

PAYING CEOs IN BANKRUPTCY: EXECUTIVE COMPENSATION WHEN AGENCY COSTS ARE LOW

*M. Todd Henderson**

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I. INTRODUCTION

The ongoing and increasingly vociferous debate about executive compensation boils down to a simple question: whether current compensation practices are a solution to the agency problem created by the separation of ownership and control in large public companies, or, alternatively, attempts by powerful managers to extract rents from underincentivized owners—that

* Assistant Professor, University of Chicago Law School. J.D., University of Chicago Law School; B.S.E., Princeton University. Stephen Bainbridge, Douglas Baird, Saul Levmore, Robert Rasmussen, and Alan Schwartz provided many helpful suggestions, as did participants at workshops at the following law schools: Boston University, University of Chicago, Colorado, Duke, Ohio State, Rutgers (Camden), UCLA, and Vanderbilt. The Russell Baker Scholars Fund and a generous gift from Tom Eggemeier supported this research.

is, evidence of the agency problem itself.¹ Legions of academic articles in law, finance, and economics literature have offered theoretical and empirical evidence in support of both sides of this debate. An entire issue of the *Journal of Corporation Law* was recently devoted to the book-length critique of executive compensation by Lucian Bebchuk and Jesse Fried.² Bebchuk and Fried claim that managers abuse the power of their office to extract rents from the corporation, and that the solution is an increased monitoring role for boards, large institutional shareholders, or both. In other words, reducing agency costs will lead to executive compensation that is lower or takes a different form.

This Article offers a test of this critique and proposed reform by examining compensation practices in firms under financial distress, where agency costs are dramatically reduced as sophisticated investors consolidate ownership interests and assert significant control over firms in precisely the way critics propose will solve the pay problem for all firms. If compensation practices remain largely unchanged in these cases, one might conclude that existing practices are by and large efficient or, at the very least, that proposed reforms to increase the role of boards or institutional investors in order to reduce managerial rent seeking are misplaced or incomplete. The data supports this hypothesis. We see that employment contracts for managers of firms in bankruptcy written by sophisticated investors with controlling stakes in the debtor look nearly identical in form and amount to those written in higher agency cost environments. In other words, this Article argues that reducing agency costs does not cause material changes in the fundamental nature of compensation bargains.

* * *

There are two competing schools in the current executive compensation debate. The so-called optimal contracting school views typical compensation packages as fair and efficient bargains struck between principals (various “owners”) and agents (management). According to this school, employment contracts are designed to align incentives among corporate participants with different risk profiles and investments in the firm, and various market forces (for labor, for products, for control) constrain managerial rent seeking. These forces create a negotiation dynamic that approximates arm’s-length bargaining between managers and owners.

¹ See ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 123 (rev. ed. 1967); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308–10 (1976).

² *Symposium on Bebchuk & Fried’s Pay Without Performance*, 30 J. CORP. LAW 647 (2005); see also LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

Critics—the so-called managerial power school—believe that CEOs are often overpaid and inefficiently paid, and that pay practices represent a taking advantage of, rather than a solution to, the agency problems in large public firms.³ According to this theory, managers are able to extract significant rents because distant, diffuse, and disinterested shareholders are unable or unwilling to discipline managers, and because the board is captured and manipulated by the CEO. A CEO accomplishes this by selecting sympathetic board members and by using a variety of monetary rewards and psychological pressures to make the board a mere instrumentality of her will, especially when it comes to compensation decisions. The obvious solution that follows is to weaken the power of CEOs by partially or completely reuniting “ownership” and “control.” The mechanism proposed for achieving this reunification is empowering either large shareholders (typically so-called institutional investors) or directors to play a more active role in the management of the firm as a counterpoise to management. In both cases, the core idea is to increase the power of shareholders vis-à-vis managers.

With respect to institutional investors, the belief is that if the firm’s equity owners are of sufficient size and sophistication, they will have greater incentives to monitor and discipline otherwise greedy, rent-seeking executives.⁴ This type of reform maps well onto the general agency theory in the modern corporation, with the one hundred percent owner-operated firm on one end of the spectrum and the manager-operated (perhaps dominated) public corporation with thousands of small shareholders on the other end. The theory suggests that, all other things being equal, managers’ ability to extract rents from shareholders increases significantly as one moves along the spectrum in the direction of the manager-operated/dominated firm. The more passive shareholders are, the argument goes, the more and more inefficiently CEOs will be paid, allowing both high pay in cases of low performance and camouflage of actual amounts of pay.

Empowering directors to play a more active role in monitoring management, by mandating independence requirements and so forth, is another example of the proposed reforms. By freeing the board from the clutches of the CEO, it is argued, true arm’s-length bargaining over compensation can take place. In this case, the reunification of ownership and control is achieved through a proxy, that is, the hypothetical disinterested, independent board. The SEC’s proposed reform allowing shareholders to nominate directors via issuers’ proxy materials under certain circumstances is one

³ See generally Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 785–87 (2002) (arguing that compensation-setting practices are distorted by CEO influence over boards, and claiming that CEOs earn more than their marginal contribution to firm value).

⁴ See Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 465–71 (1986) (constructing a model showing that the presence of “large shareholders raise[s] expected profits and the more so the greater their percentage of ownership”).

mechanism through which this reunification can be achieved.⁵ As former Commissioner Harvey Goldschmid lamented at the failure of the SEC to adopt the rule, getting owners more actively involved in policing management “is the single most significant way for investors to dramatically improve corporate governance” and discipline “lazy, ineffective, [and] grossly overpaid CEOs.”⁶

This Article tests the managerial power theory by examining a special case where these proposed reforms are effectively in place and where “owners” are already active in monitoring, advising, or even running the firm—that is, firms reorganizing under Chapter 11 of the Bankruptcy Code or restructuring their debt in private workouts with large lenders. In both cases, supposedly ineffective monitors (captured board members or relatively uninformed or undermotivated shareholders) are replaced with a group of highly sophisticated and motivated owners who have ready access to corporate information, often high levels of involvement in corporate decisionmaking, and are backed up by strong statutory rights and judicial review. As Douglas Baird and Robert Rasmussen recently observed, sophisticated creditors, who are repeat players in corporate reorganizations, “essentially control[] the corporation” when a firm files to reorganize under Chapter 11 of the Bankruptcy Code.⁷ The way that these owners write employment contracts will tell us something about whether agency costs are the cause of allegedly high levels and inefficient forms of compensation.

* * *

While executive compensation articles fill the legal and finance journals, little work has been done on compensation at firms in financial distress. In the finance literature, Stuart Gilson and Michael Vetsuypens examined compensation at seventy-seven financially distressed firms from 1981 to 1987. They concluded that managerial power was substantially weakened in these firms, and that “compensation policy is often an important part of firms’ overall strategy for dealing with financial distress.”⁸ In the legal literature, Lynn LoPucki and William Whitford looked at corporate governance practices at forty-three large firms that filed for bankruptcy from 1979 to 1988.⁹ They concluded that “[i]n the battle to determine the

⁵ Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).

⁶ Phyllis Plitch, *SEC Is Stymied on a Final Rule for Shareholder Access to the Ballot*, WALL ST. J., Oct. 11, 2004, at C3 (quoting SEC Commissioner Harvey Goldschmid).

⁷ See Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1226 (2006) (describing case of Warnaco).

⁸ Stuart C. Gilson & Michael R. Vetsuypens, *CEO Compensation in Financially Distressed Firms: An Empirical Analysis*, 48 J. FIN. 425, 426 (1993).

⁹ Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993).

compensation scheme for management and thereby fix management's incentives, [creditor-monitors] are likely to have the upper hand" in some cases.¹⁰ CEO turnover was also quite high.¹¹ But the study claims that some CEOs were able to use their privileged position as debtor-in-possession (DIP) to extract wealth in excess of their worth—what the authors call a “grab.”¹²

This Article aims to update and extend the empirical work, and to test some of the theoretical predictions about the role agency costs play in determining how and how much executives are compensated, by examining compensation of the CEOs at about eighty large publicly traded firms that filed for bankruptcy or privately restructured their debt from 1992 to 2003. In Part II, the facts about executive compensation and the arguments on both sides of the agency debate are examined briefly to set the stage for the theoretical and empirical contribution of this Article. We see that the evidence and arguments are ambiguous, with some aspects of current practice being better explained by optimal contracting and some by managerial power.

Part III considers the role of large creditors in corporate reorganizations and the burgeoning market for distressed debt, and concludes that these sophisticated investors assume a powerful role in monitoring and disciplining management of firms in distress during the period of this study. The interplay between these two Parts is examined in Part IV, where we consider the theory and practice of compensation decisions at firms in distress. We will see that while management is in a statutorily privileged position vis-à-vis creditors in terms of proposing a reorganization plan and the day-to-day running of the firm, the arguments supporting the managerial power view of compensation bargaining are largely absent in financially troubled firms. Moreover, “recontracting” costs, which could be considered a form of transaction costs, are much lower in financially distressed firms, allowing for a more equal bargaining posture. The theory developed follows the work of Andrei Shleifer and Robert Vishny¹³ and of Luigi Zingales,¹⁴ who argue for a theoretical middle ground that incorporates elements of both managerial power and optimal contracting, concluding that firms aspire to conduct arm's-length bargaining over compensation but that transaction costs prevent continuous recontracting. Finally, we will see that creditors in corporate reorganizations have significant incentives to bargain over CEO compensation because of the importance of (re)setting

¹⁰ *Id.* at 711.

¹¹ *Id.* at 723–38.

¹² *Id.* at 740.

¹³ For a summary of Shleifer and Vishny's work, see John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, 9 FRBNY ECON. POL'Y REV. 27, 28 (2003).

¹⁴ Luigi Zingales, *Corporate Governance*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 497 (Peter Newman ed., 1998).

management incentives to capture and expand the firm's going concern value.

Part V presents the empirical data on CEO compensation in firms under financial distress. Although the managerial power theory suggests that the increased monitoring typical in Chapter 11 cases should lead to lower levels or different types of compensation, or both, the data in this study does not support that conclusion. While overall compensation levels for CEOs fall slightly in and around the time of financial distress, no firm dramatically altered its compensation methods despite the reduction in agency costs. In other words, sophisticated investors with huge stakes in the success of financially distressed firms were no more likely to press for or successfully implement a sustained reduction in CEO compensation or fundamentally change the compensation structure in a way critics argue is self-evidently beneficial to these very investors.

Part VI concludes by considering some implications of these findings. For example, reform proposals claiming that directors or institutional investors would reign in executive compensation, if just given the chance, are incomplete. If vulture investors, banks, and creditors' committees are unwilling or unable to change compensation levels or types, either these contracts are efficient, or more fundamental reforms are warranted if executive compensation is a problem.

II. THE LANDSCAPE OF EXECUTIVE COMPENSATION

There is no question that the last decade was a good time to be the CEO of a large American corporation. The average compensation for CEOs of the largest 1500 publicly traded companies rose from about \$2.5 million in 1992 to about \$6.5 million in 2003 (in inflation-adjusted 2003 dollars), or a growth rate of about 9% per year.¹⁵ This increase caused a flurry of criticism and hand-wringing in academic circles,¹⁶ by the media,¹⁷ by labor unions,¹⁸ and by Congress, where several bills to limit the pay of executives were introduced.¹⁹ As a typical media criticism opined: "Execu-

¹⁵ Calculation based on Compustat's EXECUCOMP database, Wharton Research Data Services (WRDS), <http://wrds.wharton.upenn.edu/>. See also Erin White & Kris Maher, *Companies Tighten the Pinch for White-Collar Compensation*, WALL ST. J. ONLINE, Nov. 2, 2004, <http://www.careerjournal.com/salaryhiring/negotiate/20041102-white.html> (noting that executive compensation grew an average of 5–6% per year, with a 7% increase from 2002 to 2003, to a total of \$2.12 million).

¹⁶ See, e.g., Bebchuk et al., *supra* note 3.

¹⁷ See, e.g., Gretchen Morgenson, *Executive Pay, Hiding Behind Small Print*, N.Y. TIMES, Feb. 8, 2004, § 3, at 1.

¹⁸ For example, the AFL-CIO runs a website devoted entirely to cataloguing allegedly excessive executive pay packages. See AFL-CIO, Executive PayWatch, <http://www.aflcio.org/corporatewatch/paywatch/> (last visited Apr. 24, 2007).

¹⁹ See, e.g., Employee Abuse Prevention Act of 2002, S. 2798, 107th Cong. (2002); H.R. 5221, 107th Cong. (2002).

tive compensation is the cancer of corporate America. [CEOs] have too much power and it has been directed at their own enrichment.”²⁰

The source of this “enrichment” is the use of equity as a form of compensation, which has grown as a percentage of total compensation from 37% to 55% over the past ten years.²¹ A result of this trend “has been to increase CEO pay-to-performance sensitivities by a factor of more than ten times from 1980 to 1999.”²² To some scholars, this is good news, since prior to the advent of equity compensation, risk-averse CEOs with non-diversifiable human capital were paid like bureaucrats, and thus had incentives to build empires (because pay was linked to size), to shirk (because pay was not linked to performance), and to choose less risky projects than shareholders would prefer (because of misaligned risk profiles), all at the expense of maximizing shareholder value.²³

Others, however, lament the specific application of the theory to practice, noting that CEOs with large option packages are being compensated for luck or are able to enrich themselves because the board or Wall Street did not fulfill its monitoring duties or did not understand the full cost or true nature of the option packages. A common objection is that stock options are poorly designed and are over-awarded because directors are beholden to management and do not understand their true economic or accounting costs.²⁴ One recent survey of corporate governance summarized the view this way: “It is widely recognized . . . that these options are at best an inefficient financial incentive and at worst create new incentive or conflict-of-interest problems of their own.”²⁵ While this debate rages on, one unquestioned result of the increase in equity-based pay is the huge increase in the size of CEO pay, and therefore the importance of a legitimate compensation contracting process.

²⁰ Gretchen Morgenson, *Option Pie: Overeating is a Health Hazard*, N.Y. TIMES, Apr. 4, 2004, § 3, at 1 (quoting Robert A.G. Monks, a founder of Lens Governance Advisors).

²¹ Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL’Y 283, 289 (2005), available at <http://ssrn.com/abstract=648682>.

²² Bengt R. Holmström & Steven N. Kaplan, *The State of U.S. Corporate Governance: What’s Right and What’s Wrong?* 10 (ECGI, Finance Working Paper No. 23/2003, 2003), available at http://ssrn.com/abstract_id=441100.

²³ See Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It’s Not How Much You Pay, But How*, HARV. BUS. REV., May–June 1990, at 138, 139–40 (finding very weak pay-for-performance sensitivity in CEO pay during the period from 1975 to 1988; a \$1000 change in corporate value corresponds to a change in CEO compensation of \$2.59).

²⁴ See BEBCHUK & FRIED, *supra* note 2, at 78 (“Whether the problem is conscious favoritism, honest stupidity, or a combination of both, the important fact is that directors have been at least to some extent willing to approve option arrangements that favor managers at the expense of shareholders.”); see also *id.* at 144–46.

²⁵ Marco Becht et al., *Corporate Governance and Control*, in 1A HANDBOOK OF THE ECONOMICS OF FINANCE 83 (George M. Constantinides et al. eds., 2003).

A. *Compensation Theory: "Optimal Contracting" Versus "Managerial Power"*

In theory, firms enter into employment contracts with senior managers to minimize agency costs. Whether the outcome is the product of negotiation or is determined exogenously by the market for managerial talent and other markets, we can say that an efficient employment contract is one that maximizes the net economic value to shareholders less transaction costs and payments to managers.²⁶ The efficiency of any individual employment contract is difficult to measure, however, so judgments about the efficiency of executive compensation are based on theoretical models of the employment contracting process. The debate thus revolves around which model better describes reality.

1. *Optimal Contracting.*—One model, called "optimal contracting," contends that CEOs' compensation packages are specifically designed to reduce agency costs. In this model, common contractual terms, such as option grants, corporate loans, and severance agreements, are best explained as owners' attempts to overcome the tendency of managers to be risk-averse, to shirk, to build empires, to prefer idiosyncratic investments of corporate funds (e.g., saving the environment or local jobs), and to prefer a diversified investment portfolio.²⁷ Individual contracts may deviate from the optimal level because transaction costs make it impractical for firms to recontract continuously with managers over their compensation,²⁸ but "on average [and over time] the system is efficient within transaction costs."²⁹ This is because a variety of market forces—markets for managerial talent, capital, products, and corporate control—preclude managers from earning excessive salaries. In other words, optimal contracting predicts that executive compensation packages are generally those one would expect from arm's-length bargaining for labor between the manager and the firm.³⁰

²⁶ As discussed below, a CEO is "worth" her marginal contribution to the firm, meaning she should be compensated up to the amount she would contribute to firm value in excess of the next best-qualified person for the job. No good method has been yet developed to test this measure of compensation efficiency.

²⁷ See Jensen & Murphy, *supra* note 23, at 149 (describing the incentives for executives not paid like owners).

²⁸ Obstacles to recontracting include the following: (1) the fact that CEO contracts are routinely three to five years in length and include severe early termination penalties; (2) the social and psychological barriers that arise because of the close working relationship between the board and the CEO; (3) the complexity of typical compensation contracts; (4) the opportunity cost of management and board time; and (5) the lack of compensation salience in any given year. See generally BEBCHUK & FRIED, *supra* note 2, at 23–44.

²⁹ Core et al., *supra* note 13, at 28.

³⁰ See Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1872 (1992) (reviewing GRAEF CRYSTAL, *IN SEARCH OF EXCESS* (1991)).

2. *Managerial Power.*—In contrast, the “managerial power” model contends that compensation agreements *systematically* deviate from efficient results because of the ability of managers to manipulate the decision-making process to serve their own interests.³¹ Compensation contracts, we observe, are not attempts to reduce agency costs; rather, they are *evidence* of agency costs.³² Managers are able to extract rents because directors, who are firmly under management control, set their pay, and because shareholders are diffuse and uninterested in corporate governance, generally preferring liquidity to control.³³ A brief outline of the pay-setting process is needed to set the stage.

State corporation statutes vest the power to set the compensation of managers in the board of directors.³⁴ As a practical matter, however, compensation is set by the compensation committee with the input of a consultant, who prepares reports on CEO pay in general and in the specific industry in question, and makes recommendations on levels and types of compensation. Anecdotal evidence suggests that many firm charters delegate the pay-setting function entirely to the compensation committee.³⁵ Shareholder approval of compensation is limited to certain stock option awards because these awards have potential dilutive effects, but it generally amounts to nothing more than a blanket approval of the total number of options available for the entire firm: “Shareholders cannot reject or approve a particular executive’s pay package.”³⁶ Outside of Chapter 11, there are few legal restraints on levels of executive compensation, and those that exist have little bite. For example, courts occasionally review the process by which compensation agreements were reached or their substance, but rarely, if ever, set the agreements aside.³⁷ The Internal Revenue Code also em-

³¹ See BEBCHUK & FRIED, *supra* note 2, at 23–44 (arguing that the pay-setting process is corrupted by CEOs who use the following to their advantage: carrots and sticks to control directors; social and psychological factors inherent in corporate board rooms composed of other current or former CEOs; the limited time board members have to focus on compensation issues; the information asymmetries between board members and CEOs on compensation issues; and the relatively small cost of favoring executives over shareholders).

³² *Id.* at 61–62.

³³ *Id.* at 45–52.

³⁴ See, e.g., DEL. CODE ANN. tit. 8, § 122(5), (15) (2006).

³⁵ See, e.g., *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 53–54 (Del. 2006) (“[U]nder [Disney’s] governing documents the board of directors was responsible for selecting the corporation’s officers, but . . . the compensation committee . . . was responsible for establishing and approving the salaries[,] . . . benefits[,] and stock options . . . of the Company’s CEO and President.”).

³⁶ BEBCHUK & FRIED, *supra* note 2, at 49.

³⁷ See Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 262 (1983) (listing cases). A recent Delaware case has breathed life into the judges-as-saviors view of executive compensation reform because the Chancery Court found a director personally liable for a compensation decision. See *Valeant Pharms. Int’l v. Jerney*, 921 A.2d 732, 736 (Del. Ch. 2007) (holding the director of a firm personally liable for approving bonuses paid to various officers and directors after a corporate spin-off). It is doubtful, however, that this case portends a greater judicial scrutiny of run-of-the-mill compensation contracts since the case involved an extraordinary business

powers the IRS to review compensation levels for reasonableness and compliance with “performance-based” requirements, but there are no cases in which it has done so.³⁸

The managerial power view asserts that executive compensation contracts made through this process are decidedly not negotiated at arm’s length. The specific factors limiting the ability of boards to do so are: (1) the power of the CEO over the appointment of directors; (2) the ability of the CEO to reward cooperative directors;³⁹ (3) the social and psychological influences the CEO has over directors, such as the power of friendship, loyalty, collegiality, and authority;⁴⁰ (4) the cognitive biases of directors that come from being CEOs or former CEOs themselves;⁴¹ and (5) the time and informational barriers most directors face to making an informed and reasoned decision about pay.⁴² The net result, explains one critic who has seen the process from the inside, is that “the negotiations between a CEO and the outside directors who sit on the compensation committee can hardly be called negotiations at all.”⁴³

After claiming to debunk the actual negotiations claim, proponents of the managerial power model then attack the claims that market forces constrain managerial appetites and that compensation agreements reflect the terms the parties would have reached had they bargained. Market forces are ineffective because managers “camouflage” the true nature and extent of their compensation,⁴⁴ and because the stakes, while large for individual managers, are insufficient to have any significant effect on the firm’s cost of capital or to justify a takeover bid to oust greedy managers.⁴⁵ Thus, according to the managerial power model, on one side is the CEO, who controls the compensation-setting process and has strong incentives to design a compensation scheme that will be both self-serving and opaque; and on the other are directors who, despite being the representatives of the shareholders, owe their jobs to the CEO and basically serve at his pleasure, and therefore have every reason to acquiesce since the risk from offending the CEO dwarfs any potential threat from a shareholder derivative suit, proxy contest, or other battle for corporate control.

transaction and the director’s decision invited a high level of scrutiny because he was also awarded bonuses under the approved plan.

³⁸ See Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN’S L. REV. 81, 85 (1998). This may be changing. See Joann S. Lublin, *IRS Is Cracking Down on Abuse of Executive-Bonus Tax Breaks*, WALL ST. J., June 18, 2004, at B5.

³⁹ BEBCHUK & FRIED, *supra* note 2, at 25–27.

⁴⁰ *Id.* at 31–34.

⁴¹ *Id.* at 33–34.

⁴² *Id.* at 36–37.

⁴³ Yablon, *supra* note 30, at 1873 (citing GRAEF CRYSTAL, IN SEARCH OF EXCESS (1991)).

⁴⁴ See Bebhuk et al., *supra* note 3, at 789.

⁴⁵ See *id.* at 777–78.

In addition to criticizing current CEO pay levels, proponents of the managerial power model object to several specific types of compensation on efficiency or fairness grounds. For example, Bebchuk and Fried argue that restricted stock and traditional (non-indexed, at-the-money) options are suboptimal from an efficiency perspective.⁴⁶ The argument is that traditional options do not provide as much incentive bang for the buck as indexed options with a strike price above the current market price.⁴⁷ For example, if an oil firm grants the CEO 100,000 non-indexed, at-the-money options on January 1, and on July 1 the price of oil increases (because of, say, a crisis in the Middle East), causing the firm's stock price to rise \$10 per share, the CEO will earn \$1 million largely thanks to events outside of his control. In addition, because the shares of *all* oil firms will rise, shareholders in this firm get nothing from this payment that they could not have received from holding a diversified basket of oil firm securities. It would be more efficient, the argument goes, to set the strike price above the market price (to give the executive an incentive to increase share value above a certain threshold level), and to link compensation to firm-specific performance by comparing the firm's performance with an index of other firms in that industry. According to critics, managerial power is the only plausible explanation for this result because this compensation design is rather straightforward and yet is not used by firms.⁴⁸ Managerial power theorists suggest the use of improved equity compensation, such as indexed options or performance-based vesting, to increase efficiency and fairness.⁴⁹

B. Reform Proposals—Institutional Investors and Powerful Boards as Saviors

Managerial power theorists favor two approaches to reducing managerial power, and thus reining in executive compensation: an enhanced role in monitoring and disciplining management either for boards or for institutional investors.

1. *Theoretical studies and proposals.*—The argument that institutional investors should actively and systematically monitor executive compensation in healthy firms is contrary to the prevailing wisdom that shareholders generally prefer liquidity to control.⁵⁰ Managerial power theo-

⁴⁶ BEBCHUK & FRIED, *supra* note 2, at 137–46.

⁴⁷ *Id.* at 141–42.

⁴⁸ *Id.* at 138 (“These [traditional option] plans include several important features that are difficult to justify from an arm’s-length contracting perspective.”).

⁴⁹ *Id.* at 141–42. Numerous academic studies have, for many years, supported the use of indexed stock options. See, e.g., Shane A. Johnson & Yisong S. Tian, *Indexed Executive Stock Options*, 57 J. FIN. ECON. 35 (2000) (proposing an option designed to filter out market risk, and thus increase the firm-specific incentive power of the option).

