Why Don't Banks Take Stock?

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Banks in the U.S. are forbidden to hold stock in nonfinancial firms under most circumstances. This restriction contrasts with more liberal banking regulations in other countries and also with the prescriptions of traditional financial theory, which says that a firm's lender would make better decisions if it also held some equity in borrowing firms.[1] According to this theory a bank that holds an equity share in firms to which it lends would strike a more sensible balance between caution and risk-taking and would also be more concerned about its borrower's long-term financial health. The Gramm-Leach-Bliley Act of 1999 modestly expands bank powers to hold equity in nonfinancial firms, but it stops well short of permitting banks to hold mixed debt-

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[1]See the article by James Barth, Daniel Nolle, and Tara Rice for a comparison of international restrictions on bank equity holdings and Christopher James's 1995 article for a discussion of U.S. laws governing bank equity holdings in distressed firms. Loretta Mester's article provides a general overview of the issues involved in the separation of banking and commerce.

equity claims as a normal lending practice, as would be permitted, for example, in Great Britain or Germany.

Are banks in the United States really shackled compared to those in other nations? Do restrictions against U.S. banks holding equity make a difference for banks' behavior? Are U.S. banks' borrowers at a disadvantage because their lenders are too cautious when evaluating project risks and too harsh when a borrower experiences financial difficulties? And if U.S. regulations were relaxed, would we see a stampede by banks to take ownership stakes in their borrowers?

Evidence from around the world suggests that the answer to all these questions is no. Even in those nations where banks are free to take equity stakes, they mostly specialize in making loans and hold only small equity stakes in borrowing firms — when they hold any equity at all. And in countries where banks do hold equity, the evidence says that it usually has little to do with the prescriptions of traditional theory. Nonetheless, recent work by financial economists helps explain why a bank that only makes loans may be more effective than one that holds both debt and equity in the same firm. Banks play a special role in disciplining firms and in facilitating coordination among financially troubled firms' various claimants. The types of financial claims that banks hold are well designed to enable the bank to perform these functions.

BANKS DON'T HOLD MUCH EQUITY, EVEN WHEN THE LAWS PERMIT

Traditional Finance Theory Holds That Banks Should Hold Mixed Claims...The conflict between stockholders and debtholders is one of the key ideas in modern finance. The underlying conflict can be stated simply: Stockholders prefer excessively risky investments, and debtholders are excessively cautious. These preferences flow from differences in how the holders of each type of security are paid. Stockholders own the firm's profits when it does well, but they receive nothing when the firm goes bankrupt. Debtholders own the firm's assets when it goes bankrupt, but they receive a fixed payment (principal plus interest) when the firm does well. The conflict is most severe when a firm is near bankruptcy. Stockholders would prefer that the firm roll the dice (because they have little to lose), and debtholders would prefer that the firm's assets be conserved at all costs (because they have everything to lose).

One potential solution to these conflicts is to give final control over a firm's investment decisions to an investor that holds debt and stock in the same proportions as the firm's debt-equity ratio. This investor's decisions would then represent the interests of all investors in the firm, because any policy that increases the value of this investor's claim — which mirrors the financial claims on the firm as a whole — also increases the value of the firm as a whole. A large institutional investor, such as the firm's bank, is a natural candidate to monitor the firm's investment decisions, since the bank is also likely to be well informed about the firm's affairs.

...But Banks Mostly Specialize in Lending. A look at the financial claims held by banks throughout the world shows that banks' equity positions are very small compared to their loans (see Table). Bank portfolios don't look much like the holdings of an investor with a blended claim intended to mirror the financial structure of borrowing firms. In part, bank portfolios reflect regulatory restrictions on bank ownership positions, but in many countries, banks hold less equity than can be explained by regulatory restrictions. For example, banks in Great Britain, Luxembourg, and the Netherlands hold virtually no equity in borrowing firms, although they are permitted to do so by the European Community's Second Banking Directive.[2]

[2]The European Community's Second Banking Directive imposes no direct restrictions on a bank's share of a firm's equity, but it limits a bank's qualifying investments in any one firm to 15 percent of the bank's own funds and also limits total qualifying investments across all firms

