CREDITOR CONTROL IN FINANCIALLY DISTRESSED FIRMS: EMPIRICAL EVIDENCE

STUART C. GILSON
MICHAEL R. VETSUYPENS*

Until recently, academic research in corporate finance has had little to say about how corporate ownership and control are affected when companies default on their debt or file for bankruptcy. Most theories of optimal capital structure, for example, typically model bankruptcy as a wholesale transfer of the firm's assets to creditors. Ownership claims in the firm are redistributed according to the rule of absolute priority, and pre-petition stockholders receive nothing. The reality, of course, is much more complicated. Various legal and regulatory penalties effectively limit creditors' ability to influence resource allocation in troubled companies. Commercial banks, for example, are prohibited from holding significant amounts of stock in nonbank firms under section 16 of the Glass-Steagall Act, the Bank Holding Company Act, and the Federal Reserve Board's Regulation Y (exceptions to these rules exist when banks receive equity in settlement of a troubled loan, but the equity must be divested after a few years). Similar restrictions apply to insurance companies.[1] Creditors who take too active a role in corporate governance—for example, by forcing the ouster of top managers and corporate directors—also face the risk of having their claims equitably subordinated in bankruptcy, or of being sued under lender liability laws.

From the standpoint of financial economists, the uncertainty that surrounds the role of creditors in corporate governance is undesirable. The

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* Stuart C. Gilson is an Assistant Professor at the Harvard Business School, and Michael R. Vetsuypens is an Associate Professor at the Edwin L. Cox School of Business, Southern Methodist University. The authors are grateful for research support provided by the Division of Research at Harvard Business School and the Leo F. Corrigan Junior Fellowship at Southern Methodist University.

1. For example, life insurance companies domiciled in New York cannot have more than 2% of their assets invested in the stock of any one issuer; similar restrictions exist in 39 other states (covering both life and property-casualty insurers). In a recent paper, Gilson shows that such institutional restrictions on creditor equity ownership make it difficult for firms to reduce their leverage in bankruptcies or out-of-court debt restructurings. *See* Stuart C. Gilson, Debt Reduction, Optimal Capital Structure, and Renegotiation of Claims During Financial Distress (Harvard Business School Working Paper) (on file with the *Washington University Law Quarterly*).

goal of economic efficiency will be best served when decision and control rights in the firm reside with the firm's residual claimholders—those whose wealth directly rises or falls with marginal changes in firm value. When a firm is clearly insolvent, and the face value of outstanding debt far exceeds the present discounted value of the assets, creditors, as the residual claimants, should have authority to decide how the firm's assets are allocated.[2] However, legal and other institutional barriers may prevent creditors from acting in this role, and consequently the firm's assets may not be put to their most productive use.

In addition, uncertainty over creditors' appropriate role in the governance of financially distressed firms clouds the roles and responsibilities of corporate managers and directors. Efficient resource allocation requires that managers and directors act as agents for the firm's residual claimholders. When a firm is trying to renegotiate its debt contracts, however, it is often unclear where management's loyalties should lie. When a firm is highly leveraged, and the debt is risky, the market value of both debt and equity claims will typically be quite sensitive to changes in firm value. Moreover, even though creditors nominally hold only fixed claims, they can be viewed as "stockholders in waiting," since they often acquire sizable shareholdings once their claims are restructured (although, to further complicate matters, these holdings necessarily may be only temporary). Although these considerations suggest that management of troubled companies should take the interests of both shareholders and creditors into account when setting corporate policy, until recently, corporate officers have had a formal fiduciary duty only to shareholders. A recent Delaware court decision has established a broader definition of directors' duties that includes consideration of an insolvent firm's total enterprise value—and thus the welfare of creditors as well as stockholders.[3] However, the practical implications of

2. For a general discussion of the optimal allocation of decision and control rights in the firm, see Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983).

3. *See* Credit Lyonnais Bank Netherland N.V. v. Pathe Communications Corp., No. Civ. A. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991). This case involved a dispute between the primary bank lender to bankrupt MGM-Pathe Communications Company, and the company's principal stockholder, Giancarlo Parretti, who indirectly held 98.5% of the firm's outstanding stock through his affiliation with Pathe. Unable to repay the bank's loan, the company granted the bank effective control over the board of directors, with the understanding that control would revert back to Parretti if the bank's loan was reduced by a certain amount within a specified period of time. Shortly after the company emerged from Chapter 11, the bank, over the objections of the principal stockholder, rejected the proposed sale of two important assets (proceeds from which would have gone into paying down the bank's debt). Parretti and Pathe challenged the bank's decision as constituting a breach of its fiduciary

this ruling for day-to-day management of firms in financial distress are still far from clear.

In this Article we present the results of empirical research that examines how creditor control is manifested in financially troubled firms that have to renegotiate their debt contracts. Even though creditors are generally constrained from taking a direct management role in these firms, this research shows that creditors are able to influence corporate policies indirectly by imposing highly restrictive covenants in restructured lending agreements, replacing senior management, and influencing the terms of senior executives' compensation. The main protagonists in virtually all of these cases are banks and other senior institutional lenders rather than public bondholders or trade creditors. Such documentary evidence provides some useful behavioral benchmarks for creditors and managers of financially distressed firms, and helps sharpen the debate over what role creditors *should* play in the governance of financially troubled companies.

