

LEVERAGE IN THE BOARD ROOM: THE UNSUNG INFLUENCE OF PRIVATE LENDERS IN CORPORATE GOVERNANCE

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The influence of banks and other private lenders pervades public companies. From the first day of a lending arrangement, loan covenants and built-in contingency provisions affect managerial decisionmaking. Conventional corporate governance analysis has been slow to notice or account for this lender influence. Traditionally, corporate governance discourse has focused only on corporate law arrangements. The few existing accounts of creditors' influence over firm managers emphasize the drastic actions creditors take in extreme cases—when a firm is in serious trouble—but in fact, private lender influence is a routine feature of corporate governance even absent financial distress.

While lenders of course intervene when their borrowers encounter distress, recent empirical work demonstrates private lender influence at much earlier points in the debtor-creditor relationship. In addition to the effects of covenant constraints and other initial loan terms, a subsequent covenant violation may trigger active lender intervention, including imposition of additional limits on managerial discretion. Covenant violations and lender intervention, however, do not typically signal the borrower's financial distress. Instead, this interactive response to ex post contingency is routine. Both borrower and lender expect future modification of their deal terms, and they contract in anticipation of it. Initial covenants and subsequent violations effectively reallocate degrees of control from managers to lenders, in a fluid process that commences with the inception of the lending arrangement.

In this Article, I explain the regularity of lender influence on managerial decisionmaking—"lender governance"—comparing this routine influence to conventional governance arrangements and boards of directors in particular. I show that the extent of private lender influence rivals that of conventional governance mechanisms, and I discuss the doctrinal and policy implications of this unsung influence. Accounting for lender governance requires a new examination of corporate fiduciary duties, debtor-creditor laws, and the regulatory reform proposals that have

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emerged to address the current financial crisis. I also discuss the implications of private lender influence for future corporate governance research.

INTRODUCTION.....	117
I. BACKGROUND AND A FRAMEWORK FOR ANALYSIS.....	123
A. Shareholder-Centered Corporate Law.....	124
B. Creditor Governance: Banks Are Special	125
C. Gauging Influence: Private Lenders vs. Directors	129
1. Directors' Special Place in Corporate Governance Reform.....	129
2. Comparing Influence	131
II. THE STRUCTURE OF LENDER GOVERNANCE.....	135
A. Loans and Loan Covenants.....	135
1. Financial Covenants.....	136
2. Investment Constraints	137
3. Fundamental Changes.....	138
B. Institutional Practices and Information Access.....	138
III. THE DYNAMICS OF LEVERAGE.....	140
A. Durability of the Banking Relationship: The Certainty of Renegotiation.....	141
B. The Stages of Lender Influence.....	144
1. Initial Covenant Settings: Controlling Agency Costs	144
2. Built-in Contingency.....	147
3. Honor in the Breach: Covenant Violations	150
C. Important Areas of Influence	152
1. Financial Policy.....	153
2. Investment Policy	154
3. CEO Turnover	156
D. Operational Consequences and Governance Implications.....	159
IV. THE LIMITS OF LENDER GOVERNANCE: CREDIT MARKET EFFECTS	161
A. Market Liquidity	161
B. Risk Transfer	162
1. Loan Syndication and Secondary Market Transactions	163
2. Credit Derivatives.....	167
C. Assessing the Limits.....	169
V. IMPLICATIONS OF LENDER GOVERNANCE	169
A. Fiduciary Duties for Private Lenders?.....	170
B. Optimal Debtor-Creditor Law	173
C. Financial Regulatory Reform and Lender Governance.....	175
D. Is Lender Governance Efficient? And Other Empirical Corporate Governance Research.....	178
CONCLUSION	181

INTRODUCTION

In conventional accounts of corporate governance, corporate law occupies center stage as the exclusive mechanism for constraining managerial discretion. Creditor influence is generally ignored. If discussed at all, creditor influence is viewed as episodic and exceptional—arising dramatically and only in the extreme case where a firm is in distress. In fact, banks and other private lenders exercise influence over firm management that is both routine and significant. Private lender influence often exceeds that of shareholders—including major shareholders—and the board of directors, and may even dictate fundamental business decisions traditionally left to the board or officers, even outside of the distress context. The dearth of attention to lender governance is ironic given the dominance of the contractualist view of the corporation within the legal academy and the thick web of contractual commitments that bind the public company. This Article highlights private lenders' important governance role, relying on recent empirical studies showing private lenders' influence on corporations' financing and investment decisions and operational matters. This Article's major contributions are threefold. First, it explains the pervasiveness of private lender influence on corporate decisionmaking, which is based on a durable and adaptable banking relationship built on significant relationship-specific investment. Second, it details the institutional and contractual features of private lending that constrain managerial discretion, as well as the limits of lender governance. Third, and perhaps most importantly, it explores the implications of private lender influence for corporate governance. Among other things, it analyzes the important yet underappreciated link between financial regulation and corporate governance. Financial regulation affects lenders' incentives to monitor and influence their borrower firms, which in turn affects lender governance and *the way nonfinancial firms are run*. As regulators in the United States and around the world remake their financial regulatory systems in response to the recent financial crisis, they also generate important governance spillovers for nonfinancial firms. Therefore, understanding the governance implications of financial regulation has special urgency.

Ever since Berle and Means named the essential feature of the modern American public corporation¹—the separation of ownership from control—corporate scholars and policymakers have wrestled with the fundamental problem of aligning managerial incentives with investor interests.

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

Traditionally, the central challenge has been to design governance arrangements optimally to close the gap between ownership and control: to channel managers' discretion to benefit one specific class of investor—common shareholders. Corporate law has been the preferred vehicle for effecting this alignment of interests. This shareholder-centered approach is understandable. Shareholders, as the firm's residual claimants, feel most keenly the benefits and burdens of the firm's successes and failures. So for efficiency's sake, governance should rightly focus on shareholder interests.

In the standard rendering, shareholder-owners essentially "hire" managers to run the firm on shareholders' behalf. They accomplish this through their elected board of directors, to whom shareholders entrust the authority to manage the firm. The board in turn appoints officers, who are charged with managing the business on a day-to-day basis. Directors and officers, however, may not always act with shareholders' best interests at heart. They may shirk, or they may steal.² In innumerable ways, managers may favor themselves at shareholders' expense—consuming perquisites and leisure, insulating themselves from takeover risk with entrenching provisions, building empires for their own benefit, stacking boards with friendly directors who will defer to management, or giving sweetheart deals to friends and relatives.

For their part, shareholders enjoy avenues for disciplining management. Besides annually electing the board of directors, shareholders are entitled to vote on important corporate transactions; they may offer their own qualifying proposals for a shareholder vote through the firm's proxy process; they are the beneficiaries of managerial fiduciary duties and may sue to enforce these duties; they may propose amendments to the firm's bylaws. Moreover, the market for corporate control—by which acquirers may seek to displace existing management—may perform a disciplining role. The threat of ouster by hostile acquisition may focus managerial efforts.

Creditors have little or no role in this standard account of corporate governance.³ Unlike shareholders, creditors' rights are defined primarily by

2. This is not to say that all managers are knaves or thieves. Shareholders, however, are not often well positioned to identify knaves and thieves or to detect their theft or knavery. Governance mechanisms are therefore useful.

3. "According to [the] conventional account, creditors receive no special rights against the corporation. The creditors' power is limited to suing the debtors when they fail to pay as promised. Creditors do not have their hands on the levers of power." Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1215 (2006). All acknowledge that the existence of debt in the capital structure plays some disciplining role, insofar as payment obligations reduce the amount of free cash managers have on hand to squander. See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986).

their credit contracts.⁴ Creditors enjoy no special status under corporate law. They are outsiders to the firm and generally have no say in how the firm is run. Creditors are presumed to passively observe corporate wealth creation while they collect their interest payments, to be stirred from their torpor only in extreme circumstances—to enforce their contract rights only if the firm falters and repayment is imperiled. “Neither their credit provision function nor their limited equity ownership provide banks with sufficient power and incentive to monitor. As a result, the monitoring role in the American corporate governance system is relegated to those who provide only equity capital to the corporation—the shareholders.”⁵ In the standard telling, creditors are passive. They are simply not a part of the classic corporate governance story.⁶

It turns out, however, that bank creditors and other private lenders often enjoy significant oversight and influence over managerial decisions.⁷ Banks monitor investment, financing, and operational decisions as a matter of course. Banks not only constrain these managerial decisions but on occasion dictate them. The case of Warnaco offers a telling example.⁸ Warnaco’s CEO was firmly entrenched. She chaired the board of directors and packed the board with

4. See *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007); *Prod. Res. Group, L.L.C. v. NCT Group, Inc.* 863 A.2d 772, 787 (Del. Ch. 2004).

5. Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985, 989–90 (1993) (footnote omitted). Especially when the discussion turns to comparative assessment of U.S. corporate governance with the bank-centered systems of Japan and Germany, scholars emphasize that in market-oriented financial systems like the U.S., banks have only a limited role to play in corporate governance. JONATHAN P. CHARKHAM, KEEPING BETTER COMPANY: CORPORATE GOVERNANCE TEN YEARS ON 255 (2005); see LUTGART VAN DEN BERGHE, CORPORATE GOVERNANCE IN A GLOBALISING WORLD: CONVERGENCE OR DIVERGENCE? 43 (2002); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 753–58 (1997).

6. “Corporate law has focused too long on shareholders as the sole investors in the corporation, the sole recipients of director duties and energies, and the sole hope for constraining the managers of other people’s money.” Douglas G. Baird & M. Todd Henderson, *Other People’s Money*, 60 STAN. L. REV. 1309, 1343 (2008) (arguing that the complexity of modern capital structures has rendered traditional corporate fiduciary duties unworkable, and that managers instead should hew to the terms of the firm’s investment contracts).

7. Throughout this Article, for ease of exposition, I use of the term “bank” to include nonbank private lenders as well. The most common nonbank private lenders include finance companies, insurance companies, investment banks, hedge funds, and mutual funds. Nonbank lenders typically hold riskier debt than banks, Mark Carey, Mitch Post & Steven A. Sharpe, *Does Corporate Lending by Banks and Finance Companies Differ?: Evidence on Specialization in Private Debt Contracting*, 53 J. FIN. 845, 846 (1998); David J. Denis & Vassil T. Mihov, *The Choice Among Bank Debt, Non-Bank Private Debt, and Public Debt: Evidence From New Corporate Borrowings*, 70 J. FIN. ECON. 3, 5 (2003); Greg Nini, *How Non-Banks Increased the Supply of Bank Loans: Evidence From Institutional Term Loans 3–4* (Mar. 18, 2008) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=1108818>, though they typically enjoy the same contractual features as other private corporate loans. See Nini, *supra*, at 2.

8. See Baird & Rasmussen, *supra* note 3, at 1226–27.

her cronies. Yet when she faltered and the firm needed a significant infusion of new credit to continue operating, the CEO-friendly board could not resist lenders' call for new management.⁹ Though the hiring and firing of a firm's chief executive is the most crucial of board decisions, Warnaco's lenders effectively decided that question. Douglas Baird and Robert Rasmussen have accordingly dubbed private lender power the "missing lever" of corporate governance.¹⁰

Baird and Rasmussen are among a handful of legal scholars that have ventured outside of corporate law to study corporate governance. Yet even these scholars interested in creditor governance focus primarily on the distress context. They observe creditor action only after a borrower firm has lapsed into financial distress, effectively casting the influence of private debt as episodic, exceptional, and dramatic. My claim is broader. I argue that lender governance arises not only when a firm approaches distress. Lender influence is pervasive. Empirical research documents the regularity with which banks constrain fundamental managerial decisions even in the ordinary course of business. Bank influence often rivals that of conventional governance mechanisms.

Creditor and shareholder interests may not always coincide. The debt-equity conflict is well understood,¹¹ and creditor influence may not always benefit shareholders, as conventional corporate governance efforts typically intend. However, shareholder and creditor interests may in fact overlap in many circumstances—toward reducing managerial slack, for example, or curbing excessive risktaking by management—and empirical evidence suggests that bank debt may generally benefit the firm's shareholders.¹² I raise this as only a possibility and do not attempt to prove it here, although I do highlight evidence suggesting the efficiency of lender governance. Instead, my primary purpose is to cure a blind spot at the intersection of the corporate governance and bankruptcy law discourses: to show that private lender influence significantly constrains managerial discretion in the ordinary course and to discuss the

9. See *id.* at 1226.

10. *Id.* at 1211.

11. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (discussing the agency costs of debt versus equity).

12. See Joanna M. Shepherd, Frederick Tung & Albert H. Yoon, *What Else Matters for Corporate Governance?: The Case of Bank Monitoring*, 88 B.U. L. REV. 991 (2008) (demonstrating empirically the value-enhancing effect of bank monitoring); *infra* notes 37–38 and accompanying text (discussing event studies showing positive abnormal stock returns accompanying firms' public announcements of bank loans); *infra* notes 195–199 and accompanying text (discussing potential efficiency of capital expenditure covenants).

important doctrinal and policy considerations of this unsung influence.¹³ Moreover, possible conflict with equity holders is not the only potential drawback to lender governance. Even if lender governance is efficient, it is susceptible to being frustrated or hijacked,¹⁴ as are traditional governance mechanisms. Regardless, appreciation for the role of private lenders in corporate governance is crucial for a complete understanding of the influence that investors wield over firm management. Private lending is, after all, the single largest source of external financing for public corporations, larger than public debt and equity *combined*,¹⁵ and eighty percent of public companies maintain private credit agreements.¹⁶

Understanding lender governance is especially important in the current milieu, as the global financial crisis directly affects the nature of lender governance in two important respects. First, to state the obvious, borrowers may be financially unstable, and banks are nervous. This mutual insecurity has caused lenders to intensify their monitoring efforts, including tightening up on covenants¹⁷—financial benchmarks that borrowers are required to meet on a regular basis. Tighter covenants mean less slack for borrowers, which means more regular lender intervention—that is, more active lender governance. Second, the coming transformation of U.S. financial regulation will have important effects on lenders' incentives and behavior. Changes in the regulatory regime will cause changes in lender governance. Tighter covenants and regulatory reform will each affect the way nonfinancial firms—the

13. I focus on banks' influence as creditors. Banks have recently been shown to affect governance through other avenues as well. Banks may systematically affect the market for corporate control, stimulating takeovers of their borrower firms by transmitting private information about their borrowers to potential acquirers. Victoria Ivashina et al., *Bank Debt and Corporate Governance*, 22 REV. FIN. STUD. 41 *passim* (2009). Banks may play this matchmaking role in order to cause more creditworthy acquirers to acquire less creditworthy targets, thereby reducing credit risk and enhancing the strength of banks' loan portfolios. *Id.* at 72. Banks may also affect corporate managers through the voting rights they exercise as trustees for their banking clients' trust portfolios. Joao A.C. Santos & Kristin E. Wilson, *Does Banks' Corporate Control Benefit Firms?: Evidence From U.S. Banks' Control Over Firms' Voting Rights* (AFA 2007 Chicago Meetings Paper, EFA 2007 Ljubljana Meetings Paper, 2008), available at <http://ssrn.com/abstract=891671>.

14. See *infra* Part IV.

15. Gary Gorton & Andrew Winton, *Financial Intermediation*, in HANDBOOK OF THE ECONOMICS OF FINANCE: VOLUME 1A CORPORATE FINANCE 433 (George M. Constantinides et al. eds., Elsevier 2003); Michael R. Roberts & Amir Sufi, *Renegotiation of Financial Contracts: Evidence From Private Credit Agreements 1* (July 31, 2008) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=1017629>.

16. Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights and Firm Investment Policy 1–2* (Apr. 2008) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=928688>.

17. Anousha Sakoui, *Covenants in Spotlight as Banks Reduce 'Headroom' on Company Debt*, FIN. TIMES, Aug. 21, 2008, at 18, available at <http://www.ft.com/cms/s/0/47f39a76-6ecf-11dd-a80a-0000779fd18c.html>.

borrowers—are run.¹⁸ This Article is the first to analyze the effects of impending regulatory reform on the governance of nonfinancial firms. I focus on proposals for regulation of credit default swaps—so central to the financial crisis¹⁹—and their trading. Though firm predictions as to the ultimate contours of the financial regulatory framework are elusive, it is useful nonetheless to identify potential corporate governance spillovers from reforms that are sure to affect private lenders' operations and monitoring incentives. More generally, my discussion of lender governance offers one illustration of the increasing complexity of corporate capital structures and the thorny governance implications of this complexity. As financial innovation increasingly blurs the traditional line between debt and equity, a singular focus on shareholder-centered governance may well be obsolete.

The Article is organized as follows. Part I offers background, reviewing the financial and legal literature on banks' special monitoring abilities. It also recounts the conventional corporate law framework for firm governance, highlighting the director's role and proposing a framework for assessing the degree of private lender influence by comparing directors' influence. Part II outlines the contractual and institutional structure of lender governance, describing important loan covenants and banks' institutional practices that facilitate monitoring and governance. Part III explains the dynamics of private lenders' leverage over firm management. It describes the durable nature of the banking relationship, the incentive structure built into the initial lending agreement, and the range of bank responses to covenant violations. It also discusses the recent empirical learning in three important areas of private lender influence: financial policy, investment policy, and CEO replacement. Part IV discusses the limits of lender influence. Credit market effects—liquidity and risk transfer opportunities—may dampen lenders' monitoring incentives and their influence. Part V discusses the implications of lender governance for corporate law, financial regulation, and governance research.

18. To offer one concrete example, tighter covenants may reduce nonfinancial firms' levels of capital investment. See *infra* Part III.C.2. At the same time, financial regulatory reform may augment or diminish lenders' incentives to police capital investment restrictions diligently. See *infra* Part V.C.

19. "Any honest assessment [of the origins of the financial crisis] must include the role that credit default swaps have played in this mess: it's the elephant in the room, the \$30 trillion market that people do not want to talk about." Gretchen Morgenson, *Time to Unravel the Knot of Credit-Default Swaps*, N.Y. TIMES, January 24, 2009, at BU1, available at http://www.nytimes.com/2009/01/25/business/25gret.html?_r=1&scp=2&sq=morgenson&st=cse.

I. BACKGROUND AND A FRAMEWORK FOR ANALYSIS

Traditionally, corporate governance scholarship and policymaking have focused on protecting shareholder interests, with corporate law as the primary, if not exclusive, institutional arrangement for allocating control rights and constraining managerial discretion in public companies.²⁰ Explicit external contractual governance mechanisms have largely been ignored.²¹ Despite the ascendancy of the contractualist view of the corporation within the legal academy,²² legal scholars have not generally noticed the extent of lender governance or discussed its contours or potential effects.²³ Corporate law casebooks and treatises similarly ignore creditor influence on managerial decisionmaking. The sparse legal literature that does exist on lender governance focuses primarily on distress-induced creditor intervention.

This Part first offers background and then a framework for assessing the significance of lender governance. This framework previews later analysis in the Article by comparing lender influence with that of corporate directors, with special focus on independent directors, whose increased prominence and power has been central to recent corporate governance reforms. Later discussion will quantify lender influence in specific areas of corporate policy, demonstrating its significance directly.

20. “Corporate law and corporate governance are flip sides of the same coin.” Roberta Romano, *Corporate Law and Corporate Governance*, 5 INDUS. & CORP. CHANGE 277 (1996).

21. A handful of exceptions exist. Scholars have identified bond indentures and directors’ and officers’ (D&O) insurance policies as promising or potential sources of contract-based governance. See Yakov Amihud, Kenneth Garbade & Marcel Kahan, *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447 (1999) (proposing a new “supertrustee” to serve as a more active bondholder representative than the current indenture trustee arrangement); Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence From the Directors’ & Officers’ Liability Insurance Market*, 74 U. CHI. L. REV. 487 (surveying D&O insurance underwriters, who overwhelmingly view corporate governance arrangements as important for assessing liability risk, and hypothesizing that higher insurance premiums for higher risk firms may serve to deter managerial misbehavior); Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting*, 7 J. FIN. ECON. 117 (1979) (explaining the role of bond covenants in incentivizing shareholders to pursue a firm-value-maximizing investment policy). *But see* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors’ & Officers’ Liability Insurer*, 95 GEO. L.J. 1795 (2007) (finding that D&O insurers do not offer loss prevention services or otherwise monitor corporate governance).

22. See, e.g., STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 27 (2002); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies From a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1273 (1999).

23. The legal literature has extensively discussed bank influence in the context of small firms. See, e.g., Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986).

A. Shareholder-Centered Corporate Law

Corporate governance scholars and policymakers focus primarily on relations among firm managers and equity holders, relying on corporate law arrangements to align managers' incentives with shareholder interests and to mediate relations among small and large shareholders. The central project is to calibrate the right amount of shareholder, director, and market oversight for optimal governance. Important recent corporate governance debates focus on shareholder concerns as expressed through traditional corporate law mechanisms: shareholder influence in corporate elections,²⁴ the role and responsibilities of activist institutional shareholders,²⁵ the scope and nature of directors' fiduciary duties to shareholders,²⁶ amounts and forms of executive compensation,²⁷ board composition,²⁸ and the decoupling of voting rights from economic rights.²⁹ These debates illustrate the corporate-law-focused, shareholder-centered nature of corporate governance discourse, an understandable focus given shareholders' traditional centrality in corporate law as "principals,"³⁰ "owners,"³¹ and residual claimants.³²

24. Compare Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (arguing for reform of director election process to empower shareholders), and Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) [hereinafter Bebchuk, *Myth of the Shareholder Franchise*] (same), with Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006) (defending the existing limited role for shareholders), and Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) (discussing the same).

