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SECURED CREDIT, CONTROL RIGHTS AND OPTIONS

*Robert K. Rasmussen**

INTRODUCTION

Priority continues to dominate the debate over secured credit.[1] The extent to which a debtor's voluntary decision to grant a security interest, thereby assigning priority in the pledged assets, enhances social welfare has occupied the attention of commercial law scholars for well over two decades. In the bankruptcy area, where many large businesses that cannot pay their debts end up and where secured creditors loom large, there are a number of reform proposals designed to ensure that secured creditors receive the full priority for which they have contracted.[2] Implicit in this enterprise is that federal bankruptcy law should respect the priority allocation made through the state law secured credit system.[3]

The basic question of whether secured credit is efficient has proven to be quite nettlesome. Early work raised the question of the extent to which granting priority could enhance social welfare by reducing a debtor's overall borrowing costs. While assuring secured creditors that

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[1] *See, e.g.*, Lucian Arye Bebchuk & Jesse Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996); Symposium, *The Priority of Secured Debt*, 82 CORNELL L. REV. 1279 (1997). The notable exceptions here are Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986), maintaining that security interests give secured creditors control so as to ameliorate conflicts of interest, and Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992), stating that a security interest can be used as coordination devices among creditors.

[2] *See, e.g.*, Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Barry E. Adler & Ian Ayers, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE L.J. 83 (2001); Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523 (1992); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992).

[3] Taking nonbankruptcy law entitlements as the baseline for rights in bankruptcy is a theme that dates back to the 1980s. *See* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987); For an argument that respecting contractual priority decreases a corporation's cost of capital, see Alan Schwartz, A Normative Theory of Business Bankruptcy (unpublished).

they will be paid in full may lead them to lower the interest rate they charge the borrower, unsecured creditors will raise their interest rates in response to the increased risk of non-payment by raising their interest rates. There is no free lunch here. Academics thus searched for other potential benefits. For example, secured credit may lower overall borrowing costs by constraining debtors from increasing the risks associated with their operations after obtaining debt financing. The effect of pledging assets is that these assets stay with the business and cannot be substituted for other assets that have a different risk profile, one more beneficial to the residual owners.[4]

Not all scholars, however, are convinced that the explanation for secured credit is so benign. Recent scholarly discussion has focused on how the ability to grant priority may skew a business's choice of investment projects in ways that make society as a whole worse off. In particular, concerns have been raised over the extent to which security interests encourage a debtor to engage in projects that, from a societal perspective, carry too high a risk. The worry is that debtors with secured credit will launch projects where the potential costs exceed potential gains. Although such projects by definition reduce overall social well-being, debtors find it in their economic interest to undertake these projects since much of the risk of failure is borne by parties unable to protect themselves through a higher rate of interest.[5]

Despite the relentless focus on priority, too little attention has been paid to the decision of the secured lender to terminate its relationship with the debtor.[6] This is surprising. Priority only matters when the corporation is insolvent and a decision has been made to have an accounting of one sort or another. Whether the corporation will be liquidated or reorganized, creditors will see a change in the rights they hold. Many pieces simply assume that, if the debtor fails, it will have a

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[4] *See* Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. Legal Stud. 73, 78-83 (1993); Clifford W. Smith & Jerold B. Warner, *Bankruptcy, Secured Debt, and Optimal Capital Structure: Comment*, 34 J. Fin. 247 (1979); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. Legal Stud. 225, 247-48 (1992).

[5] *See* Bebchuk & Fried, *supra* note 1; Symposium, *supra* note 1. For a contrary argument, see Claire A. Hill, *Is Secured Debt Efficient?*, 80 TEX. L. REV. 1117 (2002); Schwartz, *supra* note 3, at 12-13.

[6] This lack of attention to the termination decision is part of a larger failure to focus systematically on the control rights that a secured lender acquires over the debtor's continued operations. The general question of control rights and how such a focus alters current conceptions of corporate governance is addressed in Douglas G. Baird & Robert K. Rasmussen, Corporate Governance, State-Contingent Control Rights and Financial Distress (unpublished). *See* also David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917 (2003) (examining how debtor-in-possession financing and key employee retention plans can affect the behavior of managers in Chapter 11); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 Tex. L. Rev. 795 (2004) (looking at issues of control in both secured lending and in bankruptcy).

set liquidation value.[7] To be sure, Ronald Mann has provided an insightful case study of the termination decisions of lenders in small business cases.[8] We have little to no discussion, however, of the decisions made by secured lenders to large businesses that encounter financial distress. One should hesitate before extending the tentative lessons learned in the small business setting to situations involving larger debtors. A lender making a single $100 million loan when the business is facing financial difficulties may well insist on the loan having a different structure, and invest more effort in the termination decision than would a lender making a hundred $1 million dollar loans to businesses that appear robust at the time the loans are made.

