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Lender Control Liability Functional Examination: the Firm and Heuristics

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Lender Control Liability Functional Examination: the Firm and Heuristics

I. Introduction

Control is one of the most important and commonly used concepts in corporate governance. Nonetheless, the definition of the concept has proved impossible to define with precision. This difficulty has not stopped researchers from investigating how to allocate control in firms. Since the extant work of Aghion and Bolton,¹ the finance literature suggests that control should contingently be assigned to creditors in distressed firms as a way to limit agency costs. As a matter of fact, it is common to see in the financial literature the assumption that violation of debt covenants generates shifts in control.² Some legal scholars in the United States have recently supported this view, both descriptively and normatively. Baird and Rasmussen,³ as well as Skeel,⁴ have argued that control shifts to creditors in distressed firms and that such shift is indeed beneficial from an efficiency standpoint.

This position stands in stark contrast to the recent experience in the United Kingdom which led to the adoption of the Enterprise act of 2002. This act has, for the most part, abolished the administrative receivership, which had drawn concern due to the perceived lack of transparency and accountability.⁵ Armour and Mokal describe the

¹ See Phillippe Aghion & Patrick Bolton “An Incomplete Contracts Approach to Financial Contracting”, 59 *Review of Economic Studies* 473 (1992).

² See Sudheer Chava & Michael R. Roberts “How Does Financing Impact Investment? The Role of Debt Covenants”, forthcoming *Journal of Finance*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=854324 (last visited 2/1/08), at 2 (“However, the instant that the borrower's net worth falls below this threshold, regardless of the amount, control rights shift to the creditor ...” “...transfer of control rights accompanying a covenant violation leads to a significant decline in investment activity, as creditors intervene in order to thwart inefficient investment or punish managers for perceived misbehavior”). For an exception, see Gary Gorton & James Kahn “The Design of Bank Loan Contracts”, 13 *Review of Financial Studies* 331, 359 (2000) (“The firm sometimes has an incentive to increase volatility. The outside claimant that is in a position to prevent this, the bank, only imperfectly controls borrower risk-taking”)

³ See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 *Stan. L. Rev.* 751 (2002).

⁴ See David A. Skeel, Jr. “Creditors’ Ball: The “New” New Corporate Governance in Chapter 11”, 152 *U. Pa. L. Rev.* 917 (2003).

⁵ Unsecured creditors were viewed as the main constituency suffering from the administrative receivership consequences. See *Productivity and Enterprise: Insolvency – A Second Chance*, Cm 5234, London, TSO (2001), 9.

administrative receivership as being “widely regarded as giving an unhealthy amount of power to creditors holding floating charges, who because of their secured status lacked sufficient incentives to rescue failing companies.”⁶

In this paper, I consider the implications of allocating control to a lender. Drawing inferences from the literature on the theory of the firm, I uncover the existence of lender control costs beyond conflict of interests due to claimholders with priority differences. The priority differences’ cosmology stems from a view of the firm as composed by explicit contracts. Breaking away from that paradigm allows us to identify other sources of lender control costs not tied to priority differences between classes of claimholders. Specifically, I show that even when there is only one class of legal claimholders, lender control may generate suboptimal results due to the suboptimal investment incentives that parties not fully covered by explicit contracts may have.

In addition, I argue that broadening the definition of the firm sheds light on the role of lender control and functionally related theories (i.e. equitable subordination) of liability. These theories had been criticized by academics and practitioners alike due to the dire consequences they pose on lending,⁷ while their role has been dwarfing. In particular, widening the definition of the theory of the firm allows us to visualize that lender control liability should serve to penalize self-serving behavior which runs counter to the optimal use of the assets.

Finally, I discuss the strict nature of lender control liability and its relation to cognitive errors. The ordinary understanding is that lender control triggers harmful strict lender liability. Therefore, lender control liability should be heavily limited or even

⁶ See John Armour & Rizwaan J. Mokal “Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002”, *Lloyds Maritime and Commercial Law Quarterly* 28, 29 (2005). This perception of inefficiency grew despite the existence of the so called ‘London Approach’, where secured creditors wouldn’t press for insolvency under the threat of losing future business. See John Armour & Simon Deakin “Norms in Private Insolvency Procedures: The ‘London Approach’ to the Resolution of Financial Distress”, *1 Journal of Corporate Law Studies* 21 (2001)

⁷ See, for example, John C. Joyce “Lender Liability: The Problem Is still with Us”, *115 Banking L. J.* 477, 483 (1998); J. Dennis Hynes “Lender Liability: The Dilemma of the Controlling Creditor”, *58 Tenn. L. Rev.* 635 (1991).

suppressed so that the efficient lending is not precluded. I argue that the strict nature of lender control liability may avoid inefficiencies deriving from hindsight bias, but that hindsight is not the only cognitive error distorting adjudicators. A closer look at anchoring's role in damage assessments, permits to refocus policy recommendations and help explain the shortcomings of strict liability in this context.

This paper proceeds as follows. Part II, discusses the predominant as well as competing theories of the firm and their implications for lender control evaluations. Part III, presents a model to show lender control costs even when there's only one class of legal claimants to the firm assets. Part IV, investigates rationales behind the dwarfing role of lender liability theories in the United States and argues that it is in part due to the misconception that freedom of contracts will always generate socially optimal results. Part V, shows that fears of adjudication errors due to hindsight bias in the context of lender control liability theories are somewhat misplaced and that policy oriented recommendations should focus not only on hindsight bias but also on anchoring. Part VI provides concluding remarks.

II. The Explicit Nexus of Contracts Paradigm

Knowing what constitutes a firm is important, both for healthy and distressed firms, as a way to understand whether it is beneficial to have a firm and whether allocation of control influences efficiency.⁸ Originally, the firm was viewed in terms of the technological transformations a firm was capable of doing,⁹ focusing on the maximization of the production function of the firm.¹⁰ Milgrom and Roberts suggest that

⁸ In previous work, I have discussed extensively different theories of the firm and their implications for value and control. See Sergio A. Muro "Bankruptcy Control and the Theory of the Firm", unpublished manuscript, on file with the author.

⁹ See Sidney G. Winter "On Coase, Competence, and the Corporation", 4 *Journal of Law, Economics, & Organization* 163, 164 (1988). For an early presentation of the neoclassical viewpoint, see Jacob Viner "Cost Curves and Supply Curves", 3 *Zeitschrift für National-ökonomie* 23 (1932). Hart considers that "A manager presides over this production set, buying and selling inputs and outputs in a spot market and choosing the plan that maximizes owners' welfare." See Oliver Hart "An Economist's Perspective on the Theory of the Firm", 89 *Colum. L. Rev.* 1757, 1759 (1989).

¹⁰ See Sidney G. Winter "On Coase, Competence, and the Corporation", 4 *Journal of Law, Economics, & Organization* 163, 164 (1988). Holmstrom and Tirole argue that the theory of the firm in neoclassical terms just asked "what forces ensure that the process will maximize profits". See Bengt R. Holmstrom & Jean Tirole "The Theory of the Firm", 1 *Handbook of Industrial Organization* 61, 63 (1989).

this “neoclassical theory” looked at market failures in competitive environments to find reasons for non-market organizations (i.e. market power, increasing returns to scale, externalities, coordination problems, etc).¹¹

Later advances replaced this conceptualization by what Zingales refers to as the “explicit nexus of contracts theory”,¹² which is the prevalent view of the firm in corporate finance.¹³ It originated with Alchian and Demsetz’s¹⁴ study where input from different individuals cannot be verified while output can. As free riding would emerge, their solution involved allowing one person to monitor the venture, pay the other individuals fixed amounts and receive all the residual claims from the firm.¹⁵ Jensen and Meckling¹⁶ contributed greatly to this approach by describing the firm as a legal fiction tying a set of contractual relations together.¹⁷ As a result, the firm boundaries’ are set by the costs the monitor incurs in controlling that the agents perform according to the contracts.¹⁸

As all contracts are assumed to be explicit, the explicit nexus of contracts theory considers that each constituent, except for the shareholders, is fully paid its opportunity cost. Therefore, a firm cannot be worth more than the sum of contracts it unites¹⁹ and

¹¹ See Paul R. Milgrom & John Roberts, *ECONOMICS, ORGANIZATION & MANAGEMENT*, Prentice Hall, Englewood Cliffs, N.J. (1992), at 73-7.

¹² See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1630 (2000).

¹³ See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1630 (2000).

¹⁴ See Armen Alchian & Harold Demsetz “Production, Information Costs and economic Organization”, 62 *American Economic Review* 777 (1972).

¹⁵ See Bengt R. Holmstrom & Jean Tirole “The Theory of the Firm”, 1 *Handbook of Industrial Organization* 61, 67 (1989).

¹⁶ See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 4 *Journal of Financial Economics* 305 (1976).

¹⁷ See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 *Journal of Financial Economics* 305, 311 (1976).

¹⁸ Jensen and Meckling define an agency relationship as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.” See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 *Journal of Financial Economics* 305, 308-11 (1976). Then agency costs are composed of “1. the monitoring expenditures by the principal, 2. the bonding expenditures by the agent, 3. the residual loss.” See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 *Journal of Financial Economics* 305, 322-3 (1976).

¹⁹ See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1631 (2000). In Jensen and Meckling words “The private corporation or firm is simply one form of legal fiction which serves as a

shareholders, as only residual claimants, need to be allocated the decision rights.²⁰ In the same vein, only shareholder interests should be pursued by the firm. As a corollary consequence, in order to value the firm, computing only legal claims' prices is relevant.²¹

The explicit nexus of contracts theory is widespread through law academia and court opinions. For example, in the law literature, Easterbrook and Fischel, when they discuss voting, consider that “The right to vote is the right to make all the decisions not otherwise provided by contract – whether the contract is express or supplied by legal rules”,²² implying that residual powers need merely be with the only class possessing residual rights: the shareholders. As for judicial decisions, an example can be observed in the recent opinion *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*,²³ where the Chancery Court of Delaware while considering the existence of duties towards creditors in vicinity of insolvency expressed that “So long as directors are respectful of the corporation's obligation to honor the legal rights of its creditors, they should be free to pursue in good faith profit for the corporation's equityholders”,²⁴ implying that other constituents besides shareholders are paid their full opportunity cost.

nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals. Although this definition of the firm has little substantive content, emphasizing the essential contractual nature of firms and other organizations focuses attention on a crucial set of questions—why particular sets of contractual relations arise for various types of organizations, what the consequences of these contractual relations are, and how they are affected by changes exogenous to the organization. Viewed this way, it makes little or no sense to try to distinguish those things that are “inside” the firm (or any other organization) from those things that are “outside” of it.” See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 *Journal of Financial Economics* 305, 311 (1976).

²⁰ Easterbrook and Fischel consider that “As the residual claimants, the shareholders are the group with the appropriate incentives (collective choice problems to one side) to make discretionary decisions... Yet all of the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.” See Frank H. Easterbrook & Daniel R. Fischel “Voting in Corporate Law”, 26 *Journal of Law and Economics* 395, 403 (1983).

²¹ See Michael C. Jensen “Value Maximization, Stakeholder Theory, and the Corporate Objective Function”, 14 *Journal of Applied Corporate Finance* 8, 19 (2001) (“In sum, the appropriate measure for the organization is value creation, the change in the market value of all claims on the firm.”)

²² See Frank H. Easterbrook & Daniel R. Fischel “Voting in Corporate Law”, 26 *Journal of Law and Economics* 395, 402 (1983).