25. See Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008).

26. See Stephen M. Bainbridge, Star Lopez & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559 (2008) (critiquing *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006) (en banc), for its confusing analyses of good faith and the duty of oversight); Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833 (2007) (arguing that courts should be sensitive to structural bias on boards of directors when analyzing good faith).

27. See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004); Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453 (2008).

28. See Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999); April Klein, *Firm Performance and Board Committee Structure*, 41 J.L. & ECON. 275 (1998).

29. See *infra* note 253 and accompanying text.

30. E.g., Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 761 (referring to shareholders as principals and corporate managers as their agents).

31. *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (referring to shareholders as the "owners" of the corporation).

32. EASTERBROOK & FISCHER, *supra* note 22, at 36, 91.

B. Creditor Governance: Banks Are Special

In contrast to corporate governance scholars and policymakers, finance scholars have known for some time that banks are special. Banks enjoy institutional advantages over other investors that make them ideal monitors. Their institutional arrangements facilitate their garnering of private information about their borrower firms at lower cost than other investors,³³ and banks have strong incentives to monitor these firms and influence managerial decisionmaking when necessary.

In its lending contract with the borrower, the lender includes a number of covenants that constrain the borrower's financial, investment, and operating activities.³⁴ The bank also enjoys access to private information about the borrower's business activities, including periodic reports from the borrower and access to the borrower's management and books and records. The bank may enjoy specialized expertise concerning the borrower's industry. A covenant violation triggers the lender's right to cut off further credit to the borrower and demand immediate repayment of outstanding debt.³⁵ The borrower's management therefore has strong incentives to comply with its covenants.

Because of banks' special monitoring abilities, they are often effectively delegated by other investors to monitor on their behalf. As detailed below, banks enjoy covenant protection and information access that other investors do not, but those other investors may free ride on the bank's monitoring and price their capital accordingly.³⁶ This theory of delegated monitoring enjoys strong empirical support. For example, event studies consistently show that positive abnormal stock returns accompany firms' public announcements of bank loans.³⁷ That is, the announcement of a bank loan is generally good

33. See Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUD. 393, 393 (1984); Eugene F. Fama, *What's Different About Banks?*, 15 J. MONETARY ECON. 29, 36–38 (1985); see also Tim S. Campbell & William A. Kracaw, *Information Production, Market Signalling, and the Theory of Financial Intermediation*, 35 J. FIN. 863, 864 (1980) (theorizing that financial intermediaries emerge to produce information because of the complementarity of information production, confidentiality, and the provision of transactional and other intermediary services).

34. The structure of creditor governance is described more fully in Part II.

35. Many loans to public companies take the form of a revolving loan, which allows the borrower to repay and reborrow over the life of the loan. See *infra* Part II.A. Because firms rely on the revolving loan to help manage their cash flows, cutting off further credit may be a severe sanction. See Baird & Rasmussen, *supra* note 3, at 1229.

36. See Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 836–37 (2008) (explaining the theory of delegated monitoring).

37. See Christopher James, *Some Evidence on the Uniqueness of Bank Loans*, 19 J. FIN. ECON. 217, 219 (1987); Myron B. Slovin, Shane A. Johnson & John L. Glascock, *Firm Size and the Information Content of Bank Loan Announcements*, 16 J. BANKING & FIN. 1057, 1058 (1992); Ronald Best & Hang Zhang, *Alternative Information Sources and the Information Content of Bank Loans*, 48 J.

news for the borrower firm's shareholders: The loan commits the bank to monitor the borrower firm over the life of the loan, which may also redound to shareholders' benefit.³⁸ Similarly, bank monitoring may benefit bondholders.³⁹ Firms with preexisting bank loans are able to borrow more cheaply from public debt markets than firms without. This advantage likely reflects the value of bank monitoring, which reduces moral hazard in a way that bondholders alone cannot.⁴⁰

Relying in part on this crossmonitoring literature, a handful of legal scholars have developed theories of lender governance, focusing primarily on lenders' governance role as the borrower firm approaches distress. George Triantis and Ron Daniels proposed a seminal model of interactive corporate governance over a decade ago, arguing that stakeholders' exit decisions provide

FIN. 1507, 1511 (1993); Matthew T. Billett, Mark J. Flannery & Jon A. Garfinkel, *The Effect of Lender Identity on a Borrowing Firm's Equity Return*, 50 J. FIN. 699, 700 (1995). A related literature suggests that nonbank private debt may also bring bank-like benefits to equity holders. These studies show a positive stock price reaction to announcements of nonbank private debt placements, with no statistical difference between announcements of bank debt versus nonbank private debt. See Billett, et al., *supra*; Dianna C. Preece & Donald J. Mullineaux, *Monitoring by Financial Intermediaries: Banks Versus Nonbanks*, 8 J. FIN. SERV. RES. 193, 199 (1994).

38. See Sudha Krishnaswami, Paul A. Spindt & Venkat Subramaniam, *Information Asymmetry, Monitoring, and the Placement Structure of Corporate Debt*, 51 J. FIN. ECON. 407, 409 (1999) (finding that firms with greater growth prospects—and therefore greater debt-related moral hazard problems—rely more heavily on private debt than public debt, and attributing this result to the monitoring advantages of private debt); Scott L. Lummer & John J. McConnell, *Further Evidence on the Bank Lending Process and the Capital-Market Response to Bank Loan Agreements*, 25 J. FIN. ECON. 99, 101 (1989) (finding excess stock returns almost exclusively around the announcement of loan renewals, but not new loans, and concluding that the value to shareholders comes not from the initial screening of prospective borrowers, but from private information the bank gleans during the course of its relationship with the borrower, consistent with a monitoring theory).

This positive stock market reaction may also arise from a complementary source. The bank's decision to extend credit may signal that it has positive private information about the firm—that is, the bank resolves adverse selection problems for the stock market. See Best & Zhang, *supra* note 37; Charles J. Hadlock & Christopher M. James, *Do Banks Provide Financial Slack?*, 57 J. FIN. 1383 (2002); Wayne H. Mikkelsen & M. Megan Partch, *Valuation Effects of Security Offerings and the Issuance Process*, 15 J. FIN. ECON. 31 (1986); Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984).

The crossmonitoring benefits may run in favor of the bank as well. One study finds that bank debt is cheaper for firms with publicly traded shares or investment-grade public debt outstanding. James R. Booth, *Contract Costs, Bank Loans, and the Cross-Monitoring Hypothesis*, 31 J. FIN. ECON. 25 (1992).

39. Sudip Datta, Mai Iskandar-Datta & Ajay Patel, *Bank Monitoring and the Pricing of Corporate Public Debt*, 51 J. FIN. ECON. 435, 437 (1999). This study finds that the presence of a preexisting bank loan reduces at-issue yield spreads for borrower firms' first public debt offerings by an average of 68 basis points, which is both statistically and economically significant. Moreover, the length of the bank/firm relationship is also statistically significant and negatively related to at-issue yield spreads, which is again consistent with the monitoring hypothesis. See *id.*

40. *Id.* at 436.

valuable information to one another, thereby enhancing stakeholders' collective ability to discipline management.⁴¹

The reactions of a stakeholder are in many cases observable by others who will in turn choose among their own set of available reactions. Thus, governance in the modern corporation is akin to a system of relays: stakeholders generate, collect, and analyze valuable information on managerial slack, and then pass it to those stakeholders who are better situated to take direct action to address the problem.⁴²

The bank is the central monitor under this theory. Its specialized monitoring abilities make it the low-cost monitor,⁴³ and because the borrower and creditors, as a group, care about minimizing total monitoring costs, the borrower willingly grants covenant protections to the bank that it may not grant other creditors. The bank's contract rights and ongoing monitoring enable it both to deter managerial slack and to detect it early. Upon detection, it may either exit or intervene, even to the point of having management replaced. In either case, the bank's action signals other stakeholders, who may also act to protect their interests. While classic finance theory focuses on the conflicts between debt holders and equity holders,⁴⁴ especially as the firm nears distress, Triantis and Daniels remind us that the bank lender and other stakeholders may have good reason to work toward the firm's recovery as a going concern.⁴⁵

Douglas Baird and Robert Rasmussen recently renewed the focus on creditors' role in corporate governance, describing creditor control as the "missing lever" in the corporate governance literature.⁴⁶ They note the underappreciated role that banks and bank-loan covenants play in corporate governance when a firm defaults. At that point, the bank's ability to discipline management is much greater than traditional governance devices.⁴⁷ The bank may seize control by taking control of the firm's cash as part of a

41. George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073 (1995).

42. *Id.* at 1079.

43. For example, the bank enjoys better information than other creditors, and its business model generates monitoring economies not available to other creditors. *See id.* at 1083–84.

44. *See* Jensen & Meckling, *supra* note 11, at 335.

45. For example, the prospect of repeat business with the firm may serve to align the bank's interests with those of equity holders as to investment policy and the firm's recovery. Triantis & Daniels, *supra* note 41, at 1100–01.

46. *See* Baird & Rasmussen, *supra* note 3.

47. Compare, for example, bank monitoring with monitoring by shareholders—the firm's traditional "owners." Banks enjoy far better information about the firm, and exercise far more oversight and control over the firm's affairs, than shareholders. *See id.* at 1217. The corporate charter is a short document; the loan agreement can easily exceed one hundred pages. *See id.*

debt restructuring. Through a combination of a revolving credit facility,⁴⁸ security interests in the borrower's cash and other assets, and modern cash management technology, the lender obtains the ability to cut off the borrower's cash, an arrangement that gives the bank the finest vantage point from which to monitor the borrower's business,⁴⁹ as well as a veto over any transaction or course of action not to the bank's liking.⁵⁰

The other important control device for the bank is its leverage to cause the replacement of management, a tactic that becomes available when the borrower is in serious trouble and in need of a debt restructuring. Either implicitly or explicitly, the lender may demand appointment of a turnaround specialist, typically tasked as a Chief Restructuring Officer, to run the business,⁵¹ a power that shareholders almost never enjoy. Similarly, the market for corporate control has only a weak disciplining effect on management compared to bank discipline. Firms may erect takeover defenses to deter hostile takeovers, but once they take on private debt, they have little defense against creditor control.⁵²

While these important papers by Triantis and Daniels and Baird and Rasmussen focus on the distress context, in a recent article I and my co-authors investigate the potential governance benefits of bank monitoring for public companies more generally, with a focus not limited to the distress

48. See *infra* note 79 and accompanying text.

49. See Baird & Rasmussen, *supra* note 3, at 1226–30.

50. *Id.* at 1227.

51. *Id.* at 1233–34; see also Sadi Ozelge, The Role of Banks and Private Lenders in Forced CEO Turnovers 5 (Jan. 15, 2008) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=1031814> (finding that for an underperforming firm, an average level of bank debt implies a 25 percent to 46 percent increase in the probability of forced CEO turnover compared to a firm with no bank debt, and if the underperforming firm also violates a loan covenant, the result is a 75 percent to 102 percent increase in the probability of forced CEO turnover).

52. Baird & Rasmussen, *supra* note 3, at 1244. Simply paying off the loan is typically not a ready option. The authors note:

In theory, a business can rid itself of a creditor who presses too hard by repaying the loan, but a business that encounters difficulty with a private creditor is likely to have trouble replacing it with another. Any new lender has to worry about the private information held by the existing lender. The existing lender may want to withdraw for reasons that are not yet plain to outsiders. Any new lender is in any event bound to insist upon its own control rights to protect itself.

Id.

Like Triantis and Daniels, Baird and Rasmussen resist the finance canon on the agency costs of debt, which focuses on the conflicts among different investor classes that preclude efficient investment when the firm is in distress. Baird and Rasmussen describe the incentives of the senior lender—typically the bank—to pursue even risky projects to maximize firm value. *Id.* at 1246–47.

context. Our evidence shows that the presence of bank loans improves firm value for the benefit of shareholders, especially where agency costs are high.⁵³

Aside from these few discussions, however, creditor governance has largely been ignored in the corporate governance literature.

C. Gauging Influence: Private Lenders vs. Directors

The remainder of the Article details the structure, function, and limits of lender governance. As prelude to that discussion, I offer an organizing framework to capture the significance of lender governance. I compare private lenders with corporate directors for potential monitoring efficacy. The comparison seems apt. Directors are the traditional internal governance mechanism for constraining managerial discretion, and not a few scholars and policymakers lionize independent directors as the last best hope for closing the gap between ownership and control.⁵⁴

1. Directors' Special Place in Corporate Governance Reform

Consistent with the shareholder focus of traditional governance, the corporate director⁵⁵—especially the independent director—has long held a special place in the hearts and minds of reformers as a model monitor of executives' behavior.⁵⁶ Directors are elected by shareholder vote, and independent

53. Shepherd, Tung & Yoon, *supra* note 12, at 996. Examining over 1,000 public firms for the period 1990–2004, we find that the value-enhancing effect of bank monitoring is especially strong for firms with substantial free cash flow, and that for a given level of management entrenchment, free cash flow in the presence of bank monitoring may improve firm value. *Id.*

54. See Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1291 (1998) (singing the praises of “[a]n active and independent board of directors”); Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 AM. L. & ECON. REV. 380, 403 (2002) (noting that a supermajority independent board is the norm).

55. The company CEO and certain other executive officers will also serve as directors of their company. However, as is customary, my use of the term “director” refers to outside directors—those who are not also full-time employees of the company.

56. See Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1306 (2005) (“Since the beginning of the corporate governance movement in the mid-1970s, enhancing the independence of corporate directors and their function on the board has been at the center of corporate governance reform.”); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 797–98 (2001) (describing the ascendancy of the “monitoring”-board model of corporate governance, “where independence, skepticism, and a rigorous loyalty to shareholder interests are the dominating norms”); see also Alan Palmiter, *Reshaping the Corporate Fiduciary Model: A Director’s Duty of Independence*, 67 TEX. L. REV. 1351, 1355 (1989) (advocating for a new duty of independence for directors in mixed-motive cases, a duty that explicitly recognizes their important monitoring role).

directors—autonomous from sometimes self-seeking managers—are ideally situated to safeguard shareholders' interests.

The concept of independence is straightforward: An independent director has no significant relationships with the firm or its management that might affect her judgment.⁵⁷ In addition to generalized hopes that independent directors might serve as vigilant monitors, corporate law tasks independent directors to shoulder special burdens in cases of clear conflicts of interest. Special litigation committees composed entirely of independent directors must decide whether to pursue, settle, or dismiss derivative litigation brought against other members of the board in the company's name.⁵⁸ Recent corporate governance reforms similarly place independent directors front and center in the march toward improved corporate governance.

Following accounting scandals at Enron, WorldCom, Tyco, Adelphia, and a host of other public companies, and the demise of the public accounting firm Arthur Anderson, Congress passed the Sarbanes-Oxley Act (SOX),⁵⁹ and the stock exchanges tightened their listing rules, all in an effort to improve management accountability. These new rules demand that central governance roles be reserved for independent directors. For public company

57. See Ira M. Millstein et al., *Ten Things That Every Director Should Know for 2004*, BUS. & SEC. LITIGATOR (Weil, Gotshal, & Manges LLP, New York, N.Y.), Jan. 2004, at 2–3, available at [http://www.weil.com/wgm/cwgmhomep.nsf/Files/BSLJan04/\\$file/BSLJan04.pdf](http://www.weil.com/wgm/cwgmhomep.nsf/Files/BSLJan04/$file/BSLJan04.pdf) (stating “by definition, independent directors are outsiders who lack significant relationships to the company”).

Reforms have made the requirements for independence more specific. For example, post-Sarbanes-Oxley (SOX), New York Stock Exchange (NYSE) listing rules specify a number of automatic disqualifications from independent status. A director is not independent if, among other things, she (i) is an employee of the company; (ii) has an immediate family member who is an executive officer; (iii) receives, or has an immediate family member who receives, more than \$100,000 per year in direct compensation from the company; (iv) is affiliated with or employed by the company's present or former internal or external auditor. NYSE, LISTED COMPANY MANUAL § 303A.02(b) (2009), available at <http://nysemanual.nyse.com/LCM/Sections/>. NYSE listing rules also require a three-year “cooling off” period, counting a director as independent only after three years have elapsed following the termination of the affiliation(s) that tainted independent status. *Id.* SOX adds its own specific independence requirements for audit committee members. See 15 U.S.C. § 78j-1(m)(3)(B) (2006) (prohibiting audit committee members from taking consulting, advisory or compensatory fees from the issuer, and requiring that they not be an affiliated person of the issuer or any subsidiary of the issuer).

58. See Davis, *supra* note 56, at 1306 (critiquing courts' deference to special litigation committees' dismissal decisions); see also Minor Myers, *The Decisions of Corporate Special Litigation Committees: An Empirical Investigation* 3, (Brooklyn Law School, Legal Studies Paper No. 112, 2008), available at <http://ssrn.com/abstract=1162858> (finding that special litigation committees do not uniformly dismiss derivative suits).

59. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15 and 18 U.S.C.).

boards, a majority of directors are required to be independent.⁶⁰ In addition, three crucial board committees are required to be comprised *solely* of independent directors: the audit committee,⁶¹ which hires and manages the firm's outside auditor; the compensation committee,⁶² which sets executive compensation; and the nominating committee,⁶³ which selects director nominees.

Given this faith in independent directors as fundamental corporate monitors, the degree of director influence on management may justifiably serve as a useful benchmark against which to compare private lender influence.

2. Comparing Influence

My comparison runs along four dimensions: information, incentives, expertise, and enforcement powers. A putative monitor would seem to need some measure of each in order to be effective,⁶⁴ and private lenders generally do better across all four measures than do directors. Therefore, we can fairly expect private lenders to be at least as effective as directors at monitoring, if not more so.

To be clear, this analysis is not meant to suggest that private lender monitoring is necessarily efficient or that it should replace traditional shareholder-centered monitors. After all, lender concerns may not always coincide with those of shareholders, and their actions may not always enhance value. Lenders monitor for themselves; directors have fiduciary duties to monitor on behalf of shareholders and the firm. So directors and lenders may focus on different issues in their monitoring. The point instead is that private lender influence is sufficiently serious that it deserves mainstream attention from corporate governance policymakers.

Table 1 summarizes the comparisons.

60. See NYSE, *supra* note 57 § 303A.01; NASDAQ OMX GRP., INC., NASDAQ STOCK MARKET RULES, EQUITY RULES § 5605 (b)(1)(2009), available at <http://nasdaq.cchwallstreet.com/NASDAQ/Main/>.

61. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77 (codified at 15 U.S.C. § 78j-1 (2006)).

62. NYSE, *supra* note 57 § 303A; NASDAQ OMX GRP., INC., *supra* note 60, § 5605(b).

63. *Id.*

64. Cf. Peter M. DeMarzo, Michael J. Fishman & Kathleen M. Hagerty, *Self-Regulation and Government Oversight*, 72 REV. ECON. STUD. 687 (2005) (considering information, expertise, incentives, and enforcement powers in modeling the efficacy of self-regulatory organizations in securities regulation).

TABLE 1

Governance Mechanism \ Efficacy Factor	Private Lender	Director
Information	Continuous information flow.	Discontinuous information.
Incentives	Typically strong financial incentives.	Weak, mixed incentives.
Expertise	Typical industry expertise.	Industry expertise unlikely.
Enforcement	Strong.	Varied.

Information. Private lenders enjoy important informational advantages over directors generally.⁶⁵ Private lending agreements and institutional arrangements enable the lender to receive a continuous stream of information concerning the borrower's operating performance and financial condition.⁶⁶ For example, in addition to regular financial reports and wide discretionary access to the borrower's books and records, properties, and management, a private lender often enjoys the ability to monitor a borrower's cash flows in real time as part of the lender's provision of cash management services to the borrower. This window gives the lender constant updates on the borrower's performance.⁶⁷

Directors may receive the same financial reports as the lender, and while they may theoretically be entitled to the same continuing stream of information the lender enjoys, they are unlikely to ask for it given their part-time status, discussed below, and their inability to process it. Moreover, firm managers may be tempted to manage the flow of information to directors in ways that make managers look good.⁶⁸ Directors with demanding full-time

65. See Douglas G. Baird & Robert K. Rasmussen, *The Prime Directive*, 75 U. CIN. L. REV. 921, 938 (2007) (noting that "banks have better information than do directors").

66. See *infra* Part II.B.

67. See *infra* note 103–104 and accompanying text.

68. JONATHAN R. MACEY, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN* 60 (2008).

jobs are not well positioned to gather and assess company information with the intensity of a private lender.