To the extent that one can find any discussion of the decisions of lenders here, the tendency is to view secured creditors as being unduly biased toward an early liquidation. The intuition is that the present value of a business is the discounted sum of its future potential values. To the extent that we do not place a value on the corporation today, we defer the decision to later. At that later time, if the value of the debtor has declined, or more precisely if the value of the assets in which the secured creditor has a security interest has declined, then the secured lender suffers the loss. To the extent that the value of the secured lender's assets has increased beyond the lender's debt, however, that increase goes to junior parties. In other words, the secured lender bears all of the downside of continuation but only part of the upside. To that extent, the lender would prefer fixing the value of the business today rather than waiting to see how things develop.[9]

While there is undoubtedly some truth in this, I want to raise the possibility in this essay that, at least in the case of large enterprises today, senior lenders are not prone to instigate inefficient liquidations.[10] The extant discussion generally fails to take into account two ways in which modern lending practices differ from abstract notions of secured credit. The first is that loans today are often made against the backdrop of near-term distress. Liquidity problems and the fact that the business may experience even more setbacks are front and center. In this situation, it would be surprising if we were to see the establishment of a structure that systematically decreases the value of the business. The

[7] *See, e.g.*, Bebchuk & Fried, *supra* note 1, at 926; Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy*, 72 WASH. U.L.Q. 1213, 1218-19 (1994).

[8] *See* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159 (1997).

[9] *See, e.g.*, Clas Bergström et al., *Secured Debt and the Likelihood of Reorganization*, 21 INT'L REV. L. & ECON. 359 (2002); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984).

[10] For an empirical study showing that in the bankruptcy proceedings of small and mid-size Finnish corporations secured debt inhibits reorganization, see Bergström, et al., *supra* note 9.

second is that lenders to these businesses do not face the stark liquidation/continuation decision that forms the backdrop of prior work.[11] The options that a senior lender possesses are today are more nuanced than this and these new avenues require a revisiting of the accepted wisdom on the preferences and predilections of such lenders. From a policy perspective, the relevant inquiry needs to focus squarely on the extent to which the structure of lending agreements is such that senior lenders are well positioned to make the relevant decisions. In making this inquiry, one needs to compare the incentives and expertise of these lenders with other potential decisionmakers. One need not be perfect in order to be the best.

Here, it is important not to paint with too broad a brush. There is no *a priori* reason to posit that all lenders act the same regardless of the collateral that they possess, the financial state of the debtor at the time they made the loan, or the structure of the loans that they make.[12] Collateral and lenders—just like debtors—come in different shapes and sizes. Insurance companies often make large, long-term loans secured by real estate. Finance companies make revolving short-term loans backed by inventory. Banks make purchase-money loans of medium duration backed by the individual collateral at issue. Public debt contains fewer restrictions on debtor behavior than does privately issued debt. Some lenders enter the scene well before the onset of financial distress; others specialize in working with companies facing liquidity problems. It would be foolhardy to offer a single model to capture the different dynamics. Here, I want to focus on a certain type of loan, a revolving credit facility, one that we often see today as a large firm begins the slide into financial distress.

The key attribute of a revolving credit facility that is put into place after a business runs into financial problems is that it effectively gives the lender control over the debtor's cash flow. A standard feature of the loan is that it is secured by the debtor's inventory and accounts receivable.[13] The debtor is not given free access to the amount of the loan; rather, the debtor is kept on a tight leash. Its ability to receive disbursements is keyed to the value of the collateral. As the collateral

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[11] For an account of current Chapter 11 dispositions of large, publicly held companies, see Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003).

[12] The need to pay attention the differing patterns of secured credit is an important theme in Ronald Mann's work. *See, e.g.*, Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625 (1997); Mann, *supra* note 8; *see also* Hill, *supra* note 5, at 1130-33.

