THE PRIME DIRECTIVE

Douglas G. Baird & Robert K. Rasmussen***

Al Dunlap firmly embraced the standard academic norm of running the company for the benefit of the shareholders. When he became the CEO at Scott Paper, he told the world, "Scott should be making money for its shareholders. It's a sin to lose money, a mortal sin."[1] Putting his words into action, he signed a compensation contract that tied his own wealth to the value of the company. As he had done in the past, his relentless focus on cutting costs brought millions to both Scott Paper's shareholders and himself. In his twenty months at Scott Paper, the share price more than tripled. Flushed with success, he published a book that touted his efforts at Scott Paper and at other companies.[2]

When he was hired the next year at Sunbeam, its stock leaped 49% on the announcement. Dunlap immediately applied the methods that he has used so effectively elsewhere. Payrolls were slashed, and demands on productivity were ratcheted up. "Chainsaw Al" was in charge. But something went wrong. When he looked for a buyer for Sunbeam, none materialized. Dunlap adopted a new strategy. He bought three companies, adding over a billion and a half dollars of debt to Sunbeam. Within a year, Sunbeam's stock had lost 70% of its value, and Dunlap was shown the door. Sunbeam came to terms with the debt accumulated under Dunlap's watch only when it filed for Chapter 11 bankruptcy protection.

Dunlap's career presents a challenge to the standard model of corporate law. Since Berle and Means,[3] the corporate law debate has focused on the separation of ownership and control. Jensen and Meckling launched the past three decades of corporate governance

---

* Harry A. Bigelow Distinguished Service Professor of Law, University of Chicago Law School.

** Milton Underwood Professor of Law, Vanderbilt Law School. We would like to thank Bob Helman, Todd Henderson, Randall Thomas, Bob Thompson, and George Triantis for very helpful comments on this paper. We are also grateful to Visa, U.S.A. and the John M. Olin Foundation for research support.

1. STUART C. GILSON, CREATING VALUE THROUGH CORPORATE RESTRUCTURING: CASE STUDIES IN BANKRUPTCIES, BUYOUTS, AND BREAKUPS 353 (2001).

2. *See* ALBERT J. DUNLAP WITH BOB ANDELMAN, MEAN BUSINESS: HOW I SAVE BAD COMPANIES AND MAKE GOOD COMPANIES GREAT (1996).

3. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

literature when they recast the problem in terms of agency costs.[4] Investors desire legal rules and contracts that ameliorate the agency problem that inevitably arises in a world of managers who cannot be perfectly monitored and who do not enjoy all the benefits or incur all the costs of the decisions they make. Legal rules should aim to make it easier for investors to ensure that the incentives of managers are aligned with their own.

Left to their own devices, managers become too comfortable. The more insulated the CEO and her team become, the less they take the interests of the investors to heart. They will shirk. They will empire-build. They will forgo value-enhancing projects that may increase the risk that they will be fired. They will consume excessive perks. The job of corporate law is to minimize these agency costs. This theme has dominated the corporate law debate for decades, both in the popular press and academic literature.

None of this, however, explains Al Dunlap. Dunlap lampooned corporations who touted their commitment to workers, customers, and the world at large. There was a fixed star for Dunlap, and that was increasing returns to shareholders. All of his contracts had a substantial equity component. He even insisted that the directors of Sunbeam be paid in stock rather than cash. Al Dunlap failed at Sunbeam; but his failure cannot be attributed to the ills that are said to infect today's corporate governance.[5]

Dunlap's career exposes the disconnect at the heart of today's corporate governance debate. Corporate governance focuses on devising the right set of rules that provide optimal incentives to managers. For anyone who has hired someone to perform any job, focusing obsessively on the compensation contracts seems decidedly odd. The primary problem one faces is finding the right person for the job, not worrying about agency costs. An executive who has spent her career controlling costs may be the right person to hire for a mature business facing competition on price but would be a disaster for a newly public corporation whose primary task is to build out its operations. Businesses have differing needs, both from each other and at different times in their life cycles.

CEO candidates are not fungible, nor is there a single metric by which one can assess the talent of the contenders. The problem is not coaxing the optimal amount of effort from the person selected; rather, the

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

5. One cannot chalk up Dunlap's failure as a good ex ante decision that simply did not pan out. Dunlap, after his career at Sunbeam, was damaged goods that no other company would touch.

problem is selecting the person whose skills are best suited to addressing the challenges that the company faces. To be sure, companies want to make sure that they pay their managers in the right coin and they want to monitor managers' performance. But shirking is rarely the problem. Those who become CEOs of businesses, executive directors of not-for-profits, presidents of universities, or managing partners of law firms are Type AAA personalities, completely addicted to their jobs to the exclusion of everything else in their lives. More important, when companies hire the wrong managers or when the people they hire cease to be effective, the problem is rarely the result of the type of contract companies have put in place or the type of oversight they have exercised. Changing the contract or the oversight rarely does any good. It is the personnel that needs to be changed, not the terms of the contract.

Nothing is subtle about the idea that once a company hires the right person for the job, everything else is a matter of detail. Finding the right babysitter or the right dean dwarfs the problem of writing their contracts. When a coach has too many losing seasons in a row, no one talks about a better contract or better supervision. The only question is whether the time has come to fire him. From this perspective, the dominance of the agency cost problem is inexplicable.