TABLE

Bank Stockholdings in the EU and G-10 Countries, 1996

Country	Number of Commercial Banks	Loans/ Assets (percent)	Shares/ Assets (percent)
Austria	1019	51	4
Belgium	100	35	2
Canada	11	67	0
Denmark	117	42	4
Finland	8	49	6
France	400	32	3
Germany	258	56	5
Greece	20	31	5
Italy	264	40	2
Japan	136	66	5
Luxembourg	221	19	0
Netherlands	172	64	1
Portugal	39	33	0
Spain	165	42	4
Sweden	15	38	3
Switzerland	85	45	5
United Kingdom	44	55	0
United States	9575	64	0

Sources: Bank Profitability: Financial Statements of Banks 1998, OECD, and the article by Barth, Nolle, and Rice.

The United States stands alone in generally prohibiting stockholding by banks, but even U.S. banking law gives banks some leeway to take equity positions.[3] However, specialization in lending dominates the international banking picture, whatever regulatory restrictions apply. We should be careful in drawing too many conclusions from the aggregate numbers. The figures hide a lot of variation in equity holdings by individual banks, and even for any particular bank, the composition of its holdings in individual firms will vary. One possibility is that banks concentrate their equity holdings in those firms that offer the greatest benefits. Since most countries place some restrictions on banks' equity stakes in firms, banks may decide to hold no stock in those firms in which stockholder-debtholder conflicts are small and hold significant equity shares in those firms in which such conflicts are most severe and the bank can do the most good. For example, a bank might hold little or no stock in a firm under routine financial conditions and substantially increase its equity stake should the firm enter troubled financial waters.

However, more detailed research about banks' behavior in individual countries doesn't provide much support for the view that banks do attempt to hold a mixed financial claim to reduce stockholder-debtholder conflicts, even selectively. For example, the typical German firm's capital struc-

to 60 percent of the bank's own funds. (A qualifying investment is an equity stake in excess of 10 percent of a firm's stock, and a bank's own funds roughly approximates regulatory capital.) However, formal regulations may not fully capture the constraints on banks' behavior in Great Britain and elsewhere. For example, according to Herwig Langohr and Anthony Santomero, banks in Great Britain may be subject to implicit restrictions by the Bank of England.

[3]The main exceptions to the general prohibition are that (i) banks may take substantial equity positions in borrowers that are financially distressed; (ii) bank holding companies (BHCs) may take noncontrolling positions in startups through small business investment corporations; and (iii) BHCs may engage in "merchant banking" through investment banking subsidiaries of the holding company. Thus, Citibank (the bank) can't engage in merchant banking, but Citigroup (the BHC) can provide this service through its investment banking subsidiary, Salomon Smith Barney. Merchant banking generally refers to taking temporary, noncontrolling ownership positions in nonfinancial firms. Under the terms of the Gramm-Leach-Bliley Act of 1999, which first permitted merchant banking for BHCs, bank regulators may revisit the restrictions on merchant banking activities after five years. Specifically, regulators may decide that a bank could offer merchant banking services through a subsidiary of its own.

ture includes a concentrated equity stake (or block), more often owned by a single family or nonfinancial firm than by a bank.[4] Harald Roggenbuck's study of bank equity stakes found that only a small number of cases involved banks' taking equity in financially troubled firms. In his sample, the main reason a bank took an equity position was that the firm's owners (or their heirs) wanted to sell shares to diversify their own portfolios without breaking up the block. This evidence is buttressed by Jeremy Edwards and Klaus Fischer's survey of German bankers, who expressed extreme reluctance to take equity stakes in distressed firms.

The evidence for Germany is echoed in Christopher James's studies of the behavior of banks in the United States when borrowers enter financial distress. Even though U.S. banks have substantial legal rights to take equity positions in distressed firms for long periods, banks appear very reluctant to take equity stakes. Banks are especially reluctant when their loan is collateralized — that is, when the bank can seize particular assets of the firm should the firm default — or when the firm has nonbank bondholders.

