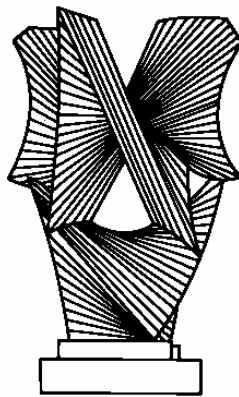


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## Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low

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## **Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low**

M. Todd Henderson<sup>†</sup>

*Conventional wisdom suggests that high agency costs explain the (excessive) amounts and (inefficient) forms of CEO compensation. This paper offers a simple empirical test of this claim and the reform proposals that follow from it, by looking at pay practices in firms under financial distress, where agency costs are dramatically reduced. When a firm files for Chapter 11 or privately works out its debt with lenders, sophisticated investors consolidate ownership interests into a few large positions replacing diffuse and disinterested shareholders. These investors, be they banks or vulture investors, effectively control the debtor during the reorganization process. In addition, all the other players in compensation decisions—boards, courts, and other stakeholders—play a much more active role than for healthy firms. In other words, agency costs are much lower in Chapter 11 firms. Accordingly, if pay practices look the same in bankruptcy as they do in healthy firms, we can conclude that either (1) the current practices are efficient, or (2) that proposals to change executive compensation by reducing agency costs are incomplete. The data support one of these hypotheses: amounts and forms of compensation remain largely unchanged as agency costs are reduced, and look similar to those of healthy firms.*

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<b>I.</b>	<b>INTRODUCTION.....</b>	<b>3</b>
<b>II.</b>	<b>THE LANDSCAPE OF EXECUTIVE COMPENSATION.....</b>	<b>6</b>
A.	COMPENSATION THEORY: “OPTIMAL CONTRACTING” VERSUS “MANAGERIAL POWER” .....	7
1.	<i>Optimal contracting</i> .....	7
2.	<i>Managerial power</i> .....	8
B.	REFORM PROPOSALS – INSTITUTIONAL INVESTORS AND POWERFUL BOARDS AS SAVIORS .....	10
1.	<i>Theoretical studies and proposals</i> .....	10
2.	<i>Empirical studies</i> .....	11
<b>III.</b>	<b>THE POWER OF CAPITAL PROVIDERS IN CHAPTER 11.....</b>	<b>12</b>
A.	MONITORING AND DISCIPLINE OUTSIDE CHAPTER 11 .....	13
1.	<i>Costs of monitoring</i> .....	13
2.	<i>Benefits of monitoring</i> .....	15
B.	MONITORING IN CHAPTER 11 .....	16
1.	<i>Consolidating ownership interests reduces monitoring costs</i> .....	17
2.	<i>The impact of financial distress on other monitoring costs</i> .....	20
<b>IV.</b>	<b>BARGAINING FOR COMPENSATION IN THE SHADOW OF CHAPTER 11.....</b>	<b>22</b>
A.	BARGAINING DYNAMICS .....	22
1.	<i>Management power</i> .....	25
2.	<i>Creditor power</i> .....	27
B.	MONITORING AND RECONTRACTING IN CHAPTER 11 .....	29
1.	<i>Creditors as monitors</i> .....	29
2.	<i>Directors as monitors</i> .....	32
3.	<i>Judges as Monitors</i> .....	36
4.	<i>Other Monitors</i> .....	39
<b>V.</b>	<b>AN EMPIRICAL LOOK AT COMPENSATION IN FINANCIALLY DISTRESSED FIRMS .....</b>	<b>40</b>
A.	THE DATA .....	40
<b>TABLE 1.....</b>	<b>41</b>	
B.	CEO TURNOVER.....	41
C.	COMPENSATION TYPES AND METHODS .....	42
1.	<i>General contracts</i> .....	43
2.	<i>Example case study – New CEO of WorldCom</i> .....	48
D.	COMPENSATION LEVELS IN FINANCIALLY DISTRESSED FIRMS .....	49
1.	<i>Cash compensation</i> .....	49
2.	<i>Equity compensation</i> .....	54
3.	<i>Total compensation</i> .....	57
<b>VI.</b>	<b>CONCLUSION.....</b>	<b>58</b>

## I. INTRODUCTION

The ongoing and increasingly vociferous debate about executive compensation boils down to a simple question of whether current compensation practices are a solution to the agency problem created by the separation of ownership and control in large public companies, or rather attempts by powerful managers to extract rents from under-incentivized owners—that is, evidence of the agency problem itself.<sup>1</sup> Legions of academic articles in the law, finance, and economics literature have offered theoretical and empirical evidence in support of both sides of this debate without resolution. In fact, an entire issue of the *Journal of Corporation Law* was recently devoted to the book-length critique of executive compensation by Bebchuk and Fried.<sup>2</sup> The book claims that managers abuse the power of their office to extract rents from the corporation, and that the solution is an increased monitoring role for boards and/or large, institutional shareholders. In other words, reducing agency costs will lead to lower and/or different forms of executive compensation.

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

\* \* \*

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

Critics – the so-called “managerial power” school – believe that CEOs are often overpaid and inefficiently paid, and that pay practices represent a taking advantage of, rather than a

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<sup>1</sup> “See ADOLPH BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY*, 123 (1932); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *J. FIN. ECON.* 305, 308 (1976).”

<sup>2</sup> See Symposium on “Pay Without Performance”, 30 *J. CORP. LAW* 647-855 (2005); see also LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

solution to, the agency problems in large, public firms.<sup>3</sup> According to this theory, managers are able to extract significant rents because distant, diffuse, and/or disinterested shareholders are unable or unwilling to discipline managers, and because the board is captured and manipulated by the CEO. CEOs accomplish this by selecting sympathetic board members, and then using a variety of monetary rewards and psychological pressures to make the board a mere instrumentality of the CEO's will, especially when it comes to compensation decisions. The obvious solution that follows is to weaken the power of CEOs by partially or completely reuniting "ownership" and "control." The mechanism proposed for achieving this reunification is empowering either large shareholders (typically so-called "institutional investors") or directors to play a more active role in the management of the firm as a counterpoise to management power. In both cases, the core idea is to increase the power of shareholders vis-à-vis managers.

With respect to institutional investors, the belief is that if the firm's capital providers are of sufficient size and sophistication, they will have greater incentives to monitor and discipline otherwise greedy, rent-seeking executives.<sup>4</sup> This type of reform maps well onto the general agency theory in the modern corporation, with the 100 percent owner-operated firm on one end of the spectrum and the manager-operated (perhaps dominated) public corporation with thousands of small shareholders on the other end. The theory suggests that, all other things being equal, managers' ability to extract rents from shareholders increases significantly as one moves along the spectrum in the direction of the manager-operated/dominated firm. The more passive shareholders are, so the argument goes, the more CEOs will be paid and/or the more inefficient compensation forms will be used, allowing both high pay in cases of low performance and camouflage of actual amounts of pay.

Attempts to empower directors to play a more active role in monitoring management, by mandating independence requirements and so forth, is another example of the proposed reforms. By freeing the board from the clutches of the CEO, it is argued, true arm's-length bargaining over compensation can take place. In this case, the reunification of ownership and control is achieved through a proxy, that is, the hypothetical disinterested, independent board. The SEC's proposed reform allowing shareholders to nominate directors for election under certain circumstances is one mechanism through which this reunification can be achieved. As former commissioner Goldschmid lamented at the failure of the SEC to pass the rule, getting owners more actively involved in policing management "is the single most significant way for investors to dramatically improve corporate governance," and without the rule "lazy, ineffective, [and] grossly overpaid CEOs" will be insulated from necessary oversight.<sup>5</sup>

This paper tests the managerial power theory by examining a special case where these proposed reforms are effectively in place and where "owners" are already very active in monitoring, advising, or even running the firm – that is, firms reorganizing under Chapter 11 of the Bankruptcy Code or restructuring their debt in private workouts with large lenders. In both cases, supposedly ineffective monitors (captured board members or relatively uninformed or

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<sup>3</sup> See generally Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 785-7 (2002).

<sup>4</sup> See Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 465-71 (1986).

<sup>5</sup> Phyllis Plitch, *SEC is Stymied on a Final Rule for Shareholder Access to the Ballot*, WALL ST. J., Oct. 11, 2004, at C3.

under-motivated shareholders) are replaced by a group of highly sophisticated and motivated owners with ready access to corporate information, often high levels of involvement in corporate decision making, and backed up by strong statutory rights and judicial review. As Baird and Rasmussen recently observed, sophisticated creditors, who are repeat players in corporate reorganizations, “essentially control[] the corporation” when a firm files to reorganize under Chapter 11 of the Bankruptcy Code.<sup>6</sup> The way that these owners write employment contracts will tell us something about whether agency costs are the cause of allegedly high levels and inefficient forms of compensation.

\* \* \*

While executive compensation articles fill the legal and finance journals, very little work has been done on compensation at firms in financial distress. In the finance literature, Gilson and Vetsuypens examined compensation at 77 financially distressed firms from 1981 to 1987. They concluded that managerial power was substantially weakened in these firms, and that “compensation policy is often an important part of firms’ overall strategy for dealing with financial distress.”<sup>7</sup> In the legal literature, LoPucki and Whitford looked at corporate governance practices at 43 large firms that filed for bankruptcy from 1979 to 1988. They concluded that “[i]n the battle to determine the compensation scheme for management and thereby fix management’s incentives, [creditor-monitors] are likely to have the upper hand,” in some cases.<sup>8</sup> CEO turnover was also quite high (about 40 percent). But the study claims that some CEOs were able to use their privileged position as debtor-in-possession to extract wealth in excess of their worth – what the authors call a “grab.”<sup>9</sup>

This project aims to update and extend the empirical work, and to test some of the theoretical predictions about the role agency costs play in determining how and how much executives are compensated, by examining compensation of chief executive officers of about 80 large, publicly traded firms that filed for bankruptcy or privately restructured their debt from 1992 to 2003. In section II, the facts about executive compensation and the arguments on both sides of the agency debate are examined briefly to set the appropriate stage for the theoretical and empirical contribution of this piece. We will see that the evidence and arguments are ambiguous, with some aspects of current practice being better explained by optimal contracting and some by managerial power.

Section III considers the role of large financial creditors in corporate reorganizations and the burgeoning market for distressed debt, and concludes that these sophisticated investors assume a powerful role in monitoring and disciplining management of firms in financial distress. The interplay between these two prior sections is examined in section IV, where we consider the theory and practice of compensation decisions in firms under financial distress. We will see that while management is in a statutorily privileged position vis-à-vis creditors in terms of proposing a reorganization plan and day-to-day running of the firm, the arguments supporting the

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<sup>6</sup> See Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1231 (2006) (describing Warnaco case).

<sup>7</sup> Stuart C. Gilson & Michael R. Vetsuypens, *CEO Compensation in Financially Distressed Firms: An Empirical Analysis*, 48 J. FIN. 425, 426 (1993).

<sup>8</sup> Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 711 (1993).

<sup>9</sup> *Id.* at 739.

managerial power view of labor bargaining are largely absent in financially troubled firms. Moreover, “recontracting” costs, what could be considered a form of transaction costs, are much lower in financially distressed firms, allowing for a more equal bargaining footing. The theory developed follows the work of Shleifer and Vishny<sup>10</sup> and Zingales,<sup>11</sup> who argue for a theoretical middle ground that incorporates elements of both managerial power and optimal contracting, concluding that firms aspire to conduct arm’s-length bargaining over compensation but that transaction costs prevent continuous recontracting. Finally, we will see that creditors in corporate reorganizations have significant incentives to bargain over CEO compensation, because of the importance of (re)setting management incentives needed to capture and expand the firm’s going concern value.

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

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

## II. THE LANDSCAPE OF EXECUTIVE COMPENSATION

There is no question that the last decade was a good time to be the CEO of a large American corporation. The average compensation for CEOs of the largest 1500 publicly traded companies rose from about \$2.5 million in 1992 to about \$6.5 million in 2003 (in inflation-adjusted 2003 dollars), or a growth rate of about 9 percent per year.<sup>12</sup> This increase caused a flurry of academic criticism and hand wringing, as well as proposed bills in Congress to limit the pay of executives.<sup>13</sup> As a typical article opined: “Executive compensation is the cancer of

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<sup>10</sup> For a summary of Shleifer’s and Vishny’s work, see John E. Core, et al., *Executive Equity Compensation and Incentives: A Survey*, 9 FRBNY ECON. POL’Y REV. 27, 28 (2003).

<sup>11</sup> Luigi Zingales, *Corporate Governance*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (P. Newman, ed. 1998).

<sup>12</sup> Calculation based on EXECUCOMP database; see Erin White and Kris Maher, *Companies Tighten the Pinch For White-Collar Compensation*, WALL ST. J. ONLINE, Nov. 2, 2004, available at <http://www.careerjournal.com/salaryhiring/negotiate/20041102-white.html> (an average of 5-6% per year, with a 7% increase from 2002 to 2003, to a total of \$2.12 million).

<sup>13</sup> See, e.g., Employee Abuse Prevention Act, S. 2798, 107th Cong. (2002); H.R. 5221, 107th Cong. (2002).

corporate America. CEO's have too much power and it has been directed at their own enrichment."<sup>14</sup>

The source of this “enrichment” is the use of equity as a form of compensation, which has grown as a percentage of total compensation from about 25 to 50 percent over the past ten years. To some scholars, this is a good news story, since prior to the advent of equity compensation, risk-averse CEOs with non-diversifiable human capital were paid like bureaucrats, and thus had incentives to build empires (because pay was linked to size), to shirk (because pay was not linked to performance), and to choose less risky projects than shareholders would prefer (because of misaligned risk profiles), all at the expense of maximizing shareholder value. A result of this trend “has been to increase CEO pay-to-performance sensitivities by a factor of more than ten times from 1980 to 1999”.<sup>15</sup>

Others, however, lament the specific application of the theory to practice, noting that CEOs with large option packages are being compensated for luck or are able to enrich themselves because the board or Wall Street did not fulfill its monitoring duties or did not understand the full cost or true nature of the option packages. A common objection is that stock options are poorly designed and are over-awarded because directors do not understand their true economic or accounting costs.<sup>16</sup> One recent survey of corporate governance summarized the view this way: “It is widely recognized . . . that these options are at best an inefficient financial incentive and at worst create new incentive or conflict-of-interest problems of their own.”<sup>17</sup> While this debate rages on, one unquestioned result of the increase in equity-based pay is the huge increase in the size of CEO pay, and therefore the importance of a legitimate compensation contracting process.

#### A. *Compensation theory: “optimal contracting” versus “managerial power”*

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

##### 1. *Optimal contracting*

One model—called “optimal contracting”—contends that compensation packages of CEOs are specifically designed to reduce agency costs. In this model, common contractual terms,

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<sup>14</sup> Gretchen Morgenson, *Option Pie: Overeating is a Health Hazard*, N.Y. TIMES, Apr. 4, 2004, at § 3, 1.

<sup>15</sup> Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 10 (ECGI Working Paper No. 23/2003, 2003), available at [http://ssrn.com/abstract\\_id=441100](http://ssrn.com/abstract_id=441100).

<sup>16</sup> See BEBCHUK & FRIED, *supra* note 2, at 45.

<sup>17</sup> Marco Becht et al., *Corporate Governance and Control*, in HANDBOOK OF ECONOMICS AND FINANCE (Constantinides, Harris, and Stulz, eds. 2002).

like option grants, corporate loans, and severance agreements, are best explained by owners' attempts to overcome the tendency of managers to be risk averse, to shirk, and to prefer a diversified investment portfolio. Individual contracts may deviate from the optimal level because transaction costs limit the ability of firms to continuously recontract with managers over their compensation,<sup>18</sup> but “on average [and over time] the system is efficient within transaction costs.”<sup>19</sup> This is because a variety of market forces—markets for labor, capital, products, and corporate control—restrain managers from earning excessive salaries. In other words, optimal contracting predicts that executive compensation packages are generally those one would expect from arm's-length bargaining for labor between the manager and the firm.<sup>20</sup>

## 2. Managerial power

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

State corporate statutes vest the power to set the compensation of managers in the board of directors.<sup>21</sup> As a practical matter, however, compensation is set by the compensation committee with the input of a consultant, who prepares reports on CEO pay in general and in the specific industry in question, and makes recommendations on levels and types of compensation. The full board may tweak the edges, but in most cases the recommendation of the compensation committee is adopted without shareholder input or vote. Outside of Chapter 11 there are few legal restraints on levels of executive compensation, and those there are have little bite. For example, courts occasionally review the process of setting or substance of compensation agreements, but rarely if ever are agreements set aside. The IRS is also empowered to review compensation levels for reasonableness and compliance with “performance-based” requirements, but there are no cases in which they have done so.<sup>22</sup>

The managerial power view asserts that executive compensation contracts set through this process are decidedly not negotiated at arm's-length. The specific factors limiting the ability of firms to do so are: (1) the power of the CEO over the appointment of directors; (2) the ability of the CEO to reward cooperative directors; (3) the social and psychological influences the CEO has over directors, such as the power of friendship, loyalty, collegiality, and authority; (4) the

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<sup>18</sup> Recontracting costs include the following: (1) the fact that CEO contracts are routinely 3 to 5 years in length and include severe early termination penalties, (2) the social and psychological barriers that arise because of the close working relationship between the board and the CEO, (3) the complexity of typical compensation contracts, (4) the opportunity cost of management and board time, and (5) the lack of compensation saliency in any given year.

<sup>19</sup> Core et al., *supra* note 9.

<sup>20</sup> See Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1872 (1992).

<sup>21</sup> See, e.g., DEL. CODE ANN. tit. 8, § 122(5), (15) (2006).

<sup>22</sup> See Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation*, \_\_ ST. JOHN'S L. REV. 81, 85 (1998). This may be changing. See Joann S. Lublin, *IRS Is Cracking Down on Abuse Of Executive-Bonus Tax Breaks*, WALL ST. J., June 18, 2004, at B5.

cognitive biases of directors that come from being CEOs or former CEOs themselves; (5) and the time and informational barriers most directors face to making an informed and reasoned decision about pay.<sup>23</sup> The net result, writes one critic who has seen the process from the inside, is that “the negotiations between a CEO and the outside directors who sit on the compensation committee can hardly be called negotiations at all.”<sup>24</sup>

After claiming to debunk the actual negotiations claim, the managerial power model then attacks the claim that market forces constrain managerial appetites and that agreements represent the terms the parties would have reached had they bargained. Market forces are ineffective because managers “camouflage” the true nature and extent of their compensation,<sup>25</sup> and because the stakes while large for individual managers, are insufficient to have any significant effect on the firm’s cost of capital or to justify a takeover to oust the greediest managers.<sup>26</sup> So on one side of the “negotiations” we have the CEO who controls the compensation setting process and has very strong incentives to put lots of time and energy into designing a compensation scheme that will be both self-serving and obscure, and on the other we have directors who, despite being the representatives of the shareholders, owe their jobs to the CEO and basically serve at his pleasure, and therefore have every reason to acquiesce, since the risk (both personal and professional) from offending the CEO dwarfs any potential threat from a shareholder derivative suit.

In addition to criticizing the amount CEOs are currently paid, critics point to several specific types of compensation as particularly objectionable on efficiency or fairness grounds. For example, Bebchuk and Fried argue that restricted stock and traditional options (with an at-the-money strike price) are suboptimal from an efficiency perspective. The argument is that traditional (non-indexed, at-the-money) options do not provide as much incentive bang for the buck as indexed options with a strike price above the current market price. For example, if an oil firm grants the CEO 100,000 non-indexed, at-the-money options on January 1, and on July 1 the price of oil increases (because of, say, a crisis in the Middle East) causing the firm’s stock price to rise \$10 per share, the CEO will earn \$1 million largely for events outside of his control. In addition, because the shares of *all* oil firms will rise, shareholders in this firm get nothing from this payment that they could not have received from holding a diversified basket of oil firm securities. It would be more efficient, so the argument goes, to set the strike price above the market price (to give the executive an incentive to increase share value above a certain threshold level) and to link compensation to firm-specific performance by comparing the firm’s performance with an index of other firms in that industry. Because this compensation design is rather straightforward and yet firms do not do it, it is believed that the “design of option programs is consistent with the presence of managerial power.”<sup>27</sup> Instead, managerial power theorists suggest the use of improved equity compensation, such as indexed options or performance-based vesting.<sup>28</sup>

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<sup>23</sup> BEBCHUK & FRIED, *supra* note 2, at 25-53.