In this paper, we confront this state of affairs. Dispersed investors cannot act in concert. They rely on a board of directors, particularly the independent directors, to monitor the managers. The board of directors is the locus of corporate governance. To understand the role that legal rules play in this environment, we need to ask what directors do and how legal rules can affect their decisions. We argue that the challenge of hiring and firing managers is the single most important job that directors face.

While this job is by far the most important one that a board faces, the failure of the corporate law debate to focus upon this issue is in part quite explicable. Courts should not be in the business of second-guessing a board's hiring decisions. Knowing which person to hire to lead the business requires judgment, and the law can do nothing to give good judgment to those who do not have it. Nevertheless, the law has a much larger effect at the margin than commonly thought. In particular, the way in which legal rules regulate a lender's exercise of its rights under a loan covenant can make dramatic—and largely neglected—differences in the ability of investors to replace managers. Boards, for understandable reasons, may be too slow in realizing that managers have to go. Lenders tend to suffer less from this bias. A robust vision of corporate governance brings lenders within its ambit. When this is done, it becomes apparent that debates about lender liability actions, the tort of deepening insolvency, or debtor-in-possession financing need to focus on the way in which such legal rules affect the control investors have over their managers. Indeed, these debates too often couple control with liability. Lender control is thought to impose a *cost* on other investors. The debate is over its magnitude and the ability of the law to constrain it. Neglected entirely are the *benefits* of lender control, the way creditors can take actions that work to the benefit of all the investors.

I. BOARDS AND THE AGENCY PROBLEM

In the United States, investors in publicly traded businesses delegate decisionmaking to the board of directors. Widely dispersed shareholders have neither the time nor the expertise needed for effective oversight. The powers of the board of directors are plenary. In theory, boards of directors can do almost anything. Although they cannot put their hands in the till, they can vote for any action that they see fit, save for the few actions that require shareholder approval. They can redirect the assets of the business any way they deem appropriate. If the board of Wal-Mart decided that it should cease being a retailer and become a manufacturer of personal computers, it has, in theory, the power to steer the company down this path.[6]

In fact, however, a board's range of action is quite constrained. The directors are part-timers. They have day jobs. They become directors by being successful in their own careers. Directors come from the ranks of current and former CEOs of other companies, bankers and lawyers.[7] These directors do not curtail their other activities once they join the board. Because they are part-timers, there are real limits on how much time they can invest in meddling in the affairs of the corporation. Although directors have the power on paper to be dictators, the way in which their jobs are structured ensures that they will not hold the reins very tightly.

Because boards are largely self-perpetuating and can be captured by the full-time managers, academics have long looked to the market for corporate control as a way to ensure that boards act effectively or are

6. Although commentators are engaged in an ongoing debate over whether shareholders should have more power than they currently do, even the staunchest advocates of shareholder decisionmaking would leave the power to run the business in the board. *See* Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006).

7. Recent evidence suggests that, after the passage of the Sarbanes-Oxley Act of 2002, current CEOs are more reticent to serve on boards, and this has led to a corresponding rise in the appointment of retired corporate leaders.

replaced when they do not.[8] Poor managers leave money on the table, and those with an eagle eye for gains will swoop in, buy the corporation, and install new executives. Much of the work on corporate governance advocates changing legal rules to enhance the market for corporate control. Staggered boards should be difficult to install and easy to remove. The same with poison pills. State action designed to stymie takeover efforts should be resisted. *Revlon* duties that limit the discretion of boards to favor the managers when a business is in play should be given a broad swath.[9]

But apart from ensuring that legal rules facilitate the market for corporate control, what else should the law try to do? It is all well and good to make it easier for shareholders to mount proxy contests and to actively participate in corporate governance, but apart from facilitating the market for corporate control how do we want the law to steer the decisionmaking of directors? To improve the way in which the board governs the business, we need to ask what the board should be doing in the first instance.

We should not expect too much. Members of the board are involved only part time. Outside directors, by definition, lack intimate familiarity with the conditions in which the firm finds itself. They have neither the time nor the expertise to make fundamental decisions about the future course of the business. It would be a mistake, however, to think a need exists for directors to make such changes. Business models are quite durable. Successful businesses are those that execute their business plans better than their competition, not the ones that refashion them as the seasons change.

Kaplan, Sensoy and Stromberg looked at forty-five corporations that began as venture-backed start ups and matured into public companies.[10] When we think of start-up ventures, we are tempted to imagine that they possess enormous flexibility, much more so than an established business. The directors here are not part-timers but rather tend to be

---

8. Henry Manne pioneered the concept of the "market for corporate control." *See* Henry G. Manne, *Mergers and the Market for Corporate Control,* 73 J. POL. ECON. 110, 112–14 (1965). Lucian Bebchuk has strenuously argued that voting rules should be altered to make it easier for shareholders to replace directors. Yet even if one made it easier in theory for shareholders to select directors, it is still unclear whether in practice they would avail themselves of that right on a frequent basis. *See* Bebchuk, *supra* note 6.

9. Again, the literature here is extensive. It ranges from what is the appropriate role of the board here, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991), to whether the board should make this decision or the shareholders, see Bebchuk, *supra* note 6.

10. *See* Steven N. Kaplan, Berk A. Sensoy & Per Stromberg, *What are Firms? Evolution from Birth to Public Companies* (Nat'l Bureau of Econ. Research, Working Paper No. 11581, 2005), *available at* http://ssrn.com/abstract=795265.

professional directors. The venture capitalist that funds them does not have the collective action problems that plague shareholders of public companies. Moreover, the funding investors have a representative on the board. For the investors on the board, this is part of their job. Venture capitalist make money by having the companies in which they invest hit home runs. With such a focused monitor and cheerleader, one could hypothesize that the business could morph along any dimension as the entrepreneur searches for her niche.