In Japan, a financially troubled firm's main bank has often taken a claim subordinated to the claims of the firm's other creditors, apparently as part of an unwritten agreement that the firm's main bank should bear the costs of its own mistakes.[5] In other words, the other creditors would be repaid before the main bank.[6] But the historical record of banks' accumulation of equity positions is actually equivocal. Paul Sheard's study shows that Japanese banks significantly increased their stockholdings in firms in the early 1960s and again in the 1970s, in large part to guard against takeovers of affiliated firms. But bank stockholdings to prevent takeovers have nothing to do with mitigating stockholder-debtholder conflicts.

In light of the theoretical case for the benefits of having an informed investor holding both debt and equity, especially when stockholder-debtholder conflicts are magnified by financial distress, the weight of the empirical evidence raises two related questions: Why do we see banks specializing so much in loans, even when regulatory constraints are not binding? What are the barriers to banks' willingness to exchange debt for equity in distressed firms? Remember that a distressed firm need not be a poor investment. Even firms with attractive long-term prospects may suffer financial difficulties. In this situation, an informed creditor willing to take equity in exchange for debt can demand very favorable terms for the exchange.

HARD BUDGET CONSTRAINTS MAKE BETTER BORROWERS

When a Bank Has Priority Debt, Why Take Equity? James's evidence seems to offer a straightforward answer to at least the second question. One of his findings is that a bank with collateralized loans is much less likely to accept an equity stake when its borrower enters financial distress. This makes sense. Why would a collateralized lender give up its contractual right

[4] In a study of large German firms with a majority shareholder, B. Iber found that in 1983 families owned 22.6 percent of the firms and nonfinancial enterprises owned 11.3 percent of the firms, while banks owned only 8.0 percent of the firms. In earlier years, families' share was larger and banks' share was smaller.

[5] W. Carl Kester's article provides an interesting account of the web of implicit agreements that have traditionally bound Japanese banks and their borrowers.

[6] The subordination of the main bank's claim hasn't typically taken the form of an exchange of debt for equity, which is the most subordinate claim, in that all creditors must be repaid before stockholders receive any payments. More typically, the firm's main bank and other large lenders have purchased the debt claims of smaller lenders. This type of behavior may not survive the current liberalization and restructuring of the Japanese financial system.

to seize a defaulting firm's inventories, or perhaps the deed to its borrower's office building, in exchange for shares of potentially worthless stock? Collateral usually gives the bank priority over the firm's other creditors, which means that it is the first in line to receive payments should the borrower go bankrupt. In bankruptcy, lenders with uncollateralized loans share only the value of those assets that have not already been pledged to lenders with collateralized loans. And the holder of an equity claim has the lowest priority and receives payments only after all creditors have already been paid in full.[7]

And most bank loans are collateralized. According to the Survey of Terms of Bank Lending, which, since 1977, has tracked the details of loans made by an evolving sample of U.S. banks, approximately 75 percent of all loans (by value) made each quarter are collateralized. For Germany, Edwards and Fischer summarize survey evidence from a number of studies that show that nearly 100 percent of long-term loans and 70 percent of short- and medium-term loans (by value) are collateralized.[8]

Actually, collateral isn't the only feature of bank loans that gives the bank effective priority over other creditors. Banks usually make short-term loans; thus, a bank that is well informed about the borrowing firm's financial health can reduce its exposure to a troubled firm before the firm's other creditors — who may be ignorant of the firm's problems or may be stuck with longer term securities — can adjust their holdings. Bank loan covenants — contractual provisions that restrict the actions that the borrower may take — have much the same effect. For example, a covenant requiring a firm to keep its net worth above some minimum level acts as a tripwire, giving the bank a chance to improve its position at other creditors' expense, perhaps by reducing its exposure or by taking collateral.

Case Closed! Or Maybe Not...While the priority of bank claims certainly helps explain banks' reluctance to take equity in distressed firms, this answer isn't completely satisfactory because it immediately poses another puzzle. If the bank's unwillingness to work flexibly with a distressed firm is a predictable consequence of having a collateralized loan, why does the firm accept this type of financing? In a competitive financial market, as in the United States, it seems sensible that a firm should be able to find bank lenders willing to offer an unsecured loan. Why don't they?