⁵⁰ See John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1281 (1991).

rists, however, claim that larger blockholders may have the right mix of incentives and costs to permit greater market discipline of managers.⁵¹ The typical theoretical model assumes that larger investors have lower information costs, lower per-share costs of action (e.g., mobilizing the proxy machinery), greater signaling credibility, and higher liquidity costs (e.g., more willingness to monitor because of the costs and risks of trading).⁵² Practice deviates from theory, however, since these investors are hamstrung by various laws, regulations, and habits that limit their role in firm oversight.⁵³ This fact has led some observers to suggest reforms that would allow institutional investors to have more influence and provide greater monitoring of firms.⁵⁴

Some suggested academic fixes are merely calls for institutional investors to assume a more powerful role in firm governance. Randall Thomas argues that institutional investors with large ownership stakes “should demand that directors justify executive pay packages as value maximizing for the firm” because owners are the best group to “insist on an accounting” of these costs.⁵⁵ This is echoed by commentators and firm stakeholders, such as labor unions; the actions of several large pension funds, such as CalPERS and TIAA-CREF; and studies suggesting a link between the share of equity owned by institutional investors and corporate governance or firm performance.⁵⁶ The pending “Say on Pay” bill, which would give share-

⁵¹ See generally Shleifer & Vishny, *supra* note 4, at 464–65 (constructing model that shows how, through improving the market for corporate control, “large shareholders raise expected profits and the more so the greater their percentage ownership”).

⁵² See, e.g., Charles Kahn & Andrew Winton, *Ownership Structure, Speculation, and Shareholder Intervention*, 53 J. FIN. 99, 100–02 (1998) (developing a model to examine the choice by institutional investors to intervene or follow the “Wall Street rule” by selling their shares); see also Coffee, *supra* note 50, at 1342–45 (discussing insider trading restrictions that come with monitoring).

⁵³ See Kahn & Winton, *supra* note 52, at 118–19; see also MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 267–76 (1994) (describing how tax law, securities law, and structural aspects of the market limit the ability of institutional investors to provide a meaningful role in corporate governance).

⁵⁴ See generally Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 836–49 (1992) (arguing for an increased role for institutional investors, especially as large blockholders, in choosing board members, approving compensation plans, and changing anti-takeover devices).

⁵⁵ Randall S. Thomas, *Should Directors Reduce Executive Pay?*, 54 HASTINGS L.J. 437, 467 (2003).

⁵⁶ See Shivram Rajgopal & Mohan Venkatachalam, *The Role of Institutional Investors in Corporate Governance: An Empirical Investigation* (Stanford Grad. Sch. of Bus., Research Paper No. 1436, 1997), available at <https://gsbapps.stanford.edu/researchpapers/library/RP1436.pdf> (correlating institutional investor ownership with better monitoring); Sunil Wahal & John J. McConnell, *Do Institutional Investors Exacerbate Managerial Myopia?* (Oct. 30, 1997) (unpublished manuscript), available at http://ssrn.com/abstract_id=47271 (arguing that firms with greater institutional ownership invest more in research and development); see also Willard T. Carleton et al., *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREF*, 53 J. FIN. 1335, 1335 (1998) (empirically verifying TIAA-CREF’s influence on firm governance).

holders an annual advisory vote on company pay packages, is also along these lines.⁵⁷

A more interventionist set of proposals argues for various structural reforms to facilitate institutional investor monitoring. George Dent argues that the “mistreatment of shareholders” can be remedied by creating shareholder committees to control the firm’s proxy process for electing directors.⁵⁸ Dent’s solution is to have the firm’s largest “ten to twenty” shareholders serve on a committee that would, among other things, nominate directors for election. He argues that these shareholder committees would constrain executive compensation by gaining expertise on management issues, nominating directors to represent them, gaining access to better corporate information, and having the right incentives to incur monitoring costs because of their large holdings.⁵⁹

Empowering boards is another proposed solution. Legions of academics believe that effective boards could provide a check on managerial rent seeking.⁶⁰ Effectiveness could be achieved in several ways. Board members could be required to take a bigger equity stake in the firm, making them, in effect, super-empowered shareholders—they would have the pocket-book incentives to act in the interests of shareholders while having the information, access, and voting power of management.⁶¹ Another option would be to create more independence between the board and the CEO so that board members could exercise their own judgments about an executive’s worth and engage in true arm’s-length bargaining.⁶² Yet another option would be making it easier for shareholders to replace complacent or

⁵⁷ See Robert Schroeder, ‘Say on Pay’ Measure Clears First Hurdle in House: Bill Giving Shareholders Vote on CEO, Officers’ Pay Now Goes to Full House, DOW JONES MARKETWATCH, Mar. 28, 2007, <http://www.marketwatch.com/news/story/say-pay-measure-clears-first/story.aspx?guid=%7BA3A50F74-5093-40E8-BB19-451B43085DA1%7D&tool=1&dist=bigcharts&>.

⁵⁸ George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 882.

⁵⁹ *Id.* at 907.

⁶⁰ See BEBCHUK & FRIED, *supra* note 2, at 201 (“Directors who safeguard shareholder interests are needed not only to address executive compensation problems but also to tackle the myriad corporate governance problems that would continue to arise even if compensation arrangements were optimized.”); MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 117–20 (1966) (permitting shareholders holding more than 5% of a firm’s stock to nominate directors in the proxy materials); LOUIS LOWENSTEIN, *WHAT’S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER* 209–18 (1988) (proposing that 25% of directors should be elected by shareholders without any management role or interference).

⁶¹ See Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 652–53 (1995) (noting that empirical studies have shown that firms with substantial director holdings outperform those with lesser director holdings).

⁶² See, e.g., Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 912–13 (1996) (noting that boards are often powerless because they are controlled by management); see also Arthur Levitt, Jr., *Money, Money, Money*, WALL ST. J., Nov. 22, 2004, at A14 (“[E]xcessive compensation . . . packages are a consequence of boards falling victim to a seduction by the CEO.”).

incompetent board members with more active and conscientiously pro-shareholder directors.⁶³ We will see that these proposals are fairly approximated by the use of creditors' committees in Chapter 11, and therefore the compensation practices in bankrupt firms are a test of this proposal.

2. *Empirical Studies.*—Recent empirical research claims to support these proposals. One study finds that “institutional ownership can serve as a monitoring device that affects the structure of executive compensation.”⁶⁴ Another recent study finds that firms with reduced agency costs (e.g., large shareholders, low CEO tenure, small boards, majority independent boards) are less likely to reward CEOs for luck.⁶⁵ This study proceeds on the assumption that “separation [of ownership and control] allows CEOs to gain effective control of the pay-setting process,” and thus allows CEOs to use “entrenchment”—packing the board with friends and allies—and “the complexity of the pay process” to “set their own pay with little oversight from shareholders.”⁶⁶ The authors find less CEO rent seeking (or “skimming”) in “[w]ell-governed firms, such as those with a large shareholder present on the board.”⁶⁷ As a shorthand, the authors describe the presence of a large shareholder as “having a principal around,” which they view as causing firms to link pay more closely with performance.⁶⁸ It is worth noting, as shown below, that Chapter 11 is the prototypical case of “having a principal around.”⁶⁹

The empirical data is far from conclusive. Many studies find no correlation between corporate governance and executive compensation. For example, a study of compensation practices at about 200 firms from 1993 to 1997 shows no evidence of a change in compensation practices despite in-

⁶³ The SEC has proposed but not adopted a rule that would allow shareholders to nominate candidates for director elections under certain circumstances. See Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274). Concerns about special interest directors and the jeopardizing of board functioning by commentators has derailed the proposal. See, e.g., Stephen M. Bainbridge, *A Comment on the SEC Shareholder Access Proposal* 14 (UCLA Sch. of Law, Law & Econ. Research Paper No. 03-22, 2003), available at <http://ssrn.com/abstract=470121> (“Large-scale investor involvement in corporate decisionmaking seems likely to disrupt the very mechanism that makes the public corporation practicable; namely, the centralization of essentially non-reviewable decisionmaking authority in the board of directors.”).

⁶⁴ Jay C. Hartzell & Laura T. Starks, *Institutional Investors and Executive Compensation* 10 (Sept. 2002) (unpublished manuscript), available at http://ssrn.com/abstract_id=236592; see also Parthiban David et al., *The Effect of Institutional Investors on the Level and Mix of CEO Compensation*, 41 ACAD. MGMT. J. 200, 202–06 (1998) (finding that the presence of pressure-resistant institutional investors (i.e., investors with no other business dealings with a firm) leads to lower pay and greater pay for performance).

⁶⁵ Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q.J. ECON. 901, 918–29 (2001).

⁶⁶ *Id.* at 902.

⁶⁷ *Id.* at 903.

⁶⁸ *Id.* at 921.

⁶⁹ See *infra* Part III.B.

creasing shareholder activism.⁷⁰ Another similar empirical study shows no link between criticized compensation practices (for example, resetting option exercise prices lower when stock prices fall and options that are “out of the money”) and poor corporate governance.⁷¹ In fact, one study finds that the number of outside, independent directors on a board is correlated with *higher* levels of executive compensation, perhaps because these directors lack information and expertise to police management in compensation decisions.⁷² While the weight of the recent literature can fairly be said to adhere to the theory of managerial power, as one survey recently concluded, “the data is largely inconclusive.”⁷³

III. THE POWER OF CAPITAL PROVIDERS IN AND OUT OF CHAPTER 11

In Chapter 11, creditors ranging from banks to specialist investors in distressed firms, known as “vulture investors,” take on an array of powers through a mix of contractual and statutory rights. The former come from detailed and extensive covenants provided in new or restructured debt contracts,⁷⁴ and the latter come from the Bankruptcy Code.⁷⁵ The rights of creditors of firms in Chapter 11 typically include: access to corporate information, pre-approval rights for certain investment decisions, participa-

⁷⁰ Marilyn F. Johnson et al., Stakeholder Pressure and the Structure of Executive Compensation 16–17, 38 (May 1997) (unpublished manuscript), available at http://ssrn.com/abstract_id=41780 (finding that pay packages are sensitive to negative media reports and specific lobbying by pension funds (i.e., CalPERS), but not shareholder proposals under Rule 14a-8).

⁷¹ Mary Ellen Carter & Luann J. Lynch, *An Examination of Executive Stock Option Repricing*, 61 J. FIN. ECON. 207, 222 (2001) (“[W]e detect no relation between institutional ownership and the repricing decision.”); see also Ronald C. Anderson & John M. Bizjak, *An Empirical Examination of the Role of the CEO and the Compensation Committee in Structuring Executive Pay* 14, 24–25 (Apr. 2000) (unpublished manuscript), available at http://ssrn.com/abstract_id=220851 (“[There is] no evidence that outside director representation on the [compensation] committee provides incentives that are substantially different from [strong] committees comprising insider or affiliated directors.”); Kam-Ming Wan, *Independent Directors, Executive Pay, and Firm Performance* 23 (EFMA 2003 Helsinki Meetings, June 27, 2003), available at http://ssrn.com/abstract_id=392595 (finding that “there is no support for the notion that non-independent directors entrench CEOs by allowing them to set their own pay” and that there is “no systematic evidence that board composition affects change in CEO compensation”).

⁷² John E. Core et al., *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 385–88 (1999).

⁷³ Michael B. Dorff, *Does One Hand Wash the Other? Testing the Managerial Power and Optimal Contracting Hypotheses of Executive Compensation* 5 (2004) (unpublished manuscript), available at <http://ssrn.com/abstract=574861>.

⁷⁴ See Harry DeAngelo, Linda DeAngelo & Karen H. Wruck, *Asset Liquidity, Debt Covenants, and Managerial Discretion in Financial Distress: The Collapse of L.A. Gear*, 64 J. FIN. ECON. 3, 5 (2002) (describing the use of debt covenants in a case study of the financial distress of L.A. Gear, and concluding that “debt covenants sometimes constrain managerial discretion more effectively than does the pressure to meet cash interest obligations”); see also HILARY ROSENBERG, *THE VULTURE INVESTORS* 19 (2000) (describing the ability of distressed investors to use the Bankruptcy Code’s voting rules to achieve control positions—known as “negative control”—in debtors); Baird & Rasmussen, *supra* note 7, at 1216–17.

⁷⁵ See Baird & Rasmussen, *supra* note 7, at 1236–42.

tion in key personnel decisions, and other actions that look more like day-to-day decisions (which are normally the exclusive province of management) than fundamental corporate decisions (where creditors usually have some say). The net effect, as we shall see in Part IV below, is that fears about managerial power distorting the compensation bargaining process are largely alleviated or mitigated for firms in financial distress.

A. Monitoring and Discipline Outside of Chapter 11

Outside of the Chapter 11 context, investors (large and small) generally do not monitor management closely, preferring liquidity to control.⁷⁶ Building on Albert Hirschman's famous generalization about the choice of "exit" or "voice," John Coffee has described the liquidity of U.S. financial markets as providing an "exit" option [that] weakens institutional 'voice.'⁷⁷ As Coffee observes, institutional investors are supposed to be watchdogs, but they are watchdogs "whose every incentive is to flee at the first sign of trouble."⁷⁸ For the vast majority of firms and investors, this is a perfectly sensible strategy because the costs of monitoring and disciplining management for potentially value-destroying actions are higher than the expected benefits from such action. This may be in part because the costs are real dollar costs, while the benefits may be hard to quantify or even illusory. There are several significant costs of monitoring that are worth examining before we consider whether they are present in the Chapter 11 context.

1. Costs of Monitoring.—First, the characteristics of the modern firm—control vested in risk-averse, opportunistic managers, and ownership held in small shares by diffuse shareholders—create not only the classic agency problem but also collective-action and free-rider problems that inhibit shareholder attempts to limit agency costs. The free-rider problem arises because shareholders are by and large dispersed and hold relatively small stakes in the firm, and therefore each shareholder is unwilling to incur monitoring costs since the benefits will inure to all shareholders without regard to who spent the time or money to monitor.⁷⁹ The presence of a large shareholder (say a mutual fund with a 10% stake) does not solve this problem completely. While this investor may be able to monitor and discipline managers more effectively (because of experience and economies of scale), it will receive only 10% of the expected value of the investment in monitoring and discipline. While one can imagine a scenario in which such an investment might make economic sense, the investor is nevertheless unlikely

⁷⁶ Coffee, *supra* note 50, at 1281.

⁷⁷ *Id.* at 1322.

⁷⁸ *Id.* at 1329.

⁷⁹ See Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 653–54 (1984).

to incur these costs.⁸⁰ This is because the relevant metric is not the absolute expected value of the investment, but rather the cost and return of the next best alternative. The investor can simply and cheaply move its funds to an infinite number of other investments that do not require a speculative investment in monitoring, and yet offer a similar, or even exact, mix of risk and return. In addition, professional investors compete for investment dollars largely on the basis of return net of management fees, and the monitoring expenditures will necessarily lower their performance. Other investment firms can free ride on this investment, earning the same expected return from better management without incurring any of the monitoring costs, resulting in a more attractive return net of costs. In effect, the monitor would be subsidizing its competitors. Accordingly, ignoring the potential ancillary benefits described below, only a one hundred percent owner would rationally invest in expensive management monitoring.⁸¹

Second, even if the free-rider problem can be overcome, say by shareholders pooling their shares or collaborating through contract, effective monitoring is expensive and difficult to execute. A primary barrier is the information asymmetries that exist between managers and investors. The only information available to most investors is the highly ritualized and often opaque information that comes through official, regulated disclosures and public statements, which do not provide sufficient information to monitor key aspects of firm behavior.⁸² As long as managers control the timing and content of information dissemination,⁸³ investors will be at a disadvantage, especially when it comes to attempts to control covert cheating, such as shirking or camouflaged compensation. Moreover, monitoring day-to-day activities of the firm is impractical and unwise, as it defeats the purpose of having agents in the first place and simply moves the locus of decision-making authority to the monitors. It is also fraught with potential risks, such as insider trading liability or limitations on trading (e.g., the Securities Exchange Act's short-swing trading rules that come with access to "inside information").⁸⁴

⁸⁰ For example, a \$1 million investment in monitoring with a 50% probability of yielding \$22 million in shareholder value has a positive expected value of \$1.1 million.

⁸¹ See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983).

⁸² Managerial power scholars note that even board members, who are required by law to be familiar with the financial and strategic state of the firm, are at an informational disadvantage vis-à-vis management. See BEBCHUK & FRIED, *supra* note 2, at 23.

⁸³ Although the securities laws prescribe disclosures in extensive detail and require various filings to be made on a strict schedule, there is compelling evidence that managers manipulate disclosures in self-serving ways. See, e.g., David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73 (2000) (finding that firms manipulate the timing of disclosures to maximize profits on options).

⁸⁴ Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2000).

A third limitation on monitoring is that managers have little reason to heed the requests of shareholders acting alone, given their relatively small stakes.⁸⁵ This can theoretically be overcome through explicit or implicit confederation among shareholders, especially since the SEC has removed barriers to intershareholder communications.⁸⁶ It rarely happens in practice, however, because the costs (of collecting information, monitoring, communicating with other shareholders, reaching an agreement on how to proceed and about what, resolving any conflicts of interest among shareholders, and following through with management) exceed the likely benefits or the cost-benefit tradeoff of the next best alternative, which is to simply sell the shares.

Fourth, there are inevitable conflicts of interest and fears of retaliation that may limit investor voice. Many institutional investors have related divisions that do business with the firms they invest in. An activist role in monitoring the firm and disciplining top management may undermine these ancillary business opportunities in ways that would erase any gains from activism. This may be true not only for cases where there is an existing business relationship that raises a potential conflict, but also in cases where the institutional investor is trying to win future business with the firm. More generally, active monitoring may result in the investor being branded as “anti-management” or in other forms of reputational damage.

A fifth limitation is the heterogeneity of investors’ incentives and potential conflicts of interest. Not all 10% blockholders (such as there are) are created equal. An insurance company can be expected to act quite differently than a mutual fund or pension fund with the same ownership stake in a given firm. While we might expect the insurance company to be quite conservative in its investments of this size, and therefore invest in monitoring in some way (perhaps through contractual means with other shareholders), a mutual fund will likely prefer liquidity because fund managers compete on costs. In contrast, a pension fund’s decisions will perhaps be influenced by political or public policy considerations favored by its union members or its political constituents in the legislature.⁸⁷ Proponents of an increased monitoring and disciplining role for institutional investors recognize this constraint on the effectiveness of this solution, but nevertheless argue that some form of “institutional voice” can be a positive contributor to the socially efficient governance of a firm.⁸⁸ The prerequisite to creating an effective “institutional voice,” according to Bernard Black, is a forum (ei-

⁸⁵ Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 545 (2000).

⁸⁶ See 17 C.F.R. § 240.14a-2 (2006).

⁸⁷ See Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796 (1993) (“Public fund managers must navigate carefully around the shoals of considerable political pressure to temper investment policies with local considerations, such as fostering in-state employment, which are not aimed at maximizing the value of their portfolios’ assets.”).

⁸⁸ Black, *supra* note 54, at 815–18.

ther explicit or implicit) in which “different *types* of institutions . . . join forces to exercise influence” in a way that lets them “monitor each others’ actions” and rely to some extent on reputational penalties to align interests.⁸⁹ This is no small task—a point Black concedes when he calls this a “complicating factor” to his proposal to empower institutional investors to monitor and discipline managers.⁹⁰

Finally, in stark contrast to the costs of trying to exert control, the depth of U.S. capital markets makes exit a more attractive alternative in most cases, underscoring the relatively high cost of monitoring. Capital providers in solvent firms may be less interested in monitoring because they can shift their investments among competing management teams with relatively low transaction costs.⁹¹ In addition, investments in monitoring may *decrease* an investor’s exit options,⁹² thus reducing the liquidity of the investment, and therefore having the perverse effect of *increasing* management’s incentive to shirk or rent seek. If the investor raises the costs of its exit—in effect choosing “voice” over “exit”—it provides management with an assurance that the investor will not sell its shares at the levels it otherwise would have. The more the investor sinks into monitoring management, the less likely (up to a point) the investor will be to sell its shares.

2. *Potential Benefits of Monitoring.*—An investor may receive a limited number of benefits from adopting a monitoring strategy. The most obvious is an increase in the value of a specific investment because the monitoring results in increased shareholder value. As discussed above, this strategy makes the most sense for an owner with a substantial stake. But even in that case, it is unlikely that an investor will engage in monitoring because there is little or no evidence that a specific investment in improving firm governance is a net present value positive investment. In fact, several studies suggest that there is no correlation at all between improved governance and shareholder value.⁹³ Without clear evidence, empirical or otherwise, supporting such an investment, investors are unlikely to pursue it, given that the monitoring costs will be real and typically quite large.

Monitoring is likely to be an unprofitable investment strategy for two additional reasons. First, once an investment firm adopts this strategy, its competitors will know that they can free ride on that investment firm’s

⁸⁹ *Id.* at 817.

⁹⁰ *Id.* at 815.

⁹¹ See Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 291 (1980).

⁹² Although the investments in monitoring may be sunk costs that should be disregarded in a rational exit calculation, it is likely that firms that have invested in the success of a particular firm will be less likely on the margin to abandon the firm notwithstanding the investments. In addition, as discussed above, certain types of monitoring, say taking a board seat, bring with them restrictions on the ability to sell shares. See *supra* note 84 and accompanying text.

⁹³ See Robert W. Hamilton, *Corporate Governance in America 1950–2000: Major Changes But Uncertain Benefits*, 25 J. CORP. L. 349, 367 (2000).

monitoring expenditures. In other words, once Fidelity signals that it is monitoring a specific firm or firms in general, why would Janus spend any money to monitor when it can simply follow Fidelity's investment choices and free ride on its monitoring expenditures? Because investment firms face a highly competitive market, the net effect will be similar returns across competitors, with the monitoring investment firm having higher management fees. Investor cash will flow to the non-monitoring investment firms, who share in the benefits of their competitor's monitoring but incur none of the costs.

Second, because any corporate governance improvements—say splitting the chairman and CEO roles, or indexing the CEO's options—are transparent and easily replicated by other investment firms, any competitive advantages for firms adopting these strategies are unsustainable and therefore unlikely to move the firm's stock price enough to justify any *ex ante* investment.⁹⁴ This is especially true because any benefits from changes in corporate governance are more likely to be revealed only in the long term, when any first-mover advantage will be dissipated as other firms adopt similar reforms. Although in this way overall societal wealth may be increased, no individual investor will care since they compete against other investors for investment dollars, and are unconcerned with total societal welfare.

There are also several potential benefits of monitoring that are unrelated to the return from a specific investment in a given firm, but these are likely to be small or attractive to only certain types of investors. For example, adopting a monitoring strategy may improve the investment firm's reputation among a subset of investors. This amounts to a sort of branding, whereby the investment firm distinguishes itself as an "activist investor." As noted above, investment firms face an extremely competitive market, and if most investors base their decisions on fund managers' performance, as one would expect, this branding strategy is unlikely to be successful over the long run unless the investments in monitoring lead to improved performance. Another potential reason for investing in monitoring is the political benefit that some public pension firms derive from investor activism. This is necessarily limited to a few investors, however, and is unlikely to translate into a broader activism movement.⁹⁵

B. Monitoring in Chapter 11

The cost-benefit analysis of monitoring changes in the Chapter 11 context. When firms are in financial distress, the monitoring costs for owners decrease significantly, allowing, or in some cases effectively requiring, greater participation in the management of the firm.

⁹⁴ This demonstrates a potentially large cost of a robust mandatory disclosure regime.

⁹⁵ See Romano, *supra* note 87, at 811–20 (noting that federal laws such as ERISA, which apply only to private funds, limit the ability of private funds to engage in certain forms of investor activism).

The primary effect of bankruptcy is, in almost all cases, to wipe out the claims of the distant, diffuse, and disinterested shareholders, and to leave only sophisticated investors, such as banks, insurance companies, hedge funds, and bondholders. These investors are specialist, repeat players in workouts or distressed investing. They achieve control either by buying significant blocks of a firm's outstanding debt or by agreeing to loan the debtor additional funds, subject to restrictive debt covenants that grant the lender contractual control of many of the firm's activities. In most cases, the holders of bank debt consolidate their interests in and around financial distress by creating a single credit facility that reorders the existing debt of many providers and pumps new cash into the debtor.⁹⁶ A similar consolidation happens with the bond debt, which vulture investors buy up in order to secure a blocking position in the reorganization process.⁹⁷

These banks and vulture investors take an active role in the governance of the distressed or bankrupt firm because the costs of monitoring and discipline decrease and the benefits increase. The vulture investors, for example, are "frequently active on boards and in management of target firms,"⁹⁸ gaining "sufficient power in these companies to discipline management."⁹⁹ The same is true for banks and other institutional creditors, who, through the use of a revolving credit facility with restrictive covenants, "essentially control[] the corporation."¹⁰⁰ The costs of monitoring for investors decrease because of the powers they wield by statute, regulation, and contract, as well as through the more robust judicial oversight by the bankruptcy court.

⁹⁶ See Baird & Rasmussen, *supra* note 7, at 1226 (describing the case study of Warnaco in which financial distress resulted in a single credit facility with strong creditor control rights being established, and the banks being given control of the corporation).

⁹⁷ A creditor holding more than 33% of the claims in a class has a blocking position and can effectively hold up approval of any plan. See 11 U.S.C. § 1126(c) (2006) (approval by two-thirds in amount, and one-half in number, of claims is needed for approval of a plan). Because creditors rarely hold such large stakes in firms, without some way for creditors to buy claims from other creditors, no single creditor can achieve this leverage position vis-à-vis management. Prior to 1990, the market for distressed debt and claims was severely limited because courts scrutinized attempted transfers of ownership stakes to the point that it impeded the development of a market for these claims. This changed in 1991 when the Advisory Committee on the Rules of Bankruptcy Procedure amended Rule 3001(e)(2) to allow claims to be traded without the court's approval. As one observer notes, "[b]efore [1990], there was no secondary market for distressed bank debt But, by the late 1990s, an investor could buy defaulted loans through practically any bank or brokerage firm." ROSENBERG, *supra* note 74, at 19. This market allows turnaround specialists to play an active role in the outcome of Chapter 11 reorganizations by permitting debt to flow to those most willing to use it to create a blocking position and exert influence over management. According to a partner at a leading distressed-debt investment/turnaround shop, "I can't think of a big-time deal in the past ten years that didn't involve substantial participation, if not total control, by major vultures and banks." Telephone Interview with New York-based distressed-debt investor (June 5, 2004).

