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ON THE SCOPE OF MANAGERIAL DISCRETION IN CHAPTER 11

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In response to Yair Listokin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with Debt*, 155 U. PA. L. REV. 777 (2007).

In *Paying for Performance in Bankruptcy*,[1] Yair Listokin invites us to rethink the role of executive compensation in bankruptcy. The key intuition behind his article is to apply the core insights from the executive compensation literature that exist in general corporate law to the problem of executive compensation in bankruptcy. Those studying corporate governance have argued for years that some form of equity compensation would serve to align the incentives of managers with those of shareholders. Even critics of current pay practices embrace the notion of equity compensation; they find fault instead with the way it has been implemented.[2] Listokin draws on the economic arguments in support of equity compensation to suggest that, inside of bankruptcy, managers should be paid with the debt of the company. Compensating managers with such an instrument, he argues, will align the managerial interests with those of the unsecured creditors, and this alignment would do a decent job of encouraging managers to take socially efficient actions. It is not perfect, but, according to Listokin, it is better than the practices that we typically see today. Thus, Listokin would provide unsecured creditors, acting

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[1] Yair Listokin, *Paying for Performance in Bankruptcy*, 155 U. PA. L. REV. 777 (2007).

[2] Lucian Bebchuk and Jesse Fried, for example, have been two of the more vocal academic critics of current compensation practice; their primary critique concerns the disconnect between executive compensation and performance. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 121 (2004) ("The problem . . . is that the high price shareholders have been paying for executive compensation has bought too little incentive.").

through the creditors committee, with the option of paying those who run the corporation with debt.

To the extent that I have some hesitation over embracing Listokin's policy prescription, my hesitation has little to do with the analytical rigor with which Listokin develops his proposal. Rather, my hesitation lies with concerns about the method he employs. *Paying for Performance* fits comfortably in the corporate law tradition of examining corporate governance through the lens of agency costs. Since Jensen and Meckling and Easterbrook and Fischel began the modern debate about corporate law, economists and legal academics have focused on the ways in which the incentives of managers diverge from the social goal of maximizing the value of the company. For the past three decades, part of the standard project in corporate law has been to devise mechanisms to reduce these agency costs. To be sure, focusing on agency costs in bankruptcy has been an essential part of bankruptcy scholarship for years.[3] In the specific context of executive compensation, however, I worry that the assumptions driving the corporate law debate over executive compensation do not hold when a company files for bankruptcy under Chapter 11.

I. EXECUTIVE COMPENSATION AS AN INCENTIVE DEVICE

To understand the limited aspirations of executive compensation in bankruptcy, it is necessary to begin with the basic case for equity compensation in corporate law generally. Executive compensation became an issue when academics realized that managers often lacked the appropriate incentives to maximize the value of the business. The motivation was straightforward. The promise of paying managers at least part of their compensation in equity was that, by tying managers' compensation to the success of the company, the managers would take actions that would maximize company value. If executives had an economic stake similar to that of shareholders, they would have

[3] Barry Adler had been a notable leader in this regard. *See, e.g.*, Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives,* 62 U. CHI. L. REV. 575, 590-94 (1995) (discussing the "overinvestment problem" caused by the actions of self-interested creditors and managers); Barry E. Adler, *Bankruptcy Primitives,* 12 AM. BANKR. INST. L. REV. 219, 226 (2004) ("My concern with the new world of chapter 11 is the same as the traditional concern in the old world, that whoever controls the bankruptcy process can use it as a tool for self interest.").

incentives to take actions that would bolster their own pay packet and, at the same time, increase shareholder wealth.[4]

The need to use compensation structure to align incentives arose from the realization that there was no investor who could monitor managers effectively. One way to ensure that managers take appropriate action would be to observe their choices and constrain managerial discretion before the fact, such as by requiring board or shareholder approval for major decisions. Alternatively, one could discipline executives after the fact by, for example, firing those who are not up to snuff. But these tasks take both power and effort. Corporate law charges the board of directors with performing this basic monitoring function. Under state laws, the authority to run the corporation is lodged in the directors: the directors can require the CEO to obtain approval for major decisions before they are implemented, and the board can fire CEOs in whom the directors have lost confidence. Yet many question the ability of boards to carry out these monitoring tasks effectively. Too often the directors seem asleep at the switch. In some cases, the CEO may be able to limit the information that the directors receive. In the extreme, the CEO over time may come to dominate the board. Corporate governance scholars in search of effective monitors thus have begun to look elsewhere.