One possibility is that a secured bank feels better protected if the firm defaults; thus, the bank will offer the firm a lower loan rate than would an unsecured lender. But this can't be the whole answer. Giving the bank a priority claim may lower the rate the firm pays for bank credit. However, the firm's other creditors — suppliers that provide trade credit or bondholders — lose in bankruptcy what the bank gains, so bondholders with lower priority will demand a higher interest rate, and suppliers will provide less generous financing terms. In theory, the higher borrowing costs for nonbank financing should directly offset any savings from the lower rate on a bank loan. If giving one creditor priority over another is meant to reduce total borrowing costs, someone's behavior must be affected in a way that makes the firm a better credit risk.

[7]This order of priority — known as the absolute priority rule — is not always strictly observed in practice, especially under U.S. bankruptcy law, which gives a bankrupt firm's top management significant power to influence the terms of the settlement. A firm's stockholders often leave bankruptcy proceedings with a positive equity stake even though noncollateralized creditors have not received their full contractual payments.

[8]Of course, the contractual right to seize collateral is not worth much if legal protections for collateralized lenders are weak. In the United States and Germany, the empirical evidence says that collateralized claims are well protected. For example, Lawrence Weiss found that in a sample of Chapter 11 reorganizations, secured creditors received 100 percent of the face value of their claim in 33 out of 37 cases. Edwards and Fischer survey the evidence for Germany.

Priority and the Economics of Hostages.[9] A useful way to analyze priority is to think about the economics of hostages. In the Persian empire, conquered kings would send their sons or daughters as hostages to the Persian court to assure the emperor that the conquered kingdoms were not plotting against the empire. Implicit in this arrangement was the threat that the hostage would be killed if his or her father didn't pay tribute or if word arrived from an outlying province that a revolt was brewing.

Similarly, under a debt contract, the borrower has posted his or her assets as a hostage. A firm's creditors have the legal right to take ownership of the firm's assets if the borrower defaults. In principle, at least, posting the firm's assets puts pressure on the borrower to hold down costs, to avoid excessively risky investments, and to make sure that loan payments are made on time.

One difficulty with the hostage arrangement is that the prince's father had to believe the emperor's threat to kill his son or else the subject king's behavior couldn't be controlled. In other words, the Persian ruler's threat had to be credible. Indeed, Persian rulers had little difficulty maintaining credibility: What was the life of a foreign prince worth to the Persian emperor? But in the case of a loan contract, a borrower may have good reason to question the credibility of a creditor's threat to impose default and to take ownership of the firm's assets, especially since the assets are often worth less if they are seized and resold than if the borrower stays in operation. For example, the borrower's main asset may be inventories of unsold goods. With an established network of retailers, even a firm experiencing financial problems can reasonably expect to sell its goods more efficiently and get a higher price than its creditors could.

The firm's owner understands this and may choose to take large risks using the following reasoning: "If things turn out badly and I can't make my loan payments on time, my creditors would be irrational to actually push me into bankruptcy. All I need to do is explain that we'll all be better off if I retain the inventories, and they will renegotiate and accept lower loan payments." If the firm's owner reasons this way, the threat to seize assets in default is not credible, and it won't impose much discipline. Economists would say that the firm faces a soft budget constraint.

But if one of the creditors, the firm's bank, has priority, its share of the firm's assets when the firm is in default is larger than its share of all the funds initially loaned to the firm. Thus, even if creditors with only proportional claims on the defaulting firm's assets would rationally back away from pushing the firm into bankruptcy, the bank — with a disproportionately large share of the value of the defaulting firm's assets — is more likely to take a hard line in the face of the borrower's entreaties to renegotiate the contract. The bank has a credible threat to seize and liquidate the firm's assets — that is, to kill the hostage — should the firm breach the terms of the debt contract. Recognizing this, the firm will take greater precautions to avoid default.

The bank's priority over the firm's other creditors is not just a transfer between claimants; it changes both the creditors' and firm's behavior in a fundamental way. In particular, priority makes the bank a very hard bargainer and the enforcer of a hard budget constraint. In turn, this imposes more discipline on the firm, but the firm readily accepts the discipline because total borrowing costs are lower when creditors know their investment is safer. Ironically, by pressing its own interests at the expense of other claimants', a bank with a priority claim increases everyone's returns.