[13] Revolving credit facilities can be used in many different situations for a wide range of borrowers. For example, credit cards are a form of a revolving credit facility. The lender sets a ceiling on the cardholder's ability to borrow; as the cardholder repays monies borrowed in the past, she has access to new funds. The basic architecture of a revolving credit facility is one that can be adapted to various settings. In this essay, I am focusing on facilities that are put in place as large companies slide into financial distress.

turns into cash, the cash goes back to the lender, not the debtor. The debtor obviously needs cash to continue its operations, and this requires another request to draw on the facility.[14] The lender, by denying the request in full or, more likely, limiting the amount that the debtor receives, can force the debtor's hand, even to the extent of precipitating a bankruptcy proceeding. This ability to control the business' cash flow cedes much control over the debtor's future operations to the lender.[15]

To evaluate the extent to which the actions of the secured lender deviate from the ideal, one needs to focus on the decisions that the lender has to make. Bankruptcy practice over the last few years has changed dramatically. Asset sales and prearranged bankruptcies dominate the scene. In this milieu, senior secured lenders in effect hold two options, a real option and a financial option. The real option is to force a change in the business' operations, even to the point of putting the company up for sale. The financial option is the ability to instigate a prearranged bankruptcy where the senior lender's debt position is changed to equity, junior lenders receive little or no equity, and old equity holders lose their interest in its entirety. This combination of options renders concerns of inefficient liquidation by secured lenders obsolete.

I. OPTIONS, REAL AND FINANCIAL

Perhaps the hardest decision for any distressed business is when to stop. Businesses tend to run into financial difficulty because their operations are flagging. The cash that they are generating cannot cover their expenses. Still, things change, and the fortunes of the business could turn around. Premature termination can result in the loss of substantial future profits, but hanging on to a business that consumes more than it generates may be throwing good money after bad.

When should such a business concede that the game is over and cease its operations? In answering this question, it is important to recognize that this is not a bimodal choice of continuing on as is or engaging in a piecemeal liquidation. The choices that a distressed corporation has can range from restructuring its operations to discontinuing part of its operations to selling itself as a going concern

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[14] *See* Baird & Rasmussen, *supra* note 6.

[15] For example, the lender may instigate the appointment of a chief restructuring officer. This person's loyalty tends to run to the creditors. *See id.*; *see also* Matt Miller & Terry Brennan, *Creditors in Possession*, *in* THE DEAL, Jan. 12, 2004 (quoting veteran bankruptcy attorney Harvey Miller as opining, "Where does the loyalty of the chief restructuring officer go? I think if you read this carefully, you'd have to say, it's not to the company and it's not to the creditors as a whole, but it's to the secured lenders.").

to, at the extreme, liquidating in the traditional sense.[16]

The question of when to give up on a project—conceived of as part or all of a corporation's operations—is an optimal stopping problem.[17] It is not simply answered by comparing the discounted future costs of the operation to the discounted future cash flow that the operation will generate. While one's intuition may suggest that this is the relevant comparison, in situations where there is uncertainty as to a business's future cash flow, it can result in terminating projects too quickly. To the extent that uncertainty will be resolved, or at least lessened, in the near future, the best decision may be not to make a final decision today, but rather to continue the operations until that new information arrives.[18] The manufacturer whose products have fallen out of favor but has a new lineup in the works may wait until the close of the upcoming season to see if its fortunes change.[19] The retailer who has implemented a new inventory method may need some time to ascertain the extent to which the new procedures will reduce expenses. An airline buffeted by recent turmoil in the industry may have a better sense of its future revenues after conditions return to normal.

One can view the decision to be made about the future of a corporation's operations as an option. The business has the option, but not the obligation, to continue with its ongoing projects. It is a "real" option as opposed to a financial one. The holder of a real option has the opportunity to continue a project and enjoy any future gains. Termination in effect destroys the option value. Deciding to end operations means that the business will receive whatever it can obtain for the assets formerly devoted to the project. It forgoes any chance of receiving more than this.

Despite the fact that termination destroys the value of the real option, forgoing this value is sometimes the right decision to make. Options are not free. In the case of real options, the cost of retaining the option is the expected losses that will be incurred while waiting for the next decision time to arrive. When the cost that will be incurred in reaching the next decision point exceeds the value of the option, it is

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[16] *See* Baird & Rasmussen, *supra* note 11, at 675-85.

[17] Baird and Morrison were the first to apply the real options literature to the question of when to liquidate a business. *See* Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision-Making,* 17 J. L. ECON. & ORG. 356 (2001).

[18] For an extensive primer on real options, see AVINASH K. DIXIT & ROBERT S. PINDYCK, INVESTMENT UNDER UNCERTAINTY (1994). For an empirical study showing that actual decisions comport with the real options model, see Alberto Moel & Peter Tufano, *When Are Real Options Exercised? An Empirical Study of Mine Closings*, 15 REV. FIN. STUD. 35 (2002).