⁹⁸ Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401, 409 (1997).

⁹⁹ *Id.* at 402.

¹⁰⁰ Baird & Rasmussen, *supra* note 7, at 1226.

The reduction in monitoring costs and the increase in benefits are evident when looking at how creditors behave in monitoring firms that are reorganizing under Chapter 11.

1. Consolidating Ownership Interests Reduces Monitoring Costs.—

The primary source of reduced monitoring costs is the consolidation of creditors' ownership interests when a firm files for reorganization. This consolidation reduces, or even solves, several of the problems identified above, including the free-rider problem, the informational asymmetries, and the weak institutional voice caused by interowner coordination costs. Consolidation is achieved in two primary ways: the consolidation of bank debt into a single credit facility, and the use of creditors' committees to provide a lower-cost forum for other claimants to exercise a voice.

*a. Consolidating bank debt.—*Healthy firms typically have many capital providers, from millions of individual equity owners to large, institutional investors of many flavors, including many mutual funds, hedge funds, insurance companies, and banks. The only significant outside constraints on management behavior, aside from labor, capital, and product markets, are the fiduciary duties running to shareholders and the covenants contained in various indenture contracts with banks.¹⁰¹ Chapter 11 alters this picture in two primary ways. First, it generally wipes out the interests of equity holders, shifting management's fiduciary duties from shareholders to debt holders.¹⁰² Second, it produces a consolidation of the bank debt. The debt of healthy firms is usually held by numerous banks and other institutional debt holders, none of which has a dominant share of the firm's debt. When a firm becomes severely financially distressed, however, these many creditors typically "morph into a single revolving credit facility."¹⁰³ One large bank or consortium of banks agrees to provide new cash and to restructure existing obligations subject to new contractual terms that grant the bank or consortium of banks an increased role in the governance of the debtor. When firms face financial distress, the need for new infusions of cash puts the debtor at a disadvantage vis-à-vis creditors willing to extend new financing. These lenders "use the terms of [the] loans to shape the

¹⁰¹ Many firms are also governed by industry-specific regulations that restrict the overall management decision space.

¹⁰² Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations that are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COM. L.J. 295, 300–01 (2004); see also *Unsecured Creditors Comm. of STN Enters., Inc. v. Noyes (In re STN Enters., Inc.)*, 779 F.2d 901, 904 (2d Cir. 1985); *Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm'ns Corp.*, No. 12150, 1991 WL 277613, at *32–33 n.55 (Del. Ch. Dec. 30, 1991) (noting the diverging interests of creditors and stockholders in the vicinity of insolvency).

¹⁰³ Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 696 (2003).

Chapter 11 case,” effectively “constrain[ing] the debtor’s managers’ wiggle room.”¹⁰⁴

These new credit facilities give creditors access to better information than shareholders usually receive, putting them in a much better position to monitor management activities.¹⁰⁵ The loan agreements are also typically replete with specific contractual restrictions on the activities of the debtor.¹⁰⁶ Standard terms include the right of the creditor to monitor firm cash flows closely (which also equalizes any informational asymmetries¹⁰⁷), to have veto rights over major investments, and to insist on a change in management personnel or incentives, including hiring a turnaround specialist. In addition, the unification of ownership in a single agreement allows creditors to enforce these contractual terms more easily and in a less costly manner. The overall effect is to give the creditor(s) behind the revolving credit facility “practical control” over the debtor and to “ensure that no major decision is made in a way that [the creditors] find[] objectionable.”¹⁰⁸ As Baird and Rasmussen described a recent reorganization, “[o]nce the revolving credit facility was in place, control rights had shifted . . . [and f]rom that point forward, the banks that ran the revolving credit facility essentially controlled the corporation.”¹⁰⁹ The firm’s capital providers, once relegated to the choice of accepting management actions or selling their shares, now have the powers “normally reserved for directors,” including “whether to sell a division, change the business plan[,] or replace the managers.”¹¹⁰

b. Consolidating unsecured debt: the creditors’ committee.— Creditors can also greatly reduce their monitoring costs by forming one or more committees to represent their interests during the reorganization.¹¹¹ These creditors’ committees are formed under section 1102 of the Bankruptcy Code, with the holders of “the seven largest claims against the

¹⁰⁴ David A. Skeel, Jr., *Creditors’ Ball: The “New” New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 925–26 (2003).

¹⁰⁵ Baird & Rasmussen, *supra* note 7, at 1226–27 (describing the use of these techniques in the financial distress of Warnaco).

¹⁰⁶ *Id.* This phenomenon is also increasingly prevalent in solvent firms, although with fewer control rights and with less power than in bankrupt firms. See generally Michael R. Roberts & Amir Sufi, *Control Rights and Capital Structure: An Empirical Investigation* (Jan. 31, 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=962131> (showing empirical evidence that lenders use control rights to shape corporate policies outside of bankruptcy).

¹⁰⁷ Baird & Rasmussen, *supra* note 7, at 1229 (“A creditor can now acquire a valid security interest in all of a debtor’s assets and ensure that all of the cash coming into the corporation and leaving it passes through its hands By virtue of controlling the business’s cash flow, the creditor is less dependent upon the debtor to tell it what is going on.”).

¹⁰⁸ *Id.* at 1241.

¹⁰⁹ *Id.* at 1226.

¹¹⁰ *Id.* at 1227; see also ROSENBERG, *supra* note 74, at 24.

¹¹¹ LoPucki & Whitford, *supra* note 9, at 680 (“To deal with [the collective action] problem, the Bankruptcy Code provides for the appointment of committees of creditors . . .”).

debtor” for each type of claim handled by a specific committee representing the entire class of such claims.¹¹² These committees are a decisionmaking forum for the creditors with the largest financial incentives and the most resources to devote to monitoring. This system largely overcomes the collective-action and free-rider problems that keep small, diffuse shareholders from being effective monitors.¹¹³ The committee structure does this by lowering the costs of collective decisionmaking through clear legal rules.¹¹⁴ Committees also create a single investor voice, with weight, that the debtor simply cannot ignore. After all, the creditors’ committee is the mechanism through which the debtor’s reorganization plan must be approved,¹¹⁵ and the committee is entitled to petition the bankruptcy court for redress as a party in interest in the event that management does not listen to them.¹¹⁶

Creditors’ committees also reduce intercreditor communication costs. Committees operate within a richly developed legal framework of statute, case law, and custom, in which communication costs are lower, and decisions can be made more quickly and efficiently.¹¹⁷ Creditors on the committee are represented by counsel experienced in debt restructurings and can freely communicate and work together to serve the interests of their class of creditors. Committees hold frequent meetings, engage in strategic and business planning parallel to management, and routinely communicate with both the debtor and the court overseeing the reorganization. The committee structure therefore has the advantage of providing straightforward decisionmaking rules for settling intercreditor disputes, thus reducing creditor transaction costs tremendously.

The committee structure benefits creditors who serve on the committee, but also provides a centralized forum that reduces communication costs for creditors who are not on the committee. Many sophisticated investors choose not to serve on creditors’ committees because access brings with it inside information, and may thus be offset by a concomitant obligation to

¹¹² 11 U.S.C. § 1102(b)(1) (2006).

¹¹³ See LoPucki & Whitford, *supra* note 9, at 680 (noting that the Bankruptcy Code allows shareholders to bypass a collective action problem by hiring professionals to represent them, passing the cost on to the debtor corporation).

¹¹⁴ Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 465 (1991) (“A group can surmount a collective action problem if pre-existing organizational structures can be converted to provide the collective good at a sufficiently low cost or the collective good can be provided as a by-product of an organization based on other, often private, incentives.” (citing MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 132–35 (2d ed. 1971))).

¹¹⁵ 11 U.S.C. §§ 1102–03.

¹¹⁶ *Id.* § 1109(b).

¹¹⁷ For example, the Code requires a meeting of creditors (the “section 341 meeting”), which is typically held twenty to forty days after the petition is filed. This meeting is run by the United States Trustee and must be attended by the debtor, who is questioned under oath about the case. *Id.* § 341. Once the committee is formed, it routinely elects a chair, engages counsel and other advisors, and sets up a meeting schedule and information-sharing protocol.

refrain from trading securities of the debtor.¹¹⁸ Because of the fear of potential liability for insider trading, many investors find other, indirect, ways to be influential.¹¹⁹ One distressed firm investor, James Rubin of Sass, Lamle, Rubin & Company, describes his ability to operate outside the committee structure by using subtle pressure and the power of suggestion to influence those on the committee or within the firm: “The longer I’ve been involved in this business the less necessary it’s been for me to serve on committees to be influential.”¹²⁰

Committees also allow creditors to overcome the informational asymmetries that owners usually have with managers. Committees have statutory powers to collect and process information relevant to running the firm, all at the expense of the debtor. For example, section 1103(c) of the Bankruptcy Code grants creditors broad powers to form committees to pool their power and to (1) consult with the DIP; (2) investigate “the acts, conducts, assets, liabilities, and financial condition of the debtor, [and] the operation of the debtor’s business”; (3) participate in formulation of a reorganization plan; and (4) “perform such other services as are in the interest of those represented.”¹²¹ Creditors, through their committees, also have the statutory power to appoint legal, financial, and strategic advisors, all of whom will be paid from the assets of the debtor.¹²² The debtor often consults the creditors at every stage before making key decisions. As stated in the reorganization plan of Silicon Graphics: “The Debtors have informed the Creditors’ Committee with respect to their operations and have sought concurrence of [the committee] for actions . . . outside of the ordinary course of business.”¹²³

In practice, sophisticated investors in modern reorganization cases typically do their own strategic and financial assessments of the debtor. They also assess investment opportunities, create business plans, and perform valuation and liquidation analyses. In short, creditors, whether vulture investors, banks, or insurance companies, set up a parallel management team—at little or no cost to them—that allows them to ensure that management decisions will maximize value for owners.

¹¹⁸ See *In re Allegheny Int’l, Inc. (Allegheny II)*, 118 B.R. 282, 298 (Bankr. W.D. Pa. 1990); see also Shawn Young, *SEC Probes WorldCom Creditors-Committee Trades*, WALL ST. J., Sept. 20, 2004, at A3.

¹¹⁹ There is a concern among distressed-debt investors that at some point “claim purchases start to equate to a *sub rosa* Chapter 11 plan, requiring the imposition of the Bankruptcy Code’s disclosure, classification, and equal treatment rules.” Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569, 585 (2002).

¹²⁰ ROSENBERG, *supra* note 74, at 31.

¹²¹ 11 U.S.C. § 1103(c).

¹²² *Id.* § 1103(a) (authorizing creditors’ committee to hire advisors); *id.* § 328(a), (c) (authorizing (and limiting) compensation of advisors retained under section 1103).

¹²³ Disclosure Statement For Debtors’ First Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code at 35, *In re Silicon Graphics, Inc.*, No. 06-10977 (Bankr. S.D.N.Y. July 27, 2006), available at http://www.sgi.com/reorg/disclosure_statement.pdf.

2. *The Impact of Financial Distress on Other Monitoring Costs.*—

The other monitoring costs identified above are also substantially mitigated in firms reorganizing their balance sheets under Chapter 11 or privately with creditors. Let us look at each briefly in turn. First, there are the possible conflicts of interest that arise when an institutional investor is not only an investor in a firm but also has or would like to have other business relations with that firm. While this may limit investor activism outside the Chapter 11 context, it is much less likely to limit monitoring by distressed-debt investors or creditors that provide DIP loans. Vulture investors are typically not affiliated with a large investment house, and are not routinely engaged in other types of business activities, such as commercial lending, consulting, or accounting.¹²⁴ These investment shops tend to be small, leanly staffed, and highly specialized in distressed investing. They are interested solely in profiting from an increase in the price of the bonds they purchased at pennies on the dollar, or in turning around the debtor and profiting from the post-emergence rise in equity value. “We are not interested in making friends with management so we can sell them advice or deals later on,” said a partner at a New York vulture fund. “We are repeat players, but not with them. At least we and they hope not.”¹²⁵

The large banks and other creditors that participate in establishing a new or restructured revolving credit facility are also unlikely to be deterred by conflicts of interest, but for different reasons. These creditors do have other business prospects that could be hurt by an aggressive, anti-management reputation, but any reputational hit is likely to be offset by the reputational benefit the investor will reap as a result of its willingness to provide additional capital to the firm in its time of dire need. A distressed-debt specialist at a large commercial bank put it this way: “We are heroes to these guys for extending them a life line. I don’t think they begrudge our increased presence; they recognize that our heroism has a price.”¹²⁶

Another impediment to monitoring that is reduced in Chapter 11 is the ease and low cost of investor exit. While the market for the debt and trade claims of distressed firms is growing, it remains a small component of traditional debt and equity markets, and is inhabited largely by firms that specialize in this type of investing.¹²⁷ In addition, the inside information these

¹²⁴ Even when these firms are affiliated with bigger institutions, so-called Chinese Walls are put in place to keep the information and activities of the relevant divisions separate. This is done to limit potential insider trading liability, so these barriers are taken seriously by the firms.

¹²⁵ Telephone Interview with managing director of New York-based distressed-debt fund with over \$2 billion in assets under management (Mar. 5, 2004).

¹²⁶ Interview with vice president of New-York based global commercial bank (Apr. 3, 2004). Interview conducted in person at bank’s offices.

¹²⁷ According to Professor Edward Altman at the New York University School of Business, in 2003, the defaulted- and distressed-debt market had a market value of about \$370 billion. See Prof. Edward Altman, Presentation at the GFA Seminar at the N.Y. Univ. Stern Sch. of Bus.: Defaulted Bond & Bank Loan Markets and Outlook (Mar. 29, 2004) (PowerPoint presentation available at

investors typically obtain as a necessary element of their turnaround efforts limits their ability to exit without having to disgorge their profits or face other legal sanctions. Until very recently, creditors serving on a creditors' committee were unable to trade bonds in the secondary market because such trading would likely be construed as insider trading or, at the very least, in conflict with the duties owed by the committee members to the estate of the debtor.¹²⁸

Finally, Chapter 11 largely solves another element of the collective-action problem for investors—namely, the heterogeneity of interests across investors that constrains agreement about the proper size and scope of monitoring activities. The use of a unitary revolving credit facility or the domination of a creditors' committee by a vulture investor solves the heterogeneity problem, more or less, and is as close as we can come to aligning perfectly the interests of ownership and control short of the owner-operated firm.

* * *

In sum, managers of a financially distressed firm are subject to oversight by creditors, bankruptcy trustees, shareholders, and even courts in ways that those of healthy companies are not. These actors have significantly lower costs of monitoring and increased incentives to monitor the distressed firm's management. As one commentator recently observed: "The mere presence of flocks of vultures in the market has fundamentally changed the dynamics of bankruptcy from a situation in which management has an overwhelming advantage to one in which these new creditors have great sway."¹²⁹ Chapter 11 thus represents a situation in which ownership and control are partially or even mostly reunited.¹³⁰ The "owners" of the firm are effectively in control of the management, at least with respect to the major decisions facing the firm. "[C]reditors have increasingly exercised de facto control" over firms reorganizing under Chapter 11.¹³¹

http://pages.stern.nyu.edu/~gfa/resources/distressed_investing.ppt). This is trivial compared with the size of U.S. debt and equity markets, which are tens of trillions of dollars each. See Tony Tassell, *Europe Tops US in Stock Market Value*, FIN. TIMES, Apr. 2, 2007 available at http://www.ft.com/cms/s/bf6a00e4-e14b-11db-bd73-000b5df10621_i_rssPage=6700d4e4-6714-11da-a650-0000779e2340.html (estimating the value of U.S. equity markets as \$16 trillion).

¹²⁸ This is starting to change somewhat. Courts are increasingly willing to approve trading by committee members if strict procedural mechanisms are put in place to keep confidential information obtained through the committee process from being used in trading. See Terry Brennan, *FiberMark Creditors to Keep Trading*, THE DAILY DEAL, Oct. 21, 2004.

¹²⁹ ROSENBERG, *supra* note 74, at 17.

¹³⁰ Vulture investors also have the advantage of being newcomers to the firm. As Frank Easterbrook observes, "[n]ew investors are better than old ones at chiseling down agency costs" because they can readily observe managerial performance prior to investing. Easterbrook, *supra* note 79, at 654.

¹³¹ Skeel, *supra* note 104, at 922.

IV. BARGAINING FOR COMPENSATION IN THE SHADOW OF CHAPTER 11

Turning the focus to executive compensation, the predominant theory is that “the principal beneficiaries of Chapter 11 . . . are corporate managers” who are able to “expropriate for themselves the wealth of [the firm’s capital providers].”¹³² This view is difficult to square with the monitoring story just described. If the rent-seeking theory is true—that is, if managers are able to entrench and enrich themselves in excess of their worth to the firm—they would have to do so under the watchful eyes of sophisticated investors who specialize in turning around distressed firms, who have voluntarily agreed to take a financial stake in the outcome of the firm, and who, through a variety of statutory and contractual rights, have a dominant say in how the firm is managed. This weakness in the predominant theory highlights a tension between Chapter 11’s preference for debtor-controlled reorganization and the role of vulture and DIP lender monitoring in reorganizing firms. Nowhere will this tension be more prevalent than in the issues about who should manage the firm and how these individuals should be incentivized.

A. *Bargaining Dynamics*

The traditional view of executive compensation in bankruptcy is that managers are at least as powerful as they are in healthy firms, and thus are able to enrich themselves at the expense of shareholders and creditors. A recent news report expresses the common outrage: “When failing companies ask employees to take huge pay cuts, when they’re laying off thousands of wage-earners, when they’re slashing pension benefits, it’s astonishing that the top executives of those companies are still enjoying stratospheric compensation packages.”¹³³

Many academic accounts of bankruptcy share this premise that managers are in a privileged position and are able to profit excessively from failing firms. According to these accounts, the Bankruptcy Code’s preference for management operation of the debtor allows managers to extract rents in the form of higher salaries, big option grants, and lavish retention and emergence bonuses.¹³⁴ The bankruptcy reform passed by Congress in 2005 codi-

¹³² Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1049–50, 1052 (1992) (emphasis omitted).

¹³³ Gail Schoetter, *CEO: Constant Excessive Outrages*, DEN. POST, Apr. 27, 2003, at E05 (opinion of Gail Schoetter, former U.S. Ambassador, Colorado lieutenant governor and treasurer, and corporate board member).

¹³⁴ See, e.g., Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1836–37 (1998) (“[F]irms operate under their current management during the pendency of a Chapter 11 reorganization and can manipulate the process to shift wealth to themselves.”); see also Lucian A. Bebchuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J.L. ECON. & ORG. 253, 267–68 (1992) (arguing that the control of the bankruptcy agenda is valuable, and noting that managers, acting in the interests of either equity or debt, can use this to their advantage to extract rents).

fies this view, to a certain extent, by restricting firms' abilities to pay executives in bankruptcy in significant ways.¹³⁵

The bargaining dynamic for compensation in bankruptcy, however, has changed significantly in the years since Michael Bradley and Michael Rosenzweig's analysis.¹³⁶ In order to better understand whether managerial power is reduced in Chapter 11 compensation negotiations, we must examine the pay-setting process for financially distressed firms. CEOs of almost all firms (healthy and distressed) are routinely employed under multi-year contracts, which include generous termination provisions, or "golden parachutes," in the event the firm breaches the contract or fires the CEO for any reason.¹³⁷ Moreover, these contracts routinely have accelerated vesting clauses for stock option plans, corporate loans, and deferred compensation, which are costly for firms to pay out or unwind.¹³⁸ These penalties limit the ability of healthy firms to reset CEO compensation levels based on changed circumstances, such as decreased firm or individual performance over the three to five years of the contract. These recontracting costs are a potentially significant impediment to healthy firms reaching efficient outcomes with respect to employment contracts; the net effect is a substantial disincentive for firms to terminate or renegotiate CEO contracts. According to several finance scholars, these recontracting costs are the primary source of inefficiency in the executive compensation market.¹³⁹

Recontracting costs are reduced, if not eliminated, when a firm enters Chapter 11 because CEO contracts are voidable by the debtor, no matter how they are written, how long they have remaining in their term, or what type of compensation they provide.¹⁴⁰ Nearly all compensation agreements, including employment contracts, retention agreements, and golden para-

¹³⁵ For example, section 503(c)(1) prohibits debtors from paying retention bonuses to insiders absent a finding by the court that: (A) the insider has a bona fide job offer from another firm at the same or higher amount of compensation; (B) the services to be provided are essential to the debtor's survival; and (C) the amount paid is not greater than ten times the average amount paid to nonmanagement employees. 11 U.S.C. § 503(c)(1) (2006).

¹³⁶ See Bradley & Rosenzweig, *supra* note 132 and accompanying text.

¹³⁷ A recent survey by compensation consulting firm William M. Mercer, Inc., found that over 80% of CEOs had employment contracts in 1998, most with generous severance packages in the case of early termination. See Valerie Patterson, *Employment Contracts Attract Top Executives*, CAREERJOURNAL.COM, Sept. 15, 1998, <http://www.careerjournal.com/myc/negotiate/19980915-patterson.html>; see also Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 WASH. & LEE L. REV. 231, 246-54 (2006) (cataloguing the use and nature of termination provisions of CEO contracts).

¹³⁸ This assertion is based on an examination of such contracts for this study. Such contracts are similar both inside and outside of bankruptcy. See *infra* Part V.

¹³⁹ See Core et al., *supra* note 13, at 28.

¹⁴⁰ See 11 U.S.C. § 365(a) (providing for rejection of "executory contracts" by debtor); *Gouveia v. Tazbir*, 37 F.3d 295, 298 (7th Cir. 1994) (noting that the lower court held that "executory contracts typically include . . . employment contracts" and that executory contracts involve future acts); see also Sarah C. Lichtenstein, *Termination of Employment Contracts in Bankruptcy*, 213 N.Y. L.J., Apr. 17, 1995, at 1 (noting that the Bankruptcy Code caps damages resulting from termination of employment contracts).

chutes, are voidable by the bankrupt firm, either as executory or pre-petition contracts.¹⁴¹ This creates substantial uncertainty and nervousness on the part of executives,¹⁴² who often have tens or hundreds of millions of dollars at stake under these contracts. This nervousness is justified; with recontracting costs near zero, CEO contracts are often rejected by the debtor when the firm first enters Chapter 11.¹⁴³ There are, of course, still social and psychological pressures on leftover directors that can be costs that limit recontracting. But these are reduced or eliminated as well because sophisticated creditors often replace incumbent directors and take an active role in key decisions, such as those regarding executive compensation.¹⁴⁴

Creditors of the debtor often drive a firm's decision to tear up a CEO's contract and actively negotiate a new one. Firms entering bankruptcy develop compensation strategies for rank-and-file employees and for senior executives. The former are routinely maintained at pre-bankruptcy levels through a first-day "wage and benefit order" that is rarely disputed by the creditors' committee and is almost always approved as a matter of course by the bankruptcy court.¹⁴⁵ Compensating the CEO and other top managers is more contentious for several reasons.

CEO compensation packages are nontrivial costs for creditors trying to squeeze every penny out of the debtor, especially for the firms examined in this Article, which are relatively small and highly unprofitable. According to compensation consultants, lawyers, and distressed investors interviewed for this Article, direct costs alone are often sufficient to warrant additional attention from creditors. Not only are cash costs significant for creditors,¹⁴⁶ but their importance is amplified by the fact that creditors are fighting for every penny. As one workout lawyer said:

It's a dollar lost or a dollar gained You're getting 10 cents on the dollar on your claim and they want to give \$10 million to the person who undoubt-

¹⁴¹ See, e.g., *In re* FBI Distrib. Corp., 330 F.3d 36, 42 (1st Cir. 2003) (citing 11 U.S.C. § 365).

¹⁴² See, e.g., Amanda Bennett, *Protecting Unsecured Pensions and Pay Becomes a Priority for Firms Under Fire*, WALL ST. J., May 21, 1987, at 31.

¹⁴³ See Edison Bros. Stores, Inc., Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (Form 10-K), Exhibit 2 at § 7.4 (May 1, 1997), available at <http://secinfo.com/dUQx.8d.d.htm#3h2v> (assuming all compensation plans); Joint Plan of Reorganization Under Chapter 11, Title 11, United States Code of Sterling Chemicals Holdings, Inc., et al., Debtors at § 7.5, *In re* Sterling Chemicals Holdings, Inc., No. 01-37805 (Bankr. S.D. Tex. Oct. 14, 2002), available at <http://www.secinfo.com/dsvRu.35Pc.d.htm> (rejecting some components, assuming others); Joint Chapter 11 Plan of Reorganization of the Debtors in Possession and the Official Committee of Unsecured Creditors of SLI Inc. at art. V.E, *In re* SLI Inc., No. 02-12608 (Bankr. D. Del. Apr. 17, 2003), available at <http://www.secinfo.com/dsVsj.21C9.d.htm#1ump> (rejecting all compensation contracts).

¹⁴⁴ See *infra* Part IV.A.2.

¹⁴⁵ This is based on anecdotal evidence from discussions with bankruptcy practitioners at several New York and Chicago law firms.