How would a mixed debt-equity claim affect the bank's behavior? Equity contracts have the

[9]The material in this section synthesizes some of the insights in articles by Eric Berglöf and Ludwig von Thadden and by Mathias Dewatripoint and Jean Tirole. See Stanley Longhofer and João Santos's article for a good survey of theories explaining the priority of bank loans.

lowest priority among all claims. So, any stock held by the bank would reduce the bank's share of the firm's assets in bankruptcy, thus reducing its willingness to press the firm to liquidate. A bank holding equity in the firm would be less effective as a tough enforcer of a hard budget constraint.

Hard Budget Constraints Don't Rule Out Renegotiation. One criticism of this argument for specialization by banks is that it is one-sided. Most important, it seems to ignore the potential benefits to the firm of having an informed lender willing to renegotiate the firm's contracts to avoid liquidating the firm when it would be more valuable as an ongoing business. And there is substantial empirical evidence that the renegotiability of bank debt is of significant benefit to firms.[10]

Actually, there is no contradiction between banks enforcing hard budget constraints and also facilitating renegotiation. Having a bias toward liquidation, rather than renegotiation, doesn't mean that banks and their borrowers would never renegotiate. When renegotiation occurs, however, a bank with priority will take a hard bargaining stance, and a significant share of any expected future profits will end up in the bank's hands as part of the deal. This is borne out by another of James's findings: in renegotiations with distressed firms, other creditors, such as the firm's bondholders, must make the lion's share of concessions before a bank is willing to exchange its priority debt claim for equity.

SPECIALIZED LENDERS ARE MORE CREDIBLE

Banks play a special role in producing and communicating information about the firms to which they lend. The type of financial claim held by a bank can affect its ability to communicate information to others, especially when a borrower experiences financial troubles. In particular, a bank with a significant equity stake in a borrowing firm will not be viewed as a credible source of information about the borrower's creditworthiness by the firm's other creditors and suppliers.[11]

Banks Are an Important Source of Information to Other Claimants...A firm's fixed claimants rely on many sources of information when they enter into a business relationship.[12] Sources include published information, such as Dun and Bradstreet, but also more informal ones, such as lawyers or accountants, as well as the firm's other suppliers and customers. Traditionally, banks have been a key source of reliable information about borrowers because it is a bank's job to be well informed about borrowers' financial affairs.

Consider Bend EZ Inc., a supplier of prosthetic joints that has maintained a profitable business relationship with New Parts Medical Supplies for nearly 10 years. Before signing the first long-term supply contract, however, the owner of Bend EZ contacted the New Parts' relationship manager at One-Stop Shop N' Bank, now a diversified financial supermarket (but, originally, a bank). By calling the bank, Bend EZ's owner saved his firm the time and trouble of collecting information about a new customer. Providing information to Bend EZ wasn't par-

[10] James's 1996 article provides evidence that banks facilitate debt restructurings for distressed firms. See my Business Review article for an introduction to the evidence that an important feature of bank debt is that it is renegotiable.

[11] The next two sections are drawn from my article with Kose John and Anthony Saunders.

[12] The term fixed claimant includes both real claimants, such as a supplier of copper pipes, and financial claimants, such as bondholders. Fixed claimants, both real and financial, have debt-like claims. The producer of copper pipes with a five-year supply contract shares many similarities with a bondholder: both get specified payments as long as the firm keeps operating, but neither gets a share of the firm's profits. In contrast, the financial claim of the firm's stockholders rises or falls in value with the firm's profits.

ticularly costly for the bank, since Shop N'Bank was already collecting information about its borrower's creditworthiness as part of its lending relationship with New Parts. And New Parts was happy to have Shop N'Bank provide information to Bend EZ, because the bank could communicate New Parts' creditworthiness to a potential supplier. Indeed, this is one of the services that the firm pays the bank to perform as part of the lending relationship. So all parties benefit from the bank's role in disseminating information.