[19] Retailers often file for bankruptcy shortly after the close of the holiday season. *See* Christopher Scinta, *Retailers File for Chapter 11 After Eking Out Holiday Sales*, WALL. ST. J, Feb. 25, 2005, at B6. The holiday season accounts for a large share of most retailers' revenues, and failure to prosper during this period suggests that the current business model is unlikely to be successful.

time to stop.

Real options stand in contrast to financial ones. Whereas real options focus on the operational decisions of the business, financial options focus more on the ownership rights in the business. Financial options grant the holder the opportunity to purchase a financial asset at a set price. For example, a person can buy the right to purchase a share of stock in a company at a set price at some future date. In terms of businesses, it is sometimes said that equity holders have an option on the future profits of the firm.[20] The strike price of the option is the sum of the entity's existing debt. Pay off the debt in full, and all proceeds from the business flow to the equity holders.

II. SECURED CREDIT AS A REAL OPTION AND A FINANCIAL OPTION

It is easy enough to abstractly articulate when a company's operations, or parts of them, should be jettisoned. Once the cost of waiting exceeds the option value of waiting, action should be taken. It is more difficult to locate the appropriate entity to make the decision. Ideally, one would want a decision maker who has both the expertise to make the necessary decisions and the incentives to ensure that its decisions attempt to mimic this ideal. It is one thing to describe the time at which a business should cease, or at least pare back, its operations. It is another to create situations where those with control have the appropriate incentives to make the decision along these lines. All major corporations have a variety of claimants, and much energy has been devoted to delineating the agency costs that drive actions away from those that would be optimal. Decision makers tend to look after their own interests, not those of the world at large.

For years, conventional wisdom held that the managers who are charged with the day-to-day operations of the business have a bias towards continuing the project well past the time at which it should have been abandoned.[21] Selling the business—either as a going concern

[20] *See, e.g.*, John C. Coffee & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1235 (1991); Edward I. Altman, *Evaluating the Chapter 11 Bankruptcy-Reorganization Process*, 1993 COLUM. BUS. L. REV. 1, 19.

[21] *See, e.g.*, Edward S. Adams, *Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results*, 73 B.U. L. REV. 581, 610-11 (1993); Barry Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343 (1997); John Armour et al., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1723-29 (2002); Bradley & Rosenzweig, *supra* note 2, at 1076-77; Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277, 288-97 (1991); Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 459-60 (1997); George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 916-17 (1993).

or part by part—results in their termination. Pruning back on the business reduces their vista. Even if one were to engage the somewhat unrealistic assumption that managers, without more, are the faithful agents of the shareholders, the results would be the same. Were managers to hew assiduously to the interests of equity holders, these claimants stand to receive nothing if we both value the business today and relentlessly apply the absolute priority rule. Managers, both on their own accord and on behalf of their shareholders, thus seek to avoid a day of reckoning.

Other claimants seem ill-suited to make the correct decision as well. Trade creditors may seek to prolong operations so that they can continue selling their product to the business. Moreover, it is far from clear that they possess the skills necessary to decide whether or not the business to which they are selling their product has a viable future. Secured lenders, in contrast, have been viewed as unduly biased toward liquidation. They would rather realize the value of their collateral today rather than wait to see how things develop. Waiting could well cost them money, and should the fortunes of the business turn around, the new value would be shared with others. Bankruptcy judges are disinterested to be sure, but there is no guarantee that they have the training or the ability to make decision of this character.[22] Bankruptcy was viewed as a forum that held in check the divergent impulses of the various parties while they hammered out a decision on the future of the corporation.

To begin to take account of the way in which the existence of a revolving credit facility put in place before bankruptcy but while the business is facing some degree of financial distress alters this description, it is necessary to first understand the way that bankruptcy operates today. Gone are the days where bankruptcy was a collective proceeding where various claimholders negotiated over the future of an enterprise.[23] The most common use of Chapter 11 by large enterprises

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[22] For an empirical analysis that suggests that bankruptcy judges may handle the shutdown decision well in the case of small, privately held corporations, see Edward R. Morrison, *Bankruptcy Decision-Making: An Empirical Analysis of Small Firm Bankruptcies, available at* http://ssrn.com/abstract=461031 (October 7, 2003). The dynamics of the bankruptcy of large, publicly held corporations, however, differ radically from those of small firms. Moreover, there is a growing consensus that at least some bankruptcy courts compete over large cases, though there remains disagreement over how this competition affects the decisions that the courts make. *See* Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom"*, 54 VAND. L. REV. 231 (2001); Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987 (2002); Robert K. Rasmussen & Randall S. Thomas, "*Whither the Race? A Comment on the Effects of the Delawarization of Corporate Reorganizations*, 54 VAND. L. REV. 283 (2001); David A. Skeel, Jr., *What's So Bad About Delaware?*, 54 VAND. L. REV. 309 (2001).