<sup>24</sup> Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1873 (1992) (reviewing GRAEF CRYSTAL, *IN SEARCH OF EXCESS* (1991)).

<sup>25</sup> See Bebchuk, *Managerial Power*, *supra* note 3 at 785-7.

<sup>26</sup> See *id* at 777-78.

<sup>27</sup> BEBCHUK & FRIED, *supra* note 2, at 45.

<sup>28</sup> *Id.* Numerous academic studies have, for many years, supported the use of indexed stock options. See, e.g., Shane A. Johnson

## B. Reform proposals – institutional investors and powerful boards as saviors

There are two favorite reform proposals designed to reduce managerial power, and thus change executive compensation: either boards or institutional investors playing a more active role in monitoring and disciplining management.

### 1. Theoretical studies and proposals

The argument that institutional investors should take an active and systematic role in monitoring executive compensation levels in healthy firms is contrary to the prevailing wisdom that shareholders generally prefer liquidity to control.<sup>29</sup> Managerial power theorists, however, claim that creating larger blockholders can create the right mix of incentives and costs to permit greater market discipline of managers.<sup>30</sup> The typical theoretical model assumes that larger investors have lower informational gathering costs, lower costs of action (e.g., mobilizing the proxy machinery), greater signaling credibility, and higher liquidity costs (i.e., more willingness to monitor because of the costs and risks of trading).<sup>31</sup> Practice deviates from theory, however, since these investors are hamstrung by various laws, regulations, and habits that limit their role in firm oversight. This fact leads some observers to suggest reforms that would allow institutional investors to join forces to have more influence and provide greater monitoring of firms.<sup>32</sup>

Some reform proposals are merely calls for institutional investors to assume a more powerful role in firm governance. Randall Thomas argues that institutional investors with large ownership stakes “should demand that directors justify executive pay packages as value maximizing for the firm,” since owners are the best group to “insist on an accounting” of these costs.<sup>33</sup> This is echoed by commentators and firm stakeholders (such as labor unions), the actions of several large pension funds, such as CalPERS and TIAA-CREF, and studies alleging a link between the share of equity owned by institutional investors and corporate governance or firm performance.<sup>34</sup>

A more interventionist set of proposals argues for various structural reforms to facilitate institutional investor monitoring. George Dent argues that the “mistreatment of shareholders,”

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& Yisong S. Tian, *Indexed Executive Stock Options*, 57 J. FIN. ECON. 35 (2000) (designing option that supposedly filters out market risk, and thus increases the firm-specific incentive power of the option.).

<sup>29</sup> See John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1287-88 (1991).

<sup>30</sup> Shleifer & Vishny, *supra* note 4, at 461-88.

<sup>31</sup> See, for example, Charles Kahn & Andrew Winton, *Ownership Structure, Speculation, and Shareholder Intervention*, 53 J. FIN. 99, 100-02(1998).

<sup>32</sup> Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992).

<sup>33</sup> Randall S. Thomas, *Should Directors Reduce Executive Pay?*, 54 HASTINGS L. J. 437, 467 (2003).

<sup>34</sup> See Shivram Rajgopal & Mohan Venkatachalam, *The Role of Institutional Investors in Corporate Governance: An Empirical Investigation* (Stanford Graduate School of Business Research Paper No. 1436, 1997), available at <https://gsbapps.stanford.edu/researchpapers/library/RP1436.pdf> (institutional investor ownership correlated with better monitoring); Sunil Wahal & John J. McConnell, *Do Institutional Investors Exacerbate Managerial Myopia?* (Oct. 30, 1997) (unpublished manuscript, available at [http://ssrn.com/abstract\\_id=47271](http://ssrn.com/abstract_id=47271)) (firms with greater institutional ownership invest more in R&D); see Willard T. Carleton et al., *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREFI*, 53 J. FIN. 1335, 1335 (1998).

can be remedied by creating shareholder committees to control the firm’s proxy process for electing directors.<sup>35</sup> Dent’s solution is to have the firm’s largest “ten to twenty” shareholders serve on a committee that would, among other things, nominate directors for election. He argues that these shareholder committees would constrain executive compensation because shareholders on these committees would gain expertise about management issues; would be able to nominate directors to represent them; would get access to better corporate information; and would be motivated to spend money on monitoring because of their large holdings. (We will see that this proposal is fairly approximated by the use of creditors’ committees in Chapter 11, and therefore the compensation practices in bankrupt firms is a test of this proposal.)

Empowering boards is another proposed solution. Legions of academics believe that effective boards could provide a check on managerial rent seeking.<sup>36</sup> Effectiveness could be achieved in several ways. Board members could be required to take a bigger equity stake in the firm, making them in effect super-empowered shareholders – they would have the pocket-book incentives to act in the interests of shareholders while having the information, access, and voting power of management.<sup>37</sup> Another option would be to create more independence between board and the CEO, so that board members could exercise their own judgment about an executive’s worth and engage in true arm’s-length bargaining.<sup>38</sup> (Again, Chapter 11 is a case in which the decision makers—boards, DIP lenders, creditors’ committees, and vulture investors—are empowered and highly motivated by their own economic incentives.)

## 2. Empirical studies

Recent empirical research claims to support these proposals. One study finds that “institutional investors are a monitoring device that provides a direct influence on the structure of executive compensation.”<sup>39</sup> Another recent study finds that firms with reduced agency costs (large shareholders, low CEO tenure, small board sizes, majority independent boards) are less likely to reward CEOs for luck.<sup>40</sup> This study proceeds on the assumption that “separation [of ownership and control] allows CEOs to gain effective control of the pay-setting process,” and thus allows CEOs to use “entrenchment”—packing the board with friends and allies—and “the

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<sup>35</sup> George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 883 (1989).

<sup>36</sup> See BEBCHUK & FRIED, *supra* note 2, at 13; LOUIS LOWENSTEIN, WHAT’S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 209-18 (1988) (proposing that 25 percent of directors should be elected by shareholders without any management role/interference); MELVIN EISENBERG, THE STRUCTURE OF CORPORATE LAW 117-20 (1966) (permitting shareholders holding more than 5 percent of a firm’s stock to nominate directors in the proxy materials).

<sup>37</sup> See Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 652-53 (1995); see also Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We’ve Been, How We Got to Here, What are the Problems, and How to Fix Them* (ECGI Finance Working Paper No. 44/2004, 2004), available at <http://ssrn.com/abstract=561305>.

<sup>38</sup> See, e.g., Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 912-13 (1996); see also Arthur Levitt, Jr., *Money, Money, Money*, WALL ST. J., Nov. 22, 2004, at A14 (“[E]xcessive compensation . . . packages are a consequence of boards falling victim to a seduction by the CEO.”).

<sup>39</sup> Jay C. Hartzell & Laura T. Starks, *Institutional Investors and Executive Compensation* 16 (Sept. 2002) (unpublished manuscript, available at [http://ssrn.com/abstract\\_id=236592](http://ssrn.com/abstract_id=236592)); see Parthiban David et al., *The Effect of Institutional Investors on the Level and Mix of CEO Compensation*, 41 ACAD. OF MGMT. J. 200, 202-06 (1998).

<sup>40</sup> See Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 QUART. J. ECON. 901 (2001).

complexity of the pay process” to “set their own pay with little oversight from shareholders.”<sup>41</sup> The authors call CEO rent seeking “skimming,” and they find less of it in “[w]ell-governed firms, such as those with a large shareholder present on the board.”<sup>42</sup> As a shortcut, the authors describe the presence of a large shareholder as “having a principal around,” which they view as causing firms to link pay more closely with performance. (Chapter 11 is the prototypical case of “having a principal around”.)

The empirical data is far from conclusive, however, as many studies find no correlation between corporate governance changes and executive compensation. For example, an empirical study of compensation practices in about 200 firms from 1993 to 1997 shows no evidence of a change in compensation practices despite increasing shareholder activism.<sup>43</sup> Another similar empirical study shows no link between criticized compensation practices (for example, resetting option exercise prices lower when stock prices fall and options are “out of the money”) and poor corporate governance.<sup>44</sup> In fact, one study finds that the number of non-management directors on a board is correlated with *higher* levels of executive compensation, perhaps because these directors lack information and expertise to capably police management in compensation decisions.<sup>45</sup> While the weight of the recent literature can fairly be said to adhere to the theory of managerial power, as one survey recently concluded, the “data is largely inconclusive.”<sup>46</sup>

### III. THE POWER OF CAPITAL PROVIDERS IN CHAPTER 11

In Chapter 11, creditors ranging from banks to specialty investors in distressed firms, known as “vulture investors,” get this power through a mix of contract and statutory rights, the former coming from detailed and extensive covenants provided in new or restructured debt contracts, and the latter from the Bankruptcy Code. The rights of creditors include: access to corporate information, pre-approval rights for certain investment decisions, participation in key personnel decisions, and other actions that look more like day-to-day decisions (which are normally the exclusive province of management) than fundamental corporate decisions (where creditors usually have some say). The net effect, as we shall see in section IV below, is that the fears about managerial power distorting the compensation bargaining process are largely alleviated or mitigated for firms in financial distress.

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<sup>41</sup> *Id.* at 902-03.

<sup>42</sup> *Id.* at 903, 921.

<sup>43</sup> Marilyn F. Johnson et al., *Stakeholder Pressure and the Structure of Executive Compensation* 16, 37 (May 1997) (unpublished manuscript, available at [http://ssrn.com/abstract\\_id=41780](http://ssrn.com/abstract_id=41780)) (finding that pay packages are sensitive to negative media reports and specific lobbying by pension funds (i.e., CALPERS), but not shareholder proposals under Rule 14a-8).

<sup>44</sup> See Mary Ellen Carter & Luann J. Lynch, *An Examination of Executive Stock Option Repricing*, 61 J. FIN. ECON. 207 (2001); see also Ronald C. Anderson & John M. Bizjak, *An Empirical Examination of the Role of the CEO and the Compensation Committee in Structuring Executive Pay* (Apr. 2000) (unpublished manuscript, available at [http://ssrn.com/abstract\\_id=220851](http://ssrn.com/abstract_id=220851)); Kam-Ming Wan, *Independent Directors, Executive Pay, and Firm Performance*, EFMA 2003 Helsinki Meetings (June 27, 2003), available at [http://ssrn.com/abstract\\_id=392595](http://ssrn.com/abstract_id=392595).

<sup>45</sup> John E. Core et al., *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 385-88 (1999).

<sup>46</sup> Michael B. Dorff, *Does One Hand Wash the Other? Testing the Managerial Power and Optimal Contracting Hypotheses of Executive Compensation* 5 (Aug. 10, 2004) (unpublished manuscript, available at <http://ssrn.com/abstract=574861>).

### A. *Monitoring and discipline outside Chapter 11*

Outside of the Chapter 11 context, investors (large and small) generally do not monitor management closely, preferring liquidity to control.<sup>47</sup> Building on Albert Hirschman’s famous generalization about the choice of “exit” or “voice,” John Coffee described the liquidity of U.S. financial markets as providing an “‘exit’ option [that] weakens institutional voice.”<sup>48</sup> As Coffee observes, institutional investors are watchdogs “whose every incentive is to flee at the first sign of trouble.”<sup>49</sup> For the vast majority of firms and investors, this is a perfectly sensible strategy because the “costs” of monitoring and disciplining management for potentially value-destroying actions are higher than the expected benefits from such action. This may be in part because the costs are real, dollar costs, while the benefits may be hard to quantify and more illusory. There are several significant “costs” of monitoring that are worth considering before we consider whether they are present or absent in the Chapter 11 context.

#### 1. *Costs of monitoring*

First, the characteristics of the modern firm – control vested in risk averse, opportunistic managers, and ownership held in small shares by diffuse shareholders – creates not only the classic agency problem but also a collective action/free rider problem that inhibits shareholder action to limit agency costs. The free rider problem arises because shareholders are by and large dispersed and hold relatively small stakes, and therefore each is unwilling to incur monitoring costs since the benefits will inure to all shareholders without regard to who spent the time or money to monitor.<sup>50</sup> The presence of a large shareholder (say a mutual fund with a 10 percent stake) does not solve this problem completely. While this investor may be able to monitor and discipline managers more effectively (because of experience and economies of scale), it will receive only 10 percent of the expected value of the investment in monitoring and discipline. While one can imagine a scenario in which such an investment might make economic sense, the investors is nevertheless unlikely to make such an investment.<sup>51</sup> This is because the relevant metric is not the absolute expected value of the investment, but the cost and return of the next best alternative. The investor can simply and cheaply move its funds to an infinite number of other investments that do not require a speculative investment in monitoring, and yet offer a similar mix of risk and return. In addition, professional investors compete for investment dollars largely on the basis of return net of management fees, and the monitoring expenditures will necessarily lower their performance. Other investment firms can free ride on this investment, therefore earning the 10 percent expected return without any of the monitoring costs, resulting in a more attractive return net of costs. In effect, the monitor would be subsidizing its competitors. Accordingly, ignoring the potential ancillary benefits described below, only a 100 percent owner would rationally invest in expensive management monitoring.<sup>52</sup>

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<sup>47</sup> Coffee, *supra* note 29, at 1281.

<sup>48</sup> *Id.* at 1322.

<sup>49</sup> *Id.* at 1329.

<sup>50</sup> See Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 653-54 (1984).

<sup>51</sup> For example, a \$1 million investment in monitoring with a 50 percent probability of yielding \$22 million in shareholder value has a positive expected value of \$1.1 million.

<sup>52</sup> See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. LAW & ECON. 395, 402 (1983).

Second, even if the free-rider problem can be overcome, say by shareholders pooling their shares or collaborating through contract, effective monitoring is expensive and difficult to execute. A primary barrier is the information asymmetries that exist between managers and investors. The only information available to investors comes through official, regulated disclosures and public statements, neither of which is conducive to effective monitoring.<sup>53</sup> As long as managers control the timing and content of information dissemination, investors will be at a disadvantage, especially when it comes to attempts to control covert cheating, such as shirking or camouflaged compensation. Moreover, monitoring day-to-day activities of the firm is impractical and unwise, as it defeats the purpose of having agents in the first place, and simply moves the locus of decision making authority to the monitors. It is also fraught with potential risks, such as insider trading liability or limitations on trading (e.g., the short-swing trading rules of §16(b)) that come with access to “inside information.”

A third limit on monitoring is managers have little reason to heed to the requests of shareholders acting alone given their relatively small stakes.<sup>54</sup> This can be theoretically overcome through explicit or implicit confederation among shareholders, especially after the SEC removed barriers to inter-shareholder communications,<sup>55</sup> but it rarely happens in practice because the costs (of collecting information, of monitoring, of communicating with other shareholders, of reaching an agreement on how to proceed and about what, of resolving any conflicts of interest among shareholders, and of following through with management) exceed the likely benefits or cost-benefit tradeoff of the next best alternative, which is to simply sell the shares.

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

A fifth limitation is the heterogeneity of investors’ incentives and potential conflicts of interest. In other words, not all 10 percent blockholders (such as there are) are created equal. An insurance firm can be expected to act quite differently than a mutual fund or pension fund with the exact same ownership stake. While we might expect the insurance firm to be quite conservative in its investments of this size, and therefore invest in monitoring in some way (perhaps through contractual means with other shareholders), a mutual fund will likely prefer liquidity given the fact that fund managers compete on costs. In contrast, a pension fund’s decisions will be perhaps influenced by political or public policy considerations favored by its union members or political constituents in legislature. Proponents of an increased

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<sup>53</sup> Managerial power scholars note that even board members, who are required by law to be familiar with the financial and strategic state of the firm, are at an informational disadvantage vis-à-vis management. See BEBCHUK & FRIED, *supra* note 2, at 25-53.

<sup>54</sup> Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 545 (2000).

<sup>55</sup> See 17 C.F.R. 240.14a-2 (2006).

monitoring/disciplining role for institutional investors recognize this constraint on the effectiveness of this solution, but nevertheless argue that some form of “institutional voice” can be a positive contributor to the socially efficient governance of a firm.<sup>56</sup> The prerequisite to creating an effective “institutional voice,” according to Black, is creating a forum (either explicit or implicit) in which “different types of institutions . . . join forces to exercise influence,” in a way in which they “can monitor each others’ actions,” and rely to some extent on reputational penalties to align interests. This is no small task, what Black calls a “complicating factor” to his proposal to empower institutional investors to monitor/discipline managers.<sup>57</sup>

Finally, in stark contrast to the costs of trying to exert control, the depth of U.S. capital markets make the cost of liquidity low, thus raising the relative cost of monitoring. Capital providers in solvent firms may be less interested in monitoring because they can shift their investments among competing management teams with relatively low transaction costs.<sup>58</sup> In addition, investments in monitoring may *decrease* an investor’s exit options, thus decreasing the liquidity of the investment, and therefore having the perverse effect of *increasing* management’s incentive to shirk or rent seek. If the investor raises the costs of its exit – in effect choosing “voice” over “exit” – that provides management with an assurance that the investor will not sell its shares at levels it otherwise would have. The more the investor sinks into monitoring management, the less likely (up to a point) the investor will be to sell its shares.

## 2. *Benefits of monitoring*

There are a few potential benefits an investor might receive from adopting a monitoring strategy. The most obvious is an increase in the value of a specific investment because the monitoring resulted in increased shareholder value. As discussed above, this strategy makes the most sense for an owner with a substantial stake. But even in that case, it is unlikely because there is little or no evidence that a specific investment in improving firm governance is a net present value positive investment. In fact, several studies suggest that there is no correlation at all between improved governance and shareholder value.<sup>59</sup> Without clear evidence (empirical or otherwise) supporting such an investment, it is very unlikely to occur on solely this basis given the fact that the monitoring costs will be real and quite large.

Monitoring is likely an unprofitable investment strategy for two reasons. First, once an investor adopts this strategy, its competitors will know that they can free ride on the investor’s monitoring expenditures. In other words, once Fidelity signals that it is monitoring a specific firm or firms in general, why would Janus spend any money to monitor when it can follow Fidelity’s investment choices and free ride on its monitoring expenditures? Because investors compete for funds in a highly competitive market, the net effect will be similar returns across competitors, with the monitoring investor having higher management fees. Investor cash will flow to the non-monitoring investors, who share in the benefits with none of the costs.

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<sup>56</sup> Bernard S. Black, *supra* note 32, at 815-18.

<sup>57</sup> *Id.*

<sup>58</sup> *See, for example*, Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. POL. ECON. 288, 291 (1980).

<sup>59</sup> *See* Robert W. Hamilton, *Corporate Governance in America 1950-2000: Major Changes But Uncertain Benefits*, 25 J. CORP. L. 349, 367 (2000).

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

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

### *B. Monitoring in Chapter 11*

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

The primary effect of bankruptcy is (in almost all cases) to wipe out the claims of the distant, diffuse, and disinterested shareholders, and to leave only sophisticated investors, such as banks, insurance companies, hedge funds, and bond investors. The investors left standing when the music stops for a firm are specialist, repeat players in workouts or distressed investing. These investors achieve control either through buying significant blocks of a firm’s outstanding debt or by agreeing to loan the debtor additional funds, subject to restrictive debt covenants that grant the lender contractual control of many of the firm’s activities. In most cases, the holders of bank debt consolidate their interests in and around financial distress by creating a single credit facility that reorders the existing debt of many providers and pumps new cash into the debtor. A similar consolidation happens with the bond debt, as vulture investors buy up large stakes of the bond debt in order to get a blocking position in the reorganization process.<sup>60</sup>

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<sup>60</sup> A creditor holding more than 33 percent of the claims in a class has a blocking position and can effectively hold up approval of any plan. *See* 11 U.S.C. § 1129(b)(1) (2006). Because creditors very rarely hold such large stakes in firms, without some way for creditors to buy claims from other creditors, no single creditor can achieve this leverage position *vis-à-vis* management. Prior to 1990, the market for distressed debt and claims was severely limited because courts scrutinized attempted transfers of ownership stakes to the point that it impeded the development of a market for these claims. This changed in 1991 when the Advisory Committee on the Rules of Bankruptcy Procedure amended Rule 3001(e)(2) to allow claims to be traded without the court’s approval. As one observer notes, “[b]efore [1990], there was no secondary market for distressed bank debt, . . . [b]ut, by the late 1990s, an investor could buy defaulted loans through practically any bank or brokerage firm.” HILARY ROSENBERG, *THE VULTURE INVESTORS* 19 (2000). This market allows turnaround specialists to play an active role in the outcome of Chapter 11

These bank and vulture investors take an active role in the governance of the distressed or bankrupt firm because the costs of monitoring/discipline decrease and the benefits increase. The vulture investors, for example, are “frequently active on boards and in management of the target companies,” gaining “sufficient power in these companies to discipline management.”<sup>61</sup> The same is true for banks and other institutional creditors, who, through the use of a revolving credit facility with restrictive covenants, “essentially control[] the corporation.”<sup>62</sup> The costs of monitoring for investors decreases because of the powers granted to investors by statute, regulation, and contract, as well as through more robust judicial oversight by the bankruptcy court. The reduction in monitoring costs and the increasing benefits are evident by looking at how creditors behave when monitoring firms reorganizing under Chapter 11.