While the bank's informational role may be important under routine conditions, it is even more important when its borrower is in trouble. New Parts' army of sales representatives has now become a costly luxury in a web-based marketing environment, but the firm has adapted too slowly and has been losing money for nearly two years. The first order of business for a firm in financial distress is usually to cut costs. While reusing paper clips or having executives fly coach may be a start, financial troubles inevitably trigger a round of negotiations with the firm's usual suppliers and customers. These negotiations may also extend to the firm's financial claimants — its lenders and bondholders.

If the firm wants to reduce costs, it must convince many of its claimants to accept lower payments, so some of the firm's financial difficulties are shared with its network of suppliers and lenders. However, negotiations over how to share the pain can be complicated, since most of the firm's claimants don't have first-hand knowledge of the firm's true cost structure. Claimants will be suspicious that the firm is looking to shift its losses onto input suppliers and customers. Bend EZ may well believe that no concessions would be needed if New Parts' managers would just fly coach, use fewer paper clips, and fire some sales reps.

Even without a phone call from a supplier to the borrower's loan officer, Shop N'Bank's willingness to continue lending to New Parts conveys information about the firm's continuing creditworthiness. Actually, the bank's willingness to continue to provide funds is more eloquent about the firm's prospects than a bill of good health from its loan officer, since actions speak louder than words.[13] Similarly, Shop N'Bank's willingness to grant concessions also conveys to Bend EZ that concessions really are necessary for New Parts to stay in business. When Bend EZ learns that the bank has renegotiated its loan, the supplier can feel more confident that New Parts and its banker are not just seeking to shift losses onto its suppliers.

...But a Bank with an Equity Stake May Be Less Credible. Consider Bend EZ's owner's thinking when New Parts proposes substantial price reductions after Shop N'Bank has exchanged its loan for a significant equity stake in New Parts. On the one hand, the debt-for-equity exchange contains some good news. Since the bank has not pushed its borrower into bankruptcy, Bend EZ may reasonably infer that the bank expects the firm to survive.

However, as a fixed claimant, Bend EZ also has reason to be suspicious. Now that Shop N'Bank has become a stockholder in New Parts, it profits directly from any concessions made by Bend EZ or by the firm's other fixed claimants. The supplier might reasonably imagine that Shop N'Bank and New Parts have made a back room deal to expropriate the firm's fixed claimants by insisting on excessive concessions and splitting the gains.

If the firm's uninformed claimants look to the outcome of negotiations between a well-informed bank and the firm before deciding whether to make concessions, the bank's financial claim on the distressed firm must take account of claimants' suspicions that the bank and firm have (implicitly or explicitly) colluded to expropriate

[13]Multiple studies have documented a positive effect on a firm's stock price when its bank announces a new loan or loan commitment. The article by Matthew Billett, Jon Garfinkel, and Mark Flannery provides an excellent review of this literature.

them. The bank's renegotiated claim should be designed to create conflicts of interest between the bank and the firm's owners; otherwise, the bank can't serve as an honest broker to facilitate the renegotiation of the firm's fixed claims. The most straightforward way to do this is for the bank to reduce the face value of its loan without taking any equity at all; that is, the bank exchanges one pure loan contract for another pure loan contract with lower payments.

LENDER LIABILITY PROMOTES SPECIALIZATION[14]

Lenders in Control May Face Liability. In many countries, under many different types of legal systems, powerful and well-informed investors, including large lenders, often have special legal responsibilities toward the borrower's other claimants. For example, in the United States, an investor with a controlling share of a firm's stock has a fiduciary responsibility to the firm's smaller stockholders, bondholders, and customers.[15] Although the legal definition of a fiduciary responsibility is very elastic — and investors' actual responsibilities can differ quite widely across countries — in the United States an investor with a fiduciary responsibility must make prudent decisions (as might be judged by a hypothetical knowledgeable investor in similar circumstances).

The laws governing an influential lender's responsibilities to other claimants of the firm fall under the general heading of lender liability. U.S. bankruptcy law includes a particular variant of lender liability called equitable subordination, a doctrine that permits a bankruptcy court to subordinate the claim of a lender to that of other claimants if the lender's behavior was inequitable. This means that the lender was responsible for improper business decisions that improved its own position at the expense of other claimants'.