Incentives. Banks and their lending officers have direct financial stakes in policing borrowers carefully. Directors by contrast do not depend on their director positions or director fees for their livelihood. They are basically part-time players who meet only a handful of times each year to consider firm affairs. They may own shares in the borrower firm, but again, these stakes are likely to be small relative to their total wealth. Directors may have some reputational stake in appearing vigilant, and potential fiduciary duty liability may offer some weak incentives to monitor. On the other hand, especially for nonindependent directors, they may be beholden to managers for their board positions, so their ability to check managerial excesses may be limited.

Granted, banks' incentive to monitor may depend on the firm's financial condition. A healthy and profitable firm is unlikely to draw much scrutiny from its lender, who is far more concerned about downside risk than upside performance. This is likely to be true for directors as well, though. They are likely to give the CEO a free hand when the sailing is smooth. Moreover, even a healthy and profitable firm may run afoul of a loan covenant. As more fully explained in Part III,⁶⁹ covenant violations are common, and though they rarely portend distress, a violation does trigger lender scrutiny and the possibility of tighter covenants.

Expertise. Private lenders typically cultivate industry expertise. Their lending relationships with multiple firms in an industry generate scale economies that enable them to price, monitor, and manage loans at lower cost than a less focused lending pattern.⁷⁰ By contrast, though it may seem counterintuitive, directors may not have much expertise in the firm's industry beyond what they learn from being a director to the one firm.⁷¹ Instead, expertise within the firm likely resides with executive officers and other full-time employees,⁷² who are typically thought of as the targets of monitoring, and not as the

69. See *infra* Part III.B.3.

70. See Randall S. Kroszner & Philip E. Strahan, *Bankers on Boards: Monitoring, Conflicts of Interest, and Lender Liability*, 62 J. FIN. ECON. 415, 436 (2001) (finding that banks specialize in lending to industries in which they enjoy board participation).

71. See Roel C. Campos, *Remarks of SEC Commissioner*, 55 CASE W. RES. L. REV. 527, 534 (2005) (complaining about the lack of industry expertise of many outside directors); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 914 (1996) (noting the problem of outside directors' lack of expertise); Dale A. Oesterle, *Are Leveraged Buyouts a Form of Governance Arbitrage?*, 3 BROOK. J. CORP. FIN. & COM. L. 53, 71 (2008) (explaining how independence rules make it difficult to use industry experts as outside directors).

72. More generally, those with industry expertise are likely to be full-time employees of the firm or one of its competitors. Employees of the firm's competitors, of course, are disqualified from serving as directors of the firm.

monitors themselves. Because of this insider expertise, directors are likely to defer to the judgment of insiders on issues where expertise matters. This dependence on insider expertise tends to weaken directors' monitoring efficacy.

Enforcement. Private lenders have fairly direct means for remedying slack or mismanagement. Covenant violations are common, even among well-run companies.⁷³ A violation rarely signals financial distress. Instead, lenders use covenants as trip wires to force managers to check in regularly. The violation triggers a conversation between the lender and the firm's management. To the extent it feels that certain changes should be made, the lender has strong leverage to effect the change. Technically, a violation triggers the lender's right to accelerate the loan and demand immediate repayment. While lenders generally do not accelerate precipitously, the option to accelerate upon a covenant violation gives the lender significant leverage over management. Lenders are also subject to reputational constraints. They will wish to avoid developing reputations for unreasonable interference with management, lest they lose future business to more reasonable competitors. When market conditions favor borrowers over lenders, for example, when liquidity is high and money is cheap, lenders may feel constrained by market competition from pressing managers so aggressively that they refinance with a different lender.⁷⁴ Conversely, however, tighter credit conditions allow lenders to be more aggressive.

Directors, by contrast, have varied enforcement effectiveness. Boards are susceptible to "capture" by management,⁷⁵ as their involvement with management causes a loss in objectivity and an allegiance to corporate policy decisions that directors participated in formulating. Even a strong-willed director with good monitoring intentions may be stymied by information and expertise deficits from challenging insiders.⁷⁶ Directors may also suffer collective action problems in maintaining a coalition to challenge management.⁷⁷ In an extreme situation, a director might resign to protest a particular management decision, but these cases are rare, and this sort of director resignation is a drastic step not often taken.

Along each of these four important dimensions—information, incentives, expertise, and enforcement—private lenders generally do better than directors. Private lenders are therefore likely to perform at least as well as

73. See *infra* Part III.B.3.

74. See *infra* Part IV.A.

75. MACEY, *supra* note 68, at 57–61.

76. See *id.* at 60–61.

77. *Id.* at 62.

directors at monitoring managers and influencing their decisionmaking. The next Part introduces the subject of private lender governance, explaining its contractual and institutional structure.

II. THE STRUCTURE OF LENDER GOVERNANCE

How do private lenders influence managerial decisionmaking? This Part explains the contractual and institutional structure of lender monitoring and governance. Public company credit agreements almost invariably contain covenants constraining managerial discretion in a number of areas. The agreements also implement monitoring structures to generate a continuing flow of private information to the lender concerning the borrower's ongoing operations and financial condition. The scope and detail of the substantive constraints give some hint of the attention that lenders devote to borrower oversight, and their multiple information-gathering arrangements confirm lenders' ability to keep close tabs on their borrowers. Overall, the structure offers potent tools for lenders to influence managerial decisionmaking when necessary.

A. Loans and Loan Covenants

While private loans to public companies may take a number of forms, the predominant types are term loans and revolving loans. A term loan is conceptually the simplest form of loan: The lender advances the entire principal amount of the loan at its inception, and the principal must be fully repaid by the expiration of the loan's stated term. Interest accrues on the outstanding principal balance over the term of the loan and must typically be paid regularly.⁷⁸

A revolving loan works like a typical consumer credit card account, insofar as it allows the borrower to draw down amounts it may need periodically. The revolving loan has an aggregate borrowing limit, and the borrower may borrow and repay at its discretion, provided that total borrowings outstanding at any given time do not exceed the stated credit limit. The borrower is required to make periodic interest payments on the amount of debt outstanding,⁷⁹ and any outstanding balance must be paid off entirely by the loan's termination date.

78. Some term loans include an amortization schedule, which mandates a regular periodic—typically monthly—payment of interest and principal. Over the life of the loan, these periodic payments fully repay the principal and outstanding interest.

79. The borrower typically pays for unborrowed money as well with a revolving loan, in the form of a commitment fee calculated as a percentage of the unused commitment under the loan—that is, the

Among public companies, the majority of private loans are revolving loans.⁸⁰ Whether a loan is revolving or term, the standard agreement may constrain the borrower firm's activities along a number of fronts. I describe important constraints below.

1. Financial Covenants

Bank loan agreements typically contain numerous financial benchmarks that borrower firms are required to meet. As discussed more fully in the next Part,⁸¹ these provisions serve not only as substantive constraints but also as trip wires, which trigger lender scrutiny when hit.

Almost all credit agreements contain a covenant limiting the borrower's latitude to incur additional debt,⁸² since additional debt increases the existing lender's risk. This restriction is typically expressed as a cap on a debt-related ratio, with some measure of debt as the numerator and a measure of earnings, cash flow, or capitalization as the denominator.⁸³

In addition to limiting debt, cash flow is also a common focus of financial covenants, since a healthy cash flow enhances the borrower's ability to repay. A straight cash flow covenant may take the form of an explicit minimum amount of required cash flow over a specified period.⁸⁴ A "coverage

borrowing limit less principal outstanding. See, e.g., Amended and Restated Credit Agreement Dated as of July 12, 2002, Among CMS Energy Corporation et al., § 2.02(a) (July 12, 2002) (on file with author) (describing a commitment fee).

80. Florin P. Vasvari, *Equity Compensation and the Pricing of Syndicated Loans* 11–14 (Apr. 2008) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=1128249>. One might be concerned that a private lender's monitoring incentives might wane for a revolving loan where the outstanding principal balance is low or zero. However, it turns out that most revolving loans are drawn promptly after their inception. See Ilia D. Dichev & Douglas J. Skinner, *Large-Sample Evidence on the Debt Covenant Hypothesis*, 40 J. ACCT. RES. 1091, 1104 n.16 (2002).

81. See *infra* Part III.B.3.

82. Almost 90 percent of the samples in one study contain a debt-limiting covenant. Michael R. Roberts & Amir Sufi, *Control Rights and Capital Structure: An Empirical Investigation* 9 (Aug. 11, 2008) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=962131>.

83. Over 79 percent of agreements contain a covenant of this variety. *Id.* at tbl.I. For example, one credit agreement defines a leverage ratio:

"Leverage Ratio" means, on any date, the ratio of (a) Total Indebtedness as of such date to (b) Consolidated EBITDA for the period of four consecutive fiscal quarters of the Company ended on such date.

Further down, the agreement caps this ratio at 3:1.

SECTION 6.12. *Leverage Ratio.* The Company will not permit the Leverage Ratio as of the last day of any fiscal quarter to exceed 3.00 to 1.00.

Credit Agreement Dated as of November 14, 2006, Among Amerisourcebergen Corporation et al., §§ 6.11, 6.12 (on file with author) [hereinafter, "ABC Credit Agreement"]. "EBITDA" is earnings before interest, taxes, depreciation, and amortization.

84. Roberts & Sufi, *supra* note 82, at 9.

ratio” covenant is also common.⁸⁵ This type of covenant requires the borrower to maintain its cash flow at or above a specified multiple of its total interest expense.⁸⁶

Lenders also care about net worth. A net worth covenant protects the lender in case it ends up having to liquidate the borrower’s assets to satisfy its debt. This covenant sets a floor on the value of the borrower’s net assets—the margin by which the value of the firm’s assets exceed its liabilities.⁸⁷

2. Investment Constraints

Because overly aggressive investments may impair the borrower’s ability to repay its debt, private lenders often use explicit restrictions on capital expenditures to “exert direct control over the financial policies of solvent firms.”⁸⁸ These restrictions are typically expressed as strict dollar limits or percentages of earnings or revenues, as the following illustrates:⁸⁹

85. Over three-quarters of agreements contained a coverage ratio covenant. *Id.* at tbl.I. A related study involving a subset of the same loans finds that 83 percent of loans contain a covenant based on some measure of cash flow. Roberts & Sufi, *supra* note 15, at 22, tbl.III.

86. For example, the provision may require the borrower to maintain a coverage ratio of 2:1, measured quarterly for the twelve-month period ending on the last day of each fiscal quarter. See, e.g., \$200,000,000 Amended and Restated Credit Agreement Dated as of July 27, 2005, Among Duquesne Light Holdings, Inc. et al., § 8.01(k) (on file with author). Other fixed charges may also be included in the denominator of this ratio.

A coverage ratio covenant also places an implicit limit on borrowing: additional debt may be incurred only if the borrower can also generate sufficient additional cash flow to maintain the required coverage.

Related to these benchmarks, meant to measure and preserve the borrower’s ability to repay, loan agreements also typically restrict the firm’s latitude to pay dividends and other distributions to equity holders. In addition, to ensure short-term liquidity, the loan agreement may require the borrower to maintain a certain ratio of short-term assets to short-term liabilities. This is the current ratio, which is calculated as current assets divided by current liabilities. Current assets are those that are reasonably expected to be converted to cash within one year—e.g., cash, accounts receivable, inventory, and marketable securities. Current liabilities are the firm’s debts that are due within one year. In the Roberts & Sufi study, almost 15 percent of agreements contained some liquidity test. Roberts & Sufi, *supra* note 15, at 9.

87. Almost half the credit agreements studied contained a net worth covenant. *Id.* Net worth covenants also effectively impose operating performance requirements, since losses reduce net worth dollar for dollar. Harry DeAngelo, Linda DeAngelo & Karen H. Wruck, *Asset Liquidity, Debt Covenants, and Managerial Discretion in Financial Distress: The Collapse of L.A. Gear*, 64 J. FIN. ECON. 3, 22 (2002).

88. Roberts & Sufi, *supra* note 15, at 1; see Nini, Smith & Sufi, *supra* note 16, at 10 (finding that 42 percent of firms faced a capital expenditure restriction during their 1996–2005 sample period). Moreover, these restrictions respond directly to managers’ potential overinvestment/asset substitution tendencies. See Jensen & Meckling, *supra* note 11, at 312 (discussing agency costs of equity). Such constraints may be efficient. See *infra* Part III.C.2.

89. Nini, Smith & Sufi, *supra* note 16, at 9.

SECTION 6.23. Limitation on Capital Expenditures.

Capital Expenditures for each Fiscal Year shall not exceed the maximum levels as set forth below opposite such Fiscal Year:

Fiscal Year Ended:	Maximum Level
December 31, 2001	\$205,000,000
December 31, 2002	\$255,000,000
December 31, 2003	\$305,000,000 ⁹⁰

Other covenants indirectly constrain borrowers' ability to make investments. Use of loan proceeds is typically restricted.⁹¹ "Sweep" covenants require the borrower to make loan prepayments upon the occurrence of certain fundraising transactions—typically asset sales or securities issuances—or if the borrower's hoard of cash simply exceeds a predetermined threshold. In effect, whenever the borrower is holding too much free cash, a sweep covenant may require that some portion of it be used to pay down the loan.⁹² These various cash management and sweep provisions constrain the borrower's latitude to make significant investments.

3. Fundamental Changes

The bank effectively enjoys veto power over a number of significant transactions that firm management might otherwise wish to pursue. For example, the firm's latitude to effect a change of control, sell or grant liens on substantial assets, make major acquisitions, merge, or change the nature of its business may all be explicitly restricted in the loan agreement.⁹³ These provisions assure the lender that the fundamental nature of the business will not be changed to its detriment.

B. Institutional Practices and Information Access

In addition to the substantive constraints described above, private lenders rely on a number of institutional practices to obtain current information about the borrower's activities and financial condition in order to facilitate monitoring.

90. Amended and Restated Credit Agreement, Dated as of June 29, 2001, Among Airborne Express, Inc. et al., 75 (on file with author).

91. See, e.g., ABC Credit Agreement, *supra* note 83, at § 5.08.

92. One study of bank loans to public and private companies found that 62.5 percent had asset sale sweeps; 46.2 percent had debt sweeps; and 45.9 percent had equity sweeps. Michael Bradley & Michael R. Roberts, *The Structure and Pricing of Corporate Debt Covenants* 11, tbl.1 (May 13, 2004) (unpublished manuscript, on file with author), <http://ssrn.com/abstract=466240>.

93. See, e.g., ABC Credit Agreement, *supra* note 83, at §§ 6.03 (prohibiting fundamental changes), 6.05 (prohibiting certain asset sales).

Regular Reporting. A private lender typically requires its borrower to provide a steady stream of information in the form of periodic financial and operating reports.⁹⁴ This information may be far more timely and detailed than any regular public disclosure the borrower may be required to make. Moreover, as earlier noted, the information banks enjoy rivals what directors receive in terms of frequency and detail.⁹⁵ With its periodic reports, the firm must additionally certify its continuing compliance with each specific condition and restriction contained in the credit agreement. For example, in addition to producing quarterly financial statements, the firm may be required specifically to certify its net worth, tangible assets, cash flow, or other accounting benchmarks in order to confirm its ongoing conformity with individual financial covenants.⁹⁶ Besides these regular reports, the borrower obligates itself to provide notice to the bank of the occurrence of any of a number of unfortunate incidents that might adversely affect the borrower's creditworthiness—for example, material litigation, a default or potential default on any material obligation, or receipt of a government notice of a material regulatory violation.⁹⁷ The lender also typically enjoys wide access to the company's books and records and properties.⁹⁸ Finally, the bank enjoys direct access to the firm's management and independent accountants to address any concerns it might have.⁹⁹

Bankers on Board. The bank often has a representative on the borrower's board of directors,¹⁰⁰ which improves the bank's access to information and offers one more avenue for active monitoring. As a board member, the banker obtains "soft" information that may be difficult to contract for ex ante. This information access is more flexible than contractual reporting requirements and can adapt more readily to changing conditions. It therefore economizes on contracting and information production costs, to the benefit of both borrower and lender.

This intimate knowledge of the borrower's operations also facilitates the bank's development of expertise on the borrower's industry.¹⁰¹ More generally,

94. See, e.g., *id.* § 5.01(a), (b) (requiring quarterly financial statements).

95. See *supra* Part I.C.2. Directors also ordinarily lack the incentives to demand all the information theoretically available to them or the expertise to process it. See *supra* Part I.C.2.

96. See, e.g., ABC Credit Agreement, *supra* note 83, at § 5.01(c) (requiring periodic certification of compliance with fixed charge ratio and leverage ratio covenants).

97. See, e.g., *id.* § 5.02.

98. See, e.g., *id.* § 5.06.

99. See, e.g., *id.*

100. See Krozner & Strahan, *supra* note 70, at 416 (noting that one-third of large U.S. firms have a banker on the board of directors).

101. Consistent with this industry expertise theory, evidence suggests that banks specialize in lending to industries in which they are represented on boards. *Id.* at 436.

private lenders often specialize in lending to particular industries or industry segments. Industry expertise enables lenders to more precisely evaluate the ongoing credit risk of individual borrower firms and to distinguish individual underperformance from industry effects.¹⁰²

Following the Money. Banks and other private lenders typically offer cash management, check clearing, and other financial services to their borrowers, who are often required to maintain their deposit accounts with their private lender.¹⁰³ This arrangement enables the lender to closely follow its borrower's aggregation and uses of cash in real time, giving the lender a clear window on the borrower's business activity.¹⁰⁴

Short Maturities for Reassessing Credit Quality. Lending practices also facilitate monitoring. Private lending is ordinarily only short or medium term,¹⁰⁵ which means that borrowers must periodically renew their bank lending arrangements. This gives the lender continual fresh opportunities to reexamine its borrowers' creditworthiness, and also gives borrower managers incentive to maintain creditworthiness.

III. THE DYNAMICS OF LEVERAGE

Drawing on the preceding structural account of the contractual and institutional setting for lender governance, this Part explains the dynamics of

102. Borrowers also gain from having bankers on board. Good information flow to the bank likely improves the firm's access to credit from that bank. Interestingly, while most banks represented on boards are lenders to the firm, they are typically not the firm's main lender. This probably results from potential conflicts of interest and lender liability concerns. *Id.* at 431. Consistent with this theory, bankers are more likely to be on boards of firms where conflicts are less likely—typically larger, more stable firms with high proportions of tangible assets and low levels of short-term debt. *Id.* at 417. A banker with industry expertise may also be a more useful adviser to the borrower firm. Finally, a banker on board may signal the bank's faith that the firm is unlikely to go into distress, since the firm's distress could create conflicts of interest and lender liability issues for the bank. *Id.* at 419; cf. Miguel A. Ferreira & Pedro Matos, When Banks are Insiders: Evidence From the Global Syndicated Loan Market (Dec. 2007) (unpublished manuscript, on file with author) (finding that for global syndicated loans, a bank's status as an insider to the borrower firm inures primarily to the bank's benefit).

103. Fama, *supra* note 33, at 37–38; Arnoud W. A. Boot, *Relationship Banking: What Do We Know*, 9 J. FIN. INTERMED. 7, 11 (2000).

104. See Fisher Black, *Bank Funds Management in an Efficient Market*, 2 J. FIN. ECON. 323, 326 (1975) (explaining the informational advantages for a lender from maintaining its borrower's deposit account); Fama, *supra* note 33, at 37–38.

105. The predominant liabilities for banks are short-term deposits. To match the timing of their assets and liabilities, banks tend to avoid long-term loans. In one study of 1,000 loans to public companies, 73 percent of the loans had stated maturity of five years or less. Roberts & Sufi, *supra* note 15, at tbl.I, Panel B. Invariable renegotiation prior to stated maturity makes the effective maturity even shorter. Average effective maturity is less than one-half of the original stated maturity. *Id.* at 2.

lender governance. It draws on existing empirical research to show the pervasiveness of private lenders' influence on managerial decisionmaking. The banking relationship involves more than a static set of contract terms: It is a durable and adaptable association that responds to the changing conditions under which the borrower's business operates, and banks influence borrower managerial decisions through the various stages of this relationship. In addition to standard covenant constraints that are tailored to the perceived risks of the borrower at a loan's inception, explicit contingency provisions and renegotiation respond to the borrower's changing circumstances over time. Renegotiation is the norm. It is often triggered by a covenant violation, which is commonplace,¹⁰⁶ and renegotiation often involves additional curbs on managerial discretion. Over the course of this dynamic relationship, lenders commonly influence—sometimes even dictate—critical corporate policy choices, especially as to financial and investment policy and management turnover. Lender influence in these areas curbs risktaking by management, which may be value enhancing for borrower firms.