### *1. Consolidating ownership interests reduces monitoring costs*

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

#### *a. Consolidating bank debt*

Healthy firms typically have many capital providers, from millions of individuals to large, institutional lenders of many flavors, including many mutual funds, hedge funds, insurance companies, banks, and so on. The only significant outside constraints on management behavior, aside from labor, capital, and product markets, are the fiduciary duties running to shareholders and the covenants contained in various indenture contracts with banks. Chapter 11 has two effects. First, it generally wipes out the interests of equity holders, therefore shifting management’s fiduciary duties from shareholders to debt holders.<sup>63</sup> The second effect is a consolidation of the bank debt. The debt of healthy firms is usually held by numerous banks and other institutional debt holders, none of which has a dominant share of the firm’s debt. When a firm becomes severely financially distressed, however, these many creditors routinely “morph into a single revolving credit facility.”<sup>64</sup> One large bank or consortium of banks agrees to provide cash influx and to restructure existing obligations subject to new contractual terms that grant the bank an increased role in the governance of the debtor. When firms face financial distress, the

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reorganizations by permitting debt to flow to those most willing to use it to create a blocking position and exert influence over management. According to a partner at a leading distressed debt investment/turnaround shop, “I can’t think of a big-time deal in the past ten years that didn’t involve substantial participation, if not total control, by major vultures and banks.” *Id.*

<sup>61</sup> Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401 (1997).

<sup>62</sup> Baird & Rasmussen, *supra* note 6, at 1226.

<sup>63</sup> See Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations that are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COMMERCIAL L. J. 295, 300 (2004); see also *Unsecured Creditors Comm. of STN Enter., Inc. v. Noyes*, 779 F.2d 901, 904 (2d Cir. 1985).

<sup>64</sup> Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 696 (2003).

need for a cash influx puts the debtor in a disadvantaged position vis-à-vis creditors willing to extend new financing. Lenders of post-petition funds “use the terms of [the] loans to shape the Chapter 11 case,” effectively “constrain[ing] the debtor’s managers’ wiggle room.”<sup>65</sup>

These new credit facilities give creditors access to better information than shareholders usually receive, putting them in a much better position to monitor management activities.<sup>66</sup> The loan agreements also are typically replete with specific contractual restrictions on the activities of the debtor. Standard terms include the right of the creditor to closely monitor firm cash flows – which also equalizes any informational asymmetries<sup>67</sup> – to have veto rights over major investments, and to insist on a change in management personnel or incentives, including hiring a turnaround specialist, known as a Chief Restructuring Officer. In addition, the unification of ownership in a single agreement allows creditors to enforce these contractual terms more easily and in a less costly manner. The overall effect is to give the creditor(s) behind the revolving credit facility “practical control” over the debtor and to “ensure that no major decision is made in a way that [the creditors] find[] objectionable.”<sup>68</sup> As Baird and Rasmussen described a recent reorganization, “[o]nce the revolving credit facility was in place, control rights had shifted . . . [and] [f]rom that point forward, the banks that ran the revolving credit facility essentially controlled the corporation.”<sup>69</sup> The firm’s capital providers, once relegated to the choice of accepting management actions or selling their shares, now have the powers “normally reserved for directors,” such as “whether to sell a division, change the business plan or replace the managers.”<sup>70</sup>

*b. Consolidating unsecured debt – the creditors’ committee*

Creditors can also greatly reduce their monitoring costs by forming a committee(s) to represent their interests during the reorganization.<sup>71</sup> These “creditors’ committees” are formed under § 1102 of the Bankruptcy Code, with the holders of “the seven largest claims against the debtor” for the type of claim represented by a specific committee, representing the entire class of such claims.<sup>72</sup> These committees are a decision-making forum for the creditors with the largest financial incentives and the most resources to devote to monitoring. This system largely overcomes the collective action and free-rider problem that keeps small, diffuse shareholders from being effective monitors.<sup>73</sup> The committee structure does this by lowering the costs of

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<sup>65</sup> David A. Skeel, Jr., *Creditors’ Ball: The “New” New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003).

<sup>66</sup> Baird & Rasmussen, *supra* note 6, at 1226-27.

<sup>67</sup> Baird & Rasmussen, *supra* note 6, at 1229 (“A creditor can now acquire a valid security interest in all of a debtor’s assets and ensure that all of the cash coming into the corporation and leaving it passes through its hands. . . . By virtue of controlling the business’s cash flow, the creditor is less dependent upon the debtor to tell it what is going on.”).

<sup>68</sup> *Id.* at 1241.

<sup>69</sup> Baird & Rasmussen, *supra* note 6, at 1226.

<sup>70</sup> *Id.* at 1227; *see also* ROSENBERG, *supra* note 60, at 24.

<sup>71</sup> LoPucki & Whitford, *Corporate Governance*, at 680 (“To deal with [the collective action] problem, the Bankruptcy Code provides for the appointment of committees of creditors. . . .”).

<sup>72</sup> 11 U.S.C. § 1102(b)(1) (2006).

<sup>73</sup> *See* LoPucki & Whitford, *Corporate Governance*, at 680.

collective decision making with clear legal rules.<sup>74</sup> Committees also create a single investor voice, with weight, that the debtor simply cannot ignore. After all, the creditors' committee is the mechanism through which the debtor's reorganization plan must be approved, and the committee is also entitled to petition the bankruptcy court for redress if management refuses to listen to its demands.

Creditors' committees also reduce inter-creditor communication costs. Committees operate within a richly developed legal context of statute, case law, and custom that establish a framework in which communications costs are lower, and decisions can be made more quickly and efficiently.<sup>75</sup> Creditors on the committee are represented by counsel experienced in debt restructurings and can freely communicate and work together to serve the interests of their class of creditors. Committees hold frequent meetings, engage in strategic and business planning parallel to management, and routinely communicate with both the debtor and the court overseeing the reorganization. The committee structure therefore has the advantage of providing straightforward decision making rules for settling inter-creditor disputes, thus reducing creditor transaction costs tremendously.

The committee structure not only benefits creditors who serve on the committee, but it also provides a centralized forum that reduces communication costs for creditors who are not on the committee. Many sophisticated investors choose not to serve on creditors' committees because access brings with it inside information, and may thus be offset by a concomitant obligation to refrain from trading securities of the debtor.<sup>76</sup> Because of the fear of potential liability for insider trading, many investors find other, indirect ways to be influential.<sup>77</sup> One investor, James Rubin from Sass, Lamle, Rubin & Company, describes his ability to operate outside the committee structure by using subtle pressure and the power of suggestion to influence those on the committee or within the firm – “The longer I've been involved in this business the less necessary it's been for me to serve on committees to be influential.”<sup>78</sup>

Committees also allow creditors to overcome the informational asymmetries that owners usually have with managers. Committees have statutory powers to collect and process information relevant to running the firm, all at the expense of the debtor. For example, § 1103(c) grants creditors broad powers to form committees to pool their power together, including the right to (1) consult with debtor in possession, (2) investigate “the acts, conducts, assets,

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<sup>74</sup> Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 465 (1991) (citing MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 132-35 (1971)) (“a group can surmount a collective action problem if pre-existing organizational structures can be converted to provide the collective good at a sufficiently low cost or the collective good can be provided as a by-product of an organization based on other, often private incentives.”).

<sup>75</sup> For example, the Code requires that the first meeting of creditors (the “section 341 meeting”) be held 20-40 days after the petition is filed; be run by the United States Trustee; and is attended by the debtor, who is questioned under oath about the case.

<sup>76</sup> See *In re Allegheny Inter., Inc. (“Allegheny II”)*, 118 B.R. 282, 298 (W.D. Pa. 1990); see also Shawn Young, *SEC Probes WorldCom Creditors-Committee Trades*, WALL ST. J., Sept. 20, 2004, at A3.

<sup>77</sup> There is a concern among distressed debt investors that at some point “claim purchases start to equate to a sub rosa Chapter 11 plan, requiring the imposition of the Bankruptcy Code's disclosure, classification, and equal treatment rules.” Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569, 585 (2002).

<sup>78</sup> ROSENBERG, *supra* note 60, at 31.

liabilities, and financial condition of the debtor, the operation of the debtor’s business,” (3) participate in formulation of a reorganization plan, and (4) “perform such other services as are in the interest of those represented.” Creditors, through their committees, also have the statutory power to appoint legal, financial, and strategic advisors, all of which will be paid from the assets of the debtor.<sup>79</sup> Creditors are often consulted at every stage by the debtor before key decisions are made. As stated in the reorganization plan of Silicon Graphics: “The Debtors have informed the Creditors’ Committee with respect to their operations and have sought concurrence of [it] for actions . . . outside of the ordinary course of business.”<sup>80</sup>

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

## 2. *The impact of financial distress on other monitoring costs*

The other monitoring costs identified above are also substantially mitigated in firms reorganizing their balance sheets under Chapter 11 or privately with creditors. Let us look at each briefly in turn.

First, there are the possible conflicts of interest that arise when an institutional investor is not only an investor in a firm but also has or would like to have other business relations with that firm. While this may limit investor activism outside the Chapter 11 context, it is much less likely to limit monitoring by distressed debt investors or creditors that provide DIP loans. Vulture investors are typically unaffiliated with a large investment house, and are not routinely engaged in other types of business activities, such as commercial lending, consulting, or accounting.<sup>81</sup> These investment shops tend to be small, leanly staffed, and super specialized on distressed investing. They are interested solely in profiting from an increase in the price of the bonds they purchased at cents on the dollar, or on turning around the debtor and profiting from the rise in equity value post emergence. “We are not interested in making friends with management so we can sell them advice or deals later on,” said a partner at a New York vulture fund. “We are repeat players, but not with them. At least we and they hope not.”<sup>82</sup>

The large banks and other creditors that participate in establishing a new or restructured revolving credit facility are also unlikely to be deterred by conflicts of interest, but for different reasons. These creditors do have other business prospects that might be hurt by an aggressive, anti-management reputation, but any reputational hit is likely to be offset by the reputational

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<sup>79</sup> 11 U.S.C. § 1103(b) (2006).

<sup>80</sup> See Silicon Graphics, Inc., Amended Joint Plan of Reorganization 34, available at [http://www.sgi.com/reorg/disclosure\\_statement.pdf](http://www.sgi.com/reorg/disclosure_statement.pdf) (last visited Aug. 25, 2006).

<sup>81</sup> Even when these firms are affiliated with bigger institutions, so-called “Chinese walls” are put in place to keep the information and activities of the separate divisions completely isolated. This is done to limit potential insider trading liability, see *infra* footnote 83 and accompanying text, so these barriers are taken seriously by the firms.

<sup>82</sup> Interview with the author conducted Mar. 5, 2004.

benefit the investor will get as a result of its willingness to provide additional capital to the firm in its time of dire need. A distressed debt specialist at a large, commercial bank put it this way: “We are heroes to these guys for extending them a life line. I don’t think they begrudge our increased presence, they recognize that our heroism has a price.”<sup>83</sup>

Another impediment to monitoring that is reduced in Chapter 11 is the ability of investors in healthy firms to use market liquidity to exit the firm quickly and at a low cost. While the market for the debt and trade claims of distressed firms is growing, it remains small compared with traditional debt and equity markets, and is inhabited largely by firms that specialize in this type of investing. In addition, these investors often obtain inside information as a necessary element of their turnaround efforts, and this limits their ability to exit without having to disgorge their profits or face other legal sanctions. Until very recently, creditors serving on the creditors’ committee were unable to trade bonds in the secondary market because such trading would likely be construed as insider trading or, at the very least, a conflict with the duties owed by the committee member to the estate of the debtor.<sup>84</sup>

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

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The end result of lower costs of monitoring and increased incentive to monitor is that the managers of a financially distressed company are subject to oversight by creditors, bankruptcy trustees, shareholders, and even courts in ways that healthy companies are not. As one observer recently observed: “The mere presence of flocks of vultures in the market has fundamentally changed the dynamics of bankruptcy from a situation in which management has an overwhelming advantage to one in which these new creditors have great sway.”<sup>85</sup> Chapter 11 thus represents a situation in which ownership and control is partially or even mostly reunited.<sup>86</sup> The “owners” of the firm are effectively in control of the management, at least with respect to the major decisions facing the firm. “Creditors have increasingly exercised de facto control” over firms reorganizing in Chapter 11.<sup>87</sup>

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<sup>83</sup> Interview with the author conducted April 3, 2004.

<sup>84</sup> This is starting to change somewhat as courts are increasingly willing to approve trading by committee members if strict procedural mechanisms are put in place to keep confidential information obtained through the committee process from being used in trading. See Terry Brennan, *FiberMark creditors to keep trading*, THE DAILY DEAL, Oct. 21, 2004 (noting that Judge Colleen Brown of the U.S. Bankruptcy Court for the District of Vermont in Rutland ruled in favor of the creditors on Tuesday, Oct. 19, 2004).

<sup>85</sup> ROSENBERG, *supra* note 60, at 17; see also, Mike Groenendaal & Ryan Harvey, *How People Issues Can Shape Bankruptcy*, FIN. EXEC., Dec. 1, 2003, at 59.

<sup>86</sup> Vulture investors also have the advantage of being newcomers to the firm. As Frank Easterbrook observes, “[n]ew investors are better than old ones at chiseling down agency costs,” because they can readily observe managerial performance prior to investing. Easterbrook, *supra* note 50, at 654.

<sup>87</sup> Skeel, *supra* note 65, at 922.

## IV. BARGAINING FOR COMPENSATION IN THE SHADOW OF CHAPTER 11

Turning the focus to executive compensation, the predominant theory is that “the principal beneficiaries of Chapter 11 . . . are corporate managers” who are able to “expropriate for themselves the wealth of [the firm’s capital providers].”<sup>88</sup> This is difficult to square with the monitoring story just described. If the rent-seeking theory is true – that is, managers entrench and enrich themselves in excess of their worth to the firm – they would have to do so under the watchful eye of sophisticated investors who specialize in turning around distressed firms, who voluntarily agreed to take a financial stake in the outcome of the firm, and who, through a variety of statutory and contractual rights, have a dominant say in how the firm is managed. This highlights a tension between Chapter 11’s preference for debtor-controlled reorganization and the role of vulture/DIP lender monitoring for reorganizing firms. Nowhere will this tension be more prevalent than in the issues about what individuals should manage the firm and how they will be incentivized.

A. *Bargaining Dynamics*

The traditional view of executive compensation in bankruptcy is that managers are as powerful (or even more so) than they are in healthy firms, allowing them to enrich themselves at the expense of shareholders and creditors. A recent news report expresses the common outrage: “When failing companies ask employees to take huge pay cuts, when they’re laying off thousands of wage-earners, when they’re slashing pension benefits, it’s astonishing that the top executives of those companies are still enjoying stratospheric compensation packages.”<sup>89</sup>

Many academic accounts of bankruptcy theory share this belief that managers are in a privileged position and are able to profit excessively from failing firms. According to these accounts, the current Bankruptcy Code’s preference for management operation of the debtor allows managers to extract rents in the form of higher salaries, big option grants, and lavish retention and emergence bonuses.<sup>90</sup> The bankruptcy reform passed by Congress in 2005 codifies this view, to a certain extent, by restricting firms’ ability to pay executives in bankruptcy in significant ways.<sup>91</sup>

The bargaining dynamic for compensation in bankruptcy, however, has changed significantly in the years since Bradley and Rosenzweig’s analysis. In order to better understand whether managerial power is reduced in Chapter 11 compensation negotiations, we must examine the pay-setting process for financially distressed firms. CEOs of almost all firms (healthy and distressed) are routinely employed under multi-year contracts, which include generous termination provisions or “golden parachutes” in the event the firm breaches the

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<sup>88</sup> Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1049, 1052 (1992).

<sup>89</sup> Gail Schoetter, *CEO: Constant Excessive Outrages*, DEN. POST, Apr. 27, 2003, at E05 (opinion of former U.S. Ambassador, Colorado lieutenant governor and treasurer, and corporate board member).

<sup>90</sup> See, e.g., Alan Schwarz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998); see also Lucian A. Bebchuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J.L. ECON. & ORG. 253 (1992).

<sup>91</sup> 11 U.S.C. § 503(c) (2006).

contract or fires the CEO for any reason.<sup>92</sup> Moreover, these contracts routinely have accelerated vesting clauses for stock option plans and corporate loans/deferred compensation that are costly for firms to pay out or unwind. These penalties limit the ability of healthy firms to reset CEO compensation levels based on changed circumstances, such as decreased firm or individual performance over the three to five years of the contract. These “recontracting costs” are a potentially significant impediment to firms reaching efficient outcomes with respect to employment contracts, since the net effect is a substantial disincentive for firms to terminate or renegotiate CEO contracts. According to several finance scholars, these recontracting costs are the primary source of inefficiency in the executive compensation market.<sup>93</sup>

Recontracting costs are reduced, if not eliminated, when a firm enters Chapter 11 because CEO contracts are voidable by the debtor, no matter how they are written, how long they have remaining in their term, or what type of compensation is spelled out. Nearly all forms of compensation, including employment contracts, retention agreements, and golden parachutes, are avoidable by the bankrupt firm, either as executory or prepetition contracts.<sup>94</sup> This creates substantial uncertainty and nervousness on the part of executives, who often have tens or hundreds of millions of dollars at stake under these contracts.<sup>95</sup> This nervousness is justified, since with recontracting costs near zero, CEO contracts are often rejected by the debtor when the firm first enters Chapter 11.<sup>96</sup> There are, of course, still social and psychological pressures on directors that can be costs that limit recontracting, but these are reduced or eliminated as well, since sophisticated creditors often replace existing directors and take an active role in key decision making, such as executive compensation.

Creditors of the debtor often are the drivers behind a firm’s decision to tear up a CEO’s contract and take an active interest in negotiating new employment contracts. Firms entering bankruptcy develop compensation strategies for rank-and-file employees and for senior executives. The former are routinely maintained at pre-bankruptcy levels through a first day “wage and benefit order” that is rarely disputed by the creditors’ committee and almost always approved as a matter of course by the bankruptcy court. Compensating the CEO and other top managers is more contentious for several reasons.

CEO compensation packages are a nontrivial amount for creditors trying to squeeze every penny out of the debtor, especially for the firms examined in this study, which are relatively

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<sup>92</sup> A recent survey by compensation consulting firm Hewitt Associates found that over 80% of CEOs had employment contracts in 1998, most with generous severance packages in the case of early termination. See Valerie Patterson, *Employment Contracts Attract Top Executives*, available at <http://www.careerjournal.com/myc/negotiate/19980915-patterson.html>.

<sup>93</sup> Core et al., *supra* note 9, at 2.

<sup>94</sup> See, e.g., *In re FBI Distrib. Corp.*, 330 F.3d 36, 40 (1st Cir. 2003) (citing 11 U.S.C. § 365 (2006)).

<sup>95</sup> See, e.g., Amanda Bennett, *Protecting Unsecured Pensions and Pay Becomes a Priority for Firms Under Fire*, WALL ST. J., May 21, 1987, at \_\_\_.