For example, Shop N'Bank may continue to extend credit to New Parts merely to postpone an inevitable liquidation. All the while, the bank may be telling Bend EZ that the firm is financially healthy while the bank takes more collateral. Or the bank may insist that New Parts liquidate receivables to pay down as large a share of its bank loan as possible while stringing out payments to Bend EZ. Any of these behaviors may be deemed inequitable in the eyes of the court, but first the court must determine that the lender's behavior constituted control of the firm. (See The Legal Definition of Control.)

The Threat of Subordination Encourages Specialization. Any lender with a priority claim — for example, a collateralized lender — will be wary of taking an open-ended management role in its borrowing firm. In general, a lender that becomes too closely involved in the management of the firm risks having a court view it as a controlling investor, which can undermine its priority should things turn out badly and the firm go bankrupt.[16] In fact, the banking law literature is chock full of cautionary tales about crossing the line into direct management of the borrower's affairs and lists of dos and don'ts for the banker with a borrower in financial distress. And although an equity stake doesn't necessarily give the bank more influence over the firm, the courts have viewed an equity position as evidence that the bank is a controlling investor.

The law draws a distinction between open-ended control and normal creditor remedies; actions that flow from rights granted by the loan

[14]This section draws heavily on my working paper with Loretta Mester.

[15]The idea of a fiduciary responsibility originates in Roman law and concerns a trustee's responsibility to act in the interests of the beneficiary of an estate.

[16]Similar lender liability doctrines appear in other legal systems. The German bankers interviewed by Edwards and Fischer said that the main reason for their reluctance to exchange debt for equity is that their entire claim, including debt claims, could be subordinated in the event the borrowing firm ultimately fails.

The Legal Definition Of Control

In the United States, an influential creditor's potential liability depends on whether the courts view the investor as in control, a term that is hard to define with any precision either in economic or legal terms. Even a very powerful lender may not be in control in the eyes of the court. In general, influence exercised according to the terms of an arm's length agreement won't be viewed as control. An arm's length agreement is one freely entered into by a borrower capable of representing its own interests; thus, an agreement between a healthy borrower and the bank would typically be viewed as an arm's length agreement.

For example, a fairly common loan covenant allows the bank to demand immediate repayment if certain trusted top managers are replaced. This covenant is very intrusive by anyone's standards. But if the contract was agreed upon at arm's length, other creditors can't successfully sue for equitable subordination if the firm is forced into bankruptcy by a bank's exercising its contractual right to withdraw funds. Since control is a prerequisite for liability, other claimants have no grounds to challenge the bank's priority, even if the firm's assets are less valuable than the value of the firm had it continued production.

However, the stringent legal standard for viewing influence as control doesn't offer the bank blanket immunity. For example, consider a distressed firm that has missed multiple loan payments (evidence that the firm has negative net worth). If the bank insists on the right of approval over future managers as a precondition for further funding, the courts may well view the bank as a controlling investor. Unlike in the previous example, the bank's influence over management didn't clearly arise as part of an arm's length agreement. In this case, the courts may look more carefully at the details of the bank's behavior if the firm fails and other creditors are harmed. Much of the case law involving equitable subordination and legal liability has been a search for rules and principles amid the details of cases like these.

contract are not viewed as control in the eyes of the law. But since contracts can't possibly describe precisely how the lender should act in all details, the courts have interpreted normal creditor remedies more broadly and asked whether a creditor's interventions have followed standard industry practice in similar circumstances. One way to think of this is that the courts have a type of boilerplate, or standardized loan contract, in mind. If a lender goes beyond its explicit contract with the borrower and if it also deviates from the court's boilerplate contract, its responsibilities to other claimants increase.[17]

The threat of liability not only prevents open-ended interventions by lenders but also promotes coordination among claimants. The firm's claimants can use the court's boilerplate contract as a type of model that delimits a powerful creditor's behavior, even if the actual loan contract between the bank and the firm isn't directly observable. This permits all claimants to form a clearer picture of how the bank will act when firms enter difficult times. And through court decisions, both banks and other claimants learn about the terms of the boilerplate contract as courts encounter novel situations.

