtor firms.[100]

2. How It Differs

Before Japan's deregulation of the 1980s, the Japanese main banks represented a stable power center in the Japanese *keiretsu* business groups.[101] The classic main banks were thought to have extracted value from their clients and to have unwisely influenced the operating firms when no financial stress was present.[102] Overall, some thought that the main banks were more of a burden than a benefit for Japanese firms.[103] And whatever it did in aligning banker incentives with the incentives of others in the enterprise, the main bank system did not prevent corporate decay in Japan.

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

3. Why American Banks Could Not Have Become Main Banks

Due to the Glass–Steagall Act, the National Bank Act, and the Bank Holding Company Act, American banks—as well as bank holding companies—are generally barred from taking the relevant equity positions in nonbank companies and from controlling industrial firms.[104] There are, however, considerable exceptions to these constraints for stocks acquired in the ordinary course of collecting a debt previously contracted ("DPC").[105] The United States also has a long history of keeping banks small in ways that

100. Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 Stan. L. Rev. 73, 87–88 (1995).

101. Xueping Wu & Jun Yao, *Understanding the Rise and Decline of the Japanese Main Bank System: The Changing Effects of Bank Rent Extraction*, 36 J. Banking & Fin. 36, 36–37 (2012). The classic *keiretsu* arose in postwar Japan. It was a group of companies—usually centered around a main bank—with the constituent companies owning cross-participations, meeting regularly, and coordinating their business activities.

102. *Id.* at 83–84, 96.

103. *See* The Japanese Main Banking System, *supra* note 99, at 210–12; Miguel A. Ferreira & Pedro Matos, *Universal Banks and Corporate Control: Evidence from the Global Syndicated Loan Market*, 25 Rev. Fin. Stud. 2703, 2704–06 (2012); Wu & Yao, *supra* note 101, at 36–37.

104. *See* 12 U.S.C. §§ 24, 335, 1843(a), 1843(c)(6), 1843(c)(8) (2006).

105. 12 U.S.C. §§ 29, 1843(c)(2).

made the banks unable to participate powerfully in corporate governance,[106] despite evidence that when they could participate (before being ousted), they created value.[107]

Banks are allowed to negotiate with borrowers in distress to exchange nonperforming loans for otherwise bank-banned equity, but only "to resolve a troubled credit situation in which the bank otherwise would face credit losses."[108] The banks must then dispose of the instruments acquired within five years.[109]

Since the 1999 Gramm–Leach–Bliley Act, American banking law expanded authority for the banks' affiliates to own equity. But the banking law, even after the 1999 Act, still requires that the equity holdings be for "investment purposes" only, and it prohibits the bank from routinely managing nonfinancial firms.[110]

IV. A Capital Market Approach to Reducing Distortive Creditor Self-Interest: New-Style Derivatives

What once was hard to accomplish via old-style financial instruments or impossible to accomplish due to bank regulation is now easier to accomplish via new-style derivatives handled by new-style activist hedge funds. While extensive academic work now shows the potential pernicious conflicts that the new-style financial instruments can create, we can turn this thinking inside out to see how this new finance presents opportunities as well as challenges. Empty voting, for example, has captured reformers' attention, as the

106. Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance 54–59 (1994); *see also* Laura Lin, *The Information Content of a Bank's Involvement in Private Workouts*, 3 Geo. Mason Indep. L. Rev. 97, 118–19 (1994).

107. J. Bradford De Long, *Did J.P. Morgan's Men Add Value?: An Economist's Perspective on Financial Capitalism*, *in* Inside the Business Enterprise 205, 205 (Peter Temin ed., 1991) ("[In the pre–World War I period] investment banker representation on boards allowed bankers to assess the performance of firm managers, quickly replace managers whose performance was unsatisfactory, and signal to investors that a company was fundamentally sound."); *see also* Michael C. Jensen, *Active Investors, LBOs, and the Privatization of Bankruptcy*, J. Applied Corp. Fin., Spring 1989, at 35–36.

108. Office of the Comptroller of the Currency, Interpretive Letter No. 1007 (Sept. 7, 2004), *available at* http://www.occ.gov/static/interpretations-and-precedents/sep04/int1007.pdf.

109. 12 C.F.R. § 1.7(b)–(d) (2012).