A. Durability of the Banking Relationship: The Certainty of Renegotiation

Renegotiation of private credit agreements is not only common; it is the rule.¹⁰⁷ Moreover, credit agreements are structured specifically with renegotiation in mind.¹⁰⁸ Almost all credit agreements are renegotiated before stated maturity—after only 44 percent of the original term has elapsed, on average.¹⁰⁹ According to one private lending officer, “lenders generally view the Loan Agreement as a living document destined to be modified periodically to take account of changing circumstances.”¹¹⁰

106. See *infra* Part III.B.3.

107. See Roberts & Sufi, *supra* note 15, at 1–2.

108. See Charles Kahn & Gur Huberman, *Default, Foreclosure, and Strategic Renegotiation*, LAW & CONTEMP. PROBS., Winter 1989, at 49, 51 (explaining that a credit agreement puts enormous negotiating leverage in creditor's hands, not necessarily to enable the creditor to foreclose but to extract value from the borrower under conditions of information asymmetry); see also Gur Huberman & Charles Kahn, *Limited Contract Enforcement and Strategic Renegotiation*, 78 AM. ECON. REV. 471 (1988) (modeling the use of unreasonable clauses in contracts to structure renegotiation under conditions of information asymmetry).

109. Roberts & Sufi, *supra* note 15, at 8. For example, 96 percent of contracts with stated maturity exceeding three years are renegotiated. *Id.* As high as this percentage is, it accounts for only those renegotiations that modify a major contract term such as principal, interest spread, or maturity. *Id.* at 7 n.4. Over 90 percent of private credit agreements with stated maturity exceeding one year are renegotiated. *Id.* at 2.

110. Edward D. Zinbarg, *The Private Placement Loan Agreement*, FIN. ANALYSTS J., July–Aug. 1975, at 35 (discussing private placement lenders).

In addition to its frequency, renegotiation also works enormous changes to the original agreement. Consider three central contract terms: maturity, credit amount, and interest rate spread.¹¹¹ The absolute value of renegotiated changes to contract maturity averages 64 percent.¹¹² Changes in amount average 43 percent.¹¹³ Changes to interest rate spread average 40 percent.¹¹⁴ These large averages, together with the near certainty of renegotiation, imply that over the course of the banking relationship, significant modifications to the fundamental terms of private lending agreements are routine.

Renegotiation may be triggered by the borrower's violation of a loan covenant.¹¹⁵ As more fully described below, technical violations are quite common. They rarely lead to default, financial distress, or loan acceleration,¹¹⁶ but lenders often impose additional constraints on borrowers following violations.¹¹⁷

The likelihood of renegotiation is also more sensitive to subsequent changes in credit quality when the initial contract contains contingency provisions based on specific measures of credit quality. For example, the original

111. Bank loans typically carry a floating interest rate, a rate that varies with prevailing credit market conditions. The contract rate is set as a "spread," say 1 percent, over a benchmark or reference rate—a widely followed interest rate that reflects general credit market conditions. The London Interbank Offered Rate (LIBOR) is one widely used reference rate in bank credit agreements. LIBOR is based on the interest rates at which London banks lend to each other on an unsecured basis. The actual interest rate the borrower pays at any given time is the sum of the spread and the reference rate, and it varies with changes in the reference rate. The interest rate spread generally reflects the riskiness of the loan.

112. Roberts & Sufi, *supra* note 15, at 2. Average maturity for the sample is 3.3 years. The average renegotiated change in maturity is 2.1 years. *Id.*

113. *Id.* The average principal amount for the sample is \$450 million. The average renegotiated change is \$193 million. *Id.*

114. *Id.* The average interest spread for the sample is 162 basis points. The average renegotiated change in spread is 64 basis points. *Id.*

115. According to Roberts and Sufi, fewer than 18 percent of renegotiations involve a covenant violation or payment default. *Id.* However, there is some possibility that they may be undercounting violations. They rely on SEC filings to determine whether a violation triggered the renegotiation. Specifically, they rely on the notes to financial statements included in Form 10-K and Form 10-Q periodic reports to indicate covenant breaches. *See id.* at 8 n.5 (referencing Roberts & Sufi, *supra* note 82, for data collection methods); Roberts & Sufi, *supra* note 82, at 6–8. However, technical violations that are routinely waived may not be captured here. Disclosure is required only for a covenant breach that exists at the date of the most recent balance sheet being filed and that has not been cured. 17 C.F.R. § 210.4-08 (2008). For similar reasons, only the most serious violations are likely to be detected with this approach. *See* Dichev & Skinner, *supra* note 80, at 1095 (noting that a renegotiation and cure would be fairly easy to accomplish except when "circumstances are sufficiently serious as to preclude any form of favorable renegotiation").

Even a technical violation gives the lender the legal right to accelerate the loan. While acceleration for a technical violation is unlikely, it may still offer the lender some leverage in renegotiation. The statement in the text still holds, however. If undercounting involves only immaterial violations, then the observed magnitudes of typical renegotiated changes remain quite staggering.

116. *See infra* Part III.B.3.

117. *See id.*

agreement may include a provision that adjusts the interest rate over the life of the loan based on subsequent changes in the borrower's cash flow.¹¹⁸ A credit agreement with this so-called "performance pricing" provision is more likely to be renegotiated following a change in cash flow than an agreement without this contingency.¹¹⁹ This finding helps to capture the relational quality of the lending agreement. It also stands at odds with standard incomplete contracts theory. Standard theory posits that renegotiation is costly, and that parties avoid such costs by drafting more complete contracts—contracts that address more future states of the world by specifying contract outcomes under those various states.¹²⁰ Private lending agreements appear to be doing just the opposite. The sensitivity of renegotiation to initial contract contingencies—changes in cash flow, in our example—suggests that rather than attempting to avoid renegotiation, the parties include contingencies in anticipation of it. Borrower and lender recognize *ex ante* the importance of the contingency, and they contract on the contingency to allocate bargaining power in different states of the world in order to structure any renegotiation.¹²¹

Finally, renegotiation rarely leads to a change of lender,¹²² suggesting the importance and durability of the lender-borrower relationship and the significance of the parties' relationship-specific investment.¹²³ From the beginning of their lending arrangement, then, borrower and lender foresee a relationship that will change but endure. They attempt in the initial contract to anticipate future changes in credit quality to some extent, not to avoid renegotiation but to structure it. Renegotiation is expected, and it may lead to very significant

118. As I discuss below, this "performance pricing" feature is now the norm. See *infra* Part III.B.2.

119. Roberts & Sufi, *supra* note 15, at 3. More specifically, a decline in cash flow will trigger an unfavorable renegotiation, reducing the borrower's credit and increasing its interest rate. *Id.*

120. See Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 730 (1991) (describing the standard view of incomplete contracts); Gur Huberman & Charles Kahn, *Limited Contract Enforcement and Strategic Renegotiation*, 78 AM. ECON. REV. 471, 471 (1988) (describing the standard bounded rationality explanation for incomplete contracting and subsequent renegotiation).

121. Roberts & Sufi, *supra* note 15, at 3–4.

122. In the Roberts & Sufi study, only 11 percent of renegotiated loans led to a change of lender or lead arranger. When we include loans that mature, the number drops to 8.5 percent. *Id.* at 15.

123. See Raghuram G. Rajan, *Insiders and Outsiders: The Choice Between Informed and Arm's Length Debt*, 47 J. FIN. 1367 (1992); Raghuram Rajan & Andrew Winton, *Covenants and Collateral as Incentives to Monitor*, 50 J. FIN. 1113 (1995). This account is also consistent with the loan market literature showing that lead banks rarely sell their positions. Instead, they have a reputational stake in preserving their borrower relationships. This helps explain the counterintuitive result that syndicate size has no effect on the likelihood of renegotiation. See Roberts & Sufi, *supra* note 15, at 23. It also helps explain results showing that banks remain special—their monitoring role is valued by shareholders—even after the advent of active loan markets. See Amar Gande & Anthony Saunders, *Are Banks Still Special When There Is a Secondary Market for Loans?* 9 (Oct. 2006) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=873353>.

changes in the fundamental terms of the original agreement. In all likelihood, borrower and lender will stick together through subsequent changes, anticipated or not. This is not to suggest their interests will necessarily coincide, but it does suggest that given the value of their relationship-specific investment, they will jointly manage contingencies in their relationship.

Given the durability of this relationship and its adaptability, it makes sense that banks might regularly influence firm governance from its inception and throughout the course of the banking relationship.

B. The Stages of Lender Influence

This Section explains the various stages of lender influence over the course of its relationship with the borrower firm. The covenant constraints in the initial loan agreement explicitly curb managers' discretion from the inception of the lending relationship. Built-in contingency provisions also offer finely tuned incentives affecting managers' decisionmaking over the life of a loan. Finally, subsequent covenant violations trigger lender scrutiny and the possibility of further constraints on managerial discretion.

1. Initial Covenant Settings: Controlling Agency Costs

Here I discuss the theory and practice of initial covenant settings. Empirical studies show that the structuring of initial covenants responds to firm characteristics that affect credit risk, and that managers alter their behavior in response to covenant constraints. Lender influence commences from the very beginning of the lending arrangement.

Financial covenants are pervasive.¹²⁴ Among other fears, lenders worry that once credit is extended, firm managers may favor their own interests or the interests of equity holders over those of creditors.¹²⁵ Managers might, for instance, substitute risky projects for more conservative ones, since in the presence of debt, equity holders do better with the former than the latter.¹²⁶

124. One study of public companies' credit agreements from 1996–2005 found that almost 97 percent included at least one financial covenant. See Roberts & Sufi, *supra* note 82, at 9. Another study using a sample period from 1995–2001 found that for loans with expected maturity of one year or more, the average loan contained three financial covenants. See Cem Demiroglu & Christopher James, *The Information Content of Bank Loan Covenants* 8 (Nov. 30, 2008) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=959393> (discussing the prevalence of sweep covenants).

125. See Jensen & Meckling, *supra* note 11, at 335; Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 155 (1977); Smith & Warner, *supra* note 21, at 118.

126. This is the problem of asset substitution. See Smith & Warner, *supra* note 21, at 118–19.

Managers might even spend free cash on negative net present value projects,¹²⁷ either to build empires for their own benefit or to improve equity holders' upside returns. The finance literature has identified situations in which these agency costs may be most troublesome. Financial distress, for example, heightens the conflict between debt and equity.

Consistent with this literature, covenant structure responds to these perils.¹²⁸ Firms with greater risk of financial distress—smaller, more highly levered, more volatile firms, and firms with highly liquid assets—are more likely to have covenants in their lending agreements.¹²⁹ By contrast, loans to firms with a higher ratio of tangible assets to total assets are less likely to include covenants.¹³⁰ This makes sense as tangible assets are easier to value and easier to liquidate than intangible assets in the event of the firm's default. Firms with intangible assets and growth opportunities are riskier because realization of the value of these opportunities depends on discretionary future investment by the firm.¹³¹ Specific covenants address this sort of risk: high growth firms are more likely to attract demands for security, financial ratio covenants, and covenants restricting dividends.¹³² More generally, private lenders set covenants fairly tightly relative to the variability of the underlying accounting measure,¹³³ adjusting covenant “slack” to account for this

127. This is overinvestment. See Elazar Berkovitch & E. Han Kim, *Financial Contracting and Leverage Induced Over- and Under-Investment Incentives*, 45 J. FIN. ECON. 765, 766 (1990).

128. Equity holders accede to these covenants because absent such protections, lenders will demand a higher price for their credit for having to bear the risks of these opportunistic maneuvers.

129. Bradley & Roberts, *supra* note 92, at 27 (analyzing commercial loans made from 1993–2001, as reflected in Loan Pricing Corporation's Dealscan database). Similar results are obtained using syndicate size as a proxy for risk: there is a positive correlation between syndicate size and the inclusion of covenants. *Id.* Loans to firms with greater cash flow volatility are more likely to include dividend restrictions and to require collateral. *Id.* at 17.

130. *Id.* at 19 tbl.6.

131. Myers, *supra* note 125, at 150.

132. Bradley & Roberts, *supra* note 92, at 19, tbl.6 (relying on the market-to-book ratio as a measure of growth). Collateral reduces the lender's downside risk. Financial covenants cabin the borrower's risktaking. The restriction on dividends addresses the problem of debt-induced underinvestment. Managers may shun efficient investments whose returns would be enjoyed disproportionately by creditors rather than equity holders. Dividend restrictions partially address the underinvestment problem by keeping cash in the company. Myers, *supra* note 125, at 160. Compared to firms without significant growth opportunities, high growth firms are more likely to suffer this harm to firm value to creditors' detriment.

133. Dichev & Skinner, *supra* note 80, at 1093. The study investigates current ratio and net worth covenants. The current ratio is calculated as current assets divided by current liabilities. Current assets are those that are reasonably expected to be converted to cash within one year—for example, cash, accounts receivable, inventory, and marketable securities. Current liabilities are the firm's debts that are due within one year. Net worth is the amount by which the value of the firm's assets exceeds the amount of their liabilities.

For the current ratio covenant, mean and median covenant slack at loan inception—the distance from the covenant threshold to the actual measure—are 0.80 and 0.52, respectively, while

variability for each borrower.¹³⁴ Tighter covenants are also associated with lower borrowing costs,¹³⁵ consistent with the proposition that lenders value these stricter limits and their effects on borrower behavior.¹³⁶

Covenants also likely affect managers' behavior. Despite the fact that technical covenant violations are common and do not typically result in punitive lender action, managers cannot count on this. A violation often triggers the lender's legal right to demand immediate repayment of the entire debt, and even though acceleration is unlikely, a violation might always cause some curtailment of managerial discretion through the bank's intervention.¹³⁷ Even for healthy firms in the best of situations, there is the hassle factor: a violation requires managers to explain. It triggers review by the bank and may impose additional reporting burdens on borrower management, which is put to the task of defending its forecasts and strategies.¹³⁸ All this takes time away from running the company. Banks also often charge a fee for a waiver or modification of the loan. The more intensive monitoring and covenant constraints that accompany private debt may even cause some healthy firms to switch from private to public debt.¹³⁹ Managers have incentive to comply.

Though measuring the effects of loan covenants on managerial behavior may be a bit tricky,¹⁴⁰ studies tend to confirm that covenants have real

their standard deviations are 0.53 and 0.32, based on quarterly data. Given that the average maturity of loans in the sample is approximately eleven quarters, this represents a generally tight covenant. Similarly, for the net worth covenant, mean and median slack at inception are 3.8 percent and 6 percent, respectively, while their standard deviations are 4.8 percent and 3.2 percent. *Id.* at 1105–06.

134. *Id.* at 1106–07.

135. Demiroglu & James, *supra* note 124, at 24 (using all-in-drawn spread as a measure of borrowing costs).

136. Tighter covenants may also simply reflect the lender's higher confidence in the borrower's future performance. See *id.* at 5 (noting that borrowers and lenders set covenant thresholds that they expect can be achieved). Stock price reactions to public announcement of loans are also larger for loans with tighter covenants. *Id.* at 20. As with the association with lower borrowing costs, this stock price effect could be explained either as a signal of private information—evidencing the lender's special confidence in the borrower's future performance—or a commitment to future performance by the firm's managers, which credits covenants with real ex post effects.

137. Managers value their financial flexibility. See John R. Graham & Campbell R. Harvey, *The Theory and Practice of Corporate Finance: Evidence From the Field*, 60 J. FIN. ECON. 187, 210 fig.5 (2001) (finding that "financial flexibility" is the single most important factor CFOs consider when deciding debt policy).

138. Dichev & Skinner, *supra* note 80, at 1096 (describing the hassle factor).

139. See Stuart C. Gilson & Jerold B. Warner, *Private Versus Public Debt: Evidence From Firms That Replace Bank Loans With Junk Bonds* (Oct. 1998) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=140093>.

140. Measuring the effects of loan covenants is important because it is at least conceptually possible that lenders and borrowers set covenant thresholds merely to anticipate the borrower's future performance. In that case, rather than setting constraints, covenants would be a formality, exerting

effects.¹⁴¹ When we look at firm performance following a loan's inception, we find some telling patterns. Comparing quarter-end accounting measures with the associated covenants, one study finds an unusually small number of loan quarters with borrower performance slightly beyond covenant thresholds—that is, in violation—while an unusually large number cluster just shy of the violation point.¹⁴² In other words, there is a significant discontinuity in the distribution of firms' performance on accounting measures constrained by covenants.¹⁴³ Moreover, the discontinuous pattern becomes more pronounced over the life of the loan. This longitudinal dimension is important. Clustering in general, while consistent with the view that covenants constrain managers, does not necessarily rule out the anticipatory contracting explanation—that covenants are set in order to anticipate the borrower's future performance, but not to constrain it.¹⁴⁴ After all, lenders set tight covenants, so we would expect to see some clustering near the covenant threshold. Anticipatory contracting could plausibly account for clustering generally or discontinuity in the quarters immediately following the loan's inception. However, the persistence and increased prominence of this discontinuous pattern in a loan's later years is difficult to explain as an artifact of anticipatory contracting.¹⁴⁵ Instead, the pattern suggests that covenants have real bite: firms attempt to manage in response to covenant constraints.¹⁴⁶

2. Built-in Contingency

In addition to setting fixed constraints, the initial credit agreement often accounts for contingencies with various conditional features. The most

no real influence on firm managers, except perhaps in extreme cases. The commonplace of covenant violations—and lenders' typical waiver of violations—may suggest that managers worry little about covenants, and that covenants do little to constrain managerial discretion.

141. The effects are especially clear in the investment policy context. See *infra* Part III.C.2.

142. Dichev & Skinner, *supra* note 80, at 1111–12 (investigating current ratio and net worth covenants).

143. If, for example, a net worth covenant had no effect on managers' behavior, one would expect to see a smooth distribution of firms' net worth across the covenant limit. The clustering just shy of the covenant limit suggests that managers are managing with an eye to remaining in compliance with the covenant.

144. See *supra* note 143.

145. Dichev & Skinner, *supra* note 80, at 1112.

146. The data make it impossible to determine, however, whether firms are engaging in “real” management or accounting management—are managers improving firm performance or only playing with the numbers? One might expect that using accounting management to remain in compliance with covenant constraints would be difficult for a chronically poorly performing firm to sustain over time. So the finding of pronounced discontinuity in the distribution of firms' performance on accounting measures in loans' later years suggests that some real management is probably going on.

common contingencies are performance pricing, “build-up” provisions, and use of a borrowing base. These built-in contingencies seek not only to constrain but to channel managerial decisionmaking over time. They operate over the life of the loan, even absent poor firm performance, covenant violations, or financial distress.

Performance pricing. Performance pricing ties interest rate spreads to specific financial performance metrics, adjusting to changes in credit risk over the life of a loan.¹⁴⁷ Among public companies, performance pricing is now standard.¹⁴⁸

Pricing provisions are quite detailed and sophisticated. They typically anticipate a wide range of changes to credit risk and offer price incentives accordingly, with initial pricing typically set toward the expensive end of the spectrum and price reductions to encourage performance improvements.¹⁴⁹ In one study, the range of interest rate spreads from the top to the bottom of the pricing grid averaged 90 basis points,¹⁵⁰ a relatively broad range given the size of the mean initial loan spread of 175 basis points.¹⁵¹

A complementary covenant typically accompanies the pricing grid.¹⁵² This associated covenant sets a constraint on the same performance measure used in the pricing grid—say, the debt-to-cash flow ratio—setting a tight limit just past the expensive end of the grid.¹⁵³ This combination of pricing grid and related covenant, with initial pricing at the expensive end of the grid, suggests that the arrangement intends to incentivize improved performance with discounted pricing, while catching credit deterioration rather quickly

147. The most commonly used performance measures are debt-to-cash flow ratios and credit ratings. See Roberts & Sufi, *supra* note 15, at 10.

148. Roberts and Sufi find performance pricing in about 73 percent of loans in their sample. See *id.* at 10.

149. Anne Beatty, Ilia D. Dichev & Joseph Weber, *The Role and Characteristics of Accounting-Based Performance Pricing in Private Debt Contracts* (June 2002) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=318399>. According to this study, most performance pricing grids contain between four and six levels, with some containing up to nine pricing levels. *Id.* at 13 fig.1 (focusing only on debt/EBITDA-based pricing grids).

150. *Id.* at 2. A basis point is one one-hundredth of a percentage point. One hundred basis points equals one percent.

151. *Id.* at 13. Similarly, among agreements with performance pricing based on debt-to-cash flow ratios, the range of this metric over the entire grid averages 1.64, which again seems relatively broad given that the mean initial setting for the debt-to-cash flow ratio is 3.60, with an interquartile range of about 2.00. *Id.* The interquartile range is the difference between the 25th and 75th percentile for the initial setting of the debt-to-cash flow ratio.

152. The pattern of performance pricing with a same-variable covenant suggests that the two are complements rather than substitutes. *Id.* at 15. Further testing confirms their complementarity. *Id.* at 18.

153. *Id.* at 14. The typical covenant is set within one pricing level of the very top of the grid. *Id.*

when the firm falters. This upside-focused pricing variability offers managers a transparent reward structure, spurring improvement that leads to cheaper debt.¹⁵⁴

Contingent interest costs offer managers powerful incentives to improve performance during the life of the loan. Lower interest costs will improve the firm's profitability and leave managers with more discretion. Poor performance and higher interest costs will hinder profitability, increasing the odds of lender intervention down the road.

Other Contingencies: Build Up and Borrowing Base. Besides performance pricing, private credit contracts sometimes include other contingencies such as a "build up" or a borrowing base.