I. RESTRICTIVE COVENANTS

When firms approach insolvency, and are in immediate danger of defaulting on their debt contracts, they face two alternatives to outright liquidation: they can file for bankruptcy, or they can restructure their debt out of court. Out-of-court restructuring is economically equivalent to formal bankruptcy, because the firm's fixed claims are either renegotiated or replaced with new claims on terms that reduce the firm's overall fixed payment burden. Negotiating an out-of-court settlement is generally in the interest of all of the firm's claimholders because this alternative appears to be much less costly than formal bankruptcy; however, firms will file for Chapter 11 when claimholders are unable to agree on how to split the cost savings.[4]

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duty to the company's stockholders—a duty that arose because of the bank's control over the board. In finding for the defendant, the court opined that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residu[al] risk bearers, but owes its duty to the corporate enterprise." *Id.* at *108.

4. For evidence on what determines the choice between Chapter 11 and out-of-court restructuring in publicly traded firms, see Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315 (1990). Consistent with out-of-court restructuring being less costly than Chapter 11, Gilson et al. find that the announcement of a successful out-of-court restructuring (i.e., avoidance of Chapter 11) is associated with an average 40% run-up in common stock values, relative to the commencement of negotiations to restructure firms' debt. In contrast, common stock values decline by 40% on average when firms are unsuccessful in

In a recent study (summarized in Table I below), one of the authors finds that commercial banks often acquire extensive influence over firms' operating and financial policies in out-of-court restructurings through the use of highly restrictive loan covenants.[5] In addition to granting the firm financial concessions (e.g., lower interest rates, or forgiveness of past-due interest or principal), creditors can demand increased protection by placing restrictions on the firm's investment and financing activities. In normal times, loan covenants confer control on creditors only "contingently"—when the firm defaults on the covenants, creditors have the right to accelerate full payment of their claims. Following a default, however, creditors often acquire direct control over corporate policies.

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restructuring their debt out of court, and are forced to file for bankruptcy. Gilson et al. also show that attempts to restructure debt are more likely to succeed when there are fewer distinct classes of creditors, relatively more debt is owed to banks and insurance companies, and more of the firm's value consists of growth opportunities and other intangible assets (as opposed to hard "assets-in-place").

5. *See* Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders*, 27 J. FIN. ECON. 355 (1990).

Table I

Creditor control conferred by restrictive covenants in restructured bank loans. Results are based on 40 firms that restructured their debt out of court during 1979-1985. Covenants are identified from the *Moody's* manuals, the *Wall Street Journal*, and firms' 10-K reports. Source: Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders*, 27 J. FIN. ECON. 355 (1990).

Covenant	Percentage of firms
Panel A. Decisions and policies over which creditors are granted veto power	
• Dividends and stock repurchases	48%
• Additional borrowing	15
• Capital expenditures	10
• Divestitures	8
• Firm's annual operating budget	8
• Mergers and other combinations	5
• Sale of new equity	3
• Redemption of subordinated debt	3
• Senior management hiring and firing decisions	3
Panel B. General restrictions on corporate policies	
Asset dispositions	
• Creditors granted increased security interest in firm's assets	73%
• Restructured debt must be prepaid with proceeds of any divestitures	55
• Cap on level of divestitures	23
• Creditors granted ownership in assets directly	13
• Restriction on asset transfers to and from subsidiaries	10
• Restriction on firm's ability to collateralize assets	5
Financing activity	
• Cap on level of borrowing	50
• Proceeds of new financings must be used to prepay restructured debt	8
• New common stock must be sold as condition of debt restructuring	8
Payouts to shareholders	
• Cap on dividends and stock repurchases	38
New investment	
• Cap on level of capital expenditures	30
• Restriction on permitted kinds of investment	23
• Cap on cumulative investment in specified assets	5
Operating activities	
• Cap on general and administrative expenses	25
• Increased financial reporting requirements to creditors	13
Management activities	
• Default declared if current CEO or chairman of the board leaves	3
• Creditors permitted to attend board meetings	3

As shown in Panel A, a significant percentage of the firms studied gave creditors actual *veto* power over firms' dividend and payout policies, capital expenditures, divestitures, mergers, new financing, and senior management hiring and firing decisions. In such cases, creditors arguably exercise more control over the corporation's activities than shareholders are able to exercise in normal times (especially when firms' shares are diffusely held).

A similarly large percentage of restructurings enacted more general restrictions on firms' investment and financing policies (Panel B). Such restrictions potentially benefit creditors by making it more difficult for managers to increase the riskiness of the firm's assets or reduce coverage on the debt.[6] Most often, these restrictions take the form of a cap on the level of some activity, such as capital expenditures, divestitures, shareholder payouts, or total borrowing. Restrictions on asset dispositions are the most common type of restriction, and come closest in spirit to the assumption underlying many option pricing models and theoretical models of bankruptcy—that creditors literally take control of the firm's assets when it defaults on its debt.[7] Interestingly, the covenants shown in Table I are quite similar to those found in leveraged buyouts and other highly leveraged transactions, where, unlike the financially distressed firms examined here, leverage is increased by choice.[8]

In addition to preserving the value of creditors' claims, covenant-based restrictions on firms' investment and financing activities can increase total firm value by preventing managers from taking actions that enrich shareholders but reduce the present value of total cashflows generated by the firm's assets. However, such a characterization, while standard in corporate finance textbooks, assumes that managers act as agents for the firm's shareholders. As seen below, managers of financially distressed firms are sometimes explicitly beholden to the firm's creditors, because the creditors either appoint the managers or set their compensation. This suggests the possibility that the covenants documented in Table I may in fact go "too far"—causing firms to forgo risky, but profitable, investment

6. For an analysis of the economic function of debt covenants, see Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

7. *See, e.g.*, Jeremy I. Bulow & John B. Shoven, *The Bankruptcy Decision*, 9 BELL J. ECON. 437 (1978); Bradford Cornell et al., Financial Distress, Capital Infusions, and Optimal Default (University of California at Los Angeles Working Paper, 1993).