110. *See* 12 U.S.C. § 1843(k)(4)(H); Bd. of Governors of the Fed. Reserve Sys., U.S. Dep't of the Treasury, Report to the Congress on Financial Holding Companies Under the Gramm–Leach–Bliley Act 22 (2003) ("[The Gramm–Leach–Bliley Act] permits an FHC [Financial Holding Company] to routinely manage or operate a portfolio company when, and for the period, necessary or required to obtain a reasonable return on the FHC's investment in the portfolio company. . . . However, to ensure that an FHC does not routinely manage or operate a portfolio company for an extended period [of] time, the rule requires that an FHC notify the [Federal Reserve] Board if it routinely manages or operates a portfolio company for more than nine months."); Paul J. Polking & Scott A. Cammarn, *Overview of the Gramm–Leach–Bliley Act*, 4 N.C. Banking Inst. 1, 4–6 (2000); João A.C. Santos & Adrienne S. Rumble, *The American Keiretsu and Universal Banks: Investing, Voting and Sitting on Nonfinancials' Corporate Boards*, 80 J. Fin. Econ. 419, 427 (2006).

new finance of derivatives and options facilitates the possibility of stockholders who command decisive votes but who lack any underlying economic stake in the enterprise.

There is also considerable literature, and considerable real world experience, on how the new finance of derivatives and options can mask a creditor's conflicting financial position in a firm, to the detriment of sound corporate decisionmaking. These analytics are correct to show the dangers of the new finance for sound corporate decisionmaking.[111] Here, we show how courts could harness the new finance to better ends by more sturdily aligning strong financial interests in firms with their firms' overall health.

Potential positives of the new finance in corporate governance are less frequently seen.[112] Here, we show how an inventive judiciary could harness these new instruments to reduce conflicts of interest and could construct a more functional set of judicial doctrines on lender liability. We do not deny the serious design problems that would need to be overcome to make the doctrinal safe harbor viable and verifiable by the judiciary as substantially eviscerating serious conflict. But, we maintain, what was once impossible is now possible.

A. *Equity Options*

One problem with using old-style equity to reduce creditor conflict is that the creditors do not want it, and stockholders may not wish to issue equity to the creditors or syndicate leader. Each side, at the time of the

111. Professors Hu and Black have some of the more widely cited analytics here. *See* Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Pa. L. Rev. 625, 732 (2008) ("[A]n empty creditor may . . . force . . . [a] bankruptcy, rather than agree to a restructuring, because the bankruptcy filing will trigger a contractual payoff on its swap position."); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811 (2006) [hereinafter Hu & Black, *The New Vote Buying*].

The pernicious impact has been more widely analyzed. *See* Viral V. Acharya & Timothy C. Johnson, *Insider Trading in Credit Derivatives*, 84 J. Fin. Econ. 110 (2007); Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. Rev. 1609 (2009); Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 Am. Bankr. L.J. 405, 427–30 (2007); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. Cin. L. Rev. 1019, 1035 (2007) ("[A] lender that has purchased credit default swaps may have an incentive to use its position as a lender to affirmatively destroy value."); András Danis, Do Empty Creditors Matter? Evidence from Distressed Exchange Offers (Feb. 27, 2012) (unpublished manuscript), *available at* www.ssrn.com/abstract=2001467 (showing data indicating that firms subject to extensive credit default guarantees of its debt are less able to effectuate an effective out-of-court workout to avoid bankruptcy); Marti G. Subrahmanyam et al., Does the Tail Wag the Dog? The Effect of Credit Default Swaps on Credit Risk 29 (Dec. 8, 2012) (unpublished manuscript), *available at* http://people.stern.nyu.edu/msubrahm/papers/EmptyCreditor.pdf ("We find strong evidence that the bankruptcy risk of reference firms increases after the inception of CDS trading.").

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

lending, may recognize the potential future efficiency of the firm's having an influential creditor with reduced conflicts. But the costs to the lender of holding equity to facilitate reconstruction upon firm failure, when most firms do not fail, can readily exceed the expected value of anticipatorily building an unconflicted structure that will frequently remain fallow.

