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Strategic Governance

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STRATEGIC GOVERNANCE

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Creditors exercise significant power over financially distressed corporations, thereby pushing corporate managers further into the realm of unprofitable risk aversion. The heavy hand of creditor power and the threats creditors are able to make to managers' professional stability and success misalign senior officers' incentives by undermining their freedom to make wealth-maximizing decisions on behalf of the corporation. The importance of independent managerial decision making is paramount in the law of corporate governance and that independence has been inefficiently undermined by the exertion of oppressive creditor control. This Article resolves the problem by creating a mechanism to balance shareholder and creditor influence over management so that no one constituent is able to dominate or undermine the independence of managerial decision making. A new shareholder representative called an "equity trustee" will represent shareholder interests during times of financial distress. The equity trustee gives voice to shareholder preferences in times when creditors are likely to dictate terms of governance so that the creditor voice does not grow too strong. The equity trustee should serve to balance competing preferences so that managers maintain independence and the ability to make value-maximizing decisions without fear of destructive retribution from either shareholders or creditors.

INTRODUCTION

Once a corporation is at risk of defaulting on major bank loans, an effective change in control occurs, and the mechanisms that tied the managers' interests to those of the corporation through the interests of shareholders fail.[1] The traditional mechanisms of fiduciary duties and incentive compensation are inadequate when it

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1. Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1228–29 (2006) (arguing that when a corporation falters, the ability of institutional lenders and creditors to control the cash flow of the corporation is a "potent threat" and managers will respond by shifting their loyalties away from the corporation and toward the creditors and lenders who have significant influence over the corporation).

comes to giving the managers[2] of troubled companies wealth-maximizing incentives. During this tumultuous time, the shareholders' limited power over the firm's management pales in comparison to the sword the company's institutional lenders can wield against the senior officers, the directors, and even the corporation itself.[3] Deference to creditors in a time of financial difficulty, no matter how severe, is neither necessarily the path to corporate wealth maximization nor consistent with the tenets of corporate law.[4] When the corporation is in financial trouble, the shareholder voice is often silenced. This weakening of the shareholder position, combined with the extreme power creditors may exercise over managers when the corporation is insolvent, leads to a level of risk aversion[5] that may not result in wealth-maximizing decisions on the corporation's behalf. Because the managers can never be sure of precisely where they are in the solvency spectrum, adopting the course of action preferred by either the shareholders or creditors will not necessarily guarantee that the managers will make the decision or adopt the level of risk that is best for the firm. Neither constituent can be relied upon to advocate consistently for positions that would lead to wealth-maximizing behavior. The best way to address this problem is to balance the amount of influence each group can exert over corporate managers throughout the life of the firm.

Contrary to the supposition of many judicial decisions[6] and much of the scholarship[7] in recent years, the problem is not one of fiduciary duties or of a

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2. Throughout this Article, the term "managers" refers to a corporation's senior officers.

3. Baird & Rasmussen, *supra* note 1, at 1231.

4. It is axiomatic that a solvent corporation is to be operated for the benefit of its shareholders. Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1384 (2007) (explaining that the corporation is owned by the shareholders and they possess economic and voting rights in the corporation).

5. A risk-averse person is one who "considers the utility of a certain prospect of money income to be higher than the expected utility of an uncertain prospect of equal expected monetary value." ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 51 (2004). For example, a risk-averse person would prefer a situation in which she was guaranteed a return of $25 to one where she had a 25% chance of receiving $100 even though the expected monetary value of each is $25. *See* AVINASH DIXIT & SUSAN SKEATH, GAMES OF STRATEGY 174 (1999).

6. *See, e.g.*, N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004); Odyssey Partners, L.P. v. Fleming Cos., 735 A.2d 386 (Del. Ch. 1999); Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784 (Del. Ch. 1992).

7. *See, e.g.*, Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 336 (2007); Hu & Westbrook, *supra* note 4; Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485 (1993); Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189 (2003); Larry E. Ribstein & Kelli A. Alces, *Directors' Duties in Failing Firms*, 1 J. BUS. & TECH. L. 529, 529 (2007).

particular "zone of insolvency";[8] rather, it is one of properly aligning managerial incentives at all levels of financial success and difficulty. Creditors and scholars alike have framed the problem of conflicting shareholder and creditor interests as one that plagues only corporations within the "zone of insolvency," because of the perceived shift in the fiduciary duties directors owe once a corporation is insolvent.[9] The debate has lasted several years and was originally born of the understanding that directors owed fiduciary duties to the firm's creditors in insolvency. Creditors sought to extend the duties owed during insolvency to something they referred to as the "zone of insolvency."[10] Dicta in some Delaware cases muddied the waters by seemingly assuming, without holding, that such a duty to creditors does exist.[11] Legal scholars took up the interesting and puzzling question of how to treat directors' duties in the zone of insolvency, a time when the directors still owe fiduciary duties to shareholders and the corporation, but must also address a loyalty claimed by creditors of the troubled company.[12] Because the exact point of insolvency is very difficult to determine, directors are faced with the problem of not quite knowing when and how their loyalties are supposed to shift. Several commentators concluded that the business judgment rule protects directors from liability for mistaking whose interests to prefer as between creditors and shareholders.[13] Directors owe duties to the corporation itself, within

8. The "zone of insolvency" is most commonly used to refer to that time in a corporation's life when insolvency is imminent. Because it is not possible to determine the exact moment a corporation becomes insolvent, courts and creditors speak of the "zone of insolvency" when talking about the time during which a switch to creditor preferences may be appropriate. *Gheewalla*, 930 A.2d at 94. In this Article, I expand the definition of this "zone" to include the time when the corporation is in serious financial trouble, such that default on loan obligations is highly probable. The likelihood of default increases the likelihood of insolvency because one default may result in a domino effect by constituting a default on other obligations. If the corporation is in default on all of its loans, all of its creditors will be able to demand immediate payment in full and those demands may inevitably lead to the company's insolvency.

9. Hu & Westbrook, *supra* note 4, at 1339–43. "Zone of insolvency" is difficult to define. That difficulty makes rules dependent on it impractical. The supposition that the rules or methods of corporate governance should change upon the perceived imminence of insolvency is simply wrong, as demonstrated by recent court decisions, and leads scholars to devise arbitrary and impractical solutions. *See, e.g.*, *Gheewalla*, 930 A.2d at 101, 103 (holding that only actual insolvency will allow creditors to sue derivatively for breach of fiduciary duty by directors and that creditors have a direct action for breach of fiduciary duty in bankruptcy); Ribstein & Alces, *supra* note 7, at 536 (This article argues that increased fiduciary duties owed to creditors in failing firms is unnecessary. Rather, the business judgment rule should apply to decisions made by the debtor and a "strong duty of loyalty is appropriate only when the agent delegates open-ended discretion to the principal."); Hu & Westbrook, *supra* note 4, at 1321 (arguing for the abolition of insolvency as the measure for duty shifting and instead using bankruptcy as the measure).

10. *See, e.g.*, *Gheewalla*, 930 A.2d at 94; *Prod. Res. Group*, 863 A.2d at 772; *Odyssey*, 735 A.2d at 386; *Geyer*, 621 A.2d at 784.

11. *Geyer*, 621 A.2d at 787–91; Ribstein & Alces, *supra* note 7, at 529.

12. *See, e.g.*, Bainbridge, *supra* note 7; Hu & Westbrook, *supra* note 4; Lin, *supra* note 7; Ribstein & Alces, *supra* note 7.

13. Bainbridge, *supra* note 7, at 366–67; Ribstein & Alces, *supra* note 7, at 536–37; s*ee also* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No.

or without insolvency.[14] This inquiry into directors' duties in a distressed firm has been valuable and has brought attention to an important problem in corporate governance. Still, the inquiry has not resolved the issue of conflicting shareholder and creditor preferences and influence in financially unstable firms. It has so far failed in that attempt, not for lack of reasoning or creativity, but because it asks the wrong question. Addressing the problem through personal liability for breach of fiduciary duty by corporate directors without considering the incentives of the firm's senior officers—its most prominent, everyday decision makers—misses the most important aspect of a corporate manager's internal conflict during the zone of insolvency.

The focus on fiduciary duties is particularly misplaced when addressing the incentives of corporate managers. Fiduciary duties are one way to exercise control over directors' decisions by threatening punishment ex post, but suits for breach of fiduciary duty, particularly those brought derivatively by shareholders, do not often result in judgments against corporate directors.[15] Procedural anomalies under Delaware law make it almost impossible to reach corporate officers in derivative suits alleging breach of fiduciary duty.[16] Protections for directors are intentionally built into the derivative suit mechanism so that directors will feel free to take beneficial risks on behalf of the corporation.[17] Chief among these protections is the business judgment rule, which shields directors from personal liability for informed decisions made in good faith that the director rationally believed to be in the best interests of the corporation.[18] A corporate officer or director could make a decision that honors either shareholder or creditor preferences without exceeding the bounds of proper business judgment and thereby subjecting herself to personal liability for breach of fiduciary duty.[19] Even

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12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991); *see infra* note 19 and accompanying text.

14. *Credit Lyonnais*, 1991 WL 277613, at *34 n.55; Ribstein & Alces, *supra* note 7, at 538.

15. *See* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 271 (1986).

16. *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 905 (2003).

17. *See* William T. Quillen, *The Federal–State Corporate Law Relationship–A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law*, 59 BROOK. L. REV. 107, 118–19 (1993) (stating that the decision in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), "discourag[ed] qualified outsiders from serving on corporate boards . . . because the risk of personal liability . . . was not worth the reward of serving on a corporate board").

18. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("[The business judgment rule] is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.").

19. *See Credit Lyonnais*, 1991 WL 277613, at *34 n.55. Chancellor Allen used the example of a solvent corporation with a $12 million debt whose only asset is a $51 million judgment with an expected value of $15.5 million which takes into account the chances of the judgment being affirmed, modified, or reversed on appeal. The Chancellor found that creditors would accept a settlement offer over $12 million, but shareholders

well-meaning managers making business decisions on behalf of the corporation in good faith will be pulled in different directions according to the power shareholders can exert over corporate management and any loan terms that may serve to grant creditors eventual control.

This Article addresses that internal struggle confronting managers. The competing interests vying for managerial favor in the zone of insolvency can indeed prove costly for the corporation, but this struggle does not involve an actionable breach of fiduciary duty. Rather, it is the consequence of personal incentives operating on managers who are making good faith decisions that would pass muster when held up to the business judgment standard. A focus on assigning liability for breach of fiduciary duty is not only inefficient and completely ineffective in most instances; it does not solve the real problem that confronts corporate managers even when the corporation is indubitably solvent—what investment strategy to use when the corporation is in a financially precarious position.

The conflict between shareholder and creditor interests that weighs on management is not necessarily caused by a fundamental uncertainty about which course of action is best for the corporation. The business decision may be difficult, but it is one corporate managers could make in a relative vacuum in which they could conceive of a "corporate" good without regard to a "shareholder good" or "creditor good."[20] The corporate managers' *personal* interests necessarily guide

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could reject a higher settlement because of the chance that the initial $51 million judgment would be affirmed. The Chancellor explained that:

> [I]f we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

Id.; Ribstein & Alces, *supra* note 7, at 538 (arguing that shifting fiduciary duties during insolvency creates a dilemma between the demands of creditors and shareholders with risks for both constituencies. Further, a "judicially imposed duty" would create uncertainty because of the "difficulty of defining . . . the 'zone' of insolvency.").

20. *Credit Lyonnais*, 1991 WL 277613, at *34 n.55. Henry Hu has disputed the clear existence of a "corporate good," arguing that many difficult decisions do not present themselves as being clearly risk averse or risk seeking and for which the wealth maximizing answer is not clear. Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 318–32 (1990). Even Hu acknowledges that a greater risk preference on the part of corporate managers would be healthy pre-bankruptcy. *Id.* at

the decision they make on behalf of the corporation. Those personal interests are not the sort of self interests whose indulgence would constitute a breach of fiduciary duty. Rather, they are a necessary part of aligning the interests of corporate managers with those of the firm's owners, a crucial mechanism used to reduce the agency costs inherent in the separation of ownership and control that defines the corporate form.[21] These are the personal interests that we must balance and conquer if we are to increase the likelihood that managers make the value maximizing decision. The key is to balance the influences shareholders and creditors may each exert over management so that neither party is so overwhelming as to compromise the independent decision making abilities of the company's officers.

The answer is to provide shareholders a voice to advance the shareholder position up to and through insolvency, and so to create a party that has an incentive to advocate shareholder interests when major corporate debt decisions are made and while the corporation is in financial trouble. This "equity trustee" would represent shareholder interests in negotiating loan terms, inform and advise shareholders about how to use their voting power during times of financial distress, and have the power to bring lawsuits in the shareholders' stead. Loan covenants in the loan agreements and the significant collateral taken to secure some of the enormous loans banks make to corporations allow dominant creditors to coerce the managers of a troubled company into taking the steps these creditors prefer.[22] Once we have reached the point at which the corporation is vulnerable to creditor threats, it is too late to make a principled stand against powerful creditors, particularly at a time when the shareholders have little or no incentive to exert energy or resources to affect corporate action. The problem must be adequately anticipated and planned for ex ante in a way that does not assume away shareholder interests in times of financial distress. These interests can provide a balance against the extreme risk aversion that is prevalent around the zone of insolvency and, therefore, lead to greater corporate wealth maximization. As long as the firm is planning to reorganize rather than liquidate, equity prefers wealth generation beyond what is needed to repay creditors. That should be recognized and honored.

This Article advances the literature by breaking with a significant body of scholarship that approaches the problem as one of misplaced fiduciary duties,[23] and offers an alternative for how best to align managerial incentives through incentive compensation both in and out of bankruptcy.[24] Those who have noted the

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330 n.145 ("When a corporation seems headed for bankruptcy, it may be shareholder-optimal for a manager to engage in risk-seeking behavior.").

21. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

22. *See* Baird & Rasmussen, *supra* note 1, at 1211.

23. *See, e.g.*, Bainbridge, *supra* note 7; Hu & Westbrook, *supra* note 4; Lin, *supra* note 7; Lipson, *supra* note 7; Ribstein & Alces, *supra* note 7, at 529.

24. *See, e.g.*, M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs are Low*, 101 NW. U. L. REV. 1543 (2007); Yair Listokin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with*

effects of enhanced institutional creditor control in the zone of insolvency have stopped short of deciding whether the phenomenon is a problem.[25] This Article demonstrates that creditor control poses a threat to corporate wealth maximization and, further, suggests a novel solution that vindicates the corporate law priority of managerial independence under the sole supervision of the board of directors. Others who have looked at officer incentive problems in the zone of insolvency have turned to traditional mechanisms such as incentive compensation to find an answer.[26] This Article explains why such an approach may be inadequate and shows how a process that encourages open bargaining between parties with relevant interests better minimizes the agency costs associated with managerial decision making in financially distressed firms.

Solving problems of misaligned managerial incentives with the limited use of a new shareholder representative is a project that has many parts. This Article is but the first necessary step in a larger project aimed at creating the equity trustee and defining the exact circumstances of its most beneficial use. Future research will more fully develop the innovation and will explore insights into how the equity trustee would affect corporate governance as a whole and what implications the use of such a trustee could have throughout the life of a corporation. This Article begins the project by elucidating the problem confronting managers in the zone of insolvency for the first time in a way that shows the problem to be one of incentives and the effects of creditor control, and not one of breached fiduciary duties. It illustrates how an equity trustee would be an effective tool in solving the problem at hand.

In Part I, the Article will look at shareholder influence over the management of a healthy corporation. It describes the preferences held by shareholders and tools at their disposal to influence managerial decision making. Part II then explains how creditor power reserved through loan covenants strongly influences managers and makes them even more risk-averse in troubled times than they are when the corporation is comfortably solvent. Part III demonstrates that this strong deference to the power of creditors applies not only when the corporation is insolvent, but also in healthier times when the chance of financial difficulty may loom on the horizon. Part IV examines the internal struggle managers face in appropriately balancing the competing interests of shareholders and creditors in order to make the best decision for the corporation while avoiding harm to their personal interests and livelihood. It shows how this struggle begins with the negotiation of a loan agreement and ends in misaligned incentives when the corporation is in financial trouble. Having established in Part IV why the current system is flawed, the Article in Part V considers how best to solve the problem. Part V defines the role and expected efficacy of an equity trustee, and explains how the limited use of an equity trustee may counter overwhelming creditor interests and afford managers more freedom to make the decisions most likely to lead to wealth maximization. Part V also explains why other attempts to

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Debt, 155 U. PA. L. REV. 777 (2007); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 920 (2003).

25. Baird & Rasmussen, *supra* note 1, at 1250.

26. *See* Henderson, *supra* note 24; Listokin, *supra* note 24; Skeel, *supra* note 24, at 920.

address this problem have fallen short, and why the equity trustee is a superior solution.