¹⁴⁶ In 2000, CEO compensation amounted to about 8% of corporate profits and about 17% of dividends. See STEVEN BALSAM, AN INTRODUCTION TO EXECUTIVE COMPENSATION 262 (2002).

edly played a role in the company filing for bankruptcy Of course, your clients get upset.¹⁴⁷

Perhaps even more important than these direct costs, however, are benefits that come from finding the right executives and setting high-powered incentives for developing an effective reorganization plan, maintaining the debtor's business during Chapter 11, and setting a successful business strategy for the firm. In addition, there are potentially significant intangible benefits from renegotiating CEO pay levels during reorganization. Cutting executive pay is one of the surest ways to signal to creditors, customers, competitors, and the courts that a firm is serious about change.¹⁴⁸ According to one practitioner, creditors "want to assert [themselves] early on to show that [they] are going to be driving the bus."¹⁴⁹

For these reasons, creditors often take the lead in renegotiating CEO contracts in bankruptcy. These contracts are a crucial part of the reorganization plan, and are often negotiated over several months. The importance of CEO employment contracts to creditors is apparent from the fact that they are regularly included in reorganization plans and other public filings.¹⁵⁰ As one vulture investor interviewed for this Article stated:

A successful Chapter 11 investment for us is premised entirely on people. We find the right managers, either inside or outside the firm; we tear up their employment agreements and start over; we give them the right incentives; and we monitor their performance.¹⁵¹

But is this creditor interest sufficient to overcome the substantial power managers are assumed to have over the board and other elements of corporate governance? A variety of factors suggest management control while others hint at creditor control over compensation negotiations.

1. Management Power.—Several factors appear to give incumbent CEOs significant power in pay negotiations with distressed firms. One is the belief that the debtor is more valuable with incumbent management in place because managers know the business best and have firm-specific skills and knowledge. This is the logic behind continued management operation of the debtor, and is the argument commonly made by managers

¹⁴⁷ See Matt Miller, *When Failure Pays*, THE DAILY DEAL, Feb. 27, 2003 (quoting lawyers involved in the reorganization of Peregrine Systems).

¹⁴⁸ "Getting new faces into management roles can be a key to changing a company's direction." Meg Richards, *CEOs on Forced Diet of Lower Pay: Some Perks Also Eliminated in Wake of Corporate Scandals*, CBS NEWS, Feb. 12, 2003, <http://www.cbsnews.com/stories/2003/02/12/national/main540271.shtml> (quoting Ken Hiltz, a partner at a crisis management firm).

¹⁴⁹ Telephone Interview with attorney in bankruptcy practice at large New York firm (Feb. 15, 2004).

¹⁵⁰ See, e.g., Spectrasite, Inc., Proposed Plan of Reorganization (Form 8-K), at 19–21 (Nov. 15, 2002), available at <http://www.secinfo.com/dsVsf.3bR9.d.htm>.

¹⁵¹ Telephone Interview with managing director of New York-based distressed-debt fund with over \$2 billion in assets under management (Mar. 16, 2004).

seeking lucrative compensation packages in bankruptcy, often in the form of so-called key employee retention plans (KERPs).¹⁵²

We will see below that this belief strains under the data, however, because CEOs are replaced in and around bankruptcy in over 60% of firms in the data set.¹⁵³ While KERPs may be useful to retain midlevel sales managers and business-unit heads, their protective force is likely much less for CEOs. CEOs have more wealth tied up in the firm, are less able to jump ship, and are, in most cases, less valuable in bankruptcy than lower-level managers with the important business contacts and operational knowledge.

A second factor that appears to favor CEO power is reorganizing firms' susceptibility to poaching. These firms are targeted by the rest of their industry for talent that may be eager to move to greener pastures. Turnover of managers requires the distressed firm to make cash expenditures (in the form of search fees, hiring bonuses, and relocation expenses to replace departing managers), and also increases opportunity and disruption costs. Again, these latter costs are probably less important for the CEO than for midlevel sales managers and business-unit heads, who are more numerous and have important line responsibilities, knowledge, and personal customer contacts. Of course, any generalizations are impossible as the value of personnel at all levels will vary across firms and industries.¹⁵⁴

A third factor apparently favoring management is the possibility that creditors will tolerate inefficient or unfair compensation to curry favor with CEOs, since the debtor has the exclusive right to propose a reorganization plan,¹⁵⁵ in order to get the company out of bankruptcy as soon as possible. Creditors want to exit quickly to reduce three costs: cash costs (including professional fees for lawyers, accountants, and bankers); business costs (lost customers); and financial costs (higher capital costs). While the total of these costs is undoubtedly very large—professional fees alone are about 2–4% of assets in a typical case¹⁵⁶—the relevant consideration is the marginal costs of extending bankruptcy. These costs do not necessarily increase linearly with time; rather, some creditor costs are lumpy, such that

¹⁵² See generally Allison K. Verderber Herriott, Comment, *Toward an Understanding of the Dialectical Tensions Inherent in CEO and Key Employee Retention Plans During Bankruptcy*, 98 NW. U. L. REV. 579 (2004).

¹⁵³ According to research done by management consultancy Booz Allen Hamilton, the average for the world's largest 2500 firms in 2004 was about 11%, and this was up dramatically from the prior decade. See Booz Allen Hamilton, *Global Turnover Set New Record in 2005*, available at <http://www.boozallen.com/publications/article/3744370>.

¹⁵⁴ There is some suggestion that the retailing sector may be especially susceptible to the poaching of key people. See, e.g., *Dai-Ichi Kangyo Bank, Ltd. v. Montgomery Ward Holding Corp.* (*In re Montgomery Ward Holding Corp.*), 242 B.R. 147, 152 (D. Del. 1999) (noting that the lower court found that these retention agreements are "particularly" important in "retail cases" (citation omitted)).

¹⁵⁵ The debtor has a 120-day period during which it has an exclusive right to file a plan. 11 U.S.C. § 1121(b) (2000).

¹⁵⁶ Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 AM. BANKR. L.J. 509, 539–41 (2000).

extending bankruptcy over reasonable periods is unlikely to increase them substantially. In addition, unlike one-time professional fees, executive compensation is a recurring expense that cannot be externalized to the “last class of shareholders,” and therefore receives more scrutiny.¹⁵⁷ Even if these costs are much greater than the expected savings from recontracting with the CEO, it does not necessarily mean that this is the profit-maximizing strategy. Creditors face a complicated tradeoff between hiring the right CEO and giving that CEO the proper incentives on the one hand, and getting out of bankruptcy quickly on the other. For example, while shortening the duration of the reorganization may reduce cash outlays and other costs, it is possible that the shortened time will lead to inferior decisionmaking, resulting in higher total costs in the long run. Creditors also want to maximize the value of the firm upon their exit, be it sooner or later, and would be unlikely to approve employment agreements that are poorly designed or that do not give key managers strong incentives to maximize firm value.¹⁵⁸

There is, of course, the possibility that firms would pay large, one-time bonuses as a bribe to management, but this concern is largely overblown. These bonuses are usually paid only upon successful emergence from Chapter 11, meaning they are incentives for timely, value-maximizing reorganization of debts. They are also usually in an amount equal to a CEO’s annual bonus pro rata over the time of the reorganization, and are therefore simply deferred bonus payments contingent on a positive outcome.¹⁵⁹

A fourth pro-management factor is the premium that potential outside replacements would demand to compensate for the increased risk from joining a failing firm. Consider a simple example: if the going rate for a CEO is \$100,000, but outsiders would demand a 20% premium to compensate for the increased risk of running a bankrupt firm, the incumbent CEO could demand an increase of up to \$120,000 and still reduce the debtor’s overall costs.¹⁶⁰ While this may seem reasonable in light of the extra risk and stress being borne by the CEO, it is possible that the CEO is being paid in excess of her worth, since the market for managerial talent may value her less than her peers because she is affiliated with a failing enterprise.¹⁶¹ Thus, given

¹⁵⁷ Cynthia Baker argues that professional fees are excessive in Chapter 11 because the debtor does not pay professional fees, which instead are borne by the “last class of creditors or shareholders still ‘in the money.’” Cynthia Baker, *Fixing What’s Broken: A Proposal for Reform of the Compensation System in Bankruptcy*, 5 J. BANKR. L. & PRAC. 435, 442 (1996).

¹⁵⁸ This should not depend on a creditor’s investment horizon, since even vulture investors looking to sell quickly for a profit, known as “Migratory Birds,” have incentives to write contracts that maximize firm value. Of course, long-term investors, known as “Nest Builders,” have the proper incentives. See ROSENBERG, *supra* note 74, at 29.

¹⁵⁹ See *infra* Part V.

¹⁶⁰ The reservation wage for outside replacement may also be higher because the pool of potential candidates capable of rescuing a reorganizing firm (e.g., turnaround specialists) is shallow.

¹⁶¹ This may not necessarily be the case; some employers may value the experience gained from working for a financially distressed firm. See Joann S. Lublin, *Ailing Employers Offer Marketable Ex-*

the firm's poor performance, whether or not it can be deemed to be the CEO's fault, the firm should be able to pay the CEO less, but the costs of the next best alternative are so much higher that the CEO is actually in a stronger negotiating position. This is also true for insiders who could be promoted to CEO, but who would face the same market dynamics.¹⁶² Again, however, the data does not support this as a powerful factor in compensation negotiations. As discussed below, most CEOs are replaced in firms under financial distress and over 70% of CEO replacements are from outside the debtor, suggesting that this is not a substantial factor in most cases.¹⁶³

2. *Creditor Power.*—On the other hand, several factors severely limit the bargaining power of incumbent managers. The most obvious limitation is the fact that the CEO will be viewed as bearing some responsibility for the firm's poor performance, which will undermine any case for a lucrative compensation package. Not only does this depreciation of the CEO's human capital impact her bargaining position vis-à-vis her current employer, but it does so with respect to other potential employers as well, reducing the risk that the CEO will leave the firm.¹⁶⁴ This point is borne out by the data, which shows incumbent CEOs making considerably less than outside replacements.¹⁶⁵

In addition, firms have strategic and political incentives to bring in new management. Firing incumbent management can send a strong signal to creditors, the market, and competitors that the firm takes the reorganization process seriously and is confident about emerging as a vibrant entity. Signaling with compensation is observed in firms conducting an initial public offering (IPO), where risk-averse managers may accept contingent compensation as a sign of confidence in the firm's prospects.¹⁶⁶ Firms in Chapter 11 engage in similar strategies—emergence is in a sense like an IPO—by increasing the use of contingent contracts and reducing certain compensa-

periences, But Beware Pitfalls, WALL ST. J., Nov. 9, 2004, at B1 (“[W]eathering the ultimate business crisis could make you more marketable.”).

¹⁶² These conclusions are supported by the data from Gilson and Vetsuypens, who found that outside replacements were paid 36% more than the managers they replaced, and that insiders who replaced the CEO were paid 35% less. See Gilson & Vetsuypens, *supra* note 8, at 425.

¹⁶³ In comparison, the percentage of outside replacements in all firms was about 25% from 1990 to 2000. See Kevin J. Murphy & Jan Zabojsnik, *Managerial Capital and the Market for CEOs* 24 (Queen's Univ., Queen's Econ. Dep't, Working Paper No. 1110, 2006).

¹⁶⁴ Although some recent research suggests that CEOs are unfairly scapegoated for poor firm performance, see Naveen Khanna & Annette Poulsen, *Managers of Financially Distressed Firms: Villains or Scapegoats?*, 50 J. FIN. 919, 929 (1995), this threat reduces the value of an existing CEO, and thus the CEO's bargaining power.

¹⁶⁵ See Gilson & Vetsuypens, *supra* note 8, at 426.

¹⁶⁶ See Randolph P. Beatty & Edward J. Zajac, *Managerial Incentives, Monitoring, and Risk Bearing: A Study of Executive Compensation, Ownership, and Board Structure in Initial Public Offerings*, 39 ADMIN. SCI. Q. 313, 332 (1994).

tion amounts to show constraint and monitoring of agency costs and problems. Consistent with this signaling theory, we see firms looking more to outsiders as replacements for CEOs, with about 70% of replacements coming from outside the firm.

Large CEO paydays in bankruptcy also generate what Bebchuk and Fried call “outrage costs,” which should reduce CEO bargaining power. They predict that “[t]he more outrage a compensation arrangement is expected to generate, the more reluctant directors will be to approve it and the more hesitant managers will be to propose it in the first place.”¹⁶⁷ Bankruptcy raises outrage costs substantially because of the frequency of job cuts by the debtor juxtaposed with wealthy executives occasionally receiving lucrative retention bonuses, all being done under the increased public scrutiny a bankruptcy filing brings.¹⁶⁸ There are, for example, frequent press reports calling CEO pay in bankrupt firms “malodorous”¹⁶⁹ and “blackmail”¹⁷⁰ for these reasons.¹⁷¹ The outrage theory predicts that CEOs of firms in financial distress would, as a result of increased outrage costs, face substantial reductions or realignments of their compensation, or would engage in extraordinary attempts to hide the true nature and cost of their compensation. This claim is tested more fully below, but a recent example is illustrative. In its recent financial distress, Delta Airlines faced a barrage of negative news stories about the pay of its CEO, Leo Mullin. Delta proposed paying Mullin over \$2 million per year, at the same time that the firm was asking its unions for substantial wage concessions. The public and internal outrage was such that Mullin agreed to waive his bonuses for two years and to give up stock awards “potentially worth millions.”¹⁷²

A CEO may also have strong incentives to stay with her current employer because her employment agreement’s value is tied to the firm. As discussed above, all elements of the CEO’s compensation—salary, bonus, unvested options or stock, and retirement benefits—are executory contracts that the firm can accept or reject. Deferred compensation, which is typi-

¹⁶⁷ Lucian A. Bebchuk & Jesse M. Fried, *Stealth Compensation via Retirement Benefits*, 1 BERKELEY BUS. L.J. 291, 294 (2004).

¹⁶⁸ For a colorful, if somewhat overstated, description of outrage costs, see Paul Krugman, Editorial, *The Outrage Constraint*, WALL ST. J., Aug. 23, 2002, at A17.

¹⁶⁹ *Eagle-Picher Executives Prosper at Troubled Firm*, USA TODAY, May 14, 1991, at 2B.

¹⁷⁰ *Chapter 11: How to Get Rich; Bankruptcy Can Mean Bonus*, BLOOMBERG BUS. NEWS, Mar. 1, 1996.

¹⁷¹ For instance, AT&T announced 40,000 layoffs while its CEO was paid nearly \$17 million. See Irwin M. Stelzer, *Are CEOs Overpaid?*, 126 PUB. INTEREST 26, 27 (1997). General Dynamics paid its CEO over \$10 million per year while cutting almost 73,000 jobs over three years. MARGARET M. BLAIR, OWNERSHIP AND CONTROL 9 (1995).

¹⁷² Dan Reed, *American’s Exec Pay Enrages Labor*, USA TODAY, Apr. 18, 2003, at 1B; see also Russell Grantham, *More Cuts for Delta Execs, Pension Funding, Bonuses Stopped*, ATLANTA J.-CONST., Aug. 12, 2003, at A1.

cally substantial,¹⁷³ is also at risk. The reorganization of Burlington Industries is typical: the firm cancelled nearly all existing compensation arrangements with top management as “unfunded . . . executory contracts,” making all payments on owed amounts contingent on the employee remaining with the firm through the end of the reorganization.¹⁷⁴ This threat encourages renegotiation and loyalty.

Management’s bargaining position is also constrained by the ability of creditors to oust managers. While shareholders theoretically have the power to throw out incompetent managers of healthy firms, this is rarely done in practice. Creditors of distressed firms, however, often contract for very specific rights to replace managers if certain contingencies come to pass. Creditors and the creditors’ committee also have the power to appoint a trustee to replace incumbent managers under the Bankruptcy Code.¹⁷⁵ While this happens in only a handful of big cases each year, it remains a “powerful leverage device.”¹⁷⁶ The bankruptcy court also has the authority, on the motion of a party in interest, to appoint an examiner to investigate management’s past practices.¹⁷⁷ The risk of an audit, while it materializes only rarely, constrains managerial overreaching because the potential downside for managers is so great.

Creditors also have leverage by virtue of their power to oppose management’s reorganization plan, either by withholding their votes in favor or by actively campaigning or litigating against it. Creditors “can conduct embarrassing discovery, expose the efforts of management or other parties to the reorganization to serve their self-interest, draw out negotiations over the plan, and inject uncertainty into the confirmation process.”¹⁷⁸ Creditors also use their power as a lender of last resort to influence compensation negotiations. Banks can refuse to loan the debtor essential funds to operate during reorganization or, as described above, agree to loan money only if certain conditions with respect to personnel or contracts are met.¹⁷⁹

¹⁷³ See Coffee, *supra* note 50, at 1333 (describing implicit contracts whereby owners defer “a considerable portion of the managers’ expected aggregate compensation until the end of their careers”).

¹⁷⁴ See Burlington Indus., Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (Form 10-K), at 35 (Dec. 21, 2001), available at <http://www.secinfo.com/dV5Ff.4fjW9.htm#6jq> (describing how Burlington entered into a new one-year agreement with the CEO to operate the company in bankruptcy, which “replace[d his] prior employment agreement”); see also *id.* at 33 (characterizing retirement, benefits, change-of-control, and stock option plans as “unfunded arrangements,” and noting that “[a]s a result of the filing of the Chapter 11 Cases, each participant [in these plans] has the status of a general unsecured creditor”).

¹⁷⁵ 11 U.S.C. §§ 1103(c)(4), 1104(a) (2000).

¹⁷⁶ See LoPucki & Whitford, *supra* note 9, at 701.

¹⁷⁷ 11 U.S.C. § 1104(c).

¹⁷⁸ LoPucki & Whitford, *supra* note 9, at 706.

¹⁷⁹ *Id.* at 703. A related factor is that debtors face cash constraints that may make them less able to pay rich compensation packages to management. If managers have limited exit options, firms can argue to management that the lack of cash limits the amount they can pay. In practice, however, the result

B. Monitoring and Recontracting in Chapter 11

The above discussion shows that while managers retain some bargaining leverage, creditors and other constituencies of the debtor play a much more active role in monitoring and even managing the debtor in bankruptcy. This monitoring role extends into executive compensation decisions.

1. *Creditors as Monitors.*—Creditors' committees are almost always involved in negotiating employment agreements for incumbent or new management. While the debtor is technically responsible for drafting the agreement and obtaining court approval, "the creditors' committee's fingerprints are [usually] all over the proposal" since it is "typically prenegotiated with the committee."¹⁸⁰ Creditor involvement in negotiating employment contracts begins in earnest when the debtor files for Chapter 11. At that time there is a clear choice for the debtor and the creditors: adopt management employment agreements as is or rip them up and start afresh. In nearly every case examined for this Article, the debtor chose to renegotiate the terms under which the CEO was employed. While most employees are maintained at pre-petition levels of salary under first-day orders approved by the bankruptcy court, the CEO's employment contract typically waits until later.¹⁸¹ Although occasionally the negotiations begin pre-petition, in the vast majority of cases the debtor and the creditors do not reach agreement on the terms of the CEO's employment for during and after the reorganization until several months after the filing date. This is perhaps because, as shown in Part V below, most CEOs are replaced in and around bankruptcy, and creditors are often engaged in a parallel search for a new CEO. In the meantime, vulture investors or bank creditors often bring in turnaround specialists to manage the debtor.¹⁸² These managers are compensated as a priority administrative expense under section 327 of the Bankruptcy Code, which allows the firm to have compensated and incentivized management in place while negotiations with the new or current CEO are ongoing.¹⁸³ In addition, the incumbent CEO is unlikely to quit the firm in the absence of an employment contract, given the wealth (in the form of

may simply be a shift from cash forms of payment (like salary and bonuses) to noncash forms (like options and deferred compensation).

¹⁸⁰ Skeel, *supra* note 104, at 929.

¹⁸¹ This assertion is based on an examination of the dates of filing the petition for reorganization and the reporting dates of new employment contracts for firms analyzed in *infra* Part V, as well as on interviews by the author with directors of New York-based distressed-debt investors conducted via telephone on June 5, 2004 and August 19, 2004.

¹⁸² For example, J.C. Penney hired Allen Questrom, a 40-year retail veteran and "turnaround king," to manage its restructuring process. When the turnaround was complete, J.C. Penney hired a new CEO to lead the newly reorganized firm. See Teri Agins & Ann Zimmerman, *J.C. Penney Names Ullman New CEO, In Early Decision*, WALL ST. J., Oct. 28, 2004, at B8.

¹⁸³ 11 U.S.C. §§ 327(a), 328(a), 1103(b) (2000) (discussing employment by the debtor of "professional persons" necessary to the reorganization).

stock options, deferred compensation, and retirement benefits) tied up in the firm, not to mention the reputational effects, which are likely to be increasingly important for the CEO. Finally, as we see below, negotiations over CEO pay can often be quite contentious, and the creditors' committee may want to postpone a fight over pay while it builds harmonious relations with the debtor so as to better influence management's reorganization plan. Therefore, CEO-pay negotiations are often put on the backburner until negotiations about the plan are well along.

Whether the debtor opts for a new candidate or retains the incumbent CEO, creditors are deeply involved in the pay-setting process. According to compensation experts, creditors will "scrutinize any retention package . . . and are likely to reject packages that seem excessive."¹⁸⁴ As a member of the unsecured creditors' committee in the reorganization of Key3Media Group, Inc. said recently, "I'm going to be looking very carefully at anything they're going to pay any of these guys."¹⁸⁵ This creditor involvement takes many observable forms.

First, creditors frequently file formal objections to the debtor's pay plans with the bankruptcy court, thus using the threat of litigation as a bargaining tactic. While judicial review is generally ineffective as a constraint on executive compensation in healthy firms, as shown below, in bankruptcy, judicial oversight is often an effective tool for reducing or changing executive pay. In addition to actually reviewing compensation packages, courts also serve as a threat that motivates the creditors and the debtor to negotiate at arm's length. To cite a few of the many examples, in the reorganization of Drexel Burnham Lambert, the creditors' committee complained about a proposed pay plan, causing Drexel to reduce proposed compensation by about 50%.¹⁸⁶ Creditors also objected to executive compensation agreements for top management proposed by debtor World Kitchen, Inc., causing the debtor to withdraw the proposal and the CEO to quit.¹⁸⁷ The committee in the reorganization of FAO Schwartz filed papers with the court noting that it was working with the debtor to create a compensation scheme "that is better tailored to the [d]ebtor's current circumstances."¹⁸⁸ According to investors involved in the case, this was because the parties were afraid of potential litigation and wanted to prepare an acceptable set of compensation packages that would expedite court ap-

¹⁸⁴ Mike Groenendaal & Ryan Harvey, *How People Issues Can Shape Bankruptcy*, FIN. EXECUTIVE, Dec. 2003, at 60.

¹⁸⁵ Michael Hiltzik, *Key3 Execs Irrepressible But Not Irreplaceable*, L.A. TIMES, Feb. 27, 2003, at C1 (quoting Jordan Teramo of Mackay Shields).

¹⁸⁶ See Wade Lambert & Ellen Joan Pollock, *Drexel Slashes Executive-Pay Proposal*, WALL ST. J., Apr. 23, 1991, at B16.

¹⁸⁷ Miller, *supra* note 147.

¹⁸⁸ Peg Brickley, *FAO Faces Challenge Over Bonuses for Execs*, AP DATASTREAM, Jan. 30, 2004 (quoting filing of creditors' committee).

proval.¹⁸⁹ A similar objection was made by creditors in the reorganization of Owens Corning, where a multi-million dollar bonus plan for top executives was proposed by the debtor.¹⁹⁰

The second type of creditor involvement is direct negotiations with the debtor. There are two causes of these negotiations. The first is the threat of judicial review discussed above. Creditor approval is not a necessary precondition for judicial approval of executive pay packages, but courts often cite such approval as important evidence of the fairness and propriety of the packages in question.¹⁹¹ This practice provides strong incentives for the debtor to seek the imprimatur of the various committees before submitting pay packages to the court for approval. The other driver of negotiations is the power creditors have over the reorganization process itself. Creditors, whether large holders acting alone or smaller holders working in confederation through the committee process, frequently wield an effective veto over any reorganization plan. This veto gives them substantial bargaining power over key decisions, including the compensation top managers will receive. As one observer noted about modern reorganization practice, “[c]reditor lawyers are questioning pay packages, and, in some cases, they refuse to move reorganization plans forward until executive retention agreements are settled.”¹⁹² These challenges often can be quite effective, as in the recent case of Peregrine Systems, where a “challenge by the creditor’s committee kept [the debtor] from realizing all of its retention and bonus payment goals.”¹⁹³

A third form of creditor involvement in compensation decisions is effected through the board of directors. The influence on boards is both direct and indirect. Creditors often exert direct influence by taking board seats in the reorganized entity, which gives them power over compensation during and after Chapter 11. For example, in the reorganization of Bruno’s, Inc., the largest creditor—a bank syndicate—had the authority to appoint at least five of the seven directors of the reconstituted board of directors.¹⁹⁴

¹⁸⁹ Telephone Interview with managing director of New York-based distressed-debt investor (Sept. 12, 2004).

¹⁹⁰ Charles Sheehan, *Owens Corning Creditors Say Executive Pay Plan Lacks Incentive to End Chapter 11*, AP DATASTREAM, Sept. 8, 2004.

¹⁹¹ See, e.g., *Caldor Receives Court Approval for Employee Retention Program*, BUS. WIRE, Mar. 27, 1996 (“Caldor’s performance retention program, as approved by the court, has the full support of the company’s Creditors Committee, Bank Committee, and Equity Committee.”).

¹⁹² See Miller, *supra* note 147.

¹⁹³ *Software Company Fails to Secure Some Retention Bonuses*, BCD NEWS & COMMENT, Nov. 8, 2002.