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

But options on equity could be easier to use. If the syndicate leader has, say, 10 percent of the firm's debt, then it could buy options on equity from third parties in an amount roughly equal to 10 percent of the firm's equity, at a strike price approximating the then-current price of the equity, with an expiration date around when the crisis is expected to be resolved one way or the other. One big advantage of such options is that the firm's management (presumably representing stockholders) and the creditor need not make a crisis-infected agreement, which they would find hard to reach. Instead the creditor can buy the right level of options from third-party market players and then can take an aggressive activist stance vis-à-vis the firm, confident that courts would be likely to accord the creditor business-judgment deference.[113]

B. *Options on Other Debt Layers*

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

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

113. The option mechanism when perfectly implemented tells the court that the controlling creditor has no direct financial incentive to reduce firm value because doing so would reduce the value of its overall investment in the firm. Even if there are equally valued alternatives, with one favoring one layer and another favoring another layer, the controlling creditor with appropriately sized options has no direct, incentive-based financial reason to favor one over the other.

C. *Credit Default Swaps*

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

D. *Implementation Limits*

The activist creditor could face implementation problems in buying options on multiple layers. For some creditors in some firms, the purchase of the vertical strip could be too expensive for the added leeway the strip would afford the creditor; the creditor may prefer to take its chances under the current doctrines. Some layers may be hard to value, so the costs of an options writer assessing, pricing, and then selling the options may be prohibitive. Untraded debt (say, to the debtor's suppliers) may also be hard to assess. And further difficulties can arise if the firm has substantial debt that is hard to define, such as from mass tort claims, tax claims, customers' claims for breach of warranty, or even soft claims not generally recognized in bankruptcy, including from employees' or customers' noncontractual expectations of future dealings.

Worse, potentially, is a second implementation problem: some strong creditors will game the system by taking on derivatives positions that appear to make them aligned with the overall health of the firm, but whose fine-print terms in fact do not give it those incentives. These wrongdoings may be hard to uncover. Courts will, as always, need to be alert and sophisticated. They may over time need to develop templates of acceptable and unacceptable terms for such creditor efforts to build vertical strips.

1. Transaction Costs of the Activist Creditor

These implementation problems are not assuredly insurmountable; moreover, even if they cannot be surmounted for some firms, they do not render the capital market approach valueless.

First, the companies here are in financial distress, which often makes many of the options and derivatives on other capital layers inexpensive. Second, sometimes these hard-to-value and nonfinancial soft claims are small and therefore not critical to the creditor's incentives and decisionmaking, and therefore not critical in the court's review of the extent the creditor was conflicted in its decisionmaking.

Third, the court could accord business-judgment deference to the strong creditor if it takes proportionate interests, but only to the extent that it takes them. That is, if the strong creditor obtains proportionate interests in the subordinated debentures and equity, the court should be inclined to give it business-judgment deference if those players complain. If the dominant creditor has not taken a proportionate interest in the company's asbestos mass tort liability, however, the court should be ready to hear the tort claimants (but not the bondholders or equity holders) without according the creditor a business-judgment defense as to the dominant creditor's dealings that affected the tort claimants.

Fourth, on the possibility that strong creditors will game the system by reporting that they have taken a vertical strip when they have set up a structure that is difficult for the court to decode, since the creditor would presumably have the burden of showing that it was not conflicted, such a complex structure would fail to satisfy the court. Presumably if the doctrine took hold, eventually courts would develop templates to use with deviations requiring explanation. And, even if it is possible that some strong creditors will try to game the system by misstating their real interests in the different layers of the debtors' capital structure, fraud and misrepresentation to the court is a serious offense. Much in law, litigation, and transactional integrity needs to limit fraud, usually by punishing its occurrence severely. The corporate law, capital market analytic here is no different. Activist creditors will carefully consider the risks of criminal sanctions before disclosing false information to the court about their economic interests in the firm. Courts and corporate law do not reject the business-judgment rule's efficacy just because there is a possibility that some directors will misstate the level of their financial interest in the transactions at hand.

There is another relevant implementation issue. Corporate business-judgment decisions tend to be binary—if the decisionmaker is sufficiently unbiased, it gets full business-judgment deference.[114] Importing the business-judgment concept into the creditor-liability area must be more nuanced, as the capital market opportunities outlined here can go a long way to eliminating some conflicts with some creditors but not all conflicts with all creditors.

2. Creditor Fallback from the Safe Harbor

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

3. Judicial Limits in Verifying the Quality of the Safe Harbor

A law review article can set forth the concept, but a court would have to verify the actual on-the-ground terms, some of which will be difficult to assess. Some creditors may not take on the proportionate risks; others may

114. *See supra* notes 68–69 and accompanying text.

take them on but offload them surreptitiously. More prosaically, once a vertical strip is assembled, the debtor may retire some debt, issue new debt, or incur new liabilities. These changes could affect whether the controlling creditor remains only weakly conflicted in its decisionmaking.