I. SHAREHOLDER PREFERENCES AND INFLUENCE

Corporate law has well established that a corporation's management owes its loyalties to shareholders.[27] Shareholders own the company. Much of modern corporate law and scholarship has focused on the agency problem resulting from the separation of the ownership and control of a corporation, identified by Adolf A. Berle, Jr. and Gardiner C. Means over seventy-five years ago.[28] The solutions to the problem have sought to align management's interests with those of shareholders, by imposing legal obligations on managers and giving them incentives to operate the company in the best interests of its collective, and often widely dispersed, owners.[29] Directors owe fiduciary duties to the corporation, enforceable by shareholders, to manage the business in a manner they "reasonably believe[] to be in the best interests of the corporation"[30] and, through the corporation, its shareholders.[31] When a corporation is solvent, its shareholders are the clear beneficiaries of the fiduciary duties owed to the firm by management.[32] These fiduciary duties work largely to constrain the behavior of directors, but their relevance to senior officers is murky at best.[33] Shareholders cling tenaciously to the fiduciary duties directors owe, although it is not clear at all that these duties are effective in ensuring that those who are truly responsible for managing the corporation do so in a manner that comports with the preferences of its equity holders.

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27. Hu & Westbrook, *supra* note 4, at 1356 ("[T]he directors owe fiduciary duties of care and loyalty to the corporation and its shareholders." (quoting Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1994))).

28. Baird & Rasmussen, *supra* note 1, at 1214 (citing ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932)).

29. STEPHEN M. BAINBRIDGE, CORPORATION LAW & ECONOMICS 408–09 (2002).

30. REV. MODEL BUS. CORP. ACT § 8.30(a) (2007).

31. Paramount Commc'ns, 637 A.2d at 43; Hu & Westbrook, *supra* note 4, at 1356 (citing REV. MODEL BUS. CORP. ACT § 8.30(a) official cmt. n.2 (2005)).

32. These fiduciary obligations exist because shareholders delegate open-ended control over the corporation to its directors. Such wide discretion requires a fiduciary standard to align the agent directors' incentives with those of the principals, the shareholders. *See* Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 217 (2005) ("[A] fiduciary duty is appropriate only where the owner delegates open-ended power to the manager . . . [a] [c]lassic example[] where the costs are justified include[s] the relationship between management and dispersed owners in a traditional publicly held corporation . . . .").

33. *See* Lyman P.Q. Johnson & Mark A. Sides, *Corporate Governance and the Sarbanes–Oxley Act: The Sarbanes–Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1194, 1225 (2004); Thompson & Sale, *supra* note 16, at 905 (explaining that federal law is currently attempting to fill in some of the gaps in Delaware law relating to the ability to impose liability and maintain "suits for breaches of the fiduciary duty of care").

A. Diversification and Risk Preferences

The agency costs inherent in the separation of ownership and control will not completely disappear under any compensation scheme.[34] Well-diversified shareholders will never be able to bring managers' incentives and goals for managing the corporation completely in line with their own. For one thing, shareholders own very small pieces of a number of companies and so are more or less equally invested in varying firms and industries.[35] Senior officers, by definition, have a far greater investment in the one firm. They only have one job and professional reputation to protect. Future employment and compensation prospects depend on the perceived success of the firm they manage.[36] A senior officer may lose his job at the hands of unhappy board members whose continued service on the board is thrown into question by the corporation's lack of success,[37] or he may be unseated at the behest of influential bank creditors.[38] Even if the officer is not removed immediately after the firm's change in fortune, the market for corporate control will know of his failure and it may be difficult, if not impossible (depending on the size of the business failure), for him to secure a similar position at a corporation of similar stature.[39] The manager's very livelihood, then, and often a substantial portion of his wealth, is tied up in the corporation's success. This significant personal investment makes managers less willing to cause the corporation to make the high risk investments or decisions that may lead to proportionately higher returns that shareholders would like.[40]

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34. *See* Jensen & Meckling, *supra* note 21, at 308 ("[I]t is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint.").

35. *See* Hu, *supra* note 20, at 319 ("A shareholder typically can diversify away much of the risk associated with any single corporation through the simple expedient of holding a portfolio of stocks.").

36. Hu & Westbrook, *supra* note 4, at 1351 ("A shareholder has shares in many companies; a manager has only one job. Moreover, from stock options and other securities holdings, managers are typically poorly diversified.").

37. Shareholders cannot remove underperforming officers directly. The senior officers of a corporation are chosen by its directors who are elected by shareholders. If shareholders want to remove an officer from his position, they must exert pressure on the board of directors or install a new board that will choose different officers. *See* BAINBRIDGE, *supra* note 29, at 441 ("Shareholders have virtually no right to initiate corporate action and, moreover, are entitled to approve or disapprove only a very few board actions."). The shareholders thus do not have a right to remove officers of the corporation and as individuals have only limited power to exert pressure on the board of directors.

38. Baird & Rasmussen, *supra* note 1, at 1244–45.

39. *See* Douglas G. Baird & Robert K. Rasmussen, *The Prime Directive*, 75 U. CIN. L. REV. 921, 931–32 (2007).

40. *See generally* Jensen & Meckling, *supra* note 21. This article develops a theory of the ownership structure of the firm. Jensen & Meckling explain that as the owner–manager's equity decreases:

> his incentive to devote significant effort to creative activities such as searching out new profitable ventures falls. He may in fact avoid such ventures simply because it requires too much trouble or effort on his part to manage or to learn about new technologies. Avoidance of these

This agency problem means that managers are more risk-averse than shareholders would prefer when it comes to making decisions about how to run the corporation. Managers are less likely to take the potentially profitable risks diversified shareholders would want them to take because the managers stand to lose more than the shareholders would if the risk is not ultimately profitable.[41] A diversified shareholder's portfolio is designed to absorb the losses associated with unsuccessful risks.[42] As Professor Henry Hu points out, well-diversified shareholders have different risk and time preferences than poorly diversified shareholders, as well as different preferences than management may have or think the shareholders have.[43] He argues that, despite public perceptions to the contrary, shareholders want corporations to engage in investment activity that entails a high degree of total risk, as long as that risk is "diversifiable" by the shareholder in designing his portfolio.[44]

Incentive compensation tools such as options encourage risk taking by allowing managers to enjoy the fruits of a successful strategy without being directly penalized if the investment fails.[45] These options may even make managers "too" risk-seeking when the corporation is healthy.[46] While the promises of great wealth that accompany stock options and other aggressive forms of incentive compensation may make managers more risk-preferring, officers remain consistently more risk-averse than the well-diversified shareholder.[47]

> personal costs and the anxieties that go with them also represent a source of on the job utility . . . .

Id. at 313.

41. *See* Hu, *supra* note 20, at 320. This article states that:

> Specifically, a diversified shareholder would not want the managers of a publicly held corporation to act in a way intended to ensure the well-being of the corporation. If managers were to focus on the total risk of an investment project instead of the nondiversifiable risk, for instance, they might enhance the health of the firm, but they would probably not maximize the share price. Shareholders, regardless of their individual risk preferences, generally would want managers instead to focus primarily on nondiversifiable risk in evaluating corporate investment opportunities.

Id. at 299–300.

42. Michael Abramowicz, *Speeding up the Crawl to the Top*, 20 YALE J. ON REG. 139, 145 (2003); *see also* BAINBRIDGE, *supra* note 29, at 259.

43. Hu, *supra* note 20, at 287–94.

44. *Id.*

45. Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1930–31 (2001).

46. Hu, *supra* note 20, at 319, 327–29; Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1492–95 (1993).

47. *See* Hu, *supra* note 20, at 318–19 (explaining that despite the promise of stock options to managers they "may be much less well diversified than shareholders as a result of the large amounts of 'human capital' . . . invested in their corporations . . . caus[ing] managers to be overly sensitive to risk."); Jensen & Meckling, *supra* note 21, at 352. Jensen and Meckling explain that where a manager has fractional ownership of a corporation his incentives will not exactly mirror that of the corporation, but:

Management's natural risk aversion is heightened considerably by the loan agreements they enter on behalf of the corporation and the power over corporate management that significant creditors can exercise as a result.[48]

One of the basic justifications of the business judgment rule, which is designed to protect directors from personal liability for failed good faith business decisions, is that corporate risk taking is beneficial to shareholders, and imposing personal liability on managers when the business decisions fail would serve only to discourage often profitable corporate risks. A well-diversified shareholder does not care if one corporation takes a risk that fails; she may not even care if one corporation becomes insolvent.[49] It is axiomatic of corporate investment that big returns accompany big risks.[50] Rational, well-diversified shareholders want corporate managers to take significant, though well-calculated and intelligent, risks in designing the corporation's investment strategy. However, shareholder influence over managerial decision making has always been limited.

B. Mechanisms of Shareholder Influence

While directors are technically in charge[51] of the corporation's management under Delaware corporate law,[52] the real decision makers of the

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> forces exist to determine an equilibrium distribution of outside ownership. If the costs of reducing the dispersion of ownership are lower than the benefits to be obtained from reducing the agency costs, it will pay some individual or group of individuals to buy shares in the market to reduce the dispersion of ownership.

Id.

48. *See* Baird & Rasmussen, *supra* note 1, 1217–18.

49. Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 345 (1997). Adler argues:

> [A] combination of preferred equity and debt allows dispersed investors to enjoy the advantages of fixed obligations without fear of liquidation while a firm is likely to be viable, and permits these investors to benefit from liquidation through creditor competition for assets when the firm is likely to be inviable. Bankruptcy law interferes with this design by protecting even those firms that should not continue . . . . The occasional successful rescue of a viable firm may not justify this ubiquitous cost.

Id.

50. *See* Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 549–50 (1983) (illustrating a hypothetical situation in which the higher payout to the corporation and dividends to shareholders includes the most risk and vice versa).

51. DEL. CODE. ANN. tit. 8, § 141(a) (2006) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

52. Corporations flock to Delaware to incorporate due to the specialized corporate court system, extensive and widely known case law, and friendly statutory law including protection for directors from personal liability relating to duty of care violations. For this reason, Delaware law is the most relevant in considering the law governing large, public corporations. *See* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 725–30 (2002).

corporation are the CEO and the rest of the senior management team.[53] The directors of large, public corporations serve on several boards and usually hold demanding day jobs.[54] Each directorship is but a part-time job. The board of directors votes on major corporate decisions, and in doing so, often defers to the recommendations and judgments of the senior management team. The day-to-day decisions and the specific details of the major decisions for the firm are made and devised by the senior officers.[55] These officers are not seriously constrained by fiduciary duties to the corporation or its shareholders.[56]

Shareholder powers are more directly designed to constrain the board of directors. Shareholders can elect board members, initiate proxy contests to replace the current board, and combine their votes in ways that may achieve some of their objectives.[57] The directors the shareholders elect choose the company's officers, so shareholders only indirectly affect who serves as a corporate manager.[58] Shareholders can excite public outrage or at least bring public attention to bad management in an effort to force the board's hand or, in extreme circumstances, to lobby for legislation that may affect corporate decision making.[59] Shareholders attempt to align managerial incentives and minimize agency costs through incentive compensation packages and employment terms.[60] These terms are negotiated on the shareholders' behalf by the board of directors. Employment terms aim to align senior officers' incentives with the goals of shareholders and measure success largely in terms of increased stock price.[61] Managers are

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53. *See* Lawrence A. Cunningham, *The Sarbanes–Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 954–56 (2003) (explaining that with the passage of Sarbanes–Oxley in 2002 federal law holds accountable the officers of the corporations, as they are the ones who really exercise control over corporate decision making).

54. BAINBRIDGE, *supra* note 29, at 231.

55. MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS CASES AND MATERIALS 155–56 (9th ed. 2005) ("Under modern corporate practice in publicly held corporations, the management function is ordinarily located not in the board, but in the executives . . . ."). There are many constraints on the board including time, information, composition, and monitoring that make it very difficult for the board of directors to control the day-to-day activities of the corporation and thus the burden of management shifts to the officers and managers. *Id.*

56. Thompson & Sale, *supra* note 16, at 906 (explaining that managers of corporations technically have fiduciary duties that can be enforced by shareholders, but the gap in Delaware's jurisdictional statutes prevents many lawsuits from being brought in Delaware for managers' breach of fiduciary duty). The problem with the current statute is that it does not allow for personal jurisdiction for managers who have allegedly breached their fiduciary duties, rather the statute only extends to the directors of the corporation. *Id.*

57. *See* BAINBRIDGE, *supra* note 29, at 439–41.

58. *Id*.

59. Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 880 (2007).

60. Henderson, *supra* note 24, at 1549–50.

61. Hu & Westbrook, *supra* note 4, at 1358 ("A second, more modern conception equates shareholder welfare with the trading price of shares. According to this view, shareholder wealth maximization is sought directly rather than as a byproduct of corporate welfare.").

compensated with equity in the firm and given stock options that allow them to capitalize on large increases in a corporation's stock price over time.[62] Senior officers may also be compensated with bonuses awarded upon certain increases in stock price or earnings or the achievement of other specific goals.[63] Shareholders can directly affect the value of these grants by exiting the firm if they believe it is being managed poorly.[64] A mass exodus would cause the stock price to decline and so make officers' stock options worthless. Managers are also motivated to maintain their professional reputations.[65]

Compensation incentives and the agency cost problem have been thoroughly studied,[66] and corporations have adopted governance mechanisms that realize the best results for the firm and its shareholders when the corporation thrives. However, shareholders neither have immediate incentives to pay much attention to what is happening within a corporation that is insolvent, nor do they or their attorneys have strong incentives to enforce the fiduciary duties they are owed.[67] If a troubled company's shareholders are unhappy with its deterioration, they will simply sell their shares.[68] Enhanced shareholder apathy only increases the managerial tendency to be risk-averse and submit to the will of strong creditor influence. At some point, the cost of the possibility of losing a position as a senior officer at the behest of angry creditors outweighs any potential benefit that

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62. Henderson, *supra* note 24, at 1549.

63. *Id*. at 1599.

64. *See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 462 (1990) (noting "[t]he traditional Wall Street rule—sell out if you dislike management . . . .").

65. *See* Baird & Rasmussen, *supra* note 39, at 921 (exploring the unfortunate situation of the former CEO Al Dunlap who followed the theory of running the corporation for the sole benefit of the shareholder and was overwhelmingly successful at Scott Paper but was unable to achieve the same success at Sunbeam, where the company had to eventually file bankruptcy and he was shown the door).

66. *See, e.g.*, Jensen & Meckling, *supra* note 21, at 305–06; Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 715, 739 (1995). Murphy analyzes the problem of executive compensation and ties it to corporate welfare. Compensation strategies need lower base salaries with high potential payoffs. Murphy predicted firms which utilize a formulaic accounting based bonus system will encourage officers to maximize short term profits while firms that utilize incentives such as stock options are increasing the incentives for officers to engage in long-term growth of the corporation.

67. The failure of shareholders and their attorneys to enforce the fiduciary duties owed to them in the insolvency context can also be analyzed through the bankruptcy context. *See* David A. Skeel Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994). Skeel writes:

> Because [shareholders] have little financial interest in an insolvent firm, and because most or all of any recovery would go to higher priority claimants, shareholders lose much of their incentive to promote and participate in derivative litigation. To the extent shareholders do play at least a minor role in a given suit, they are therefore likely to be indifferent (and perhaps even resistant) in the bankruptcy context.

Id. at 500–01.

68. Henderson, *supra* note 24, at 1558.

managers could realize by acting with their incentive compensation in mind and trying to take risks that will drive up the price of the company's stock.[69] Creditors have a particular advantage over shareholders in influencing management when the corporation is within the zone of insolvency. In fact, greater access to corporate financial information and a greater ability to use that information may give creditors an advantage as soon as strict loan terms are agreed upon by the corporation.

C. Information—The Gateway to the Exercise of Influence

Disclosure requirements ensure that the market knows more or less what a corporation is doing, how it is capitalized, and whether it is headed toward financial difficulty.[70] The market for information also helps to keep investors and the market as a whole apprised of corporations whose managers take irrational risks.[71] If a shareholder is unhappy with the level of risk a particular company is engaging in, she can sell her stock and invest elsewhere. Unfortunately, the riskiness of the investments the corporation is making is not always readily available to shareholders.[72] Shareholders do not always know when management may be making significant investment decisions or how they are resolving questions that present certain probabilities of success.[73] Although it would be very inefficient for managers to be forced to disclose this information ex ante, the decision itself and its outcome will become well known ex post. For these reasons, shareholders are not always in a position to take action that will influence managerial decision making ex ante. When they do have sufficient information, shareholders have various tools at their disposal to try to influence the direction the corporation will take but may not be able to move as swiftly as creditors can in response to upcoming managerial decisions.[74]

In addition to a more direct path to corporate managers and a unified and sophisticated representative, creditors have a significant advantage when it comes to corporate information. This is particularly true for private creditors when the corporation is in poor financial condition.[75] Creditors can build broad definitions of situations in which risky decisions may be made into their loan covenants and so receive special notice of such situations. This gives an informational advantage over and above the one creditors already have in their ability to evaluate, process,

69. Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 748 (1992).

70. *See generally* Hu, *supra* note 20, at 367–68.

71. *Id.* at 378–79.

72. *See id.* at 376–77.

73. *See id.* at 378–79; *see infra* fig.1, at 1080.

74. *See supra* Part I.A.