In fact, Kaplan, Sensoy and Stromberg report that the one durable attribute of successful startups is the core idea. If anything, public companies are even more unlikely to change direction quickly. Assets are deployed and strategies developed. The cost of switching these assets to other uses probably exceeds the cost of simply starting a new venture from scratch. Major changes in the direction of the business—such as Time Warner's merger with AOL—can backfire. To be sure, one can tweak a business plan around the margins. Firms constantly expand and contract their operations. Also, businesses can evolve over time. General Electric (GE) no longer gets the bulk of its revenues from the electricity industry.[11] Yet the kudos for GE's ability to reinvent itself go to the succession of CEOs able to ascertain what was needed at the time. It was not the directors who instituted the vision that the business needed to be transformed.

If directors are not to revamp the business plan, what is their task? The most modest vision of directors is that they act as cheerleaders. They help cement relationships with key constituents.[12] They provide a sounding board for ideas, and provide feedback to the executive.[13] If the board's best use is as a sympathetic sounding board, legal rules that induce directors to police the managers more closely may backfire. An executive may be less inclined to hide bad news from a group whose mission is to provide candid advice about difficult situations than one that is supposed to pass judgment.[14] Under this vision, greater shareholder democracy and using legal levers to reshape director decisionmaking is a mistake. Once board members represent specific constituencies, they cease to be sounding boards and counselors and

11. Indeed, General Electric is that rare company that seems able to reinvent itself. Even here, however, change is gradual and is instigated by the CEO and not by the Board.

12. *See* JEFFREY PFEFFER & GERALD R. SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS 167, 167–68 (1978).

13. *See* MYLES L. MACE, DIRECTORS: MYTH AND REALITY (1971).

14. For an examination of the tension between the advising and monitoring functions of the board and how it affects the incentives of CEOs to disclose information to the directors, see Renée B. Adams & Daniel Ferreira, *A Theory of Friendly Boards*, 62 J. FIN. 217 (2007).

instead become lobbyists.

The best way to ensure a high-quality board that is able to fill this function may be to make it self-perpetuating. The governance of many not-for-profit institutions works in precisely this way, and many of these institutions—including our great universities—are exceedingly long-lived. The fellows of Harvard College were in place for over two hundred and fifty years before GE or IBM was formed.

But one can advance a different view of what directors are supposed to do. Directors might most usefully serve not as counselors, but as monitors. Under this view, the responsibility of directors, or at least the one that the law can influence, concerns basic monitoring duties. This role is easy to understand. For much of history, the only managers of businesses were themselves members of the family that owned the business.[15] A family might send one of its own abroad as a partner, not with any expectation that the son would be much of an entrepreneur, but only with the hope that he would ensure that their foreign partner did not steal from them. Modern capitalism cannot exist in such an environment.[16] We need to be sure that managers do not line their own pockets. A corporate governance regime that does this much already does a lot, and arguably such an institution exists in a regime of self-perpetuating board of status-conscious part-time directors.

For outside directors who care about their reputations, even a small risk of legal liability in a world in which there are relatively effective courts and reliable auditors, may be enough to keep managers in line. They may give managers slack, but they will not tolerate dishonesty. They will not sacrifice their own reputations for the sake of a golfing buddy. The outside directors of Enron, as bad as they may have been, fired Andrew Fastow the second they learned he was stealing from the company. Their failure arose from complacency and their inability to understand what was going on, not their unwillingness to take action when they discovered bad acts. The kind of person who becomes a director of a publicly traded company can be counted upon to put a stop to dishonesty, fraud, and illegal conduct—provided they find out about it. Fraud and mischief usually arise because the board never suspects it.

---

15. On the rise of the corporate form, see Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006).

16. Indeed, someone whose exposure to capitalism is limited in this way is likely to misunderstand it rather fundamentally. For an example of the work of someone who failed to understand that keeping your partner from stealing from you and being an entrepreneur were two different things, see KARL MARX & FRIEDRICH ENGELS, THE COMMUNIST MANIFESTO (1848). For a discussion of Engels's failings as an entrepreneur, see George R. Boyer, *The Historical Background of the Communist Manifesto*, 12 J. ECON. PERSP. 151 (1998).

From this perspective, legal rules should not so much enhance the ability of shareholders to pick directors, but make it easier for information to come to the directors and easier for them to assess it. Some recent corporate reforms work in this fashion. Whistle-blowing rules aim to ensure that information cannot be hidden from the board. Auditors must be genuinely independent and can be required to report directly to an audit committee. One of the least problematic new rules is the New York Stock Exchange's requirement that the independent directors meet outside the presence of the managers. In the absence of a legal rule, the outside directors might not be able to have such a meeting. A good manager might see an executive session as a signal that the board has no confidence in him. The board might, on that account, choose not to have such meetings. A bad pooling equilibrium can arise, one in which such meetings do not occur, even though they would be to the investors' benefit. By requiring such executive sessions, the meetings' occurrence does not itself signal any information.

But one has to be careful not to expect that this is a margin that can be pushed very far. Part-time directors cannot be full-time police officers. To be sure, one might convert the job of director into a more full-time job and put greater responsibilities on the director for looking after the business, but at this point, the director herself becomes a manager who is invested in her job with the business. The basic premise—that her reputation as a whole matters more than her position with a particular corporation—is compromised when she becomes too invested in any one enterprise. She becomes subject to the same agency problems that she is supposed to prevent.[17]

Apart from ensuring a flow of reliable information (both to the directors and the market as a whole) and that neither the directors nor the managers interfere with the market for corporate control, what else should the directors be doing? In particular, what can legal rules do to make the directors more effective than they would otherwise be? The most recent corporate governance literature answers this question by analyzing executive compensation.