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

4. The Safe Harbor as Infectious Agent

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

But once the safe harbor is introduced, it stands as an alternative to the current (muddied) standards governing activist creditor conduct. Some courts may be unhappy if active, dominant creditors damage the debtor and get a free pass under the jurisdiction's existing doctrine if the creditor has influenced but not taken control of the firm. Such courts may adopt the safe harbor standard as mandatory and look for proportionate interests to validate the actions of every activist creditor, in effect replacing the current standard with our proposed safe harbor. But if such courts looked for vertical strips owned by the activist creditor, and too many creditors found it too expensive to acquire those vertical strips, then a safe harbor that became a de facto minimal entry expense for the activist creditor would damage debtor–creditor relations, not ameliorate them.

Potentially activist creditors in this infectious scenario would stay quiet if (1) the vertical strip were too expensive, and (2) courts abandoned the old doctrines and required activist creditors to have the (expensive) vertical strip or submit to heavy liability. Although a safe harbor could mutate to become mandatory, we do hope that such a change would occur only after enough experience with the proposed safe harbor, with courts and activist creditors finding that it provided more low-cost incentive alignment than even we predict.

There is an offsetting, more positive potential reaction by the courts: in the face of the broad use of a new safe harbor, some courts could try to do better in examining the safe harbored transactions, seeking better doctrinal categories for evaluating activist creditors.

E. *Hedge Fund Activism*

In today's restructuring world, banking syndicate leaders do not loom as large as they once did. Bankers often lend and then sell their loans to other market participants.[115] Even if they do not sell, banks are still not well situated in the regulatory framework to take multiple positions in the failing firm's capital structure when those positions involve equity stakes.

Yet modern capital markets offer an opportunity here. Oftentimes when the operating firm weakens, hedge funds, which do not face the same regulatory hurdles that traditional bank lenders face here,[116] acquire distressed debt. Then, with their industry and operating expertise,[117] their negotiating skills, and their taste for financial combat,[118] they induce operating and financing decisions in the target firm that favor the hedge fund, either by

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115. Donald S. Bernstein, *Toward a New Corporate Reorganization Paradigm*, J. Applied Corp. Fin., Fall 2007, at 8, 11–12; Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 Brook. J. Corp. Fin. & Com. L. 67, 67 (2009) ("The creation of a market in bankruptcy claims is the single most important development in the bankruptcy world since the Bankruptcy Code's enactment in 1978."); Paul M. Goldschmid, Note, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 Colum. Bus. L. Rev. 191, 200–09. With regard to the growth of assets managed by hedge funds, see Kahan & Rock, *supra* note 67, at 282, and Juliet Chung, *Hedge-Fund Assets Rise to Record Level*, Wall St. J., Apr. 19, 2012, *available at* http://online.wsj.com/article/SB10001424052702304331204577354043852093400.html#.

116. For now, at least. See Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934 from Wachtell, Lipton, Rosen & Katz, to Elizabeth M. Murphy, Secretary, SEC (Mar. 7, 2011), which proposed disclosure rules for hedge fund acquisitions of a kind that could impede hedge funds from acquiring multiple financial layers at an attractive cost. For the costs of the proposal in deterring useful investor checks on management, see Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 Harv. Bus. L. Rev. 40 (2012).

117. Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, J. Econ. Persp., Winter 2009, at 121, 132 (2009) ("Today, most large private equity firms have . . . industry and operating expertise that they apply to add value to their investments. Indeed, most top private equity firms are now organized around industries. . . . [P]rivate equity firms now often hire professionals with operating backgrounds and an industry focus. . . . [and they] also make use of internal or external consulting groups."); *see also* Viral V. Acharya et al., *Corporate Governance and Value Creation: Evidence from Private Equity*, 26 Rev. Fin. Stud. 368 (2013).