Shareholders were not attractive candidates. As a general matter, shareholders are not well-situated to act as monitors of corporate executives. The shares of many publicly-held companies are widely dispersed. Because individual shareholders receive only a small share of any increase in the value of the company, they lack incentives to gather information about the decisions that CEOs and their teams are making. Even if a shareholder takes the effort to gather the needed information, she has little ability to take direct action against managers. At most, she can withhold her vote for the current directors. Shareholders even lack the ability to propose directors more to their liking. This lack of incentives and influence means that shareholders can do little to constrain managerial actions.[5]

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[4] Of course, some have questioned the extent to which maximizing shareholder wealth is a fair proxy for maximizing the value of the enterprise as a whole. *See, e.g.*, Lynn A. Stout, *Bad and Not-So-Bad Arguments For Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002) (questioning whether focusing on shareholder interest to the exclusion of other groups that make investments in a corporation will maximize the value of the corporation).

[5] The current lack of shareholder power, along with proposals to increase such power, has been a theme in some of Lucian Bebchuk's recent scholarship. *See, e.g.*,

Corporate scholars have identified other levers that could, in theory, constrain managers. Many argue that a robust market for corporate control could corral wayward managers.[6] Hostile takeovers, however, face significant structural impediments. Today, staggered boards and the ability to implement a poison pill effectively have immunized many managers from the discipline of hostile takeovers.[7]

The market for a company's products places a limited constraint on what courses of actions managers can pursue. No executive can hope to last long when her company cannot sell its wares in the marketplace. Still, once the company produces sufficient revenues to ward off financial distress, the product market ceases to be a binding constraint on managerial behavior.

Thus, the existing legal and economic environment provides managers with extensive discretion in running the company. The fear of those studying corporate governance is that managers use this discretion to take action that benefits them but fails to maximize the value of the company. A taste for corporate jets will dominate a taste for corporate profits. Enter equity compensation. By tying a manager's overall wealth to the fate of the corporation—or at least its share price—the promise was that managers would take actions designed to boost the value of the company's shares.

II. EXECUTIVE COMPENSATION IN BANKRUPTCY

Listokin translates much of the learning of this corporate literature to the bankruptcy setting. He recognizes that, because the debtor is insolvent, giving equity to managers in the bankrupt company will not align the managers' interest with maximizing company value. Such an interest works to focus the attention of those in charge too much on the potential for gain and too little on the risk of loss. To provide a more appropriate set of incentives, Listokin

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Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

[6] The pioneering work here was done by Henry Manne. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-14 (1965) (characterizing corporate control as a "valuable asset" in and of itself and describing the turning around of poorly managed corporations as "one of the most important 'get-rich-quick' opportunities in our economy today").

[7] *See* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 928-29 (2002) ("In sum, we are unaware of any instance . . . in which a bidder successfully gained control of a target [with an effective staggered board] using the ballot box. This has not been the case, however, with respect to [targets without effective staggered boards].").

proposes that managers be given an unsecured debt claim against the company.[8]

In considering this proposal, I am willing to assume for the sake of argument that it could be implemented in a cost-effective manner.[9] The problem is not implementation but theory. Listokin's proposal is motivated by the assumption that managers have discretion in bankruptcy. He posits that they retain the operational discretion that they have in running the company outside of bankruptcy, and that they have the additional freedom to decide whether the company should be liquidated or reorganized.[10] Listokin's aim is to provide managers with incentives to ensure that they exercise this discretion to maximize the value of the company.

It is far from clear that managers enjoy the freedom that Listokin suggests. When we look closely at the dynamics of today's reorganizations, the problem that motivates Listokin's solution—agency costs resulting from managerial discretion—is difficult to identify. Those with money on the line have typically been worried about managerial discretion, and they have taken steps to ensure that it is exercised in their favor long before a bankruptcy petition is filed. Indeed, when we look at how decisions are made in today's environment, we can better understand the compensation practices that Listokin's article criticizes.