A build up provision causes a covenant threshold to ratchet upward over the life of the loan. The covenant becomes more stringent over time, based on a fixed schedule or a formula linked to the firm's future performance. For example, a leverage covenant may be set initially at 50 percent, ratcheting down to 40 percent after the first year, and so on.¹⁵⁵ Or a net worth covenant may set a specific dollar threshold at loan inception, with future upward adjustments based on the firm's positive net income or any issuance of new securities.¹⁵⁶ Build up imposes a stick that forces future improvement by managers, who otherwise suffer the consequences of a covenant violation. Build up may also be useful in signaling firm managers as to the lender's expectations concerning future performance.

A borrowing base is sometimes used in secured loans. The arrangement ties credit availability under the loan to the value of the loan's specified collateral—typically accounts receivable and/or inventory. This is the

154. It also improves on contracting efficiency. Specifying rewards upfront for later improvements in credit risk reduces renegotiation costs and the lender's prepayment risk, to the ultimate benefit of both borrower and lender. *Id.* at 7–8; Paul Asquith, Anne Beatty & Joseph Weber, *Performance Pricing in Bank Debt Contracts*, 40 J. ACCT'G & ECON. 101, 104 (2005).

Pricing grids sometimes also contemplate deterioration in credit quality, increasing interest spreads for greater credit risk. This type of pricing grid is more prevalent with financially stronger firms, where deterioration in credit quality is less likely to lead to default and therefore may be priced more accurately ex ante. Beatty, Dichev & Weber, *supra* note 149, at 22–23. This prespecified schedule of increased interest rates may tend to discourage poor performance at lower cost than traditional covenants, which do not compensate the lender for small increases in risk from poor performance that falls short of a covenant violation. Consistent with this, borrowers are generally compensated for price-increasing grids with lower initial interest rates. See Asquith, Beatty & Weber, *supra*, at 104 (finding that initial rates are almost 26 basis points lower for loans with price-increasing grids). Negative incentives may be quite powerful. Interest spreads might double, for example, as cash flow and credit quality deteriorate. See Roberts & Sufi, *supra* note 15, at 3.

155. See Demiroglu & James, *supra* note 124, at 7 n.11.

156. See Dichev & Skinner, *supra* note 80, at 1103.

prototypical working capital line.¹⁵⁷ The value of inventory and accounts is likely to fluctuate, and may depend on seasonal patterns of the borrower firm's business activity. While the credit line offers the borrower the flexibility to borrow only what it needs, use of the borrowing base helps assure the lender that at any given time, the amount of credit outstanding is consistent with the borrower's activity level. With the borrower's growth, credit availability increases to finance such growth. On the other hand, reduced activity will cause the borrower's financing to dry up.

* * *

Each of these conditional arrangements—performance pricing, build up, and borrowing base—spurs managers to improve firm performance, based on a specified accounting measure.¹⁵⁸ These incentives are in place from the outset of the lending relationship, affecting managerial decisionmaking even when the firm performs well.

3. Honor in the Breach: Covenant Violations

Not surprisingly, poor performance and covenant violations typically cause lenders to monitor their borrowers more closely and perhaps to actively intervene in managerial decisionmaking. Contrary to much of the conventional wisdom, however, financial covenant violations are common, and they do not typically presage financial distress,¹⁵⁹ though they may trigger some lender response. Over a ten-year period, according to one study, a quarter to a third of all public companies will violate a financial covenant,¹⁶⁰ and this may be a lower bound, as methodological constraints suggest that many technical

157. Roberts & Sufi find borrowing bases used in 20 percent of their loan sample. See Roberts & Sufi, *supra* note 15, at 10.

158. In addition, as earlier discussed, these contingencies affect renegotiation by altering the default option and shaping bargaining power. See *supra* Part III.A.

159. See Dichev & Skinner, *supra* note 80, at 1093; Sudheer Chava & Michael R. Roberts, *How Does Financing Impact Investment?: The Role of Debt Covenants 2* (AFA 2007 Chicago Meetings Paper, 2007), available at <http://ssrn.com/abstract=854324>.

160. See Roberts & Sufi, *supra* note 82, at 8–9 (finding that in a random sample of 1894 public companies between 1996 and 2005, more than one quarter violated a financial covenant, and for companies with an average leverage ratio of at least 5 percent, the fraction was almost one-third); see also Dichev & Skinner, *supra* note 80, at 1093 (finding that with a *Dealscan* sample of private loans from 1986–99, violations occur in about 30 percent of all loans); Chava & Roberts, *supra* note 159, at 8–9, 11 (finding that 37 percent of firms subject to a current ratio covenant and 31 percent of firms subject to a net worth covenant during the period 1994–2005 committed a violation of the respective covenant).

violations may go undetected.¹⁶¹ One lending officer at a prominent insurance company reports that in a given year, the company will receive on average one request for a covenant modification for each loan on its books.¹⁶² In any event, “covenant violations are relevant for a large fraction of public firms.”¹⁶³

Violations rarely lead to payment default or acceleration of the loan. A violation will trigger the lender’s scrutiny, and firm managers may be tasked to justify the firm’s strategies and forecasts.¹⁶⁴ Ultimately, however, the lender most often waives the violation.¹⁶⁵ According to one lender’s report, more than 95 percent of requests for covenant modification are granted with no quid pro quo—“the vast majority of corporate requests are perfectly reasonable and do not increase [lender] risk materially.”¹⁶⁶

The second most likely lender response is to impose additional constraints on the borrower.¹⁶⁷ More drastic measures such as a reduction in credit, an increase in interest rate, or a requirement of additional collateral are less likely,¹⁶⁸ though of course, if the firm’s slide continues, the bank will resort to these and other more aggressive measures.¹⁶⁹

161. Methodological constraints make it difficult to detect every violation. Some studies rely on text searching of SEC filings, but not all covenant breaches are significant enough to warrant SEC reporting. See *supra* note 115. Other studies compare initial covenant thresholds as reported in Dealscan with subsequent accounting performance as reflected in Compustat. See Dichev & Skinner, *supra* note 80, at 1104; Chava & Roberts, *supra* note 159, at 10. But loan modifications receive only limited coverage in Dealscan, so violations could be over or underreported. See Dichev & Skinner, *supra* note 80, at 1094; Chava & Roberts, *supra* note 159, at 10.

162. See Zinbarg, *supra* note 110, at 35.

163. Roberts & Sufi, *supra* note 82, at 2. The prevalence of violations is generally consistent across industries. *Id.* at 9, 53 tbl.I. The trade-wholesale category is exceptionally high, experiencing violations at almost a 35 percent rate. *Id.* at 53 tbl.I. Not surprisingly, the likelihood of violation decreases with firm size and credit rating. *Id.* at 9–10, 53 tbl.I.

164. See *supra* notes 137–139 and accompanying text.

165. V. Gopalakrishnan & Mohinder Parkash, *Borrower and Lender Perceptions of Accounting Information in Corporate Lending Agreements*, 9 ACCT. HORIZONS 13, 20 (1995) (surveying chief financial officers of Fortune 500 companies, chief lending officers of the largest 100 banks, and the heads of private placement departments at the top 100 insurance companies, with more than 95 percent of both borrowers and lenders indicating a medium or high probability of a waiver).

166. Zinbarg, *supra* note 110, at 35.

167. Seventy-five percent of borrowers and 59 percent of lenders indicate a medium to high probability of additional constraints. Gopalakrishnan & Parkash, *supra* note 165, at 20, 21 tbl.3.

168. See *id.*; Roberts & Sufi, *supra* note 82, at 34–35, 63 tbl.IX (noting from a small sample of SEC filings for covenant-violating firms that 24 percent of violations resulted in reduced credit availability, 15 percent resulted in increases in interest spread, and 7 percent resulted in the lender requiring additional collateral; and that in the aggregate, 32 percent of lenders took at least one of these actions).

169. The most drastic remedies of termination of the agreement and acceleration of the debt are, of course, the least common. Over 76 percent of Fortune 500 borrowers and more than 90 percent of their lenders assign a zero or low probability to these outcomes. Gopalakrishnan & Parkash, *supra* note 165, at 20–21 & tbl.3.

Covenants are used primarily, then, not as a device to force the borrower's immediate repayment of the loan, even though the lending agreement provides for that remedy. Instead, covenants act as trip wires that signal the need for creditor attention. When the wire is tripped, the lender steps in to update its information about the borrower. The lender will communicate with management and examine the firm's financial position and internal forecasts. In most cases, tripping the wire does not ultimately result in any punitive response by the creditor. But it does command the lender's attention and gives the lender the option to act, depending on what its investigation shows. In the run-of-the-mill case, the lender will waive the violation and may impose additional constraints to account for the new situation.

These routine interactions, typically triggered by a covenant violation or perhaps a borrower's entreaty when a violation is imminent, offer another important avenue through which routine creditor governance occurs. Not all initial covenant settings may continue to be useful or suitable over the life of a loan, and covenant violations focus the attention of lender and borrower on formulating appropriate adjustments to changed circumstances. The firm's continuing deterioration often leads to more aggressive intervention.¹⁷⁰

C. Important Areas of Influence

This section discusses three crucial areas of private lender influence—financial policy, investment policy, and CEO turnover—where lender influence rivals or may surpass that of boards, shareholders, and even managers themselves. For financial and investment policy, lender influence commences at the inception of the lending arrangement and increases if and when the borrower firm falters. CEO turnover, of course, is a more drastic corporate governance decision, where lender influence typically surfaces as the firm's performance declines.

Lender influence in these key areas is widespread among public companies, and evidence suggests that it may be efficient. Lender monitoring and influence increase as the firm falters, and lender intervention may help curb managers' risktaking at exactly the point when they may be tempted to make ill-advised bets: when the firm is in trouble and managers want to make up for earlier losses.

170. See DeAngelo et al., *supra* note 87, at 5 (describing the demise of L.A. Gear over a six-year period, its bank's continual resetting of the company's covenants as it deteriorated, and the fact that the company went through fourteen different credit agreements that gradually reduced its credit line from \$360 million to \$25 million).

1. Financial Policy

The presence of a private lender affects the borrower's financial policy from the very beginning of the lending arrangement.¹⁷¹ As earlier noted, almost all private lending agreements limit the borrower's ability to incur additional debt,¹⁷² and performance pricing provisions often use a debt-to-cash flow ratio as the performance measure.¹⁷³

Not surprisingly, a covenant violation often triggers further lender intervention in the firm's financial policy, typically resulting in a significant permanent reduction in the company's borrowing activity. Measuring firms' borrowing as a percentage of their assets, the average firm's net borrowing decreases by 70 basis points—or 0.7 percent of its assets—in the quarter immediately following a covenant violation,¹⁷⁴ an effect that is economically quite significant.¹⁷⁵ Looking at a broader time horizon, the average firm that violates a financial covenant goes from borrowing 80 basis points per quarter in the four quarters preceding the violation to decreasing its borrowing to –25 basis points two quarters after the violation, a swing of 105 basis points.¹⁷⁶ In relative terms, this reduction in borrowing pushes the firm from the 75th percentile in borrowing to the 35th percentile.¹⁷⁷ This drastic change in financial policy is long lasting: the decline in borrowing persists for over two years after the violation.¹⁷⁸

The evidence also supports a causal role for creditor leverage in effecting these significant changes in the borrower's financial policy. Initial covenant violations trigger a much sharper drop in borrowing than subsequent viola-

171. See *supra* Part III.B.1.

172. See *supra* note 82 and accompanying text.

173. See *supra* note 147.

174. See Roberts & Sufi, *supra* note 82, at 3, 19. The study measures net debt issuance, which is basically new debt incurred minus debt retired for a given period.

175. To put this effect in perspective, compare the effect of changes in firm size, which is the single most powerful predictor of net borrowing. A two-standard-deviation reduction in the size of the firm results in only a 52 basis point reduction in net borrowing per quarter. *Id.* at 3.

176. *Id.* at 2. Negative borrowing simply means that the firm reduces the net amount of existing debt rather than engaging in more borrowing.

Effects are also far more severe for firms that report creditor action in their SEC filings following the covenant violation. These creditor actions include reduction in the size of the credit facility, increase in interest spread, or a requirement of additional collateral. By the second quarter after the violation, net decreases in borrowing average 418 basis points—or 4.18 percent of assets—for this set of firms. *Id.* at 35, 63 tbl.IX. By contrast, for firms reporting a waiver with no specific creditor action, the reduction in net borrowing after two quarters is only 29 basis points. *Id.* These results should be treated with caution, however, as SEC disclosure rules do not necessarily require firms to detail all the terms involved in a waiver, so creditor action may be systematically underreported. See *id.* at 8.

177. *Id.* at 2, 13.

178. *Id.* This leads to an average decrease in leverage of more than 3 percent. *Id.*

tions.¹⁷⁹ While borrowing declines by almost 150 basis points over the two quarters following an initial violation,¹⁸⁰ subsequent violations do not trigger a statistically significant decrease in borrowing.¹⁸¹ This is consistent with the intuition that important creditor leverage comes by way of the acceleration rights that accompany an initial violation. Once that leverage exists, and the lender has intervened to influence the borrower's financial policy, subsequent violations do not significantly increase creditor influence.¹⁸²

2. Investment Policy

Investment policy is a crucial area of strategic decisionmaking for corporate managers. Allocating outlays for long-term growth effectively places the firm's bets on the future. Banks often have enormous influence on these managerial decisions.¹⁸³ The loan agreement effectively makes allocation of control over investment policy contingent on the borrower firm's performance. A covenant violation or deterioration in credit quality causes control to shift to the lender,¹⁸⁴ which the lender then uses to constrain investment. This influence is both widespread and significant.

A third of credit agreements to public companies contain a capital expenditure restriction,¹⁸⁵ and a recent study finds that 42 percent of public firms faced a covenant restricting capital expenditures at some point during a ten-year sample period.¹⁸⁶ Initial imposition of a capital expenditure covenant

179. *Id.* at 4.

180. *Id.* at 31. In the first quarter after the initial violation, net borrowing drops by 81 basis points. The estimate for the second-quarter reduction is an additional 66 basis points. *Id.*

181. *See id.* at 31. An initial violation is one that has not been preceded by an earlier violation by the firm in the previous four quarters. *Id.* at 30.

182. Robustness checks further support this causal role for covenant violations. Tests reveal, for example, that leverage ratios and debt-to-EBITDA ratios do not explain observed decreases in net borrowings following a covenant violation. *Id.* at 24–26, 60 tbl.VI.

183. As earlier noted, lending agreements often contain explicit constraints on investment policy in the form of capital expenditure covenants. *See supra* Part II.A.2.

184. *See Roberts & Sufi, supra* note 82, at 1–6.

185. Nini, Smith & Sufi, *supra* note 16, at 10.

186. *Id.* Given that approximately 80 percent of public firms have private credit agreements, extrapolating from this sample would suggest that about a third of all public companies would face a capital expenditure restriction at some point over a similar period. Smaller firms are more likely to suffer such a restriction, although even for firms with assets in the \$1BB to \$2.5BB range—large enough to make it into the Fortune 1000—about one quarter have a capital expenditure covenant. *See id.*, at tbl.2. Credit quality also matters. For firms with a credit rating, only 6 percent of investment grade firms are subject to a capital expenditure restriction, while 44 percent of below-investment-grade firms are under such a constraint. On other hand, this restriction is not just for dicey firms. Even among firms rated BB—the highest non-investment grade, with a historical default rate of less than 1 percent over a one-year horizon—almost 40 percent have a capital expenditure restriction. *See id.* The covenant is especially common for particular industries. In retail trade,

has bite, appreciably reducing borrower firms' investment. Firms obtaining new credit agreements with a capital expenditure restriction show a 15–20 percent greater decline in investment than firms obtaining new credit agreements without such a restriction.¹⁸⁷ Moreover, post-restriction investment levels cluster tightly just below the contractual cap, strongly suggesting that the initial constraint affects investment, and not the other way around.¹⁸⁸

Imposition of capital expenditure restrictions also turns out to be extremely sensitive to firm performance, suggesting that lenders are quite vigilant about monitoring firm investment levels and constraining investment in response to poor performance. A borrower that has violated a covenant, has higher debt relative to cash flow, or has lower credit quality is more likely to be subject to a capital expenditure covenant,¹⁸⁹ and capital investment typically declines sharply after poor performance or a covenant violation.¹⁹⁰ Relative to initial credit agreements, capital expenditure restrictions are 51 percent more likely following a renegotiation involving a covenant violation.¹⁹¹ Similarly, for a firm whose S&P credit rating drops from BBB to BB—slipping from an investment grade rating to non-investment grade—this almost doubles its likelihood of having a capital expenditure covenant imposed.¹⁹² Imposition of this restriction is also more sensitive to a covenant violation than other important loan terms, such as the interest rate spread, collateralization of the loan, or dividend restrictions.¹⁹³ Similarly, sensitivity with respect to deterioration in credit quality is greater for capital expenditure restrictions than for interest rate spreads and dividend restrictions.¹⁹⁴

In addition to being among the most sensitive contract features with respect to poor performance, capital expenditure restrictions may also be efficient.¹⁹⁵ Firms under such investment constraints show large and statistically significant increases in firm value (as measured by market-to-book value) and

wholesale trade, and services, roughly 40 percent of credit agreements constrain capital expenditures. See *id.* For manufacturers, the fraction is about one-third. See *id.*

187. *Id.* at 20–21. This result controls for observed changes in investment opportunities and firm performance. See *id.* at tbl.7.

188. *Id.* at 21, figs.2 & 3, tbl.8. The persistence of the clustering over time helps rule out an ex ante contracting explanation. See *id.* at 22.

189. *Id.* at 17.

190. Chava & Roberts, *supra* note 159, at 4.

191. Nini, Smith & Sufi, *supra* note 16, at 18.

192. Such a firm suffers a 21 percentage-point increase in the incidence of being subjected to a capital expenditure covenant, which represents a 95 percent increase in likelihood, evaluated at the sample mean. *Id.* at 15.

193. *Id.* at 3, 18, tbl.6.

194. *Id.* at 16–17, tbl.5. Credit quality is measured using Standard and Poor's credit ratings. *Id.* at tbl.5.

195. See *id.* at 23–25.

operating performance (as measured by return on assets) in the year after imposition of the restriction.¹⁹⁶ Consistent with able lender governance, firms' patterns of investment reduction following a covenant violation seem to track agency cost concerns. For example, firms with greater stockpiles of cash experience greater declines,¹⁹⁷ consistent with the notion that banks' post-violation measures may be especially sensitive to agency costs of free cash flow.¹⁹⁸ At the same time, capital expenditure covenants are less likely for firms with better investment opportunities.¹⁹⁹ This suggests that lenders may be sensitive to borrower firms' growth prospects and careful about imposing investment constraints that might stymie growth. Of course, these firms are also more likely to have alternative financing options, so competitive pressure may deter banks from imposing investment constraints. In either case, this outcome appears to be value enhancing. The widespread use of capital expenditure covenants suggests that banks may have wide influence in curbing managers' overinvestment tendencies, to the benefit of all claimants.

3. CEO Turnover

CEO turnover is typically not a routine event for a firm. Abundant anecdotal evidence confirms the important role lenders may play in forcing out CEOs of poorly performing companies.²⁰⁰ This lender influence may be especially important when standard corporate governance mechanisms are hobbled. For example, a firm's board of directors may be dominated by insiders or outside

196. *Id.* at 23–24, fig.4, tbl.9.

197. Chava & Roberts, *supra* note 159, at 4.

198. See Jensen, *supra* note 3, at 323. Similarly, firms borrowing from a single lender experience significantly greater declines in investment compared to firms borrowing from a large syndicate. Chava & Roberts, *supra* note 159, at 28–29. This variation is consistent with the accepted wisdom that single lenders face greater moral hazard than large lending syndicates because renegotiation is more difficult with syndicates. See Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1 (1996). Facing more misbehaving borrowers, single lenders may take more aggressive measures. Chava & Roberts, *supra* note 159, at 28–29.

Firms with no prior dealings with their existing lenders also show greater declines than firms borrowing from their long-established lenders. *Id.* at 4. This is consistent with the theory that banks facing greater information asymmetry respond more aggressively to covenant violations.

199. See Nini, Smith & Sufi, *supra* note 16, at 15. Market-to-book ratio proxies for investment opportunities. *Id.* at 39, tbl.3.