75. *See, e.g.*, Delphi Corp., $2,825,000,000 Five-Year Third Amended and Restated Credit Agreement (Form 8-K), at § 6.1 (June 15, 2005), *available at* http://www.secinfo.com/dsvR3.z3nr.d.htm#1stPage [hereinafter Delphi Corp. Loan Agreement]; Gen. Motors Corp., 364-Day Revolving Credit Agreement (Form 10-Q), at § 2.17 (Aug. 7, 2007), *available at* http://www.secinfo.com/dsvR3.u3t4.8.htm#1stPage [hereinafter General Motors Loan Agreement].

and act on regular notices about the corporation's financial well-being. The greatest advantage creditors have is in their unified representation and their ability to have one sophisticated party review corporate information and act on their behalf. The widely dispersed, rationally apathetic shareholders are comparatively disadvantaged in their inability to act and negotiate as a cohesive unit. In order to achieve balance between shareholder and creditor influences, shareholders should take a cue from creditor access to information and their ability to swiftly and meaningfully respond to it. Collectively, shareholders may be able to make investment decisions that will affect the firm's stock price and the managers' incentive compensation, but that power pales in comparison to the creditors' ability to replace a senior officer when something is amiss.

Shareholders have only very limited and indirect means to monitor and influence senior officers. While incentive compensation may work well to align managerial incentives with the interests of shareholders when a corporation is solvent, shareholder influence breaks down as insolvency nears. Further, the greater access to information and more sophisticated, unified representation creditors can boast gives them a significant advantage over shareholders when the corporation is experiencing financial difficulty.

This Part has explored what the shareholders' interests are in a corporation, what risk preference they would like the corporation to have, and how they exert influence on corporate managers. It has also noted that shareholder access to timely corporate information and their ability to act on it collectively is limited and far surpassed by the means creditors have to act intelligently and in concert. Part II of this Article will examine creditor preferences and the tools creditors, particularly large institutional creditors, can use to influence corporate decision making. It will demonstrate how that creditor power exceeds that exercised by shareholders in times of financial difficulty.

II. CREDITOR PREFERENCES AND INFLUENCE

Despite all of the attention paid to aligning management interests with those of shareholders, managers, particularly those of financially struggling companies, often feel strong pressures to make business decisions for the corporation that will please its creditors.[76] Creditors have no legal right to force their judgments upon managers. The loan agreements they enter are with the debtor—the corporation—not its management team. Nevertheless, creditors are able to exert pressure on senior officers by threatening to declare a default on corporate loans, which would send the firm into even more perilous financial waters.[77] Large institutional lenders can remove managers or install new ones by threatening to exercise their rights against the corporation under the loan agreement.[78] Through the extensive rights many credit agreements grant bank

76. *See* Baird & Rasmussen, *supra* note 1, at 1219.

77. *Id*. at 1217.

78. *Id*. at 1244–45 (explaining that creditor control is likely to arise where the possibility of loan distress looms over the corporation, and replacing the managers through creditor control is the optimal choice for the worried creditors, but not necessarily the best option for the corporation).

lenders, creditors can exert more direct control over management and the direction of the corporation than any other constituent group, even when the corporation is solvent. The ability to dictate favorable loan terms and capitalize on the advantages afforded them under fraudulent transfer and bankruptcy law notwithstanding, creditors have still tried to define their relationship with the management of a troubled company as a fiduciary one.[79]

This Part will first explain why creditors ultimately cannot rely on fiduciary duties to assure management compliance with their decision making preferences and why the debate about fiduciary duties owed to creditors does not solve the problem this Article addresses. Next it will discuss the powers creditors can exercise in bankruptcy. Finally, it will show how some creditors are able to reserve powers for themselves before bankruptcy that anticipate the control they will share with other creditors should the firm file Chapter 11.

A. Fiduciary Duties

In recent years, creditors have tried unsuccessfully to establish the existence of a fiduciary duty owed directly to them when a corporation is insolvent or within the "zone of insolvency."[80] Creditors have supported their argument in favor of fiduciary duties by reasoning that upon a corporation's insolvency, the creditors replace the shareholders as the residual claimants, so they should be the beneficiaries of the same fiduciary duties to the corporation that the shareholders benefitted from when the corporation was solvent.[81] The goal is to justify and even legally force business decisions that creditors would prefer: relatively cautious, conservative risk-avoiding actions.[82] Attempts to punish managers for erroneous

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79. *See, e.g.*, N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004); Odyssey Partners, L.P. v. Fleming Cos., 735 A.2d 386 (Del. Ch. 1999); Geyer v. Ingersoll Publ'n Co., 621 A.2d 784 (Del. Ch. 1992).

80. In *North American Catholic Educational Programming Foundation v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007), the court reestablished the proposition that a creditor could never bring a direct suit for breach of fiduciary duties against the directors of a solvent corporation in the "zone of insolvency." The court noted that other rights available to creditors include "protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights." *Id.* at 99. In *Production Resources Group L.L.C. v. NCT Group Inc.*, 863 A.2d 772, 794 (Del. Ch. 2007), the court concluded that if a corporation were insolvent, creditors could sue derivatively for breach of fiduciary duties, but, in dicta, acknowledged that although unlikely, the possibility of a direct suit for breach of fiduciary duty to creditors may exist. The *Gheewalla* court later clarified the *Production Resources* holding by explaining that direct suits by creditors against the directors of an insolvent corporation for breach of fiduciary duty should not be allowed as such an action would create uncertainty for the directors in exercising their business judgment, and create conflicts between their duty to maximize the value of the corporation and the rights of creditors. *Gheewalla*, 930 A.2d at 103.

81. *See, e.g.*, *Gheewalla*, 930 A.2d at 92; *Prod. Res. Group*, 863 A.2d at 772; *Odyssey*, 735 A.2d at 386; *Geyer*, 621 A.2d at 784.

82. *See*, *e.g.*, cases cited *supra* note 81.

but good faith, disinterested decisions have been unsuccessful.[83] The business judgment rule protects the decision about which party's interests to favor as long as the directors choose the course of action they honestly and rationally believe is in the best interests of the corporation.[84] Delaware courts have refused to recognize a direct cause of action for breach of fiduciary duty to creditors.[85] Further, in *Gheewalla*, the Delaware Supreme Court held that creditors may only derivatively enforce the fiduciary duties directors owe the corporation and may only do so when the corporation is insolvent.[86] Various scholars have weighed in on the question of fiduciary duties to creditors in the zone of insolvency.[87] Though the academic debate was long and thorough, the question may have been finally resolved by the court in *Gheewalla*.

In any event, imposition of fiduciary duties is not the answer to the conflict between creditor and shareholder interests this Article seeks to resolve. First, as mentioned above, fiduciary duties are most useful in constraining the self-interested behavior of directors. They are not helpful in devising ways to align the incentives of senior officers. Further, the managerial decisions considered here would not constitute breaches of fiduciary duty regardless of whether shareholder interests or creditor interests are preferred. The goal is to align managerial incentives so that senior officers make the business decision that results in the greatest wealth maximization for the corporation. The question is how to give managers the incentives to make the best decision for the corporation when there is no threat that any sort of fiduciary duty would be breached but the manager nonetheless faces other pressures from shareholders and creditors urging their competing interests.

Losing the fiduciary duty battle does not leave creditors without significant protections or means of influencing managers to honor their preferences in corporate decision making. Creditors are able to negotiate directly with the corporation and use very specific loan documents that often list detailed requirements about how the corporation should be run and what management can and cannot do without creditor approval.[88] Creditors are also protected by fraudulent conveyance laws[89] and, of course, by the rights they acquire when a corporation is in bankruptcy.

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83. *See*, *e.g.*, cases cited *supra* note 81.

84. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) (illustrating the difficult business decisions faced by managers and the importance of protecting the reasonable and good faith decisions of managers through the business judgment rule).

85. *Prod. Res. Group*, 863 A.2d at 776 (holding that creditors of an insolvent corporation or a corporation operating in the zone of insolvency could not bring a direct action for breach of fiduciary duty against the directors).

86. *Gheewalla*, 930 A.2d at 103.

87. *Id.* at 99 n.28.

88. Baird & Rasmussen, *supra* note 1, at 1217.

89. WILLIAM H. NORTON JR., 3 NORTON BANKR. L. & PRAC. 2D § 74:5 (2007); Steve H. Nickles, *Behavioral Effect of New Bankruptcy Law on Management and Lawyers: Collage of Recent Statutes and Cases Discouraging Chapter 11 Bankruptcy*, 59 ARK. L. REV. 329, 348–49 (2006).

B. Bankruptcy

Creditors are able to enforce the fiduciary duties directors and officers owe to the corporation once the corporation is insolvent or has entered bankruptcy.[90] While that right simply reflects a shift in the party that has standing to enforce the duties owed to the corporation rather than a shift in the beneficiary of the right,[91] the standing issue is not irrelevant. Creditors are less likely to bring an action for breach of fiduciary duty if the decision the managers and directors make is one that the creditors support.[92] While there is no enhanced legal *duty* to prefer creditor interests when creditors gain the ability to enforce the fiduciary duties owed to the corporation, there is certainly a strong disincentive to take actions creditors would perceive as compromising their positions or failing to maximize the value of the estate for distribution to them.

The standard justification for giving creditors the ability to enforce the fiduciary duties owed the corporation and to exercise enhanced control when a corporation enters bankruptcy is that the creditors become the corporation's residual claimants.[93] Junior unsecured creditors have replaced equity holders as the group that will receive whatever is left over after all other claims are satisfied.[94] For this reason, junior creditors can often assume some of the protections usually afforded shareholders, such as bringing derivative actions[95] and exercising some

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90. *In re* Scott Acquisition Corp., 344 B.R. 283, 286 (Bankr. D. Del. 2006) (finding that under Delaware law, directors and officers owe fiduciary duties to creditors when the corporation is insolvent); *In re* TEU Holdings Inc., 287 B.R. 26, 32–33 (Bankr. D. Del. 2002) (finding that creditors can sue directors and officers for breach of fiduciary duty and in this case the court found that they had breached their duties to the creditors and the corporation); *Prod. Res. Group*, 863 A.2d at 787; Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992).

91. Ribstein & Alces, *supra* note 7, at 545.

92. Creditors, for instance, would not have sued the directors for breach of fiduciary duty after the company entered bankruptcy as a shareholder did in *Agostino v. Hicks*, 845 A.2d 1110 (Del. Ch. 2004). In this case plaintiffs, shareholders, sued the directors directly for breach of fiduciary duty where the company's restructuring plan called for the elimination of the plaintiff's equity interest without compensation, and holders of the company's notes, i.e. the creditors, were issued new stock. *Id.* at 1115. In bankruptcy meritorious derivative claims can disappear this is called the "black hole effect." *Id.* at 1126. This effect "exacerbates the incentives for plaintiffs' attorneys to underinvest in the individual lawsuits in their portfolio." *Id.* (citing Skeel, *supra* note 67, at 500).

93. Ribstein & Alces, *supra* note 7, at 531.

94. 11 U.S.C. § 1129(b)(2)(B)(ii) (2006). The statute describes the absolute priority rule:

> The general principle of the subsection permits confirmation notwithstanding nonacceptance by an impaired class if that class and all below it in priority are treated according to the absolute priority rule. The dissenting class must be paid in full before any junior class may share under the plan. If it is paid in full, then junior classes may share. Treatment of classes of secured creditors is slightly different because they do not fall in the priority ladder, but the principle is the same.

Id. § 1129 (Historical and Statutory Notes).

95. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 131 cmt. g (2000) ("When an organization such as a business corporation is sued in a derivative action,

control over who will manage the firm.[96] Creditor control can be particularly effective in bankruptcy because the creditors are the main party in interest. They are the group paying the most attention to the debtor's estate and business decisions and the most likely to object to decisions or petition the court to cause the debtor to pursue a particular cause of action.[97]

The committee of unsecured creditors (the "creditors' committee") appointed by the U.S. Trustee's office consists of the debtor's largest creditors and can wield considerable power over a company's reorganization.[98] The creditors' committee has statutory power to look over the debtor's shoulder for the duration of the reorganization process.[99] It is a direct supervisor of the debtor in possession (DIP) and is specifically empowered to move for the appointment of a trustee if the debtor's management abuses its authority or take actions that harm the debtor.[100] Because a majority of the creditors who will not be paid in full must vote to confirm a plan of reorganization and the creditors' committee is supposed to represent the interests of all unsecured creditors, a plan of reorganization is generally not confirmed without the support of the creditors' committee.[101] The creditors' committee, as a party in interest, has standing to request that the DIP or trustee bring an avoidance action against a particular creditor and, if the DIP refuses, to bring the suit itself with court permission.[102] The ability to act on the DIP's behalf makes the creditors' committee a force within the debtor's reorganization. In bankruptcy, creditors can therefore exercise even more power over the corporation than its shareholders could outside of bankruptcy. Once the corporation is insolvent and files for bankruptcy, management practically serves at the pleasure of the debtor's major creditors.[103] For all of the formal power placed in the creditors' committee, one creditor or group of creditors can exert more practical control over the debtor, and particularly the debtor's management, than

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the organization is ordinarily aligned as an involuntary plaintiff. Persons associated with the organization who are accused of breaching a duty to the organization, typically officers and directors of the organization, are ordinarily named as defendants. The theory of a derivative action is that relief is sought from the individuals for the benefit of the organization."); BAINBRIDGE, *supra* note 29, at 362 ("[A] 'derivative' suit is one brought by the shareholders on behalf of the corporation. The cause of action belongs to the corporation as an entity . . . . The shareholder is merely acting as the firm's representative.").

96. Henderson, *supra* note 24, at 1569 (citing Skeel, *supra* note 24, at 922).

97. Creditors can petition the court to ask the DIP or trustee to bring certain cause of action on behalf of the estate. Kelli A. Alces, *Enforcing Corporate Fiduciary Duties in Bankruptcy*, 56 U. KAN. L. REV. 83, 138–39 (2007).

98. 11 U.S.C. § 1102(b)(1) (2006).

99. The creditors' committee may "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan." *Id.* § 1103(c)(2).

100. *Id.* § 1103(c)(4); *In re* Ionosphere Clubs Inc., 113 B.R. 164, 166 (Bankr. S.D.N.Y. 1990) (holding that the Committee of Unsecured Creditors of Eastern Airlines established the need for the appointment of a trustee by clear and convincing evidence).

101. CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 807 (1997).

102. *Ex rel.* Cybergenics, 330 F.3d 548, 564 (3d Cir. 2003); DAVID G. EPSTEIN ET AL., BANKRUPTCY §§ 2–5(c), 10–13 (1992).

103. Baird & Rasmussen, *supra* note 1, at 1236–37.

any others. That is the creditor or group of creditors providing the financing that the reorganizing corporation needs in order to operate while in bankruptcy.

In recent years, much has been made of the strict terms creditors insist upon, and are granted, when providing DIP financing.[104] Because it would be difficult to find someone willing to lend (sometimes hundreds of)[105] millions of dollars to a bankrupt company when a significant portion of those funds will be used to administer the bankruptcy case rather than to operate and generate profits for the business, the Bankruptcy Code (the "Code") authorizes bankruptcy courts to allow the debtor to pledge whatever assets and grant whatever priorities are necessary to induce the post-petition lender to finance the reorganization.[106] The Code gives bankruptcy courts the ability to award the DIP lender an administrative claim or a claim superior to all other administrative claims, allowing the DIP lender to be paid in full before any other unsecured lenders.[107] The DIP can also be granted liens in all unencumbered property and may even receive a new lien that is equal in rights to pre-existing senior liens on debtor property.[108] Beyond the formal grants to DIP lenders in the Code, DIP lenders negotiate for specific contract terms that give them significant control over the debtor's management.

David Skeel points to US Airways' bankruptcy financing as a particularly poignant example of management monitoring terms DIP lenders often include.[109] The DIP lender in that case negotiated for the right to fill five of the twelve seats on the airline's board once the company emerged from bankruptcy while only taking 37.5% of the company's post-bankruptcy equity.[110] The DIP was able to use creditor power and information to make decisions as a shareholder.[111] DIP lenders also use the terms of the financing agreement to force the DIP management's hand in making business decisions.[112]

The extent of creditor control is important because of the change of control it effects when the corporation is insolvent or files bankruptcy. Shareholders enjoy control while the corporation is healthy; creditors take over upon insolvency. Large institutional lenders have been able to reserve a good deal

104. Skeel, *supra* note 24, at 925–26 ("Lenders have responded to the greater importance of post-petition financing and to creditors' concerns about the Chapter 11 process by using the terms of DIP loans to shape the Chapter 11 case.").

105. *Id.* (giving as an example US Airways' negotiation to borrow up to $740 million during the course of reorganization).

106. 11 U.S.C. § 364 (2006); Skeel, *supra* note 24, at 923.

107. Skeel, *supra* note 24, at 923.

108. *Id*.

109. *Id.* at 925–26.

110. *Id.* at 926.

111. *Id*.