¹⁹⁴ See Debtors’ Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code as Modified December 10, 1999 at 19, *In Re PWS Holding Corp., Bruno’s Inc.*, Nos. 98-212, 98-223 (Bankr. D. Del. Dec. 10, 1999), available at <http://www.secinfo.com/dRx61.5c.d.htm> (“The initial Board of Directors of New Bruno’s shall consist of seven individuals, five of whom shall be selected by the [bank syndicate], one of whom shall be the Chief Executive Officer of New Bruno’s and one of whom shall be (a) selected by the Chief Executive Officer of New Bruno’s and (b) either an offi-

Creditors took control of the board or at least some seats in most of the firms in the data set, including: Chiquita, where the “[b]ondholders [were able to] elect five members of a seven-member board and the chairman”;¹⁹⁵ Edison Brothers, where representatives of two creditors took board seats;¹⁹⁶ and Conesco, where the reorganization plan “eliminate[d] the current board and replace[d] it with a seven-member panel controlled by the creditors.”¹⁹⁷ Often, board changes are achieved formally through contract—in the reorganization plan or by rewriting the debtor’s charter or by-laws to permit, or even require, creditors to nominate directors to stand for office. For example, in the reorganization of USAirways, the largest creditor, the Retirement System of Alabama, bargained for seven seats on a thirteen-member board as part of a deal providing the debtor with a cash infusion.¹⁹⁸ Directors are also sometimes replaced as a result of informal negotiations between creditors and the debtor that are not memorialized in a written agreement, or even due to threats to marginalize or fire the directors after the creditor gains control of the firm.¹⁹⁹

Indirectly, creditors can influence boards in the same way that the managerial power theorists allege CEOs dominate the boards of healthy firms. When firms file to reorganize under Chapter 11 or are otherwise in the “zone” or “vicinity” of insolvency, the fiduciary duties of the board unquestionably switch from shareholders to creditors, with the concomitant obligation to maximize the estate of the debtor for their benefit.²⁰⁰ There is reason to believe that boards’ allegiances do change and that they are able to overcome any supposed capture by the CEO. This is because, as discussed above, distressed-firm creditors play a more active role in the firm than do shareholders in healthy firms. This includes monitoring and actively communicating with the board on key matters, including personnel issues. This jawboning can be quite effective given creditors’ powerful position in the reorganization process and directors’ reoriented loyalties.²⁰¹

cer of New Bruno’s or a current member of the Board of Directors of Bruno’s, or, if not an officer of New Bruno’s or a current member of the Board of Directors of Bruno’s, a person acceptable to the [bank syndicate].”).

¹⁹⁵ Ken Stammen, *Banana Grower Aims for Fresh Start*, CINCINNATI POST, Nov. 29, 2001, available at <http://www.cincypost.com/2001/nov/29/chiq112901.html>.

¹⁹⁶ *Edison Brothers Names New Board; Directors to Take Seats Following Emergence From Chapter 11*, PR NEWSWIRE, Sept. 9, 1997 (noting that officers at Highline Capital Management, L.L.C. and Citibank N.A., two of Edison Brothers’s creditors, took board seats under the reorganization plan).

¹⁹⁷ Greg Andrews, *Executive Might Get Large Loan Forgiven*, INDIANAPOLIS BUS. J., Apr. 28, 2003, at 3.

¹⁹⁸ Micheline Maynard, *US Air’s Chief Lender Threatens the Ultimate*, N.Y. TIMES, Dec. 7, 2002, at C1.

¹⁹⁹ Skeel, *supra* note 104, at 931.

²⁰⁰ See *supra* notes 74–75 and accompanying text.

²⁰¹ For the power of jawboning in another, related context, see Shleifer & Vishny, *supra* note 4, at 472–74 (modeling the use of jawboning in the proxy-fight/takeover context, and finding that while jaw-

Creditors can also oust directors or promise (implicitly or explicitly) rewards or punishment of various kinds. In other words, creditors' power and influence in this situation is precisely the same as that exercised by a healthy firm's CEO that managerial power theorists find objectionable.

2. *Directors as Monitors.*—The enhanced monitoring role of directors in these cases is not simply derivative of the power of creditors. Directors of financially distressed firms have greater incentives to monitor compensation practices as firm performance deteriorates and the firm approaches insolvency, even without creditor jawboning or influence. In healthy firms, directors are nearly always shielded from personal liability for bad decisions by a hierarchy of protections: the presumption of good faith found in the business judgment rule; the waiver of liability—a form of self-insurance—found in nearly all corporate charters;²⁰² and indemnification and third-party insurance policies taken out by the firm to reimburse directors found liable for all expenses, fines, and fees. A recent study by Bernard Black, Brian Cheffins, and Michael Klausner found that this litany of protections effectively eliminates any risk of out-of-pocket liability even for terrible directors.²⁰³ In bankruptcy, however, these protections are much less effective at protecting directors, if they are effective at all. Therefore, directors are bound to be more conscientious and diligent, especially regarding issues of CEO compensation, where there is obvious risk of conflicts of interest.

As mentioned above, director loyalty begins to shift from shareholders to creditors as the firm enters the vicinity of insolvency. This change has profound effects on the standards used by reviewing courts to determine director liability, and thus can be expected to have a real impact on director behavior and monitoring incentives. The most obvious example is the applicability of the business judgment rule. If directors are given the shield of the business judgment rule, courts will respect directors' decisions to approve executive compensation agreements absent a breach of their fiduciary duties of good faith, loyalty, or due care.²⁰⁴ In other words, absent self-

boning can be useful in making small-value improvements, it may be of “negative value” to shareholders because it reduces the threat of takeover as well as the likely takeover premium).

²⁰² See, e.g., DEL CODE ANN. tit. 8, § 102(b)(7) (2001); MODEL BUS. CORP. ACT § 2.02(b)(4) (2005).

²⁰³ Bernard S. Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1074–76 (2006). While this remains true in nearly all cases, the recent settlement of a securities action against WorldCom's former directors may be a watershed event. See Gretchen Morgenson, *10 Ex-Directors from WorldCom to Pay Millions*, N.Y. TIMES, Jan. 6, 2005, at A1 (reporting that ten former directors of WorldCom agreed to pay \$18 million of their own money as part of a class-action settlement agreement).

²⁰⁴ See *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345, 361 (Del. 1993) (holding that, when shareholders allege a breach of “good faith, loyalty[,] or due care [in a corporate transaction,] . . . the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments”). If any of these are shown, the burden shifts to

dealing, or perhaps gross negligence, director decisions on how much and how to pay a CEO will be protected from judicial inquiry and liability will not result.²⁰⁵

It is not clear, however, whether the business judgment rule applies to shield director decisions for firms in the “zone of insolvency” in the same way that it does director decisions for healthy firms. Courts are split on the question. While some courts have held that the standards of review of director action are the same in and out of bankruptcy,²⁰⁶ other courts consider directors de facto trustees for the creditors, and apply a higher standard of scrutiny to their actions.²⁰⁷ In addition, those courts that do apply the business judgment rule limit it to certain types of decisions or modify it to meet the particular circumstances of the case.²⁰⁸ For example, courts reviewing director action in extraordinary transactions (such as approval of break-up fees) occasionally refuse to give the directors the benefit of the business judgment rule, or alternatively, apply a modified, more stringent standard.²⁰⁹ While executive compensation decisions would normally be considered in the “ordinary course of business,” this might not be the case for extraordinary retention, emergence bonuses, or new employment contracts. In addition, courts sometimes scrutinize pay packages under a modified business judgment standard because the final-period problems for executives present opportunities for self-dealing at the expense of shareholders and creditors. Given the heightened scrutiny of bankruptcy, practitioners recommend that “directors and officers of an insolvent or near-insolvent corporation should proceed with corporate decisions on the assumption that the business judgment rule will not apply.”²¹⁰

the directors to show the “entire fairness” of the compensation package, including both a fair price and a fair process. *See Solomon v. Armstrong*, 747 A.2d 1098, 1112 (Del. Ch. 1999) (“If the presumption [that the directors acted in the best interests of the company] is rebutted, the board’s decision is reviewed through the lens of entire fairness, pursuant to which the directors lose the presumption of good business judgment.”).

²⁰⁵ *See Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000) (“[D]irectors’ decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.”).

²⁰⁶ *See, e.g., Angelo, Gordon & Co., L.P. v. Allied Riser Commc’ns Corp.*, 805 A.2d 221, 229 (Del. Ch. 2002) (“[E]ven where the law recognizes that the duties of directors encompass the interests of creditors, there is room for application of the business judgment rule.”).

²⁰⁷ *See, e.g., Geren v. Quantum Chem. Corp.*, No. 95-7554, 1995 WL 737512, at *1 (2d Cir. Dec. 13, 1995) (“Under New York law, directors of a corporation may become trustees of the creditors when the corporation is insolvent.”); *see also Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348, 354 (N.D. Tex. 1996).

²⁰⁸ *See, e.g., NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 523 (1984) (using a somewhat stricter business judgment standard when reviewing director decisions to accept or reject executory contracts).

²⁰⁹ *In re S.N.A. Nut Co.*, 186 B.R. 98, 104 (Bankr. N.D. Ill. 1995).

²¹⁰ *See Cieri & Riela, supra* note 102, at 304.

Directors have reason to be more active monitors even when the business judgment rule applies, however, because courts are willing to strip directors of the rule's protections more freely in cases where the firm is in financial distress. The recent case of *Pereira v. Cogan*²¹¹ is illustrative. In *Pereira*, the CEO, who was also the controlling shareholder, awarded himself a huge compensation package as the firm headed toward liquidation under Chapter 7.²¹² The board approved the disbursements in a perfunctory fashion, without detailed analysis and often relying on reports from others.²¹³ When deciding whether to apply the business judgment rule, the court examined the process followed by the directors, as well as the substance of their decisions.²¹⁴ This type of peeking under the covers is already a more searching review of director actions than courts usually apply.²¹⁵ Ultimately, the court refused to defer to the business judgment of the directors, finding that they did not decide on many of the compensation issues (and hence that there were no decisions to defer to) and that the decisions they did make were so procedurally deficient as to not warrant deference. The directors were found personally liable for about \$10 million. The lesson for directors from this and similar cases is that courts' hands-off attitude for most corporate decisions does not necessarily extend to bankruptcy, and that bad decisions can result in personal liability.

Moreover, directors cannot necessarily avoid this personal liability with standard exculpatory provisions designed to limit director liability. The articles of incorporation of nearly all publicly traded firms eliminate director liability for duty of care violations, as permitted by statutes in most states.²¹⁶ These exculpatory provisions are the second line of defense for directors in case the shield of the business judgment rule is pierced. But courts do not always enforce exculpatory agreements against creditors in bankruptcy.²¹⁷ The stated reason is that these provisions are contractual bargains between shareholders and directors to which the firm's creditors are not a party, and which therefore cannot bind them.²¹⁸ In addition, these provisions typically address only claims brought on behalf of shareholders or the corporation itself, and do not mention potential liability to credi-

²¹¹ 294 B.R. 449 (S.D.N.Y. 2003).

²¹² *Id.* at 474.

²¹³ *Id.* at 477.

²¹⁴ *Id.*

²¹⁵ For a discussion of whether the business judgment rule is a doctrine of substance or abstention, see STEPHEN BAINBRIDGE, CORPORATION LAW AND ECONOMICS 242–51 (2002).

²¹⁶ See *supra* note 202 and accompanying text.

²¹⁷ See, e.g., *In re Ben Franklin Retail Stores, Inc.*, Nos. 97C7934, 97C6043, 2000 WL 28266, at *7–8 (N.D. Ill. Jan. 12, 2000) (holding that an exculpatory clause does not preclude a bankruptcy trustee from proceeding against directors); *Pereira*, 294 B.R. at 534.

²¹⁸ *In re Ben Franklin Retail Stores*, 2000 WL 28266, at *8 (“[C]reditors should not be bound by the exculpatory provision because they were not parties to the contract.”).

tors.²¹⁹ Whether or not this logic is sensible,²²⁰ the fact that courts limit the reach of these exculpatory provisions in bankruptcy gives directors extra incentive to monitor CEO compensation more closely in these cases.

The lack of self-insurance through exculpatory provisions is exacerbated by the potential failure of the last line of director defense—third-party insurance that would pay any liabilities if directors were found liable. As with exculpatory provisions, nearly all large publicly held firms purchase insurance for the legal liabilities of directors and officers while they serve in a corporate capacity (“D&O” insurance). These policies, which are authorized by state statutes,²²¹ typically reimburse directors for all out-of-pocket expenses, including legal fees and money judgments. These insurance policies are a powerful disincentive to aggressive oversight by directors since they lower the cost to directors of poor performance. The D&O insurance shield, however, may be nonexistent or limited in cases involving bankrupt or near-insolvent firms. Depending on the type of insurance and the particular circumstances of the case, “a corporation’s bankruptcy may change the degree to which, or even whether, certain D&O insurance policies will cover directors and officers of a financially distressed company.”²²²

The end result is not a clear dismantling of director protections in all cases, but rather significant questions about how effective such protections will be in the case of financially distressed firms. In terms of director incentives, this uncertainty likely causes more caution, and thus more monitoring, by directors. This is probably true even for directors who were previously captured by, or who were mere instrumentalities of, the CEO. Recall that the managerial power argument assumes that directors are beholden to the CEO because the CEO has the power over appointment of directors, is able to reward cooperative directors with perks and favors, and holds various social and psychological influences over the directors. While arguably true in some cases with some firms, these forces constraining directorial power are less persuasive when directors face a real, monetary downside as well.

A final note about director monitoring is worth mentioning. The managerial power theorists claim that directors (at least in healthy firms) are ineffective monitors of executive compensation because (1) they spend “little time” focusing on the issue, and (2) they “do not have the knowledge

²¹⁹ See *id.* (“[T]he provision explicitly states that ‘[a] director . . . shall not be personally liable to the Corporation or its stockholders for monetary damages No mention is made of the potential liability to creditors that directors may incur.’ (citation omitted)).

²²⁰ The argument that these provisions should run only to shareholder claims (either directly or derivatively) does not hold water because the firm’s charter, and thus the terms of the bargain, will be known to subsequent creditors that loan the firm money.

²²¹ See, e.g., DEL. CODE ANN. tit. 8, § 145(g) (2001) (“A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation . . .”).

²²² See Cieri & Riela, *supra* note 102, at 330.

and expertise needed to properly evaluate the compensation arrangements they are asked to approve.”²²³ The claim is that directors are largely ignorant about the details of the compensation packages they approve. According to Yale School of Management Assistant Dean Jeffrey Sonnenfeld: “I know that a lot of [the] time board members don’t understand the complexity of the documents they’re reviewing. People don’t want to look foolish by asking how some of the instruments work.”²²⁴

While this claim strains credibility in healthy firms,²²⁵ it is certainly not true for firms in financial distress. As we have seen, the largest creditors often replace the incumbent directors with their own representatives. These new directors are routinely senior executives in the investment firm who serve or have served as directors of other distressed firms, have unmatched financial savvy, and are betting their own money on the success of the debtor.²²⁶ These new directors are not susceptible to criticisms either about time or knowledge. Moreover, even if they are only a minority on the board, they are likely to have an influence on the board’s decisionmaking because of the time investment and expertise they will bring to board meetings.²²⁷

Even when directors are not replaced by representatives of large creditors, the criticisms about time and knowledge are not persuasive in the bankruptcy context. As mentioned above, director attention is more focused in bankruptcy because of the increased oversight of directors’ actions (by creditors, the media, and the courts) and the threat of liability for bad decisions. This at least solves the problem of inattention. As for lack of knowledge, bankruptcy raises the salience of compensation issues, which spurs the demand for and provision of information on executive pay. Compensation decisions are very important in bankruptcy, and as such are often made by the full board instead of being delegated to compensation committees.²²⁸ Directors might sensibly demand data and information on executive

²²³ BEBCHUK & FRIED, *supra* note 2, at 37.

²²⁴ *Id.* (quoting Jeffrey Sonnenfeld, Assistant Dean, Yale School of Management).

²²⁵ As Ken Langone wrote regarding the flap over Richard Grasso’s pay at the New York Stock Exchange, “It is absurd to suggest that the [directors, some of the] brightest minds and keenest thinkers on Wall Street[,] were befuddled by the complexity of Richard Grasso’s compensation package—especially one composed just like their own.” Kenneth Langone, *Let’s Bring on the Jury, Mr. Spitzer*, WALL ST. J., June 10, 2004, at A12.

²²⁶ For example, four members of the buyout firm Kohlberg Kravis Roberts & Co. were elected to serve on the board of debtor Borden Chemical. See Borden Chem., Inc., Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (Form 10-K), at 63–65 (Mar. 28, 2003).

²²⁷ See CASS R. SUNSTEIN, WHY SOCIETIES NEED DISSENT 37 (2003) (examining the benefits of including different or dissenting opinions in group decisionmaking in a variety of non-corporate contexts).

²²⁸ See, e.g., Am. Banknote Corp., Amendment No. 1 to Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (Form 10-K/A), at 8 (Apr. 30, 2004), available at <http://www.secinfo.com/dsvr4.15bh.htm#1stPage> (“The Parent did not have a Compensation Committee subsequent to the filing of a petition for reorganization relief under Chapter 11 of the United States Bankruptcy Code, on December 8, 1999. Subsequent to the confirmation of the Plan and prior to April

pay to avoid criticisms and potential legal liability, while accounting firms and other compensation consultants actively provide a ready supply of information, including assessments of various pay strategies, comparisons between types of options and other pay mechanisms, reports on the design and operation of KERPs, and materials addressing the overall approach to compensation in bankruptcy.²²⁹ These consulting firms compete for business based on the quality of the information they provide, and their materials “provide firms with everything one would need to know about the latest thinking on compensation issues.”²³⁰ Directors, especially the members of the compensation committee, thus have access to an abundance of information and strong incentives to educate themselves about compensation issues.

3. *Judges as Monitors.*—Another constraint on managerial power over compensation bargaining in Chapter 11 is the direct oversight by the bankruptcy court. The most obvious manifestation of this power is the court’s review of executory contracts pursuant to section 365(a) of the Code: “subject to the court’s approval, [the DIP] may assume or reject any executory contract . . . of the debtor.”²³¹ Because compensation agreements are executory contracts, the rejection or adoption of *any* contract must be approved by the bankruptcy court.

While section 365(a) leaves open the possibility of perfunctory review, courts do routinely analyze the substance of executive compensation agreements. Judicial influence takes two forms: a hard form and a softer form. The hard form is a formal review and adjudication of the propriety and fairness of proposed compensation plans, raised either by a “party in interest” or *sua sponte*. More typically, courts engage in a softer form of oversight, using the leverage of a threat of official action to force the parties to alter the terms of contracts.²³² This mere threat lowers the firm’s recontracting costs by raising the cost to the firm and manager of excessive compensation agreements, and by overcoming the psychological or social norm barriers to renegotiation and tougher negotiating. For example, directors can force the CEO to renegotiate without losing face by blaming their action on the possible threat of litigation or court involvement.

2001, compensation agreements and plans subject to Compensation Committee action were instead addressed by the full Board of Directors.”); *see also* SLI Inc., Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Schedule 14A), at 4 (May 22, 2002) (“Due to the Company’s financial conditions . . . the [entire] Board of Directors . . . reviewed the compensation arrangements of its executive officers including the Company’s Chief Executive Officer.”).

²²⁹ Telephone Interviews with executives at two of the largest global compensation consulting firms (December 9, 2003).

²³⁰ Telephone Interview with managing director at New York-based vulture fund investor (June 2, 2004).

²³¹ 11 U.S.C. § 365(a) (2000).

²³² This generalization is based on an examination of court records, interviews with parties to the cases described in *infra* Part V, and telephone interviews with distressed-debt investors. *See supra* note 181 and accompanying text. *See also infra* p. 1592.

Outside the bankruptcy context, judicial review of executive compensation is quite limited because “the size and structure of executive compensation are inherently matters of judgment,” entitled to “great deference” by courts.²³³ While some cases exist in which courts have invalidated compensation agreements,²³⁴ judicial review is not a meaningful constraint on negotiations outside of the Chapter 11 context.

Courts exert much more power over compensation decisions for bankrupt firms. In fact, under Chapter X of the pre-1978 Bankruptcy Act, prior court approval was required for all executive compensation contracts.²³⁵ The logic behind requiring prior court approval of compensation was “so that the retention of the debtor’s officers will be based on their actual worth and not on their desire to perpetuate their tenure or control at the expense of the . . . creditors and stockholders.”²³⁶ In a notable pre-1978 Act case, the District Court for the Southern District of New York rejected specific elements of an officer’s employment contract with the debtor on the ground that prior court approval was not granted, and this was required by section 191 “to safeguard the administration of the debtor’s property in the custody of the court.”²³⁷

The new Bankruptcy Code rejects this paternalistic approach to compensation as part of a broader policy shift away from court control and toward court supervision. The grounds for this reform sounded largely in matters of institutional competence, preservation of judicial resources, and the benefits of private resolution of business decisions.²³⁸ Despite the fairly clear congressional intent to remove judges from the day-to-day business of running bankrupt firms,²³⁹ courts nevertheless continue to review compensation levels much as they did under the pre-1978 Act. While the new Code does not explicitly or unambiguously grant judges the power to approve or change management compensation, most courts find the authority to do so in a grab bag of Code provisions. For example, many courts interpret section 327, which authorizes the court to approve compensation of “profes-

²³³ See *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) (upholding the Chancery court’s deferral regarding executive compensation).

²³⁴ See, e.g., *Kerbs v. Cal. E. Airways*, 90 A.2d 652, 656 (Del. 1952) (finding a stock option plan deficient in the specific circumstances of the case).

²³⁵ Section 191 of the pre-1978 Code provided in pertinent part that “[a] trustee or debtor in possession may employ officers of the debtor at rates of compensation to be approved by the court.” 11 U.S.C. § 591 (1976), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, tit. IV, § 401(a), 92 Stat. 2549. The Supreme Court affirmed this power in 1963, concluding that bankruptcy courts have the “authority to pass in advance upon the . . . salary of an officer of the Debtor before he assumes or continues in office.” *Wolf v. Weinstein*, 372 U.S. 633, 648 (1963).

²³⁶ 6 COLLIER ON BANKRUPTCY ¶¶ 8, 14[1], at 1430 (14th ed. 1978).

²³⁷ *In re Lyntex Corp.*, 403 F. Supp. 284, 286 (S.D.N.Y. 1975) (quoting *In re J.P. Linahan, Inc.*, 111 F.2d 590, 592 (2d Cir. 1940)).

²³⁸ See *In re Curlew Valley Assoc.*, 14 B.R. 506, 510–11 n.6 (Bankr. D. Utah 1981) (detailing the legislative history of portions of the new Bankruptcy Code).

²³⁹ See *id.*

sional persons,” like lawyers, bankers, and accountants, to allow similar review of executive compensation.²⁴⁰ It seems clear that this provision applies to third party specialists and not to officers of the debtor, but some courts use it as a hook to increase their supervisory role in bankruptcy. Recognizing that this reasoning strains the language and structure of the new Code, one court explained, “[although] the Code contains no provision analogous to [section] 191 of the [pre-1978] Act, . . . the substance of that section has arguably been incorporated in . . . [section] 327(a)” of the Code.²⁴¹ Courts not relying on section 327 nevertheless find the requisite power in the Code’s general provisions allowing courts to enter any order “necessary or appropriate to carry out the provisions” of the Code.²⁴² These courts take a fairly active role in adjudicating compensation issues.

Many courts under the new Code have exercised this power to reject proposed employment agreements and reduce compensation of the debtor’s employees.²⁴³ As a procedural matter, the typical case is brought by creditors, usually acting through the creditors’ committee. Creditors have standing as a “party in interest,” and their objections are routinely supported by lengthy reports from compensation experts. Alternatively, courts can raise issues about the propriety or fairness of executive compensation *sua sponte*.²⁴⁴ For example, the court in *In re New York City Shoes, Inc.*, reduced the compensation of the debtor’s CFO, despite the fact that neither

²⁴⁰ 11 U.S.C. § 327 (2000). *See, e.g., In re Athos Steel & Alum., Inc.*, 69 B.R. 515, 520–21 (Bankr. E.D. Pa. 1987) (“I see no reason to distinguish corporate officers from other professional persons employed in the operation of a debtor’s business [Therefore] I have the authority to review the proposed compensation of the debtor’s chief executive officer in this case”); *In re Hooper, Goode Realty*, 60 B.R. 328, 332 (Bankr. S.D. Cal. 1986) (“This court finds . . . that the employment of the debtor’s officers is subject to court scrutiny and is governed by 11 U.S.C. § 327”); *In re Schatz Fed. Bearings Co., Inc.*, 17 B.R. 780, 782 (Bankr. S.D.N.Y. 1982) (holding that directors acting to administer an estate exercised additional duties placing them in the scope of section 327).

²⁴¹ *In re Zerodec Mega Corp.*, 39 B.R. 932, 933 (Bankr. Pa. 1984).

²⁴² 11 U.S.C. § 105(a); *see In re New York City Shoes, Inc.*, 89 B.R. 479, 483 (Bankr. E.D. Pa. 1988) (holding that corporate officer’s compensation by the debtor created an intolerable conflict allowing the court to review it *sua sponte*); *In re Lyon & Reboli, Inc.*, 24 B.R. 152, 153–54 (Bankr. E.D.N.Y. 1982) (holding that the court must be able to review executive compensation to meet the goals of the Bankruptcy Code).

