Corporate Governance and Bankruptcy: A Preliminary Inquiry

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Debates over corporate governance tend to focus on what happens when the firm is doing well. It is a commonplace that corporate governance matters most when the firm finds itself in the midst of a corporate control transaction. Indeed, much of the focus of corporate law scholarship over the last quarter century has focused on the market for corporate control and the way in which the corporate law affects it. Poison pills, staggered boards, Revlon duties, and the other focal points of debates about corporate governance look at ensuring that the board acts effectively when the firm itself is in play. Corporate control transactions, however, happen in bad times as well as good. While only a handful of hostile takeovers arise each year, dozens of papers on hostile takeovers come into being. By contrast, there have been nearly a thousand large corporate Chapter 11s, and the role that the board plays has been largely neglected.†

Very often the solution of choice to firms in financial distress short of bankruptcy is a corporate control transaction. The assets are sold outright or some new investor acquires control of the business. And bankruptcy is no different. The consequence of a Chapter 11 reorganization of a large firm today is a change of ownership. The change takes place through a number of different mechanisms, but the end result is, in the majority of cases, a change in ownership. By the end of the case, a new investor has appeared and, either by buying the assets outright or acquiring control of the fulcrum security, that investor becomes the new owner of the business.

As various reforms are put forward, especially on the role of independent directors, it is important to ask how these reforms operate where they may matter the most. The reforms that are promoted to ensure better corporate governance in good times may

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work as well or even better in bad times. But the opposite may also be true. Rules designed to ensure that directors set executive compensation of well-performing managers may not work at all when the firm is in trouble and the question is not how much or in what form to pay the management team, but whether to dump them. Rules that ensure director independence may leave them with too little at stake when they matter the most. They may not care. Worse yet, they may simply do the bidding of whoever is operating the levers of corporate control.

We plan to set out the basic questions that need to be asked about the role that independent directors actually play and the role that they should play when a firm encounters financial distress. We shall then try to obtain some empirical purchase on these questions by combining the Bankruptcy Research Database with databases that have been constructed to assess the quality of corporate governance. We hope to be able to see whether firms with less independent boards enter bankruptcy in a different condition and fare differently while they are there.