112. *See In re* Source Enters., Inc., No. 06-11707(AJG), 2007 WL 2903954, at *17 (Bankr. S.D.N.Y. Oct. 1, 2007) (confirming the reorganization plan over the objections of an unsecured creditor that the DIP relinquished control of the company to the DIP lender to the detriment of other creditors); *In re* Trans World Airlines Inc., No. 01-00056(PJW), 2001 WL 1820326, at *9 (Bankr. D. Del. April 2, 2001) (approving the proposed financing plan over the objections of TWA that the plan included provisions which the corporation argued ceded to much control to the DIP lender).

of control when the corporation is in the zone of insolvency.[113] They achieve most of this power during the transition by using particularly onerous loan covenants to constrain the decision making of corporate managers so that less than perfectly healthy corporations do not take undue risks with creditor funds.[114]

C. Loan Covenants

Loan agreements contain covenants, affirmative and negative, about how the debtor should behave during the loan term. The covenants are freely agreed to by corporate management, and most are fairly standard in loans of a considerable size. They often go beyond requiring that the corporation keep the creditor informed and make specific capitalization demands.[115] Loan covenants and the power they give creditors have the potential not only to change the standard to which managers are held, but also to result in an effective change in control.[116] Covenants give creditors leverage to limit the risk of their investment. The agreements are set up so that breach of a covenant constitutes an event of default that accelerates the payment of the loan. A creditor can threaten to declare a default if a covenant is breached and so may extract certain management decisions from the debtor with an offer to forego the declaration of default.[117] These covenants, then, define circumstances under which the creditor can exercise indirect control over management. The covenants themselves limit the decisions the corporation can make and the significance of risks it can take.[118] In many ways, they allow creditors to have more power than shareholders would be able to claim. This section will explore each of these issues while looking at typical loan covenants, as well as those that might be imposed on a riskier loan.

When loaning significant cash to a corporation, either on a revolving basis or as a straight loan of capital, bank creditors require that they be kept apprised of the corporation's financial condition. They typically require annual and quarterly financial statements,[119] as well as the right to inspect the corporation's property, books, and records and require immediate notice of default, litigation against the debtor, or any other event that may have a "material adverse effect" on the corporation.[120] Debtor corporations are also typically prohibited from incurring additional indebtedness, except for loans specifically permitted by the relevant

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113. Baird & Rasmussen, *supra* note 1, at 1250.

114. *Id*. at 1216–17.

115. *See* Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355, 367 (1990).

116. Baird & Rasmussen, *supra* note 1, at 1219.

117. *Id.* at 1232.

118. Gilson, *supra* note 115, at 367.

119. *See, e.g.*, Delphi Corp. Loan Agreement, *supra* note 75, § 6.1; General Motors Loan Agreement, *supra* note 75, § 5.01; Visteon Corp., Amended and Restated Five-Year Revolving Loan Credit Agreement (Form 8-K EX-10.4), § 7.1 (June 30, 2005), *available at* http://www.secinfo.com/dsvR3.z4Z9.a htm#1stPage [hereinafter Visteon Corp. Loan Agreement].

120. *See, e.g.*, Delphi Corp. Loan Agreement, *supra* note 75, §§ 6.6, 6.7(c); General Motors Loan Agreement, *supra* note 75, §§ 3.01, 3.05; Visteon Corp. Loan Agreement, *supra* note 119, §§ 7.6–7.7.

covenant, and from giving additional liens in its present- or after-acquired property, with specifically named exceptions.[121] Through these positive and negative covenants and others like them, the bank creditors take steps to ensure that the risk they are taking by loaning money is not unduly increased and that they remain aware of the quantity and nature of that risk throughout the life of the loan. Events of default, at minimum, are defined as breaches of the loan covenants and may result in the acceleration of the loan so that it is immediately due and payable in full.[122]

In the agreements that accompany particularly risky loans, not only are the affirmative and negative covenants more strict, but the events of default are more numerous. Because of the loan covenants and events of default, creditors may rely less on the skill or trustworthiness of the corporation's management. The banks can simply monitor the corporation's financial condition and declare a default if the position or security they have negotiated for themselves is compromised. Because a declaration of default on one loan can result in a declaration of default on all loans,[123] which will result in the acceleration of all of the corporation's obligations at once, the instant any creditor has the right to declare a default, it has the power to drive the corporation into severe financial distress, if not insolvency, and can then begin to exert control over the corporation.[124] The loan covenants creditors add when they are making a loan for a risky proposition, loaning a large amount of money to a company in a precarious financial position, or restructuring a loan that a corporation needs help honoring, include stricter constraints on the actions managers can take while the loan is outstanding and also allow the creditor to declare a default as soon as the stability the creditor relied upon is threatened.

As an example, consider Visteon Corporation's loan agreement with five banks entered in 2005, just after it negotiated a bailout of sorts with its former parent and largest customer, Ford Motor Company.[125] The agreement contains

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121. Delphi Corp. Loan Agreement, *supra* note 75, § 7.2; Visteon Corp. Loan Agreement, *supra* note 119, § 7A.2.

122. Covenant language like this can be found in some loans:

> [I]n each and every case, with the consent of the required banks, the administrative agent may, or upon the request of the required banks, the administrative agent shall, by notice in writing to the Company, terminate the commitments and/or declare the principal of all loans to the company and its affiliates and all other amounts owing under the Agreement . . . to be due and payable immediately, and upon any such declaration the same shall become and shall be immediately due and payable, without presentment, demand, protest or other notice of any kind, all of which are hereby expressly waived.

Delphi Corp. Loan Agreement, *supra* note 75, § 8; General Motors Loan Agreement, *supra* note 75, § 7; Visteon Corp. Loan Agreement, *supra* note 119, § 8.1(k).

123. Another loan covenant that can be found in particularly risky loans requires that the corporation continue to pay all of its obligations as agreed. Visteon Corp. Loan Agreement, *supra* note 119, § 7.3; Delphi Corp. Loan Agreement, *supra* note 75, § 6.3.

124. Baird & Rasmussen, *supra* note 1, at 1211.

125. Visteon Corp. Loan Agreement, *supra* note 119, pmbl.

affirmative covenants that require Visteon to pay all of its obligations to other creditors as agreed,[126] to maintain its current lines of business,[127] and to give the bank group a first lien on any after-acquired property,[128] among other things. The negative covenants prohibit management from allowing certain debt ratios to exceed set quarterly quantities for the remainder of the loan term.[129] Other covenants limit the amounts of other indebtedness Visteon could incur,[130] as well as the amount and kind of liens the company could grant in its presently owned or after-acquired property.[131] Visteon is also prohibited from disposing of its assets with few, specific exceptions.[132] The negative covenants go on to limit the nature and amount of capital expenditures and investments Visteon can make and to prohibit the prepayment of loans to other creditors.[133] The loan agreement even requires that Visteon not maintain any bank accounts with banks other than those that make up the bank group granting the loan. Because the banks can exercise a right of setoff over any cash they hold in a deposit account for the corporation, they are secured to the extent that Visteon holds cash in a bank account so long as that account is held by a member of the bank group.[134] All of these loan covenants carefully and specifically detail what management may and may not do with the corporation's assets and how it should manage its investments. They fix the levels of risk the corporation can assume and the extent of its capitalization in ways shareholders cannot. Creditors achieve this sort of power over the corporation through their ability to declare a default on the loan. The events of default can grow more numerous and specific in a particularly risky loan.

Common events of default include the failure to make principal or interest payments on the loan, a judgment of a certain size entered against the corporation that is not quickly vacated, discharged, satisfied, or stayed pending appeal, and the

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126. *Id.* § 7.3.

127. *Id.* § 7.4.

128. *Id.* § 7.9(a).

129. *Id.* § 7A.1.

130. *Id.* § 7A.2 (explaining that the corporation cannot "[c]reate, incur, assume, become liable in respect of or suffer to exist any [i]ndebtedness, except . . . [what has already been agreed to]").

131. *Id.* § 7A.3.

132. *See, e.g.*, *id.* § 7A.5(a)–(i) ("[T]he [d]isposition of obsolete or worn out property in the ordinary course of business, the sale of inventory in the ordinary course of business . . . the sale or issuance of any Subsidiary's Capital Stock to the [c]ompany or [s]ubsidiary [g]uarantor . . . ."). This is an example of an exception.

133. *Id.* §§ 7A.7–A.9.

134. EPSTEIN ET AL., *supra* note 102, §§ 6-38, 6-39, at 360–64. Equitable setoff is a creditor's remedy. Both parties are both a creditor and a debtor to each other. The remedy is most commonly used by banks. The depositor of the bank is also a borrower. The bank is then a creditor and a debtor at the same time. The two parties are thus indebted to each other and "[s]etoff thus allows the bank to apply the borrower's deposit account to reduce the borrower's obligation to the bank." In bankruptcy proceedings under 11 U.S.C § 553 a setoff right exercised prior to the bankruptcy case cannot normally be avoided, thus the right of setoff survives bankruptcy. Furthermore, "a creditor's right of setoff [is] a form of collateral or security so that the creditor's claim against the debtor is treated like a secured claim." *Id.*

voluntary or involuntary filing of a bankruptcy petition.[135] Visteon also defaults on its loan if a change in control occurs.[136] This is a slightly more unusual provision that gives creditors a level of control over and a voice in matters of corporate governance about which they are usually powerless. The creditors probably do not plan to use this provision as a means of actually declaring a default after a change in control occurs, of course. The provision gives the corporation's management a takeover defense in the creditors' favor. That is, any entity interested in purchasing control of the debtor must pay off the creditors' loans in full or negotiate with the creditors directly about whether and how it can assume the obligations. Such a provision gives the creditors a seat at the table in any takeover negotiations. Aside from their use of loan covenants and the power to declare defaults to control the debtor corporation and its management, institutional creditors routinely prohibit management from taking actions that would have a "material adverse effect" on the corporation's status quo.

A "material adverse effect" is commonly defined as one that affects "the financial condition of the Borrower and its Subsidiaries taken as a whole or . . . the validity or enforceability of this Agreement and any of the other Loan Documents or the rights or remedies of the . . . Lenders under the Loan Documents."[137] Creditors are able to use the "material adverse effect" principle to change the standard of management behavior by directly prohibiting managers from causing the corporation to take any action that would result in a material adverse effect or change in the debtor's circumstances. The requirement is often phrased more as a permissive exception. For instance, Visteon must continue to engage in its current lines of business, preserve and maintain its corporate existence, and "take all reasonable action to maintain all rights, privileges and franchises necessary or desirable in the normal conduct of its business . . . except . . . to the extent that failure to do so could not reasonably be expected to have a Material Adverse Effect."[138] This "first, do no harm" admonition appears throughout the negative covenants in the loan agreement. While at first it may seem to give managers more discretion within the agreement—managers can ignore certain requirements and prohibitions if they reasonably expect that doing

135. Delphi Corp. Loan Agreement, *supra* note 75, § 8; General Motors Loan Agreement, *supra* note 75, § 7; Visteon Corp. Loan Agreement, *supra* note 119, §§ 8.1–8.2.

136. Visteon Corp. Loan Agreement, *supra* note 119, § 8.1(k). Despite the default provisions pertaining to the change of control some firms have given banks "a special class of equity security that guarantees them control over a minimum number of board seats." These provisions can lead to "direct lender representation on the board of directors." Gilson, *supra* note 114, at 365.

137. General Motors Loan Agreement, *supra* note 75, § 1; *See* Gilson, *supra* note 115, at 362 (explaining that when default occurs there is a transfer of the firm's assets to the creditors. Bank lenders have significant control over resource allocation in distressed firms through two sources: "(i) explicit stock ownership and representation on the board of directors and (ii) restrictions on corporate financing and investment policy contained in the firm's debt covenants."). Some agreements contain exceptions for the events disclosed in certain federally mandated filings and shareholder litigation arising there from, but reserve the right to consider any resulting condition or circumstance when determining whether a material adverse affect has occurred in the future.

138. Visteon Corp. Loan Agreement, *supra* note 119, § 7.4.

so will not harm the corporation's financial standing or compromise the creditors' rights—it significantly lowers the standard for challenging managerial discretion that would otherwise apply. Under these "material adverse effect" terms, managers must act on reasonable expectations that are much easier to second guess and undermine than the business judgment rule's standard of rationally or honestly believing a decision to be in the best interests of the corporation.[139] Corporate law has long avoided imposing a reasonableness standard on decisions made by corporate managers.[140] In these loan agreements, the creditors suggest a course of conduct that they think will insure that the corporation is very likely to be able to meet its obligations to the creditors. If those suggestions are ignored, then the course chosen must be one that the managers can reasonably expect not to cause harm to the corporation's financial health or continued existence. If the managers make a decision that does end up harming the corporation, then the creditors will have a credible reason to challenge it as unreasonable and declare a default for the breach of a covenant. The "material adverse effect" language is, therefore, yet another way creditors can directly, though subtly, exercise control over the decisions corporate managers make on behalf of the firm.

This combination of control mechanisms gives creditors more implicit power over corporate management, particularly when the corporation is in a bad financial position, than they could explicitly reserve or exert and more power than shareholders are legally entitled to exercise. Shareholders may not make business decisions for a corporation. They may not remove officers, and they can remove directors only through shareholder elections.[141] Shareholders have no expedient means to hold managers directly accountable for decisions they make that harm the corporation or compromise the nature of the risk the shareholders are taking with their investment. The best shareholders can do is rely on a compensation system that gives managers incentives to increase shareholder value and disincentives to compromise it. A corporation's large bank creditors are able to exercise more oversight than shareholders can, or will be motivated to exercise, when a corporation is in trouble. They are able to dictate particular decisions management will make and can quickly and effectively punish management in ways shareholders never could because of the rights they reserve for themselves in loan agreements. Furthermore, when these creditors take corporate stock as collateral for the loans they make, a default on the loan can effect a change in control without shareholders' ever voting to approve the change or receiving the payment of a control premium that usually accompanies corporate takeovers.[142] Large, institutional creditors really are able to exercise a kind of direct control over a

139. Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).

140. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968 n.16 (Del. Ch. 1996).

141. 1 JAMES D. COX ET AL., COX & HAZEN ON CORPORATIONS INCLUDING UNINCORPORATED FORMS OF DOING BUSINESS § 9.12 (2d ed. 2003).

142. *See, e.g.*, Odyssey Partners v. Fleming Co., No. C.A. 14770, 1998 WL 155543 (Del. Ch. Mar. 27, 1998); Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Ch. 1997). Theoretically, the shareholders are not left uncompensated. The corporation realizes a benefit from using its stock as collateral for the loan because it will pay a lower interest rate for the loan as a consequence of providing corporate control as collateral.

corporation's management when a corporation poses a significant risk of default that shareholders cannot exercise even when the corporation is healthy. That power significantly influences managerial discretion and thereby intensifies the risk aversion that is typical of corporate management. This level of creditor control threatens to undermine the independent managerial decision making upon which corporate governance law is built.

Having examined the powers creditors have over management both when the corporation is solvent and when it is not, this Article will now turn to the effect the mere prospect of creditor control can have on corporate investment decisions when the company is still solvent.

III. HOW CREDITOR INFLUENCE BLEEDS INTO SOLVENT TIME (THE UNRAVELING PROBLEM)

Creditor control in times of default, insolvency, and bankruptcy is relevant to the pre-insolvency struggle between shareholders and creditors because the power creditors can wield upon default affects managerial decisions well before those powers are realized. It is the specter of those consequences that weighs on management when deciding whether to cause the corporation to take a particular business risk.[143] While the threat of creditor control over the corporation becomes a more real and immediate concern when the corporation faces financial difficulty or is at risk of breaching a loan covenant or of defaulting on a major loan, the specter of creditor control always looms over the decisions a responsible manager will make on behalf of the company.[144] Hu and Westbrook warn that recognizing a fiduciary duty to creditors before bankruptcy would result in directors who "avoid the entrepreneurial risk taking crucial to our country's global competitiveness."[145] They understate the point. Creditors have already reserved for themselves the kind of control that will assure risk aversion in managers when a corporation is less than completely financially stable. The ability to enforce direct breaches of fiduciary duty would indeed discourage value-maximizing decision making, but creditor control in the zone of insolvency is a more direct route to the same result. This Part will show how the creditor power reserved in loan agreements can affect even the decisions of solvent firms and how management

143. Baird & Rasmussen, *supra* note 1, at 1225–27. Baird and Rasmussen use Warnaco Corporation as an example of the amount of control that creditors can have over a solvent corporation. Warnaco was in the Fortune 1000 but invested unsuccessfully in the 1990s in Calvin Klein Jean Outlets. The company had to borrow to continue to operate and increased its debt from $500 million to $1.5 billion. The shift in control from the shareholders to creditors occurred at this time. The CEO was replaced even though the company remained solvent. Warnaco was no longer able to borrow on an unsecured basis and could only continue to operate with the permission of the institutional lenders. The incentives to engage in risky transactions disappeared. "The presence of such an institutional lender fundamentally alters corporate governance. The lending agreement contains many affirmative and negative covenants that give the lender de facto control over every aspect of the business." *Id.* at 1227.

144. *Id*. at 1227–28.

145. Hu & Westbrook, *supra* note 4, at 1328.

loyalties will shift to creditor interests in advance of default or insolvency when creditor and shareholder preferences are at odds.