²³ See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, Del. Ch. (2006)

²⁴ See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174-5 Del. Ch. (2006)

The explicit nexus of contracts paradigm has generated a standard way of approaching control allocation in distressed firms. Following the works of Jensen and Meckling²⁵ and Myers²⁶ allocation of control is associated exclusively to conflict of interests between classes of individuals holding claims with different priority levels. Jensen and Meckling's observed that if shareholders of an over-leveraged firm (i.e. debt over asset ratio over 1) are at the helm, they will have incentives to over-invest in high variance projects leaving them to enjoy potential benefits and the creditors to suffer potential losses. Myers' uncovered the underinvestment problem. He described a firm's investment opportunity as call options whose likelihood of being exercised depends on the conflict of interests between debtholders and shareholders. As debtholders had a cap on maximum recovery, if they were at the helm they would disregard opportunities that made them suffer losses in bad scenarios without letting them enjoy the benefits in the good scenarios, regardless of the net present value of the project. Therefore, debtholders' control over investment policy may lead to underinvestment. Empirical studies linking firm characteristics to financial policy decisions suggest the accuracy of those theories.²⁷ Aghion and Bolton extended this line of work to show that ex ante efficiency is advanced by allocating control contingent in the financial signals of the firm.²⁸

Relying on theoretical implications of the explicit nexus of contracts theory, Baird and Rasmussen, as well as Skeel, have praised what they perceive as a new bankruptcy era where control shifts to creditors upon distress.²⁹ Baird and Rasmussen consider that

²⁵ See Michael C. Jensen & William H. Meckling "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 *Journal of Financial Economics* 305 (1976)

²⁶ See Stewart C. Myers "Determinants of Corporate Borrowings", 5 *Journal of Financial Economics* 147 (1977).

²⁷ See, generally, Clifford W. Smith & Ross L. Watts "The Investment Opportunity Set and Corporate Financing, Dividend, and Compensation Policies", 32 *Journal of Financial Economics* 263 (1992).

²⁸ See Phillippe Aghion & Patrick Bolton "An Incomplete Contracts Approach to Financial Contracting", 59 *Review of Economic Studies* 473 (1992).

²⁹ See Douglas G. Baird & Robert K. Rasmussen "Private Debt and the Missing Lever of Corporate Governance", 154 *U. Pa. L. Rev.* 1209 (2006); David A. Skeel, Jr. "The Past, Present and Future of Debtor-in-Possession Financing", 25 *Cardozo L. Rev.* 1905, 1920-1 (2004). The idea of control transfers due to debt covenant violations is widely accepted in the finance literature. See, for example, Sudheer Chava & Michael R. Roberts "How Does Financing Impact Investment? The Role of Debt Covenants", forthcoming *Journal of Finance*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=854324 (last visited 2/1/08), at 1 ("Upon breaching a covenant, control rights shift to the creditor who can use the threat of accelerating the loan to choose their most preferred course of action or to extract concessions from the borrower to choose the borrower's most preferred course of action")

“Today’s investors allocate control rights among themselves through elaborate and sophisticated contracts that already anticipate financial distress. In the presence of these contracts, a law of corporate reorganizations is largely unnecessary.”³⁰ Professor Skeel believes that the new “governance levers have dramatically improved the quality of chapter 11 governance.”³¹

Regardless of the appeal of its straightforward logic,³² several papers have discussed some shortcomings of the explicit nexus of contracts theory. Fama and Miller have pointed out that bondholders are not completely protected from shareholder decision making.³³ Becker points to worker’s specialization to observe that those employees can be affected if the firm fires them before they recoup the investment in specialization and therefore are residual claimants also.³⁴ In addition, Shleifer and Summers studied efficiency gains of takeovers to conclude that at least in part they arise out of wealth redistribution from stakeholders to shareholders (the redistribution of wealth may come from employees, government or suppliers).³⁵ Therefore, even though shareholders are the

³⁰ See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 755 (2002). In the same vein they mention “When control rights are allocated coherently, no legal intervention is needed to ensure that decisions about the firm’s future are made sensibly. Most large firms now allocate control rights among investors in a way that ensures coherent decisionmaking throughout the firm’s life cycle.” See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 778 (2002).

³¹ See David A. Skeel, Jr. “Creditors’ Ball: The “New” New Corporate Governance in Chapter 11”, 152 U. Pa. L. Rev. 917, 920 (2003)

³² In this regard, Jensen notes that “It is logically impossible to maximize in more than one dimension at the same time unless the dimensions are what are known as “monotonic transformations” of one another. Thus, telling a manager to maximize current profits, market share, future growth in profits, and anything else one pleases will leave that manager with no way to make a reasoned decision. In effect, it leaves the manager with *no* objective.” See Michael C. Jensen “Value Maximization, Stakeholder Theory, and the Corporate Objective Function”, 14 Journal of Applied Corporate Finance 8, 10-1 (2001)

³³ See Eugene Fama & Merton H. Miller, *The Theory of Finance*, Dryden Press, Hinsdale, Ill. (1972)

³⁴ See Margaret M. Blair “Firm-Specific human Capital and Theories of the Firm”, in *Employees and Corporate Governance*, Margaret M. Blair and Mark J. Roe, eds., Brookings Institution Press (1999), at 60-3, citing Gary S. Becker *Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education*, National Bureau of Economic Research, New York (1964).

³⁵ See Andrei Shleifer & Lawrence H. Summers. “Breach of Trust in Hostile Takeovers”, in *Corporate Takeovers: Causes and Consequences*, Alan J. Auerbach ed., The University of Chicago Press, Chicago (1988), at 33-56. They contended that firms usually rely on implicit contracts which the company must be trusted to respect. To the extent that long term contracts reduce costs, such trustworthiness is a valuable asset to the firm. The need for long term contracts derives from the equal need to promote firm specific investment. The problem is that even if *ex ante* efficient, in certain states of the world it will be *ex post* efficient to breach those contracts. Hence, *ex post* cost breaching needs to be measured against *ex ante* increase in cost (plus it is more likely to be, at least in part, a redistribution of wealth than anything else).

only *de jure* residual claimants in the nexus of contracts, it doesn't mean that they are the only *de facto* residual claimants.³⁶

Other theories, such as the explicit and implicit nexus of contracts,³⁷ the property rights theory of the firm³⁸ and the nexus specific investment,³⁹ have been proposed to overcome the problems of the explicit nexus of contracts theory.⁴⁰ Despite important differences, all these theories share an important feature: the allocation of residual decision rights via ownership can have an effect on investments in relationship specific capital (one which has lesser or no value outside the relation for which is created), because it determines to some extent ex post distribution of surplus and therefore will determine the parties' willingness to invest ex ante. For example, Hart mentions the case of GM ownership of Fisher Body, electricity generating plants owning coal mines, and aluminum refineries owning bauxite mines as cases where allocating ownership generates lesser possibilities of a hold-up and thereby more efficient ex ante investment.⁴¹

These theories of the firm present a more complex structure than the explicit nexus of contracts paradigm,⁴² recognizing the existence of value outside mere transaction costs and focusing on the existence of efficient complementarities. Implicit contracts and the interaction of specific investments are difficult to understand and value,

³⁶ Milgrom and Roberts suggest that "it may be impossible to identify any individual or group that is the unique residual claimant or, indeed, to identify the benefits and costs accruing to any decision and so compute the residuals." See Paul R. Milgrom & John Roberts, *ECONOMICS, ORGANIZATION & MANAGEMENT*, Prentice Hall, Englewood Cliffs, N.J. (1992), at 315.

³⁷ See George Baker, Robert Gibbons & Kevin J. Murphy "Relational Contracts and the Theory of the Firm", 117 *Quarterly Journal of Economics* 39 (2002).

³⁸ See Sanford J. Grossman & Oliver D. Hart "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration", 94 *Journal of Political Economy* 691 (1986); Oliver Hart & John Moore "Property Rights and the nature of the Firm", 98 *Journal of Political Economy* 1119 (1990).

³⁹ See Raghuram G. Rajan & Luigi Zingales "Power in a Theory of the Firm", 113 *Quarterly Journal of Economics* 387 (1998); Raghuram G. Rajan & Luigi Zingales "The Firm as a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms", 116 *Quarterly Journal of Economics* 805 (2001).

⁴⁰ For an enlightening discussion of different theories of the firm, see Erica Gorga & Michael Halberstam "Knowledge Inputs, Legal Institutions and Firm Structure: Towards a Knowledge Based Theory of the Firm", 101 *Northwestern L. Rev.* 1123 (2007).

⁴¹ See Oliver Hart "Firms, Contracts, and Financial Structure", Oxford University Press, New York (1995), p. 29- 33, 50-1. For another clear example, see Patrick Bolton & David S. Scharfstein "Corporate Finance, the Theory of the Firm, and Organizations", 12 *Journal of Economic Perspectives* 95, 98-9 (1998).

⁴² See George Baker, Robert Gibbons & Kevin J. Murphy "Relational Contracts and the Theory of the Firm", 117 *Quarterly Journal of Economics* 39, 70-1 (2002).

but their existence implies that there are hidden assets in an organization.⁴³ As a consequence, the mere aggregation of financial claims may not accurately represent the value of the firm. Further, focusing merely on financial claims to decide what to do with the assets of a distressed firm may be suboptimal because it may disrupt an appropriate asset allocation and control structure.⁴⁴ End game situations like bankruptcy maximize the importance of control allocation, as the ability of the economic system to penalize inefficient actions is considerably diminished.

The preceding discussion suggests that control allocation under different theories of the firm may not be innocuous towards incentives beyond mere balancing of agency costs of different set of claimants. The next section will look at control allocation costs abandoning the explicit nexus of contracts paradigm and will show the existence of other costs that need to be taken into account before advancing a definite judgment on the desirability of lender control.

III. Single class of claimants and lender control costs

A. A Simple Model

In this section, I intend to specifically tie the notions of lender control and the theory of the firm in bankruptcy. I present a stylized model drawing from previous work by Hart,⁴⁵ to illustrate inefficiencies that may arise in reorganization under lender control. The focus of this section is different from previous work on the matter because it focuses on lender control costs where there is only one class of legal claimants. The existence of more than one class of legal claimants has been shown to be the source of inefficiencies in bankruptcy.⁴⁶ Hence, I will show that assignment of property rights in reorganization

⁴³ See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1635 (2000).

⁴⁴ See George Baker, Robert Gibbons & Kevin J. Murphy “Relational Contracts and the Theory of the Firm”, 117 *Quarterly Journal of Economics* 39, 41 (2002).

⁴⁵ See Oliver D. Hart “Incomplete Contracts and the Theory of the Firm”, 4 *Journal of Law, Economics and Organization* 119, 125-7 (1988).

⁴⁶ The problem is closely related to what Hansmann and Kraakman call “liquidation protection” when discussing affirmative asset partitioning. See Henry Hansmann & Reinier Kraakman “The Essential Role of Organizational Law”, 110 *Yale L.J.* 387, 403 (2000) (“That threat lies principally in the possibility that partial or complete liquidation of the firm’s assets could destroy some or all of the firm’s going concern value, with the result that, even if the firm were to remain solvent after a partial liquidation, the net value left to the firm’s owners, and available as security for the firm’s creditors, might well be reduced”).

is not irrelevant, under certain conditions, to the value of a firm and that its effects have been overlooked by authors defending the idea of lender control of reorganizations.

This section, hence, illustrates a stylized version of chapter 11 case where, as Baird and Rasmussen and Skeel have discussed, a lender is in control of the bankrupt debtor⁴⁷ and, as a result, in control of the proceedings also.⁴⁸ Unlike general chapter 11 proceedings, I assume that there is only one class of legal claimants, the lender in control (LC) who owns all the debt claims to the firm, and another party, an independent service provider (SP), who has the ability to make relationship specific investments. The existence of only one source of legal claimants could be interpreted as a situation where a firm is so heavily indebted that there is not any plausible scenario under which the lender could be fully paid. Alternatively, it could be understood as a situation where one person provided all the financing to the firm, as a result being the only equity and debt holder for a business which due to a potent financial shock is currently worth a lot less than the face value of debt.⁴⁹ It is important to note that SP is not an employee of the debtor and therefore will not generate a claim to salary under the model. This feature of the model is not essential, but serves the purpose of highlighting the existence of control related costs where there's only one class of legal claimants.⁵⁰

At the outset of the model, I am denying the possibility that controlling lenders can make any relationship specific investments. Although I acknowledge that this is an extreme assumption, there are reasons to believe that it is closely related to lending practices. At least in the US, lenders focus seems to be on assessing the viability of

⁴⁷ See Douglas G. Baird & Robert K. Rasmussen "The End of Bankruptcy", 55 *Stan. L. Rev.* 751 (2002); David A. Skeel, Jr. "Creditors' Ball: The "New" New Corporate Governance in Chapter 11", 152 *U. Pa. L. Rev.* 917 (2003).