<sup>96</sup> Compare *Edison Brothers Stores, Inc.*, 10-K (Feb. 1, 1997) (§ 7.4, assuming all compensation plans), available at <http://secinfo.com/dUQx.8d.d.htm#3h2v>; *In re Zenith Electronics Corporation*, 241 B.R. 92 (Bankr. D. Del. 1999); with *In re Sterling Chemicals Holdings, Inc.*, Chapter 11 Case No. 01-3780 (Bankr. S.D. Tex. 2002) (*Joint Plan of Reorganization Under Chapter 11, Title 11, United States Code of Sterling Chemicals Holdings, Inc., et al., Debtors*) (§ 7.5, rejecting some components, assuming others); *In re SLI, Inc.*, et al., Chapter 11 Case No. 02-12608, 2005 WL 1668396 (Bankr. D.Del. June 24, 2005) (*Joint Chapter 11 Plan of Reorganization of the Debtors in Possession and the Official Committee of Unsecured Creditors*) (§ E, rejecting all compensation contracts).

small and highly unprofitable. According to compensation consultants, lawyers, and distressed investors interviewed for this study, direct costs alone are often sufficient to warrant additional attention from creditors. Not only are cash costs significant for creditors (in 2000, CEO compensation amounted to about 8 percent of corporate profits and about 17 percent of dividends),<sup>97</sup> but the size is amplified by the fact that creditors are fighting for every penny. As one workout lawyer said:

It's a dollar lost or a dollar gained . . . . You're getting 10 cents on the dollar on your claim and they want to give \$10 million to the person who undoubtedly played a role in the company filing for bankruptcy. Of course, your clients get upset.<sup>98</sup>

Perhaps even more important than these costs, however, are indirect benefits that come from finding the right executives and setting high-powered incentives for developing an effective reorganization plan, maintaining the debtor's business during Chapter 11, and setting a successful business strategy for the firm. In addition, there are potentially significant intangible benefits from renegotiating CEO pay levels during reorganization. Cutting executive pay is one of the surest ways to signal that a firm is serious about change to creditors, customers, competitors, and the courts.<sup>99</sup> According to practitioners, creditors "want to assert [themselves] early on to show that [they] are going to be driving the bus."<sup>100</sup>

For these reasons, creditors often take the lead in renegotiating CEO contracts in bankruptcy. These contracts are often negotiated over several months, and are a crucial part of the reorganization plan. The importance of CEO employment contracts to creditors is apparent from the fact that they are regularly included in reorganization plans and other public filings.<sup>101</sup> As one vulture investor interviewed for this piece described:

A successful Chapter 11 investment for us is premised entirely on people. We find the right managers, either inside or outside the firm; we tear up their employment agreements and start over; we give them the right incentives; and we monitor their performance.<sup>102</sup>

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

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<sup>97</sup> STEVEN BALSAM, AN INTRODUCTION TO EXECUTIVE COMPENSATION 262 (2002).

<sup>98</sup> See Matt Miller, *When failure pays*, THE DAILY DEAL, Feb. 27, 2003 (quoting lawyers involved in the reorganization of Peregrine Systems).

<sup>99</sup> "Getting new faces into management roles can be a key to changing a company's direction" See Meg Richards, *Ailing Firms Pay for Executive Talent*, THE HARRISBURG PATRIOT, Feb. 13, 2003 (quoting Ken Hiltz, a partner at a crisis management firm).

<sup>100</sup> Interview with author on February 15, 2004.

<sup>101</sup> See, for example, *In re Spectrasite Holdings, Inc.*, Chapter 11 Case No. 02-03631-5 (Bankr. E.D.N.C. 2002) (*Proposed Plan of Reorganization of Spectrasite Holdings, Inc. Under Chapter 11 of the Bankruptcy Code*) (Ex. B "Summary of New Senior Management Employment Contracts").

<sup>102</sup> Interview with author on March 16, 2004.

### 1. Management power

In terms of negotiations, there are several factors that do seem to cut in management's favor. First, there is the belief that the debtor is more valuable with existing management because managers know the business best and have firm-specific skills or knowledge that makes them superior managers than outsiders. This is precisely the logic that motivates allowing management operation of the debtor, and is the argument commonly made by managers when asking for lucrative compensation packages in bankruptcy, often in the form of so-called "key employee retention plans" (KERPs).<sup>103</sup>

We will see below that this belief strains under the data, however, since CEOs are replaced in and around bankruptcy in over 60 percent of firms in the dataset.<sup>104</sup> While KERPs may be useful to retain top line managers and sales personnel, their protective force is likely much less for CEOs. These executives have more wealth tied up in the firm, are less able to jump ship, and are, in most cases, less valuable in bankruptcy than line managers with the important business contracts and functional knowledge.

Second, reorganizing firms are susceptible to poaching, since they are targeted by the rest of industry for talent that might be eager to move to greener pastures. Turnover of managers increases costs for the firm both in cash expenditures (in the form of search fees, hiring bonuses, relocation expenses, etc.) and opportunity and disruption costs. Again, these latter costs are probably less important for the CEO than for midlevel sales managers and business unit heads, who are more numerous and have important line responsibilities, knowledge, and personal customer contacts. Of course, any generalizations are impossible as the value of personnel at all levels will vary across firms and industries.<sup>105</sup>

A third factor potentially favoring management is the possibility that creditors will tolerate inefficient or unfair compensation levels/types to curry favor with CEOs (who have the exclusive right to propose a reorganization plan) in order to get the company out of bankruptcy as soon as possible. Creditors want to exit quickly to reduce three costs: cash costs (professional fees for lawyers, accountants, bankers, etc.), business costs (lost customers), and financial costs (higher capital costs). While the total of these costs is undoubtedly very large (professional fees alone are about 2-4% of assets in a typical case),<sup>106</sup> the relevant consideration is the marginal costs of extending bankruptcy a certain period of time. The marginal costs of bankruptcy are not directly related to duration in all cases, since while professional fees increase linearly with time, other costs are lumpy, with extensions of reasonable periods unlikely to increase them substantially. In addition, unlike one-time professional fees, executive compensation is a recurring charge that cannot be externalized to the "last class of shareholders," and therefore gets

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<sup>103</sup> See, generally, Allison K. Verderber Herriott, Comment, *Toward and Understanding of the Dialectical Tensions Inherent in CEO and Key Employee Retention Plans During Bankruptcy*, 98 N.W. L. REV. 579 (2004).

<sup>104</sup> The average for healthy firms in 2003 was about 3 percent. See Patrick McGeehan,

<sup>105</sup> There is some suggestion that retail may be especially susceptible to poaching of key people. See, for example, *In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 152 (D. Del. 1999) (noting that these retention agreements are "particularly" important in "retail cases" (quoting bankruptcy court)).

<sup>106</sup> Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 AM. BANK. L. J. 509, 539-41 (2000)

more scrutiny.<sup>107</sup> Even if these costs are much greater than the expected savings from recontracting with the CEO, this does not necessarily mean that this is the profit maximizing strategy. There is a complicated tradeoff (with no obvious or generalizable solution) between getting the right CEO and getting that CEO properly incentivized versus getting out quickly. For example, while shortening the duration of the reorganization might reduce cash and other costs, it is possible that the shortened time to make decisions will lead to inferior ones, resulting in overall higher total costs in the long run. Creditors also want to maximize the value of the firm upon their exit, be it sooner or later, and would be unlikely to approve employment agreements that are poorly designed or that would not give key managers strong incentives to maximize firm value.<sup>108</sup>

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

A fourth pro-management factor is the fact that potential outside replacements would demand higher compensation levels than current management (all else being equal), to compensate for the increased risk from joining a failing firm. Consider a simple example: if the going rate for an CEO is \$100,000, but outsiders would demand a 20 percent premium to compensate for the increased risk from running a bankrupt firm, the existing CEO could demand an increase up to something less than \$120,000 and still reduce the debtor's overall costs.<sup>109</sup> While this may seem reasonable in light of the extra risk and stress being borne by the CEO, it is possible that the CEO is being paid in excess of her worth, since the labor market may value her less than outsiders due to the taint of being affiliated with a failing enterprise.<sup>110</sup> Given the CEO's poor performance, whether or not it can be deemed her "fault," the firm should be able to pay her less, but the costs of the next best alternative are so much higher that the CEO is actually in a stronger negotiating position. This is also true for insiders who might be promoted to CEO, who would face the same labor market dynamics.<sup>111</sup> Again, however, the data do not support this as a powerful factor in compensation negotiations. As discussed below, most CEOs are replaced

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<sup>107</sup> Cynthia Baker argues that professional fees are excessive in Chapter 11 because the debtor doesn't pay professional fees, but rather the "last class of creditors or shareholders still 'in the money.'" Cynthia Baker, *Fixing What's Broken: A Proposal for Reform of the Compensation System in Bankruptcy*, 5 J. BANK. L. & PRAC. 435, 442-3 (1996).

<sup>108</sup> This should not depend on a creditor's investment horizon, since even vulture investors looking to sell quickly for a profit – know as "migratory birds" – have incentives to write contracts that maximize firm value. Of course, long-term investors – known as "nest builders" – have the proper incentives. See ROSENBERG, *supra* note 60, at 29.

<sup>109</sup> The reservation wage for outside replacement may also be higher because the pool of potential candidates capable of rescuing a reorganizing firm – a Chief Restructuring Officer, for example – is shallow, thus driving up the market price for such talent.

<sup>110</sup> This may not necessarily be the case, since some employers may value the experience gained while working for a financially distressed firm. See Joann S. Lublin, *Ailing Employers Offer Marketable Experiences, But Beware Pitfalls*, WALL ST. J., Nov. 9, 2004, at B1.

<sup>111</sup> These conclusions are supported by the data from Gilson and Vetsuypens, who found that outside replacements were paid 36 percent more than the managers they replaced, and that insiders who replaced the CEO were paid 35 percent less. See Gilson & Vetsuypens, *supra* note 7, at \_\_\_.

in firms under financial distress and over 70 percent of CEO replacements are from outside the debtor,<sup>112</sup> suggesting that this is not a substantial factor in most cases.

## 2. *Creditor power*

On the other hand several factors severely limit the bargaining power of incumbent managers. The most obvious limitation is the fact that the CEO will be viewed as bearing some responsibility for the firm's poor performance, which will undermine any case for a lucrative compensation package. Not only does this depreciation of the CEO's human capital impact her bargaining position vis-à-vis her current employer, but it does so with respect to other employers as well, therefore reducing the risk that the CEO will leave the firm.<sup>113</sup> This is, as we will see, also borne out by the data, with inside CEOs making considerably less than outside replacements.<sup>114</sup>

In addition, firms have strategic and political incentives to bring in new management. Firing existing management can send a strong signal to creditors, the market, and competitors that the firm takes the reorganization process seriously and that the firm is confident about emerging as a vibrant entity. Signaling with compensation is observed in firms conducting an IPO, where the firm often forces risk-averse managers to accept contingent compensation as a sign of confidence in the firm's prospects.<sup>115</sup> Firms in Chapter 11 engage in similar strategies, increasing the use of contingent contracts (emergence is in a sense like an IPO) and reducing certain compensation amounts to show constraint/monitoring of agency costs/problems. Consistent with this signaling theory, we see firms looking more to outsiders as replacements for CEOs, with about 70 percent of replacements coming from outside the firm.

Large CEO paydays in bankruptcy also generate what Bebchuk and Fried call "outrage costs," which should reduce CEO bargaining power. They predict that "[t]he more outrage a compensation arrangement is expected to generate, the more reluctant directors will be to approve it, and the more hesitant managers will be to propose it in the first instance."<sup>116</sup> Bankruptcy raises outrage costs substantially because of the frequency of job cuts by the debtor juxtaposed with wealthy executives occasionally receiving lucrative retention bonuses, all being done under the increased press scrutiny a bankruptcy filing brings.<sup>117</sup> There are, for example, frequent press reports calling CEO pay in bankrupt firms "malodorous,"<sup>118</sup> and "blackmail,"<sup>119</sup>

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<sup>112</sup> The percent of outside replacements in all firms was 25 percent during the past 10 years. See Kevin J. Murphy & Jan Zabojsnik, "Managerial Capital and the Market for CEOs," USC Working Paper, Oct. 2003.

<sup>113</sup> Although some recent research suggests that CEOs are unfairly scapegoated for poor firm performance, see N. Khanna & A. Poulsen, *Managers of Financially Distressed Firms: Villains or Scapegoats?*, 50 J. FIN. 919, 929 (1995), this threat reduces the value of an existing CEO, and thus the CEO's bargaining power.

<sup>114</sup> See Gilson & Vetsuypens, *supra* note 7, at 426.

<sup>115</sup> Randolph P. Beatty & Edward J. Zajac, *Managerial Incentives, Monitoring, and Risk Bearing: A Study of Executive Compensation, Ownership, and Board Structure in Initial Public Offerings*, 39 ADMIN. SCI. Q. 313, 332 (1994).

<sup>116</sup> Lucian Arye Bebchuk & Jesse M. Fried, *Stealth Compensation via Retirement Benefits*, 1 BERKELEY BUS. L.J. 291, 294 (2004).

<sup>117</sup> For a colorful, if somewhat overstated, description of the outrage constraint, see Paul Krugman, Editorial, *The Outrage Constraint*, WALL ST. J., Aug. 23, 2002, at A17.

<sup>118</sup> *Eagle-Picher Executives Prosper at Troubled Firm*, USA TODAY, May 14, 1991, at 2B.

for these reasons.<sup>120</sup> So the outrage theory would predict that CEOs of firms in financial distress would, as a result of increasing outrage costs, face substantial reductions or realignments of their compensation or would engage in extraordinary attempts to hide the true nature/cost of their compensation. This claim is tested more fully below, but a recent example is illustrative. In its recent financial distress, Delta Airlines faced a barrage of negative news stories about the pay of its CEO, Leo Mullin. Delta proposed paying Mullin over \$2 million per year, while the firm was asking for asking its unions for substantial wage concessions. The public and internal outrage was overwhelming, however, so Mullin agreed to waive his bonuses for two years and to give up stock awards “potentially worth millions.”<sup>121</sup>

CEOs may also have strong incentives to stay with their current employer because of the value of their employment agreements are tied to the firm. As discussed above, all elements of the CEO’s compensation – salary, bonus, unvested options or stock, retirement benefits – are executory contracts that the firm can accept or reject. Deferred compensation, which is typically substantial,<sup>122</sup> is also at risk. The acts of the debtor in the reorganization of Burlington Industries is typical – the firm cancelled nearly all existing compensation arrangements with top management as “unfunded . . . executory contracts,” making all payments on owed amounts contingent on the employee remaining with the firm through the end of the reorganization.<sup>123</sup> This threat encourages renegotiation and loyalty.

Management’s bargaining position is also constrained by the ability of creditors to readily oust them. While shareholders theoretically have the power to throw out incompetent managers, this is very rarely done in practice. Creditors, however, often contract for very specific rights to replace managers if certain contingencies come to pass. Creditors also have the power to appoint trustee to replace incumbent managers under § 1104(a) of the Bankruptcy Code. While this happens in only a handful of big cases each year, it remains a “powerful leverage device” because the risks to incumbent managers are so great.<sup>124</sup> The bankruptcy court also has the authority, on the motion of a party in interest, to appoint an examiner to investigate management’s past practices.<sup>125</sup> The risk of an audit, while also quite rare, also constrains managerial overreaching because the potential downside for managers is so great.

Creditors also have the power to oppose management’s reorganization plan, either by withholding their votes in favor or by actively campaigning/litigating against it, and this gives them leverage over any decisions. Creditors “can conduct embarrassing discovery, expose the

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<sup>119</sup> *Chapter 11: Bankruptcy Can Mean Bonus*, BLOOMBERG BUS. NEWS, Mar. 1, 1996.

<sup>120</sup> AT&T announced 40,000 layoffs while CEO paid nearly \$20 million Irwin M. Stelzer, *Are CEOs Overpaid?*, 126 PUB. INTEREST 26, 27 (1997); General Dynamics paid CEO about \$10 million per year while cutting almost 75,000 jobs over three years. MARGARET M. BLAIR, *OWNERSHIP AND CONTROL* 9 (1995).

<sup>121</sup> See, e.g., Dan Reed, *American’s Exec Pay Enrages Labor*, USA TODAY, Friday, Apr. 18, 2003, at 1B; Russell Grantham, *More Cuts for Delta Execs Pension Funding, Bonuses Stopped*, THE ATLANTA JOURNAL-CONSTITUTION, Aug. 12, 2003, at A1.

<sup>122</sup> John C. Coffee, *supra* note 29, at 1333 (describing implicit contracts whereby employees defer “a considerable portion of the managers’ expected aggregate compensation until the end of their careers.”).

<sup>123</sup> See “Item 1. Business — Proceedings Under Chapter 11 of the Bankruptcy Code,” Burlington 10-K (Sept. 29, 2001), available at <http://www.secinfo.com/dV5Ff.4fjW9.htm#6jq>.

<sup>124</sup> See LoPucki & Whitford, *supra* note 8, at 701.

<sup>125</sup> 11 U.S.C. § 1104(b)(2) (2006).

efforts of management or other parties to the reorganization to serve their self-interest, draw out negotiations over the plan, and inject uncertainty into the confirmation process.”<sup>126</sup> Creditors also use their power as a lender of last resort to influence compensation negotiations. Banks can refuse to loan the debtor essential funds to operate during reorganization or, as described above, agree to loan money only if certain conditions with respect to personnel or contracts are met.<sup>127</sup> A related factor is the fact that debtors face cash constraints that may make them less able to pay rich compensation packages to management. If managers have limited exit options, firms can argue to management that the lack of cash limits the amount they can pay.<sup>128</sup>

## B. *Monitoring and Recontracting in Chapter 11*

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

### 1. *Creditors as monitors*

Creditors committees are almost always involved in negotiating employment agreements for existing or new management. While the debtor is technically responsible for drafting the agreement and obtaining court approval, “the creditors’ committee’s fingerprints are [usually] all over the proposal” since it is “typically prenegotiated with the committee.”<sup>129</sup> Creditor involvement in negotiating employment contracts begins in earnest when the debtor files for Chapter 11. At that time there is a clear choice for the debtor and the creditors – adopt management employment agreements as is or rip them up and start fresh. In nearly every case in this study, the debtor chose to renegotiate the terms under which the CEO was employed. While most employees are maintained at pre-petition levels of salary under first-day orders approved by the bankruptcy court, the CEO’s employment contract typically waits until later. While occasionally the negotiations begin pre-petition, in the vast majority of cases the debtor and the creditors do not reach agreement on the terms of the CEO’s employment during and after the reorganization until several months after the filing date. This is perhaps because, as shown in section V below, most CEOs are replaced in and around bankruptcy, and creditors are often engaged in a parallel search for a new CEO. In the meantime, vulture investors or bank creditors often bring in turnaround specialists to manage the debtor.<sup>130</sup> These managers are compensated as a priority administrative expense under § 327, which allows the firm to have compensated and incentivized management in place while negotiations with the new or current CEO are ongoing. In addition, the existing CEO is unlikely to quit the firm in the absence of an employment

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<sup>126</sup> LoPucki & Whitford, *supra* note 8, at 706.

<sup>127</sup> *Id.* at 703.

<sup>128</sup> In practice, this may have the result of merely shifting from cash forms of payment (like salary and bonuses) to noncash forms (like options and deferred compensation).

<sup>129</sup> Skeel, *supra* note 65, at 929.

<sup>130</sup> For example, J.C. Penny hired Allen Questrom, a 40-year retail veteran and “turnaround king,” to manage its restructuring process. When the turnaround was complete, J.C. Penny hired a new CEO to lead the newly reorganized firm. See Teri Agins & Ann Zimmerman, *J.C. Penny Names Ullman New CEO, In Early Decision*, WALL ST. J. Oct. 28, 2004, at B8.

contract, given the wealth (in the form of stock options, deferred compensation, and retirement benefits) tied up in the firm, not to mention the reputation effects, which are likely to be increasingly important for the CEO. Finally, as we will see, negotiations over CEO pay can often be quite contentious, and the creditors committee may want to postpone a row over pay in order to build harmonious relations with the debtor so as to better influence management's reorganization plan. Therefore, negotiations are often put on the back burner until negotiations about the general scope of the plan are well along.

Starting from scratch, either with a new candidate or the existing CEO, creditors are deeply involved in the pay setting process. According to compensation experts, creditors will "scrutinize any retention package . . . and are likely to reject packages that seem excessive."<sup>131</sup> As a member of the unsecured creditors committee in the reorganization of Key3Media Group, Inc. said recently, "I'm going to be looking very carefully at anything they're going to pay any of these guys."<sup>132</sup> This creditor involvement takes many observable forms.