8. *See* George P. Baker & Karen H. Wruck, *Organizational Changes and Value Creation in Leveraged Buyouts: The Case of The O.M. Scott & Sons Company*, 25 J. FIN. ECON. 163 (1989).

opportunities. Such an opportunity loss, if it exists, represents a cost of financial distress that has heretofore received little attention from corporate financial economists.

II. CREDITOR-INITIATED MANAGEMENT CHANGES

In a recent study, one of the authors finds that creditors frequently initiate senior management changes when firms are financially distressed.[9] The study analyzed 381 publicly held firms that experienced severe stock price declines, and found that there was a 52% likelihood of observing senior management turnover in any year that a firm was bankrupt or restructuring its debt out of court. (Senior management turnover was defined as any change in the identity of the firm's top management team, including the chairman, CEO, and president). According to public sources (e.g., newspaper accounts and company annual reports), banks were responsible for forcing out incumbent managers, or appointing new managers, in one out of every five such management changes.[10] Public bondholders or trade creditors, in contrast, were never identified as having played a role in replacing management.[11]

In bankrupt firms, creditors sometimes effect the removal of senior managers by proposing a new management team in the firm's plan of

9. *See* Stuart C. Gilson, *Management Turnover and Financial Distress,* 25 J. FIN. ECON. 241 (1989). This study presents logit regression evidence that high turnover in financially distressed firms is specifically caused by high leverage, or factors related to firms' bankruptcy or debt restructuring, rather than past declines in profitability (that ultimately may have led to default or bankruptcy). Results cited below also draw on Stuart C. Gilson, Management-Borne Costs of Financial Distress (1988) (unpublished Ph.D. dissertation, University of Rochester (New York)).

10. A related study by both authors reports similar findings. *See* Stuart C. Gilson & Michael R. Vetsuypens, *CEO Compensation in Financially Distressed Firms: An Empirical Analysis,* 48 J. FIN. 425 (1993). Results similar to ours are reported by Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies,* 141 U. PA. L. REV. 669, 742-47 (1993). Based on news reports and interviews with attorneys, they found that creditors "participated" in 18 of 40 CEO firings in large publicly traded firms that filed for Chapter 11. *Id.*

11. For two reasons, these and other results cited herein may understate the actual role played by public bondholders in the governance of financially distressed companies. First, the studies that we reference are mostly based on cases taken from the 1980s, when activity by so-called "vulture investors," and active trading in distressed securities, was less developed. Extending the analysis to include more recent cases would no doubt uncover cases where bondholders exerted considerable influence over corporate policies. Second, the majority of firms studied had no publicly traded debt, which is true of U.S. public companies in general.

reorganization.[12] Anecdotal evidence and several recent academic studies suggest that whether creditors are successful in pushing these and other initiatives through will depend in part on where the bankruptcy case is heard. For example, judges who sit in the Southern District of New York are believed to be more favorably disposed to debtors than creditors; in the Southern District of Florida, judges' biases are said to run in the opposite direction.[13]

In firms that restructure their debt out of court, creditors can threaten to vote against the firm's restructuring plan and force it into bankruptcy unless senior management is replaced. This threat will be more credible when creditors' claims are relatively more senior or secured, and shareholders' expected losses in bankruptcy are relatively more severe. Related evidence suggests that shareholders suffer significant wealth losses when attempts to restructure debt out of court break down and their firms file for Chapter 11.[14]

In the aforementioned study, approximately three out of four firms in which creditors forced a senior management change were, at the time, attempting to restructure their debt out of court. In the remaining twenty-five percent of cases involving bankrupt firms, creditors threatened to petition the court to have a trustee appointed unless managers resigned. However, in only one instance was a manager removed by the bankruptcy

12. For example, the reorganization plan of Worlds of Wonder Inc. (submitted by the company's banks and unsecured creditors) explicitly provided for the resignation of its founder, chairman and CEO, Donald Kingsborough. *See* Carrie Dolan, *Worlds of Wonder's Founder Resigns From Top Jobs at Request of Creditors*, WALL ST. J., Apr. 4, 1988, at A23. As part of the agreement, the company also agreed to pay Kingsborough a lump sum of $212,500 for "emotional distress."

13. Academic studies that consider the differential treatment of debtors and creditors across bankruptcy jurisdictions include Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11, and Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990). Determining whether a particular judge is creditor- or debtor-"friendly" is obviously a subjective exercise. One judge in Miami exhibited explicit concern for creditors' interests by ordering the removal of clothing retailer Cascade International's two top executives, "citing their inability to detect various frauds" that were committed in the company. *See* Daniel Pearl, *Judge Orders Removal of Two Cascade Officials*, WALL ST. J., June 1, 1992, at A4. The judge justified his decision by noting that the Cascade officials "carry a 'significant taint' that makes it difficult for the company's creditors to trust them." *Id.* More systematically, LoPucki and Whitford find that judges extend debtor exclusivity more often in the Southern District of New York than in other jurisdictions (even though these cases tend to run for longer than cases in other jurisdictions). LoPucki & Whitford, *supra*.