⁴⁸ See Lucian A. Bebchuk & Howard F. Chang "Bargaining and the division of value in Corporate Reorganization", 8 *Journal of Law, Economics and Organization* 253 (1992)

⁴⁹ Notice that this interpretation doesn't necessarily mean that the business was originally undercapitalized. It is conceivable that a financially healthy business from the onset may become bankrupt after losses and/or a financial shock.

⁵⁰ In fact, very little would change if SP was an employee with a fixed salary. This presentation is admittedly extreme, in the sense that no part of the relationship between LC and SP is subject to an explicit contract at date 1.

possible investments and in monitoring those investments.⁵¹ This specialization in monitoring is documented by lenders' extensive experience on the matter.⁵² At the same time, lenders' lack of specific knowledge about other type of business' aspects (i.e. day to day running of the firm) is demonstrated by Mann who obtained extensive anecdotal information showing that lenders prefer to leave assets with debtors under the expectation of higher recovery rates.⁵³

The debtor firm has only one asset producing a profit with certainty (alternatively, all the assets of the firm can be thought as a unity where the ability to work with them is either given or not). This bankruptcy reorganization model has two periods, 1 and 2. In period 1, SP chooses an action e representing relationship specific investment which generates a total return at date 2 equal to the value of the firm $V(e)$. SP's action cannot be observed by any other person and makes him incur a private cost equal to e .⁵⁴ In the case that SP does not invest ($e=0$) then at period 2 firm value is $V(0)$.⁵⁵ The previous depiction of the reorganization time frame is entirely plausible given the reported length of US chapter 11 proceedings. For example, Carapeto found the length of the proceedings for firms reorganizing after the proposal of the first plan to be on average 272 days, while for firms where more than one plan was proposed the average length was 524 days.⁵⁶ To

⁵¹ See Dianna Preece & Donald J. Mullineaux "Monitoring, Loan Renegotiability, and Firm Value: The Role of Lending Sincates", 20 *Journal of Banking & Finance* 577, 578 (1996) ("The prevalent interpretation in the literature is that financial intermediaries provide specialized monitoring, screening, and certification services to borrowers"). See also Douglas W. Diamond "Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt", 99 *Journal of Political Economy* 689 (1991)

⁵² Roberts and Sufi who show that more than one quarter of publicly listed firms in the US between 1996 and 2005 violate a financial covenant at least once. See Michael R. Roberts & Amar Sufi "Control Rights and Capital Structure: An Empirical Investigation", working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962131 (last visited 1/29/08)

⁵³ See Ronald J. Mann "Strategy and Force in the Liquidation of Secured Debt", 96 *Mich. L. Rev.* 159, 178 (1997) ("When questioned about their reticence to repossess collateral, the account executives uniformly pointed to the general success of allowing the debtor to sell the collateral: the executives ordinarily expect to get full repayment if they leave collateral in the debtor's possession and rarely expect to get full repayment if they do not. Surprisingly, that perception seems to be well justified.")

⁵⁴ It is assumed that SP does not have any financial constraints which would force him to invest a level of e inferior to his first best option.

⁵⁵ When $e=0$, LC and SP do not enter into an agreement in date 2 and LC obtains the 100% of $V(0)$.

⁵⁶ See Maria Carapeto "Is Bargaining in Chapter 11 Costly?", Cass Business School Working Paper, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=241569 (2003). This figure is consistent with the findings in other studies. See, for example, Keneth M. Ayotte & Edward R. Morrison "Creditor Control and Conflict in Chapter 11", working paper available at

keep things as simple as possible, it is assumed that $V(e)$ is deterministic, twice differentiable and strictly concave.⁵⁷

Following Grossman and Hart,⁵⁸ there is an action involving the asset which can be taken at date 2 but cannot be specified in the contract at date 1. This generates contractual incompleteness, in turn making residual control rights relevant as whoever is in control will be able to obtain a share of any possible benefits arising out of a consensual transaction. To show this contractual incompleteness, it is assumed that whoever is in control always obtains a non-verifiable fraction $(1-\alpha)$ of $V(e)$, where $0 < \alpha < 1$. This $(1-\alpha)$ fraction of firm value may be interpreted as if the controlling lender presents a reorganization plan where the value of the firm is underscored, so that he can obtain a larger portion of resulting business' equity. Indeed, $(1-\alpha)$ speaks about one of the most significant problems in bankruptcy, determining firm value, one that the United States reorganization scheme was designed to sidestep.⁵⁹

The remaining share $\alpha V(e)$ is verifiable, and therefore contractible upon in the second period. As a result, a contract between LC and SP can only consist of a division of the firm's verifiable return or profits, $\pi = \alpha V(e)$. As only π is verifiable, SP's reward upon trading depends on it and is represented by a fraction $\beta\pi$, where $0 < \beta \leq 1$ is the rule the parties adopted on the division of any profits arising out of a transaction in period 2.

In order to maximize social efficiency and regardless of who is in control, the investment should work to maximize $V(e)-e$. As LC controls the firm, SP settles at date 1 for a level of e knowing that LC will obtain at least the fraction of value $(1-\alpha)V(e)$ and maybe more depending on LC's bargaining power. Therefore, SP works to maximize his

http://www.law.duke.edu/conference/triangle/morrison_chapter11.pdf (last visited 5/02/07) (reporting that firms stay in bankruptcy an average of 15 months)

⁵⁷ Ergo, $V'(e) > 0$ and $V''(e) < 0$.

⁵⁸ See Sanford J. Grossman & Oliver D. Hart "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration", 94 Journal of Political Economy 691, 696 (1986) ("We have in mind a situation in which it is prohibitively difficult to think about and describe unambiguously in advance how all the potentially relevant aspects of the production allocation should be chosen as a function of the many states of the world").

⁵⁹ One of the principal innovations of the Bankruptcy Code was to use voting in Chapter 11 in order to avoid the need for the court to perform cumbersome valuations.

private benefit $\beta\alpha V(e)-e$. It follows that because $\beta \leq 1$ (which is the case as $(1-\alpha)V(e)$ is not contractible) SP will not capture the full value deriving from his effort. Contrasting this case to the one where SP controls the firm⁶⁰ and invests in order to maximize both the verifiable and non-verifiable part

$$(1-\alpha)V(e)+\alpha V(e)-e$$

confirms the intuition that in the former scenario SP's investment decision will not be socially optimal.⁶¹ Only when SP controls the firm's asset the investment level allows achieving the first-best.

This simple model shows that, under conditions of contractual incompleteness (which allow value diversion) and relationship specific investments, the value of a firm may heavily depend on control allocation. In fact, Hart states that giving the party capable of making a value enhancing relationship specific investment "entitlement to the asset's profit stream will not be enough since an outside owner may be able to divert some of the asset's return for his own uses, thus dulling the manager's incentives."⁶² In the same spirit, Blair and Stout state, while discussing the importance of legal personality of corporations, that "Specific investment is discouraged when individual investors have a legal right to prematurely withdraw their contributions (and with it, the ability to opportunistically threaten to withdraw in order to "hold up" their fellow investors in an attempt to extract a larger share of the surplus generated by corporate activity)."⁶³

B. Relaxing the restriction on the number of claimholders

Allowing for the introduction of more than one class of claimholders, or even just more than one claimholder in the same class, does not provide a rosier picture. In fact, when LC is not the only claimholder (i.e. where there is a class of equityholders and/or junior creditors), which is usually the case in corporate reorganization proceedings, his claim will have a cap (C). This cap limits the ability of LC of reaping benefits from

⁶⁰ Ergo, SP doesn't need to share with LC $(1-\beta)\alpha V(e)$ either

⁶¹ This follows from the assumption that $V(e)$ is twice differentiable and strictly concave which means that $V(e)$ will have a larger value than $\alpha V(e)$ for any value of e .

⁶² See Oliver D. Hart "Incomplete Contracts and the Theory of the Firm", 4 Journal of Law, Economics and Organization 119, 127 (1988).

⁶³ See Margaret M. Blair & Lynn A. Stout "Specific Investment: Explaining Anomalies in Corporate Law", 31 Iowa J. Corp. L. 719, 730 (2006)

reorganization in two ways: it makes C the maximum LC can obtain from $(1-\beta)\alpha V(e)$; in addition the maximum LC will be able to divert to himself from underscoring the value of reorganization is also capped. The cap on the diversion amount is also derived from C, and follows from

$$[(1-\alpha)V(e)] * \frac{C}{(1-\beta)\alpha V(e)}$$

because $\frac{C}{(1-\beta)\alpha V(e)}$ is the maximum percentage of stock assignable to LC under a reorganization plan. The relative importance of the cap on a controlling lender is apparent. For corporate bankruptcies in the second part of 2001, Ayotte and Morrison report that ratio of secured debt to assets in the filing schedules was 0.65. This figure likely represents a higher bound on the ratio as there is a significant drop in the value of the assets reported in the last 10-K relative to the figure reported in the bankruptcy schedules.⁶⁴

Unfortunately, these effects are not beneficial to SP or more generally any party making relationship specific investments (unless the intersection of the set of relationship specific investors and the set of other claimholders is non empty). Further, they may be prejudicial as it makes any liquidation strategy (usually generating smaller returns) more attractive to LC as his benefits from reorganization are reduced. In turn, making the liquidation strategy more appealing to LC boosts his bargaining position, which generally means that β is smaller and negatively affects SP's ex ante investment.

The analysis above did not take into account an additional factor which is at the heart of lender control: security interests.⁶⁵ As long as LC is over-secured his ability to gain from any growth in $V(e)$ in good states of the world, as mentioned earlier, is partly reaped by other claimholders. The other claimholders, though, do not share in the same

⁶⁴ The mean value of assets reported in the last 10-K in their sample was 122.81 millions, while the median value of the assets reported in the bankruptcy schedules was 37.34 millions.

⁶⁵ Ayotte and Morrison have recently conducted an empirical investigation of this issue, finding that when secured creditors are oversecured reorganization cases are significantly shorter and more likely to result in a sale. See Kenneth M. Ayotte & Edward R. Morrison "Creditor Control and Conflict in Chapter 11", working paper available at http://www.law.duke.edu/conference/triangle/morrison_chapter11.pdf (last visited 5/02/07).

way with the losses that may occur in the bad states of the world. Hence, LC's assessment of the growth in V will be biased again making the liquidation option more viable, further reducing β and affecting the ex ante investment in e .

C. Inefficient restrictions to business plans

Start-up firms financed by venture capital firms (VC) have been related to distressed firms, because in both cases the investors have to deal with robust conflict of interests.⁶⁶ According to Kaplan, Sensoy and Stromberg it is possible and likely that VC firms place implicit constraints in business plan modifications⁶⁷ because they invested their money in a certain business plan.⁶⁸ This situation is in sharp contrast from the evidence on adaptation obtained by Bhide on other start-ups lacking VC funding.⁶⁹ Bhide discusses many entrepreneurs who started successful businesses without a detailed business plan at all and little funds. In the case of these entrepreneurs, the success of their ventures depends heavily on opportunistic adaptation, rather than merely following ex ante ideas. As a result, it appears that VC firms in their attempt to limit conflict of interests also restrict the set of growth opportunities.

Most likely, the same scenario appears with a lender in control. Conditional on the conjecture of similarity between distressed and start-ups' firms, controlling lenders of distressed firms will tend to constrain more business plan changes or adaptations limiting the ability of distressed firms to gain on unexpected opportunities. The fundamental reason behind the adaptation ability difference is the relatively poorer ability of a controlling lender to attribute unexpected events to the right causes due in large part to

⁶⁶ See Steven N. Kaplan & Per Strömberg "Financial Contracting Meets the Real World: An Empirical Analysis of Venture Capital Contracts", 70 *Review of Financial Studies* 281, (2003).

⁶⁷ See Steven N. Kaplan, Berk A. Sensoy & Per Stromberg "What Are Firms? Evolution from Birth to Public Companies", working paper available at <http://www.nber.org/papers/w11581.pdf> (last visited 1/29/2008), at 30.