To appreciate how creditor power accumulates as the corporation faces a greater likelihood of financial difficulty, suppose a firm ("Firm") is a large, publicly held company and has had some financial difficulties but remains solvent. Firm owes its Bank Group $250 million on a revolving credit facility. The assets securing the facility are worth $175 million, including cash collateral, so the Bank Group is undersecured by $75 million. Firm has two investment options. Option A is a safe bet. It has a 100% chance of earning a $76 million return. Option B is a riskier proposition but carries a potential return of $150 million. Management faces a difficult decision when choosing between the two because it will be in default if the loan remains undersecured at the end of the next fiscal quarter. As explained above, a default could be catastrophic because it would cause the corporation to default on its other credit obligations and Firm would certainly be insolvent if it were forced to pay all of its obligations in full. The Bank Group is therefore strongly urging Firm's management to pursue Option A. It has made clear that if the management team chooses Option B and the venture fails, then Bank Group will only refrain from declaring a default if the directors agree to install senior officers of the Bank Group's choosing. Senior managers face a possible job loss if they take the action disfavored by the Bank Group and may face similar, though less focused and therefore less powerful, unrest from shareholders if they do not pursue the opportunity to make $150 million with Option B. What probability of success or failure must Option B present to sway the managers in one way or another? Modeling the strategic decision, or game, and finding the indifference point provides an answer.[146]

The managers act first. They choose either Option A or Option B. If they choose Option A, the Bank Group will be happy and will not take further action. The shareholders will then have to decide whether to treat the managers well or treat them poorly. Because the shareholders can only act through their election of the board of directors to change management, they are not able to as directly exert their will over individual managers. Still, shareholder voting and monitoring has become increasingly relevant in recent years as shareholders have adopted various methods to form influential blocks.[147] Although indirect, shareholder power over management cannot be dismissed out of hand; poor treatment by shareholders can exact a cost senior management cannot discount.[148] More directly, angry shareholders can exit the firm, thereby making equity compensation for managers

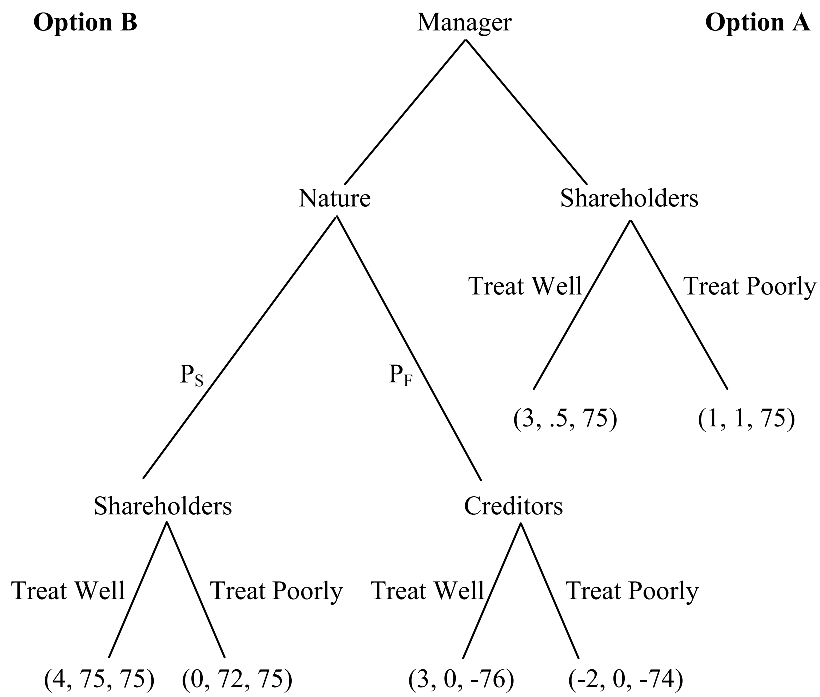
146. Special thanks to Professor Jonathan Klick for his help in modeling this hypothetical. The basic facts of the hypothetical come from the kind of problem considered by Chancellor Allen in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) which is based on the facts in *In re Central Ice Cream Co.*, 836 F.2d 1068 (7th Cir. 1987).

147. *See* Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 820–21 (2006).

148. *See* Polsky, *supra* note 59, at 888–89 n.59 (citing Melvin A. Eisenberg & Brett H. McDonnell, *Expectation Damages and the Theory of Overreliance*, 54 HASTINGS L.J. 1335, 1366 n.36 (2003)).

significantly less valuable and making the firm more susceptible to takeover.[149] Because equity compensation accounts for a large portion of senior officer compensation these days, the cost of such shareholder "punishment" may be significant.[150] A job the manager originally valued at $3 million, in the event of mass shareholder exit, might only be worth $1 million. Alternatively, if the senior managers choose Option B, the success of the investment will determine which party will respond to their choice as well as what the likely reaction will be. The probability of Option B's success is therefore an important determinant of how strongly managers will be influenced by the consequences of its failure, that is, the punishment threatened by the Bank Group. Here is a diagram of the game which includes payoffs to be discussed further below:

Figure 1



Key:

Payoffs: (Directors, Shareholders, Creditors)

P_S: Probability of Success

P_F: Probability of Failure

149. Henderson, *supra* note 24, at 1558–61.
150. *Id*. at 1548–50, 1553–55.

It is true that shareholders would prefer Option A if Option B had a poor chance of success. But, given the large payoff associated with Option B, Option B would have to have a chance of failure greater than 98% before its expected value would be less than the $1 million in equity left over after the creditors are satisfied under Option A.[151] Rational, well-diversified shareholders would be willing to see the corporation take a significant risk in order to try to obtain the $150 million payoff possible under Option B, so they will have an incentive to punish management for not taking the risk if the likelihood of failure is somewhat less than 98%. Of course, a risk preference that extreme does not comport with the objective of corporate wealth maximization either. Balance between shareholder and creditor interests should be the goal.

Now consider the expected outcomes given the result of Option B. If Option B is successful, again, the creditors will not take any action, but this time the shareholders will be very pleased. The manager will keep his job, which, for the sake of comparing payoffs, I am valuing at $3 million, and receive a bonus of $1 million as a reward for the increase in the value of the company due to his savvy investing on its behalf. Because the shareholders realize a benefit in enhanced corporate value and thus enhanced stock price, they benefit from treating the manager who has enhanced the value of their investment well. If Option B fails, the company will most likely be pushed into insolvency by a declaration of default or will have to adopt whatever changes the Bank Group insists upon to avoid such a declaration. In that case, the creditors act. They are now undersecured, and therefore have lost the $75 million collateral that would have been available had the company chosen Option A. If they decide to treat management well, they will not only lose the collateral they counted on, but they will be the creditors of a company with management that is willing to take imprudent risks with their money. This effectively makes the loan more expensive and so the creditors suffer a loss if they fail to take any action against the managers. Under these circumstances, the creditors will act to install managers that will be more careful with loan proceeds and better protect the creditors' position within the firm. The manager who has decided not to honor creditor preferences will not only be replaced, but his reputation on the job market will be diminished and he will have to waste six months of his career assisting the turnaround specialist the creditors will have the right to appoint before he can move on to his next position. This accounts for the additional $2 million "cost" of punishment to the manager.

What decision should Firm's management make? To which preferences will they be more sympathetic? The answers to those questions depend on the likelihood of Option B's failure. Likelihood of failure equals likelihood of default here, because if Option B fails, the creditors will be able to declare a default. By considering this simple example, we can see how likely default has to be in a given situation for managers to begin to weigh more heavily creditor preferences and concerns over the investment ambitions of shareholders. This is done by finding

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151. Shareholders would realize $75 million in value after the creditors are paid under Option B. The expected value of Option B with a probability of success of 2% is $1.5 million. ($75 million)(.02)=$1.5 million.

the indifference point, the point at which a manager is indifferent between Option A and Option B given his own payoffs. By setting the payoffs on each side equal to each other and solving for the probability of losing with Option B, we find that the manager is indifferent as between the two courses of action when it is 50% likely that Option B will fail.[152] Stated more generally, when there is greater than a 50% chance that Firm will default on its loans from the Bank Group, the managers will weight the Bank Group's preferences more heavily. We now have decidedly risk-averse managers.

This indifference point can be manipulated upward by increasing the payoff for managers for a successful Option B, or by strengthening the penalty shareholders can or will impose if Option A is chosen. It can be manipulated downward by creditors if they are able to impose a greater reputation cost on managers for being removed at the behest of concerned creditors.[153] Some managers may consider the loss of their job at the hands of displeased creditors to be a greater cost or punishment than the $5 million supposed in the diagram above. A manager for whom that circumstance would mean a loss of $6 million would take the course of action preferred by creditors when the chance of default was only 43%.[154] Managers may make the mistake of assigning too great a value to this result and so may be more risk averse than even their own personal circumstances require. Fiduciary duties doctrine would prevent managers from taking bonus payments or rewards from creditors, and creditors cannot contract directly with managers for loyalty or decisions made in their favor. While their methods of affecting managers are indirect (as are shareholders', for that matter), they are not ineffective.

Shareholders can also adjust rewards to managers for favorable decisions and the severity of the punishments they impose. An equity trustee, described in more detail in Part V, infra, can help make shareholder punishment of managers more likely and less expensive to accomplish. In the example considered in this section, the shareholders exited the firm and punished the managers through a decline in the valuation of incentive compensation. This is a much easier and more efficient alternative to removing managers by lobbying or threatening the board. If Firm had had an equity trustee serving as a shareholder representative, that equity trustee's duties would have begun with the negotiation of the loan from the Bank Group. An equity trustee privy to all information the creditors would have had could have informed the shareholders of the upcoming choice and may have made it easier for the shareholders to register their preferences with the board. More importantly, a shareholder representative such as an equity trustee could have led

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152. The algebra follows:
$1 = 4(1\text{-PF})\text{-}2\text{PF}$
$1 = 4\text{-}4\text{PF}\text{-}2\text{PF}$
$-3 = -6\text{PF}$
$1/2 = \text{PF}$

153. This is the greatest cost managers face when removed or replaced in their position or authority by displeased creditors. The cost can be considerable. Baird & Rasmussen, *supra* note 39, at 935, 938–39.

154. $-3 = -7\text{PF}$
$3/7 = \text{PF}$

to negotiation of less onerous loan covenants. The equity trustee still would not make any decisions for management, and the actual powers to which shareholders are legally entitled would not change. Rather, the equity trustee would increase the power of the shareholders relative to the power of creditors, so that the balance would not tip so far in the creditors' favor when the corporation is in a difficult financial position. If the creditors retained the ability more credibly to threaten a more severe punishment for managers, then the indifference point would move to a relatively lower probability of default and so keep managers more risk-preferring for more of the corporation's solvent time.

Larger creditors that have loaned significant amounts of cash to a business have incentives to invest more time and resources in remaining well informed about the business's financial condition. They are also able to exercise more influence, if not outright control, over the business decisions the corporation makes because of the terms they insist upon in loan agreements.[155] Creditors have no incentives to take risks that jeopardize their goal to be repaid in full with interest because they do not receive any upside from the business' success. Shareholders, on the other hand, care only about the prospect of returns above and beyond what creditors are owed, and if those risky investments fail, they are no worse off than they would have been if the corporation only had enough to repay its creditors.[156] Shareholder and creditor risk preferences are therefore very different, and the results of those differences can make some decisions difficult for management. Too much pressure from either side may push managers to make decisions that are not value-maximizing. Part IV will demonstrate how dominance by either shareholder or creditor preferences will not necessarily lead to corporate wealth maximization. Instead, balanced influence and managerial independence is essential.

IV. THE STRUGGLE—DIFFICULT DECISIONS FOR MANAGEMENT, FINDING THE OPTIMAL PATH

The constant struggle between shareholder and creditor interests and preferences is magnified when a corporation is in a perilous financial position where resources may be scarce. Sometimes shareholder preferences dominate and sometimes they go too far, particularly when control is concentrated in a few dominant owners.[157] Other times, creditor risk aversion is the primary influence on management. There is often a noticeable lack of balance in one direction or the other, and that imbalance will not necessarily lead to the decision most likely to maximize corporate wealth. Shareholders often lack the detailed monitoring abilities creditors can reserve for themselves and therefore may not fully appreciate a corporation's financial position and the choices management faces.[158] Creditor power, when reserved and exercised, is not necessarily reviewed or constrained, and shareholders might not even try to prevent it at the time it is

155. Baird & Rasmussen, *supra* note 1, at 1211–17.

156. This point is made clearly and famously by Chancellor Allen. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

157. *See id.*

158. Henderson, *supra* note 24, at 1558–61, 1565–66.

granted. As the struggle over limited resources intensifies, managers face difficult choices, not only about which group's interests to prefer, but also about what choice is best for the corporate enterprise. The decision that may have the greatest hope of wealth maximization for the corporation may not necessarily be one the creditors or shareholders would choose if they had the choice.

Agency costs may generally be lower for a financially distressed company than a healthy one because of the enhanced supervision provided by creditors and vulture investors.[159] Indeed, agency costs may be lower due to a lessened concern that managers could loot the company at this sensitive time. Still, the agency cost caused by the struggle between shareholder and creditor interests in the zone of insolvency is that managers will lose sight of the goal of wealth maximization in favor of extreme risk aversion that will allow them to enjoy other personal benefits such as the ability to retain their position with the company and preserve their professional reputations. They might not steal or engage in self-dealing, but that does not guarantee that they will make the best decisions for the firm.

First, this Part will evaluate the decision to enter into a loan with strict covenants or numerous possible events of default. Shareholder interests are cast aside during the negotiation of such loans when planning for the possibility of financial distress, and such negotiations would serve as an important trigger for the use of an equity trustee to insure that a shareholder voice remains if the company endures financial distress under the terms of the loan. Next, I will turn to the role of market forces in evaluating this problem and argue that the fact that the market has not responded to this problem does not mean that it does not exist. Finally, I will model an investment decision to show why a balance of shareholder and creditor interests, and absolute dominance by neither, is the best way to ensure that managers have the independence to make the best business decision for the firm.

A. Loan Terms—Business Judgment and Business Risk

Entering into the loan agreements that give bank creditors significant power over the corporation through loan covenants and default terms is a business decision, and a business risk in and of itself. This Article has focused so far on the behavior and decision making of managers after a risky loan has been undertaken, as those managers struggle with the resulting balance of power among the corporate constituents when deciding how to operate a troubled company. Before we can determine with certainty whether the position in which managers find themselves after agreeing to various loan covenants is a bad one for shareholders or the corporation, we must first examine the decision to enter into a particular loan agreement in the first place. When the money is borrowed, the managers may be making a choice to expand the corporation, even if it is experiencing financial difficulty, rather than making the more risk-averse decision to try to cut costs while carefully continuing to operate the current business.[160] At first glance, it may seem that this system has achieved an optimal balance. After all, if the managers try to take corporate risks and those risks are unsuccessful, the corporation, its

159. *Id.* at 1544.
160. *See* LoPucki & Whitford, *supra* note 69, at 748–49.

shareholders, and management have had their chance and lost, and now the creditors should be able to do whatever they must to recover the loan made to the company. Some version of this "balance" may be appropriate, but, upon closer examination, it becomes clear that the current practice does not necessarily lead to corporate wealth maximization.

Corporate law and practice usually welcome outcomes that result from informed bargaining. In the circumstances considered above, the corporation was in financial trouble and the managers decided to borrow cash to take a business risk anyway. If the risky investment were unsuccessful, the corporation would become insolvent. At the time of the loan, neither the managers nor the shareholders wanted the creditor powers to ripen. Both groups remained hopeful that the investment would produce a substantial return and crisis would be averted. Nevertheless, all of the relevant parties knew creditor control was a realistic possibility under the loan agreement and accepted it as an additional cost of the loan, in lieu of a higher interest rate, and an additional cost of failure. Indeed, if we put loan terms to a shareholder vote, the loan agreement might be approved. Such covenants are the price corporations pay to have the funds with which to take investment risks. Managers and shareholders alike assume that the current shareholders will exit if the investment fails and creditor control becomes a reality.[161] Both groups lack incentives to provide for shareholder rights and preferences upon financial failure because both assume that the current shareholders will be gone. The circumstances of financial distress and creditor control, rather than insolvency or bankruptcy, may be the endgame for which shareholders and their managerial "agents" should plan.

B. Market Forces

There is certainly a valid argument that the market can and would work to limit creditor power in times of financial distress if it were really a problem. Significant loan agreements are attached as exhibits to the public disclosures of large, publicly traded companies. Shareholders in these companies are thereby informed of the terms under which the corporation has borrowed and are free to exercise their market power to show their disapproval of credit terms by selling their stock. If such loan covenants really are harmful to shareholder or corporate profits, the market will value shares in victim companies less, and managers and creditors alike will stop favoring such terms. If they thought they needed to, corporations would plan ahead for troubled times and consider how managers should make decisions when the corporation nears insolvency. Shareholders, through the corporation, could then find ways to push managers to act in a certain way when the corporation is in trouble through the compensation packages and employment terms offered the managers. Instead, strict loan covenants prevail and serve as the only real guidelines for corporate decision making in the zone of insolvency.