14. *See* Gilson et al., *supra* note 4.

court and a trustee actually installed.[15]

Creditors, unlike shareholders in conventional contests for corporate control, were able to bring about management changes without owning a significant amount of firms' voting stock. In only two cases studied (out of a total of twenty-five) did creditors own a significant percentage of firms' equity, and in neither case was it possible to say whether the management change occurred as a result of creditors exercising their explicit voting power. Although in five cases bank representatives sat on the board when a management change occurred, this presence always reflected an association of long standing. In most cases these directors resigned to avoid conflicts of interest following the commencement of restructuring talks.

Consistent with the above findings, we also found that significant shareholdings by *managers* were not an effective defense against creditor initiatives to replace them. In one case studied, senior managers were forced out even though they collectively owned 44% of the firm's outstanding common shares. This finding is perhaps not surprising, given that original shareholders' claims are often severely diluted (or eliminated) due to the issuance of a majority of new shares to creditors under firms' bankruptcy reorganization or debt restructuring plans.[16]

Departing managers were replaced by outsiders (i.e., managers who had little or no past affiliation with the firm) in 55% of all cases where management turnover was caused by creditors. In contrast, 34% of all management changes in financially distressed firms resulted in outside appointments.[17] The threat of lender liability may create an added

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15. This is the case of Auto-Train, which filed for bankruptcy in 1980. As reported by the *Wall Street Journal*:

> In Mr. Drabkin's first few weeks as trustee, he went to court to block two major creditors from pulling the tracks out from under the company's trains, and won court permission to fire Auto-Train's founder, president and chief executive officer, Eugene Garfield. In his petition, he told the court that if Mr. Garfield remained, the company would have 'little or no credibility among those upon whom the company depends for its survival.'

Auto-Train Trustee Plans Court Action to Remove Company's Two Top Officers, WALL ST. J., Oct. 9, 1980, at A5. Consistent with our evidence, LoPucki and Whitford found that a trustee was appointed in only 5% of the bankruptcies they studied. *See* LoPucki & Whitford, *supra* note 10, at 699.

16. We conjecture that a given percentage shareholding in a financially distressed firm will confer greater effective voting power on the holder when the firm is relatively less insolvent, and fewer new shares will have to be issued to return the firm's financial leverage to its "normal" level.

17. A new manager was considered to be an outside replacement if he or she had been affiliated with the firm for less than three years. The same definition of outside replacements is used by Gilson & Vetsuypens, *supra* note 10, at 442. The results are qualitatively unchanged when the cutoff is

incentive for banks to make a clean break with incumbent management, in order to preempt charges that managers are being allowed to keep their jobs in return for granting the banks special consideration under the firm's bankruptcy or debt restructuring plan. In addition, banks, as senior secured lenders, may be less concerned than more junior classes about whether senior management has experience running the business, and in particular, whether the firm's going-concern value (in excess of its liquidation value) will be maximized. Outsiders who have no experience with the firm or the firm's industry may therefore be more attractive to banks than to shareholders or subordinated lenders (whose claims are more closely tied to the firm's going-concern value). Finally, good-faith bargaining between the firm and its banks may be impossible unless incumbent management is replaced and a clean break is made from the firm's past failed policies.[18]

Despite sometimes taking an active role in choosing senior managers, banks rarely sought representation on boards of directors. In only one instance did banks explicitly receive the right to elect directors; in one other they were granted veto power in board elections. Presumably, the banks' reluctance to acquire board seats results from the greater visibility and the increased risk of legal liability that such representation would bring.[19] Additionally, during a loan workout, bank representatives tend to circulate within the debtor company, attend board meetings, and directly participate in most major management decisions, making a formal presence on the board unnecessary.

Since the above study necessarily relies on public data, and banks understandably wish to avoid exposing themselves to the threat of lender liability or equitable subordination, this evidence clearly provides a lower-bound estimate of the actual extent of such activity. Only rarely do banks

reduced to one year.

18. For example, Dome Petroleum, while negotiating with lenders to restructure its debt in 1983, announced that its CEO would be succeeded by the group treasurer of Royal Dutch/Shell. *See Dome Petroleum Ltd. Names Finance Expert as Chairman and Chief*, WALL ST. J., June 29, 1983, at A30. Several of Dome's U.S. bankers reportedly welcomed the change. According to one banker: "It's terrific news . . . [Dome doesn't need an] operational oil and gas-type guy, but someone who knows how to deal with bankers." *Id.* Another banker suggested that the new CEO's background would help "restore Dome's credibility with the financial community." *Id.*

19. As noted by Smith and Warner, banks can be liable to *all* of the firm's other claimholders, including public bondholders. Smith & Warner, *supra* note 6, at 147-48. For example, in Kelly v. Central Hanover Bank and Trust Co., 85 F.2d 61 (2d Cir. 1936), the debtor's banks were charged by the public bondholders with violating the bond's trust indenture agreement by accepting increased security from the debtor.

publicly admit to having had a role in replacing managers.[20] Turnover statistics also understate the extent of creditor influence on manager decisionmaking because creditors can exert such influence without actually replacing managers—for example, by threatening to replace them.[21]

III. Creditor Influence Over Executive Compensation Policy

A third way that creditors can influence corporate policies is by setting managers' compensation. In a recent study,[22] the authors analyzed senior executive compensation policy in seventy-seven publicly held firms that filed for bankruptcy or restructured their debt out of court during the 1980s. Table II presents capsule descriptions of eleven cases where creditors explicitly influenced the terms of such compensation. As with the above evidence on management turnover, these findings are based on public data, and thus establish a lower bound on the actual level of creditor influence in financially distressed firms.