⁶⁸ Referring to corporations (as banks or lenders in general) preference towards investments, Bhide states "The nature of the evidence required by corporate decision-makers leads them to favor initiatives where the risks and returns can be objectively assessed." See Amar V. Bhide, *The Origin and Evolution of New Business*, Oxford University Press, New York, NY (2000), at 120

⁶⁹ See Amar V. Bhide, *The Origin and Evolution of New Business*, Oxford University Press, New York, NY (2000), at 53-68.

the lack of expertise in the particular venture.⁷⁰ It should be noted that this investment scope restriction is separate and complementary to an investment magnitude restriction imposed by lenders when firms' performance is poor.⁷¹

Ambiguity appears to play a role in a controlling lender decision-making process also.⁷² According to Camerer, ambiguity is "known to be missing information".⁷³ Several experiments, following Ellsberg's famous paradox,⁷⁴ have shown that people are prone to have aversion towards ambiguity.⁷⁵ Interestingly, a person's attitude towards ambiguity is unrelated to her attitude towards risk.⁷⁶ Therefore, the fact that a lender has extensive expertise on decisionmaking in general (i.e. takes risks neutral decisions) does not immediately translate into adequate decisions when there is ambiguity involved. Expertise has been identified as an offsetting factor for ambiguity aversion.⁷⁷ Despite their ability to analyze investments,⁷⁸ it is unlikely that controlling lenders will be willing to invest on gaining the necessary experience to offset the ambiguity aversion in a particular firm, as it is not their forte.

The investment scope restriction and ambiguity aversion arguments would further suggest that lenders are suboptimal controlling parties not just due to Myers'

⁷⁰ Bhide considers that the capacity for adaptation depends on the entrepreneurs decisiveness, open-mindedness, managing internal conflict and attribution skills. See Amar V. Bhide, *The Origin and Evolution of New Business*, Oxford University Press, New York, NY (2000), at 99-104.

⁷¹ See Greg Nini, David C. Smith & Amir Sufi "Creditor Control Rights and Firm Investment Policy", working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928688, p. 3 (last checked 11/23/07) ("whether a loan includes an investment restriction is often more sensitive to changes in firm performance than amendments to interest rates and collateral requirements"). See also, Amar Sufi "Banks Lines of Credit in Corporate Finance: An Empirical Analysis", working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=723361 (last visited 1/30/08), at 25 ("Even controlling for the financial factors leading to covenant violations, a covenant violation has an independently large and statistically significant effect on the availability of lines of credit")

⁷² It is unclear whether ambiguity aversion causes the restriction on business' plan adaptations, are both generated by a different phenomenon or are completely independent.

⁷³ See Colin F. Camerer "Individual Decision Making", in *The Handbook of Experimental Economics*, John H. Kagel & Alvin E. Roth eds. Princeton University Press, Princeton, N.J 1995, at 645.

⁷⁴ See Daniel Ellsberg "Risk, Ambiguity, and the Savage Axioms" 75 *Quarterly Journal of Economics* 643 (1961)

⁷⁵ See Paul Slovic & Amos Tversky "Who Accepts Savage's Axioms?" 19 *Behavioral Science* 368 (1974)

⁷⁶ See Colin F. Camerer "Individual Decision Making", in *The Handbook of Experimental Economics*, John H. Kagel & Alvin E. Roth eds. Princeton University Press, Princeton, N.J 1995, at 646

⁷⁷ See Amar V. Bhide, *The Origin and Evolution of New Business*, Oxford University Press, New York, NY (2000), at 97

⁷⁸ See section III.A supra

underinvestment argument or a preference towards low volatility projects, but also due to credibility problems for project alterations: a project modification would require the lender to incur additional investigation costs to assess its profitability while his investment upside would remain the same. Hence, the lender would tend to disfavor investing new money and would favor a sale of the business. Intimately related, if a controlling lender limits the investment opportunity set, it may foster an expectation of failure which in itself could trigger actual failure.⁷⁹

D. Summary

I have shown that broadening the view of the theory of the firm permits to see that lender control poses costs non-investigated before. In addition, the above discussion shows that lender control social costs are boosted by the costs of lender control discovered under the nexus of explicit contracts. Finally, I exposed the fact that lender control may also constrain the investment opportunity set in order to exclude sizable business plan changes. Therefore, when considering control allocations in lengthy processes as chapter 11, the above analysis suggest that having a controlling lender at the helm may be as bad as having equityholders there. It follows that policymakers reflecting on bankruptcy reform should try to move beyond either possibility. The following section uses these intuitions to argue that lender control liability should serve to penalize self-serving behavior which runs counter to the optimal use of the assets.

IV. Lender control liability and functionally related theories

As the previous section has shown, DIP lender control may generate ex ante inefficient investment even in the absence of conflict of interests between legal claimholders. This section argues that the theory of the firm is further useful in providing a rationale for lender control liability and functionally related theories whose role has been dwarfed under current interpretations.⁸⁰ In fact, I argue that once the explicit nexus

⁷⁹ For a similar point made on start-ups, see Amar V. Bhide, *The Origin and Evolution of New Business*, Oxford University Press, New York, NY (2000), at 72.

⁸⁰ See William H. Lawrence “Lender Control Liability: An Analytical Model Illustrated with Applications to the Relational Theory of Secured Financing”, 62 S. Cal. L. Rev. 1387, 1389 (1989)

of contracts theory is abandoned lender control liability theories' can regain their proper role as deterrent of socially inefficient behavior.

A. A System with no Bite

Control inspired theories of lender liability have an important pedigree line in the United States dating at least as far back as *Baltimore & O. Tel. Co. of Baltimore County et al. v. Interstate Tel. Co.*⁸¹ Nonetheless, and despite its increased sophistication, a long line of precedents in this area does not translate into much clarity, at least beyond the objective of preserving equality of distribution.⁸² For example, since *In The Matter of Mobile Steel Co.*, in order to subordinate certain claims there is a clear test requiring a combination of inequitable conduct and either unfair advantage or injury to other creditors,⁸³ but what amounts to inequitable conduct remains vague. The same can be said about the law of agency for those cases where there is no explicit consent by the agent to be acting on the principal's behalf and subject to the principal's control.⁸⁴ Nor have legal scholars' work eradicated the uncertainty.⁸⁵ As a result, it is not farfetched to think that lender control liability theories have been applied as a reaction to situations

⁸¹ See *Baltimore & O. Tel. Co. of Baltimore County et al. v. Interstate Tel. Co.*, 54 Fed. 50 (4th Circuit, 1893)

⁸² This equality of distribution is no more than a default rule from contract and property law. See Henry Hasmann & Reinier Kraakman "The Essential Role of Organizational Law", 110 Yale L.J. 387, 407 (2000) ("The default rules of property and contract law in effect provide that, absent contractual agreement to the contrary, each of the entrepreneur's creditors has an equal-priority floating lien upon the entrepreneur's entire pool of assets as a guarantee of performance.")

⁸³ See *In The Matter of Mobile Steel Company*, 563 F2d 692, 699-700 (3rd Circuit, 1977) ("... three conditions must be satisfied before exercise of the power of equitable subordination is appropriate. (i) The claimant must have engaged in some type of inequitable conduct; (ii) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.")

⁸⁴ See "Restatement of the Law Third, Agency", American Law Institute Publishers, St. Paul, Minnesota Vol. 1 p. 17 (2006). The Restatement defines agency as a "fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act"

⁸⁵ For example, Professor Lawrence has considered that "Lender control is neither illegal nor inherently bad. Control, however, is easily subjected to a variety of excesses and abuses, so legal responses are justified to keep such behavior in check." See William H. Lawrence "Lender Control Liability: An Analytical Model Illustrated with Applications to the Relational Theory of Secured Financing", 62 S. Cal. L. Rev. 1387, 1390 (1989). It is not clear what exactly constitutes abuse but, as a result of the abuse backed reasoning, some scholars call for the substitution of lender liability by fiduciary duty principles. See William H. Lawrence "Lender Control Liability: An Analytical Model Illustrated with Applications to the Relational Theory of Secured Financing", 62 S. Cal. L. Rev. 1387, 1423-30 (1989).

strongly suggesting a “sense of wrongdoing” from an equality standpoint, rather than the implementation of a systematic approach.

A more in depth look into prominent lender control liability cases deriving from the law of agency and equitable subordination seems to reaffirm this theory. A milestone case from the law of agency is *A. Gay Jenson Farms Co. v. Cargill, Inc.*⁸⁶ In *Jenson Farms*, Cargill, the creditor, financed Warren’s, the debtor, grain elevator operation and purchased the majority of the its grain. Cargill also made constant recommendations to Warren, as it believed that the debtor needed strong paternal guidance. After Warren ceased operations, other creditors sued Cargill under the theory that Cargill became liable as a principal of Warren on contracts made by the debtor with the farmers. Minnesota’s Supreme Court affirmed a judgment finding that an agency relationship was established because Cargill became a principal when it assumed de facto control over the conduct of his debtor as an active participant in the debtor's operations, made key economic decisions and decided whether to keep the debtor in existence. The court stated “By directing Warren to implement its recommendations, Cargill manifested its consent that Warren would be its agent. Warren acted on Cargill's behalf in procuring grain for Cargill as the part of its normal operations which were totally financed by Cargill. Further, an agency relationship was established by Cargill's interference with the internal affairs of Warren, which constituted de facto control of the elevator.”⁸⁷

Despite being frequently cited as a way to explain lender control liability, *Jenson Farms* doesn’t provide a clear understanding of why it is desirable to subject a controlling creditor to liability (when limited liability is readily available for equity holders) nor what should the extent of that liability be.⁸⁸ The same could be said of equitable subordination

⁸⁶ See *A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285 (Minnesota Supreme Court, 1981). Another important case involving agency law is *Buck v Nash-Finch Company*, 78 S.D. 334; 102 N.W.2d 84 (Supreme Court of South Dakota, 1960).

⁸⁷ See *A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285, 291 (Minnesota Supreme Court, 1981).

⁸⁸ There is, nonetheless, a limit on the amount of the awards, as lender control liability theories generally have a retributinal character (unless a statute determine otherwise). See “Restatement of the Law Third, Agency”, American Law Institute Publishers, St. Paul, Minnesota Vol. 2 p. 115-23 (2006).

cases. In the famous *Taylor v. Standard Gas & Electric Co.*,⁸⁹ the court found that Standard Gas & Electric had operative control of Deep Rock, the debtor. A majority of Deep Rock's officers were officers or directors of Standard or Standard's parent corporation. The officers of Deep Rock reported to and were always subject to the direction of officers and directors of Standard. In addition, the fiscal affairs "were wholly controlled by Standard, which was its banker and its only source of financial aid."⁹⁰ When Standard tried to obtain a controlling position in the reorganized firm, the Supreme Court ordered that "No plan ought to be approved which does not accord the preferred stockholders a right of participation in the equity in the Company's assets prior to that of Standard"⁹¹ because Deep Rock was bankrupt as a result of "the abuses in management due to the paramount interest of interlocking officers and directors in the preservation of Standard's position, as at once proprietor and creditor of Deep Rock."⁹² Once again, the questions regarding the reason behind the desirability of lender control liability and the extent of that liability remain largely unanswered.