[23] These changes and the reasons for them are detailed in Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002), and Baird & Rasmussen, *supra*, note 11.

is to engineer a sale of the business, either as a going concern or in discrete parts. A large fraction of the remaining cases are prearranged bankruptcies. Here, the business files for Chapter 11 for the sole purpose of quickly putting a new capital structure in place. The new arrangement tends to eliminate old equity holders, drastically reduce debt, and place the majority of the new equity in the hands of the senior lender. Finally, in the remaining cases, the senior creditors dominate the decisionmaking process. By and large, major decisions as to the future of the business are made usually at their urging and certainly only with their blessing.

Against this landscape, we need to reassess the stock characterization of the secured lender as having an undue bias towards liquidation, with liquidation conceived of as a piecemeal sale of the discrete assets in which the secured creditor has a security interest. In particular, the mechanics of a revolving credit facility coupled with today's bankruptcy practice suggest that the senior lender today has both a real and financial option on the business. I want to first sketch out the contours of these options, and then suggest that while the senior lender is by no means perfect, there are reasons to believe that its incentives and expertise will lead to decisions that may approximate those that would be made by a sole owner.

To delineate the ranges of choices facing a senior lender who has put a revolving credit facility in place, consider a stylized example. Manufacturer is an established enterprise that has been in operation for decades. As with many such businesses, it has a capital structure that consists of a mixture of secured debt, unsecured debt and equity. Most of these relationships were established in the past, when Manufacturer's future seemed assured. Recent events, however, have called Manufacturer's profitability, and even its continued existence as a stand-alone operation, into question. Faced with a rash of new competitors, the managers of Manufacturer believe that through austerity measures and a more aggressive sales campaign they can return the business to long-term profitability. In order to execute this strategy, however, they find that they need an infusion of cash.

The managers approach Capital Finance. After prolonged negotiations, the following deal is put in place. Capital Finance establishes a $50 million credit facility. As is usually the case, no other type of financing was available.[24] The loan to Manufacturer is backed up by the business's inventory and accounts receivable. Manufacturer,

[24] *See Asset-Based Lending: Why it May—or May not—Be Right for Your Company*, GE Corporate Financial Services ("At a time when many profitable companies have stumbled, posting net losses or weak cash flow, CFO's are increasingly finding it difficult to obtain debt financing. But even as one door—cash-flow financing from banks—closes, another one—asset based lending—remains open."), *at* http://www.gelending.com (last visited Feb 5, 2004).

however, is not given unchecked access to the money. Rather Capital Finance has a formula by which it determines the amount to lend. The formula usually allows the firm to borrow a set fraction of the amount of the assets backing the loan. For example, the facility may allow the debtor to borrow 1 – (2D + 5) times the outstanding receivables where D is the amount that the debtor has historically been unable to collect on its receivables.[25] The business services the loan, but the proceeds go to the lender. To the extent that the business needs additional funds to continue its operations, it has to get them from the lender. The lending may be done as frequently as on a daily basis. The lending agreement typically contains covenants that give the lender some degree of flexibility in deciding whether to terminate the loan.[26] Termination of the loan in this situation would generally lead to Manufacturer filing for bankruptcy.

This arrangement gives Capital Finance tremendous de facto control over Manufacturer's business. The cash that is coming into the business is Capital Finance's cash, not Manufacturer's. To the extent that Manufacturer needs additional cash, it needs to go back to Capital Finance. Capital Finance can force Manufacturer into bankruptcy by denying a requested advance. Few companies survive long outside of bankruptcy when they do not have cash to make their payroll. Alternatively, Capital Finance can condition future advances on certain actions that Manufacturer takes. To the extent that the managers of Manufacturer wish to avoid bankruptcy, a route that may well cost them their jobs, they will consider the advice offered by Capital Finance seriously.

In this situation, Capital Finance holds a real option. It can encourage the managers of Manufacturer to explore the possibility of a sale of the business to another corporation.[27] Any such sale would be consummated in bankruptcy conducted in a bankruptcy court chosen, at least in part, by Capital Finance.[28] Alternatively, Capital Finance can

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[25] This formula is taken from *Guide to Asset Based Lending* by the Commercial Finance Division of GE Capital 13 [hereinafter *Guide to Asset Based Lending*], *at* http://www.gelending.com (last visited Feb. 24, 2004).