First, creditors frequently file formal objections to the debtor's pay plans with the bankruptcy court, thus using the threat of litigation as a bargaining tactic. While judicial review is generally ineffective as a constraint on executive compensation in healthy firms, as shown below, in bankruptcy judicial oversight is often an effective tool for reducing or changing executive pay. In addition to actually reviewing compensation packages, courts also serve as a threat that motivates the creditors and the debtor to negotiate at arm's-length. To cite a few of many examples, in the reorganization of Drexel the creditors' committee complained about a proposed pay plan, causing Drexel to reduce proposed compensation by about 50 percent.<sup>133</sup> Creditors also objected to executive compensation agreements for top management proposed by debtor World Kitchen, Inc., causing the debtor to withdraw the proposal and the CEO to quit.<sup>134</sup> The committee in the reorganization of FAO Schwartz filed papers with the court noting that it was working with the debtor to create a compensation scheme "that is better tailored to the Debtor's current circumstances."<sup>135</sup> According to investors involved in this case, this was because the parties were afraid of potential litigation, and wanted to prepare an acceptable set of compensation packages that would expedite court approval.<sup>136</sup> A similar objection was made by creditors in the ongoing reorganization of Owens Corning, where a multi-million dollar bonus plan for top executives was proposed by the debtor.<sup>137</sup>

The second type of creditor involvement is direct negotiations with the debtor. There are two causes of these negotiations. The first is the threat of judicial review discussed above.

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<sup>131</sup> Mike Groenendaal & Ryan Harvey, *How People Issues Can Shape Bankruptcy*, FIN. EXEC., Dec. 1, 2003, at 59.

<sup>132</sup> Michael Hiltzik, *Key3 Execs Irrepressible But Not Irreplaceable*, L.A. TIMES, Feb. 27, 2003, at 1 (comments of Jordan Teramo of Mackay Shields, a member of the unsecured creditors committee).

<sup>133</sup> See Wade Lambert & Ellen Joan Pollock, *Drexel Slashes Executive Pay Proposal*, WALL ST. J., Apr. 23, 1991, at B16.

<sup>134</sup> See Matt Miller, *When failure pays*, THE DAILY DEAL, Feb. 27, 2003.

<sup>135</sup> Peg Brickley, *FAO Faces Challenge Over Bonuses for Execs*, AP DATASTREAM, Jan. 30, 2004 (quoting filing of creditors' committee).

<sup>136</sup> Confidential interview with author on September 12, 2004.

<sup>137</sup> Charles Sheehan, *Owens Corning Creditors Say Executive Pay Plan Lacks Incentive to End Chapter 11*, AP DATASTREAM, Sept. 8, 2004.

Creditor approval is not a necessary precondition for judicial approval of executive pay packages, but courts often cite such approval as important evidence of the fairness and propriety of the packages in question.<sup>138</sup> This provides strong incentives for the debtor to seek the imprimatur of the various committees before submitting pay packages to the court for approval. The other driver of negotiations is the power creditors have over the reorganization process itself. Creditors, either large holders acting alone or smaller holders working in confederation through the committee process, are frequently able to have an effective veto over approval of any reorganization plan, which gives them substantial bargaining power over key management decisions, including compensating top managers. As one observer noted about modern reorganization practice, “[c]reditor lawyers are questioning pay packages, and, in some cases, they refuse to move reorganization plans forward until executive retention agreements are settled.”<sup>139</sup> These challenges can often be quite effective, as in the recent case of Peregrine Systems, where a “challenge by the creditors’ committee kept [the debtor] from realizing all of its retention and bonus payment goals.”<sup>140</sup>

Another form of creditor involvement in compensation decisions is through the board of directors. The influence on boards is both direct and indirect. Creditors often take board seats in the reorganized entity, which gives them power over compensation during and after Chapter 11. For example, in the reorganization of Bruno’s, Inc., the largest creditors – a bank syndicate – had the authority to appoint all three directors of the reconstituted board of directors.<sup>141</sup> Creditors took control of the board or at least some seats in most of the firms in the dataset, including: Chiquita, where the “bondholders [got to] elect five members of a seven-member board and the chairman”; Edison Brothers, where representatives from two creditors took board seats; and Conesco, where the reorganization plan “eliminate[d] the current board and replace[d] it with a seven-member panel controlled by the creditors.”<sup>142</sup> Board changes are achieved formally through contract, in the reorganization plan, or by rewriting the debtor’s charter or by-laws to permit, or even require, creditors to nominate directors to stand for office. For example, in the ongoing reorganization of USAir, the largest creditor, the Retirement System of Alabama, bargained for 7 seats on a 12-member board as part of a deal providing the debtor with a cash infusion.<sup>143</sup> Directors are also sometimes replaced as a result of informal negotiations between creditors and the debtor that are not memorialized in a written agreement, or even by threats to marginalize or fire the director after the creditor gains control of the firm.<sup>144</sup>

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<sup>138</sup> See, e.g., *Caldor Receives Court Approval for Employee Retention Program*, BUS. WIRE, Mar. 27, 1996 (“Caldor’s performance retention program, as approved by the court, has the full support of the company’s Creditors Committee, Bank Committee, and Equity Committee.”).

<sup>139</sup> Matt Miller, *When Failure Pays*, THE DAILY DEAL, Thur., Feb. 27, 2003.

<sup>140</sup> *Software Company Fails to Secure Some Retention Bonuses*, BCD NEWS AND COMMENT, Nov. 8, 2002.

<sup>141</sup> See *In Re Bruno’s Inc.*, Chapter 11 Case Nos. 98-212 through 98-223 (Bankr. D.Del. 1999) (*Debtors’ Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code as Modified December 10, 1999*).

<sup>142</sup> See, e.g., Ken Stammen, *Chiquita Brands Files for Chap. 11*, CIN. POST, Nov. 28, 2001, at 1A; *Edison Brothers Names New Board: Directors to Take Seats Following Emergence From Chapter 11*, PR NEWSWIRE, Sept. 9, 1997; Greg Andrews, *Executive Might Get Large Loan Forgiven*, INDIANAPOLIS BUS. J., Apr. 28, 2003, at 3.

<sup>143</sup> See Michelle Maynard, *USAir’s Chief Lender Threatens the Ultimate*, N.Y. TIMES, Dec. 7, 2002, at C1.

<sup>144</sup> Skeel, *supra* note 65, at 931.

Indirectly, creditors can influence the board in the same way that the managerial power theorists allege CEOs dominate the boards of healthy firms. When firms file to reorganize under Chapter 11 or are otherwise in the “zone” or “vicinity” of insolvency, the fiduciary duties of the board unquestionably switch from shareholders to creditors, with the concomitant obligation to maximize the estate of the debtor for their benefit.<sup>145</sup> While one might think that CEO domination of the directors would continue unabated regardless of this theoretical, legal change, there is reason to believe that boards’ allegiances do change and they are able to overcome any supposed capture by the CEO. This is because, as discussed above, creditors play a more active role in monitoring the firm than shareholders in healthy firms. This includes actively communicating with the board on key matters, including personnel issues. This jawboning can be quite effective, given creditors powerful position in the reorganization process and directors’ changing loyalties.<sup>146</sup> Creditors can also oust directors or promise (implicitly or explicitly) rewards or punishment of various kinds. In other words, creditors in this situation have precisely the same power and influence as the CEOs in healthy firms that managerial power scholars find objectionable.

## 2. *Directors as monitors*

The enhanced monitoring role of directors in these cases is not simply derivative of the power of creditors. Directors of financially distressed firms have greater incentives to monitor compensation practices as firm performance deteriorates and the firm approaches insolvency, even without creditor jawboning or influence. In healthy firms, directors are nearly always shielded from personal liability for bad decisions by a hierarchy of protections: the presumption of good faith found in the business judgment rule, the waiver of liability – a form of self-insurance – found in nearly all corporate charters, and finally indemnification and third-party insurance policies taken out by the firm to reimburse directors found liable for all expenses, fines, and fees. A recent study by Black, Cheffins, and Klausner, found that this litany of protections effectively eliminates any risk of out-of-pocket liability for even terrible directors.<sup>147</sup> In bankruptcy, however, these protections are much less effective at protecting directors, if at all. Therefore, directors are bound to be more conscientious and diligent, especially regarding issues of CEO compensation where there is obvious risk of self-dealing.

As mentioned above, director loyalty begins to shift from shareholders to creditors as the firm enters the “vicinity of insolvency.” This change has profound affects on the standards of review courts use to evaluate potential director liability, and thus can be expected to have real impact on director behavior and monitoring incentives. The most obvious example is the applicability of the business judgment rule. If directors are given the shield of the business judgment rule, decisions approving executive compensation agreements will be respected absent

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<sup>145</sup> See footnote 63 and accompanying text.

<sup>146</sup> For the power of jawboning in another, related context, see Andrei Schleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 472-74 (1986).

<sup>147</sup> See Bernard S. Black, et al., *Outside Director Liability* (Stanford Law and Economics Olin Working Paper No. 250, 2003), available at <http://ssrn.com/abstract=382422>. While this remains true in nearly all cases, the recent settlement of a securities action against WorldCom’s former directors may be a watershed event. See Gretchen Morgenson, *10 Ex-directors from WorldCom to Pay Millions*, N.Y. TIMES, Jan. 6, 2005 at A1.

a breach of their fiduciary duties of good faith, loyalty, and due care.<sup>148</sup> In other words, absent self-dealing, director decisions on how much and how to pay a CEO will be protected from judicial inquiry and potential liability.

It is not clear, however, whether the business judgment rule applies to shield director decisions in the “zone of insolvency” in the same way that it does for healthy firms. Courts are split on whether the business judgment rule applies at all for director actions in financially distressed firms. While some courts have held that the standards of review of director action are the same in and out of bankruptcy,<sup>149</sup> other courts consider directors de facto trustees for the creditors, and apply a higher standard of scrutiny to their actions.<sup>150</sup> In addition, those courts that do apply the business judgment rule limit it to certain types of decisions or modify it to meet the particular circumstances of the case.<sup>151</sup> For example, courts reviewing director action regarding extraordinary transactions (such as approval of break-up fees) occasionally refuse to give the directors the benefit of the business judgment rule, or apply a modified, more stringent standard.<sup>152</sup> While executive compensation decisions would normally be considered in the “ordinary course of business,” this might not be the case for extraordinary retention or emergence bonuses or new employment contracts. In addition, courts sometimes scrutinize pay packages under a modified business judgment standard since the obvious final period problems for executives present opportunities for self-dealing at the expense of shareholders and creditors. Given the heightened scrutiny of bankruptcy, practitioners recommend “directors and officers of an insolvent or near-insolvent corporation should proceed with corporate decisions on the assumption that the business judgment rule will not apply . . . .”<sup>153</sup>

Directors have reason to be more active monitors even when the business judgment rule applies, however, because courts are willing to strip directors of its protections more freely in cases where the firm is in financial distress. The recent case of *Pereira v. Cogan* is illustrative. In *Pereira*, the CEO, who was also controlling shareholder, awarded himself a huge compensation package as the firm headed toward liquidation under Chapter 7. The board approved the disbursements in perfunctory fashion, without detailed analysis and often relying on reports from others. When deciding whether to apply the business judgment rule, the court examined the process followed by the directors, as well as the substance of their decisions. This type of peeking under the covers is already a more searching review of director actions than courts

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<sup>148</sup> See *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345, 361 (Del. 1993). If any of these are shown, the burden shifts to the directors to show the “entire fairness” of the compensation package, including both a fair price and a fair process. See *Solomon v. Armstrong*, 747 A.2d 1098, 1112 (Del. Ch. 1999).

<sup>149</sup> See, e.g., *Angelo Gordon & Co., L.P. v. Allied Riser Comm. Corp.*, 805 A.2d 221, 229 (Del. Ch. 2002).

<sup>150</sup> See, e.g., *Geren v. Quantum Chem. Corp.*, 99 F.3d 401 (Table), 1995 WL 737512 (2nd Cir. Dec. 13, 1995) (“Under New York law, directors of a corporation may become trustees of the creditors when the corporation is insolvent.”); see also *Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348, 354 (N.D. Tex. 1996); *Miramar Res., Inc. v. Schultz*, 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997)

<sup>151</sup> See, e.g., *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 523 (1984) (business judgment rule used when reviewing director decisions to accept or reject executory contracts).

<sup>152</sup> See *In re S.N.A. Nut Co.*, 186 B.R. 98 (Bankr. N.D. Ill. 1995).

<sup>153</sup> See Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations that are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COM. L.J. 295, 304 (2004).

usually apply.<sup>154</sup> Ultimately, the court refused to defer to the business judgment of the directors, finding that it did not decide on many of the compensation issues (and hence there were no decisions to defer to) and that the decisions it did make were so procedurally deficient as not to warrant deference.<sup>155</sup> The directors were found personally liable for about \$10 million. The lesson from this line of cases for directors is that courts' hands-off attitude for most corporate decisions doesn't necessarily obtain in bankruptcy, and that bad decisions can result in personal liability.

To make matters worse, directors cannot necessarily avoid this personal liability with standard exculpatory provisions designed to limit director liability. The articles of incorporation of nearly all publicly traded firms eliminate director liability for duty of care violations, as permitted by statutes in most states.<sup>156</sup> These exculpatory provisions are the second line of defense for directors in case the shield of the business judgment rule is pierced. But courts do not always enforce exculpatory agreements against creditors in bankruptcy.<sup>157</sup> The stated reason is that these provisions are contractual bargains between shareholders and directors to which the firm's creditors are not a party, and therefore cannot be bound.<sup>158</sup> In addition, these provisions typically address only claims brought on behalf of shareholders or the corporation itself, and do not mention potential liability to creditors.<sup>159</sup> Whether or not this logic is sensible,<sup>160</sup> the fact that courts limit the reach of these exculpatory provisions in bankruptcy gives directors extra incentive to monitor CEO compensation more closely in these cases.

The lack of firm self-insurance through exculpatory provisions is exacerbated by the potential failure of the last line of director defense – third-party insurance that would pay any liabilities if directors were found liable. As with exculpatory provisions, nearly all large, publicly held firms purchase insurance for the legal liabilities of directors and officers while serving in a corporate capacity (“D&O” insurance). These policies, which are authorized by state statutes,<sup>161</sup> typically reimburse directors for all out-of-pocket expenses, including legal fees and money judgments. These insurance policies are a powerful disincentive to aggressive oversight by directors, since they lower the cost to directors from poor performance. The D&O insurance shield, however, may be nonexistent or limited in cases involving bankrupt or near insolvent firms. Depending on the type of insurance and the particular circumstances of the case, “a

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<sup>154</sup> For a discussion of whether the business judgment rule is a doctrine of substance or abstention, see STEPHEN BAINBRIDGE, CORPORATION LAW AND ECONOMICS 45 (2003).

<sup>155</sup> See *Pereira v. Cogan*, 294 B.R. 449, 500 (S.D.N.Y. 2003).

<sup>156</sup> See, e.g., DGCL § 102(b)(7); MBCA § 2.02(b)(4).

<sup>157</sup> See, e.g., *Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, No. 97 C. 7934, 97 C. 6043, 2000 WL 28266 (N.D. Ill. Jan. 11, 2000) (exculpatory clause does not preclude bankruptcy trustee from proceeding against directors); *Pereira v. Cogan*, 294 B.R. 449, 534 (S.D.N.Y. 2003).

<sup>158</sup> *In re Ben Franklin*, 2000 WL 28266 at \*8 (N.D. Ill. 2000).

<sup>159</sup> *Id.*

<sup>160</sup> The argument that these provisions should run only to shareholder claims (either directly or derivatively) does not hold water, since the firm's charter, and thus the terms of the bargain, will be known to subsequent creditors that loan the firm money.

<sup>161</sup> See, e.g., DEL. CODE ANN. tit. 8, § 145(g) (“A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation . . .”).

corporation's bankruptcy may change the degree to which, or even whether, certain D&O insurance policies will cover directors and officers of a financially distressed company."<sup>162</sup>

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

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A final note about director monitoring is worth mentioning. The managerial power critics claim that directors (at least in healthy firms) are ineffective monitors of executive compensation because (1) they spend "little time" focusing on the issue and (2) they "do not have the knowledge and expertise that is needed to properly evaluate the compensation arrangements they are asked to approve."<sup>163</sup> The claim is that directors are largely ignorant about the details of the compensation packages they approve. According to Yale business school professor Jeffrey Sonnenfeld:

I know that a lot of time board members don't understand the complexity of the documents they're reviewing. People don't want to look foolish by asking how some of the instruments work.<sup>164</sup>

While this claim strains credibility in healthy firms,<sup>165</sup> it is especially unlikely in firms in financial distress. As we've seen, the largest creditors often replace the existing directors with their own representatives. These new directors are routinely senior executives in the investment firm who serve or have served as directors for other distressed firms, have unmatched financial savvy, and are betting their own money on the success of the debtor.<sup>166</sup> These new directors are not susceptible to either criticisms about time or knowledge. Moreover, even if they are only a minority on the board, there are likely to have an influence on the board decision making because of the time and understanding they will bring to board meetings.<sup>167</sup>

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<sup>162</sup> See Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations that are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COM. L.J. 295, 330 (2004).

<sup>163</sup> BEBCHUK & FRIED, *supra* note 2, at 44-45.

<sup>164</sup> *Id.* at 45.

<sup>165</sup> As Ken Langone recently wrote regarding the flap over Richard Grasso's pay at the NYSE, "[I]t is absurd to suggest that the [directors, some of the] brightest minds and keenest thinkers on Wall Street [were] befuddled by the complexity of Richard Grasso's compensation package – especially one composed just like their own." Kenneth Langone, *Let's Bring on the Jury, Mr. Spitzer*, WALL ST. J., June 10, 2004, at A12.

<sup>166</sup> For example, four members of the buyout firm Kohlberg Kravis Roberts & Co. were elected to serve on the board of debtor Borden Chemical. See Borden Chemical 2003 10-K.

<sup>167</sup> See CASS R. SUNSTEIN, *WHY SOCIETIES NEED DISSENT* 37 (2004).

Even when directors are not replaced by representatives of large creditors, the criticisms about time and knowledge are not persuasive in the bankruptcy context. As mentioned above, director attention is more focused in bankruptcy because of increased oversight of their actions (by creditors, the media, the courts) and the threat of liability for bad decisions. This solves (at least) the problem of inattention. As for lack of knowledge, bankruptcy raises the saliency of compensation issues, which is a spur to information on executive pay being provided. Compensation decisions are very important in bankruptcy, and as such are often made by full board instead of being delegated to compensation committee.<sup>168</sup> Directors demand data and information on executive pay to avoid criticisms and potential legal liability, while accounting firms and other compensation consultants actively provide a ready supply of information, including assessments of various pay strategies, comparisons between types of options and other pay mechanisms, design and operation of KERPs, and overall approach to compensation in bankruptcy. These firms are competing for business based on the quality of the information they provide, and their materials “provide firms with everything one would need to know about the latest thinking on compensation issues.”<sup>169</sup> Directors, especially the members of the compensation committee, thus have access to an abundance of information and strong incentives to educate themselves about compensation issues.

### 3. Judges as Monitors

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

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

Outside the bankruptcy context, judicial review of executive compensation is quite limited because “the size and structure of executive compensation are inherently matters of

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<sup>168</sup> See, e.g., American Banknote, Form 10-K/A, Dec. 31, 2003 (“The Parent did not have a Compensation Committee subsequent to the filing of a petition for reorganization relief under Chapter 11 of the United States Bankruptcy Code, on December 8, 1999. Subsequent to the confirmation of the Plan and prior to April 2001, compensation agreements and plans subject to Compensation Committee action were instead addressed by the full Board of Directors.”); see also SLI Inc. Proxy May 22, 2002 (“Due to the Company’s financial conditions . . . the [entire] Board of Directors . . . reviewed the compensation arrangements of its executive officers including the Company’s Chief Executive Officer.”).

<sup>169</sup> Interview with manager at New York vulture investor conducted by author on June 2, 2004.

judgment,” entitled to “great deference” by courts.<sup>170</sup> While some cases exist in which courts have invalidated compensation agreements,<sup>171</sup> judicial review is not a meaningful constraint on negotiations outside of the Chapter 11 context.