Perhaps as a reaction against this lack of clarity, there has been a steady stream of cases objecting to the existence of lender control liability. The trend can be seen in cases such as *In The Matter of Mobile Steel Company*,⁹³ *In re Ludwig Honold Manufacturing Company, Inc.*,⁹⁴ *Kham & Nate's Shoes No. 2, Inc. v First Bank of Whiting*,⁹⁵ *In the Matter of Clark Pipe and Supply Co., Inc. v Associates Commercial Corporation*,⁹⁶ *Thomas Pearson v. Component Technology Corporation; General Electric Capital Corporation*,⁹⁷ *Schwan's Sales Enters. v Commerce Bank & Trust Co.*,⁹⁸ *Mike Smith v*

⁸⁹ See *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939). Another landmark case involving equitable subordination is *Pepper v. Litton*, 308 U.S. 295 (1939)

⁹⁰ See *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307, 311 (1939)

⁹¹ See *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307, 324 (1939)

⁹² See *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307, 323 (1939)

⁹³ See *In The Matter of Mobile Steel Company*, 563 F.2d 692 (3rd Circuit, 1977)

⁹⁴ See *In re Ludwig Honold Manufacturing Company, Inc.*, 46 B.R. 125 (Bkrtcy.D.Ea.Penn., 1985)

⁹⁵ See *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7th circuit, 1990)

⁹⁶ See *In the Matter of Clark Pipe and Supply Co., Inc. v. Associates Commercial Corporation*, 893 F.2d 693 (5th Circuit, 1990)

⁹⁷ See *Thomas Pearson v. Component Technology Corporation; General Electric Capital Corporation*, 247 F.3d 471 (3rd Circuit, 2001)

⁹⁸ See *Schwan's Sales Enters. v. Commerce Bank & Trust Co.*, 397 F. Supp. 2d 189 (U.S. District Court of Massachusetts, 2005)

Ajax Magnathermic Corp., et. al.,⁹⁹ and *Henry v Lehman Commercial Paper*,¹⁰⁰ all of which appear to limit the extent to which remedies on controlling lenders can be applied.¹⁰¹ In this counter-wave, the first line of defense against findings of liability comes from a safe harbor obtained from agency law theory. As a way of distinguishing what controlling parties may do without becoming principals, the Restatement suggests that the difference between mere influence and control depends on the consent given by the agent to the exercise of that dominance.¹⁰² Therefore, the formality of an agreement between parties on the way forward prevents the lender from being deemed in active control of the debtor. For example, in *Thomas Pearson v. Component Technology Corporation; General Electric Capital Corporation*, Chief Judge Becker considered that “...we must be scrupulous in our efforts to distinguish between situations in which a parent/lender has ultimately assumed responsibility for the continuing viability of a company... and situations in which the borrower has retained the ultimate responsibility for keeping the company active.”¹⁰³

⁹⁹ See *Mike Smith v. Ajax Magnathermic Corp., et. al.*, 144 Fed. Appx. 482 (6th Circuit, 2005)

¹⁰⁰ See *Henry v. Lehman Commercial Paper*, 471 F.3d 977 (9th Circuit, 2006)

¹⁰¹ A notable exception comes from *Citibank, N.A. v. Data Lease Financial Corporation*, 828 F.2d 686 (11th Circuit, 1987), where the court reversed a summary judgment which considered that Citibank (the lender) was not a principal of Data Lease (the debtor) (“In determining whether an agency relationship exists between Citibank and the third party defendants, the key issue is control and domination... In his deposition, Joseph Stefan made the following admission: Q. Did you work for Citibank? A. At the bottom of everything the answer would be yes. They put me there and they took me out. Stefan further testified that he worked in close coordination with Citibank on “major matters”, including major changes of policy. Finally, Stefan described his displeasure with Miami National’s head of operations and his inability to remove the man from office: Q. Why couldn’t you get rid of Mr. Connor? A. He was there at the wishes of Citibank and they would have to remove him.”, *Citibank, N.A. v. Data Lease Financial Corporation*, 828 F.2d 686, 691-2)

¹⁰² “A relationship is one of agency only if the person susceptible to dominance or influence has consented to act on behalf of the other and the other has a right of control, not simply an ability to bring influence to bear.” See “Restatement of the Law Third, Agency”, American Law Institute Publishers, St. Paul, Minnesota Vol. 1 p. 28 (2006). A similar test can be found for example in *Chemtool, Inc. v. Lubricant Technologies Inc.* noting that “the test to determine whether a principal-agent relationship exists is whether the alleged principal has the right to control the agent, and whether the alleged agent can affect the legal relationships of the principal.” See *Chemtool, Inc. v. Lubricant Technologies Inc.*, 148 F.3d 742 (7th Circuit, 1998). This consensual characteristic sets apart the agency definition of control from the definitions of power in the social sciences. For example, Professor Dowding classifies power in outcome power, “the ability of an actor to bring about or help to bring about outcomes” and social power, “the ability of an actor deliberately to change the incentive structure of another actor or actors to bring about or help to bring about outcomes”, without any references to consent or assent as the Restatement section 1 comment f does. See Keith Dowding “Power”, University of Minnesota Press, Minneapolis, MN (1996), at 5.

¹⁰³ See *Thomas Pearson v. Component Technology Corporation; General Electric Capital Corporation*, 247 F.3d 471, 506 (3rd Circuit, 2001).

As a second part of the strategy, courts combine the previous reasoning with equitable subordination special considerations in cases where the party who allegedly acted in an inequitable manner was not an insider. For example, in *In re Ludwig Honold Manufacturing Company, Inc.*, the court held that “a creditor who is not an insider is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim.”¹⁰⁴ In *Henry v. Lehman Commercial Paper*, the court expressed that “Where non-insider, non-fiduciary claims are involved, as is the case here, the level of pleading and proof is elevated: gross and egregious conduct will be required before a court will equitably subordinate a claim.”¹⁰⁵

This counter-wave of cases is heavily defended from a contractual freedom point of view. For example, in *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting* Judge Easterbrook mentioned that “...we are not willing to embrace a rule that requires participants in commercial transactions not only to keep their contracts but also do ‘more’ - just how much more resting in the discretion of a bankruptcy judge assessing the situation years later... Courts may not convert one form of contract into the other after the fact, without raising the cost of credit or jeopardizing its availability. Unless pacts are enforced according to their terms, the institution of contract, with all the advantages private negotiation and agreement brings, is jeopardized.”¹⁰⁶ This reasoning has been embraced by courts in similar situations, as it can be seen in *Trenwick America Litigation Trust v. Ernst & Young*.¹⁰⁷ In *Trenwick*, while discussing a claim for deepening insolvency and the existence of creditor protection under Delaware Law, the Delaware Chancery Court stated “And Delaware public policy is strongly supportive of freedom of contract, thereby supporting the primary means by which creditors protect themselves - through the negotiations of toothy contractual provisions securing their right to seize on the assets of the borrowing subsidiary.”¹⁰⁸ Therefore, in order to limit the negative extent

¹⁰⁴ See *In re Ludwig Honold Manufacturing Company, Inc.*, 46 B.R. 125, 128 (Bkrtcy. D. Ea. Penn., 1985)

¹⁰⁵ See *Henry v. Lehman Commercial Paper*, 471 F.3d 977, 1006 (9th Circuit, 2006)

¹⁰⁶ See *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356-7 (7th circuit, 1990).

¹⁰⁷ See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch., 2006)

¹⁰⁸ See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 173 (Del. Ch., 2006). In addition, the court considered that “So long as directors are respectful of the corporation's obligation to honor the legal rights of its creditors, they should be free to pursue in good faith profit for the corporation's equityholders. Even when the firm is insolvent, directors are free to pursue value maximizing strategies,

of their rulings on the credit market, courts consistently decide that a creditor exercising his contractual rights can not be subject to wrongdoing.

It appears, then, that the objective of equality of distribution which has been put forward so far as the rationale behind lender control liability theories may not be actually accomplished, as these theories have little, if any, impact on creditors' behavior. The impact on lender behavior must indeed be relatively trivial when the trend signaling the absence of lender control liability is combined by a recent steady stream of legal academics claiming that creditors are calling the shots in reorganization proceedings.¹⁰⁹ A similar type of claim can regularly be found in the financial literature.¹¹⁰ Although many situations are likely engineered to prevent any sort of control taking by the

while recognizing that the firm's creditors have become its residual claimants and the advancement of their best interests has become the firm's principal objective." See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174-5 (Del. Ch., 2006). Contrast the former to the role of the administrator under the UK Enterprise Act (2002). As Armour and Mokal put it "The new administration regime, by providing for out-of-court appointment by a floating charge holder, is designed to capture many of the benefits of the information acquired by banks about their customers. However, the revised procedure is also designed to ensure that the bank's appointee is genuinely accountable to all creditors." See John Armour & Rizwaan J. Mokal "Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002", *Lloyds Maritime and Commercial Law Quarterly* 28, 29 (2005)

¹⁰⁹ See Douglas G. Baird & Robert K. Rasmussen "The End of Bankruptcy", 55 *Stan. L. Rev.* 751 (2002); Lynn M. LoPucki "The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy", 56 *Stan. L. Rev.* 645 (2003); Douglas G. Baird & Robert K. Rasmussen "Chapter 11 at Twilight", 56 *Stan. L. Rev.* 673 (2003); David A. Skeel, Jr. "Creditors' Ball: The "New" New Corporate Governance in Chapter 11", 152 *U. Pa. L. Rev.* 917 (2003); David A. Skeel, Jr. "The Past, Present and Future of Debtor-in-Possession Financing", 25 *Cardozo L. Rev.* 1905 (2004); Stephen Lubben "The "New and Improved" Chapter 11", 93 *Kentucky Law Journal* 839 (2004); Barry E. Adler "Bankruptcy Primitives", 12 *Am. Bankr. Inst. L. Rev.* 219 (2004); Jay L. Westbrook "Bankruptcy Control of the Recovery Process", 12 *Am. Bankr. Inst. L. Rev.* 245 (2004); Harvey R. Miller & Shai Y. Waisman "Is Chapter 11 Bankrupt?", 47 *B. C. L. Rev.* 129 (2005); Douglas G. Baird & Robert K. Rasmussen "Private Debt and the Missing Lever of Corporate Governance", 154 *U. Pa. L. Rev.* 1209 (2006); Keneth M. Ayotte & Edward R. Morrison "Creditor Control and Conflict in Chapter 11", working paper available at http://www.law.duke.edu/conference/triangle/morrison_chapter11.pdf (last visited 5/02/07); Douglas G. Baird & Robert K. Rasmussen "The Prime Directive", 75 *U. Cin. L. Rev.* 921 (2007); Adam Feibelman "Commercial Lending and the Separation of Banking and Commerce", 75 *U. Cin. L. Rev.* 943 (2007). The disagreement among these authors is relative to the beneficial effects of lender control, not its existence.

¹¹⁰ See, for example, Sudheer Chava & Michael R. Roberts "How Does Financing Impact Investment? The Role of Debt Covenants", forthcoming *Journal of Finance*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=854324 (last visited 2/1/08), at 2 ("However, the instant that the borrower's net worth falls below this threshold, regardless of the amount, control rights shift to the creditor, who can then use the threat of accelerating the loan to take any number of actions that may impact the investment policy of the firm (e.g., increasing the interest rate on the loan, shortening the maturity of the loan, reducing the available funds, or directly intervening in the investment decisions of the firm). Thus, the distance to the covenant threshold is irrelevant for the purpose of understanding how the violation and subsequent transfer of control rights impact investment).

lender,¹¹¹ it can not be the case that this is what happens in every case unless all the previous authors are wrong.¹¹² Therefore, lending practices and case law seem to be talking to each other in different tongues.

B. Beyond the Explicit Nexus of Contracts Paradigm

In this subsection, I argue that, at least in part, the previously described “control disconnect” derives from an understanding of the theory of the firm similar to the explicit nexus of contracts theory. As it was noted in section II, the explicit nexus of contracts theory looks at firms as mere ways of connecting contracts which fully pay everyone but the shareholders their opportunity costs.¹¹³ This has been the traditional way of looking at lender liability, as can be seen in Fischel’s analysis.¹¹⁴ Accordingly, this theory deeply believes in the freedom of contracts as a wealth creating mechanism. The string of thought is as follows: if freedom of contracts is limited, then the possible set of contract permutations and combinations that may generate a firm gets reduced. As a result, there exists the possibility that value enhancing combinations are left out and social efficiency

¹¹¹ There is evidence of this legal engineering. See Randall S. Kroszner & Philip E. Strahan “Bankers on Boards: Monitoring, Conflict of Interests, and Lender Liability”, 62 *Journal of Financial Economics* 415, 417-8 (2001) (“Our analysis shows that bankers tend to be on the boards of firms in which shareholder–creditor conflicts are likely to be relatively unimportant. Typically, these firms are large and stable and have a high fraction of tangible assets and a low level of short-term financing in their capital structure... At low levels of risk, the benefits of monitoring appear to dominate, while at higher levels of risk, the conflict of interest costs and lender liability concerns become more important.” “There is an important tradeoff in the U.S. between the benefits to firms of active monitoring and the costs of potential conflicts of interest and lender liability”). In addition, the use of chapter 11 sales is indicative of measures taken to avoid lender control liability.