The most vocal of the current critics of executive compensation schemes are Lucian Bebchuk and Jesse Fried. For them, the way in which executive compensation is set is badly in need of reform.[18] The

---

17. Indeed, things may be even worse. We see very few operations where day-to-day authority is vested in a group rather than a single individual. The law should hesitate before it moves corporations toward a governance model that has yet to be adopted in virtually any setting.

18. Setting of executive compensation has spawned an impressive body of work, both in the popular press and the legal and economic literatures. Lucian Bebchuk and Jesse Fried's recent book aggressively sets forth the argument that current levels of executive pay reflect CEOs' capture of the

lavish pay that CEOs receive reflects CEO control over the compensation process.[19] Even if the board is otherwise competent and dedicated, over time, the board is stacked with either the friends of the CEO or at least people to whom she did not object. Directors enjoy being directors. None of this leads directors to tolerate bad behavior, but they will give the CEO the benefit of the doubt. These factors lead to CEOs receiving more compensation than they would if the board engaged in hard-nosed negotiations. Legal rules can, in principle, correct for this bias.

The SEC, for example, has recently enacted regulations designed to make executive compensation more transparent. As things now stand, not only are executives well compensated by any measure, but it is also often difficult for investors to pin down the exact remuneration they receive. Money can be funneled to managers in creative ways, such as increases to pensions, use of private jets, and other means. The goal of the new regulation is to make it easier for investors to ascertain precisely how much the CEO is receiving for her services. With such knowledge in hand, shareholders can attempt to shame those directors who lavish undeserved pay on poorly performing CEOs.

The attention executive pay has received in the popular press is understandable. There is always a bit of prurient interest involved in learning how much someone makes. Who doesn't read about the pay of corporate chieftains with a bit of envy? Also, the growth in executive pay has come at a time when many other pay packets are being squeezed. The growing differential between executive compensation and the compensation of the average worker sparks outrage.[20] Whether legal rules should direct their principal attention to executive compensation, however, is a quite different matter.

Disclosure will not necessarily curb executive compensation. As Ed Iacobucci points out, mandatory disclosure may increase the level of executive compensation, even when one assumes that the board is bargaining hard with the CEO.[21] There is a market for executives and

---

compensation process. *See* LUCIAN A. BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004). An excellent survey of the economic literature on executive compensation can be found in Kevin J. Murphy, *Executive Compensation*, *in* 3B HANDBOOK OF LABOR ECONOMICS 2485 (Orley Ashenfeller & David Card eds., 1999).

19. BEBCHUCK & FRIED, *supra* note 18.

20. One sees the same understandable outrage in bankruptcy when senior executives receive incentive plans to induce them to stay with the company while at the same time ordinary workers are asked to make substantial sacrifices.

21. *See* Edward M. Iacobucci, *The Effects of Disclosure on Executive Compensation*, 48 U. TORONTO L.J. 489, 504–17 (1998). *See generally* Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1200–09 (2004)

the more that is known about how others are paid, the better bargains that prospective CEOs can strike.

Moreover, the rise in executive compensation might not reflect agency costs run amok. Increases in compensation over the years may reflect in part an increase in the size of the corporation. The more assets a corporation deploys, the more value a CEO can add. A talented manager who, relative to the next best available manager, can add even a modest one percent of value to a ten billion dollar company on an annual basis increases shareholder wealth by $100 million. There is a market for CEOs, and it is not surprising that as CEOs can add more value, they can demand higher wages.[22] As Holmstrom and Kaplan point out, investors buying a basket of American corporations during the time of the rapid increases in executive compensation received higher returns than investors who invested in other markets.[23] We see generous executive compensation in environments in which the agency problems seem quite small.[24]

To be sure, abuses undoubtedly exist, but this alone does not show CEO compensation should be a centerpiece of corporate governance. Legal rules that try to rein in excessive compensation can do more harm than good. The most obvious example is recent ill-conceived amendments to the Bankruptcy Code. These amendments forbid payments to an insider "for the purpose of inducing such person to remain with the debtor's business" absent a number of specific findings, including a finding that the payment is "essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater compensation."[25] This attempt to rein in compensation is simply silly. The very last thing a principal wants to have in place is a rule that induces her agents to spend time and energy looking for jobs elsewhere that pay more.

To see something being done badly, however, is not to prove that it cannot be done sensibly. A last-minute bankruptcy amendment written by amateurs falls far short of proving it cannot be done. No one should

(explaining why increasing compensation may be part of a well-functioning labor market).

22. Indeed, even if a CEO of a multi-billion dollar corporation increases profits by a smaller percentage than a CEO of a hundred-million corporation, she may have created more absolute wealth and thus be able to garner higher earnings.

23. *See* Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, 15 J. APPLIED CORP. FIN. 9 (2003).

24. To give only one example: the sophisticated group of private investors (including KK&R) that controls VNU were willing to pay $100 million to recruit a new CEO from General Electric, where he had been a long-time veteran. *See* Kathryn Kranhold & Joann S. Lublin, *$100 Million Helps Lure Away General Electric Veteran*, WALL ST. J., Aug. 24, 2006, at B1.