118. *See* Kahan & Rock, *supra* note 67, at 295 ("[H]edge fund activism is strategic: Hedge funds invest *in order to* become active, and the activism is designed to generate gains rather than reduce [losses]. . . . By contrast, activism by traditional institutions is incidental to their investment activities. Traditional institutions tend to become active when an investment they hold for different reasons suffers a significant decline in value, and their activism is designed to recoup some of these losses."). On hedge fund activism generally, see also William W. Bratton, *Hedge Funds and Governance Targets*, 95 Geo. L.J. 1375, 1381 (2007); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. Corp. L. 681, 682–84 (2007); Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. Corp. L. 51, 56–58 (2011); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. Corp. Fin. 323,

shifting value to the hedge fund or by inducing the firm to operate better than before.[119]

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

> more supportive of efficiency gains brought by hedge funds than of value extraction from other claims. The presence of hedge fund unsecured creditors is associated with both higher total debt (including secured and unsecured) recovery and a more positive stock market response at the time of a bankruptcy filing, suggesting a positive effect of hedge fund creditors on the firm's total value. . . . Similarly, [they] show that hedge funds participating in bankruptcy do not have as short a horizon as their counterparts specialized in pure trading. These hedge funds benefit more from companies' emergence, where the long-term prospects of the firm are important.[120]

Hedge funds can create value in distress situations by overcoming a dominant secured creditors' liquidation bias, thereby increasing the likelihood that the firm emerges from bankruptcy, reassuring the market that the firm will survive, signaling that sophisticated financiers think that the firm is survivable, removing some managers while retaining others,[121] reducing the time spent in Chapter 11, and providing liquidity for companies that cannot find other lenders.[122] But the most important finding is that, according to recent studies, many hedge funds' investment strategy privileges the long-term prospects of the firms.[123] The purpose here is to find judicial doctrines

325 (2008); and April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. Fin. 187, 225 (2009).

119. April Klein & Emanuel Zur, *The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders*, 24 Rev. Fin. Stud. 1735, 1766 (2011) (finding that activist hedge funds with equity positions damage bondholders); Lipson, *supra* note 82, at 1038.

120. Wei Jiang et al., *Hedge Funds and Chapter 11*, 67 J. Fin. 513, 515 (2012). For similar conclusions, see Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. Fin. 1729, 1773–74 (2008); Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. Fin. Econ. 401, 404 (1997); and Jongha Lim, *The Role of Activist Hedge Funds in Distressed Firms* (June 18, 2012) (unpublished manuscript) (on file with the authors) (reporting that in a sample of 184 financially distressed firms for the period from 1998 to 2009, hedge funds often shortened the time needed to alleviate financial distress).

121. Jiang et al., *supra* note 120, at 555.

122. David J. Brophy et al., *Hedge Funds as Investors of Last Resort?*, 22 Rev. Fin. Stud. 541, 543 (2009); Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 Fordham L. Rev. 703, 753 (2008); Suniati Yap, *Investing in Chapter 11 Companies: Vultures or White Knights?*, 2 Sw. J. L. & Trade Am. 153, 157–61 (1995) ("[W]hen investors infuse new capital in the debtor, it often serves as a 'catalyst for a restructuring' and may be the debtor's only chance for survival." (footnote omitted) (quoting Hilary Rosenberg, The Vulture Investors 300 (1992))); Goldschmid, *supra* note 116, at 249–55.

123. Jiang et al., *supra* note 120, at 554; Goldschmid, *supra* note 115, at 267–74. But see, for their negative potential, Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarian at the Gate?*, 89 Wash. U. L. Rev. 155, 158 (2011); Hu & Black, *The New Vote Buying*,

that will encourage this constructive, value-enhancing action and discourage destructive, value-shifting activity.

Indeed, the increased volatility in creditor instruments, trading, and control has heightened problems of, and potential for, creditor control. But while creditor control capacity has increased, the judicial doctrine has not adapted to the new business reality and has not yet found ways to channel the increasing creditor activity into the positive, value-enhancing mechanisms and away from the negative, value-diminishing mechanisms.[124] Lenders have become more active than they were before.[125] "The crucial question [then becomes] the extent to which private lenders' self-interest is aligned with the interests of all the investors in the corporation."[126] We have proposed here theory, doctrine, and mechanisms to facilitate that alignment.

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

And the new finance of hedge funds acquiring debt instead of banks holding loans makes it possible that activist creditors can emerge who are not as limited as banks are in their portfolio choice—as the Glass–Steagall Act, the National Bank Act, and the Bank Holding Company Act have traditionally limited deposit-taking banks but do not limit the new deposit-free hedge funds.[127] With bank regulation no longer circumscribing portfolio choice of the powerful new finance lender, it becomes possible to use the

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supra note 111, at 821–22; Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 Vand. L. Rev. 1987, 2016 (2002).