Courts exert much more power over compensation decisions for bankrupt firms. In fact, under Chapter X of the pre-1978 Bankruptcy Act, prior court approval was required for all executive compensation contracts.<sup>172</sup> The logic behind requiring prior court approval of compensation was “so that the retention of the debtor’s officers will be based on their actual worth and not on their desire to perpetuate their tenure or control at the expense of the . . . creditors and stockholders.”<sup>173</sup> In a notable, pre-1978 Act case, the court rejected specific elements of an officer’s employment contract with the debtor on the ground that prior court approval was not granted, and this was required by § 191 “to safeguard the administration of the debtor’s property in the custody of the court.”<sup>174</sup>

The new Bankruptcy Code rejected this paternalistic approach to compensation as part of a broader policy change away from court control and toward court supervision. The grounds for this reform sounded largely in matters of institutional competency, preservation of judicial resources, and the benefits of private resolution of business decisions.<sup>175</sup> Despite the fairly clear congressional intent to get judges out of the day-to-day business of running bankrupt firms, courts nevertheless continue to review compensation levels much as they had under the pre-1978 Act. While the new Code does not explicitly and unambiguously grant judges the power to approve or change management compensation, most courts find the authority to do so in a grab bag of code provisions. For example, many courts interpret § 327 (as well as §§ 328 and 330), which authorizes the court to approve compensation of “professional persons,” like lawyers, bankers, and accountants, to allow similar review of executive compensation.<sup>176</sup> It seems clear that this provision applies to third party specialists and not officers of the debtor, but some courts use it as a hook to increase their supervisory role. Recognizing this reasoning strains the language and structure of the new Code, one court explained, although “the Code contains no provision analogous to § 191 of the Act, . . . the substance of that section has arguably been incorporated in . . . § 327(a)” of the Code.<sup>177</sup> Courts not relying on § 327 nevertheless find the requisite power in the Code’s general provisions allowing courts to enter any order “necessary or appropriate to

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<sup>170</sup> *Brehm v. Eisner*, 746 A.2d 244, 262-3 (Del. 2000).

<sup>171</sup> See, e.g., *Kerbs v. Cal. Eastern Airways*, 90 A.2d 652, 656 (1952).

<sup>172</sup> Section 191 of the pre-1978 Code provided in pertinent part that “(a) trustee or debtor in possession may employ officers of the debtor at rates of compensation to be approved by the court.” 11 U.S.C. § 591 (1976) (emphasis added), repealed, Bankruptcy Reform Act of 1978, Pub.L. No. 95-598, tit. IV, § 401(a), 92 Stat. 2549. The Supreme Court affirmed this power in 1963, concluding that bankruptcy courts have the “authority to pass in advance upon the . . . salary of an officer of the Debtor before he assumes or continues in office.” *Wolf v. Weinstein*, 372 U.S. 633, 648 (1963).

<sup>173</sup> 6 *Collier on Bankruptcy* ¶ 8, 14[1] at 1430 (14th ed. 1978).

<sup>174</sup> *In re Lyntex Corp.*, 403 F. Supp. 284, 285 (S.D.N.Y. 1975).

<sup>175</sup> See *In re Curlew Valley Assoc.*, 14 B.R. 506 (Bankr. Utah. 1981).

<sup>176</sup> See, for example, *In re Phoenix Steel Co.*, 110 B.R. 141, 142 (Bankr. D. Del. 1989); *In re Athos Steel & Alum., Inc.*, 69 B.R. 515, 521 (Bankr. E.D. Pa. 1987); *In re Schatz Federal Bearings Co., Inc.*, 17 B.R. 780 (SDNY 1982); *In re Hooper, Goode Realty*, 60 B.R. 328 (SD Cal. 1986).

<sup>177</sup> *In re Zerodec Mega Corp.*, 39 B.R. 932 (Bankr. Pa. 1984).

carry out the provisions” of the Code.<sup>178</sup> These courts take a fairly active role in adjudicating compensation issues.

Many courts under the new Code have exercised the power to reject proposed employment agreements and reduce compensation of the debtor’s employees.<sup>179</sup> As a procedural matter, the typical case is brought by creditors, usually acting through the creditors’ committee. Creditors have standing as a “party in interest,” and their objections are routinely supported by lengthy reports from compensation experts. Alternatively, courts can raise issues about the propriety or fairness of executive compensation *sua sponte*. For example, the court in *In re New York City Shoes, Inc.*, reduced the compensation of the debtor’s CFO, despite the fact that neither the debtor nor the creditors’ committee objected to the form or amount of the compensation.<sup>180</sup>

Courts are split on the question of where to place the burden of proof, a key determinant of the level of review. Some find that employment agreements at pre-petition levels are presumptively valid, although this presumption can be overcome with evidence that the contracts are not in the best interest of the estate.<sup>181</sup> Other courts play a more active role in reducing or changing executive compensation, even when the proposed compensation was the same at pre-petition levels.<sup>182</sup> In general, when extraordinary contracts are proposed to the court for review under a so-called “§ 363(b) proceeding,” courts decide whether “a sound business purpose” justifies the debtor’s compensation plan.<sup>183</sup> This is all much more scrutiny than in healthy firms.

This increased judicial monitoring of compensation is shown in several recent, high-profile reorganizations. In the WorldCom bankruptcy, the court reviewed the compensation of new CEO Michael Capellas, ultimately reducing it by about 25 percent over three years.<sup>184</sup> The judge in that case said the package “raises serious concerns as to whether proposed new management is committed to reform as the nature of this requires.”<sup>185</sup> This is not a recent or occasional phenomenon. Courts have consistently played an active role in supervising compensation packages of top executives. To cite just a few examples, the bankruptcy judge presiding over the reorganization of A.H. Robins Co. reduced compensation of senior officers and directors, lowering the annual salary of the CEO by 20 percent.<sup>186</sup> Likewise, the court in the

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<sup>178</sup> 11 U.S.C. § 105(a) (2006); see *In re New York City Shoes, Inc.*, 89 B.R. 479, 483 (Bankr. E.D. Pa. 1988); *In re Lyon & Reboli, Inc.*, 24 B.R. 152, 153-54 (Bankr. E.D.N.Y. 1982).

<sup>179</sup> See, e.g., *Matter of All Seasons Indus., Inc.*, 121 B.R. 822, 825 (Bankr. N.D. Ind. 1990); *In re New York City Shoes, Inc.*, 89 B.R. 479, 483 (Bankr. E.D. Pa. 1988); *In re State Optical Co., Inc.*, 70 B.R. 82, 83-84 (Bankr. E.D. Pa. 1987); *In re Zerodec Mega Corp.*, 39 B.R. 932, 935 (Bankr. E.D. Pa. 1984).

<sup>180</sup> *In re New York City Shoes*, 89 B.R. 479 (E.D. Pa. 1988).

<sup>181</sup> See, e.g., *In re All Seasons Indus., Inc.*, 121 B.R. 822 (N.D. Ind. 1990).

<sup>182</sup> See, e.g., *In re State Optical Co., Inc.*, 70 B.R. 82 (E.D. Pa. 1987) (reduced compensation by about 15 percent because the size and profitability of the DIP decreased); *In re Zerodec Mega Corp.*, 39 B.R. 932 (E.D. Pa. 1984) (authorized employment of CEO but reduced compensation by over 30 percent upon the objection of two creditors).

<sup>183</sup> *In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 153 (Bankr. D. Del. 1999).

<sup>184</sup> See, for example, Rebecca Blumenstein & Lingling Wei, *WorldCom’s CEO’s Pay is Criticized: Judge Says Compensation May Be Unreasonable with Firm in Chapter 11*, WALL ST. J., Dec. 11, 2002, at B5; Meg Richards, *supra* note 99.

<sup>185</sup> See Matt Miller, *When failure pays*, THE DAILY DEAL, Feb. 27, 2003.

<sup>186</sup> See Morton Mintz, *Judge Limits A.H. Robins Executive Pay*, WASH. POST, Sept. 30, 1986, at \_\_\_; Sonja Steptoe, *A.H. Robins to Cut Top Officers’ Pay, End Some Former Executives’ Consulting*, WALL ST. J., Sept. 15, 1986.

reorganization of Paragon Trade Brands, Inc., approved a broad-based “key employee retention plan,” but rejected a compensation and bonus plan for eight top executives after objections from trade creditors. Courts also have the power to undo agreements. The court supervising the reorganization of Coram Healthcare, Inc., rejected a transition employment agreement entered into with creditors, and authorized the Chapter 11 trustee to seek reimbursement from the CEO.<sup>187</sup>

In addition to formal review, bankruptcy judges exercise indirect influence over executive compensation. This power, and willingness to use it, reinforces the negotiations among creditors and the debtor by evening out any bargaining asymmetries between management on the one side and directors and/or creditors on the other side. For example, in the bankruptcy of failed retailer Caldor, the judge objected to a proposed management compensation plan, noting that the plan would “reward emergence for emergence’s sake” without considering the health of the firm after emergence. Although the judge did not rule on the plan, Caldor renegotiated a more acceptable bonus plan with shareholders and creditors.<sup>188</sup> Another example was in case of C.R. Anthony Co. where the judge expressed significant concern about approving a compensation package for the CEO that would reward him for mismanaging the company.<sup>189</sup> Likewise, the judge overseeing reorganization of Peregrine Systems “sent the company back to the drawing board” on requests for some executive compensation.<sup>190</sup>

#### 4. Other Monitors

There are several other constraints on managerial power in Chapter 11 that are worth briefly mentioning. As discussed above, employee activism, often through labor unions or other representatives, raise outrage costs for CEOs in Chapter 11 cases.<sup>191</sup> Labor unions, where active, frequently evaluate and criticize executive compensation plans in Chapter 11. Formal objections have been used in recent airline, steel, and telecommunications bankruptcies.<sup>192</sup> Informal public statements and intrafirm signals also raise outrage costs and focus attention (either of the court or powerful creditors) on executive compensation issues.<sup>193</sup> For example, several employees of debtor Guilford Mills sent a letter to the bankruptcy court “vehemently” opposing a proposed executive retention plan, thus focusing the court’s attention on the plan.<sup>194</sup> These tactics raise the

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<sup>187</sup> Coram Healthcare, Inc. 10-K.

<sup>188</sup> *Chapter 11: Bankruptcy Can Mean Bonus*, *supra* note 119.

<sup>189</sup> See Nancy Raiden Titus, *Anthony's Urges Approval of Plan for Compensation*, THE JOURNAL RECORD, Dec. 12, 1991.

<sup>190</sup> *Software Company Fails to Secure Some Retention Bonuses*, *supra* note 140.

<sup>191</sup> See, e.g., Dan Reed, *American's Exec Pay Enrages Labor*, USA TODAY, Friday, Apr. 18, 2003 (noting that compensation decisions at Delta, Northwest, and Continental airlines “outraged workers and some in Congress,” and describing the outrage of the flight attendants union at retention bonuses for top six executives at American: “the equivalent of an obscene gesture from management to employees.”).

<sup>192</sup> See, e.g., Micheline Maynard, *US Air Asks Court to End Labor Contracts*, NY TIMES, November 13, 2004, at B1, B12; *Contracts Frontline Workers Critical of Adelpia Reorganization*, PR NEWSWIRE, Feb. 11, 2003.

<sup>193</sup> Mike Groenendaal & Ryan Harvey, *How People Issues Can Shape Bankruptcy*, FIN. EXEC. (Dec. 1, 2003) (noting that “employee groups, and some creditors are quick to criticize executive compensation and benefits, based on public information “ and this leads to increased attention on compensation issues).

<sup>194</sup> See, e.g., Eric Heisler, *Guilford Mills Plans Unfold: Proposals for Guilford Mills Bonuses are Modest in Comparison to Those of Burlington Industries*, GREENSBORO NEWS & RECORD, Jul. 13, 2002, at B12.

costs of outrageous executive compensation, and push the parties in the direction of arm’s-length contracting over compensation.

Another constraint is the threat of litigation to recover “excessive” or illegal compensation. Courts have recently allowed cases to proceed against the executives of bankrupt firms on theories of fraudulent conveyance for certain compensation packages.<sup>195</sup> Take the example of a CEO of a corporation who one day before the filing of a bankruptcy petition received payments from the firm totaling over \$50 million for services rendered by him, by his family, by affiliated companies, and for payment of his questionable legal expenses.<sup>196</sup> The potential for abuse in this “final period” is obvious, since the CEO can enrich himself at the expense of the firm and its creditors without reliable recourse if the firm fails.<sup>197</sup> To prevent this, the firm or the bankruptcy trustee can avoid transfers of this type under several sections of the Bankruptcy Code or under state law.<sup>198</sup>

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The traditional view of executive compensation in bankruptcy—that Chapter 11 serves as an anti-takeover device for managers, allowing managers to rent seek at the expense of shareholders and creditors—is no longer true. Chapter 11 now “has a distinctly creditor-oriented cast,” and today’s reorganizations look more like the market for corporate control where creditors provide powerful oversight of managerial conduct and prevent excessive rent seeking.<sup>199</sup> One would therefore expect the data about executive compensation in bankrupt firms to show some evidence of active recontracting by firms and for the results of the recontracting to approximate the contracts one would expect to see result from arm’s-length negotiations. Let us turn now to the data to see if these hypotheses prove to be true.

## V. AN EMPIRICAL LOOK AT COMPENSATION IN FINANCIALLY DISTRESSED FIRMS

### A. *The data*

The data sample for this study consists of 76 large, publicly traded firms that faced severe financial distress during the period 1992 to 2003 – 68 firms filed to reorganize under Chapter 11 while 8 privately restructured their debt.<sup>200</sup> The data about compensation levels, types, and methods is primarily from the EXECUCOMP database, a repository of executive compensation and other data on the largest 1500 publicly traded firms. This database is the accepted standard for research in this area. It is incomplete, however, with respect to firms in Chapter 11 due to the

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<sup>195</sup> Skeel, *supra* note 65, at 943, 946.

<sup>196</sup> These facts are adapted from the case of *In re Sharon Steel Corp.*, 871 F.2d 1217, 1220, n.9 (3d Cir. 1989), where the court found that transfers of this type were fraudulent conveyances, and that justified the appointment of a bankruptcy trustee.

<sup>197</sup> Baird & Rasmussen, *supra* note 6, at 1231 (“[Managers] know that they are in the end game. Final-period problems tend to reduce the efficacy of controls designed to bind managers over the long term. Left unchecked, managers are even more likely to put their interests ahead of those of the company.”).

<sup>198</sup> Skeel, *supra* note 65, at 944 n.88; *see* Uniform Fraudulent Transfer Act, 7A Part II U.L.A. 266 (2003) (in force in 39 states).

<sup>199</sup> Skeel, *supra* note 65, at 918.

<sup>200</sup> The process for identifying firms that privately restructured their debt followed that of Gilson & Vetsuypens, *supra* note 7, at 425. There are undoubtedly more firms that did private workouts over this period, but a conservative identification approach was used to minimize overinclusion problems.

lack of some publicly available information, as well as a change in the way this information is reported for firms in Chapter 11, which leaves some holes in the data. To fill in the holes, the dataset was supplemented with research from a variety of public sources (e.g., proxy statements and 10-Ks filed with the SEC, reorganization plans filed with the bankruptcy court, and press releases and public comments) as well as a series of interviews conducted with lawyers and distressed debt investors that worked on these deals, as well as executives of firms in the sample. These interviews provided raw data, color, insights, and corroboration on the other data sources used.

As shown on Table 1, the 76 financially distressed firms in the data set are small, shrinking, and unprofitable relative to the other firms in the rest of the EXECUCOMP database.

TABLE 1

**Characteristics of financially distressed firms**

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

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

*B. CEO turnover*

Before examining compensation, let us look at CEO turnover, which tells us something about the relative bargaining power of CEOs and firm “owners” in compensation negotiations. The traditional view, as noted above, is that Chapter 11 is an entrenchment mechanism for managers that allows them to stay in power and extract rents from the firm. We have seen

theoretical and anecdotal evidence that this is no longer true, with the new Chapter 11 foreshadowing the replacement of managers and directors. The data bolsters this conclusion, with over 60 percent of CEOs being replaced in the “zone of insolvency.” This turnover rate contrasts sharply with CEO turnover of less than 10 percent in solvent firms.<sup>201</sup> Creditors are clearly exercising their substantial theoretical power outlined above to discipline managers. This threat of replacement also unquestionably constrains managerial overreaching in compensation negotiations in the zone of insolvency.

The turnover rate in this study is also somewhat higher than that of previous work. Gilson and Vetsuypens found a turnover rate of about 30 percent for firms in financial distress during the period 1981 to 1987.<sup>202</sup> The much higher rate for firms in this study (1992-2003) is consistent with the overall thesis that bankruptcy has changed in two fundamental ways: first, the liberalization of the distressed debt market has allowed vulture investors and other creditors to play a much more active role in monitoring and disciplining managers; and second, the nature of firms in financial distress has changed from firms with good management and bad balance sheets to firms with both bad management and bad balance sheets.

Another interesting piece of data is the fact that almost 70 percent of CEO replacements are firm outsiders. This data supports the signaling theory described above, whereby firms replace managers in part because doing so evinces a seriousness about the reorganization process and the firm’s future prospects. It is consistent, although somewhat higher than the data from the 1980s (less than 60 percent outsiders), suggesting weakly that the importance of the informational component of personnel decisions has increased over time.<sup>203</sup>

### C. *Compensation types and methods*

We are now positioned to examine the content of compensation bargains to see what they tell us about agency cost theories. If CEO employment contracts look the same before distress, when agency costs and managerial power are high, as after distress, when, as shown above, they are greatly reduced, this suggests one of two possibilities. First, compensation contracts in healthy firms are “optimal”, meaning that they fairly replicate the results one would expect from arm’s-length bargaining. The second possibility is that the contracts are “efficient”, meaning that they are the best we can expect given the costs, even with an increased role for judges, boards, and investors. There may be many reasons why the contracts written by near-principal agents are not likely to be different from those written by less motivated agents. For example, Jensen and Murphy argue “cultural practice” is a powerful reason why firms do not have provisions that limit CEO rights to unwind incentive contracts.<sup>204</sup> In a similar vein, Randolph Beatty argues that “aspects of top executive compensation . . . in large corporations may often be the result of historical tradition and bureaucratization.”<sup>205</sup> There is substantial evidence that contractual forms

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<sup>201</sup> See Jerold B. Warner et al., *Stock Prices and Top Management Changes*, 20 J. FIN. ECON. 461, 468 (1988); Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431 (1988).

<sup>202</sup> Gilson & Vetsuypens, *supra* note 7, at 441.

<sup>203</sup> *Id.* at 442.

<sup>204</sup> See Jensen & Murphy, *supra* note 37.

<sup>205</sup> Beatty & Zajac, *supra* note 115, at 314; see also George P. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593 (1988).

can be quite sticky, even irrationally so.<sup>206</sup> Additional explanations are also possible, such as inertia and cognitive biases and heuristics of decision makers, be they the board or other owners or stakeholders. Reading dozens of reports from compensation committees, one finds a similarity in language (if not actual text), style, and approach, which suggests some boiler-plate aspects to the work, or at least the reporting of the work. In this sense the form of compensation can be “sticky.” If one believes these are behind the similarity in compensation methodology, however, the proposed solutions to reform allegedly excessive compensation—to increase the power of institutional investors to act as a counterbalance to managerial power—is unlikely to help. If distressed debt investors with strong statutory, judicial, and customary rights cannot overcome managerial power over compensation in this context, then no investors under any conceivable reforms are likely to do so for healthy firms.

### 1. *General contracts*

To test these hypotheses, this section examines the structural content of employment contracts of the firms in this dataset before and after distress.<sup>207</sup> Overall and in general, pre-distress contracts look nearly identical to post-distress contracts, and to contracts in healthy firms that did not experience financial distress.<sup>208</sup> In other words, sophisticated institutional investors with huge stakes in the firm write CEO employment contracts (from scratch!) that look exactly like contracts written by healthy firms with higher agency costs: they have multi-year terms, are automatically renewable, pay a fixed salary, provide for generous performance-based bonuses, use large grants of at-the-money options and restricted stock, allow reloading and repricing of options, and grant lucrative severance/retirement benefits. Let us look at the elements of typical contracts.

*General terms:* The vast majority of healthy firms use multi-year, written contracts to employ their CEOs.<sup>209</sup> The fact that executives can lock in their employment for several years on favorable terms has been criticized by some corporate observers as evidence of excessive managerial power in compensation negotiations.<sup>210</sup> We see, however, that long-term contracts are used in the post-distress period as commonly as they are for healthy firms or in pre-distress periods: about 90 percent of the firms in this study in the pre-distress period. The contracts written by creditors look identical in length and scope to those of healthy firms in the Schwab and Thomas study – these contracts are 2 to 5 years in length and are typically automatically renewable in one-year increments after the initial term expires. This is not to say that contracts

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<sup>206</sup> See, e.g., Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77, 91-92 (venture fund contracts); Ian Ayres & Stewart Schwab, *The Employment Contract*, 8 KAN. J.L. & PUB. POL’Y 71, 85-87.