25. 11 U.S.C. § 503(c)–(c)(1)(A) (2006).

take issue with the uncontroversial idea that legal rules can, in principle, curb excessive executive compensation. But focusing upon the problem of compensation misses the point. Antecedent to the question of compensation is the question of whether the current manager should be kept at all. Put differently, academic literature that focuses upon the optimal design of compensation contracts starts in the wrong place.[26] If a manager is performing poorly, she should be fired, not subject to a pay cut.

The obsession with the compensation contract flows from accepted principal/agent models in economics. In the standard model, the agent and the principal both seek to further their own well-being.[27] The parties try to write a contract that maximizes their joint surplus by inducing the agent to put forth optimal effort. In the basic model, the optimal contract would pay the principal a fixed sum and give all of the residual due to effort to the agent. Translated to the more complex world of the corporation, the stated goal of those focusing on executive compensation is to induce the executive to maximize the welfare of the shareholders.[28]

The assumption is that, absent the correct contractual incentives, CEOs will tend to shirk. Shirking may take many forms. The CEO may not work as hard as she can. The CEO may also choose not to pursue risky projects; rather, she may play it safe so as not to risk being terminated. The CEO may look for projects that bring personal fame, say a sexy merger, rather than projects that increase shareholder wealth. Regardless of the outcome, the constant fear is that, absent a well-designed contract, the CEO will not put the interests of the shareholders first.

Incentives, of course, matter, but focusing on them to the exclusion of all else is a mistake. Finding good managers is much harder and much more important than writing their contracts. Those hired to run major corporations are winners of a tournament.[29] People compete for the top

---

26. *See, e.g.*, James Dow & Clara C. Raposo, *CEO Compensation, Change, and Corporate Strategy*, 60 J. FIN. 2701, 2703 (2005) ("We assume that change requires substantial effort from the CEO at the implementation stage, while business as usual requires much less. Hence, the reward for success must induce the CEO to put in enough effort to implement change . . . .").

27. For a description of the basic principal/agent model, see DAVID M. KREPS, A COURSE IN MICROECONOMIC THEORY 577, 577–614 (1990).

28. Of course, this goal flows from the proposition that the objective of corporate law should be to maximize shareholder value. Although this view is widespread, it is not universal. For those who espouse a more complicated role for the CEO, articulating the goal of executive compensation becomes more difficult.

29. *See* Sherwin Rosen, *Prizes and Incentives in Elimination Tournaments*, 76 AM. ECON. REV. 701 (1986).

job, with the board of directors making the final selection.[30] The prospect of the brass ring brings competitors to the tournament. Is it realistic to assume, however, that the winners of such a tournament are slackers-in-waiting? The person likely to do well in the tournament has a certain set of traits.[31] Among these is the desire to work hard. Other traits include overconfidence and a false sense of the ability to control outcomes. Those with these traits tend to survive. Are we really worried that the winner of such a tournament lacks the incentive to work hard?

Indeed, often contractual incentives are designed to channel energy rather than to induce effort in the first place. Consider, for example, the contract that the University of Colorado has given its most recent football coach. The coach will receive a $50,000 bonus if the students he coaches make sufficient academic progress. He will receive an additional $100,000 if he wins the conference title and $250,000 if he wins the national title. Although academics and victories are both desirable goals, the contract signals their relative importance.

Similarly, one can tie a CEO's compensation to any number of metrics, such as an increase in shareholder wealth, an increase in sales, or an increase in market share. The goal of these milestones is not so much as to induce optimal effort as they are to signal to the CEO where the board wants her efforts focused. Yet the contract goals here reflect the goals of the board. Even then, however, the goals are most reflected in the person that the board chooses to lead the business. A board intent upon cost-cutting commits itself to such a strategy by hiring Al Dunlap more completely than a board that hires a charismatic visionary and then builds cost-cutting incentives into her contract.

II. THE PRIME DIRECTIVE

Much of the executive compensation debate assumes away the problems associated with finding the best managers. Again, the empirical evidence from the venture capital contract literature suggests that this is a mistake. Finding good managers is hard. The single biggest predictor of the success of a venture capital deal is the venture capitalist's ex ante assessment of the strength of the initial management

30. To the extent that the board views the current CEO as successful and a good steward for the company, the board may defer to her opinion as to which candidate would be a suitable replacement.

31. Don Langevoort has done pioneering work integrating insights from cognitive psychology into the standard model of CEO selection. *See* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001).

team. Moreover, this is what all of our experience tells us. The best teams may or may not get paid the most, but we do not think the best team owners are those who write the best employment contracts. Looking at the compensation structure of the New York Philharmonic provides little insight into the quality of the performance. Daniel Barenboim and James Levine are the two highest paid conductors, but the contractual negotiations are over the amount of time they spend with the orchestra and the amount of time they spend doing something other than conducting, such as fundraising. There is no need for incentives once they are on the podium.

Similarly, New York Yankee fans were excited to get third baseman Alex Rodriguez. To be sure, everyone expected that the contract would contain incentives and bonuses, but the excitement came from the prospect of having his bat and glove, not from contract design.[32] When law schools look to hire new faculty members, they are concerned with the hiring committee's assessment of the person's ability to generate new insights and provide meaningful instruction to the students, not whether the dean will put into place a contract that ensures best efforts. Regardless of the extent to which incentive contracts matter for academics,[33] a school with the stronger faculty dominates the one with the better contracts.