200. See Baird & Rasmussen, *supra* note 3, at 1209–11 (describing the 2005 ouster of the Krispy Kreme CEO); Ozelge, *supra* note 51, at 4–5 (same); see also Mitchell Pacelle, *Waiving or Drowning: Banks Face Loan Bind*, WALL ST. J., Oct. 15, 2001, at C1 (describing the appointment of a new chief restructuring officer for ANC Rental Corp., parent of Alamo and National rental car companies, at the request of lenders who agreed to defer an enormous principal payment and suspend certain covenants).

directors with close ties to the CEO.²⁰¹ And formal shareholder challenges to incumbent directors are quite rare, and even more rarely successful.²⁰²

One study confirms that the likelihood of forced CEO turnover is much more sensitive to firm performance for firms with private debt.²⁰³ The study compares similar poorly performing firms,²⁰⁴ with either no bank debt or an average amount of bank debt. The presence of the bank debt increases the likelihood of forced CEO turnover by anywhere from 25 percent to 46 percent, depending on the performance measure used.²⁰⁵ If the underperforming firm also violates a loan covenant, the result is a 75 percent to 102 percent increase in the probability of forced turnover, compared to an underperforming firm with no bank debt.²⁰⁶

Banks' influence in this regard may rival that of independent boards of directors, especially when a loan covenant has been violated. One study gauges the influence of independent boards in replacing poorly performing CEOs by comparing the probability of CEO resignation under insider-dominated boards.²⁰⁷ The study measures the difference in CEO resignation rates for firms with poor performance versus strong performance under both types of boards.²⁰⁸ This comparison is captured in Figures 1 and 2 below, with

201. See Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431 (1988) (noting the much higher rate of CEO retirements following poor performance when the company's board of directors had 60 percent or more independent directors). Exchange listing rules now require that listed companies have a majority of independent directors on their boards. See NYSE, *supra* note 57 § 303(A); NASDAQ OMX GRP., INC., *supra* note 60, §5605(b). This may not prevent insider domination, however. See Hill & McDonnell, *supra* note 26, at 852–55.

202. See Bebchuk, *Myth of the Shareholder Franchise*, *supra* note 24, at 677 (noting that from 1996–2005, companies with market capitalization exceeding \$200 million saw fewer than three election contests per year on average, with less than one per year being successful).

203. Ozelge, *supra* note 51, at 14; see also Stuart C. Gilson *Bankruptcy, Boards, Banks, and Blockholders*, 27 J. FIN. ECON. 355, 369–71 (documenting high CEO and director turnover rates for firms experiencing financial distress).

204. A poorly performing firm is one whose performance is one standard deviation below the average industry residual performance. Ozelge, *supra* note 51, at 10, 23.

205. *Id.* at 23, 50 tbl.6 panel G. This estimate accounts for the endogeneity of bank borrowing. Return on assets and stock performance are the two performance measures used. *Id.* at 14.

206. *Id.* at 32. Moreover, when the sample of firms experiencing a forced CEO turnover is split based on whether a covenant violation occurred, the worst one-third of firms in terms of performance that have also violated a covenant are roughly 3 to 7 times more likely to have their CEO forced out than poorly performing firms with no violation, with the likelihood increasing with the amount of bank debt. *Id.* at 51 tbl.7 panel B.

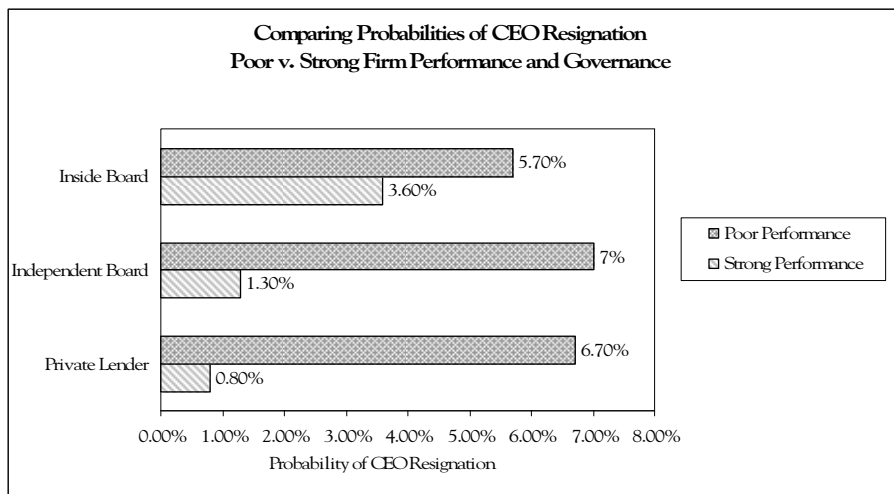
207. Weisbach, *supra* note 201, at 431. For purposes of the study, an independent or “outside” board is defined as one for which 60 percent or more of the directors are not full-time employees of the company. *Id.* at 431, 436. While this is not identical with the current post-SOX definition of an independent board, see *supra* note 57 and accompanying text, the concepts are quite similar.

208. Weisbach, *supra* note 201, at 431. Performance is measured by stock returns. Firms with strong performance are those in the top decile of stock returns in the sample, and weakly performing firms are those in the bottom decile. *Id.* at 440.

Figure 1 showing the probabilities of CEO resignation under both types of boards and with both poor and strong performance, while Figure 2 shows the differences in probabilities. With independent boards, the probability of CEO turnover is 7 percent for firms with weak performance and 1.3 percent for firms with strong performance, a difference of 5.7 percent, which is both statistically and economically significant.²⁰⁹ The corresponding probabilities for insider-dominated boards are 5.7 percent and 3.6 percent, for a difference of 2.1 percent, which is not significant.²¹⁰ This evidence suggests that independent boards punish poor performance, but insider-dominated boards do not.

Compare private lender governance, using the corresponding difference in probabilities for firms with an average level of bank debt that have violated a loan covenant. This comparison is also included in Figures 1 and 2. For firms with weak performance, 6.7 percent of CEOs get replaced annually; for firms with strong performance, the probability is 0.8 percent,²¹¹ for a difference in probabilities of 5.9 percent—which is greater than for independent boards.²¹² This comparison demonstrates that bank influence on CEO turnover for poorly performing firms indeed rivals that of independent boards.

FIGURE 1



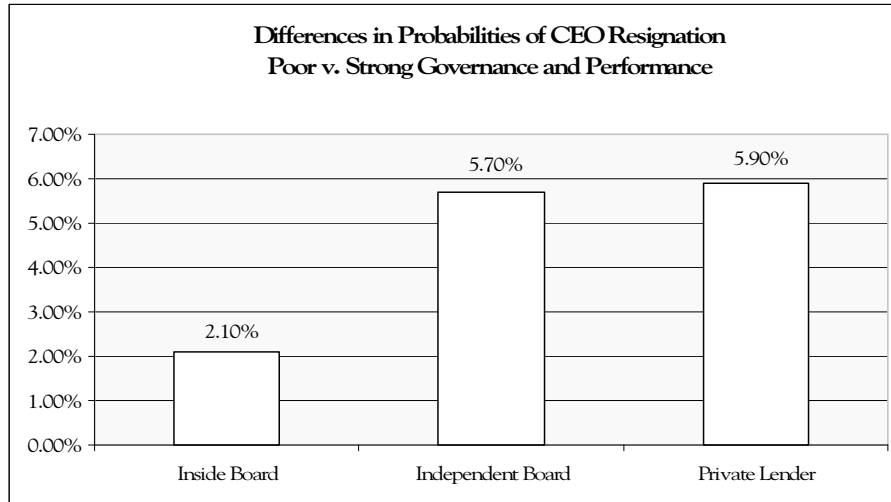
209. *Id.* at 441. Here, Weisbach uses stock returns as his performance measure. See *id.* at 440.

210. *Id.* at 441–42.

211. Ozelge, *supra* note 51, at 1–2.

212. For firms with an average level of bank debt that have not violated a covenant, the probabilities are 5.2 percent (bottom decile in performance) and 1.4 percent (top decile), respectively, for a 3.8 percent difference. *Id.*

FIGURE 2



D. Operational Consequences and Governance Implications

Note the operational consequences of the various incentives and constraints that accompany private debt. Even with the initial loan agreement and in the absence of any covenant violation, managers' efforts to manage cash flow or current ratio or net worth for purposes of covenant compliance or performance pricing may affect fundamental operational decisions. For instance, a debt-limiting covenant may preclude a firm from borrowing to build a factory or open new stores. So when the lender and the firm's management disagree about the advisability of debt-financed expansion, the lender's potential veto may give it significant influence over the ultimate size and scope of expansion.²¹³ At the least, management would have to negotiate with its bankers over the project. Or a capital expenditure covenant may restrict any expansion, even an internally financed expansion. Similarly, cash flow covenants have wider effects than simply assuring debt repayment; they may affect the borrower's uses of cash generally. These limitations may constrain the scale of the borrower's operations, and by acceding to them, the firm's management effectively cedes to the lender some amount of discretion over fundamental business decisions. Moreover, the lender's vote here may

213. Of course, the borrower has the option of refinancing with a different lender, but this may be costly, and the borrower may not be able to convince another lender to relax the borrowing limitation either.

count for far more than the vote of any individual director or even the entire board, since the lender may enjoy an effective veto.

In contrast to the veto implicit in standard covenant constraints, performance pricing offers more nuanced incentives for managers to improve performance. Earning a lower interest rate through good performance not only lowers borrowing costs but also frees up cash, which increases managerial flexibility. Conversely, poor performance increases borrowing costs and reduces free cash, while also foreshadowing the possibility of future lender intervention.

A covenant breach triggers the lender's right to cut off further credit and to accelerate the debt, which could jeopardize the firm's viability. Of course, it is ordinarily not in the lender's interest to accelerate precipitously.²¹⁴ Given competitive loan markets, it behooves each lender to nurture a reputation for reasonable dealings with borrowers.²¹⁵ On the other hand, the power to accelerate may give the lender tremendous leverage over firm managers.²¹⁶ The covenant violation essentially causes a change of control in favor of the lender,²¹⁷ giving the lender some latitude to effect changes in the borrower's business.

Lender-induced constraints and changes in financial and investment policy, firm management, and operational strategy illustrate the significant influence that a private lender enjoys over a borrower's fundamental business decisions. Ordinary shareholders enjoy nothing approaching this level of intervention. Creditor control rivals even the influence of the board of directors. No board would presume to impose controls at the level of detail that private lenders typically prescribe—setting debt levels or capital expenditure ceilings to constrain the firm's executive officers, for example. As noted earlier,²¹⁸ in contrast to private lenders, directors suffer significant expertise and informational deficits compared to the officers they purport to monitor, and directors' monitoring incentives are relatively weak. Board monitoring and governance seems feeble compared to lender governance.

214. For example, a lender with more profitable lending opportunities might wish to call a loan on a technicality in order to enable it to relend at higher spreads.

215. "From the lenders' standpoint, it pays not to 'pull the trigger' and call the loan too early. There is competition among banks for good loans, and imposing costs on borrowers when circumstances do not warrant this results in a loss of business." Dichev & Skinner, *supra* note 80, at 1096–97.

216. Chava & Roberts, *supra* note 159, at 1.

217. *Id.*

218. See *supra* Part I.C.

IV. THE LIMITS OF LENDER GOVERNANCE: CREDIT MARKET EFFECTS

To this point, we have focused on broadening the conventional thinking on the influence of private lenders on firm governance. In this Part, I discuss potential limitations on lender influence from credit market effects: liquidity and opportunities for risk transfer. Liquidity simply refers to the competitiveness of lending markets. Stronger competition among lenders reduces each lender's enforcement leverage²¹⁹—to set covenants, monitor borrowers, and influence firm governance. Risk transfer opportunities—through syndication, secondary loan markets, and markets for credit derivatives—offer private lenders the ability to reduce or even eliminate exposure to particular credit risks, which may reduce their monitoring incentives and thereby impair lender governance.²²⁰

A. Market Liquidity

Competition among lenders affects each lender's leverage over its borrowers. When money is cheap, competition intensifies, sometimes causing riskier lending overall with fewer constraints on managerial discretion. The advent of “covenant-lite” loans—loans with few or no covenant constraints—that preceded the recent credit crisis offers one salient example. From 2003–2007, a liquidity explosion in international credit markets led to cheap money and fierce competition among lenders to finance leveraged buyouts (LBOs).²²¹ This competition led to lax underwriting standards and weaker monitoring incentives, as evidenced by increasingly higher leverage of funded deals over the period and weaker covenants. For borrowers—the LBO target firms—covenant-lite loans reduced the likelihood

219. See *supra* Part I.C.2.

220. The one existing study on this issue finds no evidence consistent with reduced bank monitoring when the borrower firm's loans trade. See Gande & Saunders, *supra* note 123.

Loan purchasers may also not have the same reputational stakes that banks have in maintaining good working relationships with their borrowers. A loan purchaser may therefore be less willing to forbear from taking precipitous action in the face of a technical covenant violation. If the loan is securitized, exercising any governance rights at all may be tricky. With a securitization, the new owner of the pooled bank loans (or participations) issues securities backed by the cash flows from the loans. This new issuing entity is managed by a trustee, who has little incentive to become actively involved in any one loan. Henry T.C. Hu & Bernard Black, *Debt and Hybrid Decoupling: An Overview*, M&A LAWYER, Apr. 2008, at 8.

221. See Viral V. Acharya, Julian Franks & Henri Servaes, *Private Equity: Boom and Bust?*, J. APPL. CORP. FIN., Fall 2007, at 44–46 (discussing worldwide liquidity explosion and its effects on LBO financing); Robert P. Bartlett III, *Taking Finance Seriously: How Debt Financing Distorts Bidding Outcomes in Corporate Takeovers*, 76 FORDHAM L. REV. 1975, 2014–16 (2007) (same).

of technical default and preserved their operational flexibility, but these loans left banks with fewer tools to constrain managers and dampened monitoring incentives.²²²

Though seldom discussed, traditional mechanisms of corporate governance may suffer similar capital market effects. For example, even underperforming CEOs are less likely to be replaced when general industry or market performance is strong.²²³ After all, nothing succeeds like success, so shareholders and directors are unlikely to challenge management during good times. Strong firm performance might reflect good management and good governance, or it may simply reflect the natural ebb and flow of industry-wide success or frothy equity markets. Boards apparently are not entirely successful at filtering out industry and market effects when evaluating CEO performance.²²⁴ So while the efficacy of lender governance may be affected by debt market conditions, traditional shareholder-centered governance arrangements are not immune to similar capital market effects.

B. Risk Transfer

Private lenders have increasingly more and finer opportunities to transfer risk to third parties, which may blunt lenders' incentives to monitor. Common risk transfer mechanisms include loan syndication, secondary loan markets, and markets for credit derivatives. Large loans are typically syndicated. A group of lenders shares a loan's exposure in specified percentages, reducing the risk for any given lender. A liquid secondary loan market enables a lender to sell its stake in an existing loan.²²⁵ Finally, the ready availability of credit derivatives enables a lender to insure against default by specific borrowers.²²⁶

222. The higher debt levels and weaker monitoring likely increased systemic risk overall. See Acharya, Franks & Servaes, *supra* note 221, at 46.

223. See Dirk Jenter & Fadi Kanaan, *CEO Turnover and Relative Performance Evaluation* 4–5 (Stanford Graduate Sch. of Bus., Research Paper Series, Research Paper No. 1992, 2008), available at SSRN: <http://ssrn.com/abstract=885531>.

224. See *id.* at 2.

225. See Steven A. Dennis & Donald J. Mullineaux, *Syndicated Loans*, 9 J. FIN. INTERMEDIATION 404, 404 (2000) (describing the growing prevalence of syndicated loans); Gary B. Gorton & George G. Pennacchi, *Banks and Loan Sales: Marketing Nonmarketable Assets*, 35 J. MONETARY ECON. 389, 391 (1995) (describing the dramatic rise in loan sales that occurred in the 1980s).

226. The most popular credit derivative for bank lenders is the credit default swap. As with conventional insurance, the insured (here, the lender) pays a premium to the issuer of the swap agreement, which obligates the issuer to repay the insured debt (or some portion) to the insured should the borrower default. See Frank Partnoy & David A. Skeel, Jr., *The Promise and Peril of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1021–22 (2007).

Though each of these devices might theoretically blunt private lenders' monitoring incentives by enabling them to reduce risk exposure to a particular loan, offsetting considerations in loan syndication and secondary loan trading tend to bond lenders as faithful monitors. Derivatives, however, pose a more thorny problem for lender governance, and for corporate governance generally.

1. Loan Syndication and Secondary Market Transactions

The typical bank loan to a public company is syndicated. A large money center bank—the “lead” bank—negotiates the loan with the borrower while it assembles the lending syndicate.²²⁷ The lead bank takes the laboring oar in performing due diligence on the borrower, and prospective syndicate members typically rely on the lead bank's documentation in performing their credit analyses.²²⁸ Once the syndicate is assembled and the loan is in place, the lead bank—which typically holds the largest stake in the loan²²⁹—is granted wide powers to act as agent for the syndicate, for which the lead bank is paid a fee.²³⁰ It takes the lead in administering the loan, monitoring the borrower and communicating with firm management on behalf of the syndicate, and disseminating information within the syndicate.²³¹ When a borrower violates a covenant or defaults, the lead bank plays a central role in investigating and recommending a course of action to the syndicate.²³²

227. See Amir Sufi, *Information Asymmetry and Financing Arrangements: Evidence From Syndicated Loans*, 62 J. FIN. 629, 633 (2007); Kamphol Panyagometh & Gordon S. Roberts, *Private Information, Agency Problems and Determinants of Loan Syndications: Evidence From 1987–1999*, at 4 (Apr. 25, 2002) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=310003>. The arranging bank may underwrite the loan as well, in effect committing to extend the specified loan even before the formation of the syndicate is complete.

228. See Barry Bobrow, Mercedes Tech & Linda Redding, *An Introduction to the Primary Market*, in THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING 155, 179 (Allison Taylor & Alicia Sansone eds., 2007); Panyagometh & Roberts, *supra* note 227, at 5; Katerina Simons, *Why Do Banks Syndicate Loans?*, NEW ENGLAND ECON. REV. 45, Jan.–Feb. 1993, at 47.

229. See Baird & Rasmussen, *supra* note 3, at 1244; Sufi, *supra* note 227, at 633.

230. The credit agreement spells out these relations among syndicate members. See Richard Wight, Warren Cooke & Richard Gray, *Understanding the Credit Agreement*, in THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING, *supra* note 228, at 209, 354. As competition among banks intensified and league tables became a popular device for “keeping score” among banks and ranking them, lead arrangers began carving out new distinguishing roles and accompanying titles to induce participation in their syndicates. New—and largely ceremonial—titles include “administrative agent,” “syndication agent,” “documentation agent,” and “managing agent,” which may also indicate some sharing of functions that had traditionally been performed by the sole lead bank. See Steve Miller, *Players in the Market*, in THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING, *supra* note 228, at 47, 50.

231. Sufi, *supra* note 227, at 632–33.

232. See Roberts & Sufi, *supra* note 15, at 23–24.

As the arranger for the loan and its primary monitor and administrator, the lead bank typically enjoys informational advantages over other syndicate members. One might therefore worry that the lead bank could behave opportunistically toward syndicate members—for example by syndicating poor quality loans or shirking on its monitoring duties. As the agent for the syndicate, the lead bank reaps only a pro rata benefit from diligent monitoring—sharing with the entire lender group—while it enjoys all the benefits from shirking.²³³ Lead banks and other private lenders may also sell their loans in liquid secondary loan markets. This ready exit option may create moral hazard, encouraging lax credit analysis in the origination process or weaker monitoring after the loan is made.²³⁴

Existing studies strongly suggest, however, that lead banks have reputational stakes in their treatment of syndicate members. Far from behaving opportunistically, lead banks in fact syndicate loans of higher ex ante quality in larger proportions,²³⁵ and they retain larger proportions of riskier loans.²³⁶ Lead banks also syndicate a larger proportion of loans to borrowers whose creditworthiness holds up over time, as measured by ex post credit ratings.²³⁷ More generally, lead banks' reputations as faithful agents improve their ability

233. For example, the lead bank might decide to devote more resources to originating new loans rather than monitoring existing syndicated loans, as to which risk is shared.

234. See Gorton & Pennacchi, *supra* note 225 (discussing moral hazard in the secondary loan market). Given originating lenders' likely informational advantages over secondary market purchasers, it might not be surprising if lower quality loans were more likely to trade than those of higher quality. Especially given the emerging "originate-to-distribute" model of syndication—in which the lead arranger anticipates selling large portions of a given loan to institutional investors in secondary markets shortly after origination—arrangers may be less concerned about careful credit analysis or subsequent monitoring than if they expected to hold the loans for longer periods. See Antje Berndt & Anurag Gupta, Moral Hazard and Adverse Selection in the Originate-to-Distribute Model of Bank Credit (Oct. 24, 2008) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=1290312>; Greg Nini, How Non-Banks Increased the Supply of Bank Loans: Evidence From Institutional Term Loans (Mar. 18, 2008) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=1108818> (documenting the boom in syndicating leverage loan tranches to nonbank institutional investors).

235. See Dennis & Mullineaux, *supra* note 225, at 424 (testing for ex ante quality); see also Kamphol Panyagometh & Gordon S. Roberts, Loan Syndicate Structure: Evidence From Ex Post Risk 3–4 (Jan. 14, 2008) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=1083707> (finding that lead banks syndicate greater proportions of loans to ex post higher quality borrowers as measured by bond ratings).