124. *See* Hu & Westbrook, *supra* note 62, at 1354; Kahan & Rock, *supra* note 67, at 283. Lipson states:

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

Lipson, *supra* note 82, at 1038–39 (footnotes omitted).

125. *See* Baird & Rasmussen, *Antibankruptcy*, *supra* note 66, at 676.

126. Baird & Rasmussen, *supra* note 50, at 1245.

127. *See* Jiang et al., *supra* note 120, at 516–17; Lim, *supra* note 120, at 10–11 ("[H]edge funds can enjoy great . . . flexibility as to the securities they can hold and investments they can make. . . . Unlike conventional financial institutions, hedge funds are not burdened by most regulatory schemes, oversight, or reporting requirements due to the fact that they [sic] open to only a limited range of 'accredited' or 'qualified' investors. . . . For example, unlike other

new finance of derivatives to construct the nonconflicted (or, more realistically, only weakly conflicted) creditor-in-control.

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

Figure 5. Hedge Fund Activism with Credit Default Swaps and Equity Options: A "Vertical Strip"

Time (1)

Assets	*Liabilities*
$1,000 value	$1,000 secured debt (but security is less than $1,000)
	$1,000 trade debt and bonds
	Stockholders

Time (2)

Hedge fund buys 10 percent of secured debt and seeks to influence the failing firm's strategic direction.

Assets	*Liabilities*	
$1,000 value	$100 hedge fund	$ 900 other secured
		$1,000 trade and bonds
		Stockholders

Time (3)

Hedge fund acquires a vertical strip.

Assets	*Liabilities*	
$1,000 value	$100 hedge fund	$ 900 other secured
	$100 hedge fund owns credit default swap on unsecured debt (it will pay $100 to a third party if trade creditor not paid)	$1,000 trade and bonds
	10% hedge fund buys options on 10% of firm's stock	Stockholders

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

F. *Similar Situational Conflicts and Solutions*

We believe that we are the first to show how corporate law doctrine points toward a way to reduce the creditor conflict difficulties in theory and how modern financial instruments and institutions provide the potential for a practical application. We have, however, seen similar observations of how

investment advisers, hedge funds do not have diversification requirement. . . . Moreover, unlike other financial institutions hedge funds have no restriction on the 'riskiness' of their portfolios.").

corporate players can hold multiple financial instruments and thereby reduce their conflicts.

Frederick Tung shows that, during the recent financial crisis, bank managers who owned debt-like claims on their financial institution steered their institutions through the financial storms more safely than managers who did not.[128] In a complementary fashion, Lucian Bebchuk and Holger Spamann show that bank executives with substantial equity investments had reason to, and did, take socially excessive risks with the bank, with the potential systemic impact of that excessive risk-taking borne by others outside the bank.[129] Presumably if such managers held debt-like claims as well as equity, their interests would better align with the public interest. To achieve this result, Sallie Krawcheck, a well-known bank executive, proposes to restructure bank managers' compensation to align their incentives with the bank overall. In particular, according to Krawcheck,

> A simple but powerful way for boards to alter the risk appetite of senior bank executives would be to add fixed-income instruments to the compensation equation. Any shift in this direction would have an impact, *but the most logical end point would be a compensation mix that mirrors the bank's capital structure*. Thus, as bank financial leverage (and therefore financial risk) increased, senior executives would be motivated to become more risk-averse.[130]

And Yair Listokin proposes that bankruptcy trustees get unsecured debt to align the trustees' incentives with the overall value of the firm:

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

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128. Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 Nw. U. L. Rev. 1205, 1228 (2011) ("Giving managers a stake in the value of the firm's debt makes them less willing to sacrifice its value to benefit shareholders. This is especially important when the firm is in distress. Debt compensation can improve managerial effort and firm value in distress situations because, unlike equity, debt is sensitive to the firm's liquidation value. That is, debtholders may still recover value when the firm is in distress. By contrast, equity is worthless once the firm is insolvent. Managers holding inside debt may therefore be less inclined to make risky bets when the firm gets into trouble." (footnote omitted)).

129. Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 Geo. L.J. 247 (2010).