When a business survives huge challenges and navigates difficult waters, it is going to be because Jack Welsh or Lou Gerstner is at the helm. From this perspective, one obligation of the board of directors of a corporation dominates all others: ensuring that the right person serves as Chief Executive Officer. All of the other decisions that we associate with the board are second order. The prime directive is to hire and, when necessary, fire the boss. Do this well, and most other concerns evaporate.

The law barely affects the hiring decision, which may explain why this aspect of corporate governance has received little attention in the legal literature. The tepid duty of care sets the legal standard. Unless it is corrupt, a board is unlikely to run afoul of its commands when it hires a new leader for the business. The weakness of the duty-of-care

---

32. Rodriguez, while with his prior team, the Texas Rangers, signed a 25-year contract that had a nominal value of more than half a billion dollars.

33. We are not arguing that incentives do not matter, even for legal academics. At least at one time, George Mason Law School seemed to adapt some of the executive compensation concepts to the academic setting when it offered a cash bonus to faculty members who placed their articles in "Top 10" legal journals. Even so, however, incentives achieve only so much. They can direct talent, but they cannot create it where none exists. In the case of George Mason Law School, the purpose was not so much to get the faculty to work harder, but rather to steer them toward particular types of publications (i.e., legal rather than, for example, economics journals).

constraint, however, is not because judges are courting managers. One cannot fashion a legal instruction to the directors, with attendant legal review, that would improve matters here. The instinctive hesitation of judges to second-guess business decisions seems well founded in this setting.

Law can, however, make matters worse. If anything, the current concern with the compensation contract may be counter-productive for exactly this reason. Were directors to heed the prescriptions of the pundits, they may well spend more time fretting over the details of the CEO's employment contract and not enough on ensuring they have the right person at the helm. Moreover, excessive scrutiny of compensation arrangements can lead directors to pick the candidate with more modest demands rather than more needed skills.

The flip side of the hiring decision is the firing decision, and it is in this context where law matters. Even the best directors can make mistakes. The promising CEO may simply not be up to the task of running the operation. Also, situations can change. The CEO who had the skills necessary to meet the challenges for which she was hired may lack the ability to meet new challenges that arise. The responsibility for firing CEOs, like their hiring, is vested in the board. Although the duties may appear symmetrical, they are not. Here, the board may be prone to systematic error. A CEO will be able to insulate herself from meaningful review, and directors are in any event inclined to see the CEO in a positive light, either because they have picked her or because she has picked them. Capture of the board by a dominant CEO has long been a concern of those who study corporations,[34] and this is the context in which it matters the most.

Michael Eisner's highly visible ouster from Disney provides a telling example. Hiring Eisner in the first instance was not a bad decision. To the contrary, he added enormous value to the company in his first ten years. He was well-paid, but the general view was that he deserved it.[35] Nor was the problem that Eisner stopped working hard. The problem was that Eisner lost the team that brought him success in the first place and, after ten years, became the wrong person for the job. Seen ex post, to the extent that corporate governance failed, Disney's failure was that

---

34. *See* BEBCHUK & FRIED, *supra* note 18, at 23 ("Directors have financial and nonfinancial incentives to favor, or at least get along with, executives."); Langevoort, *supra* note 31, at 797 ("The dominant view in corporate governance theory today is that heavy emphasis on teamwork and conflict-avoidance marks a board that has been captured by its CEO, an illusion of a governing body that acts largely as an elite private club with a rubber stamp.").

35. *See, e.g.*, Muriel Reddy, *Fairytale Comes True with a Kiss of Life for Disney*, ADVERTISER/SUN. MAIL, May 14, 1987.

it did not fire him soon enough.

In theory, it is easy to articulate the circumstances under which the board should cashier the CEO. The firing of a CEO is the exercise of a real option. The choice that the board faces is whether to exercise the option and fire the current manager or postpone the decision as it gets more information about the manager's performance. Of course, there are substantial costs to changing a CEO. The search period takes time, a time during which period the company may lack direction. Also, senior executives may spend more effort in an attempt to secure the top job rather than performing their jobs. The possibility of frequent turnover also chills the ability to attract outsiders. Failed CEOs rarely get a second chance. To the extent that a CEO has built a resume likely to generate future job offers, she is not likely to jump to a company with a reputation for quickly pulling the plug on the CEO. In other words, the optimal approach may be to promise a certain amount of slack to the CEO to land the most attractive candidate.

It is thus unclear how often we should expect executive turnover even if the board terminated CEOs in an optimal fashion. Yet there are many reasons to think that boards will be too slow to pull the trigger. One such reason is the CEO's capture of the board. In the standard account, the CEO is able to dominate the board. Over time, the board becomes a subset of her friends. She remains in place not so much because her performance is up-to-snuff, but rather because her friends appreciate her attributes.

Yet one does not have to subscribe to the notion that CEOs dominate boards to realize that boards face a difficult task when it is time to discharge a CEO. Crucial to assessing the CEO's performance is information about how the company is running under her leadership. Much of the necessary information goes beyond that which is required to be reported publicly. The board may lack the information necessary to take the correct measure of the CEO. The board by and large does not have its own source of information. It depends in large measure on the CEO for information. The CEO, like most of us, wants to appear in a good light. She has the incentive to put the best spin on her accomplishments. Successful and promising projects get top billing; those that go awry receive scant mention. Indeed, some work suggests that people who do not see their own shortcomings have a competitive advantage in the tournament to become CEO. Thus, the CEO may not even recognize bad news, let alone report it to her superiors.