The defining feature of modern reorganization practice is creditor control.[11] Before a company files for bankruptcy, the holders of its private debt have a good deal of influence in the boardroom.[12]

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[8] One alternative that Listokin does not explore is giving managers a set interest in the reorganized debtor or liquidation proceeds. For example, the manager could have a 1% claim against the proceeds if the company is sold, or a 1% amount of every instrument the company issues upon reorganization. Having received a stake in the full value of the firm, the manager also has an incentive to maximize company value.

[9] This is an assumption that both Adam Levitin and Jonathan Lipson challenge directly, in their own responses to Listokin's article. Jonathan C. Lipson, *Where's the Beef? A Few Words About Paying for Performance in Bankrupcty*, 156 U. PA. L. REV. PENNUMBRA 64 (2007) (http://www.pennumbra.com/issues/articles/155-4/Lipson.pdf); Adam J. Levitin, *The Problematic Case for Incentive Compensation in Bankruptcy*, 156 U. PA. L. REV. PENNUMBRA 88 (2007) (http://www.pennumbra.com/issues/articles/155-4/Levitin.pdf).

[10] Listokin does not explore the extent to which responsibility here is divvied up between the CEO and the board of directors.

[11] *See* Douglas G. Baird & Robert K. Rasmussen, *Reply: Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 693-99 (2003) (concluding that loan covenants and concerns about director liability ensure that creditors have substantial control over distressed firms, even before bankruptcy).

[12] Douglas Baird and I have explored how the holders of private debt can pressure boards to terminate underperforming executives and bring in short-term managers.

Lending agreements are structured so that the company will violate covenants if its fortunes decline. The company needs the consent of its lenders to waive these defaults. Absent a waiver, the company faces the prospect of the lender declaring the loan in default. Such a declaration would result in the company filing for bankruptcy in the near future. Directors understand this dynamic, and the threat to throw a company into default means that the board will be attuned to the demands of lenders.

Often the lenders, as a price of the waiver, "suggest" either replacing the CEO or, at minimum, bringing in a chief restructuring officer (CRO) who reports directly to the board.[13] Indeed, outright replacement of the CEO is quite common; for example, one study that explored CEO turnover in large corporations in financial distress reported that about half of the CEOs were replaced in a two-year window.[14] If one were to include the appointment of a CRO, the figure would be even higher. The new CEO or the new CRO is often a turnaround specialist. These executives do not plan on staying with a company long; rather, they are attempting to right the ship. They stabilize operations and offer advice to the creditors as to the best course of action for the business.

We would not expect sophisticated creditors to have an inordinate amount of concern about the structure of a turnaround specialist's compensation package. The creditors know the reputation of the person they bring in (or, as they do not want to be seen as exercising control, the person they "suggest"). The choice of which turnaround specialist gets selected will depend on the situation. Creditors can engineer the installation of a new CEO at various points in the life of a distressed company. At times, creditors put a new head in place after they have already decided the fate of the company. If the creditors have already decided to place the company on the block, they will push for a manager whose talents lie in readying companies for such sales. If they have decided to reorganize the company, they will veer toward a professional whose skills lie in fixing the company's

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

[13] *See id.* at 1233-36 (discussing the role of the Chief Restructuring Officer and other techniques banks use to exercise power over troubled firms).

[14] *See* Ethan S. Bernstein, *All's Fair in Love, War & Bankruptcy?: Corporate Governance Implications of CEO Turnover in Financial Distress*, 11 STAN. J.L. BUS. & FIN. 299, 308-09 (2006) (noting a 48% CEO turnover rate among companies declaring bankruptcy and firms experiencing out-of-court financial distress).

problems. If they have yet to decide what the best course of action will be, they will endorse someone whose judgment they trust. Hiring the right person, here as elsewhere, easily dominates writing the best compensation contract.[15]

The new executive has reasons to attend to the desires of the creditors quite apart from the way in which her compensation package is structured. Turnaround managers move from company to company. They do not view any assignment as a permanent one. Fail to do the job well at one company, and a turnaround manager will find less demand for her services in the future. The short time that a turnaround manager plans on spending with any one company means that she will not impair her long-term employment prospects for a short-term gain at the helm of her current employer. The need to get rehired on a constant basis provides a strong incentive to appease the creditors.