²⁴³ *See, e.g., In re All Seasons Indus., Inc.*, 121 B.R. 822, 825–26 (Bankr. N.D. Ind. 1990) (noting that even when a court cannot review a debtor’s decision to employ pre-petition insider management, the compensation may be reviewed for “reasonableness”); *In re New York City Shoes*, 89 B.R. at 483–84 (holding that a corporate officer would not receive any payment for services to the debtor after the debtor’s assets were sold to his other employer); *In re State Optical Co., Inc.*, 70 B.R. 82, 83–84 (Bankr. E.D. Pa. 1987) (reducing CEO’s salary from \$104,000 to approximately \$88,000); *In re Zerodec.*, 39 B.R. at 935 (reducing officer’s compensation by one-third).

²⁴⁴ *See* 11 U.S.C. § 105(a) (“The [bankruptcy] court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.”).

the debtor nor the creditors' committee objected to the form or amount of the compensation.²⁴⁵

Courts are split on the question of where to place the burden of proof, a key determinant of the level of review. Some find that employment agreements at pre-petition levels are presumptively valid, although this presumption can be overcome with evidence that the contracts are not in the best interest of the estate.²⁴⁶ Other courts play a more active role in reducing or changing executive compensation, even when the proposed compensation was at pre-petition levels.²⁴⁷ In general, when extraordinary contracts are proposed to a court for review under a so-called section 363(b) proceeding, courts decide whether "a sound business purpose" justifies the debtor's compensation plan.²⁴⁸ Courts, through these searching forms of review, apply much more scrutiny to executive compensation agreements in financially distressed firms than in healthy ones.

This increased judicial monitoring of compensation is apparent in several recent, high-profile reorganizations. In the WorldCom bankruptcy, the court reviewed the compensation of new CEO Michael Capellas and ultimately reduced it by about 25% over three years.²⁴⁹ The judge in that case said the package "raise[d] serious concerns as to whether proposed new management [was] committed to reform as the nature of this requires."²⁵⁰ To cite a few more examples, the bankruptcy judge presiding over the reorganization of A.H. Robins Co. reduced compensation of senior officers and directors, lowering the annual salary of the president and CEO by nearly 20%.²⁵¹ Likewise, the court in the reorganization of Paragon Trade Brands, Inc. approved a broad-based KERF, but rejected a compensation and bonus plan for eight top executives after hearing objections from trade creditors.²⁵²

²⁴⁵ *In re New York City Shoes*, 89 B.R. at 484.

²⁴⁶ *See, e.g., In re All Seasons*, 121 B.R. at 826 (noting that the objector "must introduce evidence of exigent circumstances or the prima facie appearance of abuse" indicating compensation is unreasonable).

²⁴⁷ *See, e.g., In re State Optical Co.*, 70 B.R. at 84 (reduced compensation by about 15% because the size and profitability of the DIP decreased); *In re Zerodec*, 39 B.R. at 935 (authorized employment of the CEO but reduced compensation by over 30% upon the objection of two creditors).

²⁴⁸ *In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 153 (Bankr. D. Del. 1999); *see also* 11 U.S.C. § 363(b).

²⁴⁹ *See, e.g.,* Rebecca Blumenstein & Lingling Wei, *WorldCom's CEO's Pay is Criticized: Judge Says Compensation May Be Unreasonable with Firm in Chapter 11*, WALL ST. J., Dec. 11, 2002, at B5 (reporting that the bankruptcy court would be reviewing Capellas's compensation for excessiveness); Richards, *supra* note 148 (noting that Capellas's compensation was reduced by \$5 million over three years).

²⁵⁰ *See* Miller, *supra* note 147 (quoting Judge Jed Rakoff).

²⁵¹ Morton Mintz, *Judge Limits A.H. Robins Executive Pay*, WASH. POST, Sept. 30, 1986, at C1; Sonja Steptoe, *A.H. Robins to Cut Top Officers' Pay, End Some Former Executives' Consulting*, WALL ST. J., Sept. 15, 1986, at 17.

²⁵² Modified Second Amended Plan of Reorganization, *In re Paragon Trade Brands, Inc.* at 31, No. 98-60390 (Bankr. N.D. Ga. Jan. 13, 2000), available at <http://www.secinfo.com/dr4Yq.5d.d.htm>.

Courts also have the power to undo agreements. The court supervising the reorganization of Coram Healthcare, Inc. rejected a transition employment agreement entered into with creditors, and authorized the Chapter 11 trustee to seek reimbursement from the CEO.²⁵³

In addition to formal review, bankruptcy judges exercise indirect influence—the softer form of oversight—on executive compensation. This power, and the willingness to use it, reinforces the negotiations among the creditors and the debtor by evening out any bargaining asymmetries between management on the one side and directors, creditors, or both on the other side. For example, in the bankruptcy of failed retailer Caldor, the judge objected to a proposed management compensation plan, noting that the plan would “reward emergence for emergence’s sake” without considering the health of the firm after emergence.²⁵⁴ Although the judge did not rule on the plan, Caldor renegotiated a more acceptable bonus plan with shareholders and creditors.²⁵⁵ Another example was in the case of C.R. Anthony Co., where the judge expressed significant concern about approving a compensation package for the CEO that would reward him for mismanaging the company.²⁵⁶ Likewise, the judge overseeing reorganization of Peregrine Systems “sent the company back to the drawing board” upon requests for some executive compensation.²⁵⁷

4. *Other Monitors.*—There are several other constraints on managerial power in Chapter 11 that are worth briefly mentioning. As discussed above, employee activism, often through labor unions or other representatives, raises outrage costs for CEOs in Chapter 11 cases.²⁵⁸ Labor unions, where active, frequently evaluate and criticize executive compensation plans in Chapter 11. Formal objections have been used in recent bankruptcies of firms with traditionally strong unions, such as airlines and telecom-

²⁵³ See Coram Healthcare Corp., Annual Report (Form 10-K), at 34 (Apr. 15, 2003), available at <http://www.secinfo.com/dvjdn.27c.htm#1stPage> (“On March 3, 2003, the Bankruptcy Court denied the Chapter 11 trustee’s motion for authorization to enter into the Transition [Employment] Agreement [with the incumbent CEO].”).

²⁵⁴ *Chapter 11: How to Get Rich; Bankruptcy Can Mean Bonus*, supra note 170 (quoting Judge James L. Garrity, Jr.).

²⁵⁵ *Id.*

²⁵⁶ See Nancy Raiden Titus, *Anthony Urges Approval of Plan for Compensation*, THE J. REC., Dec. 12, 1991, at 1.

²⁵⁷ *Software Company Fails to Secure Some Retention Bonuses*, supra note 193.

²⁵⁸ See, e.g., Dan Reed, *American’s Exec Pay Enrages Labor*, USA TODAY, Apr. 18, 2003 (noting that compensation decisions at Delta, Northwest, and Continental airlines “outraged workers and some in Congress,” and describing the outrage of the flight attendants’ union at retention bonuses for the top six executives at American: “the equivalent of an obscene gesture from management to employees”); see also Carissa Wyant, *Rep. Ellison, Others Join Pilot Protest of NWA Exec Pay*, MINN./ST. PAUL BUS. J., May 29, 2007 (“Northwest pilots are angry that their 40 percent pay cuts are being turned into compensation increases for Northwest’s senior executives. This egregious act is not only bad for NWA employees, but will have a counterproductive long-term effect on Northwest Airlines and unfortunately its customers.” (internal quotations omitted)).

munications.²⁵⁹ Informal public statements and intra-firm signals also raise outrage costs and focus attention—either of the court or powerful creditors—on executive compensation issues.²⁶⁰ For example, several employees of debtor Guilford Mills sent a letter to the bankruptcy court “vehemently” opposing a proposed executive retention plan, thus focusing the court’s attention on the plan.²⁶¹ These tactics raise the costs of outrageous executive compensation and push the parties in the direction of arm’s-length contracting over compensation. In effect, these parties lower the monitoring costs for creditors, directors, and others by doing the monitoring for them.

Another constraint is the threat of litigation by the firm or the bankruptcy trustee to recover “excessive” or illegal compensation. Courts have recently allowed cases to proceed against the executives of bankrupt firms on theories of fraudulent conveyance for certain compensation packages.²⁶² Take the example of a CEO of a corporation who, one day before the filing of a bankruptcy petition, received payments from the firm totaling over \$50 million for services rendered by him, by his family, by affiliated companies, and for payment of his questionable legal expenses.²⁶³ The potential for abuse in this final period is obvious; the CEO can enrich himself at the expense of the firm and its creditors without reliable recourse if the firm fails.²⁶⁴ To prevent this, the firm or the bankruptcy trustee can challenge transfers of this type under several sections of the Bankruptcy Code or under state law.²⁶⁵

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²⁵⁹ See, e.g., *Judge Clears Way for Northwest Airlines to Exit Bankruptcy*, N.Y. TIMES, MAY 19, 2007, at C4 (noting that the bankruptcy court judge approved compensation for top executives, including \$26.6 million for the CEO, over “union objectors who argued that the equity award plan unfairly enriched executives”); *Contracts Frontline Workers Critical of Adelphia Reorganization*, PR NEWSWIRE, Feb. 11, 2003 (reporting that the labor union representing Adelphia’s workers asked the court to reject the proposed executive compensation plan).

²⁶⁰ Groenendaal & Harvey, *supra* note 184, at 60 (noting that “employee groups, and some creditors[,] are quick to criticize executive compensation and benefits, based on public information,” and this leads to increased attention to compensation issues).

²⁶¹ Eric Heisler, *Guilford Mills Plans Unfold: Proposals for Guilford Mills Bonuses Are Modest in Comparison to Those of Burlington Industries*, GREENSBORO NEWS & REC., Jul. 13, 2002, at B12.

²⁶² Skeel, *supra* note 104, at 943, 946.

²⁶³ These facts are adapted from the case of *In re Sharon Steel Corp.*, 871 F.2d 1217, 1220 n.9 (3d Cir. 1989), where the court found that transfers of this type were fraudulent conveyances that justified the appointment of a bankruptcy trustee.

²⁶⁴ Baird & Rasmussen, *supra* note 7, at 1231 (“[Managers] know that they are in the end game. Final-period problems tend to reduce the efficacy of controls designed to bind managers over the long term. Left unchecked, managers are even more likely to put their interests ahead of those of the company.”).

²⁶⁵ See Skeel, *supra* note 104, at 944 n.88 (arguing that the Code be amended to capture suspicious stock sales); see also UNIFORM FRAUDULENT TRANSFER ACT § 7, *printed in* 7A Uniform Laws Ann. Part II (West 2006) (in force in 34 states).

The traditional view of executive compensation in bankruptcy—that Chapter 11 serves as an anti-takeover device for managers, allowing managers to rent seek at the expense of shareholders and creditors—is no longer true. Chapter 11 now “has a distinctly creditor-oriented cast,” and today’s reorganizations look more like the market for corporate control where creditors provide powerful oversight of managerial conduct and prevent excessive rent seeking.²⁶⁶ One would therefore expect the data about executive compensation in bankrupt firms to show some evidence of active recontracting by firms, and further, for the results of this recontracting to approximate the contracts one would expect to see in arm’s-length negotiations. Let us turn now to the data to see if these hypotheses prove to be true.

V. AN EMPIRICAL LOOK AT COMPENSATION IN FINANCIALLY DISTRESSED FIRMS

A. *The Data*

The data sample examined for this Article consists of seventy-six large publicly traded firms that faced severe financial distress during the period from 1992 to 2003—sixty-eight firms filed to reorganize under Chapter 11, while eight privately restructured their debt.²⁶⁷ The data about compensation levels, types, and methods is primarily from the Compustat Executive Compensation database (EXECUCOMP), a repository of executive compensation and other data on the largest 1500 publicly traded firms.²⁶⁸ This database is the accepted standard for research in this area. It is incomplete, however, with respect to firms in Chapter 11 due to the lack of some publicly available information, as well as a change in the way this information is reported for firms in Chapter 11; this leaves some holes in the data. Research from a variety of public sources (e.g., proxy statements and 10-Ks filed with the SEC, reorganization plans filed with the bankruptcy court, press releases, and public comments) and a series of interviews, conducted with lawyers, distressed-debt investors who worked on these deals, and executives of firms in the sample, filled these holes. These interviews provided raw data, color, insights, and corroboration for the other data sources used.

²⁶⁶ Skeel, *supra* note 104, at 918.

²⁶⁷ The process for identifying firms that privately restructured their debt followed that of Gilson & Vetsuypens, *supra* note 8, at 425. There are undoubtedly more firms that did private workouts over this period, but a conservative identification approach was used to minimize overinclusion problems.

²⁶⁸ Compustat EXECUCOMP Database, *supra* note 15.

Table 1

<i>Characteristics of financially distressed firms</i>	<i>Mean values</i>	
	<i>Financially distressed firms</i>	<i>All firms</i>
<i>Characteristic</i>		
Asset value (\$ billions)	3.8	19.8
Sales (\$ billions)	2.3	6.3
Sales growth (year–year; percent)	-7	9
Net income (\$ billions)	-0.4	0.5
Total return to shareholders (over 3 years; percent)	-22	5

As shown in Table 1, the seventy-six financially distressed firms in the data set are small, shrinking, and unprofitable relative to the other firms in the rest of the EXECUCOMP database. In terms of the amount of executive pay, there is significant difference in total compensation between the two data sets, with larger, more successful firms paying their executives more.²⁶⁹ Over the period, the average compensation (salary plus bonus and options granted) for financially distressed firms grew at a rate of about 5% per year, while the growth rate for all firms was about 10% per year. The faster growth rate suggests a crude, big-picture linkage between pay and performance—the larger, more successful firms pay, on average, more than smaller, distressed firms. This is explained almost entirely by the difference in the value of options awarded, as shown below.²⁷⁰ The differences in compensation levels between healthy and distressed firms are not meaningful in terms of the analysis, however, in that this Article compares compensation levels and methods at distressed firms before, during, and after financial distress. Over the ten-year period, most of the firms spent several years outside of the “zone of insolvency”—on either side of the filing—thus permitting an isolation of the impacts of bankruptcy.

B. CEO Turnover

Before examining compensation, let us look at CEO turnover, which tells us something about the relative bargaining power of CEOs and firm “owners” in compensation negotiations. The traditional view, as noted above, is that Chapter 11 is an entrenchment mechanism for managers that allows them to stay in power and extract rents from the firm. We have examined theoretical and anecdotal evidence that confirms this is no longer true, with the new Chapter 11 foreshadowing the replacement of managers

²⁶⁹ The average CEO compensation for all firms in 2002 was about \$6 million per year, compared to about \$2 million for financially distressed firms.

²⁷⁰ See *infra* Part V.D.2.

and directors. The data bolsters this conclusion; over 60% of CEOs were replaced in the zone of insolvency. This turnover rate contrasts sharply with CEO turnover of less than 10% in solvent firms.²⁷¹ The data suggests that creditors are exercising their substantial theoretical power outlined above to discipline managers. This threat of replacement also almost unquestionably constrains managerial overreaching in compensation negotiations in the zone of insolvency.

The turnover rate found in the data set examined in this Article is somewhat higher than that found in previous work. Gilson and Vetsuypens found a turnover rate of about 30% for firms in financial distress during the period from 1981 to 1987.²⁷² The much higher rate for firms here (1992 to 2003) is consistent with the overall thesis that bankruptcy has changed in two fundamental ways over the last twenty years: first, the liberalization of the distressed debt market has allowed vulture investors and other creditors to play a much more active role in monitoring and disciplining managers; and second, the profile of firms in financial distress has changed from firms with good management and bad balance sheets to firms with both bad management and bad balance sheets.²⁷³

Another interesting piece of data is the fact that almost 70% of CEO replacements are firm outsiders. This data supports the signaling theory described above, whereby firms replace managers in part because doing so evinces a seriousness about the reorganization process and the firm's future prospects. This finding is consistent with, although somewhat higher than, the data from the 1980s, where CEO replacements were less than 60% outsiders, suggesting weakly that the importance of the signaling component of personnel decisions has increased over time.²⁷⁴

C. Compensation Types and Methods

We are now positioned to examine the content of compensation bargains to determine what they tell us about agency cost theories. If CEO employment contracts look the same before distress, when agency costs and managerial power are high, as after distress, when, as shown above, they are greatly reduced, the data would suggest two possibilities. First, it would suggest that compensation contracts in healthy firms are "optimal," meaning that they fairly replicate the results one would expect from arm's-length bargaining. The second possibility is that the contracts are "efficient,"

²⁷¹ See Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 454 (1988) (finding a mean tenure of about ten years for CEOs at firms with both insider- and outsider-dominated boards).

²⁷² Gilson & Vetsuypens, *supra* note 8, at 441.

²⁷³ Telephone Interview with managing partner of distressed-debt trading arm of major investment bank (Apr. 3, 2004).

²⁷⁴ Gilson & Vetsuypens, *supra* note 8, at 442.

meaning that they are the best we can expect given the costs, even with an increased role for judges, boards, and investors.

There may be many reasons why the contracts written by near-principal agents are not likely to be different from those written by less motivated agents. For example, Michael Jensen and Kevin Murphy argue that “cultural practice” is a powerful reason why firms do not have provisions that limit CEO rights to unwind incentive contracts.²⁷⁵ In a similar vein, Randolph Beatty and Edward Zajac argue that “aspects of top executive compensation . . . in large corporations may often be the result of historical tradition and bureaucratization.”²⁷⁶ Additional explanations are also possible, such as inertia and the cognitive biases and heuristics of decisionmakers, be they the board or other owners or stakeholders.²⁷⁷ There is also substantial evidence that contractual forms can be quite “sticky.” Reading dozens of reports from compensation committees, one finds a similarity in language (if not actual text), style, and approach, which suggests some boilerplate aspects of the work, or at least the reporting of the work. This may be efficient in some sense in that it reduces the costs of contracting for executive compensation, but it may lead to some irrational results during periods where no innovation is taking place.²⁷⁸

If one believes behavioral anomalies and stickiness are behind the similarity in compensation methodology, however, the proposed solution to reform allegedly excessive compensation—to increase the power of institutional investors to act as a counterbalance to managerial power—is unlikely to help. If distressed-debt investors with strong statutory, judicial, and cus-

²⁷⁵ Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them* 66 (ECGI Finance Working Paper No. 44/2004, 2004), available at <http://ssrn.com/abstract=561305>.

²⁷⁶ Beatty & Zajac, *supra* note 166, at 314; see also George P. Baker, Michael C. Jensen & Kevin J. Murphy, *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593, 597–99 (1988) (noting that changing compensation systems in large firms is extremely costly, even when moving toward a more efficient system, because of the risk of disrupting vested political and economic interests of employees).

²⁷⁷ See Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 123–24 (2004) (“Decision makers experience greater regret when undesirable consequences follow from action than from inaction. Hence, decision makers tend towards inertia. Because the effect of these cognitive biases is considerably greater than traditional rational choice theory predicts, even a small risk of liability can be expected to have a large deterrent effect on managers who are already risk averse by virtue of their non-diversifiable investment in firm-specific human capital.”). See generally Adam Butler & Scott Highhouse, *Deciding to Sell: The Effect of Prior Inaction and Offer Source*, 21 J. ECON. PSYCHOL. 223 (2000) (discussing inertia and business decisionmaking); Charles R. Schwenk, *Information, Cognitive Biases, and Commitment to a Course of Action*, 11 ACAD. MGMT. REV. 298 (1986) (discussing heuristics and biases in business management).

²⁷⁸ See, e.g., Ian Ayres & Stewart Schwab, *The Employment Contract*, 8 KAN. J.L. & PUB. POL'Y 71, 85–87 (1998) (discussing default rules and the use of penalty defaults to overcome some persistently irrational or unfair results in boilerplate employment and consumer contracts); Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Examination of Sovereign Bonds*, 53 EMORY L.J. 929, 938–39 (2004) (finding that contract innovation in a somewhat similar, lawyer-driven context proceeds in bursts that are separated by long periods of sticky status quo).

tomary rights cannot overcome managerial power over compensation in this context, then no investors under any conceivable reforms are likely to do so for healthy firms.

1. *General Contracts.*—To test these hypotheses, this Section examines the structural content of employment contracts of firms before and after distress.²⁷⁹ Overall, and in general, pre-distress contracts look nearly identical to post-distress contracts, and to contracts in healthy firms that did not experience financial distress.²⁸⁰ In other words, sophisticated institutional investors with huge stakes in the firm, and thus lower agency costs, rewrite CEO employment contracts that look exactly like contracts written by healthy firms with higher agency costs: they have multi-year terms, automatically renew, pay a fixed salary, provide for generous performance-based bonuses, use large grants of at-the-money options and restricted stock, allow reloading and repricing of options, and grant lucrative severance and retirement benefits. Let us look at the specific elements of typical contracts.

a. *General terms.*—The vast majority of healthy firms use multi-year, written contracts to employ their CEOs.²⁸¹ The fact that executives can lock in their employment for several years on favorable terms has been criticized by some corporate observers as evidence of excessive managerial power in compensation negotiations.²⁸² We see, however, that long-term contracts are used for firms in the post-distress period as commonly as they are used for healthy firms or for those in pre-distress periods: about 90% of the firms studied here used long-term contracts in the pre-distress period.²⁸³ The contracts written by creditors appear identical in length and scope to those of the healthy firms in the Schwab and Thomas study—these contracts are two to five years in length and are typically automatically renewable in one-year increments after the initial term expires. This is not to say that firm-specific contracts before and after are identical. Some renego-

²⁷⁹ Contracts or contractual terms were taken from SEC filings, reorganization plans filed with bankruptcy courts, other public sources, or parties to the case. In order to create a fair pre-distress control group, employment contracts from years well before financial distress (years -6 to -3) were used. The terms of both “before” and “after” contracts were coded in several key areas, including salary, bonuses, equity compensation, long-term retirement, and so on. In addition, post-distress contracts were compared with the set of standard contractual terms for healthy firms as described in a recent empirical work by Schwab and Thomas, *supra* note 137. This comparison with firms outside the data set provides a check to ensure that the pre-distress contracts are representative of compensation contracting at healthy firms generally.

²⁸⁰ See generally Schwab & Thomas, *supra* note 137, at 246–58.

²⁸¹ See *id.* at 247 (finding that approximately 82% of CEO employment contracts have terms greater than 1 year); Bebchuk et al., *supra* note 3, at 765.

²⁸² See Joann S. Lublin, *Many High Executives are Working Without a Net*, WALL. ST. J., Oct. 26, 2004, at C4 (reporting that some firms have ceased using employment contracts for top executives because they do not provide for sufficient accountability).

²⁸³ Only one firm out of forty changed its practice in the post-distress period. See Table 2.

tiation did take place, and some firms did alter the basic contract form in minor ways. For example, debtor Carmike Cinemas wrote a new employment contract with the same length as its pre-distress contract, but removed the automatic renewal provision.²⁸⁴ Other firms changed the length of the term for various reasons, sometimes making it shorter and sometimes longer. For example, Federal Mogul Corp. changed the length of the CEO's employment contract from three years (pre-Chapter 11) to five years (post-Chapter 11).²⁸⁵ Again, we see firms recontracting and writing contracts anew, but mostly with little or no change in the terms.

The contracts of healthy firms and pre-distress firms also provide for a fixed salary regardless of performance, with a one-way "up" ratchet, and a discretionary bonus, which is a multiple of the employee's salary and payable only if certain firm performance criteria are met. Rewritten, post-distress contracts are the same as other contracts: all provide for a fixed salary and nearly all provide for performance-based bonuses.²⁸⁶ As above, firms do make a few changes after experiencing financial distress. For example, while healthy firms use primarily financial bonus metrics, distressed firms include non-financial metrics, such as making debt payments, conducting asset sales, and emerging from distress.²⁸⁷ In addition, in some post-distress cases, bonuses are a guaranteed element of compensation, payable from KERP plans. These changes are not, however, significant rejections of pre-distress terms. All in all, the basic structure of employment contracts is the same before and after distress, as well as the same as employment contracts for firms outside of the data set.

b. Equity components.—Critics point to multi-year terms, guaranteed salaries, and big bonuses as evidence of managerial power, but the bulk of criticism is reserved for the way firms reward executives with various forms of equity compensation. While some critics point solely to the size of option awards as evidence of greed or wrongdoing,²⁸⁸ others levy a

²⁸⁴ Compare Carmike Cinemas, Inc., Annual Report (Form 10-K/A), at 8 (Apr. 29, 2002) (describing 5-year term with no automatic renewal), with Carmike Cinemas, Inc., Annual Report (Form 10-K/A), at 7 (Apr. 30, 2001) (describing 5-year term with automatic renewal).

²⁸⁵ See Federal Mogul Corp., Annual Report (Form 10-K), at 111 (Mar. 15, 2004) (describing contract length for former CEO Frank Macher and new CEO Charles McClure Jr.).

²⁸⁶ About 95% of pre-distressed firms had a performance-based bonus plan for the CEO. This fell to almost 90% in post-distress contracts, as some firms paid guaranteed bonuses as part of KERPs (perhaps to offset CEO wealth losses from stock options that went underwater).

²⁸⁷ See, e.g., Carmike Cinemas, Proxy Statement (Schedule 14A), at 33 (Apr. 16, 2004) (noting that the discretionary portion of the CEO's compensation was tied to "debt pay-down, asset sales and other performance metrics" in addition to the standard metric of EBITDA performance).