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20. The amount of public disclosure of bank involvement in these cases varies considerably. For example, the resignation of D. Gale Reese as chairman and chief executive officer of Seiscom Delta, Inc. was reported as being "under pressure from the company's bankers." *Seiscom Delta's Reese Quits Under Pressure As Chairman and Chief*, WALL ST. J., July 23, 1984, at A13. John R. Waldock, treasurer of Seiscom Delta, explained Reese's departure as follows: "It's just a matter of the bank being willing to do certain things provided Gale Reese was not on the team." *Id.* In contrast, the appointment of Conrad M. Black as chairman of Massey-Ferguson Ltd. in late 1978 was not publicly identified as having been caused by creditors until May 1980, following Black's departure.

21. The banks of one bankrupt company that we studied alternatively extended their influence by demanding that the CEO be given an effective veto over most board decisions (he could be overruled only by a two-thirds majority of the other directors) in order to facilitate decisionmaking and accelerate the firm's reorganization. *See* Gilson & Vetsuypens, *supra* note 10, at 438 n.18.

22. Gilson & Vetsuypens, *supra* note 10.

Table II

Publicly disclosed cases of creditor control over management compensation policy. Results are based on 77 firms that either filed for Chapter 11 or restructured their debt out of court during 1981-1987. Source: Stuart C. Gilson and Michael R. Vetsuypens, *CEO Compensation in Financially Distressed Firms: An Empirical Analysis*, 48 J. FIN. 425 (1993).

Panel A. CEO's compensation or wealth is explicitly tied to creditor wealth

- CEO's bonus is explicitly based on the amount of cash paid to creditors under the company's Chapter 11 reorganization plan
- No awards can be made under the CEO's bonus plan unless company is current on its interest payments
- Banks acquire a claim on the CEO's option exercise profits, and he promises to seek shareholder approval to reduce the option exercise price
- Pursuant to the recommendation of the company's private lenders, senior managers are to be paid a bonus based on net cash collections from the sale of discontinued assets
- Management bonuses can only be paid if the company is current on its payments to public bondholders
- At behest of creditors, the company agrees not to award management stock options over a specified amount unless it has redeemed a specified fraction of preferred stock issued under its debt restructuring plan
- Payments under the CEO's severance agreement are explicitly subordinated to unsecured creditors' claims
- The CEO is to be paid a special bonus upon confirmation of company's reorganization plan, with payment to be made in same debt and equity securities that creditors receive under the plan
- Warrants are issued to the CEO in return for his personal guarantee of subsidiary debt

Panel B. CEO's compensation is reduced under creditor pressure

- Creditors' committee abrogates recent severance agreement with CEO, reduces and postpones payments CEO was to receive

Panel C. Creditors propose giving management stronger incentives to maximize the stock price

- Creditors propose establishing a new incentive plan for the CEO that would result in grant of options on three million shares
- New stock or stock options are reserved for management under firms' bankruptcy reorganization or debt restructuring plans (9 firms)

Over ten percent of sampled firms enacted compensation plans that explicitly tied the CEO's compensation or wealth to the value of creditors' claims (Panel A). Most directly, this was accomplished by paying the CEO a bonus based on total creditor recoveries, or by paying him or her with the same securities that creditors received under the firm's bankruptcy reorganization or debt restructuring plan.[23] This sample is approximately evenly divided between firms that were bankrupt (five) and firms that restructured their debt out of court (four). As far as we are aware, these types of compensation plans are unique to firms in financial distress. If creditors are the residual claimholders in these firms, such plans promote economic efficiency by providing managers with stronger incentives to maximize firm value and, like the covenants documented above, discourage managers from investing in risky, but unprofitable, projects in an attempt to increase share values at creditors' expense. In addition, these plans may enhance firm value by increasing creditors' willingness to settle, thus shortening the firm's bankruptcy or debt restructuring and allowing it to conserve on associated legal and other costs.

In another case, creditors were responsible for reducing cash payments to the ex-CEO under a previously negotiated severance agreement (Panel B). Based on private conversations with bankruptcy and restructuring professionals, as well as anecdotal evidence drawn from outside our sample, we conclude that creditor pressure on management's cash compensation is much more widespread among financially distressed firms than is suggested by public reports of such activity. In both bankruptcies and out-of-court restructurings, management almost invariably has to give up part of its compensation—even if only symbolically—to induce creditors and other stakeholders to make meaningful financial concessions; some bankruptcy and restructuring professionals refer to this as "sharing the pain."[24] In the case of bankrupt firms, the extent to which creditors are

23. One example of such compensation is provided by Southmark Corp., a firm not in our sample, which proposed paying its CEO an annual bonus after emerging from Chapter 11, with the bonus payouts to be based on how much cash was paid to holders of the firm's new notes and preferred stock (2% of total payments between $100 million and $150 million, and 5% of payments above $150 million). In another example, the unsecured creditors committee in Pan Am's bankruptcy proposed paying the company's top managers a bonus based on the total proceeds from asset sales, the value of claims distributed to creditors under the reorganization plan, and the number of jobs saved (the committee included representatives from Pan Am's labor unions).