[26] *See id.* at 16 ("Covenants help the lender monitor and control the loan while providing the borrower with the greatest possible loan.").

> [I]f a lender provides an asset based loan with no covenants, the lender may have to structure the deal as a demand loan to protect its interests. Then, if the borrower's financial condition deteriorates markedly, the lender may decide to cut off cash availability to the borrower and terminate the loan without notice.

Id.

[27] It can also suggest the appointment of a Chief Restructuring Officer, or CRO. Such a person often enters a corporation at the behest of the senior lenders with a mandate to ready the company for sale. *See* Baird & Rasmussen, *supra* note 11.

[28] *See* Marcus Cole, *"Delaware is Not a State:" Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 VAND. L. REV. 1845, 1869 (2002).

have Manufacturer sell some of its assets outside of bankruptcy, or condition future advances on Manufacturer terminating some of its operations. The key point here is that the lender is in effect exercising a decision over whether the enterprise will continue into the future in its current configuration.

Bankruptcy offers Manufacturer little promise of relief from Capital Finance's control. Firms such as Manufacturer need financing while in bankruptcy. Often, this financing will come from the prepetition lender.[29] Indeed, the revolving credit facility lender may use the debtor-in-possession financing to increase its control. Capital Finance could insist on a rollup. In such an arrangement, Capital Finance could, in effect, convert much of its pre-petition debt into post-petition debt with an administrative expense priority. Having such a priority increases Capital Finance's control because administrative expense priorities have to be paid in full at the end of the case unless the creditor agrees to other treatment.[30]

The upshot is clear. Capital Finance can control the future of Manufacturer. It can instigate a sale of the business, either as a going concern or as a piecemeal liquidation, whichever promises the greater return. It can force a restructuring of operations. It holds a real option on Manufacturer's continued operations.

Capital Finance holds a financial option as well. This option comes from the ability of Capital Finance to engineer a prearranged bankruptcy. Its security interest may cover all or substantially all of the assets of the business, and it may be owed more than the business is worth. Alternatively, the capital structure of the corporation may be such that the lender can combine with a handful of other secured creditors and perhaps major unsecured creditors so that, as a group, they have security interests in all of the assets and are owed more than these assets are worth. In either event, Capital Finance can craft a new capital structure for Manufacturer, one that eliminates or substantially reduces the debt that it is owed. In exchange, Capital Finance (and other secured lenders to the extent that such lenders exist) would receive a majority (at times all) of the equity in Manufacturer. The unsecured

[29] For example, when Solutia, Inc., filed for bankruptcy in December 2003, it received $500 in debtor-in-possession financing. This financing came from its prepetition lenders. $350 million of the financing was used to pay off Solutia's senior credit facility. *See* BANKR. WK. (Dec. 22, 2003), at 1; *see also* Sandeep Dahiya et al., *Debtor-in-possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. FIN. ECON. 259, 265 (2003) (stating that in the ten-year period beginning in 1988, fifty-eight percent of debtors receiving DIP financing received such financing from their pre-petition lenders).

[30] *See* 11 U.S.C. 1129(a)(9). To be sure, Manufacturer could seek alternative DIP financing. Such financing, however, would generally require a take out of Capital Finance. Moreover, the new DIP lender will likely insist on control over the business similar to that enjoyed by Capital Finance.

creditors would see their debts eliminated, often receiving a minority (or at times none) of Manufacturer's new shares. The old shareholders would have their interests terminated, and would receive nothing in return. In essence, Capital Finance converts some of its debt to equity.

Starting such a bankruptcy is, in effect, exercising a financial option. The senior lender acquires all or almost all of the equity of the reorganized firm. The price of the option is the debt that the lender gives up in the reorganization. The lender does not lose its real option by taking this tact. If anything, a prearranged deal may leave the senior lender more firmly in control of the business. As the majority shareholder of the reorganized Manufacturer, it usually controls the corporation's Board of Directors.[31] Moreover, Capital Finance may well retain a portion of its old debt along with its security interest. To the extent that it later decides it wants to sell the business, it retains the power to do so.

It is one thing to recognize the nature of the options that a secured creditor with a revolving credit facility holds. It is another to pass judgment on whether we should applaud or decry such a development.[32] In particular, when deciding which of its options the secured creditor should exercise and when, the relevant inquiry is the secured creditor to make a decision that is better, from the perspective of social welfare, than a decision made by other potential actors?