¹¹² In addition, it could be claimed that the recent escalation of cases claiming “deepening insolvency” has been a practical answer to courts closing the lender control liability possibility. On the escalation deepening insolvency cases, see Gerald L. Blanchard “Recent Developments in the Area of Lender Liability Law”, *Ann. Surv. of Bankr. Law Part I S 3* (2006) (“the year saw continued development in the area of deepening insolvency”).

¹¹³ See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1630 (2000).

¹¹⁴ For example, when Fischel discusses damages arising due to lender liability he says that “the relationship between a lender and a borrower is contractual.” See Daniel R. Fischel “The Economics of Lender Liability”, 99 *Yale L. J.* 131, 148 (1989). Also, when considering the source of liability, Fischel looks at opportunistic behavior: “Opportunistic behavior occurs whenever one party attempts to obtain, at the expense of the other, a benefit not contemplated by the initial agreement, either explicitly or implicitly. Thus, whenever a lender attempts to renegotiate with the borrower for better terms when there is no basis for doing so, the lender is behaving opportunistically”. See Daniel R. Fischel “The Economics of Lender Liability”, 99 *Yale L. J.* 131, 138 (1989). Even though Fischel talks about implicit contract terms, he doesn’t view the existence of non-contractability as a possibility, as on this particular point he relies on the analysis of Muris, who explicitly considers that “the victim would have avoided the problem [of opportunism] so long as the costs of prevention were less than the expected costs of the opportunism.” See Timothy J. Muris “Opportunistic Behavior and the Law of Contracts”, 65 *Minn. L. Rev.* 521, 524 (1981).

is not achieved. Following this logic, it comes to no surprise to encounter claims like the ones found in the *Kham Shoes* or *Trenwick* opinions cited above.¹¹⁵

The above description of freedom of contracts when combined with the explicit nexus of contracts paradigm and agency law's negative control safe harbor is misleading. The problem arises because the combination of those theories' assumptions determines what the causes for unfairness and damages can be.¹¹⁶ If two parties enter into a contract without incurring in any sort of fraudulent or misrepresenting behavior, then because they have acted within their scope of freedom and by assumption other parties are paid their full opportunity cost for their services, the parties' conduct cannot be considered unfair nor produce damages unless the contract is breached.¹¹⁷ This reasoning can be seen in, for example, *Adams v. Erwin Weller Co.*,¹¹⁸ a case arising for responsibility for backpay and benefits owed to employees when their employer closed without giving them sixty days written notification, as required under the Worker Adjustment and Retraining Notification (WARN) Act.¹¹⁹ A class of employees moved to collect against Westinghouse Credit Corporation, the main lender of the employer, under the theory that through its financing it had become the principal. While denying the employees claim, Judge Fagg stated Westinghouse Credit Corporation's "use of legitimate financial controls to protect its security interest does not make [Westinghouse Credit Corporation] an employer under WARN."¹²⁰

Interestingly, lender control liability theories interpreted under the umbrella of the explicit nexus of contracts theory are reduced to exactly the same role as the absolute

¹¹⁵ For another example, see *Thomas Pearson v. Component Technology Corporation; General Electric Capital Corporation*, 247 F.3d 471, 502 (3rd Circuit, 2001) ("We do not intend to create a jurisprudence that discourages loans in general or rescues of troubled business enterprises in particular")

¹¹⁶ This is very important, as some courts recognize that certain cases may generate equitable subordination without a specific proof of inequitable conduct. See *In The Matter of Virtual Network Services Corporation*, 902 F.2d 1246, 1250 (7th Circuit, 1990) ("In sum, we conclude that § 510(c)(1) authorizes courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors") See also *United States v. Noland*, 517 U.S. 535, 540 (1996)

¹¹⁷ This is where control by a lender becomes important, as without control a lender could not opportunistically breach a contract

¹¹⁸ See *Adams v. Erwin Weller Co.*, 87 F.3d 269 (8th Circuit, 1996)

¹¹⁹ See 29 U.S.C. §§ 2101-2109

¹²⁰ See *Adams v. Erwin Weller Co.*, 87 F.3d 269, 272 (8th Circuit, 1996)

priority rule¹²¹ for those cases where the lender did not incur in any fraudulent or misrepresenting behavior. The absolute priority rule codifies a judge-made rule providing that any plan of reorganization in which claimholders of lower priority obtain payment when claimholders of higher priority are not fully compensated is invalid.¹²² And exactly this is the scope of what can be achieved, at least for voluntary creditors, when lender control liability theories are restricted by the explicit nexus of contracts theory and agency law notions of negative control.

Only after we move away from the explicit nexus of contracts paradigm, can lender control liability theories regain a proper role. Their role should be to penalize self-serving behavior that a controlling lender imposed on the firm when that behavior runs counter to socially desirable behavior. In practical terms, lender control liability should work in a similar way as compensatory liability work under general tort law theory: lender control liability should impose a penalty ex post which would make the lender take efficient actions ex ante.¹²³ Such an understanding would be consistent with the idea championed by Professor Shavell that damages basically should operate to achieve only optimal deterrence of injurers.¹²⁴

Although broadening the scope of lender control liability theories permits to reposition them in such a way as to promote socially efficient decisionmaking by the controlling lender, it should be noted that their effect over a party with the ability to make relationship specific investments is limited. Lender control liability theories impose a penalty on a lender whose strategy was self serving, but this doesn't fully restore the incentives of a service provider to invest in order to achieve the first best. There are cases when even though the impact of lender control liability will cause the controlling lender to ex post act in a socially efficient manner, the amount of relationship specific

¹²¹ See 11 U.S.C. §1129(b)(2)(B)(ii) (“the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property”)

¹²² See *In re Iridium Operating LLC*, 478 F.3d 452, 463 (2nd Circuit, 2007)

¹²³ Recently, Baird and Rasmussen have called to reconsider the role of lender control liability theories in order to promote the ex ante incentives of lenders to monitor and control the debtors when it is efficient for them to do so. See Douglas G. Baird & Robert. K. Rasmussen “The Prime Directive”, 75 U. Cin. L. Rev. 921, 939-40 (2007)

¹²⁴ See Steven M. Shavell “Strict Liability versus Negligence”, 9 Journal of Legal Studies 1, 2-9 (1980)

investments will be smaller than the social optimal. Nonetheless, it is not clear whether in these later situations having a controlling lender would be worse or better than having the debtor remain in control.¹²⁵ Therefore, imposing liability on a lender merely for gaining control doesn't seem appropriate.

It should be noted, nevertheless, that the prescribed role for lender control could not be fully achieved if the agency law formalistic distinction between positive and negative control is not dropped. This categorization seems to have little to do with reality (as both legal and finance scholars regularly point to actual transfers of control achieved only through negative control)¹²⁶ and may be generating worse problems (though masked ones) than the ones it is intended to solve. Further, lender counsel claims such as “the dire consequences [for their clients] of lender involvement in a borrower’s business” haven’t been demonstrated in any way.¹²⁷ The following section analyses problems derived from lender control strict liability and connected to the voiced fears of biased judgments against lenders.

V. Hindsight Bias, Strict Liability and other Heuristics

So far, I have used the theory of the firm to show that lender control may generate inefficiencies regarding legally not recognized claims, regardless of the existence of more than one class of legal claimants. In addition, I have used the intuitions from the theory of the firm to show a proper role for lender control liability theories. Lender control liability may need to be constrained if adjudicating problems due to cognitive errors impedes

¹²⁵ For authors (focusing on agency problems) suggesting that contingent creditor control is more efficient, see Phillippe Aghion & Patrick Bolton “An Incomplete Contracts Approach to Financial Contracting”, 59 *Review of Economic Studies* 473 (1992); Mathias Dewatripont & Jean Tirole “Biased Principals as a Discipline Device”, 8 *Japan and the World Economy* 195 (1996). Langevoort has defended the idea that introducing outside directors may help to limit inside corporate directors’ overoptimism. The same argument could be used in favor of lender control. See Donald C. Langevoort “The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability”, 89 *Geo. L.J.* 797, 803 (2001)

¹²⁶ Agency law has had this distinction even before the appearance of the explicit nexus of contracts theory of the firm, as can be seen on section 14(o) of the Restatement (Second) of Agency Law (1958). Nonetheless, it could be argued that the emergence of this theory has served to support this categorization. It could be argued, though, that the negative control category is, argued other contexts an “attempt to avoid relying on hindsight by identifying an ex ante norm to apply.” See Jeffrey J. Rachlinski “Heuristics and Biases in the Courts: Ignorance or Adaptation?”, 79 *Or. L. Rev.* 61, 72 (2000)

¹²⁷ See John C. Joyce “Lender Liability: The Problem Is still with Us”, 115 *Banking L. J.* 477, 483 (1998).

achieving its purpose. Hindsight bias has been signaled as the reason behind those limits. This section will analyze damage assessments to show that control based theories need to cope not just with hindsight bias but also with anchoring.

A. Hindsight Bias and Anchoring

A common argument against lender control liability comes from the perils of unevenly heard cases by both juries and judges. This fear is associated to the inability of adjudicators, juries and judges, to correctly understand business decisionmaking (i.e. due to their lack of expertise on the matter) and the likelihood that they will incur in systematic errors due to cognitive biases.¹²⁸ The former criticism is largely limited by the specificity of bankruptcy courts' jurisdiction. The later problem, hindsight bias, seems to remain strong.

The risk of opinions tainted by hindsight bias, in connection with the strict liability character of lender control liability theories, has generated sharp criticism. For example, Hynes believes that it creates a dilemma for a controlling creditor: "The more critical the financial condition of a business, the more control the creditor will want to assert in an effort to keep the business in a state of solvency and thus able to repay its debts. Yet the more control the creditor asserts, the greater risk it runs under the common law of agency of incurring personal liability for the debts of the business".¹²⁹ In addition, supporters of limiting lenders liability also look into comparisons with the business judgment rule (BJR).¹³⁰ If under BJR a manager is not liable unless there's some sort of

¹²⁸ For an example of concern over hindsight bias in the business setting, see *In The Matter of Mobile Steel Company*, 563 F.2d 692, 702-3 (3rd Circuit, 1977) ("Absolute measures of capital inadequacy, such as the amount of stockholder equity or other figures and ratios drawn from the cold pages of the corporation's balance sheets and financial statements, are of little utility, for the significance of this data depends in large part upon the nature of the business and other circumstances. Nor is the fact of eventual failure an appropriate test. This would be tantamount to ruling that an investor who takes an active role in corporate affairs must advance to his corporation all of the funds, which hindsight discloses it needed to survive.")

¹²⁹ See J. Dennis Hynes "Lender Liability: The Dilemma of the Controlling Creditor", 58 *Tenn. L. Rev.* 635, 637-8 (1991). Hynes' understanding of the lender liability problem is centered on agency costs, relying on the famous phrase of Justice Learned hand in *Admiral Oriental Line v. United States* expressing that "The doctrine stands upon the fact that the venture is the principal's, and that, as the profits will be his, so should be the expenses." See *Admiral Oriental Line v. United States*, 86 F.2d 201, 202 (Second Circuit, 1936).

¹³⁰ For a definition of the business judgment rule, see Jeffrey J. Rachlinski "A Positive Psychological Theory of Judging in Hindsight", 65 *U. Chi. L. Rev.* 571, 619 (1998), citing American Law Institute,

gross negligence, then imposing strict liability on a controlling lender would be strikingly inconsistent.

Cognitive errors are mental shortcuts which “can create cognitive illusions that produce erroneous judgments.”¹³¹ Among those errors, hindsight bias occurs when “[p]eople overstate their own ability to have predicted the past and believe that others should have been able to predict events better than was possible.”¹³² Psychologists explain the hindsight bias as resulting “primarily from the natural (and useful) tendency for the brain to incorporate known outcomes into existing knowledge automatically, and to make further inferences from that knowledge.”¹³³ Kamin and Rachlinski report the persistency of the effect despite numerous debiasing attempts.¹³⁴ It easily follows that the hindsight bias defies the prowess of decisionmakers (blurring the distinction between opportunism and an unfortunate turn of events) while it also questions the benefit of broadening the scope of lender control liability due to the important possibility that non-negligent controlling lenders would be found liable.