We have to worry about incentives here, but these are not the incentives created by the compensation contract. Rather, we must examine the goals of the creditors who pressure the board to bring in the turnaround expert. The turnaround specialist is likely to be a faithful agent of the creditors. These investors are unlikely to experience any agency costs. When the creditors' interests run counter to those of maximizing the value of the company, we would expect the turnaround specialist to take actions that decrease social welfare. When the creditors do better if the company prospers, we would expect the opposite. Those worried about the actions taken by managers in bankruptcy need to focus their attention here.[16]

Viewed in this light, Listokin's critique of Stephen Cooper's stint at Enron is misplaced. Cooper is the head of one of the country's most respected turnaround firms. No one expected Cooper to stay at Enron for an extended period of time, least of all Cooper himself. The future profitability of his firm turned on maintaining his reputation.[17] Indeed, Cooper eventually took the reins at Kripsy Kreme when it ran into financial distress.

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[15] This is also true outside of the bankruptcy context. *See* Robert K. Rasmussen & Douglas G. Baird, *The Prime Directive*, 75 U. CIN. L. REV. (forthcoming 2007) (manuscript at 11, on file with authors), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=930187 ("Finding good managers is much harder and much more important than writing their contracts.").

[16] For an argument that creditors often have an incentive to maximize the value of the company, see Robert K. Rasmussen, *The Search for Hercules: Residual Owners, Directors, and Corporate Governance in Chapter 11*, 82 WASH. U. L.Q. 1445, 1456-67 (2004).

[17] Listokin seems to attribute Cooper's hiring of people at his firm to Cooper's compensation scheme. This cannot be right. When a turnaround manager is hired,

One can always second guess Cooper's decisions.[18] Perhaps he did not fetch top dollar for Enron's assets. Maybe he was not aggressive enough in pursuing actions against those who had a hand in Enron's collapse. Cooper is by no means immune from scrutiny. Yet there is little reason to believe that his decisions were affected by the structure of his compensation contract. A more plausible hypothesis is that Cooper's actions would have been the same regardless of how his compensation was structured.[19] Cooper was hired because of who he is, not because of how he was to be compensated.

Turnaround specialists are, admittedly, not put in place at all companies that file for Chapter 11. Even when long-serving CEOs remain ostensibly in charge without a CRO looking over their shoulder, they remain under considerable pressure to serve the interests of creditors. In some cases, the majority of the debt may be held by a private lender. The CEO who wishes to remain in charge needs to maintain the confidence of that lender. The threat of replacement casts a long shadow.

Even when there is no such primary lender, creditors can act collectively to police managerial behavior. There is an active market for claims in modern bankruptcy practice. Any party who dealt with the company and has a claim against it can quickly sell the claim to an eager buyer. Trade creditors and others who have little incentive to participate in the Chapter 11 process can sell their claims to those who make a living dealing in the affairs of distressed companies. Similarly, a company's debt instruments are actively traded as well. Creditors who do not wish to monitor the debtor or wait for payment have an easy exit.

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the company is hiring both the turnaround manager and his firm. The expectation is that the manager will turn to his firm for the assistance that he needs.

[18] While Listokin notes that Cooper's contract called for him to avoid a liquidation, it should be noted that, in fact, the company's assets were all sold. Douglas G. Baird & Robert K. Rasmussen, *Four (or Five) Easy Lessons from Enron*, 55 VAND. L. REV. 1787, 1809-10 (2002). Enron did confirm a plan of reorganization, but this plan was basically a vehicle for distributing the cash and securities that Cooper was able to obtain in exchange for Enron's operating assets. By the end of the case, all of Enron's operating assets that had been under the jurisdiction of the bankruptcy court had been sold. *Id.* at 1808-11.

[19] One should distinguish here between the structure of the compensation and the amount of the compensation. There is a robust market for turnaround managers. While the top ones may command premium dollar, Listokin does not identify any reason to think that the price is not set by the market.