<sup>207</sup> Contracts or contract terms were taken from SEC filings, reorganization plans filed with bankruptcy courts, other public sources, or parties to the case. In order to create a fair pre-distress “control” group, employment contracts from years well before financial distress (years –6 to –3) were used. The terms of both “before” and “after” contracts were coded in several key areas, including salary, bonuses, equity compensation, long-term retirement, and so on. In addition, post-distress contracts were compared with the set of standard contract terms for healthy firms as described in recent empirical work by Schwab and Thomas. This comparison with firms outside the dataset provides a check to ensure that the pre-distress contracts are representative of compensation contracting at healthy firms generally.

<sup>208</sup> Stewart J. Schwab & Randall S. Thomas, *What Do CEOs Bargain For?: An Empirical Study of Key Legal Components of CEO Employment Contracts*, available at [http://ssrn.com/abstract\\_id=529923](http://ssrn.com/abstract_id=529923).

<sup>209</sup> See *id.* at 5; Bebchuk et al., *supra* note 3, at 765.

<sup>210</sup> Joann S. Lublin, *Many High Executives are Working Without a Net*, WALL. ST. J., Oct. 26, 2004.

before and after are identical. Some renegotiation did take place and some firms did alter the basic contract form in minor ways. For example, debtor American Banknote wrote a new employment contract with the same length as its pre-distress contract, but removed the automatic renewal provision.<sup>211</sup> Other firms changed the length of the term for various reasons, sometimes making it shorter and sometimes longer.<sup>212</sup> Again, we see recontracting and firms writing contracts anew, but little or no change in the terms.

The contracts of healthy firms and pre-distress firms also provide for a fixed salary regardless of performance (with a one-way “up” ratchet), and a discretionary bonus (as a multiple of the employee’s salary), payable only if certain firm performance criteria are met. Rewritten, post-distress contracts are the same as other contracts, with all providing a fixed salary and nearly all providing performance-based bonuses.<sup>213</sup> As above, firms do make a few changes after experiencing financial distress. For example, while healthy firms use primarily financial bonus metrics, distressed firms include non-financial metrics, such as making debt payments, conducting asset sales, and emerging from distress.<sup>214</sup> In addition, in some cases bonuses are a guaranteed element of compensation, payable from KERP plans. These changes are not, however, significant rejections of pre-distress terms. All in all, the basic structure of employment contracts is the same before and after distress, as well as the same as employment contracts for firms outside of the dataset.

*Equity components:* While critics point to multi-year terms, guaranteed salaries, and big bonuses as evidence of managerial power, the bulk of criticism is reserved for the way firms reward executives with various forms of equity compensation. While some populist-minded critics point solely to the size of option awards as evidence of greed or wrongdoing, a more powerful criticism is that commonly used options are inefficiently designed to properly motivate managers. The argument, made by Bebchuk among others, is that non-indexed, at-the-money options reward executives for market- or industry-wide rises in stock prices instead of linking pay specifically with idiosyncratic firm performance.<sup>215</sup>

There are two proposed solutions: to use either performance-priced or “indexed” stock options. The first type is simply options whose exercise or strike price is set above market price in order to give recipients incentives to raise the stock price before profiting. As one firm that uses this type option reports, this strategy gives executives rewards only for “superior results.”<sup>216</sup> According to recent research “giving managers out-of-the-money options rather than at-the-money options does, on average, boosts firm value.”<sup>217</sup> Thus, the argument goes, the failure to use these options can only be explained by managerial rent seeking. This hypothesis is not born

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<sup>211</sup> See American Banknote, Form 10-K, filed Dec. 21, 2002.

<sup>212</sup> See Carmike Cinemas, Form 10-K, filed Apr. 1, 2002.

<sup>213</sup> About 95 percent of pre-distressed firms had a performance-based bonus plan for the CEO. This fell to almost 90 percent in post-distress contracts, as some firms paid guaranteed bonuses as part of Key Employee Retention Plans (perhaps to offset CEO wealth losses from stock options that went underwater).

<sup>214</sup> See Carmike Cinemas, Form 10-K, filed April 16, 2004, at 15.

<sup>215</sup> Bebchuk et al., *supra* note 3, at 812.

<sup>216</sup> See Casual Male, SEC Form 10-K, May 5, 1998.

<sup>217</sup> Michel A. Habib & Alexander Pl. Ljungqvist, *Firm Value and Managerial Incentives: A Stochastic Frontier Approach*, 78 J. BUS. 2053 (2005).

out by the data in this study. About 95 percent of firms in the dataset used conventional options in the pre-distress period, which is fairly representative of pricing policies generally, and no firm changed its option pricing policy after agency costs were reduced.<sup>218</sup>

Although corporate critics believe premium-priced options to be better than at-the-money options, they “still have the potential to reward executives even in situations where they are not performing well simply because the market is strong.”<sup>219</sup> Accordingly, the strongest call for reform is the use of “indexed” options. These are options with a variable exercise price that is determined by comparing firm performance with an index of competitor firms – only when the firm outperforms its rivals by some predetermined amount will the options be “in the money.” The belief is that “indexed options can generate more incentive per dollar . . . by tightening the link between compensation and performance.”<sup>220</sup> Critics believe the case is so strong for using indexed options that the only explanation for their absence from typical employment contracts is managerial power: “as long as managers can get away with the use of conventional options, they will do so.”<sup>221</sup>

And yet when managers can’t get away with it, when sophisticated investors with large stakes and who know about the alleged benefits of indexed options<sup>222</sup> write new employment contracts, firms use traditional options, that is, at-the-money, non-indexed options. In all cases in the dataset, the debtor used stock options in the pre-filing period, cancelled existing stock options upon the occurrence of distress, and issued new options under new terms after reorganization.<sup>223</sup> None of them used indexed options in either period. Moreover, other stock option characteristics, such as vesting periods (3, 4, or 5 years), expiration dates (10 years), and stock holding requirements (several percent), were generally the same before and after distress.

Alternative explanations for the lack of appeal of indexed options have been made well by others. These include: there is already implicit indexing in CEO stock portfolios due to managerial risk aversion and the fact that human capital is nondiversifiable;<sup>224</sup> they are costly to implement due to the need for an observable, non-manipulable index and are complex to handle from an accounting standpoint;<sup>225</sup> they may create excessive risk preferences on the part of

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<sup>218</sup> There were a handful of firms that used premium-priced options in both pre- and post-distress periods. *Compare, for example*, Casual Male, SEC Form 10-K, May 5, 1998 (“all stock options granted to executive officers in fiscal year 1997 have an exercise price 140% higher than the fair market value of shares of Common Stock on the day of grant”) *with* Casual Male, Form DEF 14A, July 6, 2004 (awarding some options with an exercise price of fair market value and some with a 20 percent premium built in).

<sup>219</sup> BEBCHUK & FRIED, *supra* note 2, at n.235

<sup>220</sup> *Id.* at 25.

<sup>221</sup> *Id.* at 812.

<sup>222</sup> The explanation for the failure of sophisticated institutional investors to implement indexed options cannot be lack of awareness. In fact, the reformers claim that “sophisticated institutional investors and their advisors do not share managers’ negative view of indexed options . . . [and] have called for the use of indexed options, even though this step would reduce reported earnings.” BEBCHUK & FRIED, *supra* note 2, at 146.

<sup>223</sup> See Guilford Mills, SEC Form 10-K, Dec. 29, 2003. See also Lason Inc., SEC Form 10-K, April 27, 2004.

<sup>224</sup> See Core, et al., *supra* note 10, at 12 (“there is considerable implicit [indexing] in these portfolios.”).

<sup>225</sup> See Susan J. Stabile, *Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool to Focus Reform*, 35 WAKE FOREST L. REV. 153, 208 (2000) (“[Indexed] options create adverse accounting consequences”).

managers;<sup>226</sup> and that they don't work as intended.<sup>227</sup> Given that sophisticated investors choose not to issue indexed options when they hold all the cards, it is more likely that one or a combination of these alternative explanations instead of managerial power is the reason why they are not used.

Not only do firms not implement indexing when agency costs are reduced, some of the changes they do make are, in the view of the managerial power theorists, steps in the wrong direction. For example, the only thing worse than non-indexed, at-the-money options according to these critics is restricted stock, which has an exercise price of zero, and therefore provides no incentive effects to recipients. About 60 percent of firms in the dataset used restricted stock in the pre-distress period, but several that did not use it in the pre-distress period chose to issue restricted stock in post-distress contracts.<sup>228</sup> Only one firm—Acme Metals—chose to eliminate the use of restricted stock.

There are several other characteristics of standard option contracts that critics claim are explained largely by excessive managerial power, including the lack of contractual restrictions on the ability of CEOs to unwind options through hedging. Bebchuk and Fried bemoan the lack of unwinding restrictions in CEO contracts, arguing that their absence allows CEOs to “weaken . . . (if not eliminat[e]) the incentive effects of the option grant by selling an equivalent number of shares they already own.”<sup>229</sup> According to a recent study of hundreds of employment contracts in healthy firms, no firms have such restrictions despite this being “the natural place where corporations could make CEOs promise not to unwind their stock option positions using derivative securities.”<sup>230</sup> Bebchuk and Fried point to this failure as evidence of excessive managerial power, and argue that reducing agency costs by empowering shareholders and boards to be more active would change contracting behavior in this area. Jensen and Murphy echo this, noting that they “have been mystified for many years why boards do not formally restrict managers’ freedom to unwind the incentives the [board] constructs for them.”<sup>231</sup> But no firms in the dataset placed any contractual restrictions on CEO portfolio management when creditors rewrote employment contracts, suggesting that there are other forces at work besides high agency costs.

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<sup>226</sup> Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901 (2001).

<sup>227</sup> Lisa K. Meulbroek, *Executive Compensation Using Relative-Performance-Based Options: Evaluating the Structure and Costs of Indexed Options* (Harvard Business School Working Paper No. 01-021, 2001), available at <http://ssrn.com/abstract=281028>.

<sup>228</sup> See, e.g., Borden Chemical, SEC Form 10-K (not used in pre-distress period (1999) and used in post-distress period (2003)); Carmike Cinemas, SEC Form 10-K (same).

<sup>229</sup> See BEBCHUK & FRIED, *supra* note 2, at 759.

<sup>230</sup> Schwab & Thomas, *supra* note 208, at 5.

<sup>231</sup> See Jensen & Murphy, *supra* note 37, at 67.

**Table 2**  
**Summary statistics of sample contract terms for firms in financial distress**

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

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

*Retirement elements:* The final part of compensation packages that raises the ire of critics is the lucrative retirement and severance provisions these contracts offer.<sup>232</sup> A recent expose in the New York Times condemned generous retirement plans, quoting an investor advocate as asking: “[W]hat’s the point of paying somebody after they’re gone?”<sup>233</sup> The elements that managerial power theorists find particularly objectionable include: large amounts of deferred compensation and severance packages, change of control provisions that accelerate option vesting and provide big cash payouts in the event of a merger or sale of the firm, and lucrative consulting deals for CEOs in retirement. While on the surface there appears much to fault in the design of some CEO retirement benefits, firm owners did not in most cases take advantage of reduced recontracting costs and reduced managerial power to alter these benefits. Some firms changed the form of retirement benefits—e.g., moving from defined-benefit pension plans to lump sum deferred compensation under KERP plans—but the general nature of retirement benefits looked the same before and after distress in over 90 percent of cases. Post-distress contracts contained large deferred cash plans, long-term incentive plans consisting mostly of mega-grants of company stock, extremely generous pension payments, and consulting contracts in the same manner and frequency as pre-distress and healthy firms. For example, debtor Covanta Energy entered into an agreement, approved by creditors and the bankruptcy court, to provide its outgoing CEO with a generous “soft landing,” including millions in annual payments and a two-year consulting contract to “retain the critical knowledge and insight of the waste-to-energy business that [the CEO] possesses.”<sup>234</sup> This agreement, cut between an outgoing CEO and motivated owners who were not captured by the CEO, is typical of post-distress contracting.

<sup>232</sup> Timothy L. O’Brien, *Mayday? Payday! Hit the Silk!*, N.Y. TIMES, Jan. 9, 2005, at 31.

<sup>233</sup> *Id.* The answer to this question is obvious – retirement benefits are merely compensation deferred into future periods. Employees may benefit for tax reasons while employers may benefit for a variety of tax, accounting, or monitoring reasons. For this latter point, see M. Todd Henderson & James C. Spindler, *Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption*, 93 GEO. L.J. 1835, at 1851-52.

<sup>234</sup> See Covanta Energy Reorganization Plan (“THE MACKIN AGREEMENT”).

## 2. Example case study – New CEO of WorldCom

The employment contract of WorldCom’s CEO Michael Capellas provides a nice case study illustrating the resiliency of employment contract terms in the face of enhanced scrutiny. Prior to Capellas’s arrival at the end of 2002, WorldCom collapsed from one of the world’s leading telecommunications firms into Chapter 11 (with over \$100 billion in assets, the largest bankruptcy in history). The fall was reported ubiquitously and continuously for months, as thousands lost their jobs, shareholders were wiped out, and the details of the accounting scandals and the excesses of former Chairman and CEO Bernie Ebbers were uncovered. Ebbers, who built the firm from nothing into a hundred-billion-dollar behemoth through a series of bold acquisitions, received annual compensation in the tens of millions of dollars, and borrowed over \$400 million from WorldCom to fund everything from share purchases to a boat building business. In the wake of the collapse, the Department of Justice, the SEC, and numerous state attorneys general launched civil and criminal investigations. As a result of these investigations, numerous former employees have been sentenced to prison and millions of dollars in fines have been levied.

In Chapter 11, WorldCom (acting as debtor in possession) recruited Capellas, then president of Hewlett Packard, to be the new CEO. At the time, WorldCom’s fate was being largely controlled by a bank syndicate that had agreed to loan the debtor about \$2 billion in additional funding under a revolving credit facility, and by a group of vulture investors, who took large, blocking positions in WorldCom and MCI bonds. These creditors were active in personnel decisions, evaluating business strategy, and disposing of assets, as well as developing a reorganization plan. In addition to creditor oversight, WorldCom’s significant actions were subject to the approval of former SEC Chairman Richard Breeden, who was appointed as a “Corporate Monitor” by the federal bankruptcy court overseeing the reorganization. Breeden issued an eponymous report on WorldCom’s corporate governance that contained 78 specific recommendations that WorldCom had to implement as a precondition to emerging from Chapter 11.<sup>235</sup> The enormous public scrutiny, creditor involvement, and unprecedented judicial oversight made the WorldCom reorganization an extreme example of the reduced agency costs model described above.

It was in this environment that the debtor and its owners negotiated an employment agreement with new CEO Capellas. The original contract was submitted for review by the court (both the U.S. District Court and U.S. Bankruptcy Court sitting together) and the Corporate Monitor, and was rejected on the grounds that the amount of pay was excessive. Breeden then negotiated a revised agreement that reduced the amount of pay by about 25 percent, and this contract was approved by the courts.<sup>236</sup> The final contract, which was therefore subject to creditor, Corporate Monitor, and judicial approval, is substantially the same in structure and basic terms as contracts in healthy firms and pre- and post-distress debtors in this sample. The contract has the following key characteristics: (a) a three-year term; (b) a fixed salary that cannot be reduced; (c) a guaranteed bonus for the first two years (during the expected period of

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<sup>235</sup> See Restoring Trust: Corporate Governance for the Future of MCI, Inc., (Breeden Report), available at <http://www.corplawblog.com/archives/000181.html>.

<sup>236</sup> Despite the reduction, Capellas was still scheduled to earn in excess of \$20 million over three years to turn around WorldCom. See Larry Neumeister, *CEO to earn \$22 million for WorldCom rescue*, ASSOC. PRESS, Dec. 17, 2002, available at <http://the.honoluluadvertiser.com/article/2002/Dec/17/bz/bz10a.html>.

reorganization) and a performance-based bonus (after emergence) determined by specified, objective financial criteria; (d) grant of millions of dollars of non-indexed, at-the-money options with a 3-year vesting period and 10-year term; (e) grant of millions of dollars in restricted stock; (f) generous severance provisions in the event of a change of control.<sup>237</sup> So even under these extreme circumstances, we see substantially similar contractual terms being written as for firms in general. If anything, the Capellas contract, following from the Breeden Report, relies more heavily on restricted stock than typical contracts, a fact corporate critics would surely point to as evidence of excessive managerial power but for the unprecedented oversight in this case.

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We thus see employment agreements written in low agency cost environments that look substantially the same along key dimensions as those written in higher agency cost settings. The general structure of the agreements is the same, payment of cash compensation and equity are made in the same way, and retirement packages are constructed of similar terms. This supports the view that the contracts we observe are the best that we can expect – they can either be said to be the product of arm’s-length bargaining or the best any owners (short of the theoretical 100 percent owner) are likely to write. Let us turn now from the manner to the amount of compensation to see if this further supports the efficiency claim.

#### *D. Compensation levels in financially distressed firms*

The data shows that firms actively renegotiated key elements of compensation, frequently reducing salaries, bonuses, and option grants. That being said, about 33 percent of firms made no changes in compensation levels, and another 25 percent made changes to only one element of the compensation mix (e.g., shifting the compensation mix from cash-rich to equity-rich). Those firms that did reduce compensation at some point around distress tended to increase it after the financial clouds lifted, suggesting performance-related adjustments. Since compensation is typically broken down into two components – cash and equity (including options, LTIP, and so on) – we will consider each type in turn, by comparing compensation levels in the periods before, during, and after distress.<sup>238</sup>

##### *1. Cash compensation*

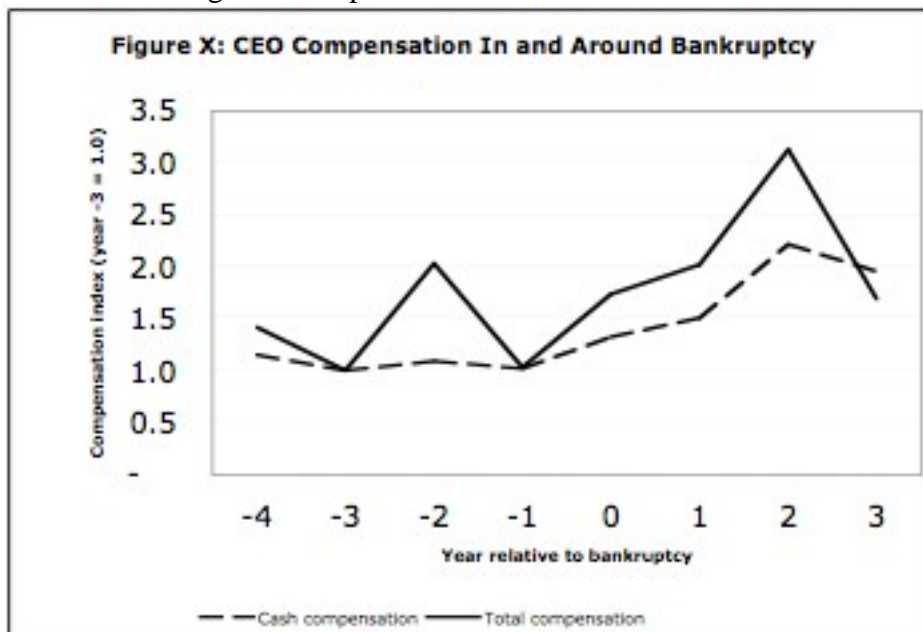
Comparing the average total cash compensation in pre-distress and post-distress periods, the median change was an increase of 13 percent, with almost 70 percent of firms increasing or keeping total cash compensation the same. (The results are roughly the same for the subset of firms with the same CEO,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

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<sup>237</sup> See Terms and Conditions of Employment of Michael D. Capellas and WorldCom, Inc., Dec. 2, 2002, available at <http://news.findlaw.com/hdocs/docs/worldcom/120902cpllswcmk.pdf>. The contract, in accord with the Breeden Report, did limit the maximum amount of compensation in any year to \$15 million without shareholder approval and limit severance payments to \$10 million. See Breeden Report, *supra* note 235.