The board may have its own blind spots as well. Commitment bias is a well-documented risk in many settings.[36] The basic notion is that once an individual or group has made a decision, they are likely to overweight information that suggests that their decision was correct and underweight information that calls that decision into question. We are not perfect Bayesians.

It is relatively easy to see how this tendency can infect the board's evaluation of the CEO. Having selected her, they are more likely to overlook her stumbles.[37] Even if the CEO has no role in selecting new directors, the old directors may be inclined toward candidates who view the CEO they selected favorably. The frequency with which CEOs come to dominate the board is an empirical question about which it is difficult to generate firm conclusions. Yet even a board that is not captured will have difficulty terminating an underperforming executive. The limited time that board members have to spend on matters coupled with skewed information and various predictable biases all suggest that a CEO may stay on longer than is warranted.

All in all, we should anticipate that boards hiring a CEO will be to slow to dump her when necessary. Seen from this perspective, the margin at which legal rules might be pressed the most may lie in this domain. In asking how to improve the rules of corporate governance, we might first focus on those that enhance the ability of directors to fire underperforming managers. For example, reforms that ensure a flow of information to the board may be useful for exactly this reason. Merely forcing the directors to discuss the performance of the CEO may bring benefits. A board that might never consider firing a CEO may think twice if it is forced to confront the issue and make an up-or-down judgment.

In thinking how legal rules work in this environment, however, one should look beyond the conventional boundaries of corporate law. It focuses narrowly upon shareholders. Creditors are also investors in the business. Indeed, the difference between creditors and shareholders is somewhat artificial. It has long been understood that the difference between the cash flow rights of debt and equity is entirely permeable. An equity-holder can enjoy the cash flow rights of a debt-holder with the right combination of puts and calls, and a debt holder can do the opposite.[38] But so, too, with control rights. Law makes the initial

---

36. *See, e.g.*, Barry M. Staw, *Knee-Deep in the Big Muddy: A Study of Escalating Commitment to a Chosen Course of Action*, 16 ORG. BEHAV. & HUM. PERFORMANCE 22, 22–44 (1976).

37. The level of continuation bias may be affected by how united the board was in the first instance.

38. *See* Hans R. Stoll, *The Relationship Between Put and Call Option Prices*, 24 J. FIN. 801, 803

assignment, but the parties are free to alter this arrangement in any way they see fit.

Creditors, of course, enjoy control rights only if they contract for them, which they routinely do. Private loan agreements contain elaborate covenants.[39] These covenants typically include limitations on liens, asset sales, debt, financial investments, distributions, as well as prohibitions on mergers, transactions with affiliates, and changes in business lines. As one would expect, the more creditors are likely to be residual owners, and the more they are able to act in concert, the more covenants they put in place. These covenants do not prevent such transactions, but rather give the creditor a seat at the table and a voice in these decisions. Because creditors exercise a voice in corporate decisionmaking, it is worth exploring the role they play in dumping underperforming managers and the way that legal rules affect this role.

III. DEBT AND TERMINATION

Private debt dramatically affects the dynamics of the firing decision.[40] The disciplining role of debt is well known. A defining feature of a debt contract is that it requires the company to make fixed payments. Failure to make a required payment imperils the future of the company. While one can worry about the accuracy of accounting data, all understand that not paying money when it is due is not a good sign. Indeed, failing to make a payment often signals that a bankruptcy proceeding is not far off.[41]

Yet debt plays another role as well, one that is too often overlooked. Private debt ensures that the private lender has control over many decisions once the business becomes distressed. Asset sales, new projects and new incurring of debt all require the explicit blessing of the lenders. Most importantly, however, the lenders can force the ouster of the CEO. To be sure, the formal power to remove the CEO remains with the board. However, the bank can make it known that it has lost confidence in the current management. Default, the directors know, can spell the end of their tenure with the business. If the company does enter Chapter 11 bankruptcy protection, little chance exists that the board of directors will remain intact even if the company emerges from

---

(1969).

39. *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1231–32 (2006).

40. We detail the role of debt more extensively in Baird & Rasmussen, *supra* note 39.

41. For example, the Dana Corporation filed for bankruptcy about one week after missing a required payment on its outstanding public debt.

bankruptcy. Directors, both as fiduciaries for the corporation and in their own interest, do not wish to see a default. The price of the lender's agreeing not to call the loan can be the dismissal of the CEO.

The crucial question is whether the banks exercise their power in a way that leads the board of directors to better decisionmaking. After all, the board of directors is charged with fiduciary duties that are designed to benefit the corporation. Lenders look after only themselves. They will push the board in ways that advance their own agendas, not anyone else's. Banks, however, have information and incentives that may lead them to decisions that advance everyone's interests.

As to information, banks have better information than do directors. The documents that borrowers sign give banks access to all of the information that the board has, and more. Banks can inspect their collateral. They can interview any member of the management team. They can be proactive. They do not have an agenda set by the CEO. Perhaps most importantly, they can observe the cash flows of the business on as frequent as a daily basis, something that is not feasible for part-timer directors. The directors may have an X-ray of the business, but the lender can get a CAT scan.

It might seem that lenders would suffer from a bias much like that of the directors. When a corporation seeks to borrow money, competition is fierce. Lenders have an incentive to offer as attractive terms as they can and to ingratiate themselves with the current management team. Having shown faith by putting in hundreds of millions of dollars, why then do banks not suffer from some of the same pitfalls that affect boards? If boards are likely to retain their chosen CEO for too long, why not lenders?