To the extent that rational passivity on the part of shareholders provides discretion to managers outside of bankruptcy, this passivity is replaced by vigilance once a company becomes distressed. In bankruptcy, the claims are often held by repeat players who want to be there. They are quite adroit at pursuing their interests while the company is in bankruptcy. These parties, which today are often hedge funds that specialize in this activity, frequently take an active role in all aspects of the reorganization process. When the question becomes whether or not to sell the company, the manager does not have the free reign that is the foundation of Listokin's concern. This and most of the other major decisions are going to be influenced, if not actually made, by the creditors. The bottom line is that few managers in bankruptcy today enjoy the freedom that Listokin suggests.

III. EXISTING COMPENSATION SCHEMES RECONSIDERED

Once we recognize the role of creditor control, we can look at some of the compensation practices that Listokin criticizes in a new light. Consider first pay-to-stay packages, at least in large corporations.[20] Listokin criticizes pay-to-stay plans on the ground that they do not tilt managerial action toward the value-maximizing outcome. While this observation is correct, it overlooks the function that these plans in fact can serve. They basically provide a real option to the new managers on the existing workforce. When there is a management change, the new managers often have not yet had an opportunity to determine which employees are providing value and which are not. By having everyone stay in the short term, the new managers are able to assess what each employee offers.

United Airlines illustrates this process. Shortly after it entered bankruptcy, the management team, with the approval of the bankruptcy court, put in place a much-criticized pay-to-stay plan. Moreover, after a year, more than half of the employees covered by the plan had left the company. Such a state of affairs could be easily criticized: the company paid money to those who left; money that should have gone to those with claims against the company instead went to employees who left the airline.

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[20] In small corporations where the manager has skills necessary to the success of the business, giving her a bonus in the form of stock in the reorganized company may be part of her optimal compensation contract. *See* Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 948-50 (2001) (positing that existing managers are often essential to maintaining going-concern value during a reorganization).

But such an attack would be misguided. United had brought in a new CEO three months before it filed for bankruptcy. He was tasked with turning around the airline. He and his team did not yet know which employees added value to the business and which ones needed to be replaced. Had he and his team taken no action to retain employees, they very well could have lost the employees they most needed to keep. The pay-to-stay plan allowed them to assess who should be retained and who should be shown the door. It bought time to make considered decisions about who should stay and who should go.[21]

Listokin also condemns compensation structures that provide a bonus to managers for a rapid reorganization. Listokin notes, quite rightly, that these arrangements create an incentive for the managers to reorganize the company. Yet that does not mean it is a mistake to use them. Listokin's implicit assumption is that the bonus plan was put in place at a time when it was unclear which option was the best one for the company. The value maximizing choice is unclear, and the bonus inclines managers toward a path that may not be the correct one from the perspective of social welfare.

In fact, however, it is often the case that decisions about the fate of companies are made in advance of the filing for bankruptcy. If the creditors have already decided that the optimal course is to reorganize the company, one can understand why they may agree to give a bonus to the managers. The basic decision has already been made, and they simply want to induce managers to work as expeditiously as possible.

To be sure, there may be situations where Listokin's new compensation scheme dominates the others. There may be some companies where managers have been able to insulate themselves from effective oversight, both outside of bankruptcy and inside of bankruptcy. Those who own the debt of the company may not be able to work together toward a common purpose. In such a situation, the best course may be to give the managers an incentive to make the right decision. However, it is far from clear that such situations are common occurrences in today's Chapter 11. Today's managers, when

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[21] I am not asserting that all pay-to-stay plans necessarily are value maximizing. Rather, the point is that they can serve a legitimate purpose in the reorganization setting. To that extent, Congress's recent amending of the Bankruptcy Code to restrict the use of such plans is misguided. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11, 18, and 28 U.S.C.).

they are not put in place by the creditors, find themselves on a very short leash.

In the end, Listokin has provided another option that creditors have as they work out the affairs of the financially troubled debtor. To the extent that creditors find it in their interest to use debt to motivate their managers, they should be free to do so. Little harm can come from adding this device to the toolbox box of reorganization practice. Little harm, but perhaps not much good.