The extent to which the secured creditor makes decisions that advance social welfare depends on two factors, the incentives that it has and the expertise it has developed. Incentives tell us the factors that the secured creditor will consider. They identify which course of action is in Capital Finance's self-interest, and the extent to which the interest of Capital Finance deviates from maximizing the value of the enterprise as a whole. Put in the language of finance, what are the agency costs embedded in this arrangement? The extent to which Capital Finance has expertise in making such a decision tells us how well it will make its decision, at least as measured by its own self interest.

Capital Finance's incentives come primarily from the profits that it makes on the revolving facility.[33] In the typical revolving credit facility, the lender makes money through two sources. The first is that it charges upfront fees to put the facility in place.[34] To the extent that the lender profits from these fees, it pockets this profit as soon as the

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[31] *See* Baird & Rasmussen, *supra* note 11, at 697-99.

[32] Some have viewed the recent developments by which secured creditors control reorganization proceedings with alarm. *See, e.g.*, Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 12 (2003).

[33] No doubt reputational effects play a part as well. To the extent that a lender to distressed entities establishes a reputation for prematurely terminating ventures, holding all else constant, it can expect to see fewer distressed corporations seeking a loan.

[34] *See Guide to Asset Based Lending*, *supra* note 25, at 24.

loan is made. These fees tell us little about how Capital Finance will exercise its options.[35]

The second source of Capital Finance's profits is through the interest that it charges on the outstanding loan. To the extent that a lender exercises its real option to terminate or pare back Manufacturer's operations, it receives payment on its loan. This reduces the amount of the loan outstanding. While reducing Capital Finance's exposure to Manufacturer, it also reduces the potential to gain further profits on the outstanding balance.

To what extent, with this arrangement in place, do we anticipate Capital Finance having incentives that come even close to maximizing the value of the enterprise? One cannot give too firm an answer in the abstract. Much depends on the structure of the loan and the business in question. The lender will monitor the future cash flow of the business. It will continue with the loan to the extent that the option value of continuation promises the highest return. Thus, one needs to determine the extent to which the value of the lender's option approximates that of the business as a whole. The higher the correlation between the value of the lender's option and the value of the corporation, the more likely that the lender's decision will maximize the value of the business.

The lender looks at cash flow and the value of its collateral. When Capital Finance decides that Manufacturer's present and future cash flow is such that it will receive more by selling the business and ending its relationship than by continuing with the credit facility, it will have an incentive to do so. Predicting future cash flow is part of the overall value of the firm. A sole owner of a business deciding whether or to continue would focus on future profits. The more that near-term cash flows are correlated with future profits, the more the incentives of the lender approach those of a sole owner. One can easily conjure up a range of possibilities. One could posit that Manufacturer fails to make adequate investments for the future so that it can prop up short-term cash flows—thus inducing Capital Finance to stay in the relationship—at the cost of long-term profitability. Here, Capital Finance would have an incentive to continue the operations of Manufacturer too long, at least from the perspective of social welfare. Conversely, one could hypothesize that even though Manufacturer's current and near-term cash flows are meager, great profits lie in the future. Such a state of affairs would imply that Capital Finance would be tempted to give up on Manufacturer too quickly. Finally, it may be the case that current and near-term cash flows indeed give a fairly accurate gauge of the

[35] To be sure, to the extent that Capital Finance has limited capital, the ability to extract profits at the beginning of the lending relationship will create an incentive to terminate lending facilities already in place so as to make additional loans. Counterbalancing this incentive is the constraint of not developing a reputation as a lender that pulls out too quickly. *See supra* note 30.

business's future profits. In such a situation, Capital Finance may be the party in the best position to decide Manufacturer's fate.

Whether or not the lender's incentives tend to maximize the value of the business is thus an empirical question that may differ across corporations. It is important to note, however, what is not at issue. What we do not see is the collective action problem that has been the staple of bankruptcy explanations for the past two decades. Control lies in the hands of the senior lender.

Incentives, however, can only do so much. A perfect alignment of incentives will not enhance social welfare if the decision maker is inept . Making wise decisions requires knowledge and judgment. Thus, we need to inquire as to what information and expertise Capital Finance needs so as to exercise its real option in a way that maximizes its return. Much depends on the ability of Capital Finance to predict Manufacturer's future. Failure to see a coming turnaround can lead to premature liquidation. Unwavering optimism, on the other hand, may result in running the business too long.[36] A hallmark of revolving loans is that the lender understands the industry. Many industries have cycles. A lender who knows the industry is more likely to make a value maximizing decision than one who does not.[37]

Moreover, lenders such as Capital Finance today tend to get into the game only when the business has encountered financial difficulties. To the extent that some lenders seek to terminate a lending relationship due to bad times and increased loan risk,[38] this is not this situation. Rather, part of the business model of these lenders is that they seek to profit by their ability to make the right decision. There will undoubtedly be cases where they get it wrong. But in the long run, it is fair to expect that they are more likely to make a decision that maximizes their profits than would other actors. For situations where the secured creditor's real option approximates the real option that would be held by a sole owner, it is difficult to expect an alternate arrangement that would necessarily increase social welfare when times are tough.