24. For example, in 1990 the bondholders of Western Union required that the company's Chairman give up his $2.4 million annual management fee in return for agreeing to restructure the firm's bonds. John J. Keller, *ITT Spreads Cheer to Some Retirees of Western Union*, WALL ST. J., Dec. 27, 1990, at C13. Similarly, creditors in the recent Greyhound Lines bankruptcy forced the company to cut the

able to influence the level of management's compensation (or other aspects of corporate governance) will again depend on the relative importance that judges attach to the interests of creditors as opposed to those of debtors.[25]

Finally, in over ten percent of the firms that we studied, creditors either directly or indirectly were involved in setting aside new stock or stock options for senior managers (Panel C). In one case, bank lenders explicitly proposed the establishment of a new equity-based incentive plan for the firm's CEO.[26] In nine additional cases, creditors played an indirect role

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CEO's annual salary from $501,300 to $400,000, and cancel a proposed severance plan that would have paid its senior executives three years' salary if they were replaced or demoted. Robert Tomsho, *Greyhound's Union Falters in Buy-Out Bid*, WALL ST. J., Apr. 19, 1991, at A9. More systematic evidence of this bargaining dynamic is found in a recent study of seven financially troubled U.S. steel producers that sought large wage concessions from their unions. *See* Harry DeAngelo & Linda DeAngelo, *Union Negotiations and Corporate Policy: A Study of Labor Concessions in the Domestic Steel Industry During the 1980s*, 20 J. FIN. ECON. 3 (1991). In years that such concessions were granted, the study reports, the CEOs of these firms experienced an average 18% decline in their cash compensation. *Id.* Arguably, such concessions were important symbolically, but by themselves had no substantive impact on companies' bottom line.

In our study of CEO compensation in financially troubled firms, we find that such downward pressure on salary levels tends to be much less pronounced in the case of new CEOs hired from outside the firm. Gilson & Vetsuypens, *supra* note 10, at 442-44. We find that the median outside replacement CEO was actually paid 36% more than his or her predecessor, while the median CEO replacement promoted from within the firm was paid 35% less than the CEO he or she replaced. *Id.* This difference has several plausible interpretations. Outside managers are not tainted by the firm's past poor performance, and often claim to possess special expertise in turning around troubled companies. Such managers may also require additional compensation for the risk and emotional stress associated with running a troubled company. In their study of bankrupt firms, LoPucki and Whitford argue that managers may also sometimes be able to "grab" additional compensation for themselves as a result of the leverage that they exert over the bankruptcy negotiations. *See* LoPucki & Whitford, *supra* note 10, at 740. They characterize 5 of 43 cases in their sample as "grabs," although they concede that their characterization is based on subjective criteria. *Id.*

25. In the recent bankruptcy of Zale, for example, the judge, spurred by pressure from the unsecured creditors, forced the company to substantially lower the cash value of the new CEO's compensation agreement (from over $4 million to approximately $650,000). *See* Christi Harlan, *Court Rejects Plan by Zale to Hire a Chief Executive*, WALL ST. J., Aug. 26, 1992, at B6. In explaining his ruling, the judge noted that "the debtors have closed hundreds of stores, laying off hundreds of employees . . . these estates should not be paying (for the CEO's personal expenses)." *Id.*

26. The firm in question is Zapata Corporation, which restructured its debt out of court. In its 1987 annual shareholder proxy statement, the company explained management's compensation as follows:

> Pursuant to the proposed debt restructuring, the Company's bank creditors will receive a substantial portion of the Company's equity securities . . . and will have a large and continuing interest in the success of the Company over the next few years. . . . [The] inclusion in the restructuring agreement of a provision for the issuance of up to 3,000,000 shares of the Company's common stock under a new management incentive stock plan evidences the importance which the banks attach to the continuing efforts of existing management of the Company in achieving a successful restructuring.

in giving management stronger stock-based incentives by approving a reorganization or restructuring plan that provided for the establishment of such incentives. These changes in managerial incentives are desirable on economic grounds because they cause managers' wealth to become more closely aligned with the value of the firm's residual claims. Importantly, creditors of the firms we studied also stood to benefit from such changes because they received large percentage stakes in firms' postreorganization equity—forty percent on average on a fully-diluted basis. Arguably, current legal and regulatory restrictions on creditors' ability to hold equity in nonfinancial firms[27] are undesirable because they potentially discourage adoption of such improved financial incentives for managers.

To investigate whether creditors influenced managerial incentives more generally in our firms, we estimated ordinary least-squares regressions that relate annual changes in CEO wealth to corresponding changes in total shareholder wealth and various empirical proxies for creditor control. The change in CEO wealth includes the change in the CEO's cash compensation (excluding profits from exercising stock options) and the change in the value of his or her stock options and inside stockholdings.[28] The change in shareholder wealth equals the annual change in the market value of the firm's outstanding common stock. Regressions are estimated using annual panel data, with each firm appearing in the sample for up to twelve years (centered around the start of the firm's bankruptcy or debt restructuring) based on data availability.