²⁸⁸ See AFL-CIO PayWatch, 2005 Trends in CEO Pay, <http://www.aflcio.org/corporatewatch/paywatch/pay/> (last visited Apr. 24, 2007) ("A reasonable and fair compensation system for executives and workers is fundamental to the creation of long-term corporate value. However, the past two decades have seen an unprecedented growth in compensation only for top executives and a dramatic increase in the ratio between the compensation of executives and their employees.").

more powerful criticism, arguing that commonly used options are inefficiently designed to properly motivate managers. The argument, made by Bebchuk among others, is that non-indexed, at-the-money options reward executives for market- or industry-wide rises in stock prices instead of linking pay specifically with idiosyncratic firm performance.²⁸⁹

There are two proposed solutions to remedy the flawed design of options: use either premium-priced or “indexed” stock options. The first type—premium-priced—are simply options whose exercise or strike price is set above market price in order to give recipients incentives to raise the stock price before profiting. As one firm that uses this type of option reports, this strategy gives executives rewards only for “superior results.”²⁹⁰ According to recent research, using out-of-the-money options rather than at-the-money options increases firm value.²⁹¹ Thus, the argument goes, the only explanation for the failure to use these options is managerial rent seeking. This hypothesis is not borne out by the data. About 95% of firms in the data set used conventional options in the pre-distress period, which is fairly representative of pricing policies generally, and no firm changed its option pricing policy after agency costs were reduced.²⁹² In short, at-risk institutional investors made the same choices about equity compensation as directors in healthy firms with higher agency costs made.

Although some corporate critics believe premium-priced options to be better than at-the-money options, they are still viewed as inefficient because they can reward recipients for rising markets that have nothing to do with a CEO’s individual value contribution to the firm and that do not indicate something that shareholders could not have received from holding other securities.²⁹³ Accordingly, the strongest calls for reform are to use “indexed” options—the second solution. These are options with a variable exercise price that is determined by comparing firm performance with an index of competitor firms; only when the firm outperforms its rivals by some predetermined amount will the options be “in the money.” The belief is that “indexed options can generate more incentive per dollar” by “tightening the

²⁸⁹ Bebchuk et al., *supra* note 3, at 812; *see also supra* notes 46–49 and accompanying text.

²⁹⁰ *See* Casual Male, Annual Report (Form 10-K), at 40 (May 1, 1998).

²⁹¹ Michel A. Habib & Alexander Ljungqvist, *Firm Value and Managerial Incentives: A Stochastic Frontier Approach*, 78 J. BUS. 2053, 2076 (2005) (finding that options used by firms do not induce optimal risk taking).

²⁹² There were a handful of firms that used premium-priced options in both pre- and post-distress periods. *Compare, e.g.* Casual Male, Proxy Statement (Schedule 14A), at 13 (May 5, 1998) (“[A]ll stock options granted to executive officers in fiscal year 1997 have an exercise price 140% higher than the fair market value of shares of Common Stock on the day of grant.”), *with* Casual Male, Proxy Statement (Schedule 14A), at 21 (July 6, 2004) (awarding some options with an exercise price of fair market value and some with an approximately 15% premium built in).

²⁹³ BEBCHUK & FRIED, *supra* note 2, at 142 (“The overwhelming majority of executives have therefore been rewarded for absolute share price increases, even those that are purely a function of broad market or sector rises that lift all boats.”).

link between compensation and performance.”²⁹⁴ Critics maintain that the case is so strong for using indexed options that the only explanation for their absence from typical employment contracts is managerial power: “as long as managers can get away with the use of conventional options, they will do so.”²⁹⁵

And yet even when managers cannot get away with it—when sophisticated investors with large stakes and with knowledge of the alleged benefits of indexed options²⁹⁶ write new employment contracts—firms still use traditional at-the-money, non-indexed options. In all cases in the data set, the debtor used stock options in the pre-filing period, cancelled existing stock options upon the occurrence of distress, and issued new options under new terms after reorganization.²⁹⁷ None used indexed options in either period. Moreover, other stock option characteristics, such as vesting periods (three, four, or five years), expiration dates (ten years), and stock holding requirements (several percent), were generally the same before and after distress.

Alternative explanations for the lack of appeal of indexed options have been made effectively by others. These include: there is already implicit indexing in CEO stock portfolios due to managerial risk aversion and the fact that human capital is nondiversifiable;²⁹⁸ indexed options are costly to implement due to the need for an observable, non-manipulable index and the complexity from an accounting standpoint;²⁹⁹ they may create excessive risk preferences on the part of managers;³⁰⁰ and they do not work as in-

²⁹⁴ *Id.* at 141.

²⁹⁵ *Id.* at 144.

²⁹⁶ The explanation for the failure of sophisticated institutional investors to implement indexed options cannot be lack of awareness. In fact, the reformers claim that “sophisticated institutional investors and their advisors do not share managers’ negative view of indexed options . . . [and] have called for the use of indexed options, even though this step would reduce reported earnings.” *Id.* at 148–49.

²⁹⁷ Two examples demonstrate the general trend. See, e.g., Guilford Mills, Annual Report (Form 10-K/A), at 66 (Dec. 29, 2003) (“Pursuant to the [Reorganization] Plan, all options outstanding on the Effective Date to acquire shares of Old Common Stock (including the options granted to [the CEO] during fiscal 2001) were cancelled. The options granted to the [CEO] during the 2003 fiscal year represent options . . . to acquire shares of New Common Stock.”); Lason Inc., Annual Report (Form 10-K/A), pt. III, at 3 (Apr. 27, 2004) (“All options previously granted under the Company’s 1995 Stock Option Plan and under the 1998 Equity Participation Plan were cancelled pursuant to the [Reorganization] Plan . . . Pursuant to the [Reorganization] Plan, the Company adopted the Executive Management Incentive Plan . . . [under which it] issued [new] shares of its common stock to the . . . participants.”).

²⁹⁸ See Core et al., *supra* note 13, at 38 (“[T]here is considerable implicit [indexing] in these portfolios.”).

²⁹⁹ See Susan J. Stabile, *Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool to Focus Reform*, 35 WAKE FOREST L. REV. 153, 208–09 n.235 (2000) (“[Indexed] options create adverse accounting consequences.”).

³⁰⁰ Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1922–24 (2001) (describing indexed stock options as “asymmetric calls”—that is, options on the firm’s performance that amount to a heads-I-win, tails-you-lose bet—that create a preference for “super” risk, and stating that “[i]f the firm does better than the market, the holder-employee gains; if the firm does worse than the market, the same employee does not pay the employer or otherwise emerge with negative income”).

tended.³⁰¹ Given that sophisticated investors choose not to issue indexed options when they hold all the cards, managerial power is an inadequate explanation for why they are not used; it is more likely that one or a combination of these alternative explanations is the reason.

Not only do firms not implement indexing when agency costs are reduced, some of the changes they do make are steps in the wrong direction in the eyes of the managerial power theorists. For example, the only thing worse than non-indexed, at-the-money options, according to these theorists, is restricted stock, which has an exercise price of zero, and therefore provides no incentive effects to recipients. About 60% of firms in the data set used restricted stock in the pre-distress period, but even several firms that did not use it in the pre-distress period chose to issue restricted stock in post-distress contracts.³⁰² Only one firm—Acme Metals—chose to eliminate the use of restricted stock.

There are several other characteristics of standard option contracts that these theorists claim are largely explained by excessive managerial power, including the lack of contractual restrictions on the ability of CEOs to unwind options through hedging. Bebchuk and Fried bemoan the lack of unwinding restrictions in CEO contracts, arguing that their absence allows CEOs to “eliminate[] the incentive benefits of these instruments,” thus giving shareholders either “weaker incentives for a given level of compensation” or requiring shareholders to “pay more for a given level of incentives.”³⁰³ According to a recent study of hundreds of employment contracts in healthy firms, no firms have such restrictions despite this being “the natural place where corporations could make CEOs promise not to unwind their stock option positions using derivative securities.”³⁰⁴ Bebchuk and Fried point to this failure as evidence of excessive managerial power and argue that reducing agency costs by empowering shareholders and boards to be more active would change contracting behavior in this area.³⁰⁵ Jensen and Murphy echo these sentiments, noting that they “have been mystified for many years as to why boards do not formally restrict managers’ freedom to unwind the incentives the [board] constructs for them.”³⁰⁶

³⁰¹ Lisa K. Meulbroek, *Executive Compensation Using Relative-Performance-Based Options: Evaluating the Structure and Costs of Indexed Options* (Harvard Business School Working Paper No. 01-021, 2000), available at <http://ssrn.com/abstract=281028>.

³⁰² Compare Borden Chemical, Annual Report (Form 10-K), at Item 11, Summary Compensation Table (Mar. 31, 1999) (pre-distress: no restricted stock issued), with Borden Chemical, Annual Report (Form 10-K), at Item 11, Summary Compensation Table (Mar. 28, 2003) (post-distress: CEO issued approximately one million shares of restricted stock); compare Carmike Cinemas, Proxy Statement (Schedule 14A), at 13–14 (July 24, 2002) (pre-distress: no grants of restricted stock), with Carmike Cinemas, Proxy Statement (Schedule 14A), at 25 (Apr. 16, 2004) (post-distress: CEO issued approximately \$15.5 million in restricted stock).

³⁰³ See BEBCHUK & FRIED, *supra* note 2, at 174.

³⁰⁴ Schwab & Thomas, *supra* note 137, at 235.

³⁰⁵ BEBCHUK & FRIED, *supra* note 2, at 191.

³⁰⁶ See Jensen & Murphy, *supra* note 275, at 67.

But no firms in the data set placed any contractual restrictions on CEO portfolio management when creditors rewrote employment contracts, suggesting that there are other forces at work besides high agency costs.

Table 2: Summary Statistics of Sample Contract Terms for Firms in Financial Distress

Term	N	Number of firms with substantially the same terms		Change
		Pre-distress	Post-distress	
Multi-year contract	40	35	34	1
Fixed salary, performance bonus	41	39	33	6*
At-the-money, non-indexed options	38	36	36	0
Restricted stock	37	22	21	1
Long-term incentive programs/severance	38	38	38	0
Change of control provisions	34	34	34	0

* Each of these was a change from performance bonus to guaranteed bonus or emergence bonus during the reorganization

c. *Retirement elements.*—The final part of compensation packages that raises the ire of critics is the lucrative retirement and severance provisions these contracts offer.³⁰⁷ A recent exposé in the *New York Times* condemned generous retirement plans, quoting an investor advocate as asking: “[W]hat’s the point of paying somebody after they’re gone?”³⁰⁸ The elements that managerial power theorists find particularly objectionable include: large amounts of deferred compensation and severance packages, change-of-control provisions that accelerate option vesting and provide big cash payouts in the event of a merger or sale of the firm, and lucrative consulting deals for CEOs in retirement. While on the surface there appears much to fault in the design of some CEO retirement benefits, firm “owners” did not in most cases take advantage of reduced recontracting costs and reduced managerial power to alter these benefits. Some firms changed the form of retirement benefits—e.g., moving from defined-benefit pension

³⁰⁷ Timothy L. O’Brien, *Mayday? Payday! Hit the Silk!*, N.Y. TIMES, Jan. 9, 2005, § 3, at 1.

³⁰⁸ *Id.* (quoting Elliot Schwartz, research director at the Council of Institutional Investors). The answer to this question is obvious: retirement benefits are merely compensation deferred into future periods. Employees may benefit for tax reasons while employers may benefit for a variety of tax, accounting, or monitoring reasons. For this latter point, see M. Todd Henderson & James C. Spindler, *Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption*, 93 GEO. L.J. 1835, 1851–52 (2006).

plans to lump-sum deferred compensation under KERP plans—but the general nature of retirement benefits looked the same before and after distress in over 90% of cases. Post-distress contracts contained large deferred cash plans and long-term incentive plans consisting mostly of mega-grants of company stock, extremely generous pension payments, and consulting contracts, all in the same manner and frequency as pre-distress and healthy firms. For example, debtor Covanta Energy entered into an agreement, approved by creditors and the bankruptcy court, to provide its outgoing CEO with a generous “soft landing,” including millions in annual payments and a two-year consulting contract so that the firm could “retain the critical knowledge and insight of the waste-to-energy business that [the CEO] possess[e]d.”³⁰⁹ This agreement, cut between an outgoing CEO and motivated owners who were not captured by the CEO, is typical of post-distress contracting.

2. *Example Case Study: New CEO of WorldCom.*—The employment contract of WorldCom’s CEO Michael Capellas provides a nice case study to illustrate the resiliency of employment contract terms in the face of enhanced scrutiny. Prior to Capellas’s arrival at the end of 2002, WorldCom collapsed, falling from its place as one of the world’s leading telecommunications firms into Chapter 11. With over \$100 billion in assets, WorldCom represents the largest bankruptcy in history.³¹⁰ The fall was reported ubiquitously and continuously for months, as thousands lost their jobs, shareholders were wiped out, and the details of the accounting scandals and the excesses of former Chairman and CEO Bernie Ebbers were uncovered.³¹¹ Ebbers, who built the firm from nothing into a hundred-billion-dollar behemoth through a series of bold acquisitions, received annual compensation in the tens of millions of dollars and borrowed over \$300 million from WorldCom and its banks to fund everything from share purchases to a boat building business.³¹² In the wake of the collapse, the Department of Justice, the SEC, and numerous state attorneys general launched civil and criminal investigations.³¹³ As a result of these investigations, numerous former em-

³⁰⁹ See Covanta Energy Corp., Quarterly Statement (Form 10-Q), at “Reorganization Disclosure” (Nov. 14, 2003).

³¹⁰ Luisa Beltran, *WorldCom Files Largest Bankruptcy Ever*, CNN MONEY, July 22, 2002, http://money.cnn.com/2002/07/19/news/worldcom_bankruptcy/.

³¹¹ See, e.g., Jake Ulick, *WorldCom’s Financial Bomb*, CNN MONEY, June 26, 2002, <http://money.cnn.com/2002/06/25/news/worldcom/>.

³¹² Beltran, *supra* note 310; Susan Pulliam et al., *Former WorldCom CEO Built an Empire on Mountain of Debt*, WALL ST. J., Dec. 31, 2002, at A1 (“Bank of America ponied up \$253 million. Citigroup lent Mr. Ebbers \$552 million. To help Mr. Ebbers pay back some of those loans, the WorldCom board lent him \$415 million from the company’s coffers. The bank loans went to fund a jumble of acquisitions, including timberland, a yacht-building company and a refrigerated trucking firm.”).

³¹³ See, e.g., Press Release, DOJ, U.S. Charges Ex-WorldCom CEO Bernard Ebbers; Former WorldCom CFO Scott Sullivan Pleads Guilty (Mar. 24, 2004), available at <http://www.fbi.gov/dojpressrel/pressrel04/world030204.htm>.

ployees have been sentenced to prison, and millions of dollars in fines have been levied.³¹⁴

In Chapter 11, WorldCom (acting as the DIP) recruited Capellas, the then-president of Hewlett Packard, to be the new CEO.³¹⁵ At the time, WorldCom's fate largely was being controlled by a bank syndicate that had agreed to loan the debtor about \$2 billion in additional funding under a revolving credit facility, and by a group of vulture investors, who took blocking positions in WorldCom/MCI bonds.³¹⁶ These creditors were active in making personnel decisions,³¹⁷ evaluating business strategy, and disposing of assets, as well as developing a reorganization plan.³¹⁸ In fact, a large bondholder/distressed-debt investor was instrumental in the search for and choice of Capellas to replace Ebbers.³¹⁹ In addition to this creditor oversight, WorldCom's significant actions were subject to the approval of former SEC Chairman Richard Breeden, who was appointed as a corporate monitor by the federal bankruptcy court overseeing the reorganization.³²⁰ Breeden issued an eponymous report on WorldCom's corporate governance; the report contained seventy-eight specific recommendations that WorldCom had to implement as a precondition to emerging from Chapter 11.³²¹ The enormous public scrutiny, creditor involvement, and unprecedented judicial oversight made the WorldCom reorganization an extreme example of the reduced agency costs model described above.

It was in this environment that the debtor and its owners negotiated an employment agreement with new CEO Capellas. The original contract was submitted for review by the courts—both the U.S. District Court and U.S. Bankruptcy Court sitting together—and the corporate monitor. It was rejected on the grounds that the amount of pay was excessive.³²² Breeden

³¹⁴ Krysten Crawford, *Ebbers to Forfeit Assets*, CNN MONEY, June 30, 2005, <http://money.cnn.com/2005/06/30/news/newsmakers/ebbers/index.htm>; Sullivan Gets Give Years for WorldCom Fraud, ASSOC. PRESS, Aug. 11, 2005, available at <http://www.msnbc.msn.com/id/8907976/>.

³¹⁵ See Andrew Backover, *Giuliani's Firm Helps WorldCom Creditor*, USA TODAY, Nov. 18, 2002, at 38.

³¹⁶ *Id.*; Daniel Gross, *WorldCom is Bankrupt; So How Did It Get a \$2 Billion Loan?*, SLATE, July 24, 2002, <http://www.slate.com/id/2068443/>. At this point in the history of the firm, there were outstanding bonds for both WorldCom and MCI, and each had a role in the restructuring, but the details are not relevant to this discussion.

³¹⁷ See Backover, *supra* note 315, at 38.

³¹⁸ Based on numerous in-person conversations with employees of the distressed-debt investors and their advisors during the years 2002–2003.

³¹⁹ *Id.*

³²⁰ See Andrew Backover, *Overseer Confident WorldCom Will Come Back*, USA TODAY, Dec. 29, 2002, at 48.

³²¹ RICHARD C. BREEDEN, RESTORING TRUST, REPORT TO THE HON. JED S. RAKOFF, THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK, ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC. (2003), available at <http://www.corplawblog.com/archives/000181.html> [hereinafter BREEDEN REPORT].

³²² David Schepp, *Judge Slams WorldCom CEO Pay Plan*, BBC NEWS, Dec. 11, 2002, <http://news.bbc.co.uk/1/hi/business/2567669.stm>.

then negotiated a revised agreement that reduced the amount of pay by about 25%, and this contract was approved by the courts.³²³ The final contract, which was therefore subject to creditor, corporate monitor, and judicial approval, was substantially the same in structure and basic terms as contracts in healthy firms and pre- and post-distress debtors in the data set examined in this Article. The contract had the following key characteristics: (a) a three-year term; (b) a fixed salary that cannot be reduced; (c) a guaranteed bonus for the first two years (during the expected period of reorganization) and a performance-based bonus (after emergence) determined by specified, objective financial criteria; (d) a grant of millions of dollars of non-indexed, at-the-money options with a three-year vesting period and ten-year term; (e) a grant of millions of dollars in restricted stock; and (f) generous severance provisions in the event of a change of control.³²⁴ So even under these extreme circumstances, we see substantially similar contractual terms being written for distressed firms as for firms in general. If anything, the Capellas contract, following from the Breeden Report, relies more heavily on restricted stock than typical contracts, a fact some critics would surely point to as evidence of excessive managerial power but for the unprecedented oversight in this case.

In a revealing post-script to this case study, Capellas took home nearly \$40 million in severance pay when Verizon acquired MCI (nee WorldCom) in 2005.³²⁵ This “golden goodbye” looks similar to severance packages that are trotted out as exhibits of managerial domination of the pay-setting process.³²⁶ But, as noted above, the contract that gave Capellas this alleged windfall was not written in an environment of high agency costs. Two federal judges, a government-appointed corporate monitor (who is a governance expert), and a few uber-sophisticated investors holding nearly all of WorldCom’s debt, wrote the contract under intensive public scrutiny.

³²³ Seth Schiesel, *Judges Approve WorldCom CEO Pay Plan*, N.Y. TIMES, Dec. 17, 2002, at C10. Despite the reduction, Capellas was still scheduled to earn in excess of \$20 million over three years to turn around WorldCom. See Larry Neumeister, *CEO to Earn \$22 Million for WorldCom Rescue*, ASSOC. PRESS, Dec. 17, 2002, available at <http://the.honoluluadvertiser.com/article/2002/Dec/17/bz/bz10a.html/>.

³²⁴ See Terms and Conditions of Employment, Michael D. Capellas and WorldCom, Inc. (Dec. 2, 2002), available at <http://news.findlaw.com/hdocs/docs/worldcom/120902cplswcmk.pdf>. The contract, in accordance with the Breeden Report, limited the maximum amount of compensation in any year to \$15 million without shareholder approval and limited severance payments to \$10 million. See BREEDEN REPORT, *supra* note 321, at 92 (Recommendation 4.03 (capping severance, without shareholder approval, at \$10 million)); *id.* at 95 (Recommendation 4.04 (capping total compensation, without shareholder approval, at \$15 million per year)).

³²⁵ Dawn Kaawamoto, *MCI Chief’s Severance Deal Nears \$40 Million*, ZDNET NEWS, Sept. 2, 2005, http://news.zdnet.com/2100-1035_22-5846030.html.

³²⁶ See BEBCHUK & FREID, *supra* note 2, at 90–91 (“[T]hese payments indicate the existence of managerial power over directors.”); AFL-CIO Executive PayWatch, Top 25 Largest CEO Pensions, <http://www.aflcio.org/corporatewatch/paywatch/goldengoodbyes.cfm> (last visited Mar. 2, 2007) (lampooning large executive compensation packages awarded in the face of poor performance).

* * *

We thus see employment agreements written in low agency cost environments that look substantially the same along key dimensions as those written in higher agency cost settings. The general structure of the agreements is the same, payment of cash compensation and equity are made in the same way, and retirement packages are comprised of similar terms. This evidence supports the view that the contracts we observe are the best that we can expect—they can be said to be either the product of arm's-length bargaining or the best any owners are likely to write, short of the theoretical one hundred percent owner. Let us turn now from the form to the amount of compensation to see if this further supports the optimality and efficiency claims.

D. Compensation Levels in Financially Distressed Firms

The data shows that firms actively renegotiated key elements of compensation, frequently reducing salaries, bonuses, and option grants. That being said, about 33% of firms made no changes in compensation levels, and another 25% made changes to only one element of the compensation mix (e.g., shifting the compensation mix from cash-rich to equity-rich). Those firms that did reduce compensation at some point during distress tended to increase it after the dark financial clouds lifted, suggesting performance-related adjustments. Since compensation is typically broken down into two components—cash and equity (including options, long-term incentive plans, and so on)—we will consider each type in turn and compare compensation levels in the periods before, during, and after distress.³²⁷

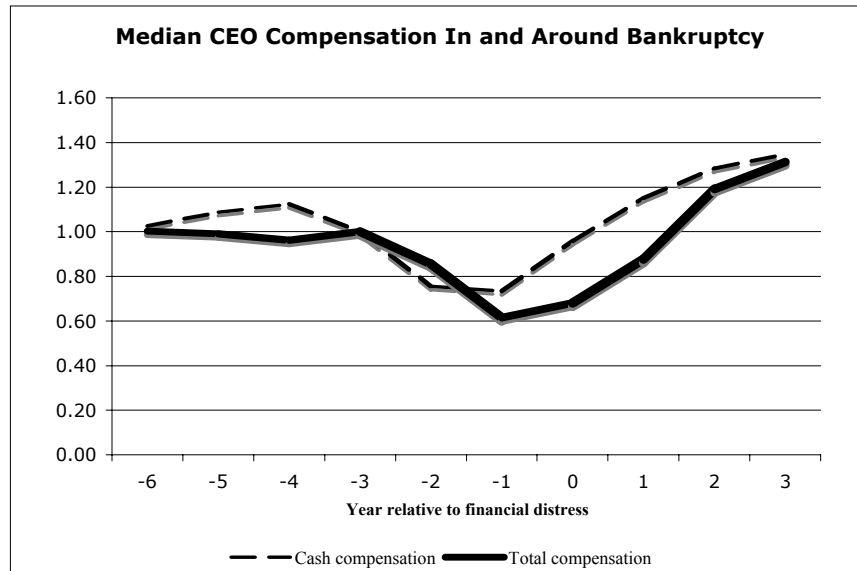
1. Cash Compensation.—Comparing the average total cash compensation in pre- and post-distress periods, the median change was an increase of 13%, with almost 70% of firms increasing or keeping total cash compensation the same.³²⁸ The results are roughly the same for the subset of firms retaining the same CEO, with increases of 20–30% in the post-distress period. The amount firms pay in cash compensation in the shadow of Chapter 11 is shown in Figure 1. Generalizing from this pattern, we can see that in the years prior to significant financial distress, but while the firm is still underperforming (years -4 to -3), firms modestly increase cash compensation

³²⁷ The four years prior to the triggering event are designated -4 to -1, while the period after filing is designated 0 to 4. The average time a firm spends in Chapter 11 is about 18 months, but the increased monitoring of outside investors starts before the firm files for reorganization and continues after the firm emerges from Chapter 11. In the typical case, creditors begin to exert influence six months to one year prior to the firm filing for Chapter 11, although the intensity of the monitoring role increases as bankruptcy approaches. After bankruptcy, firms that emerge as new public firms often have a board appointed by or with several members from the distressed-debt investors.

³²⁸ The mean increase was approximately the same.

in order to keep pace with inflation and to provide sufficient levels of compensation to attract and retain talented managers. As the firm faces the threat of bankruptcy, cash compensation is reduced as performance suffers. Over 40% of the firms reduced cash compensation in the two years preceding a distress event (years -2 to 0).³²⁹ Firms then increase cash compensation as they emerge from bankruptcy (year 1), usually in the form of a cash bonus payable on the successful emergence of the firm from bankruptcy. Pay then remains flat, on average, for the next few years. It then rises substantially, perhaps when the firm's fortunes rise as bankruptcy is left far behind, or perhaps when firms that have remained in bankruptcy beyond the typical one to two years emerge and pay bonuses that are tied to a successful reorganization plan.

Figure 1



These results are generally consistent with the data from the prior ten years,³³⁰ and by and large are what one would expect. Firms are more likely to reduce cash compensation in the several years leading up to Chapter 11 or private workout; during this period, performance falls and the firms face

³²⁹ This conclusion is consistent with the prior work of Gilson and Vetsuypens, who found that “firms systematically restructure their management compensation contracts when they experience severe financial difficulty.” Gilson & Vetsuypens, *supra* note 8, at 439. The changes in compensation levels are not dramatic (modest decreases in salaries and, more often, bonuses) but are real, and suggest that firms are facing the issue of executive compensation as part of their dealing with the impact of financial distress.