Principles of Corporate Governance: Analysis and Recommendations §4.01(c) at 177-78 (ALI 1991) (“an officer or director who is informed about a transaction being undertaken by the corporation, and is not an interested party in the transaction, “fulfills his duty [of care to the shareholders] if...he rationally believes that his business judgment is in the best interests of the corporation.”)

¹³¹ See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Judicial Mind”, 86 Cornell L. Rev. 777, 780 (2001)

¹³² See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Judicial Mind”, 86 Cornell L. Rev. 777, 799 (2001) (“the hindsight bias consists of using known outcomes to assess the predictability at some earlier time of something that has already happened”). See, also, Mitu Gulati, Jeffrey J. Rachlinski & Donald C. Langevoort “Fraud by Hindsight”, 98 Nw. U.L. Rev. 773, 774 (2004) (“People consistently overstate what could have been predicted after events have unfolded... Consequently, they blame others for failing to have foreseen events that reasonable people in foresight could not have foreseen”)

¹³³ See Jeffrey J. Rachlinski “Heuristics and Biases in the Courts: Ignorance or Adaptation?”, 79 Or. L. Rev. 61, 68 (2000).

¹³⁴ See Kim A. Kamin & Jeffrey J. Rachlinski “Ex Post ≠ Ex Ante: Determining Liability in Hindsight”, 19 Law & Hum. Behav. 89, 92 (1995) (“Unfortunately, the hindsight bias has proven resistant to most debiasing techniques... Some researchers have obtained limited debiasing by significantly restructuring the decision-making task, or by having participants consider alternative outcomes. Although these cognitive strategies have reduced the influence of the bias, no known technique completely eliminates the effect”). Somewhat surprisingly, one study found no evidence of hindsight bias on judges determinations of probable cause. See Andrew J. Wistrich, Chris Guthrie & Jeffrey J. Rachlinski “Can Judges Ignore Inadmissible Information? The Difficulty of Deliberately Disregarding”, 153 U. Pa. L. Rev. 1251, 1313-18 (2005).

Empirical studies have demonstrated that judges, including in particular bankruptcy judges, are also affected by cognitive biases.¹³⁵ In addition, several opinions recognize that adjudicators may be under the influence of hindsight bias and therefore try to avoid taking actions that would make them prone to cognitive errors.¹³⁶ For example, in *Kham & Nate's Shoes No. 2, Inc. v First Bank of Whiting* Judge Easterbrook mentioned that “Debtor submits that conduct may be “unfair” and “inequitable” for [the] purpose [of determining whether to apply equitable subordination] even though the creditor complies with all contractual requirements, but we are not willing to embrace a rule that requires participants in commercial transactions not only to keep their contracts but also do “more” -just how much more resting in the discretion of a bankruptcy judge assessing the situation years later.”¹³⁷ In *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, the Delaware Chancery Court expressed “What Delaware law does not do is to impose retroactive fiduciary obligations on directors simply because their chosen business strategy did not pan out.”¹³⁸

Another well-known cognitive error is referred to as anchoring. Tversky and Kahneman define anchoring as the bias which occurs when people make estimates depending on an irrelevant starting point.¹³⁹ Guthrie, Rachlinski and Wistrich consider that “[a]nchors affect judgment by changing the standard of reference that people use when making numeric judgments.”¹⁴⁰ Anchoring derives from the difficult problem of disregarding known information.¹⁴¹ Wistrich, Guthrie and Rachlinski provide three theories to help explain this phenomenon: motivation, ironic process theory and mental

¹³⁵ See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Judicial Mind”, 86 Cornell L. Rev. 777 (2001); Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Bankruptcy Judge’s Mind”, 86 B.U.L. Rev. 1227 (2006).

¹³⁶ Gulati, Rachlinski and Langevoort state that “Courts cite concerns with hindsight in nearly one-third of all published opinions in securities class action cases.” See Mitu Gulati, Jeffrey J. Rachlinski & Donald C. Langevoort “Fraud by Hindsight”, 98 Nw. U.L. Rev. 773, 775 (2004).

¹³⁷ See *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356 (7th circuit, 1990) (emphasis added)

¹³⁸ See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 173 (Del. Ch., 2006)

¹³⁹ See “Judgment Under Uncertainty: Heuristics and Biases”, in *Judgment Under Uncertainty: Heuristics and Biases*, Daniel Kahneman, Paul Slovic, & Amos Tversky eds., Cambridge University Press, New York, NY (1982), p. 14.

¹⁴⁰ See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Judicial Mind”, 86 Cornell L. Rev. 777, 788 (2001)

¹⁴¹ See Andrew J. Wistrich, Chris Guthrie & Jeffrey J. Rachlinski “Can Judges Ignore Inadmissible Information? The Difficulty of Deliberately Disregarding”, 153 U. Pa. L. Rev. 1251, 1260-70 (2005)

contamination. Motivation implies that people told to disregard information may increase their desire to attend to it, a concept researchers refer to as “psychological reactance”. Ironic process theory poses that even if individuals want to ignore information, they may find it difficult to avoid thinking about information they want to ignore. Mental contamination appears because the brain does not compartmentalize gathered information. Then, this information may affect their judgment by influencing how subsequent events are processed and which beliefs are formed. The strength of the anchoring effect has been shown to be negatively correlated to the confidence the evaluator has in its own assessment (i.e. “when people are not confident in their judgments, they are more susceptible to anchoring effects”), a confidence which Sunstein, Kahneman and Schkade believe to be low when awarding dollar amounts.¹⁴²

Anchoring has been empirically observed in many diverse fields.¹⁴³ Specifically relating to the focus of this paper, Guthrie, Rachlinski and Wistrich have produced three separate studies on anchoring effects in federal magistrates, state and federal judges and bankruptcy judges.¹⁴⁴ The first study was conducted over a sample of federal magistrate judges who were asked to assess damages arising out an accident. They found that their sample group is also subject to anchoring,¹⁴⁵ despite the fact that “judges are

¹⁴² See Cass R. Sunstein, Daniel Kahneman and David Schkade “Assessing Punitive Damages (with Notes on Cognition and Valuation in Law)”, 107 *Yale L. J.* 2071, 2109 (1998).

¹⁴³ Ariely, Loewenstein and Prelec asked MBA students whether they would buy some products for a price equal to the dollar figure equivalent to the last two digits of their social security number. Afterwards, they were asked to specify the highest amount they would be willing to pay for the products while reminded that the social security number is random. The subjects with higher social security numbers were willing to pay more for the products. See Colin F. Camerer & George Loewenstein “Behavioral Economics: Past, Present, Future”, in Colin F. Camerer, George Loewenstein & Matthew Rabin eds., Princeton University Press, Princeton, NJ (2004), p. 13., citing Dan Ariely, George Loewenstein & Drazen Prelec “Coherent Arbitrariness: Stable Demand Curves without Stable Preferences”, 118 *Quarterly Journal of Economics* 73 (2003). For another example regarding underwriters recommendations, see Roni Michaely & Kent L. Womack “Market Efficiency and Biases in Brokerage Recommendations”, in *Advances in Behavioral Finance*, Richard H. Thaler ed., Princeton University Press, Princeton, NJ (2005), p. 408.

¹⁴⁴ See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Judicial Mind”, 86 *Cornell L. Rev.* 777, 780 (2001); Andrew J. Wistrich, Chris Guthrie & Jeffrey J. Rachlinski “Can Judges Ignore Inadmissible Information? The Difficulty of Deliberately Disregarding”, 153 *U. Pa. L. Rev.* 1251 (2005); and, Jeffrey J. Rachlinski, Chris Guthrie & Andrew J. Wistrich “Inside the Bankruptcy Judge’s Mind”, 86 *B.U.L. Rev.* 1227 (2006).

¹⁴⁵ See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Judicial Mind”, 86 *Cornell L. Rev.* 777, 787-94 (2001).

experienced, well-trained, and highly motivated decision makers”.¹⁴⁶ The second study, a similar damage assessment case, was conducted over a sample of federal magistrates, state and federal judges and tested anchoring effects with both low and high anchors. They found that both anchors had a significant impact on the amount of damages awarded. In the third study, bankruptcy judges faced a determination of interest rate in a chapter 13 case. Although, the results were smaller, anchoring still had an impact on the outcome.¹⁴⁷ To the best of my knowledge, there has not been any study yet connecting anchoring to control related liability theories.

B. Damage Assessments: the Role of Anchoring

Despite the criticism voiced against strict liability when applied to controlling lenders, it has been advanced as a way to reduce the problems presented by hindsight bias in cases where “the technology of precaution is unilateral (in the sense that only the potential injurer can realistically take action to reduce the probability or severity of an accident)”.¹⁴⁸ Lender control liability appears to fit the bill, as usually only the controlling lender is responsible for decisions affecting the outcome (i.e. whether to liquidate or reorganize).

Theoretically, strict liability insulates injurers from the possibility of hindsight bias because the party who may potentially damage another assesses the situation *ex ante*, as he is always found liable, and doesn’t have to pay attention to *ex post* determinations of probabilities. To see why, it is convenient to look at the standard unilateral tort model

¹⁴⁶ See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Judicial Mind”, 86 *Cornell L. Rev.* 777, 782 (2001)

¹⁴⁷ See Jeffrey J. Rachlinski, Chris Guthrie & Andrew J. Wistrich “Inside the Bankruptcy Judge’s Mind”, 86 *B.U.L. Rev.* 1227, 1233-37 (2006) (“In the first of these studies, we showed that the introduction of an extremely low anchor reduced damage awards by 0.41 standard deviations. In the second study, we tested the effects of both a low and a high anchor and found that the low anchor reduced awards by 0.58 standard deviations, while the high anchor increased awards by 0.75 standard deviations. In the present study of bankruptcy judges, the anchor increased the interest rate by 0.37 standard deviations. The effect size observed in this study is only slightly smaller than the effect size we have observed in our previous studies of generalist judges. Therefore, we cannot conclude from this that bankruptcy judges are less susceptible than generalist judges to the anchoring effect”)

¹⁴⁸ In fact, Korobkin and Ulen propose to increase the use of strict liability as a way to limit the effect of hindsight bias. See Russell B. Korobkin & Thomas S. Ulen “Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics”, 88 *Calif. L. Rev.* 1051, 1098-9 (2000)

of law and economics.¹⁴⁹ In the model, there are two variables: injurers' activity level z (chosen by injurers) and the level of care x which they can engage in. The activity level will generate benefit $b(z)$ and the level of care generates a probability of harm $p(x)$. In addition, it is assumed that x represents the private cost of an injurer deriving from prevention and that h , a fixed value, represents the possible damage caused by the injurer each time an injurer engages in his activity. Then, the social object would be to maximize

$$b(z) - z(x + p(x)h) \quad (1)$$

which is advanced as the main rationale legal system should have. A potential injurer then prefers to be judged by strict liability when there's a possibility of hindsight bias, as he erases the possibility that adjudicators determine that x generates a larger probability of accident than it actually did. The potential injurer will know *ex ante* the values of x , $p(x)$ and h and therefore will maximize (1) without the need to pay attention to anything else. Hence, efficient activity and care levels are taken irrespective of hindsight bias.¹⁵⁰

It doesn't necessarily follow that strict liability should be applied to liability assessments against controlling parties (as lenders) as a way to prevent hindsight bias. Speaking of the functionally related BJR, Rachlinski considers that while it works as a "no liability" rule it is as an efficient way to achieve a second best in dealing with hindsight bias.¹⁵¹ Rachlinski provides both "equitable and economic" reasons to use a no

¹⁴⁹ See Steven Shavell "Strict Liability Versus Negligence", 9 J. Legal Stud. 1 (1980)

¹⁵⁰ Nonetheless, Rachlinski argues that even if negligence is the standard used to assess liability social efficiency may not be substantially affected, as lenders will understand the negligence standard as a quasi-strict liability one. See Jeffrey J. Rachlinski "A Positive Psychological Theory of Judging in Hindsight", 65 U. Chi. L. Rev. 571, 595-600 (1998) ("the hindsight bias converts the negligence standard into a *de facto* system of strict liability. Negligence judgments influenced by the hindsight bias should therefore have economic consequences similar to those of a system of strict liability.")