130. Sallie Krawcheck, *Four Ways to Fix Banks*, Harv. Bus. Rev., June 2012, at 107, http://hbr.org/2012/06/four-ways-to-fix-banks/ar/1 (emphasis added). For a careful academic analysis of the possibility, see Tung, *supra* note 128.

unlikely to award debt compensation if they feel that the manager has made inefficient decisions in the pre-bankruptcy period.[131]

* * *

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

Conclusion

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

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

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

131. Yair Listokin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with Debt*, 155 U. Pa. L. Rev. 777, 830 (2007); *see also* Alex Edmans & Qi Liu, *Inside Debt*, 15 Rev. Fin. 75, 92 (2011). But see criticism of this kind of compensation inside bankruptcy as unnecessary and hard to implement, in Adam J. Levitin, *The Problematic Case for Incentive Compensation in Bankruptcy*, 156 U. Pa. L. Rev. PENNumbra 88 (2007).

could push the firm to self-liquidate and destroy value, even if the creditor stayed at arm's-length from day-to-day control.

While deference to contract could trump all judicial decisionmaking here, in most settings that are of interest, the contract is silent—with the specific creditor action not fully contemplated by the contract—or the creditor action affects other creditors that were not party to the contract. For example, the debtor may be in default under a financial ratio, and the creditor may seek under its contract to collect. That kind of action should give rise to no special obligations of the creditor under current or updated doctrines. But if the creditor offers to forbear, if the debtor liquidates its major facility, to the detriment of trade, tort, and governmental creditors, we now have contradictory doctrines governing that behavior. Moreover, even if the contract gives the creditor carte blanche, we should want mechanisms that would facilitate a Coasian ex post rebargaining to deploy the firm as efficiently as possible. Our proposal is for a safe harbor that would internalize enough of the Coasian incentives into a single player so that the Coasian results would be achieved more often than they are now.

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

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

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

We can consider this reformulation as either a safe harbor for creditors that comply or as a screen to help induce healthy creditor action. We cannot be sure how much creditor activity today benefits the enterprise and how much shifts value inside the enterprise, although we now have some data indicative of both being in play. Moreover, even if the behavior were now good overall, a bright-line permission for creditors would prompt more negative behavior. And a bright-line ban, if we thought that current creditor activity was largely negative, would stymie potential innovation. An advantage of the rule we propose is that we need not know right now the relative weight of good and bad creditor behavior. The overlay of corporate law duties on the creditor-control problem gives us a doctrinal solution, and the new finance in capital markets gives us the possibility of on-the-ground practical implementation. Creditors who use the offered safe harbor could intervene to improve firm value. If there are no such creditors, or none that are willing to pay the capital costs of doing so, then the ongoing, muddy rules will govern their actions.

We hardly think that the capital market, corporate law mechanism we have outlined here is the only means to improve on failing firm decision-making. The emergence of the rapid § 363 sale in bankruptcy, often a sale to a dominant creditor, is an alternate way for creditors to replace incumbent managers. One could also focus on better motivating the board of the failing firm (perhaps by having them obtain those vertical strips and tying their incentives into the case law on board duties of failing firms). Courts could also reexamine whether their baseline rules on creditor conduct could be improved. That other efforts may be valuable does not preclude the capital market, corporate law approach from being valuable as well.

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

A long history of boardroom corporate law doctrine aims to make the boardroom a neutral, unbiased decisionmaker, one that can balance the interests of all affected by the corporation. Delaware corporate courts have made strong efforts during the past decades to make board duties, liabilities, and business-judgment deference facilitate better decisionmaking when the firm is in distress.[132] Under our approach, the critical decisionmaker is deeply interested, with much money, investment, and value on the line and, hence, may have an advantage over the neutral board when the firm is distressed. But that advantage has long been thought to be countered by the creditor's undeniable and historically irremediable conflicts of interest. Our structural goal here is to make its interest correspond as much as possible to the total value of the corporation, a goal that is now viable. We can reduce the persistent doctrinal and fairness problems of the actions of a controlling creditor in a distressed firm, while simultaneously increasing the chance that the distressed firm will be better run. We have outlined how this could be done, by using core corporate law doctrine to bring forth a correct usage of modern capital markets to reduce creditor conflict and enhance creditor incentives in managing distressed firms.

132. *See* Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 788 (Del. Ch. 2004); Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 789 (Del. Ch. 1992); Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991).