³³⁰ *Id.* at 434–35.

cash constraints, increased monitoring costs, and higher outrage costs. Firms may also want to change the compensation mix to reduce cash in favor of incentive compensation to motivate CEOs. The decrease in compensation as a result of lower performance is consistent with the fact that most CEO employment contracts, which are still enforceable in the shadow of Chapter 11, provide for a fixed salary with a variable bonus pegged to various performance metrics. The data supports this conclusion—the average salary component of cash compensation was 8% higher in firms that experienced financial distress at some point during this ten-year period, while the average bonus component was 45% lower.³³¹ Outrage is likely the highest as a firm approaches and enters bankruptcy, and, at first glance, the data showing reduced cash compensation in the several years leading up to Chapter 11 supports that intuition.³³²

Perhaps somewhat surprising is the fact that only about one-third of firms reduce cash compensation during the one or two years the firm is in Chapter 11. There are several possible explanations for this observation. First, during this period, wage levels may have already fallen to a level at or near the CEO's reservation price, that is, the level below which compensation would be insufficient to retain and motivate the CEO. Second, some firms may actually increase cash compensation in Chapter 11 to compensate for the loss in value of CEO stock option wealth, as shareholders are relegated to the back of the creditors' line. Finally, the firms resetting cash compensation in Chapter 11 are typically not those that made changes before the filing of the petition. Thus, the firms reducing compensation in years 0 to 2 are merely responding to a different set of pressures and incentives than the firms that reset compensation levels in years -4 to 0. In order to get a better picture, let us look at the components of cash compensation.

a. Salary.—A CEO's base salary is routinely a fixed amount payable regardless of firm performance. Base salaries are not typically renegotiated at any time during the duration of the employment agreement, even when the amount is objectively undeserved—a policy called “no cut” contracts.³³³ These salaries are contractually guaranteed, making the CEO's bargaining position quite strong. Salary can be viewed as the reservation

³³¹ Our data indicate that average salary for healthy firms was about \$600,000 per year, and for distressed firms \$650,000 per year; average annual bonus was \$450,000 per year for healthy firms, and \$250,000 for distressed firms. The net result is that cash compensation in distressed firms was about 20% lower than in healthy firms.

³³² An alternative explanation for the decrease in cash compensation is that powerful managers tweak salaries and bonuses slightly to reduce outrage, knowing fully well that compensation levels will return to “normal” once the specter of bankruptcy is lifted. This explanation does not hold water, as discussed in *supra* Part IV.A.2.

³³³ Contracts often allow for increases but not decreases in salary levels. *See, e.g.*, Hayes Lemmerz Int'l, Inc. Annual Report (Form 10-K), at 34 (May 1, 2002) (“The initial annual salar[y] for [the CEO is] \$755,000 . . . , to be reviewed annually, and may be increased, but not decreased, by the Compensation Committee of the Company's Board of Directors.”).

wage or bare minimum required to secure the CEO's services for a given period. Any amount below the fixed salary would mean losing the executive and possibly generating costly litigation. Finally, as the managerial power theorists argue, the CEO likely has some power over the board with respect to compensation negotiations, and the board is unlikely to challenge a CEO on the contractually agreed-upon terms given these costs.

As we have seen, however, when the firm files for Chapter 11, the barriers that prohibit recontracting over salary levels are overcome.³³⁴ We therefore see reductions in CEO base pay as creditors tear up executory employment agreements and write new ones. This occurred in nearly all of the cases in the data set.³³⁵ The average firm increased salary levels slightly from pre-distress levels, suggesting salary levels were not excessive in most cases.³³⁶ The salary increases outside of the shadow of bankruptcy (before filing in years -4 to -3, and after emergence in years 1 to 4) are similar to the two to three percentage point increases for the largest 2500 U.S. firms during the study period.³³⁷ Thus, if we take out the period immediately prior to filing and the time firms spend in Chapter 11, the picture is one in which distressed firms largely mimic the compensation patterns of healthy firms.

Looking firm by firm, we see that about 80% of firms either increased their compensation in the period after distress or kept it the same compared with pre-distress levels: eighteen increased compensation an average of 32% (median: 25%); fourteen kept the salaries the same before and after distress. Ten firms wrote new contracts that reduced the average CEO salary compared with pre-distress levels. The average reduction for these firms was about 25% (median: 22%). Most of these firms emerged in 2002 and 2003, however, when CEO pay decreased on average for all firms in the Fortune 500 by about 8%.³³⁸ This market-wide decrease in compensation makes the decrease for the ten firms lowering CEO salaries significantly less.

³³⁴ These barriers are lowered somewhat when an employment contract ends, and firms take advantage of these reduced costs to renegotiate in some instances. See Company News, *Coca-Cola Chief to Be Paid Less Than Predecessor*, N.Y. TIMES, Sept. 18, 2004, at C4 (reporting that Coca-Cola's new CEO's salary and bonus package was reduced to \$4.5 million from the \$5.5 million his predecessor received). Chapter 11 not only terminates every contract regardless of its term, but also reduces other recontracting costs.

³³⁵ See, e.g., Covanta Energy, Annual Report (Form 10-K), at 139 (Mar. 30, 2004) ("Prior to the Company's emergence from the Chapter 11 cases, it formally rejected all of the prepetition employment contracts covering the executive officers named in the compensation tables.")

³³⁶ The median salary in the pre-distress period was \$650,000, compared with \$665,000 in the post-distress period.

³³⁷ The average salary for all firms in 1993 was \$554,000, compared with \$678,000 in 2002, representing an approximately 2.5% constant growth rate. Calculation based on Compustat's EXECUCOMP database, *supra* note 15. See also Erin White & Kris Maher, *Please, Sir, a Bit More?*, WALL ST. J., Oct. 26, 2004, at B1.

³³⁸ Patrick McGeehan, *Is CEO Pay Up or Down? Both.*, N.Y. TIMES, Apr. 4, 2004, § 3, at 1.

The change in salary (plus and minus) for these firms was not caused by firm performance—in all cases, the revenue, profitability, and market return data were all negative for these firms over the periods in question. In addition, a regression of salary levels against these potential explanatory variables—sales, net income, return on assets, total return to shareholders (TRS), and a dummy variable for a new CEO—shows that they are all insignificant (p value > 0.005) at the 95% confidence level. A regression of year-to-year salary changes against the year-to-year changes in these variables also shows they are insignificant.

To isolate the variability introduced by the change of CEO, consider the subset of firms ($N=12$) that kept the same CEO during the entire study period. The data for these firms mirrors that for all firms in the sample, with average salary in post-distress years being about 5% higher than that in pre-distress years. This suggests that the hiring of a new CEO, either from inside or outside the firm, does not have a big impact on the conclusion. This is also supported by the regression, as noted above.

While the vast majority of firms kept their compensation the same or increased it in the period after distress, ten firms did lower salaries, suggesting that some recontracting took place. This data squares with the theory outlined above that creditors increase monitoring and cause some firms to reduce compensation levels. The rarity of changes also suggests, however, that salary is basically off the table in terms of renegotiations for most firms for the reasons outlined in the beginning of this subsection. Let us now look more closely at bonus levels.

b. Bonus.—All of the firms in the data set had discretionary bonus programs, which are, on average, about 50% of an executive's cash compensation in a given year. The bonuses are typically paid in a year-end lump sum, and the algorithm for calculating the amount is contractually specified. In nearly all cases, the bonus is a multiple of the employee's salary (ranging from 0.5 to 2)³³⁹ and is linked to an objective measure of firm performance, such as earnings per share.

As expected, we see bonuses fall in and around financial distress, most likely due to the decrease in firm performance. Bonuses also rise significantly in the first years after filing Chapter 11 because firms routinely pay "emergence bonuses" when the firm restructures its debt. These bonuses are negotiated with the creditors' committee or bank consortium providing DIP financing and are included in KERPs or revised employment agreements. In addition, the bankruptcy court overseeing the reorganization must approve these bonus programs. The average emergence bonus in the data set was approximately the average bonus for the executive in one or two prior years, and was usually about equal to the executive's annual sal-

³³⁹ Bonuses were guaranteed in about 10% of the firms in the sample.

ary.³⁴⁰ In other words, an executive's bonus during the one or two years of reorganization is deferred until after the firm successfully reorganizes. This is a sensible strategy on the part of the creditors and the firm because it prevents the CEO from cheating in a final period by allowing the firm to verify performance.

In order to control somewhat for the impact of firm performance and emergence bonuses, we can compare bonus levels several years prior to distress (say, in years -6 to -3) with post-distress bonus levels (say, in years 2 to 4). The data shows that firms did not dramatically reduce the amount of discretionary bonuses paid post-distress. The median change was a 19% increase compared to pre-distress levels. About 80% of firms increased or kept bonus levels the same: twenty-four firms increased bonuses an average of over 200%, while nine kept levels the same. Eleven firms did reduce bonuses by an average of about 50%. In each of these cases, however, firm performance was a potential explanatory factor. A simple regression of bonus levels against metrics of firm performance shows that a firm's return on assets is a significant explanatory factor (p value < 0.005) at the 95% confidence level. This is corroborated by the fact that three of these firms remained in Chapter 11 during the entire duration of the study period.

Another control is, as above, examining firms with the same CEO over the entire period. The potential impact that outgoing and incoming CEOs can have on bonus data is substantial; firms might be expected to give outgoing CEOs a "soft landing" or "golden goodbye" and incoming CEOs a "golden handshake." The data for these firms, however, corroborates the data from the broader data set, with the mean and median bonuses rising similarly in the post-distress period.

Thus, the bottom line on bonus levels is that, like salaries, they are renegotiated with creditors and approved by the court, and they look very much the same post-distress as they do pre-distress. In other words, the employment contracts written for the firm by the sophisticated, nearly one hundred percent owners are quite similar to those written for the firm when managers were more firmly in control.

2. *Equity Compensation.*—The other major component of CEO compensation is equity compensation. During the period of study, the largest part of the compensation mix was this noncash compensation, usually in the form of restricted stock, various forms of stock options, or both. While dis-

³⁴⁰ For example, in the reorganization of Fruit of the Loom, the debtor disclosed the following about its emergence bonus:

The Bankruptcy Court also approved a retention plan for key employees, including executive officers. Pursuant to such order, executive officers, other than [the CEO], receive retention and emergence payments equal to 65% to 80% of their base pay. [The CEO] is entitled to receive an emergence bonus equal to \$800,000.

Fruit of the Loom Inc., Annual Report (Form 10-K), at 117 (Apr. 16, 2001). This was approximately the CEO's annual salary and bonus level prior to distress. *See id.* at 113 (showing a salary of \$700,000 and zero bonus).

tressed firms paid less of their total compensation in stock options than healthy firms, options still composed 50% to 60% of total compensation on average.

The decision to use options for CEO compensation in and around bankruptcy is complicated by a variety of factors. On the one hand, stock options should have great appeal to firms in financial distress; if used correctly, they are a seemingly cashless way for firms to provide high-powered incentives to management to improve the firm's performance. Options are also the accepted method for ensuring the alignment of principal and agent risk profiles. This alignment becomes increasingly important as a firm struggles to reorganize its debt and turn around its business prospects.

On the other hand, options will be worth less to the executive as the firm's financial position deteriorates and its stock price falls, such that the cost of issuing the options (for example, dilution costs) may outweigh their incentive effects. Options are also an inefficient way to pay managers of firms in financial distress because "firms whose top management . . . face substantial risk, due to either the firm's riskiness or their managers' level of equity holdings, receive diminishing benefits from imposing further risk bearing on managers through compensation contracts."³⁴¹ In addition, as the probability of bankruptcy becomes more certain, any stock options will become effectively worthless because shareholders' equity claims will have the lowest priority when the firm reorganizes. Finally, firms with fewer growth opportunities and whose investment decisions are easier to monitor—both of which are true for distressed firms—should be expected to use less incentive compensation.

In terms of amount, the median firm increased the average value of stock option grants by 8% in post-distress contracts compared with the average value in pre-distress contracts.³⁴² This holds true for firms that did not change CEOs during the relevant period. Comparing pre-distress and post-distress contracts, about 60% of firms increased or kept the same the value of options granted to their CEOs. Of those firms that did reduce the value of options granted, about half granted some options (reducing the amount on average by about 50%), while the other half had reductions of 100%—that is, they granted no options at all during the study period. This complete reduction was not a repudiation of options as a compensation mechanism or necessarily a rejection of the amount of pre-distress grants. Rather, it is explained by the fact that the firms remained in bankruptcy, were in the process of completing a liquidation or merger with another firm, or were operating with a chief restructuring officer who did not get an equity stake

³⁴¹ Beatty & Zajac, *supra* note 166, at 327 (noting that options granted in periods of distress also may impose excessive risk upon managers because of the diminishing marginal benefit of risk-increasing compensation methods in already risky circumstances).

³⁴² This data comes from EXECUCOMP category "BLK_VALU," which is the Black-Scholes value of options granted. Compustat EXECUCOMP Database, *supra* note 15.

as part of a short-term contract. Therefore, less than 20% of firms reduced the value of options granted in post-distress periods for reasons unrelated to Chapter 11 processes. Moreover, the reduction in value for these firms may be explained more by their performance than by a change in bargaining power—TRS for firms decreasing option values is a significant explanatory variable at the 95% confidence level. The TRS for these firms was almost ten times worse than that for firms that increased or kept values the same, holding other potential variables, such as sales, net income, CEO identity, and return on assets, constant.

Since the value of options may be impacted by the decline in stock price prior to or during bankruptcy, another way to gain additional insight into this question is to look at the total number of options granted as opposed to the Black-Scholes values of the options as issued. If we compare the average number of options granted in the two years prior to bankruptcy (years -2 to -1) with the average number granted in the prior years, we find that about 70% of the firms substantially increased the number of options granted to the CEO in the shadow of bankruptcy.³⁴³

While one might think that this can simply be explained by the fact that a decreasing stock price requires the firm to increase the number of options granted to achieve the same compensation level or incentive effects, the data does not support that conclusion. The magnitude of the increase in the number of options granted dwarfs any decrease in the stock of these distressed firms. For the firms that increased the number of options granted to the CEO, the increases were far greater than required to offset any decrease in stock price—the mean increase was about thirty times and the median increase was almost three times prior levels, far more than needed to offset price declines.³⁴⁴ In fact, the reported value of stock options issued on the eve of, or in, bankruptcy is on average three times greater than that of options issued in prior years. It is unlikely that the firm's owners—inevitably at this point the creditors—would want to impose additional risk-taking incentives on managers. But shareholders, including directors, may want precisely this “bet the company” approach as the firm teeters on the edge of bankruptcy.

Several other explanations are also possible. The most obvious is that significant option grants are made to attract outsiders to serve as CEOs of distressed firms. The data supports this hypothesis to a certain extent; in about half of the cases the increase was given to a new CEO in his first or second year on the job. In these cases, the grant may be designed to align shareholder-manager incentives by giving the new CEO some skin in the game, so to speak. Firms usually set target ownership levels of firm stock

³⁴³ The median increase from distress-free periods (years -6 to -3) to the eve of distress (years -2 to -1) was 188%.

³⁴⁴ The mean and median for the few firms reducing the number of stock options was about one-half prior levels.

or give substantial option grants to better align executives' financial incentives with shareholders' interests. In a failing firm, giving options is a less costly way for the firm to meet ownership targets because it does not require the new CEO to alter her portfolio, or to spend real money, to purchase shares that are losing value and that may soon be worthless. Giving options thus achieves a similar incentive effect without imposing a portfolio rebalancing cost on a new executive—that is, increasing her risk profile by putting her human capital into a faltering firm. In addition, a substantial option grant may be required to match the market price for CEO talent. Here, again, options are a less costly way to meet the CEO's reservation price because paying large amounts in salary or other cash consideration may put pressure on already tight working capital constraints and may also generate significant outrage costs.

This explanation is not complete, however, because in over half the firms, significant option grants in the shadow of bankruptcy were given to incumbent CEOs who stayed on during part or all of the reorganization. Several other explanations are possible. First, shareholders may be trying to reincentivize managers whose (under-water) options no longer provide the right incentive to engage in risk-taking.³⁴⁵ For the reasons noted above, however, this is an unlikely explanation given the large difference between the value of stock options granted on the eve of bankruptcy and in the years before distress.

The second possibility is that shareholders may be trying to realign management's incentives with their interests, given that management will owe fiduciary duties to creditors, not shareholders, once the firm approaches bankruptcy. The theory is simple: executives with substantial equity positions may act to preserve recovery for shareholders (i.e., themselves) at the expense of creditors.³⁴⁶ This attempt to buy managerial loyalty is not implausible since “in some cases, [executives] openly embrace the idea that their duty lies with the shareholders.”³⁴⁷ Several studies support this explanation, finding that “Chapter 11 often enables equityholders to obtain a share of the value of the reorganized company even when that value is less than sufficient to cover debtholders' claims.”³⁴⁸

³⁴⁵ See Cieri & Riela, *supra* note 102, at 301 (“Arguably, with an insolvent corporation, its shareholders would prefer that directors and officers take the corporate assets and ‘go to Las Vegas’: using the assets in extremely risky ventures that have a high probability of failure, but hold even the smallest possibility of astounding success.”).

³⁴⁶ Milton Harris & Artur Raviv, *The Theory of Capital Structure*, 46 J. FIN. 297, 300 (1991).

³⁴⁷ Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J. L. & ECON. 633, 645 (1993).

³⁴⁸ Bebchuk & Chang, *supra* note 134, at 255 (citing Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority Claims*, 27 J. FIN. ECON. 285, 286 (1990)); see also Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1459 (1990) (“[M]anagement has considerable leverage in having a plan confirmed that results in deviations from the [absolute priority rule.]”); Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 752–55, 759 (1989) (offering several reasons for deviations from absolute priority, and noting that “[t]he ability to remain in

If this is the strategy of shareholders, however, it is unlikely to work well or as intended. Creditors can easily negate this bribe through a severance package (if the CEO leaves) or by rolling it into future compensation (if CEO stays).³⁴⁹ Shareholders and the CEO likely know this, so a more plausible explanation is that the substantial increase in options granted by a majority of firms is an attempt to raise CEO exit costs (i.e., those borne by creditors, who typically make CEOs whole upon departure, or by prospective employers, who typically do the same to entice CEOs to jump ship).³⁵⁰ One of many examples of this is from debtor Allegheny Energy, whose new CEO “received an initial make-whole payment of \$6,300,000 to compensate him for forfeitures of financial and other benefits from his former employer.”³⁵¹ Therefore, these awards could be either a rational decision by the firm—to raise the cost of external poaching of CEOs or to reset risk-taking incentives—or a suspect, self-awarded payment at the expense of the firm and its creditors.

Some scholars have examined the practice of timing option grants to take advantage of favorable market news.³⁵² The above explanation of option grants by distressed firms is just the flipside of that practice—timing option grants to raise exit costs before *bad* news. In any case, the possibility of expropriation by managers is significant enough that bankruptcy courts should look with greater scrutiny at pre-filing option grants. David Skeel has recently proposed an expansion of existing fraudulent conveyance practice by trustees and bankruptcy courts, suggesting that “[e]xecutives should be forced to disgorge the proceeds of any stock sales they make within eighteen months of bankruptcy.”³⁵³ A sensible reform goes a step further by calling not just stock sales but option grants into question, and by extending the fraudulent conveyance “look back” period long enough to capture specious grants. These large option grants may have escaped atten-

Ch[apter] 11 when the costs are borne by the firm, and therefore in most part by creditors, may encourage [creditors] to give something to the equity holder”).

³⁴⁹ See LoPucki & Whitford, *supra* note 9, at 689 (“So even if it is desirable to retain management, from the creditors’ perspective it is cheaper to reward them by providing advantageous employment contracts than by providing a distribution to the entire shareholder class.”).

³⁵⁰ See Valerie Patterson, *Employment Contracts Attract Top Executives*, CAREER J., Sept. 15, 1998, <http://www.careerjournal.com/jobhunting/negotiate/19980915-patterson.html> (noting that “[u]pfront award[s] often [are] designed to motivate executives to leave the perks, expected stock option awards[,] and bonuses from their current firms and make a move . . .” (quoting Yale Tauber, a senior executive compensation consultant with William M. Mercer, Inc.)); see also Joann S. Lublin, *Should Financial Turmoil Force You Out of a Company?*, CAREER J., Nov. 10, 2004, <http://www.careerjournal.com/columnists/manageyourcareer/20041110-managingyourcareer.html> (“[The] next employer [will probably] cover at least a portion of the retention bonus you would lose by jumping ship prematurely.”).

³⁵¹ See Allegheny Energy Inc., Proxy Statement (Schedule 14A), at 36 (Apr. 8, 2004).

³⁵² For example, the problem of CEOs timing option grants in self-interested ways that destroy shareholder value was recently considered in Iman Anabtawi, *Secret Compensation*, 82 N.C. L. REV. 835 (2004).

³⁵³ Skeel, *supra* note 104, at 944 n.88.

tion up until now because the value of options granted on the eve of bankruptcy falls as the stock drops. But with firms buying out option packages at grant value,³⁵⁴ the possibility for abuse is real.

3. *Total Compensation.*—Turning finally to the total compensation package, which includes the current value of all present and future payments awarded to the executive in any year, we see a similar pattern. About three-quarters of firms increased or kept average post-distress compensation levels the same as pre-distress levels. The median change is an increase of 12%.³⁵⁵ The increase is the same for the subset of firms that did not change CEOs. The basic regression also supports the conclusion that the change is not driven by the presence of a new CEO, as the dummy variable of a new CEO is not significant. The change is therefore not likely the result of buying off the outgoing CEO or bribing the incoming CEO at levels above the exogenously set market wage.

The big-picture pattern is quite similar to the cash compensation data shown in Figure 1. In the pre-distress years, where the firms may be underperforming but are not facing an acute financial crisis, around 30% of firms reduce total compensation in any given year. We might think of this as a natural or equilibrium pattern for firms in this situation. But as bankruptcy comes on and creditors take an active role in monitoring the firm, over half of the firms reduced their grants of stock options in any given year. In fact, over the four-year period that we call the shadow of bankruptcy (years -2 to +2), over 75% of all firms reduced the total compensation at least once. But compensation levels return to the pre-distress equilibrium levels after the firm emerges from the shadow of bankruptcy, with no fundamental, long-term shift in total compensation amounts.

VI. CONCLUSION

Contrary to some standard accounts of bankruptcy, specialist providers of capital to distressed firms and these firms' preexisting creditors wield significant influence over debtors in Chapter 11, including over key management decisions on issues like executive compensation. This power is derived from covenants contained in typical DIP financing contracts, as well as from the statutory powers granted by the Bankruptcy Code and the customary rules of creditors' committee practice. These latter powers have dramatically increased as a result of the growth in the distressed-debt market, which allows so-called vulture investors to acquire blocking positions that enable them to virtually control the corporation in bankruptcy.

³⁵⁴ Anecdotal evidence based on interviews with partners at two executive search and compensation consulting firms. *See supra* note 229.

³⁵⁵ This data is from EXECUCOMP category "TDC1," which is "total compensation for the individual year, comprised of the following: salary, bonus, other annual, total value of restricted stock granted, total value of stock options granted (using Black-Scholes), long-term incentive payments, and all other total." Compustat EXECUCOMP Database, *supra* note 15.

As a result, and again contrary to the conventional wisdom, the pay-setting process for senior executives in Chapter 11 functions reasonably well, or as well as can be expected. The power of incumbent managers and the power of the firm are fairly equal, and there is evidence that the parties actually dicker over compensation terms and amounts. Therefore, recent reform efforts to limit executive pay in bankruptcy are largely misplaced. One caveat is needed, however, with respect to pre-petition option grants. The data shows disproportionately large grants to CEOs in the two years leading up to Chapter 11 that may be better explained as self-serving attempts to increase severance payments or to get “golden handshake” payments from a new employer than as sincere attempts to realign incentives or reduce poaching by increasing exit costs. Courts should give these grants additional scrutiny. During the several years leading up to bankruptcy, creditors are not yet closely monitoring the firm, and external forces may not be providing the disciplinary constraint required in such a final period for the executive and (perhaps) the firm.

The compensation data from about eighty firms that restructured their debts during the past ten years also sheds some light on the ongoing debate about whether existing compensation practices in healthy firms are better explained as the result of excessive managerial power or as the result of arm's-length contracting. As we have seen, agency costs are greatly reduced in Chapter 11 because of the increased monitoring role of creditors and the oversight provided by courts and other stakeholders. Compensation negotiations in this context are therefore largely freed from the taint of alleged managerial power that critics say corrupts negotiations in healthy firms. And yet, in the absence of high agency costs and clear managerial power, compensation practices are largely the same as they are in pre-distress periods and in healthy firms. In other words, when sophisticated creditors (who are spending their own money) write employment agreements from scratch, they resemble those written by firms with more diverse ownership interests.

This does not necessarily prove that existing contracting practices are efficient, but it does suggest, at the very least, that these contracts are the best we can expect, even if the reforms of managerial power theorists are implemented. These monitors are likely to be less effective at writing employment agreements or policing compensation practices than are creditors in bankruptcy, since this latter group will have larger ownership stakes, greater statutory and customary rights, better information and access to corporate decisionmakers, and a more powerful negotiating position. If these creditors are unwilling or unable to alter compensation practices, we can conclude either that the compensation system is not broken or that none of the proposed corporate governance changes is likely to fix it.