Even if imperfect and prone to error, lenders may be better able than directors to guard against bias. For one thing, lenders have a greater incentive to not make a mistake. Unlike the directors, lenders have invested a substantial amount of money in the company. Banks that routinely make bad loans do not survive in the market place.

More importantly, banks have structures designed to prevent the biases that may plague boards. They have a special department for handling troubled loans. This division of functions can be explained in part as repairing the cognitive bias that would otherwise result. The fate of the CEO lies not with the client partner whose compensation depends on how many loans she can close, but rather with the banker whose own compensation depends on how much she can recover from the troubled loan. She has no allegiance to the CEO. For her, the bottom line is what the bank can salvage from the situation.[42]

Maximizing the bank's return does not necessarily maximize the value of the company. By the same token, maximizing the bank's return does not necessarily reduce the value of the company. Some decisions may benefit the bank and the company alike. To the extent that part of the problem is that the CEO has lost her way, both can profit from a new leader. A new CEO who puts matters aright increases both the value of the bank's loan and the value of the company.

To be sure, it is easy to conjure up situations where the interests of the bank and the interests of the company are opposed. Banks may favor too cautious a strategy. Yet caution is not the concern with respect to the central issue of corporate governance. The question of replacing the CEO comes with few of the biases that usually lead senior and junior investors in different directions. To be sure, the bank will have a bias towards safe projects, and junior investors will favor risky ones. But in a world in which business plans are stable, these biases are not likely to affect the choice of a new leader.

If a sale or a reorganization of the business is in prospect, such bias is even more remote, as the senior investor is even less likely to suffer from bias. A risk-neutral buyer will pay an amount that collapses all future possibilities to their present value. In the event of a reorganization in which the senior investor receives equity in the business, her interests are again best served by choosing the path that maximizes long-term revenues.[43]

We should look at the way in which the law regulates corporate lenders from this perspective. Lender liability actions discipline banks that did not make their decisions in "good faith."[44] Equitable subordination in bankruptcy can penalize lenders who are deemed

42. Recent changes in the loan syndication market and the secondary market for loans, changes that reduce (sometimes dramatically) a bank's exposure to loans it makes, may put pressure on these functions.

43. For those who fret that bankers have a culture that makes them overly cautious, one need only remember that many of today's lenders are not traditional banks. Private hedge funds are on the prowl for investments that promise above market returns. Indeed, we see some hedge funds making loans comfortable in the expectation that, if things go wrong, they will own the company. *See* David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003). With the amount of liquidity in today's markets, it requires something of a leap of faith to posit that there are sophisticated investors such as modern lending institutions that continually take actions that fail to maximize the value of the investment.

44. Creditors who cut square corners and act within the limits of their loan agreement are usually safe. *See, e.g.*, Smith v. Assocs. Commercial Corp. (*In re* Clark Pipe & Supply Co.), 893 F.2d 693, 702 (5th Cir. 1990) ("[A] creditor is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim." (quoting *In re* W.T. Grant Co., 699 F.2d 599, 609 (2d Cir. 1983))).

responsible for the collapse of the company.[45] The tort of deepening insolvency threatens lenders who keep a struggling company afloat in order to protect their own interests.[46] Today, there are calls, especially in the bankruptcy community, for limiting the power of lenders.[47]

The costs of aggressive regulation in this area strike us as higher than any potential benefits. Few are happy when a failed company pays lenders in full (or nearly so) and leaves nothing for the junior investors. Yet across the range of cases, control by lenders may be in the interests of all. The more that the lenders can play a disciplining role and have the de facto power to rid a business of underperforming managers, the less the need to worry that members of the board do not have the stomach for it. For some corporations, the optimal arrangement may be to have a board that does not monitor the CEO but rather leaves that task to outsiders. Some corporations may do better with a board that provides strategic resources to the CEO and supports her projects enthusiastically. While this creates the risk of not seeing the faults of the CEO, the cost of this risk is capped by the ability of the lenders to engage in shock therapy.

We should not ask directors to do more than humanly possible. Mentoring, monitoring and disciplining are all important tasks, but that does not mean that a single group should necessarily attempt all three. Here, as elsewhere, there may be gains to specialization. The challenge of corporate law may not lie in finding the right set of rules so that shareholders can hire the right set of directors who then write the best employment contracts. The challenge is to ensure that the board pays attention to the prime directive—hire the best person. Yet this is an on-going obligation. Not all CEOs should be left to decide their time for departure. When it is time for a CEO to go, the lender may be in the best position to deliver the news.

CONCLUSION

Any assessment of corporate law has to take place against the backdrop of the role the lenders play in corporate governance. Should lenders be liable if they continue to lend to a company in financial

---

45. *See* Pepper v. Litton, 308 U.S. 295, 307–08 (1939).

46. *See* Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re* Exide Techs., Inc.), 299 B.R. 732, 750–52 (Bankr. D. Del. 2003).

47. *See, e.g.*, Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases*, 21 BANKR. STRATEGIST 1, 2 (2003) ("The excuse . . . of remedial rights given secured creditors upon the occurrence of default, in effect, puts those creditors in control of the debtor/borrower.").

difficulty? Should they, on the other hand, be liable for not lending when the chips are down? Do they have obligations to creditors? Although corporate directors do have fiduciary duties to shareholders, these duties are minimal at best when it comes to the hiring decision. No reported case holds a director liable for hiring the wrong person. The law in any event cannot give good judgment to those who do not have it. But the firing decision may be different, and here we should be far more attuned to the way the law affects the various levers of corporate control and the extent to which these levers advance the interests of all investors.