Strict loan covenants may confer advantages on both the corporation and its shareholders. First, they reduce the cost of credit needed to continue the business or undertake a potentially risky investment. Second, everyone can benefit

161. Henderson, *supra* note 24, at 1558.

from, or free ride on, the additional supervision of management that the creditors provide.[162] Finally, corporations may have to accept these terms in order to take the risks shareholders would want them to take. Alternatives the creditors may prefer, such as not making a particular investment at a particular time, or passing on an investment opportunity with a certain risk of loss, or using available cash to pay off debts rather than make further corporate investments, may be rejected in favor of a more aggressive approach if the creditors are assured they will be able to recoup their investment in the event the corporation falls to a particular level of financial distress. In a hypothetical shareholder vote, shareholders may willingly agree to seemingly onerous credit terms in exchange for an opportunity to make a potentially lucrative corporate investment. Loan covenants and implicit creditor control are simply costs of much needed credit; indeed, they are costs of the credit that enables corporations to make risk-seeking investments. While one might think this is good news for shareholders, a closer examination reveals otherwise.

Shareholder acquiescence in the negotiation of strict loan covenants should not be mistaken for a signal that such covenants result in the maximization of corporate or shareholder profits. Rather, such silence on the part of shareholders simply reflects the decline of shareholder powers and value in the zone of insolvency; as a result, shareholders have very little incentive to guard their ability to influence management in times of financial distress.[163] Individual shareholders may find it more efficient to simply exit a failing firm. Investors buying the shares of exiting shareholders may be those “vulture investors” known for investing in struggling companies to turn a short-term gain. Those interests may not be in line with the goal of long-term corporate wealth maximization.

Even if shareholders do have the proper incentives to resist strict loan covenants, managers are not breaching their duties to shareholders or the corporation by entering into the loan agreements discussed here. Because no duty is breached, shareholders have very few tools at their disposal to object.[164] The least expensive means available to shareholders for expressing disapproval of a corporate action is the sale of the corporation’s stock.[165] The threat posed by shareholder exit is much less meaningful in a financially distressed company when the stock price is already depressed. Then, the stock price might already have fallen so that the officers are effectively punished with the loss or devaluation of incentive compensation, whether or not the poor financial condition is their doing. While the appropriate message of shareholder disapproval may be sent by the decline in stock price, the decline in price could also result from the decreased value of the firm. Any angry shareholder exit may be masked by the decrease in value of the corporation that originally caused the shareholder ire. At this point in the corporation’s life, as the law now stands, the shareholders really are

162. Baird & Rasmussen, *supra* note 1, at 1250.

163. Skeel, *supra* note 67, at 501; Henderson, *supra* note 24, at 1558.

164. Even if shareholders would otherwise be tempted to bring derivative suits against corporate directors on account of the loan terms or the effects of the loan agreements in times of financial trouble, the shareholders, and, most importantly, their attorneys, are less likely to pursue the derivative remedy in the zone of insolvency. Skeel, *supra* note 67, at 501; Alces, *supra* note 97, at 122–23.

165. Henderson, *supra* note 24, at 1558.

powerless.[166] For all of these reasons, the simple fact that shareholders have not vocally and meaningfully objected to or prevented the adoption of loan terms should not serve as dispositive evidence that such terms are in the shareholders' or the corporation's best interests. Rather, it means that all of the relevant parties assume the current shareholders will have exited by the time strict loan covenants become effective, and so there is no need to protect equity interests as they may exist upon that eventuality. No one will likely complain when the loan agreement is negotiated, and it is too late to complain once the corporation is in financial distress.

The chief problem caused by strong creditor control is the undermining of managerial independence that occurs when any one group can exercise significant control over managerial decision making. Shareholders should want to object to loan terms that implicitly or explicitly give creditors more power over the corporation than shareholders would be allowed to claim under state law. The prevalence of such loan covenants effectively wrests control of the corporation from shareholders before insolvency, and, certainly before bankruptcy. This constrains managers to act to the advantage of creditors in a way shareholders could never pressure managers to act. While the tools used by each constituency must necessarily be different,[167] they need not and should not be unequal in their ability to reach management and their obligation to honor the independence of managerial business judgment. It is only with the appropriate balances between supervision and managerial independence and between shareholder authority and creditor power that management will be free and encouraged to make the decisions most likely to lead to corporate wealth maximization. Only then will the appropriate level of risk be preferred.

Professor Barry Adler makes the point that companies that have reached the end of the line and are abject failures would do better to liquidate than to engage in a long, expensive reorganization process.[168] Such "dead" companies should liquidate, individually, sooner and, collectively, more often.[169] But, if a corporation still has long term prospects, still has a viable and potentially profitable business model, and still could reasonably exist in a competitive market, then the risk aversion that leads to the decision to cut the company's losses and either liquidate or file for bankruptcy is not necessarily the optimal level of risk preference.[170] Corporations that seek large cash loans either to continue to operate or to pursue new opportunities in the hopes of turning the business around may still have life and should not necessarily be governed by the degree of risk aversion creditors would prefer. The same can be said of companies that renegotiate loans,

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166. This is another extension of the "vestigialization" principle introduced by Skeel, which explains that state law corporate governance is ineffective for insolvent corporations because state law was not built to address the problems and circumstances that confront financially distressed companies. Skeel, *supra* note 67, at 489–92.

167. Creditors could not, for example, offer managers incentive compensation through shares in the corporation's debt, at least not before bankruptcy.

168. Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575, 597 (1995).

169. *Id.*

170. Skeel, *supra* note 24, at 937–38.

agreeing to be bound by stricter covenants, in the hopes of reorganizing their debt outside of bankruptcy. Such companies with long-term prospects and reasonable hopes for profitability should still be taking more risks than creditors would approve under cautious loan agreements. As long as a corporation is "alive," meaning financially viable, its risk preferences should tend more to risk-seeking behavior than the absolute risk aversion that results from the combined risk aversion of creditors and individual managers when a corporation faces financial difficulty. Equity preferences still pertain, because it is still possible that an equity position will exist in the future. Managers should still try to maximize corporate wealth, above and beyond the company's debt load, as long as the firm is not liquidating with the sole objective of repaying creditors. Corporations may bounce in and out of the zone of insolvency a few times without ever liquidating or entering bankruptcy.[171] Shutting down wealth-maximizing behaviors and risk preferences may leave money on the table.

Too strong a risk preference would not be prudent either. Some caution during troubled times is warranted lest the corporation's reasonable hopes for recovery and profitability be dashed. The goal is not to allow shareholder preferences to grow in influence so as to overwhelm completely the risk aversion of managers and creditors. Rather, it is to balance constituent powers of influence so that neither can completely assert its will upon managers, thereby preserving managerial independence to pursue corporate wealth maximization subject only to removal by the board of directors.

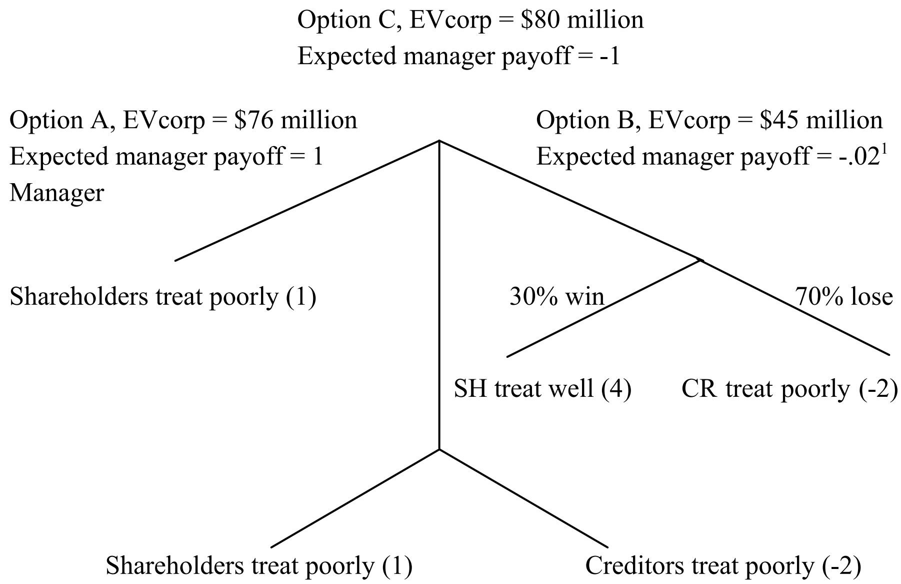
C. Business Decisions in the Zone—The Cost of Lost Managerial Independence

Dominance by either shareholders or creditors when a corporation is in financial trouble may deprive managers of the independence they need to make the best investment decision for the corporation's financial future and wealth maximization. With Figure 1[172] and its illustration of shareholder and creditor preferences and influence each group can exert on managerial decision making given the corporation's risk of default in mind, consider the following example and its conclusion about corporate wealth maximization. Recall that our fictional Firm had two investment choices. Option A had a 100% chance of earning a $76 million return. Option B is a riskier proposition, with only a 30% chance of success, but carries a potential return of $150 million. Now suppose that a third option is available and has an 80% chance of producing a $100 million return. Figure 2 illustrates the decision before management.

171. The recent struggles of the American automotive companies outside of bankruptcy demonstrate this point.

172. *See supra* fig.1, at 1080.

Figure 2



[1] (0.3)(4) + (0.7)(-2) = -0.2

In this example, a rational manager will choose Option A even though Option C has the highest expected return for the corporation. This is because, considering their own best interests, neither creditors nor shareholders will prefer Option C and so both will treat the manager poorly for choosing that option. Option C has an expected value for shareholders of $20 million, as opposed to the $22.5 million Option B offers. Option C has an expected value for creditors of $60 million, which would still leave them undersecured as Option A would not. Because of the power creditors can yield, a rational manager would choose Option A over Option B under these circumstances. If shareholders and creditors could somehow pre-commit to treat the managers well, or at least to refrain from treating the managers poorly were Option C chosen, then the managers would be free to make the decision that accepts the appropriate amount of risk and carries the highest expected value for the corporation.

This guaranteed soft landing for managers could take different forms. There is always the chance that the investment choice fails and in order for managers to take the risk anyway, the chance that they will be punished for taking the risk must be reduced. The current system tends to push managers either further toward complete risk aversion or toward the "nothing to lose" kind of risk preference of shareholders in a highly leveraged company.[173] The fiduciary duty law that applies to directors has grown to protect directors from liability to either creditors or shareholders for preferring the interests of either group, as long as the

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173. Baird & Rasmussen, *supra* note 1, at 1231.

directors made an informed decision with a good faith interest in doing what is best for the corporation.[174] Because other factors are at work in incentivizing and supervising them, managers are not so protected. No good reason explains the lack of protection, however, because we are as interested, if not more interested, in senior officers' feeling free to make the decision that is best for the corporation's wealth maximization, even if that decision will anger either shareholders or creditors. Because the punishment of officers does not require court approval or a litigant's making it through the long and obstacle-ridden derivative suit process, corporate policy and legal rules cannot protect them as easily. Rather, a true balance of interests and powers between shareholders and creditors is most likely to result in the freedom managers will need to make the best decision for the corporation without particular reference to what decision either the creditors or shareholders would prefer or demand. Part V of this Article describes how to achieve this balance within the corporate decision making mechanism currently in place.

Managers make difficult decisions when negotiating a loan agreement that will significantly affect the company if it encounters financial difficulty. The high rate of turnover among shareholders, and their relative inability to challenge meaningfully the terms of a loan, means that their interests are not necessarily accounted for when managers and creditors plan ahead for the possibility of the corporation's default or insolvency. The lopsided representation of creditors in these circumstances may detract from managers' ability to make wealth-maximizing decisions for the corporation in times of financial distress. A more balanced representation of shareholder and creditor interests is needed to promote wealth-maximizing objectives and to preserve managerial independence from the whims of either constituency. The next Part explains how an equity trustee charged with the task of representing shareholder interests upon the occurrence of certain triggering events can help achieve the best balance.

V. CHANGING CORPORATE POLICY AND PRACTICE TO MAXIMIZE WEALTH

The key to finding a balance in corporate decision making that will allow the corporation's bottom line to remain the primary focus and priority for officers is to balance the power and influence shareholders and creditors can exercise over the corporation throughout its life, but particularly when the company is in financial trouble. The particular need for a seat at the table for shareholders arises even as early as when the firm is thinking of entering into a significant credit agreement with bank lenders. The most efficient and productive way to address the competing pressures shareholders and creditors directly and indirectly place on management is to move the debate out of the managers' minds and into an open negotiation between shareholders and creditors themselves, through their designated representatives.

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174. *See* N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007); Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

This Part of the Article explains what a shareholder representative, or equity trustee, would do, when its duties would be triggered, and how the equity trustee would be monitored. Corporate law and practice operate under the assumption that the shareholders' interests are represented by a firm's officers and directors.[175] This may be true enough when the corporation is healthy, but the other factors weighing on managers' decision making become more pronounced when the corporation endures financial difficulties. Silencing the shareholder voice and perspective under these circumstances can result in taking risk aversion too far, so that the corporation stops moving toward continued wealth maximization and becomes too conservative in its investments. Conversely, leaving creditors powerless during this time in some instances of a particularly strong equity presence[176] can be just as harmful, by leaving unchecked strong incentives for risk preference.[177] If shareholders and creditors can be brought together to negotiate over the supervision of management going forward and what powers each will have and be able to exercise over managerial decision making (and, in this instance, less is more), then managers will feel free to make wealth-maximizing decisions that might not be ideal from the standpoint of either constituency.

This Part will begin by looking briefly at why altering the current regime of executive compensation is not the best way to adjust managerial incentives appropriately. Next, it will describe how informed and concentrated shareholder representation can work to balance effectively the power creditors have when a corporation is highly leveraged. Creditors may decide to charge more for credit. Shareholders may find that they are prepared to agree to higher interest rates in exchange for the freedom they can retain for managers to make decisions that may be more beneficial to shareholders. In the end, the goal should be to allow monitoring of management that prevents bad faith or disloyal conduct, but also to remember that managers owe loyalty to the corporation. Managers should not be punished for making decisions motivated by the best interests of the corporation.[178]

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175. Shareholders choose the directors of the corporation through voting and thus "[t]he directors and officers of a corporation independently owe fiduciary duties directly to the stockholders." Arnold v. Soc'y. for Sav. Bancorp, Inc., No. 12883, 1995 Del. Ch. LEXIS 86, at *24 (Del. Ch. June 15, 1995) (citing Smith v. Van Gorkom, 488 A.2d 858, 890 (Del. 1985)).

176. Such a strong equity presence is most common in corporations where there is a concentration of stockholding in one person or entity.

177. This can arise when the dominant equity presence can protect the managers and can provide or already has provided them with other employment opportunities if the current corporation fails.

178. Managers could still be removed in the ordinary course by directors who feel that the officers are not particularly competent or are not exercising good judgment. As Baird and Rasmussen point out, having the best person in office is more important than aligning an officer's individual incentives. Baird & Rasmussen, *supra* note 39, at 931–32. *Prime Directive* reveals that having too quick a trigger finger can be damaging by itself. This Article maintains that corporate management can find the right answer for the corporation by listening to and balancing the interests of all corporate constituencies. Managers who are not making the best decisions for the corporation will still be removed through the usual process and that process may operate more efficiently with the input of shareholder and creditor representatives.

Finally, this Part will describe exactly how the new position of a shareholder representative can be created and what it would look like, including how to select, pay, monitor, and appropriately incentivize the shareholder representative.

A. Why Executive Compensation Is Not the Answer

In the past, incentive compensation has served as the chief means to align managers' incentives with the interests of shareholders.[179] If the managers' compensation depends upon maximizing the corporation's profits, then they will have personal incentives to take actions consistent with that goal. Commentators have recognized possible problems with this means of aligning incentives. For instance, if managers' compensation is based on enhanced earnings, then they will have incentives to take actions that increase the amounts reported on "earnings statements," even if those same actions will have a negative impact on stock price.[180] Conversely, payment with options, which should serve to reward officers for an increase in their firm's stock price, may provide managers perverse incentives by making them too risk-preferring, even more so than shareholders would want them to be.[181] We have learned from Enron, WorldCom, and other accounting disasters that increased stock prices do not necessarily mean increased corporate wealth.[182] Shareholders have strong incentives to realize increased share prices in the short term, while that interest may not serve corporate wealth maximization.[183] All of this demonstrates that incentive compensation can help to

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179. *See* William W. Bratton, *Supersize Pay, Incentive Compatibility, and the Volatile Shareholder Interest*, 1 VA. L. & BUS. REV. 55, 98–100 (2006) (arguing that incentive compensation is designed to align managers with shareholders who want long term financial growth as opposed to short term speculative shareholders); Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1878 (2001) ("The main issue in corporate governance is therefore to create incentives for managers to run the company in the interest of shareholders."); Listokin, *supra* note 24, at 783 (In a solvent corporation the shareholders are the residual claimants and the fiduciary duties of the managers are owed to the shareholder, but in bankruptcy it is not as easy to identify the residual claimants. In many cases the unsecured creditor's committee is the residual claimant and they should be granted the right to give managers a percentage of the unsecured debt. This mechanism would "enable the residual claimants to align the incentives of the manager with their own.").

180. Kamin v. Am. Express Co., 383 N.Y.S.2d 807 (N.Y. 1976) (examining the case of shareholders who brought a derivative suit against the directors because they chose to issue a dividend instead of taking a loss on the earnings statement. The court dismissed the suit for failure to state a claim and applied business judgment rule protection to the decision of the board of directors.).