¹⁵¹ See Jeffrey J. Rachlinski "A Positive Psychological Theory of Judging in Hindsight", 65 U. Chi. L. Rev. 571, 619 (1998) ("have fewer adverse consequences than a rule of negligence judged in hindsight"). Jolls and Sunstein believe that this type of debiasing rules are of an invasive character, as entirely block choice in the hope that legal outcomes will not fall prey to problems of bounded rationality and recommend the adoption of a less intrusive method. See Christine Jolls & Cass R. Sunstein "Debiasing through Law", 35 J. Legal Stud. 199, 202 (2006) ("Compared with the more common approach of insulating legal outcomes from the effects of bounded rationality, a significant advantage of strategies for debiasing through law is that they aim to correct errors while still preserving as much opportunity as possible for people to make their own choices... An important corollary of choice-preserving strategies is that they help to address boundedly rational behavior while avoiding the imposition of significant costs on those who do not exhibit bounded rationality.")

liability rule in the case of the BJR. The later arguments refer to the disincentive that a strict liability would pose on people to become firm's managers and the incentives to take excessive precautions, in turn undermining general economic activity.¹⁵² The former arguments focus on shareholders ability to fire managers directly or indirectly by selling their stock, the limited amount of loss suffered by shareholders and their ability to diversify their risk of loss.

Regardless of whether the Rachlinski's BJR analysis can be extended to lender control liability,¹⁵³ the inability to trust adjudicators on liability assessments is due to a separate cause. Where lender control liability theories are involved, the superior characteristic of strict liability in unilateral torts doesn't apply due to the difference in the formation of damage assessments. As it can be readily seen from the unilateral tort model description, the level of damages is entirely independent from the level of care exercised by the potential injurer, which in turn determines the probability of harm. This is not the case for lender control liability theories. An example will help to show the difference.

Let's assume that a controlling lender has 2 options¹⁵⁴: he can either liquidate the firm (obtaining a fixed amount L) or reorganize it. If he chooses the reorganization option, he will incur for sure in reorganization costs C (i.e. negotiation costs, costs of running the firm until a plan is approved, etc) and may obtain a favorable reorganization value R^+ with a probability $p(R^+)$ or an unfavorable reorganization value R^- with

¹⁵² See Jeffrey J. Rachlinski "A Positive Psychological Theory of Judging in Hindsight", 65 U. Chi. L. Rev. 571, 622-3 (1998)

¹⁵³ The "equitable" reasons provided by Rachlinski do not seem compelling for lender control liability on firms formed partially with implicit contracts. First, as stock is not the only way to participate in the "ownership" of the firm, then voting control has a limited disciplining power. In addition, because the firm is in distress selling the stock (or claims) to sanction a controlling lender would have a very limited effect (if any at all). Second, if there are firm specific investments, the magnitude of the loss could be higher (i.e. in lost wages) than what was invested, frustrating for these actors the limited liability of corporations. Third, firm specific investments are not easily diversifiable (i.e. you can't make large numbers of firm specific investments). The "economic" reasons may not deter a controlling lender. It is not clear what comprises excessive precautions. As lender control liability can potentially generate costs which are externalized to other constituents, it is not clear that today the optimal level of precautions is taken. I leave the resolution of these issues for future research.

¹⁵⁴ In this example, I am assuming that there are no problems emerging from different classes of legal claimholders and that relationship specific investments are not affected by the decision. Although I recognize the unrealistic nature of these assumptions, using them will help us to focus on why strict liability cannot help to insulate against the hindsight bias.

probability $p(R^-)$. Therefore, a controlling lender decides on a course of action depending on whether L is bigger or smaller than

$$R^+ * p(R^+) + R^- * p(R^-) - C \quad (2)$$

Let's assume, further, that the controlling lender chooses option L , the state of the world that realizes is the favorable one (R^+) and then he is sued under lender control liability. If the adjudicator is to rule in favor of the plaintiff he will need to assess the amount of damages (which by assumption are traceable to the controlling lender's decision). To accomplish the damage evaluation, the adjudicator needs to compare L to its assessment of the ex ante result of reorganization, given by (2). Provided that the later is bigger than the former, the controlling lender would have to pay damages equal to that difference.¹⁵⁵ As L is fixed (whatever is obtained in the liquidation of the firm's assets), then the damage assessment will depend on the estimated value of the reorganization.

To obtain such a value, three values need to be estimated: the probabilities of each state of the world occurring, the costs of restructuring and the value of reorganizations. It is safe to assume that courts can estimate rather accurately restructuring costs due to their extended experience in the subject. As we have seen before, probabilities would likely be overestimated due to hindsight bias. Again, strict liability would prevent a controlling lender from suffering ex ante excessive damages if this was the setting. But the estimate of the reorganization value in different states of the world change the picture. In the simple model presented above, R^+ is given; R^- needs to be assessed. Therefore, only if R^- is assessed incorrectly, then strict liability may not limit the effects of cognitive biases. R^- value may be overestimated not due to hindsight, as it is not a probability, but most likely due to anchoring (produced by R^+).¹⁵⁶

¹⁵⁵ We are abstracting here from any damages occurring out reliance in the behavior or words of the controlling lender.

¹⁵⁶ Another possibility of bias may be due to representativeness heuristics (i.e. a great description of the firm). See "Judgment Under Uncertainty: Heuristics and Biases", in Judgment Under Uncertainty: Heuristics and Biases, Daniel Kahneman, Paul Slovic, & Amos Tversky eds., Cambridge University Press, New York, NY (1982), p. 8.

To sum up, a controlling lender may accurately estimate probabilities *ex ante* and therefore avoid problems related to hindsight bias if strict liability is used. Nonetheless, as other values need to be estimated (i.e. the value of the reorganized firm under other states of the world) and these estimates are outside of his control (actually decided upon by the adjudicator), strict liability may be an insufficient attempt to achieve an efficient outcome. The efficiency of the outcome of a lender control liability case then depends not just on hindsight bias but also on anchoring, their magnitude of the distortions and maybe the effects of these two heuristics on each other, if any.¹⁵⁷

Recognizing the existence of the combined effects of hindsight bias and anchoring is very important for practical adjudicating and legal policy debiasing efforts.¹⁵⁸ Strategies geared to debias lender control liability adjudications need to pay attention to both hindsight and anchoring.¹⁵⁹ Although both cognitive errors have proven to be very resistant to attempts to limit them, some partial results were obtained using different techniques for debiasing anchoring and hindsight bias. For example, applying a “consider the opposite strategy” has been shown to reduce the anchoring effect¹⁶⁰ and a smaller anchoring effect was found when decision makers were specialized (bankruptcy judges and insurers).¹⁶¹ In addition, suggested solutions to hindsight bias, as strict liability or eliminating the adjudicator’s contact with some evidence¹⁶² may not work in the same way for anchoring.

¹⁵⁷ In relation to their experiment Kamin and Rachlinski discuss hindsight bias interaction with anchoring. See Kim A. Kamin & Jeffrey J. Rachlinski “Ex Post ≠ Ex Ante: Determining Liability in Hindsight”, 19 *Law & Hum. Behav.* 89, 101 (1995)

¹⁵⁸ On the different debiasing techniques, see Christine Jolls & Cass R. Sunstein “Debiasing through Law”, 35 *J. Legal Stud.* 199 (2006).

¹⁵⁹ The point here is not about the different source these two effects, but about the different consequences for legal policy. In fact, some authors believe that anchoring and the hindsight bias have the same cognitive source. See Rüdiger Pohl, Markus Eisenhauer & Oliver Hardt “Sara: A Cognitive Process Model to Simulate the Anchoring Effect and Hindsight Bias”, 11 *Memory* 337, 338 (2003)

¹⁶⁰ See Thomas Mussweiler, Fritz Strack & Tim Pfeiffer “Overcoming the Inevitable Anchoring Effect: Considering the Opposite Compensates for Selective Accessibility”, 26 *Pers Soc Psychol Bull* 1142, 1146 (2000)

¹⁶¹ See Jeffrey J. Rachlinski, Chris Guthrie & Andrew J. Wistrich “Inside the Bankruptcy Judge’s Mind”, 86 *B.U.L. Rev.* 1227, 1237 (2006); Chris Guthrie & Jeffrey J. Rachlinski “Insurers, Illusions of Judgment & Litigation”, 59 *Vand. L. Rev.* 2017, 2022 (2006)

¹⁶² Wistrich, Guthrie and Rachlinski recommend to separate “managerial judging” from adjudication. See Andrew J. Wistrich, Chris Guthrie & Jeffrey J. Rachlinski “Can Judges Ignore Inadmissible Information? The Difficulty of Deliberately Disregarding”, 153 *U. Pa. L. Rev.* 1251, 1259 (2005) (“a judge who supervises settlement discussions should not serve as the fact finder in the same case”)

VI. Conclusion

The central goal of this paper has been to functionally analyze the ubiquitous problem of lender control by, first, tying it to modern economic understandings of what a firm is, then, reestablishing a proper role for lender control liability theories, and, finally, examining how cognitive errors may affect the adjudication of lender control liability cases. Lender control liability theories have largely fallen in disuse by United States courts. The implicit understanding of the theory of the firm by legal academics and courts has made it possible. Broadening the scope of the theory of the firm permits a better understanding that there is a role for lender liability theories besides mimicking the so called absolute priority rule.

In addition, the paper serves to uncover that lender control liability theories are not sufficient to correct all the inefficiencies arising out of allocating control to a lender. Because allocation of control is not innocuous in chapter 11 reorganizations, some of the effects it poses on ex ante relationship specific investors cannot be corrected by merely penalizing a controlling lender without at the same time penalizing lender's gain of control. It is yet to be proven that a lender's gain of control is inefficient. On the contrary, the finance literature considers that lenders obtaining control contingent on some imperfect signal is the more efficient state of affairs.

Finally, the paper has exposed that even though lender control may not be optimal, cognitive errors may produce systematic distortions that challenge the application of lender liability theories. Specifically, the paper uncovered that hindsight bias is not the only heuristic which must be taken into account when thinking about lender control liability application. Anchoring plays a substantive role which limits the desirability of applying strict liability as a debiasing technique.

There are several avenues for future research, three of which I outline here. First, as the theory of the firm shows that there may be value not captured by legal claims, it would be interesting to investigate whether bankruptcy definition of claims should be

enlarged to incorporate some of these economic factors today not accounted by bankruptcy laws. Second, the relation between different heuristics used in control liability adjudications seems to be a fruitful field for future research. Questions regarding the potential influence of anchoring on hindsight bias or hindsight bias on anchoring or both need to be answered to provide better policy recommendations. In addition, an assessment of the overall effect of heuristics, given the individual variation on cognitive errors, would be especially helpful.¹⁶³ Finally, it would be interesting to explore the exactitude of the common assumption in the literature stating that control shifts to the lender after covenant violations.¹⁶⁴ Such a study would help in assessing the magnitude of the societal costs generated by refusing to accept the possibility of lender control costs.

¹⁶³ For discussions on individual variation, see Jeffrey J. Rachlinski “Cognitive errors, Individual Differences and Paternalism”, 73 *U. Chi. L. Rev.* 207 (2006); and, Christine Jolls & Cass R. Sunstein “Debiasing through Law”, 35 *J. Legal Stud.* 199 (2006)

¹⁶⁴ See Stuart C. Gilson “Bankruptcy, Boards, Banks, and Blockholders”, 27 *Journal of Financial Economics* 355, 356 (1990) (“...models of bankruptcy often assume that creditors take control of the bankrupt firm’s assets”); Phillippe Aghion & Patrick Bolton “An Incomplete Contracts Approach to Financial Contracting”, 59 *Review of Economic Studies* 473 (1992).