As explained above, Capital Finance holds a financial option as well. It can, through a prearranged bankruptcy, convert some or all of

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[36] To the extent that a lender cannot assess the future prospects of the debtor, this rise in uncertainty will lead the lender to delay in exercising its option. The value of a real option increases as uncertainty over the future increases. This increase in the value of the option makes exercising the option more costly. The less uncertainty a lender sees, the more likely it is going to exercise its option rather than wait for additional information.

[37] For example, GE Capital, which is a leader in the distress lending area, hawks its asset-based lending group by touting the fact that it has industry expertise. *See GE Teams Pair Industry Expertise with Dedicated Account Management to Speed Lending,* Lending Views from GE (Feb. 2004), *available at* http://gelending.com.

[38] *See* Mann, *supra* note 8.

its debt into a controlling equity stake in Manufacturer.[39] Being a financial option, this ability tends not to affect the value of Manufacturer. Rather, what is at stake is the legal entitlements to the cash generated by Manufacturer's continued operations. To be sure, one could imagine the senior lender acting opportunistically. Capital Finance, by converting its debt into equity and extinguishing the interests of Manufacturer's former shareholders, could be attempting to capture future profits that would have eventually flowed to unsecured creditors. By placing a low value on the business, Capital Finance could increase the share of the corporation that it owns under the new capital structure.

The ability to engage in such a maneuver, however, is not unlimited. Once Manufacturer is in bankruptcy, unsecured creditors can challenge the valuation that the prearranged plan places on Manufacturer. It is unclear why unsecured creditors would sit back and allow Capital Finance to grab more than it is owed. Indeed, changes in the proposed allocations in a prearranged bankruptcy do occur.[40] Alternatively, to the extent that Capital Finance has cut itself too good a deal, outside bidders may appear.[41]

More likely, Capital Finance's exercise of its financial option may be relatively benign. To the extent that Manufacturer's current value is less than the amount owed to Capital Finance, converting debt into equity may better align Capital Finance's incentives with those of the enterprise in general. Such an exercise may leave Capital Finance holding both a substantial portion of Manufacturer's remaining debt and the substantial majority of its outstanding stock. In such a situation, Capital Finance may be left with incentives that nearly match those a sole owner of Manufacturer would have. As with real options, the dynamics may differ across cases. What is clear, however, is that the old assumption that secured lenders have a bias towards inefficient liquidation should be discarded. Secured creditors, by converting debt into equity, can participate in the future gains of the business.

Much work remains to be done. These observations are intended to frame future inquiries, not pretermit them. Recognizing that a revolving credit facility can be structured to give the senior lender both real and financial options, clarifies, but does not answer, the crucial question of whether these new arrangements are for the good. While there are reasons to believe that this new world may overcome some of

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[39] Prearranged bankruptcies accounted for over a quarter of the reorganization cases for large, publicly held companies that concluded in 2002. *See* Baird & Rasmussen, *supra* note 11, at 678-79.

[40] *See* Baird & Rasmussen, *supra* note 11, at 679 & n.20 (detailing changes in four out of twenty-six prearranged bankruptcies for large, publicly-held firms that concluded their reorganization proceedings in 2002).

[41] As happened in the case of XO Communications. *See id.* at 677-78.

the problems that used to justify Chapter 11, final conclusions require more information. In particular, the extent to which a corporation's cash flow—the beacon for the senior lender—serves as a proxy for the future profitability of the business requires further exploration. Likewise, the motivating factors behind prearranged bankruptcies could profit from additional inquiries. Still, by recognizing the nature of the interests that the secured creditor holds, we can make progress on the question of whether today's reorganization practice deserves commendation or condemnation.

CONCLUSION

The dynamics of distress change over time. New markets develop. New players come onto the scene. To the extent that existing structures tend to lead to less than optimal decisions, there is money on the table for the creative to seize. The old fears of premature liquidation by unchecked secured creditors or unwarranted continuation by entrenched managers are becoming relics of the past. Rather, we see a new world dominated by secured creditors. These creditors hold options, both real and financial, on the future of the debtor. It is the exercise of these options that will determine the extent to which current reorganization practice maximizes social welfare.