<sup>238</sup> The four years prior to the triggering event are designated -4 to -1, while the period after filing is designated 0 to 4. The average time a firm spends in Chapter 11 is about 18 months, but the increased monitoring of outside investors starts before the firm files for reorganization and continues after the firm emerges from Chapter 11. In the typical case, creditors begin to exert influence six months to one year prior to the firm filing for Chapter 11, although the intensity of the monitoring role increases as bankruptcy approaches. After bankruptcy, firms that emerge as new public firms often have a board appointed by or with several members from the distressed debt investors.

while the firm is still underperforming, firms modestly increase cash compensation in order to keep pace with inflation and to provide sufficient levels to attract and retain talented managers. As the firm faces the threat of bankruptcy, cash compensation remains flat or is slightly reduced. Over 40 percent of the firms reduced cash compensation in the two years preceding a distress event (-2 to 0).<sup>239</sup> Firms then increase cash compensation as they emerge from bankruptcy (year 1), usually in the form of a cash bonus payable on the successful emergence of the firm from bankruptcy. Pay then remains flat, on average, for the next few years, before rising substantially, perhaps when fortunes rise for the firm when bankruptcy is left far behind or perhaps when firms that have remained in bankruptcy beyond the typical one to two years emerge and pay bonuses tied to a successful reorganization plan.



This result is generally consistent with the data from the prior ten years,<sup>240</sup> and is what one would expect. Firms are most likely to reduce cash compensation in the several years leading up to Chapter 11 or private workout as performance falls and the firm faces cash constraints, increased monitoring, and higher outrage costs. Firms may also want to change the compensation mix to reduce cash in favor of incentive compensation to motivate CEOs. The decrease as a result of lower performance is consistent with fact that most CEO employment contracts, which are still enforceable in the shadow of Chapter 11, provide for a fixed salary with a variable bonus pegged to various performance metrics. The data support this conclusion – the average salary component of cash compensation was 8 percent higher in firms that experienced financial distress at some point during this ten-year period, while the average bonus component was 45 percent lower.<sup>241</sup> Outrage is likely the highest as a firm approaches and enters bankruptcy, and, at first glance, the data support that intuition.<sup>242</sup>

<sup>239</sup> This conclusion is consistent with the prior work of Gilson & Vetsuypens, who found that “firms systematically restructure their management compensation contracts when they experience severe financial difficulty.” Gilson & Vetsuypens, *supra* note 7, at 438. The changes in compensation levels are not dramatic (modest decreases in salaries and, more often, bonuses) but are real, and suggest that firms are facing the issue of executive compensation as part of their dealing with the impact of financial distress.

<sup>240</sup> Gilson & Vetsuypens, *supra* note 7, at 434-5.

<sup>241</sup> Average salary for healthy firms was about \$600,000 per year, and for distressed firms \$650,000 per year; average annual

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

### *a. Salary*

A CEO's base salary is routinely a fixed amount payable regardless of firm performance. Base salaries are not typically renegotiated at any time during the duration of the employment agreement, even when the amount is objectively undeserved – a policy called “no cut” contracts.<sup>243</sup> This is because salaries are contractually guaranteed, making the CEO's bargaining position quite strong. In addition, there is anecdotal evidence that firms and executives view salary as the reservation wage or bare minimum required to secure the CEO's services for a given period. Any amount below the fixed salary would mean losing the executive and possibly generating costly litigation. Finally, as the managerial power theorists suggest, the CEO likely has some power over the board with respect to compensation negotiations, and the board is, given these costs, unlikely to challenge a CEO on the contractually agreed upon terms.

As we have seen, however, when the firm files for Chapter 11, the barriers that prohibit recontracting over salary levels go away.<sup>244</sup> We therefore see reductions in CEO base pay as creditors tear up executory employment agreements and rewrite new ones. This happened in nearly all of the cases in this dataset.<sup>245</sup> The average firm increased salary levels slightly from pre-distress levels, suggesting salary levels were not excessive in most cases. The salary increases outside of the shadow of bankruptcy (before filing in years -4 to -3; and after emergence in years 1 to 4) are similar to the average 3 to 5 percentage point increases for large firms during the study period, according to the Corporate Library.<sup>246</sup> Thus if we take out the

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bonus was \$450,000 per year for healthy firms, and \$250,000 for distressed firms. The net result is that cash compensation in distressed firms was about 20 percent lower than in healthy firms.

<sup>242</sup> An alternative explanation for the decrease in cash compensation is that powerful managers tweak salaries and bonuses slightly to reduce outrage, knowing full well that compensation levels will return to “normal” once the specter of bankruptcy is lifted. This explanation does not hold water, as discussed in section IV.A.2.

<sup>243</sup> Contracts often allow for increases but not decreases in salary levels. *See, e.g.*, Hayes Lemmerz International, Inc. 10-K (May 1, 2002) (“The initial annual salaries for [the CEO is] \$755,000 . . . , to be reviewed annually, and may be increased, but not decreased, by the Compensation Committee of the Company's Board of Directors.”)

<sup>244</sup> These barriers are reduced somewhat when an employment contract ends, and firms take advantage of these reduced costs to renegotiate in some instances. *See* Company News, *Coca-Cola Chief To Be Paid Less Than Predecessor*, N.Y. TIMES, Sept. 18, 2004, at B4 (new CEO salary and bonus reduced to \$4.5 million from \$5.5 million for predecessor). Chapter 11 not only terminates every contract regardless of its term, but also reduces other recontracting costs.

<sup>245</sup> *See, e.g.*, Covanta Energy, 10-K, filed Mar. 30, 2004: “Prior to the Company's emergence from the Chapter 11 cases, it formally rejected all of the prepetition employment contracts covering the executive officers named in the compensation tables.”

<sup>246</sup> *See* Erin White & Kris Maher, *Please, Sir, A Bit More?*, WALL ST. J., October, 26, 2004, at B1.

period immediately prior to filing and the time firms spend in Chapter 11, the picture is one in which distressed firms largely mimic the compensation patterns of healthy firms.

Looking firm by firm, we see that about 80 percent of firms increased their compensation in the period after distress or kept it the same compared with pre-distress levels: 18 increased compensation an average of 32 percent (median = 25%); 14 kept the salaries the same before and after distress. Ten firms wrote a new contract that reduced the average CEO salary compared with pre-distress levels. The average reduction for these firms was about 25 percent (median = 22%). Most of these firms emerged in 2002 and 2003, however, when CEO pay decreased on average for all firms in the Fortune 500 by about 8 percent.<sup>247</sup> This market-wide decrease in CEO pays lessens the size of the 25 percent average decrease for the ten firms lowering CEO salaries.

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

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

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

#### *b. Bonus*

All of the firms in the dataset had discretionary bonus programs, which are, on average, about 50 percent of an executive's cash compensation in a given year. The bonuses are typically paid in a year-end lump sum, and the algorithm for calculating the amount is contractually specified. In nearly all cases, the bonus is a multiple of the employee's salary (ranging from 0.5 to 2 times),<sup>248</sup> and is linked to an objective measure of firm performance, such as earnings per share.

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<sup>247</sup> Patrick McGeehan, *Is CEO Pay Up or Down? Both*, N.Y. TIMES, Apr. 4, 2004, at § 3, 1.

<sup>248</sup> Bonuses were guaranteed in about 10 percent of the firms in the sample.

As expected, we see bonuses fall in and around financial distress due to the decrease in firm performance. Bonuses also rise significantly in the first years after filing Chapter 11 because firms routinely pay “emergence bonuses” when the firm restructures its debt. These bonuses are negotiated with the creditors’ committee or bank consortium providing DIP financing, and are included in KERPs or revised employment agreements. In addition, the bankruptcy court overseeing the reorganization approves all of these bonus programs. The average emergence bonus in the dataset was approximately the average bonus for the executive in one or two prior years, and is usually equal to about one times annual salary.<sup>249</sup> In other words, an executive’s bonus during the one or two years of reorganization is deferred until after the firm successfully reorganizes. This is a sensible strategy on the part of the creditors (and the firm) since it prevents the CEO from cheating in a final period by allowing the firm to verify performance.

In order to control somewhat for the impact of firm performance and emergence bonuses, we can compare bonus levels several years prior to distress (say, -6 to -3) with post distress bonus levels (say, +2 to +4). The data shows that firms did not dramatically reduce the amount of discretionary bonuses paid post-distress. The median change was a 19 percent increase compared with pre-distress levels. About 80 percent of firms increased or kept bonus levels the same: 24 increased bonuses an average of over 200 percent, while 9 kept levels the same. Eleven firms did reduce bonuses, by an average of about 50 percent. In each of these cases, however, firm performance was a potential explanatory factor. A simple regression of bonus levels against metrics of firm performance shows that a firm’s return on assets is a significant explanatory factor (p value << 0.005) at the 95 percent confidence level. This is supported by the fact that three of these firms remained in Chapter 11 during the entire duration of the study period.

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

The bottom line on bonus levels is that they are renegotiated with creditors and approved by the court, like salaries are, and that they look very much the same post-distress as they do pre-distress. In other words, the employment contracts that the sophisticated, nearly 100-percent owners write for the firm going forward are quite similar to those written when managers were more firmly in control.

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<sup>249</sup> For example, in the reorganization of Fruit of the Loom, the debtor disclosed the following about its emergence bonus:  
The Bankruptcy Court also approved a retention plan for key employees, including executive officers. Pursuant to such order, executive officers, other than [the CEO], receive retention and emergence payments equal to 65% to 80% of their base pay. [The CEO] is entitled to receive an emergence bonus equal to \$800,000.

This was approximately the CEO’s annual salary and bonus level prior to distress.

## 2. Equity compensation

The other major component of CEO compensation is equity compensation. During the period of study, the largest part of the compensation mix was non-cash compensation, usually in the form of restricted stock and/or stock options of various forms. While distressed firms paid less of their total compensation in stock options than healthy firms, options still composed 50 to 60 percent of total compensation on average.

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

On the other hand, options will be worth less to the executive as the firm's fortune, and thus its stock price, falls, and therefore the cost of issuing the options (for example, dilution costs) may outweigh their incentive effects. Options are also an inefficient way to pay managers of firms in financial distress since "firms whose top management face substantial risk, due to either manager's equity holdings or firm riskiness, receive diminishing benefits from imposing further risk bearing through compensation contracts."<sup>250</sup> Options granted at this time also may be imposing excessive risk upon managers, because of the diminishing marginal benefit of risk-increasing compensation methods in already risky circumstances.<sup>251</sup> In addition, as the probability of bankruptcy becomes more certain, any stock options will become effectively worthless because shareholders are bound to be wiped out after the firm reorganizes. Finally, firms with fewer growth opportunities and whose investment decisions are easier to monitor – both of which are true for distressed firms – should be expected to use less incentive compensation.<sup>252</sup>

In terms of amount, the median firm increased the average value of stock option grants 8 percent in post-distress contracts compared with the average in pre-distress periods.<sup>253</sup> (The value of stock options, calculated using the Black-Scholes option pricing formula, was taken from the EXECUCOMP database along with the other data.) The same findings are true for firms that did not change CEOs during the relevant period. Comparing pre-distress and post-distress contracts, about 60 percent of firms increased or kept the same the value of options granted to their CEOs. Of those firms that did reduce the value of options granted, about half granted some options (reducing the amount by an average of about 50%) while the other half had reductions of 100 percent – that is, they granted no options at all during the time of the study. This complete reduction was not a repudiation of options as a compensation mechanism or necessarily a rejection of the amount of pre-distress grants, but rather is explained by the fact that the firms

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<sup>250</sup> Gilson & Vetsuypens, *supra* note 7, at 434-5.

<sup>251</sup> Beatty & Zajac, *supra* note 115, at 327.

<sup>252</sup> See Baker, Jensen, & Murphy, *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593 (1988).

<sup>253</sup> EXECUCOMP category "BLK\_VALU," which is the Black-Scholes value of options granted.

remained in bankruptcy, were in the process of completing a liquidation or merger with another firm, or were operating with a CRO who did not get an equity stake as part of a short-term contract. Therefore, less than 20 percent of firms reduced the value of options granted in post-distress periods for reasons unrelated to Chapter 11 processes. Moreover, the decrease for these firms may be explained more by their performance than by a change in bargaining power – TRS for firms decreasing option values is a significant explanatory variable at the 95 percent confidence level and was almost 10 times worse than for firms that increased or kept values the same, holding other potential variables, such as sales, net income, CEO identity, and return on assets, constant.

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

While one might think that this is can simply be explained by the fact that a decreasing stock price requires the firm to increase the number of options to achieve the same compensation level or incentive effects, the data does not support that conclusion. The magnitude of the increase in the number of options granted dwarfs any decrease in the stock of these distressed firms. For the firms that increased the number of options granted to the CEO, the increases were far greater than required to offset any decrease in stock price – the mean increase was about 30 times and the median increase was almost 3 times prior levels, far more than needed to offset price declines.<sup>254</sup> In fact, the reported value of stock options issued on the eve of, or in, bankruptcy is on average three times greater than options issued in prior years. It is unlikely that the firm’s owners – inevitably at this point the creditors – would want to impose additional risk taking incentives on managers. But shareholders, including directors, may want precisely this “bet the company” approach as the firm teeters on the edge of bankruptcy.

Several other explanations are also possible. The most obvious is that large options are paid to attract outsiders to be CEO of a distressed firm. The data supports this hypothesis to a certain extent, since in about half of the cases the increase was given to a new CEO in his first or second year on the job. In these cases, the grant may be designed to align shareholder-manager incentives by giving the new CEO some skin in the game, so to speak. Firms usually set target ownership levels of firm stock or give substantial option grants to try to better align executives’ financial incentives with that of shareholder value. With a failing firm, giving options is a less costly way for the firm to meet ownership targets because it does not require the new CEO to alter her portfolio, and spend real money, to purchase shares that are falling and may soon be worthless. Giving options thus achieves a similar incentive effect without imposing a costly portfolio rebalancing cost on a new executive, that is, already increasing her risk profile by putting her human capital into a faltering firm. In addition, a large grant may be required to match the market wage for CEO talent. Here again, options are a less costly way to meet the CEO’s reservation price, because paying large amounts in salary or other cash consideration may

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<sup>254</sup> The mean and median for the few firms reducing the number of stock options was about one half prior levels.

put pressure on already tight working capital constraints and may also generate significant outrage costs.

This explanation is not complete, however, because in over half the firms, huge option grants in the shadow of bankruptcy were given to existing CEOs who stayed on during part or all of the reorganization. Several other possibilities are evident. First, shareholders are trying to reincentivize managers whose (under-water) options no longer provide the right risk-taking motivation.<sup>255</sup> For the reasons noted above, this is an unlikely explanation given the large difference between the value of stock options granted on the eve of bankruptcy and the years before distress.

The second possibility is that shareholders are trying to align their incentives with those of management, who they know will owe fiduciary duties to creditors, not shareholders, once the firm approaches bankruptcy. The theory is simple: executives with substantial equity positions may act to preserve recovery for shareholders (i.e., themselves) at the expense of creditors.<sup>256</sup> This attempt to buy managerial loyalty is not implausible since, “in some cases, [executives] openly embrace the idea that their duty lies with the shareholders.”<sup>257</sup> Several studies support the attempt by shareholders, finding “Chapter 11 often enables equityholders to obtain a share of the value of the reorganized company even when that value is less than sufficient to cover debtholders’ claims.”<sup>258</sup>

If this is the strategy of shareholders, it is unlikely to work well or as intended. Creditors can easily buy out this bribe through a severance package (if the CEO leaves) or rolling it into future compensation (if CEO stays).<sup>259</sup> Shareholders and the CEO are likely know this, so a more plausible explanation is that this is an attempt to raise CEO exit costs (either for creditors or for other firms, both of who typically make CEOs whole upon their departure).<sup>260</sup> One of many examples of this is from debtor Allegheny Energy whose new CEO “received an initial make-whole payment of \$6,300,000 to compensate him for forfeitures of financial and other benefits from his former employer.”<sup>261</sup> Therefore, these awards could be either a rational decision by the

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<sup>255</sup> See Cieri & Riela, *supra* note 162, at 301 (“Arguably, with an insolvent corporation, its shareholders would prefer that directors and officers take the corporate assets and ‘go to Las Vegas’: using the assets in extremely risky ventures that have a high probability of failure, but hold even the smallest possibility of astounding success.”).

<sup>256</sup> Milton Harris & Artur Raviv, *The Theory of Capital Structure*, 46 J. FIN. 297, 300 (1991)

<sup>257</sup> ROSENBERG, *supra* note 60, at 51.

<sup>258</sup> Lucian A. Bebchuk and Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J.L. ECON. & ORG. 253, 255 (1992) (citing Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority Claims*, 27 J. FIN. ECON. 285, 286 (1990); Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1458 (1990); Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 752-55 (1989).

<sup>259</sup> See LoPucki & Whitford, *Corporate Governance*, at 689.

<sup>260</sup> See Valerie Patterson, *Employment Contracts Attract Top Executives*, WALL ST. J., Sept. 15, 1998, available at <http://www.careerjournal.com/myc/negotiate/19980915-patterson.html> (noting that “[u]pfront award[s] often [are] designed to motivate executives to leave the perks, expected stock option awards and bonuses from their current firms and make a move.”); see also Joann S. Lublin, *Should Financial Turmoil Force You Out of a Company?*, WALL ST. J., Nov. 10, 2004, available at <http://www.careerjournal.com/columnists/manageyourcareer/20041110-managingyourcareer.html> (observing that the “next employer [will probably] cover at least a portion of the retention bonus you would lose by jumping ship prematurely.”).

<sup>261</sup> See Allegheny Energy Proxy Statement Form 14A, April 8, 2004 at 36.

firm – to raise the cost of external poaching of CEO or resetting risk-taking incentives – or a suspect, self-awarded payment at the expense of the firm and its creditors. Others have examined the question of timing option grants to take advantage of favorable market news,<sup>262</sup> and this is just the flip side of that argument – timing option grants to raise exit costs before bad news. In any case, the possibility of expropriation by managers is significant enough that bankruptcy courts should look with greater scrutiny at pre-filing option grants. David Skeel has recently proposed an expansion of existing fraudulent conveyance practice by trustees and bankruptcy courts, suggesting that “[e]xecutives should be forced to disgorge the proceeds of any stock sales they make within eighteen months of bankruptcy.”<sup>263</sup> A sensible reform goes a step further, by calling not just stock sales but option grants into question, and extending the fraudulent conveyance “look back” period long enough to capture specious grants. These large option grants may have escaped attention up until now because the value of options granted on the eve of bankruptcy falls as the stock drops. But with firms (either current or new) buying out option packages at grant value, the possibility for abuse is real.

### 3. Total compensation

Turning finally to the total compensation package, which includes the current value of all payments present or future for the executive awarded in any year, we see a similar pattern with about three-quarters of firms increasing or keeping average post-distress compensation levels the same as pre-distress. The median change is an increase of 12 percent.<sup>264</sup> (The increase is the same for the subset of firms that did not change CEO. The basic regression also supports the conclusion that the change is not driven by the presence of a new CEO, as the dummy variable of a new CEO is insignificant. The change is therefore not likely the result of buying off the outgoing CEO or bribing the incoming CEO at levels above the exogenously set market wage.)

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

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<sup>262</sup> The problem of CEOs timing option grants in self-interested, and shareholder value destroying ways, was recently considered in Iman Anabtawi, *Secret Compensation*, 82 N.C. L. REV. 835 (2004).

<sup>263</sup> Skeel, *supra* note 65, at 944 n.88.

<sup>264</sup> EXECUCOMP category “TDC1,” which is “total compensation for the individual year, comprised of the following: salary, bonus, other annual, total value of restricted stock granted, total value of stock options granted (using Black-Scholes), long-term incentive payments, and all other total.”

## VI. CONCLUSION

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

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

The compensation data (both form and amount) from about 80 firms that restructured their debt during the past ten years also sheds some light on the ongoing debate about whether existing compensation practices in healthy firms can be better explained by excessive managerial power or arm's-length contracting. As we have seen, agency costs are greatly reduced in Chapter 11 because of the increased monitoring role of creditors and the oversight provided by courts and other stakeholders. Compensation negotiations are therefore largely freed from the taint of alleged managerial power that critics say corrupts negotiations in healthy firms. And yet, in the absence of high agency costs and clear managerial power, compensation practices are largely the same as they are in pre-distress periods and in healthy firms. In other words, when sophisticated creditors (who are spending their own money) write employment agreements from scratch, they look just like those written by firms with more diverse ownership interests.

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

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