236. See Simons, *supra* note 228, at 49 tbl.3 (showing that the proportion of a syndicated loan retained by the lead bank increases with the severity of the borrower's credit problems, as subsequently determined by bank examiners' loan quality classifications); Sufi, *supra* note 227, at 633. For more opaque borrowers, that require greater due diligence and monitoring, the lead bank generally retains a larger share of the loan and forms a more concentrated syndicate, with lenders that are "closer" to the borrower both geographically and in terms of prior lending relationships. *Id.*

237. Panyagometh & Roberts, *supra* note 235, at 24.

to arrange syndications.²³⁸ These findings suggest that lead banks value their reputations, which should induce them to monitor conscientiously despite the risk diversification from syndication.

As far as loan sales, the lead bank typically does not sell its stake,²³⁹ preferring instead to preserve its relationships with both the borrower and its syndicate members, who not only depend on the lead bank for monitoring services,²⁴⁰ but likely agreed to join the syndicate relying at least in part on the lead bank's continuing involvement in the loan. Lead banks also often constrain resale by syndicate members, imposing requirements that may include lead bank and even borrower consent.²⁴¹ Lead banks and borrowers may be concerned about syndicate size and composition, since, all other things being equal, a larger syndicate makes collective decisionmaking more difficult.²⁴² Holdout problems increase with syndicate size,²⁴³ which may be especially troubling when the borrower's distress requires a modification of the loan.²⁴⁴

Lenders in general also appear to anticipate potential secondary market purchasers' concerns about moral hazard with respect to monitoring, as well as adverse selection.²⁴⁵ Selling lenders do not always sell their entire stake in a loan, often retaining a portion in order to assure purchasers of both the quality of the loan and the seller's continuing stake in monitoring the borrower. Consistent with this implicit assurance, loan sellers typically retain

238. See Dennis & Mullineaux, *supra* note 225, at 407 (finding that lead banks' success in syndicating larger percentages of their loans is positively associated with reputational measures).

239. Baird & Rasmussen, *supra* note 3, at 1244.

240. See Panyagometh & Roberts, *supra* note 235, at 3 (describing the lead bank's role as the delegated monitor for the syndicate); Sufi, *supra* note 227, at 632 (noting the lead arranger's role as the syndicate's primary monitor). For their part, borrowers generally expect and prefer a durable relationship with their lead bank, which has specialized knowledge of its borrowers' business and financial condition. If the lead bank exits by selling its loan, the borrower may be left with a different agent bank that it has never worked with and that may not be to its liking.

241. Sang Whi Lee & Donald J. Mullineaux, *Monitoring, Financial Distress, and the Structure of Commercial Lending Syndicates*, 33 FIN. MGMT. 107, 111 (2004). Forty-four percent of the transactions in their sample of syndicates loans from 1987–1995 included a requirement for lead bank consent for loan resale. *Id.* at 117.

242. Modification of a syndicated loan requires a vote among the members. For major changes—in principal, interest, maturity, or collateral—unanimity is typically required. For technical violations or covenant waivers, a simple majority or supermajority will typically suffice. See Sufi, *supra* note 227, at 633.

243. OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE (1995).

244. See Lee & Mullineaux, *supra* note 241, at 111. The effect of loan sale restrictions may be ambiguous in terms of reducing holdout problems, however. Originating syndicates tend to be larger and loan concentrations lower for loans with resale constraints. These liquidity constraints make the loan less attractive to participants, who take smaller shares as a result. *Id.* at 120–21.

245. That is, potential purchasers may fear that sellers only want to dump their bad loans.

larger portions of riskier loans.²⁴⁶ Loans that are ultimately sold also contain more restrictive covenants than loans that are not sold.²⁴⁷ These tighter covenants, by putting borrowers on a tighter leash, help address both presale moral hazard and adverse selection.²⁴⁸ Tighter covenants set quick triggers for intervention, so that even a lender expecting to sell its loan would be prompted to investigate earlier and more often than with loose covenants, if for no other reason than to approve a waiver of any violation. Moreover, waivers too readily extended might elicit later inquiries from a prospective loan purchaser. Tighter covenants also help mitigate the loan purchaser's informational disadvantage by offering the same quick trigger for intervention that the seller enjoyed.²⁴⁹

Overall, the evidence suggests that while syndication and secondary loan trading might theoretically dampen banks' monitoring incentives, lead banks and selling banks anticipate and address this concern for the benefit of syndicate members and loan purchasers, respectively. Lead banks have reputational stakes in refraining from opportunism in a syndication, and both lead banks and selling banks take steps to bond themselves as monitors.²⁵⁰

246. Gorton & Pennachi, *supra* note 225, at 408 & tbl.5; cf. Berndt & Gupta, *supra* note 234 (finding evidence of bank moral hazard insofar as firms whose loans are sold have worse risk adjusted stock returns over the three years following the loan sale compared to firms whose loans are not sold).

247. Steven Drucker & Manju Puri, *On Loan Sales, Loan Contracting, and Lending Relationships 2* (FDIC Ctr. for Fin. Research Working Paper No. WP 2007-04, 2007), available at <http://ssrn.com/abstract=920877>.

248. Moreover, tighter covenants help increase borrowers' debt capacity by making their loans more saleable in secondary markets. *Id.*

249. More generally, bank monitoring continues to have value in the presence of bank debt trading. Amar Gande and Anthony Saunders find that bank loan announcements are associated with positive stock price reactions, even when the borrower's loans already trade on the secondary market. See Gande & Saunders, *supra* note 123, at 3. This result holds even for distressed firms, for which reduced incentives for bank monitoring would ex ante be expected to have the most adverse effects. *Id.* Additionally, the inception of trading in the borrower's bank debt also elicits a positive stock price reaction, suggesting that bank monitoring and the secondary market offer complementary sources of information about borrower firms. *Id.* at 22.

250. Charles Whitehead has offered a reason to embrace loan markets as a facilitator of lender governance. More complete credit markets may improve governance through transparent pricing of credit risk. In the same way that stock prices inform equity holders about the firm's condition and prospects, liquid credit markets may offer price signals to creditors about a firm's creditworthiness, enabling those creditors to adjust their relations with the firm. Creditors might come to rely on these credit market price signals as a supplement to or substitute for traditional covenants and monitoring. Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP L. 641, 660 (2009).

2. Credit Derivatives

Liquid markets in credit derivatives may have more pernicious consequences for bank governance than syndication or secondary loan markets. Derivatives markets enable investors to construct portfolios that disaggregate cash flow rights from the control rights associated with their investments. Governance rights and economic rights no longer need go together.²⁵¹ Among other worries for corporate governance scholars, this slicing and dicing enables equity holders to vote shares with no underlying economic interest in the issuing company. More perversely, it facilitates voting against value. An investor may take a short position in the issuer's equity and then profit by voting for a value-destroying course of action.²⁵² This is the problem of "decoupling" or "empty voting."²⁵³

Similar problems plague credit markets. For lenders, credit derivatives offer infinite opportunities to diversify risk while still nominally holding debt. For example, a private lender can easily purchase a credit default swap (CDS) that fully insures against the risk of a specific borrower's nonpayment.²⁵⁴ A CDS, the most common and most widely traded credit derivative, is a two-party contract pursuant to which a protection seller (an investment bank, for example) agrees to insure a protection buyer (a lender, for example) against default for a specified loan.²⁵⁵ For a fee, the protection seller in effect guarantees the original lender against the specified default risk, enabling the lender

251. See Henry T.C. Hu & Bernard Black, *Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUR. FIN. MGMT. 663 (2008), available at <http://ssrn.com/abstract=1084075>.

252. A short position in a security—in which an investor profits from a decline in the security's price—can be accomplished in any number of ways. For example, a short seller may borrow securities from a broker to sell in the market, hoping the market value of the securities later drops. This would enable the short seller to repurchase the securities at a lower price, repaying the securities to the broker while reaping a profit.

253. See Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008) [hereinafter Hu & Black, *Decoupling II*]; Henry T. C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343 (2007); Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).

254. Douglas G. Baird & Robert K. Rasmussen, *Anti-Bankruptcy*, 33 (Univ. S. Cal. Ctr. Law, Econ. & Org., Research Paper No. 08-9, 2009), available at <http://ssrn.com/abstract=1396827>. Other hedging-decoupling strategies may include other types of credit derivatives or even equity hedges. See Hu & Black, *Decoupling II*, *supra* note 253, at 728–29.

255. A "credit event" that triggers payment to the lender-protection buyer includes a payment default or bankruptcy filing.

to fully hedge against the risk of a given loan.²⁵⁶ As a result of this debt decoupling, the lender eliminates its economic stake in the borrower's fortunes, while retaining its original governance rights with respect to the loan.

Not only does this minimize the lender's incentive to monitor,²⁵⁷ but it may also induce the lender to refuse to renegotiate even technical covenant violations.²⁵⁸ Default and acceleration guaranty the lender's full payment on the debt under the terms of the CDS. More perversely, the nominal creditor could be overhedged—overinsured on its loan. For example, a lender with a \$100 million exposure on a loan may have purchased protection for a notional amount of \$200 million. In that case, the lender holds a net negative position in the debt, which means it would profit from the borrower's default.²⁵⁹ That creditor would be worse than indifferent to a workout; it would gain the most by affirmatively sabotaging any workout effort and causing the borrower to fail.²⁶⁰

Private lenders may also sometimes vote their debt, and as with a short equity position,²⁶¹ an overhedged lender might be induced to vote against value. A private lender typically votes in two contexts—as a syndicate member regarding modification of a syndicated loan and as a creditor in bankruptcy. For a syndicated loan, modification of major contract terms—principal amount or interest spread—typically requires unanimity among syndicate members.²⁶² In bankruptcy, creditors are entitled to vote on any plan of reorganization.²⁶³ In both cases, a lender with a net negative position may exercise its vote to frustrate rehabilitative efforts in order to tank the business and maximize its payout under its swap contracts.²⁶⁴

In theory, then, credit default swaps might not only weaken private lenders' monitoring incentives, but might also encourage them to pursue value-destroying strategies to maximize their private profits. The reputational

256. Credit default swaps are also commonly written on debt securities as well, insuring debt holders against the issuer's default risk. See *infra* Part V.C.

257. Hu & Black, *supra* note 220, at 8.

258. *Id.*

259. See Hu & Black, *Decoupling II*, *supra* note 253, at 731; see also Baird & Rasmussen, *supra* note 254, at 18 (discussing the possibility of perverse voting incentives in bankruptcy for holders of securities in two or more classes of claims or interests).

260. See Hu & Black, *supra* note 220, at 6–7 (discussing rumors of hedge funds' short debt positions in the 2005 bankruptcy of Tower Automotive).

261. See *supra* note 253 and accompanying text.

262. Sufi, *supra* note 227, at 633.

263. Creditors are placed into classes for voting purposes based on the nature of their claims. Each class is ordinarily required to approve the plan in order for it to be confirmed, see 11 U.S.C. § 1129(a) (2006), and approval of a creditor class requires an affirmative vote of two-thirds in dollar amount and a simple majority in number of claims in the class. *Id.* § 1126(a).

264. See Hu & Black, *Decoupling II*, *supra* note 253, at 732 (discussing empty voting by creditors).

constraints discussed above in the loan trading context might constrain private lenders from pursuing hedging strategies that put them at odds with their borrowers or other syndicate members, but it is hard to be sure that value destruction does not occur. To date, empirical investigation of this phenomenon has been stymied by a lack of transparency in CDS markets. Swaps typically trade over the counter, without the benefit of a public exchange or comprehensive disclosure requirements.²⁶⁵ While pricing information is publicly available based on the reference entity—that is, the borrower of the underlying debt²⁶⁶—transaction-specific information about buyers and sellers is relatively scant. At the least, vibrant but opaque CDS markets may limit the promise of private lender governance. As discussed above,²⁶⁷ shareholder-centered governance suffers a similar threat from equity-based derivatives.

Regulatory reforms relating to derivatives are in the offing in the wake of the current credit crisis.²⁶⁸ In Part V, I discuss current proposals and their likely beneficial effect on lender governance.

C. Assessing the Limits

Market liquidity and risk transfer opportunities affect the efficacy of lender governance by affecting lenders' influence over managers and lenders' monitoring incentives. Similar liquidity and risk transfer issues may affect traditional shareholder-centered governance mechanisms as well. Ultimately, it perhaps should not be surprising that capital market activities affect investors' incentives and ability to discipline corporate managers.

V. IMPLICATIONS OF LENDER GOVERNANCE

Having explained the operation and limits of lender governance, and made the case for its significance, I now explore its important and wide-ranging implications and the new questions it raises. Doctrinal, regulatory, and research issues may all require reexamination in order to account for lender influence. On doctrine, lender governance sits at the intersection of corporate law and debtor-creditor law, and its newfound significance may implicate legal applications in both these areas. As for financial regulation,

265. Trading occurs privately, facilitated by securities dealers' proprietary networks.

266. See generally Viral V. Acharya & Timothy C. Johnson, *Insider Trading in Credit Derivatives*, 84 J. FIN. ECON. 110, 115–17 (2007) (discussing data availability with CDS trading).

267. See *supra* notes 251–253 and accompanying text.

268. Sarah N. Lynch & Serena Ng, *U.S. Moves to Regulate Derivatives Trade*, WALL ST. J., May 14, 2009, at C1 (describing the Obama administration's recent proposal for new regulation of derivatives).

current reform proposals are understandably concerned primarily with systemic risk, and not with corporate governance. Reform should, however, be sensitive to potential spillovers that might affect lenders' monitoring incentives and governance role. After all, much of the proposed reform intends to alter significantly the operations of both creditors and credit markets, especially proposals aimed at the origination and trading of credit default swaps. Finally, corporate governance research must incorporate lender governance in order to offer a complete account of how corporate governance works.

A. Fiduciary Duties for Private Lenders?

Since private lenders wield influence over managerial decisionmaking comparable to that of directors, perhaps private lenders should be charged with similar duties to the corporation and its shareholder body. Certainly for shareholders, control is generally viewed as a touchstone for imposition of fiduciary duties.²⁶⁹ Iman Anabtawi and Lynn Stout have recently proposed an expansion of this approach to include noncontrolling "activist" shareholders seeking to influence management decisionmaking as to certain specific transactions.²⁷⁰ Control-based theories applicable for shareholder fiduciary duties, however, seem an ill fit for private lenders. Because of both the conceptual difficulties and practical consequences, no generalized fiduciary duties should apply to private lenders.

The standard contractarian account of corporate fiduciary duties does not lend itself well to a justification for lender fiduciary duties. Corporate fiduciary duties are generally meant to fill the gaps in the inevitably incomplete contract between shareholders and managers.²⁷¹ The inevitable incompleteness stems from the breadth of discretion managers must enjoy in order to manage a complex business organization. Given the complexity and unpredictability of the future decisions managers must make, it would be difficult to specify all the terms of the shareholder-manager contract *ex ante*. Instead, fiduciary duties offer a hypothetical contract that operates as a set of general standards for managerial conduct. A controlling shareholder inher-

269. See Anabtawi & Stout, *supra* note 25, at 1269 (noting that "the degree to which a shareholder controls the board has become the judicial touchstone of shareholder fiduciary duty").

270. See *id.* at 1295 (arguing that a shareholder's ability to influence the outcome of a particular corporate decision in which it has a personal conflict should trigger a duty of loyalty).

271. EASTERBROOK & FISCHER, *supra* note 22, at 92.

its these duties because its control position enables it to replace—and therefore control—the firm’s management.²⁷²

In contrast to this hypothetical shareholder-manager contract, private lenders enjoy actual, explicit contracts with the borrower company. This explicit contract spells out the borrower’s obligations and the lender’s remedies, all of which are designed to facilitate the lender’s individual recovery, independent of any effects on shareholders or other creditors. Moreover, it is well understood that the standard creditor remedy of seizing borrower assets to satisfy unpaid debts may cause the borrower’s demise and the destruction of shareholder value. The lender no doubt has influence over managers’ decisionmaking and may in distress situations—which I discuss below—have sufficient influence to demand the replacement of senior management or other significant changes. Unlike an officer or a controlling shareholder, however, the lender’s influence derives from its external contract with the firm, and not from an organic role in the firm’s internal management. The lender does not enjoy the general wide-ranging discretion over the firm’s affairs that managers exercise, but only the specific rights described in its contract with the firm. The firm responds to lender influence—agreeing to covenant constraints or financial disclosure, for example—in order to receive favorable treatment under the contract. Similar negotiating dynamics occur with respect to the firm’s other contracts as well, for example its property leases and labor agreements. By contrast, managers’ and controlling shareholders’ influence derives from their grip on the firm’s internal corporate governance levers. It is this wide-ranging open-ended control and discretion over the firm’s affairs that demands fiduciary duty constraints, both as to controlling shareholders and managers.

Similarly, the case for fiduciary duties for activist shareholders rests on specific shareholder-related premises. Shareholders are generally meant to share equally in the corporate spoils. A controlling shareholder’s attempt to garner gains for itself to the exclusion of other shareholders triggers duty of loyalty constraints.²⁷³ Anabtawi and Stout argue for an extension of this basic rule to include the activist shareholder that uses its influence to promote a specific transaction or management decision that enables it to capture a personal

272. It may replace the board for a good reason or no reason at all. The articles of incorporation may specify, however, that outside the annual election context, directors may be removed only for cause. MODEL BUS. CORP. ACT § 8.08 (2005). No similar constraint operates with respect to annual director elections. The controlling shareholder is not required to justify its vote, and may elect whomever it wishes.

273. See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

economic benefit not captured by shareholders generally.²⁷⁴ Even crediting Anabtawi and Stout's analysis as applied to shareholders, the framework seems inapt for private lenders. A private lender has no implicit agreement to share recoveries with any other party, and shareholders have no such expectation of sharing with creditors. Moreover, line drawing problems abound once we move away from shareholders. Because many of the firm's contracts will contain important limits on managers' discretion intended for the specific benefit of the counterparty to the contract,²⁷⁵ imposing a generalized fiduciary duty in these cases seems fraught with peril. It seems an intractable task to structure a general duty that would both allow private lenders to exercise their explicit contract rights—negotiating a tighter covenant in exchange for waiver of a covenant violation, for example—and at the same time constrain them from generally acting in their own interest in favor of shareholders or the corporation as a whole. Incorporating such an ambiguous generalized fiduciary duty would inject perhaps debilitating uncertainty into creditors' collection efforts, which would translate directly into higher borrowing costs for companies.

Distress situations admittedly may deserve special attention. Private lenders' influence is greatest in that context, as are the conflicts among private lenders and other investors. In fact, courts have, through a variety of lender liability doctrines, constrained banks' decisionmaking regarding troubled borrowers. Courts have imposed good faith requirements upon lenders.²⁷⁶ Courts have also held that domination and control of the distressed borrower's day-to-day operations may cause the lender to be deemed an insider or fiduciary,²⁷⁷ such that fraudulent or inequitable conduct would subject the

274. For example, when a hedge fund, holding shares in a proposed merger target, acquires voting rights in shares of the prospective acquirer and hedges away any economic interest in those shares, and then votes in favor of the merger in order to benefit the fund's investment in the target shares, that triggers loyalty duties for the hedge fund as a shareholder of the acquirer. Anabtawi & Stout, *supra* note 25, at 1287.

275. For example, a lease agreement may contain a prohibition on change of control. A merger by the firm might trigger a default. LOU R. KLING & EILEEN T. NUGENT, *NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS* 2–51 (2005).

276. See *K.M.C. Co., Inc., v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985) (imposing a good faith requirement with respect to a bank lender's discretionary refusal to advance funds or demand repayment); see also Shepherd, Tung & Yoon, *supra* note 12, at 1039–40 (discussing lender liability and deepening insolvency).

277. See *In re Exide Techs., Inc.*, 299 B.R. 732, 743–46 (Bankr. D. Del. 2003) (upholding allegations in the complaint that the lenders' control over the borrowers rendered them insiders, whose claims may be subject to equitable subordination). According to the *Exide* complaint, the secured lenders caused the borrower to (a) grant the lenders significant pledges of prepetition collateral as part of an acquisition; (b) delay its bankruptcy filing to minimize the risk of preference avoidance to the lenders; and (c) fraudulently continue operating long after it should have been

lender to damages for harm caused to the company.²⁷⁸ The lender's own claim might also be subordinated below the claims of competing creditors harmed by such conduct.²⁷⁹ In addition to the threat of legal liability, as earlier noted, lenders have important reputational stakes in working with borrowers and avoiding precipitous collection action.²⁸⁰ These various constraints operate to temper aggressive lenders in distress situations, with courts willing to punish fraudulent or inequitable conduct without broadly requiring lenders to share with other investors. Generalized fiduciary duties are unnecessary and would be counterproductive.

B. Optimal Debtor-Creditor Law

As the preceding discussion of lender liability demonstrates, regulating debtor-creditor relations optimally is tricky business, and courts and bankruptcy systems play an important regulatory role here. Courts periodically perceive imbalance in the equities between borrowers and lenders, and they attempt to rectify it by policing creditor collection efforts with the equitable doctrines discussed earlier.²⁸¹ The traditional goals of debtor-creditor law have always been to promote fairness or efficient credit markets,²⁸² but tinkering with

liquidated. The court refused to dismiss claims for deepening insolvency and equitable subordination. See *id.* at 743–46. The court also upheld insider preference claims. See *id.*; see also *In re Adelphia Commc'ns Corp.*, 365 B.R. 24, 63 (Bankr. S.D.N.Y. 2007) (stating that the lender's control of the borrower's day-to-day management and operations or "the ability to compel the borrower to engage in unusual transactions" may trigger a fiduciary duty to the borrower); *Temp-Way Corp. v. Cont'l Bank*, 1369 B.R. 299, 317–18 (Bankr. E.D. Pa. 1992) (same).