The results of this analysis are shown in Table III. A large, positive coefficient on the annual change in shareholder wealth variable (denoted DSHW) means that CEOs have strong incentives to maximize the value of their firms' common stock. As shown in the table, the estimated coefficient on DSHW is always positive and statistically significant, regardless of how the regression model is specified.

ZAPATA CORPORATION, 1987 PROXY STATEMENT 33 (1988).

27. *See* Gilson, *supra* note 1.

28. We exclude reported option exercise profits from our calculation of CEO wealth changes because such profits represent only the transformation of one type of wealth (stock options) into another (cash), without altering the total amount of wealth. The change in the value of stock options is approximated by the number of options held by the CEO at the beginning of the year, multiplied by (1) the annual change in the stock price, and (2) the constant 0.6. The latter value approximates the average sensitivity of option values to common stock prices as estimated in Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990). We use this approximation rather than attempt to value managers' options directly because certain data that need to be inputted in standard option-pricing models are either unavailable or unreliable. *See* Gilson & Vetsuypens, *supra* note 10, at 449.

Table III

Estimated coefficients from ordinary least-squares regressions relating annual changes in CEO wealth to corresponding annual changes in shareholder wealth and various proxies for creditor control.

Regressions are based on pooled time-series and cross-sectional data for 77 publicly traded firms that either filed for bankruptcy under Chapter 11 or privately restructured their debt to avoid bankruptcy between 1981 and 1987. The change in CEO wealth equals the annual change in the CEO's reported cash compensation (excluding profits from exercising stock options) and the corresponding annual change in the value of the CEO's stock options and his or her inside stockholdings. The change in shareholder wealth equals the annual change in the market value of the firm's outstanding common stock. Financial statement and share ownership data are obtained from firms' annual 10-K reports and shareholder proxy statements. For each firm in the sample, data are available up to a maximum of twelve years, centered on the start of firms' bankruptcy or debt restructuring. T-statistics are shown in parentheses.

Explanatory variable	(1)	(2)	(3)	(4)
DSHW	0.0241	0.0259	0.0258	0.0250
	(12.6)	(13.4)	(12.6)	(11.7)
BANKD	0.0432			0.0529
	(2.5)			(2.7)
CREDE·		-0.0003		-0.0025
		(-1.6)		(-1.2)
BANKE			-0.002	0.0021
			(-0.2)	(0.9)
Adjusted R^2	0.31	0.31	0.31	0.32

DSHW = Change in shareholder wealth

BANKD = DSHW x the percentage of long-term debt that is owed to banks just prior to the start of firms' bankruptcy or debt restructuring (set equal to zero in prior years)

CREDE = DSHW x the percentage of firms' common stock received by creditors under firms' bankruptcy or debt restructuring plans (set equal to zero in years prior to bankruptcy or debt restructuring)

BANKE = DSHW x the percentage of firms' common stock received by bank lenders under firms' bankruptcy or debt restructuring plans (set equal to zero in years prior to bankruptcy or debt restructuring)

The regressions also include three interactive terms that measure whether creditors are likely to be able to exercise control in a particular firm. The variable BANKD increases with the amount of bank debt that was outstanding before firms became financially distressed, while CREDE and BANKE increase with the percentage of outstanding common stock distributed to creditors and banks, respectively, under firms' bankruptcy or debt restructuring plans. The positive and significant coefficient on BANKD in the first and fourth regressions implies that the sensitivity of CEO wealth to shareholder wealth is significantly higher when firms initially owe more of their debt to banks. In economic terms, the sum of the coefficients on DSHW and BANKD in the first regression (0.0241 + 0.0432 = 0.0673) means that when shareholder wealth increased by $1000 in our sample, CEO wealth increased on average by $67.30. (To put this figure in context, a recent study of solvent firms finds that the same increase in shareholder wealth is associated with an average CEO wealth increase of only approximately $3.00.)[29] In contrast, neither of the other two interactive terms (CREDE and BANKE) are significant in any of the regressions.[30]

Consistent with the above-reported evidence on creditor-initiated management turnover, these results suggest that banks play a more important role in the governance of financially troubled firms than other types of creditors. In addition, formal voting power conferred by stock ownership seems to be unimportant in terms of whether creditors are able to exert influence over corporate policies. The important monitoring role for banks in financially distressed firms probably reflects banks' financial sophistication and experience in dealing with defaulted loans relative to other creditors. In addition, coordination and incentive problems among banks are probably less severe than, say, among trade creditors or public bondholders, because the banks are typically fewer in number.

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29. *See* Jensen & Murphy, *supra* note 28, at 225. The results of this latter study are based on a sample of 2,213 CEOs who were listed in *Forbes'* Executive Compensation Surveys from 1974 to 1986. Some reasons why management compensation is more sensitive to equity values following financial distress are discussed in Stuart C. Gilson & Michael R. Vetsuypens, *Creating Pay-for-Performance in Financially Troubled Companies*, J. APPLIED CORP. FIN., Winter 1994, at 81.