181. Hu, s*upra* note 20, at 318–32; Hu, *supra* note 46, at 1492–95.

182. *See* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes–Oxley Act of 2002*, 28 J. CORP. L. 1, 8–9 (2003) (In the Enron case the market failed to see that Enron was in fact not making money or acquiring wealth but the stock price tended to reflect a healthy corporation. Even after the stock price dropped by half, suggesting that the company was in trouble, the stock price was still much higher than the worth of the corporation.).

183. *See* Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989) (The shareholders of Time brought an action to enjoin the merger of Paramount and Time claiming that the Directors breached their fiduciary duties by not maximizing their short

a point, but each variety of incentive compensation may still pervert managers' incentives to work for overall corporate wealth maximization.

Beyond the basic inability to align managers' incentives precisely with the interests of the shareholders or the corporation, the bigger problem with incentive compensation in financially distressed companies is that it often serves either to make managers too risk-averse or too risk-seeking and fails to strike the balance of risk preference that the corporation itself has[184] as a distinct entity with "best interests" of its own.[185] The executive compensation scheme designed at the outset for healthy companies focuses on aligning managers' interests with those of shareholders. The presumption at the time is that what is good for shareholders will be good for the company. In the bankruptcy context, Professor Yair Listokin has suggested that companies compensate managers with debt, essentially because creditors have replaced shareholders as the residual claimants managers are charged with serving.[186] Professor Skeel has considered how to pay managers in Chapter 11 to give them particular incentives, such as maximizing the wealth of the estate or reorganizing the company as quickly as possible.[187] It might seem, then, at first blush, that the answer to the question of how to compensate managers when the corporation is in trouble, but not yet in bankruptcy, is to give them some incentive compensation that combines the solvent and bankruptcy approaches to approximate the firm's capital structure. The problem when the corporation is in

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term shareholder value in the corporation. The court found that the directors did not have a *Revlon* duty to maximize the shareholders short term value); Hu & Westbrook, *supra* note 4, at 1357–59.

184. In financially distressed or bankrupt companies, creditors or vulture investors take over and avail themselves of compensation plans that try to align managerial interests with their own. Henderson, *supra* note 24, at 1572–78.

185. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *33–34 (Del. Ch. Dec. 30, 1991) ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise"); Hu, *supra* note 20, at 334–35 (noting that incentivizing too much can create "managerial gamesmanship," and entrench managers in the firm through overinvestment. On the other hand, bonus related compensation will create incentives for managers to invest in short term projects that create a profit, and not long term growth oriented endeavors because the profits from these projects will not be realized in the present.).

186. Listokin, *supra* note 24, at 803. Listokin writes:

> Debt compensation aligns the incentives of managers with the incentives of the typical residual claimants in bankruptcy—the unsecured creditors. As a result, debt compensation encourages a manager to pursue actions that are in her self-interest, while also improving the return of the unsecured creditors. Just as grants of stock options and restricted stock are believed to foster good behavior in managers of solvent firms, so too does unsecured debt compensation promote value-maximizing behavior in managers of bankrupt firms. This alignment of a manager's incentives with those of bankruptcy's typical residual claimants makes debt compensation an improvement upon other pay-for-performance plans and proposals.

Id.

187. Skeel, *supra* note 24, at 919, 927.

financial trouble is not that the managers do not have enough at stake; it is, rather, that they have their very livelihood to lose, and this causes them either to be too risk-averse, which is more likely in a large, public corporation, or far too risk-preferring, more likely in a corporation in which equity is significantly concentrated in one entity.[188]

Tying the managers' personal wealth more closely to the corporation's serves only to misalign their incentives from those of the corporation's constituent parties. Recall that corporations are designed to be riskier endeavors than savings accounts.[189] If a manager will lose everything if the corporation goes under, or if the shareholders are sufficiently angered, or if the creditors can declare a default, he will be far more risk-averse in his decision making than the best financial interests of the corporation would dictate.[190] Therefore, making the manager's short-term interests depend too heavily on the corporation's remaining afloat or upon his making certain decisions will compromise his independent decision making. That independent decision making is essential to looking objectively at corporate choices and taking the course of action that will most likely enhance corporate wealth, even without the express approval of shareholders or creditors.

Another possible solution is to give the manager the right to collect some compensation in the future that depends on how well the corporation did during his tenure. This only works, of course, if the corporation still exists after he leaves it. If the corporation enters bankruptcy, the manager would receive a priority claim for any back salary and an administrative claim for any salary earned during the bankruptcy.[191] The manager has an incentive to maximize corporate wealth in order to collect on his claim. If the corporation does particularly well, either by avoiding bankruptcy or by earning a significant sum in bankruptcy, the manager will be able to collect on a greater percentage of his claim. The threat of being removed from office by creditors inside or outside of bankruptcy may still weigh more heavily on managers than whatever chance they may have of recovering some or all of the salary the company owes them.[192] Being removed by creditors may adversely impact their chances of finding another managerial position with another company and that next job may prove much more lucrative than whatever income could be salvaged from the current company.[193] Outside of bankruptcy, a manager could be incentivized with a future approximation of the corporation's

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188. *See* Hu, *supra* note 20, at 328 ("Shareholdings can exacerbate a problem of inadequate diversification by managers and actually can make managers more reluctant to choose appropriately risky projects.").

189. *See id*. at 320–22.

190. *Id*.

191. 11 U.S.C. § 507(a)(4) (2006).

192. Adler, *supra* note 49, at 359 (explaining that managers favor reorganization over liquidation, in part, because they want to keep their jobs).

193. "[S]tudies have shown that the management that led the company into financial distress is very often replaced, before or after the Chapter 11 petition is filed. For those reasons, notwithstanding the DIP system, management may have substantial incentives to resolve the debtor's financial difficulties outside of bankruptcy." Hu & Westbrook, *supra* note 4, at 1377 (citing Barry E. Adler et al., *Destruction of Value in the New Era of Chapter 11*, at 12, 29 (Oct. 24, 2006), *available at* http://ssrn.com/abstract=795987).

wealth during his term with an incentive-laden severance package or retirement plan. This may still cause managers to remain too risk-averse and depends on the corporation's continued solvency of the corporation, something the manager may not necessarily be able to control. All of these compensation alternatives are more effective in healthy companies.[194] They also keep the hypothetical bargaining between the shareholder and creditor positions in a manager's head, which imposes a significant agency cost. Appointing an equity trustee may help to reduce this agency cost and promote bargaining between the parties, by allowing a shareholder representative to argue in favor of shareholder interests even when the corporation is in trouble.

B. The Equity Trustee—A Seat at the Table for Shareholders

Giving shareholders informed, unified representation would leave managers free to take the business risks most likely to lead to corporate wealth maximization. A shareholder representative, or equity trustee, would be able to provide balance against creditor power in a troubled company, so that creditor influence does not dominate managerial decision making. An equity trustee would achieve this balance by enhancing the other side of the payoff equation, and specifically by curtailing the powers creditors reserve in loan covenants. Managers who make bad judgments or who do not perform competently or faithfully can still be removed by the board of directors. Even though the shareholders can exercise their powers over management more effectively through a single representative, those powers will remain limited by corporate law so that shareholders cannot unduly force their preferences on management or make business decisions. The very purpose of the equity trustee, as this Article conceives it, is to balance the powers creditors assume so that managers will be more likely to maintain the independence to make corporate wealth maximizing decisions.

A shareholder representative can only be effective in this role if the creditor parties and management hear and respect the position he or she advocates. At first blush, it may seem that the equity trustee would be as ignored as shareholders typically are in this context. Further, it may seem that the equity trustee simply creates new agency costs rather than alleviating others. This section will show how bankruptcy practices can inform the design of an equity trustee that will operate outside of bankruptcy in a way that will make that representative an influential advocate in the negotiation of corporate debt. It will also demonstrate the importance of defining the rights and responsibilities of the equity trustee so as to ensure that it is a meaningful advocate for shareholder preferences both when corporate debt is taken on and when the corporation is in the zone of insolvency, a time when shareholder preferences may not have been properly defended in the past.[195]

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194. Henderson, *supra* note 24, at 1569, 1573–75.

195. Skeel, *supra* note 67, at 500–02.

> [W]hile the shareholders of a healthy firm are its true residual owners and, as a result, are the appropriate plaintiffs of a derivative suit outside of bankruptcy, most corporations have become insolvent by the time they file for bankruptcy. Because they have little financial interest in an

1. How Bankruptcy Practices Can Be Instructive

Once a corporation enters bankruptcy, it is operated for the benefit of its creditors.[196] Creditors can exert significant control over a corporation in bankruptcy, particularly through the committee of unsecured creditors (the "creditors' committee") that is appointed in large, corporate bankruptcies. The creditors' committee represents the interests of the corporation's unsecured creditors and consists of the company's seven largest unsecured creditors.[197] In most cases, when the debtor company is insolvent, the creditors' committee represents the residual claim. In cases where the company has or is likely to have some equity remaining, the bankruptcy court will appoint an equity committee.[198] The equity committee will represent the shareholder interests and is authorized to take action within the bankruptcy case on the shareholders' behalf.[199] While bankruptcy is admittedly a different beast because, for instance, managerial authority in bankruptcy is seriously constrained by the bankruptcy court and the influence of the representative committees,[200] the use of equity committees in bankruptcy and the success they enjoy,[201] even when there is little or no equity value remaining, may inform the potential utility of an equity trustee.

The U.S. Trustee appoints the seven largest equity security holders to the equity committee.[202] The equity committee members then select a team of attorneys, accountants, and other professionals to represent the committee's interests in the bankruptcy case.[203] An equity committee's representatives are compensated by the bankruptcy estate for its reasonable fees for actions it takes that are helpful to the estate.[204] The equity committee and the creditors' committee may both exercise significant control over the debtor and are granted a right of access to important information about the debtor.[205] The input of the committees

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> insolvent firm, and because most or all of any recovery would go to higher priority claimants, shareholders lose much of their incentive to promote and participate in derivative litigation.

Id. at 500–01. Skeel further comments that plaintiff's attorneys, like the shareholders, also lose incentives in bankruptcy because of the loss of control of the derivative litigation to the bankruptcy court. Furthermore, derivative litigation can be seen as disruptive to the overall reorganization process and the attorney will have to justify the litigation and the attorneys fees to the bankruptcy judge. *Id.* at 501. A shareholder representative can give continuity between stages of corporate existence and can be a useful tool for interested, sophisticated shareholders.

196. Steven L. Schwarcz, *Rethinking a Corporation's Obligation to Creditors*, 17 CARDOZO L. REV. 647, 667 (1996).

197. 11 U.S.C. § 1102(b)(1) (2006).

198. *Id.* § 1102(a)(1).

199. *Id.* § 1103(c).

200. Alces, *supra* note 97, at 134–39.

201. *See* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 138–39 (1990).

202. 11 U.S.C. § 1102(b)(2).

203. *Id.* § 1103(a).

204. *Id.* § 503(b)(1)(D)(3).

205. Section 1103(c) of the Bankruptcy Code states:

cannot be ignored by the debtor in possession (DIP) or trustee because both committees will have to vote on and approve any plan of reorganization,[206] and both can move to appoint a trustee if they think the DIP, meaning the debtor's current management, is behaving fraudulently or incompetently.[207] Equity committees are not ignored when the plan is being formulated or when the estate's assets are being distributed to its claimants, even when the company is insolvent.[208]

In an empirical study on the subject, Professors Lynn LoPucki and William Whitford discovered that debtor and creditor attorneys agreed to provide some degree of return to equity holders even when they had no legal right to a portion of the estate's assets.[209] The reason appears to be that the lawyers representing the corporate debtors, members of creditors committees, and equity committees interact professionally on a regular basis and so are engaged in a continuing game of sorts.[210] Game theory dictates that repeat players will treat one another fairly, or, in these cases, perhaps more than fairly, because they hope to receive the same treatment from the others in the future.[211] All of these elements of equity representation can be transported out of bankruptcy and adapted to the zone of insolvency situation, or circumstances in which the corporation's debt structure may significantly change in order to allow shareholders' interests to be represented in an effective, informed, sophisticated, and cohesive way.

> A committee appointed under section 1102 of this title may –
>
> (1) consult with the trustee of debtor in possession concerning the administration of the case;
>
> (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
>
> (3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
>
> (4) request the appointment of a trustee or examiner under section 1104 of this title; and
>
> (5) perform such other services as are in the interest of those represented.

Id.

206. TABB, *supra* note 101, at 807.

207. 11 U.S.C. § 1104(a).

208. LoPucki & Whitford, *supra* note 201, at 138.

209. *Id.* at 194–95 (explaining that shareholders exert pressure on the debtor's counsel (through threatened litigation or simply through threats of professional awkwardness and estrangement) so that the debtor's counsel feels obligated to give the shareholders a cut of the estate's assets).

210. *Id.*

211. DIXIT & SKEATH, *supra* note 5, at 265.

2. The Mechanics of the Equity Trustee

The equity trustee is modeled on the indenture trustee in bond issuances[212] and the equity committee in bankruptcy. An indenture trustee represents the interests of widely dispersed bondholders upon certain named events in the life of the indenture agreement. Shareholder opinions have long been silenced and largely ignored, because shareholders in public corporations not only are rationally apathetic,[213] but also generally lack the business experience and access to the detailed corporate information necessary to make informed, well-reasoned decisions about corporate business.[214] While managerial independence in decision making should still be the paramount object of corporate governance laws and practices, there is a way for shareholders to have the same kind of sophisticated, informed representation creditors enjoy when necessary. The equity trustee must be designed so that it can be an effective advocate of shareholder interests, is well-monitored, and has the right incentives. This section will discuss how the equity trustee would be chosen and compensated, and considers possible creditor objections to its existence.

An equity trustee would be appointed by a committee of the corporation's seven largest equity holders as measured at a certain time each year.[215] Many professional companies could decide to offer equity trustee services. Corporate consulting companies come to mind as particularly qualified. Investment banks could also form divisions to offer these services, as could large, institutional investors.[216] As with any other professional representative, the equity trustee would be empowered to retain lawyers, accountants, and other professionals to aid in its representation of a corporation's shareholders. Like an indenture trustee, the equity trustee would monitor the corporation and remain informed as to its financial condition and important business decisions and capital structure, ready to spring into action when its agreement with the corporation requires it. Because the shareholders in public corporations are so diffuse and change daily, an agreement with "the shareholders" as a distinct body is infeasible. The equity trustee would have to enter an agreement with and receive compensation from the corporation on the shareholders' behalf. This does make the equity trustee a creditor of the

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212. In fact, scholars have suggested replacing traditional indenture trustees with a supertrustee that would represent all public debt in many of the same ways the equity trustee suggested in this Article would represent shareholders. Yakov Amihud et al., *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 447 (1999).

213. *See* Rock, *supra* note 64, at 455–56.

214. Julian Velasco, *Taking Shareholder Rights Seriously*, 41 U.C. DAVIS L. REV. 605, 625–26 (2007).

215. Some institutional shareholders and scholars have suggested the use of shareholder committees to advise management on various aspects of corporate business. The suggestions have been met with hostility by management, but interest from shareholders. All of the committees would have enhanced shareholder powers or would have involved more direct shareholder involvement in business decisions. Rock, *supra* note 64, at 490–503. The equity trustee I propose avoids those potentially costly pitfalls.

216. Proxy advisors, who work to compile information about companies and to make voting recommendations to institutional investors, may also be able to adapt their businesses to the demands of the equity trustee trade.

corporation, but gives the equity trustee priority in bankruptcy.[217] While it may seem that paying the equity trustee in the same way as managers and making the trustee a creditor of the corporation compromises the equity trustee's loyalties, one should keep in mind that the equity trustee would owe enforceable fiduciary duties to the shareholders and no other constituents. The equity trustee will not be protected by a business judgment rule or other procedural shields available to directors. An equity trustee really would be an employee of the shareholders and would be directly accountable to and removable by them. Shareholders would not rely on payment of the equity trustee to align its incentives or monitor it and equity trustees would care more about the overall success of its business, measured by the satisfaction of the shareholders it serves, than it would about the recovery of a particular fee.

The equity trustee I propose is not a mandatory one. It is created by private contracts between the corporation and its shareholders, as well as the corporation and the appointed equity trustee. Shareholders may demand that a corporation provide them an equity trustee and may find that the best way to force the managers to use the equity trustee as they intend is to amend the bylaws to require the appointment of a trustee and to allow the trustee to have certain representative powers at enumerated times. These bylaw amendments would constitute the agreement between the shareholders and corporation about how an equity trustee will be used. The corporation, through its management, will then negotiate an agreement with the equity trustee, which will be subject to approval by the group of shareholders responsible for choosing the trustee.