278. See *Exide Technologies, Inc.*, 299 B.R. at 751–52 (finding that controlling the borrower in order to force it to fraudulently continue its business while suffering massive losses to the detriment of competing creditors—deepening its insolvency—was actionable); see also Official Comm. of Unsecured Creditors v. R. F. Lafferty & Co., Inc., 267 F.2d 340, 349 (3d Cir. 2001) (finding an independent cause of action against firm managers and third parties for improperly expanding corporate debt and prolonging the life of an insolvent company). Some observers argue that courts appear to be abandoning the cause of action for deepening insolvency. Hugh M. McDonald, Todd S. Fishman & Laura Martin, *Lafferty's Orphan: The Abandonment of Deepening Insolvency*, AM. BANKR. INST. J., Jan. 26, 2008, at 1.

279. See *In re Fabricators, Inc.*, 926 F.2d 1458, 1467 (5th Cir. 1991) (noting that a lender that uses its leverage over the borrower to control the borrower's management to its own advantage and the detriment of other creditors may be subject to subordination); *Exide Technologies, Inc.*, 299 B.R. at 744 (requiring inequitable conduct to justify equitable subordination); 4 COLLIER ON BANKRUPTCY § 510.5 (Lawrence P. King, ed., 15th rev. ed. 2008) (explaining that equitable subordination may be available against a lender when it has engaged in inequitable conduct resulting in injury to other creditors or an unfair advantage to the lender).

280. See *supra* notes 214–215 and accompanying text.

281. See *supra* notes 276–279 and accompanying text.

282. See, e.g., Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996) (arguing that full priority for secured credit in bankruptcy is inefficient); Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199 (proposing an efficient business bankruptcy scheme, whose singular goal is to minimize capital

debtor-creditor relations also has important effects on the degree of lender influence over firm management—that is, lender governance.

Lender governance may be value enhancing or not depending on the circumstances. Overly aggressive creditor action such as premature liquidation may be wasteful, destroying value.²⁸³ The threat of aggressive creditor action may even suboptimally dampen managerial risktaking.²⁸⁴ One important study finds that where creditor rights are too strong, managers may feel very keenly the personal cost of unsuccessful firm projects, and they may react with excessive conservatism.²⁸⁵ Lender liability doctrines may help curb some forms of lender opportunism. Even the possibility of such suits affects the bargaining between borrowers and lenders, causing lenders perhaps to be gunshy in their enforcement strategies. But overdeterrence of lenders may be problematic as well. Private lenders' role in constraining overinvestment or replacing a poorly performing CEO are likely to be value enhancing,²⁸⁶ not just for lenders but for all investors.²⁸⁷ To the extent the shadow of liability overdeters private lenders from exercising their contractual leverage, it may harm investors generally by hampering lender governance.²⁸⁸ Given these important governance spillovers from debtor-creditor laws, their design should

costs for firms); Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436 (1997) (discussing the debate over the efficiency and distributional fairness of secured lending).

283. On the other hand, a deal that looks inefficient ex post may be one that is efficient ex ante. A conditional threat of value destruction may be necessary to incentivize managers to avoid the condition in the first place. See Baird & Henderson, *supra* note 6, at 1314.

284. See Viral V. Acharya, Yakov Amihud & Lubomir Litov, *Creditor Rights and Corporate Risk-Taking* (Apr. 6, 2009) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=1103102> (finding that across countries, stronger creditor rights leads to diversifying, risk-reducing acquisitions and lower operating risk, which may be suboptimal).

285. *Id.*

286. See *supra* Part III.C.

287. Manager-shareholder opportunism is also a risk. Independent of any contractual constraints, courts have long implied a fiduciary duty to creditors upon a firm's insolvency, attempting to curb managers' overinvestment tendencies upon financial distress. See Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 820 (2008). The scope of this court supervision has waxed and waned over time. Compare *Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm'ns Corp.*, No. 12150, 1991 WL 277613, at *34 & n.55 (Del. Ch. 1991) (finding that when a firm is in the "vicinity of insolvency," firm managers must include creditors in the "community of interests" to whom managerial duties run), with *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (explicitly rejecting *Credit Lyonnais'* vicinity-of-insolvency duties).

288. A similar issue arises with respect to environmental cleanup liability under CERCLA—the Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9601–9675 (2006). A lender who exercises control over the borrower's facility runs the risk of being subjected to cleanup liability, as either an "operator," see *U.S. v. Bestfoods*, 524 U.S. 51 (1998), or an entity deemed to "participate in management." 42 U.S.C. § 9601(20) (E), (F).

incorporate lender governance considerations, in addition to the traditional fairness and credit market efficiency concerns.²⁸⁹

C. Financial Regulatory Reform and Lender Governance

The current financial turmoil in the United States and around the world has spurred policymakers to rethink the fundamental structure of financial regulation. The failure or nationalization of major financial institutions has incited calls for reform to assure institutions' safety and soundness. While these issues relate only indirectly to the efficacy of private lender influence in corporate governance, the latter will certainly be affected. Given the significance of lender influence on managerial decisionmaking, consideration of regulatory reform should include analysis of its effects on lenders' corporate governance-related behavior and incentives. I consider one important target for reform, the credit default swap (CDS) market.

CDS transactions and trading have been an integral component of the current financial crisis.²⁹⁰ Therefore, it is no surprise that calls for regulatory reform include proposals for CDS regulation. Several too-big-to-fail financial institutions took precarious positions in credit default swaps, which led to their demise. For example, by the time the Federal Reserve seized American International Group (AIG) on September 16, 2008, AIG had written billions of dollars worth of unhedged protection on mortgage-backed securities.²⁹¹ Other failed institutions, though not especially exposed to credit risk per se,²⁹²

289. We may not yet know enough about the governance considerations to recommend specific changes to debtor-creditor law, but further research may prove fruitful in this regard. See *infra* Part V.D.

290. See Matthew Philips, *The Monster That Ate Wall Street: How "Credit Default Swaps"—An Insurance Against Bad Loans—Turned From a Smart Bet Into a Killer*, NEWSWEEK, Oct. 6, 2008, at 46, available at <http://www.newsweek.com/id/161199>.

291. In other words, AIG made enormous, lopsided bets on the credit quality of mortgage-backed securities. See Christopher Cox, *Swapping Secrecy for Transparency*, N.Y. TIMES, Oct. 19, 2008, at WK12 (noting that AIG had issued \$440 billion in credit default swaps); Steven M. Davidoff & David Zaring, *Big Deal: The Government's Response to the Financial Crisis* 30 (Jan. 2009) (unpublished manuscript, on file with author), available at <http://ssrn.com/abstract=1306342> (explaining how rating agency downgrades of AIG's debt required AIG to post \$14.5 billion in collateral to back its \$441 billion in CDS contracts). The Federal Reserve takeover was initially coupled with a two-year \$85 billion line of credit to help AIG weather the downturn. Davidoff & Zaring, *supra*, at 30. Massive amounts of additional aid have subsequently been required. *Id.* at 33–34. As of this writing, AIG has received a total of \$180 billion in government bailout funds in four separate interventions, and holds the dubious distinction of having announced the largest quarterly loss in history—a \$61.7 billion loss. Andrew Ross Sorkin & Mary Williams Walsh, *A.I.G. Reports Loss of \$61.7 Billion as U.S. Gives More Aid*, N.Y. TIMES, March 2, 2009, available at http://www.nytimes.com/2009/03/03/business/03aig.html?_r=1&scp=6&sq=AIG&st=cse.

292. A CDS trader could, for example, by holding a balanced portfolio of long and short positions, have no net credit default exposure. Lehman Brothers, for example, purportedly held \$400

were important players in the CDS market, and their inability to honor their obligations as CDS sellers led to instability at other institutions.²⁹³

Reform proposals have generally addressed transparency and safety-and-soundness issues. For example, the Securities and Exchange Commission has proposed mandatory reporting and centralized clearing of CDS trades through public securities exchanges, changes that would improve transparency and reduce counterparty risk.²⁹⁴ The Financial Accounting Standards Board has proposed more detailed financial disclosure concerning credit derivatives, including the nature of the derivative, the maximum contingent liability, and possible recoveries from third parties.²⁹⁵

Though these reforms are directed primarily at systemic risk, where the major concern is the solvency of CDS sellers and dealers, the proposed reforms would also have effects on private lenders as prospective CDS purchasers, which in turn would affect their monitoring capacities and incentives. In general, increased transparency in the CDS market along the lines proposed above would likely strengthen lender governance by deterring private lender hedging, thereby curbing the pathologies from hedging discussed earlier.²⁹⁶

With transparency in terms of transactions and CDS holdings, lead banks and other private lenders who might otherwise covertly contract out of certain credit exposures would likely be assessed market and reputational penalties for CDS hedging. A lender's reputation as a faithful monitor has value,²⁹⁷ and transparent hedging maneuvers would likely diminish the lender's reputational capital in a number of ways. A bank with a reputation for hedging might be a less desirable funding source for prospective borrowers and a less attractive lead bank for prospective syndicate members.

A prospective borrower might fear that a hedging bank would too readily send negative market signals concerning the borrower's creditworthiness

billion in CDS contracts, but after it declared bankruptcy and its CDS contracts were cleared and settled, its net exposure turned out to be only \$5.2 billion. See Press Release, Depository Trust & Clearing Corp., DTCC Trade Information Warehouse Completes Credit Event Processing for Lehman Brothers (Oct. 22, 2008), available at http://www.dtcc.com/news/press/releases/2008/dtcc_processes_lehman_cds.php.

293. See, e.g., Karen Brettell, et al., *US Credit—Lehman Threatens CDS Market With First Real Test*, REUTERS, Sept. 14, 2008, available at <http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSN1472586720080915> (citing Lehman as the seventh-largest credit derivatives counterparty in the U.S., according to a Fitch Ratings survey from 2007).

294. See Cox, *supra* note 291.

295. See FIN. ACCOUNTING STANDARDS BD., STAFF POSITION NO. FAS 133-1 AND FIN 45-4 (2008), <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175818750586&blobheader=application%2Fpdf>.

296. See *supra* Part IV.B.2.

297. See *supra* Part IV.B.1.

by purchasing CDS coverage in a transparent market. For example, the trading value of a syndicated loan would likely fall as the lead bank hedged its exposure, since prospective loan purchasers would interpret this as both a sign of poor loan quality and reduced monitoring incentives for the lead bank. The borrower's stockholders would also read these signals negatively, causing a drop in the trading value of the borrower's equity as well. A hedging bank may also be less motivated to work with the borrower should financial distress ensue. A potentially larger loss for the bank gives it a larger stake in the borrower's recovery as a going concern, so it might be more accommodating. By contrast, a bank with a smaller exposure might as easily satisfy its debt by seizing borrower assets. At the limit, a lender that is fully hedged by the time financial distress occurs has no incentive to work with the borrower.

A hedging bank would also suffer in the market for lead bank roles in loan syndications. Because prospective syndicate members depend on the lead bank for monitoring and administrative services,²⁹⁸ they would likely wish to avoid the potential moral hazard from lead bank hedging. For these various reasons, private lenders might be subjected to contractual constraints on hedging transactions, which would otherwise reduce their credit risk and monitoring incentives.

Exchange trading of CDS contracts would also have important benefits for lender governance by supplying market assessments of borrowers' creditworthiness. A better functioning CDS market would generally facilitate hedging: transparency, liquidity, and reduced counterparty risk would attract more CDS investors and would reduce hedging costs, resulting in more accurate CDS market pricing. This in turn would generate better pricing information to reflect the quality of the underlying loans, in the same way that stock option trading prices provide important information about market expectations concerning the value of the underlying stocks.²⁹⁹ Transparent CDS pricing might therefore offer an important complement to the private monitoring that banks do.³⁰⁰ A sharp price drop for the CDS contracts for a particular loan, for example, would likely spur private lenders and other creditors to investigate.

Improved CDS markets will have important effects on lender governance. Future research may tell us more about the circumstances in which lender

298. See *supra* Part IV.B.1.

299. See Steven Manaster & Richard J. Rendleman, Jr., *Option Prices as Predictors of Equilibrium Stock Prices*, 37 J. FIN. 1043 (1982) (investigating the role of call option prices in predicting equilibrium prices of underlying stocks).

300. See Whitehead, *supra* note 250, at 672.

influence improves firm value or performance. Credit market regulation should account for these potential spillovers.

D. Is Lender Governance Efficient? And Other Empirical Corporate Governance Research

Standard corporate governance arrangements have been intensely scrutinized empirically for their potential efficiency.³⁰¹ Similarly, it makes sense to ask whether and when bank governance might be efficient. Though the finance canon generally stresses the conflicts among different claimant classes, evidence suggests that the interests of private lenders and equity holders in maximizing firm value may coincide under a range of circumstances. As mentioned earlier, I and co-authors have offered evidence in a previous article that bank monitoring may be efficient.³⁰² Other evidence suggests the same.³⁰³ Bank loans appear to be good for shareholders.

Even when the firm is in distress, creditor influence may be value-enhancing to the firm. According to the conventional wisdom, the conflicts among creditors and other investors in the firm become acute as the firm approaches insolvency, and creditors may have inefficient investment incentives. Creditors will shy away from risky projects, even those that might enhance firm value.³⁰⁴ Creditors may also favor inefficient early liquidation, rather than suffer additional risk to the firm that would primarily benefit equity holders.³⁰⁵

301. See, e.g., Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 430 (2005) (concluding that staggered boards are associated with lower firm value); Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009) (identifying six governance provisions as being the most significant for managerial entrenchment); John E. Core, Robert W. Holthausen & David F. Larcker, *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 403–04 (1999); Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 144 (2003) (finding a relationship between an index of corporate governance measures and stock performance during the 1990s); Richard A. Lambert & David F. Larcker, *Golden Parachutes, Executive Decision-Making and Shareholder Wealth*, 7 J. ACCT. & ECON. 179, 201 (1985) (suggesting that Golden Parachute adoption is associated with a positive and statistically significant market reaction); Michael Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. FIN. ECON. 377, 411 (1988) (finding that poison pill plans do not benefit shareholders).

302. See *supra* note 12 and accompanying text.

303. See *supra* notes 37–38 and accompanying text (discussing event studies showing positive abnormal stock returns accompanying firms' public announcements of bank loans); see also *supra* notes 195–199 and accompanying text (discussing potential efficiency of capital expenditure covenants).

304. See Jensen & Meckling, *supra* note 11, at 337.

305. See Mark J. Roe, *Bankruptcy and Debt: A New Model of Corporate Reorganization*, 83 COLUM. L. REV. 527, 542–43 (1983) (discussing senior lenders' preference for slow liquidation rather than promoting firm viability).

Even in distress situations, however, and against the conventional wisdom, private lenders may have efficient incentives and interests that overlap with those of equity holders. Private lenders are likely to be the senior lenders when a firm is in distress. If a sale of the firm is in the offing—as is becoming more common for firms in distress—private lenders interested in maximizing the sale price will not oppose the highest-value projects, even risky ones, if a sale is likely to conclude before returns from the project are realized.³⁰⁶ This timing is increasingly likely. Assets are sold relatively quickly, while projects are realized over time.³⁰⁷ If the firm enters Chapter 11 bankruptcy, private lenders as senior claimants are likely to see their claims satisfied, at least to some extent, with equity in the reorganized entity. To that extent, they will have the efficient incentives of residual claimants.³⁰⁸

Private lenders may also play a crucial role in forcing management changes as distress approaches. Lenders are much less likely than directors to be beholden to a CEO who should be replaced. Lenders will therefore be less willing to suffer poor management and more aggressive in forcing management changes than will many boards. Consistent with this notion of lender activism, as earlier noted, in the presence of private debt, the probability of CEO turnover is more sensitive to firm performance.³⁰⁹

Better insights as to the specific channels for creditor influence on managerial decisionmaking and firm value can only enhance our understanding of corporate governance and improve its design. Widely cited empirical studies make claims concerning the effects of Delaware corporate law,³¹⁰ staggered boards,³¹¹ poison pills,³¹² institutional shareholders, independent boards,³¹³ and the like, showing effects across a number of performance measures. Other studies rely on elaborate corporate governance indices, constructed in an attempt to isolate the combined effects of important traditional corporate law

306. Baird & Rasmussen, *supra* note 3, at 1246 (discussing private lenders' incentives in bankruptcy).

307. *Id.*

308. *Id.*

309. See *supra* notes 203–206 and accompanying text.

310. See Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 556 (2001) (finding evidence consistent with the theory that Delaware corporate law improves firm value); Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J. L. ECON. & ORG. 32, 57 (2004) (finding that the “Delaware effect” is limited to small firms during the period 1991–1996 but not afterward, and not for larger firms).

311. See Bebchuk & Cohen, *supra* note 301.

312. See Ryngaert, *supra* note 301.

313. See Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

arrangements.³¹⁴ Important recent debates among scholars and policymakers focus on the balance of power among shareholders, boards, and officers.³¹⁵ To complement these ongoing shareholder- and board-centered discussions, further research on lender governance may clarify the conditions under which it may be value enhancing. For example, banks are quite adept at monitoring borrower cash flows,³¹⁶ and lender-imposed investment constraints may be especially effective at addressing agency costs of free cash flow.³¹⁷ Private lender influence may substitute for or complement standard corporate governance mechanisms in key areas. Testing interactions among loan covenants, conventional governance provisions, and firm or industry characteristics may identify optimal governance arrangements, and we may find predictable patterns of efficient covenant structure. At the least, private lender influence can no longer be ignored in analyses of corporate governance.

Future research should also account for the effects of debtor-creditor laws and credit markets on lender incentives. As with discussions of lender governance generally, debt decoupling has been discussed primarily in the distress context. But even routine lender monitoring and governance are likely to be affected.³¹⁸ As another example, loans originated with a quick resale in mind may look very different from “buy-and-hold” loans, that initial lenders foresee retaining in their portfolios.³¹⁹ Conventional bank regulation and nonlegal influences such as banks’ reputational stakes may matter as well.

314. See, e.g., Bebchuk, Cohen & Ferrell, *supra* note 301 (devising their E-index, consisting of a subset of six G-index provisions); Bernard S. Black, Hasung Jang & Woochan Kim, *Does Corporate Governance Predict Firms’ Market Values?: Evidence From Korea*, 22 J.L. ECON. & ORG. 366, 368 (2006) (proposing a corporate governance index for Korean companies and showing a strong association between good governance and firm value); Gompers, Ishii & Metrick, *supra* note 301, at 144–45 (introducing their G-index of corporate governance measures and finding a relationship between it and Tobin’s Q and stock performance during the 1990s).

315. See *supra* Part I.A.

316. See *supra* notes 103–104 and accompanying text.

317. See *supra* Part III.C.2.

318.

Debt contracts and workout procedures will need to adjust to the new world of hedged interests.

For example, financial covenants, especially in bank loan agreements, are often written fairly strictly, to provide an early warning of financial trouble and an opportunity for renegotiation.

This pattern becomes less viable if hedging is the norm. The lead lenders may have little or no economic exposure, and hence less interest in monitoring borrowers, renegotiating loan terms, or in injecting new funds as part of a workout.

Hu & Black, *supra* note 220, at 8.

319. See Nini, *supra* note 7, at 1 (describing the trend in syndicated lending toward creation of loan tranches specifically designed for purchase by institutional investors, which have longer maturities and slower amortization than bank term loans).

The complexities of such a broad research agenda are admittedly not trivial. Ignoring the effects of lender influence, however, misses an important lever of corporate governance.

CONCLUSION

Inquiries on corporate governance should include the interests and influences of all investors regarding the activities of the firm, and not just equity holders.³²⁰ Given the now quite blurry border that separates debt from equity and the increasing separation of cash flow rights from control rights, influence over firm governance is becoming both more fragmented and less concentrated in the hands of conventional equity holders. A singular focus on equity holders therefore is inapt.

Private lenders exercise important influence on managerial decisionmaking through constraints built into their lending arrangements. Their special monitoring abilities and institutional expertise make private lenders especially useful for constraining managerial agency costs, perhaps for the benefit of other investors as well as the lenders themselves. Conventional corporate governance analysis has generally overlooked this important influence, and the few existing discussions focus primarily on lender influence in the distress context. I have shown instead that lender influence is pervasive, and that lender governance has vast implications for both policymaking and research. Corporate governance discourse must therefore expand beyond its traditional narrow focus on corporate law and equity investors if it is to generate useful prescriptions for complex modern capital markets.

320. See Baird & Rasmussen, *supra* note 3, at 1212 (“Corporate law . . . properly includes all the ways in which investors exercise control over the affairs of the corporation. Hence, one must take into account the rights that creditors acquire through contract.”).