Equitable Subordination Allows Claimants to Make Commitments. While the doctrine of equitable subordination may seem to be nothing but a restriction on lenders' opportunities to contract freely, it also allows all claimants to make commitments they otherwise couldn't make. As long as a lender restricts its influence to rights granted under its loan contract and to standard creditor remedies, other claimants can't effectively challenge the priority of the bank's claim. So, if a bank presses its own interests at the expense of other creditors — for example, if a bank

[17]Of course, there are multiple legal jurisdictions and no two business transactions are truly identical, so the idea of a single boilerplate contract that lenders and claimants can consult underplays the uncertainty they face in the real world.

with a secured loan exercises its contractual right to push a firm into default — the bank has protection against future challenges by the firm's stockholders, its nonbank creditors, and its customers, all of whom may have been harmed by the default.

But is this a good thing? And why view this as an increase in other claimants' ability to make commitments, rather than just as a restriction on their rights? Recall the main argument for giving the bank priority in the first place: A priority claim ensures that the bank benefits disproportionately when the firm defaults. Thus, nearly every default would be grounds for a legal challenge if imposing harm on other claimants were sufficient grounds for challenging the bank's priority. This situation would be good for the lawyers, accountants, and economists paid to advise the bankruptcy court, but it would use up lots of time and money. Also, the right to challenge and reopen contracts may lead claimants to neglect simple, cost-effective precautions to reduce the risks of a borrower's or customer's default. For example, a bondholder can diversify his or her portfolio and a supplier can avoid excessive dependence on a single customer.

In fact, all claimants may benefit if they can make a prior commitment not to seek to undo existing contracts in court, but writing lots of bilateral contracts to enforce this promise may be impossibly costly. The protections granted a bank by the doctrine of equitable subordination severely limit claimants' ability to undo existing contracts; thus, the legal doctrine serves as a substitute for such contracts. In effect, the law acts as a coordinating device that facilitates the making of commitments by a firm's many claimants.

CONCLUSION

Even though elementary financial theory suggests there may be gains from permitting banks and other institutional investors to hold mixtures of debt and equity, banks in the United States and other countries don't seem to hold as much equity as regulations permit. Instead, banks typically make loans, which are pure debt claims. And in those cases where banks do take equity positions, the weight of the empirical evidence offers little support that banks are seeking to achieve the blended financial claim predicted by theory.

Recent work in financial economics provides some insights into the reasons banks may prefer to specialize in lending rather than holding mixed claims. All investors may benefit when the bank acts as a tough bargainer should the firm experience financial problems, and tough bargaining may require a priority debt claim. Also, banks may avoid taking equity stakes in distressed firms to reassure other claimants who watch the bank's negotiations with the firm before deciding whether they should make concessions. A significant equity stake in the distressed firm may make other claimants suspicious that the bank and the firm's managers are colluding to seek unnecessary concessions. Finally, lender liability tends to promote specialization by lenders, because blended financial claims and open-ended interventions by lenders may trigger liability and threaten the priority of their debt claims.

These findings put traditional arguments about the potential benefits and costs of mixing banking and commerce in some perspective. A central argument of those who oppose relaxing the walls separating banking and commerce is the concern that banks with equity stakes in nonfinancial firms will feel compelled to bail out such firms when they encounter financial troubles. If so, the safety net would extend to the nonfinancial sector, and taxpayers would be the losers.[18]

[18]The safety net includes access to deposit insurance and to the discount window. More broadly, banking regulators stand ready to intervene if they determine that problems at a financial institution threaten the stability of the financial system. See Loretta Mester's article for a full account of arguments that mixing banking and commerce might inappropriately extend the safety net.

While the available evidence doesn't strictly allay these concerns, there do appear to be some powerful market-driven forces — strengthened by lender liability laws — that limit banks' desire to take large ownership positions in borrowing firms. And these forces operate quite strongly when borrowers are distressed, just when opponents of mixing banking and commerce would be most concerned. That said, the evidence doesn't provide strong support for proponents of expanding banks' powers to take equity stakes in firms, either. The evidence does not say that most banks are straining against regulatory barriers to hold the stock of nonfinancial firms. To the contrary, banks and their borrowers often seem to enforce a separation of banking and commerce voluntarily, in the normal course of making contractual agreements.

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