Shareholders should anticipate that the corporation would spend money to provide them an enhanced presence and independent voice in the corporation within the zone of insolvency, particularly if such a presence will prove beneficial to the corporate enterprise as a whole. The presence of an equity trustee may comfort shareholders and minimize precipitous declines in share price upon bad financial news and may prevent such a decline in the face of enhanced debt or debt reorganization negotiations. Exiting shareholders may realize more on the sale of their stock on account of the services the equity trustee has provided. The presence of an equity trustee may also make it more likely that a company that should liquidate would actually do so because it has pushed the corporation to continue to take business risks rather than fold into a position of purely conserving assets for reorganization. This may provide efficiency from which investors as a whole would benefit. Further, large shareholders, particularly those who invest in troubled companies, may grow to insist on equity trustee representation. They may benefit from the similar kind of informed representation creditors enjoy when the corporation is in trouble. An equity trustee that has been paying attention to the corporation for a long time may prove a valuable asset to "vulture investors," who buy stock in the company in the final stages before bankruptcy. The enhanced information available to and analyzed for shareholders may allow investors to

217. The equity trustee would at least receive priority as a corporate employee for fees earned 180 days before the bankruptcy filing. 11 U.S.C. § 507(a)(4) (2006). To the extent the equity trustee continues to serve after the bankruptcy filing, it could receive administrative priority. *Id.* § 503(b).

make better investment decisions, and allow the market to identify more accurately companies with the potential for future profits and those without it.

Creditors, however, are not likely to be so sanguine about allowing the corporation to incur an additional expense for the benefit of shareholders, particularly one they see as posing a direct threat to their repayment and control when the corporation has limited resources. Creditors are unlikely to endorse any action that would enhance management consideration of shareholders. Still, creditors would not stop lending in the face of the use of an equity trustee. Banks need to lend to large corporations as much as public firms in financial distress need to borrow. They may, however, respond by increasing the price they charge for credit. That response would impose an additional cost on the corporation, a cost that may be directly associated with the creation of an equity trustee, insofar as the trustee's work limits the control over the corporation creditors can reserve in loan covenants. Shareholders may choose to allow this extra cost, or the equity trustee may recommend that they do so because paying additional interest may be preferable to allowing creditors to take disproportionate control over the management of the corporation in troubled times.

This tradeoff becomes particularly palatable if we accept that the existence of an equity trustee means that shareholders should not necessarily give up their shares when a corporation experiences financial difficulty. There are two reasons shareholders may retain their investment if an equity trustee is present. First, the equity trustee could represent their interests during that difficult time, so that shareholder powers do not become irrelevant to managers and hope of shareholder returns in the zone of insolvency is enhanced. Second, balancing creditor and shareholder powers serves to lower the cost of corporate financial difficulty to shareholders and managers alike. Managers will have greater job security; shareholders will have less risk-averse managers at the helm of their company and, therefore, a better potential for higher returns. Even if banks insist upon charging onerous interest rates, corporations may decide to issue more public debt as an alternative to borrowing from institutional lenders. If this is the case, the bondholders will benefit from the presence of an indenture trustee. The shareholders should enjoy the same advantage in the form of their equity trustee. Preserving the importance of shareholder interests in troubled times should prevent managers from agreeing to give the store to creditors upon the occurrence of "material adverse effects" or broadly defined events of default.[218] Limiting creditor power aligns managers' incentives with the goal of corporate wealth maximization.

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218. Creating a "highly leveraged capital structure" imposes a duty to pay principal and interest payments and thus limits or constrains managers in their decision making and allows shareholders or equity holders to retain some control. *See* Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1468 (2006) (citing Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. (PAPERS & PROC.) 323 (1986)).

3. The Equity Trustee's Role and Duties

The equity trustee will represent shareholder interests when the corporation negotiates or reorganizes major loans and when the corporation experiences financial difficulty. This is achieved several ways. First, the equity trustee will participate in loan negotiations to make recommendations about the use of covenants and the definition of events of default. An equity trustee may only be necessary when the corporation is in financial trouble, reorganizes its loan obligations, or negotiates loans considered risky by lenders. If creditors can discern objectively what a risky loan is, the corporation should be able to use the same measures to define by bylaw and agreement when a loan negotiation will require the presence of an equity trustee. Second, the equity trustee will either approve the agreement reached or inform the corporation's shareholders of its disapproval and the grounds therefore. Third, when the corporation reorganizes its capital structure or is in perilous financial waters, the equity trustee will be entitled to all of the financial disclosures creditors receive, and will have responsibility for communicating its impressions of the corporation's financial position and the effectiveness of management to shareholders. Fourth, if the equity trustee believes the directors or officers are breaching their fiduciary duties to the corporation or shareholders, it can sue on the shareholders' behalf. Fifth, the equity trustee will be able to launch proxy contests to seek and vote shareholder proxies at shareholder meetings. This will give the equity trustee a powerful influence in the election of directors who, in turn, choose corporate officers without unnecessarily increasing the shareholders' legal entitlements to power over corporate management. Corporations will require an equity trustee's services in certain, specifically defined circumstances.

4. When the Equity Trustee Is Triggered

For the purposes of this Article, the equity trustee is a device corporations would use when certain circumstances are present that may compromise shareholder interests in favor of those of creditors. I save for another day the question of whether an equity trustee could be used at other times in a corporation's life. Even though the equity trustee will only actively participate in corporate affairs upon the occurrence of certain events, it may be necessary to designate a trustee before the triggers occur. This keeps a well-informed equity trustee at the ready, able to assert itself when its contract so designates. The only other alternative is for shareholders to require the corporation to notify them of the occurrence of triggering events so that they can find and appoint an equity trustee. If an equity trustee is not named before its duties are triggered, managers may not be forthcoming about when an equity trustee could be used, and shareholders may find out too late. This section of the Article discusses two circumstances under which an equity trustee would be particularly useful. The first is negotiation of major loan agreements and the second is when the corporation experiences serious financial difficulty as defined in the equity trustee's agreement or in the corporation's equity trustee provision.

Recall that the initial business risk at issue is the decision to enter into the loan and agree to strict covenants.[219] In such situations, one may argue that management is the shareholder representative. That may be true insofar as the managers are deciding to take a business risk by borrowing money to make an investment they believe will enhance corporate wealth. The managers appear to make the risk-preferring decision for shareholders at that point. If the investment succeeds, the company can repay the loan with cash to spare, and if it fails, the current shareholders will not be around to complain about the creditor control. This failure to account for the shareholder position and the representation of their preferences if the company fails leads to the problem this Article seeks to address.[220] Managers act on the good-faith, but mistaken, belief that they can ignore a separate set of shareholder preferences simply because the creditors would take over as residual claimants.[221]

The shareholder preferences are different and very valuable when the corporation is in trouble. Providing the shareholders a sophisticated, informed representative to participate in corporate decision making when the corporation's debt is set to change or become an issue will serve to balance the creditor interests and potential powers. There are two advantages to this approach. First, creditors will not be able to exercise more power over managerial decision making than shareholders could. Second, shareholder preferences and the benefits of the investment risks they would support are not lost when the corporation is in financial trouble, because a shareholder representative will remain actively interested in advocating and litigating on behalf of shareholder interests, if necessary, long after equity's value has seriously declined. This balance will allow managers to make the decision they honestly believe to be in the best interests of the corporation without fear of retribution from either shareholders or creditors, and will allow managers to exercise independent decision making authority under only the supervision of the board of directors. This is the decision making model corporate law has identified as most profitable.[222] No good reason exists for creditors to dominate managerial decision making, and there is no reason to

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219. *See supra* Part IV.A.

220. Henry Hu suggests that corporations appoint a committee of directors to particularly represent the investment preferences of shareholders. Hu, *supra* note 20, at 367–70. This acknowledges the need for a voice that is particularly devoted to shareholder investment interests, even when a corporation is solvent. Asking a director to change his allegiance, though, from one owing to the corporation as a whole to one devoted particularly to shareholder interests may pose problems. However, I do not recommend changing the fiduciary duties owed by directors or how directors should exercise those duties. Rather, I propose the creation of a separate shareholder representative who can work, without fear of litigation or conflicting interests, entirely for the representation of shareholder preferences in times of financial difficulty.

221. Hu & Westbrook, *supra* note 4, at 1344.

222. DEL. CODE. ANN. tit. 8, § 141(a) (2006) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ."); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("[The business judgment rule] is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.").

believe that such dominance would serve to maximize corporate wealth, because maximization of corporate wealth beyond the point of creditor repayment is not in the creditors' best interests.

The equity trustee will serve to represent the shareholders when corporate debt arrangements are made or altered, and will also be a shareholder representative when the corporation is in the zone of insolvency. The presence of the equity trustee in the zone of insolvency will keep the shareholder voice from falling out of the corporate decision making process and will provide a shareholder representative that has a continued incentive to represent the equity interest even when the value of the equity position is very low or worthless. Because this Article seeks to solve the problems caused by increased managerial risk aversion in the zone of insolvency, I propose to limit the equity trustee to this time in a corporation's life. The zone of insolvency is, of course, difficult to define. Each corporation must do so in a way most appropriate for it, much in the same way they define default with creditors. Perhaps a corporation enters the zone if it does not meet earnings expectations or if it climbs above a certain debt to equity ratio or if a certain percentage of the firm's assets are hypothecated as collateral on a loan. The contours of the zone of insolvency may vary by company or industry, and I will leave it to the appropriately trained professionals to define it for each agreement. Like an indenture trustee on a bond issuance, the equity trustee will receive periodic disclosures from the corporation and remain apprised of its financial condition and major decisions, but will only participate in corporate negotiations when the company's capital structure may change in a significant way, when the corporation plans to take on substantial additional debt or reorganize old debt, or when the firm is experiencing financial difficulty.

5. Why the Equity Trustee Is Effective

One of the more persistent arguments against shareholder activism is that shareholders are relatively unsophisticated and uninformed, and they cannot act with a single, unified voice.[223] Creditors do not have that problem. Appointing a shareholder representative to remain informed about corporate affairs gives the shareholders a single, unitary, sophisticated voice in communicating with management. The use of such a representative moots any advantages creditors may

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223. *See* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 626 (2006). Bainbridge writes:

> Active investor involvement in corporate decisionmaking seems likely to disrupt the very mechanism that makes the public corporation practicable; namely, the centralization of essentially nonreviewable decisionmaking authority in the board of directors. The chief economic virtue of the public corporation is not that it permits the aggregation of large capital pools, as some have suggested, but rather that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. . . . Shareholder activism necessarily contemplates that institutions will review management decisions, step in when management performance falters, and exercise voting control to effect a change in policy or personnel.

Id.

have in monitoring corporate governance. A shareholder representative available to participate in the negotiation of significant credit agreements and to represent the shareholder position even after equity has little or no value, will allow the shareholders to prevent creditors from exercising undue control over management, and will also promote the best interests of corporate wealth maximization, even after specific shareholders have exited the firm. The continuity of the shareholder position that a shareholder representative can provide, can serve to enhance corporate wealth. That only works, of course, if the shareholder representative's voice is one management cannot ignore.

One may ask why we would expect managers or creditor representatives to give any credence to a shareholder representative, particularly in light of the fact that the equity trustee has no directly exercisable authority over corporate management and the powers the trustee could wield are based on the very limited and indirect powers afforded shareholders. The effectiveness of equity committees in bankruptcy, even where the corporation is insolvent and no equity remains, demonstrates how successful a respected professional can be in negotiating some concessions for his client.[224] Of course, the fact that an equity trustee may have the power to motivate shareholders to exercise their voting rights, to sue management derivatively, or to rally public opinion against a certain company's management, makes the trustee's voice impossible to ignore completely. The equity trustee eliminates the shareholders' traditional weakness as a corporate constituency caused by their wide dispersal, inability to confer with each other, and rational apathy.[225] An equity trustee that can summon the power of the shareholders, though effectively and legally limited, is a force to be reckoned with.

There may be some concern that we should not encourage a system in which shareholders are able to receive benefits to which they are not legally entitled, just because they have a particularly effective representative. This is not a valid concern for two reasons. First, creditors have been able to, and have made quite a business out of, effectively reserving for themselves powers that would lead to lender liability[226] if those powers were explicitly reserved to them or exercised. While this Article argues that such powers are not warranted, they are indeed the effect of rigorous bargaining by the interested parties. This Article does not argue that such agreements should be outlawed but, rather, suggests that the parties can reach a more efficient agreement, and one more beneficial to the corporation in the long run, if another constituent's—the shareholders'—interests are more fully considered and actively represented. Second, if, through open bargaining with creditors and managers, shareholders can extract benefits they could not otherwise demand under state law, there is nothing in that outcome that is inconsistent with the tenets or goals of Delaware corporate law, and such a result is likely efficient if it is the product of fair, arm's length bargaining. Such creative bargaining should be favored above agreements imposed on parties by inflexible state law considered and enacted ex ante. As the Coase Theorem tells us, if

224. LoPucki & Whitford, *supra* note 201, at 194–95. *See supra* text accompanying notes 209–11.

225. Rock, *supra* note 64, at 453–64.

226. Baird & Rasmussen, *supra* note 1, at 1235–36.

transaction costs are low, parties will devise an optimal rule through bargaining.[227] Let us now turn to a discussion of the transaction costs imposed by the equity trustee.

6. Another Agent to Monitor

There could be concern that an equity trustee would raise the costs associated with entering loan agreements and operating the company in the zone of insolvency. The proposition adds yet another agent with its own, unique agency costs. Nevertheless, it lowers the agency costs associated with managerial uncertainty and misaligned incentives in times of financial difficulty. The equity trustee is a more closely monitored agent and owes fiduciary duties directly to shareholders. Shareholders know that their interests and only their interests will be represented by the equity trustee. In many ways, the fiduciary duties owed by a trustee to one, identifiable beneficiary—here, the equity position[228]—are easier to enforce than corporate fiduciary duties because of the procedural barriers to shareholder derivative suits that Delaware corporate law has erected. While corporate fiduciary duties have been analogized to the duties owed by trustees, the analogy is not perfect, and enforcing fiduciary duties against traditional trustees is easier than enforcing the same duties against corporate managers who have the benefit of a business judgment rule and a prohibitive litigation scheme. In this way, shareholders could use fiduciary duties to monitor an equity trustee much less expensively and more effectively than they can use the same principles to monitor managers in the first place. Furthermore, the equity trustee will owe fiduciary duties specifically to the shareholders and only to the shareholders. Corporate managers, on the other hand, owe duties to the entire corporate enterprise and so it has become increasingly clear that shareholders cannot use the fiduciary mechanism to defend their position and preferences alone.[229] The bargaining the managers, creditors, and equity trustee will engage in will lower the agency costs associated with trusting that negotiation to the indirectly conferred incentives enjoyed by management. By adding an equity trustee, we add an agent directly monitored by and responsible to shareholder interests—an agent who lowers the overall agency costs associated with leaving managerial decision making exposed to the possibility of significant creditor control.

Further, equity trustees will likely have a number of corporate or corporate–shareholder clients, just like other professionals retained by corporations. This means that various equity trustees would work to build a reputation in the market and would place a high value on maintaining a favorable reputation that is likely to bring more work their way. The importance of their reputation to their ultimate success would serve as a strong check on the agency

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227. Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 15 (1960).

228. *See* Hu, *supra* note 20, at 288–89 (Though many shareholders make up the collective equity interest, the shareholder interest may nevertheless be identified as a singular "beneficiary.").

229. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 298 (1999) ("Corporate law only permits shareholders to bring successful derivative claims against directors in circumstances where bringing such claims benefits not only shareholders, but other stakeholders in the coalition as well.").

costs associated with any kind of fiduciary relationship. Shareholders could obviously sue an equity trustee for breach of fiduciary duty, but the more effective and less expensive check on equity trustee power and incentives will be the importance of an equity trustee's reputation to his, her, or its success on the market.[230] Granted, reputational constraints are not perceived as being very forceful in the wake of the failures of accountants and SEC analysts whose concerns about reputation did not prevent wrongdoing in the case of Enron. An equity trustee's incentives are tied less to the success of the corporation and more to the quality of representation the shareholders get. An equity trustee needs to demonstrate to the market that it is a good monitor, that it effectively communicates important information to shareholders, and that it gives good advice and effectively uses the tools available to it for disciplining management. Furthermore, because, for the purposes of this Article, an equity trustee becomes more active when the corporation is in financial trouble, its reputation will not depend on how well the company appears to be doing to the market. In this way, its reputation will not be as dangerously tied to management's success as those involved in the Enron disaster. An equity trustee's success is also tied to reputation because it depends in part on how effective the equity trustee is in negotiating with managers and creditors on the shareholders' behalf. Only an equity trustee that commands the respect of the leaders in the corporate governance and financial marketplaces will be an effective representative for shareholders.

CONCLUSION

Managers of financially distressed companies face competing interests in deciding how best to operate the firm while also trying to keep their jobs. Creditors can exercise significant control over how a company in the zone of insolvency is run, while shareholders choose to exit the firm and so do not exert their will as forcefully. The loss of the shareholder voice can result in a loss of managerial incentives to make value-maximizing decisions, as already risk-averse managers become even more cautious under the watchful eyes of creditors. Providing a shareholder advocate in the form of an equity trustee to represent equity preferences when a corporation is in severe financial trouble or reorganizes its debt or capital structure can provide a balance against the significant powers reserved by creditors, so that managers remain free to make investment decisions that will maximize corporate wealth.

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230. Whether an equity trustee should be an individual (as a bankruptcy trustee is) or a company or institution (like indenture trustees are) is not certain. The exact formulation of an equity trustee business and the most effective combination of credentials and experience for an equity trustee is left to another article.