30. The regression coefficients are qualitatively unchanged when we include measures of firm size (e.g., the book value of assets) as additional explanatory variables in the regressions. We performed this check because the positive coefficient on BANKD could simply be capturing a relation between firm size and managerial equity ownership (managers of smaller firms can afford to own a larger percentage of firms' common stock), and a relation between firm size and the amount of debt owed to banks (smaller firms typically make less frequent use of public bond markets, and rely more on bank debt financing).

IV. FACTORS THAT ENCOURAGE CREDITOR CONTROL

The above evidence suggests that creditors played an important governance role in a nontrivial percentage of the firms studied.[31] However, such control is still far from universal (although, as already noted, our analysis is limited to publicly reported cases of creditor control). In Table IV we investigate what factors may be conducive to the exercise of creditor control in financially distressed firms. We partitioned our sample into two groups of firms: those where creditors openly exercised control by forcing out senior managers or setting the CEO's compensation (seventeen firms), and those where there was no public manifestation of creditor control (sixty firms).[32]

31. Using a different approach to identify cases of creditor control, LoPucki and Whitford found that management is arguably aligned with creditor interests in slightly over a third (9 of 25) of the cases they studied involving large, publicly held firms in Chapter 11 (where they felt confident enough to be able to make such a classification, based on field interviews with bankruptcy attorneys and other professionals who served in these cases). *See* LoPucki and Whitford, *supra* note 10, at 742-47.

32. This classification ignores control conferred by restrictive debt covenants (per Table I), inasmuch as such covenants were adopted by virtually all firms that restructured their debt out of court. As for firms that reorganize in Chapter 11, Gilson shows that most debt contracts outstanding prior to bankruptcy are extinguished under firms' reorganization plans, making a measure of control based on covenants less meaningful for our purposes. *See* Gilson, *supra* note 1.

Table IV

Relation between creditor control and selected firm attributes.

Sample consists of 77 publicly traded firms that either filed for bankruptcy under Chapter 11 or privately restructured their debt to avoid bankruptcy between 1981 and 1987. Income and balance sheet data are obtained from the COMPUSTAT Annual Industrial and Research tape and the *Moody's* manuals. Total liabilities ÷ total assets, total assets, and total revenues are based on information contained in financial statements that most closely predate the start of firms' bankruptcy or debt restructuring. Differences in means (medians) are evaluated using a t-test (Wilcoxon rank-sum test).

	Mean (median)		
Firm attribute	Creditors force CEO change or tie CEO's pay to creditor wealth (N=17)	All other firms (N=60)	p-value for difference in means (medians)
% of long-term debt initially owed to banks	58.3	40.1	0.11
	(68.0)	(27.0)	(0.03)
% of common stock received by:			
All creditors (undiluted)	25.3	22.0	0.67
	(11.9)	(11.4)	(0.83)
All creditors (fully diluted)	37.8	35.6	0.80
	(42.5)	(27.0)	(0.76)
Banks (undiluted)	3.6	6.1	0.62
	(0.0)	(0.0)	(0.71)
Banks (fully diluted)	12.9	11.2	0.81
	(0.0)	(0.0)	(0.47)
Total liabilities ÷ total assets	0.86	0.85	0.90
	(0.85)	(0.82)	(0.51)
Total revenues ($millions)	1,326	697	0.15
	191	205	(0.35)
Total assets ($millions)	1,976	741	0.14
	277	240	(0.36)

Consistent with earlier evidence presented in our study, the results in Table IV suggest that creditor control is more likely to be exercised in financially distressed firms that owe more of their debt to banks (row one). For the subsample of firms in which creditors exercised control, 68% of the median firm's long-term debt (face value) was owed to banks; in contrast, only 27% of long-term debt was outstanding to banks for the median firm in the subsample where no creditor control was found. This difference is statistically significant based on a Wilcoxon rank-sum test for medians (mean values are also significantly different based on a t-test). As before, explicit stock ownership by creditors, whether calculated on a fully diluted or undiluted basis, does not appear to be necessary in order for the creditors to exercise control (rows two to five). One would also expect secured creditors to be more powerful when they can credibly threaten to force the firm into liquidation. One proxy for a firm's closeness to liquidation is the ratio of debt to assets measured just prior to the start of its bankruptcy or out-of-court restructuring. However, this variable is also unrelated to our measure of creditor control (row six). Finally, the presence of creditor control appears to be unrelated to firm size, as measured by revenues or total assets (rows seven and eight). One might expect creditors to exercise control more effectively in smaller firms where they are likely to be fewer in number, making it possible for them to bargain as a unit.[33]

V. CONCLUSION

The results of our study suggest that creditors can play a significant role in the governance of financially distressed public companies. Creditors exerted direct influence over management hiring and compensation policy in approximately one-fourth of the firms we studied. In the large majority of sample firms that restructured their debt out of court, creditors also indirectly influenced corporate policies through the imposition of highly restrictive covenants in renegotiated lending agreements. In all cases, such control was exercised by commercial banks and other institutional lenders, rather than by trade creditors or public bondholders. This documentary evidence provides useful behavioral benchmarks for management and

33. This last comparison is possibly confounded by the fact that large firms tend to attract more media attention, and so may be associated with more *publicly reported* cases of creditor control (even if no greater number of *actual* cases).

creditors of financially distressed firms. Whether corporate resources are efficiently allocated when creditors are allowed to exercise control during financial distress represents an interesting subject for future research.