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Asset liquidity, debt covenants, and managerial discretion in financial distress: the collapse of L.A. Gear ☆

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Abstract

A hot growth stock in the 1980s, L.A. Gear's equity fell from $1 billion in market value in 1989 to zero in 1998. For over six years as revenues declined precipitously, management tried a series of radical strategy shifts while subsidizing the firm's large losses through working-capital liquidations. The L.A. Gear case illustrates that asset liquidity (broadly construed, not limited to excess cash) can give managers substantial operating discretion during financial distress. It also shows (1) that debt covenants can be stronger disciplinary mechanisms than requirements to meet cash interest payments, (2) why debt contracts typically constrain earnings instead of cash flow, (3) why cash balances are not equivalent to negative debt, and (4) why debt maturity matters. We find that many firms have highly liquid asset structures, thus their managers have the potential to subsidize losing operations should the need arise. © 2002 Elsevier Science B.V. All rights reserved.

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Keywords: Asset liquidity; Debt covenants; Financial distress; Capital structure; Bank lending

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1. Introduction

In 1989, L.A. Gear was the top-performing common stock on the NYSE, after having registered the third largest percent gain among NASDAQ stocks in 1988. The firm became famous in the 1980s for its trendy women's casual footwear and racy ads featuring scantily clad California blondes. L.A. Gear's exceptional stock price performance began with the firm's 1986 IPO, which was one of only seven non-penny stock offerings in the decade that more than doubled on the first trading day, outpacing even Genentech's 104% initial day return (Ritter, 2000). In 1988, it was named Company of the Year by *Footwear News Magazine* and also ranked number three on *Business Week*'s list of the 100 Best Small Corporations. In the late 1980s L.A. Gear produced a number of wildly successful fashion hits with teenage girls and young women, including such items as high-top pink sequined sneakers and silver and gold lamé workout shoes, growing its revenues from $11 million in 1985 to $820 million in 1990.

L.A. Gear's initial success was short-lived, as the fashion excesses of the 1980s were followed in the early 1990s by more austere lifestyle trends that the firm failed to anticipate. This blunder engendered liquidity problems due to restrictive covenants in the firm's bank credit line. Management responded by selling excess inventories to deep discount outlets, thereby damaging the brand with consumers and alienating full price retailers. By 1991, quarterly loss-induced covenant violations led management to seek external financing, which it obtained by selling operating control to Trefoil Capital Investors L.P. Trefoil immediately brought in a new president and eased out Robert Greenberg, the founder/CEO who had masterminded L.A. Gear's glitzy designs. Over the next six years, Trefoil oversaw three different operating managements who tried a series of radical strategic shifts, all of which failed to resuscitate L.A. Gear. By mid-1998, the company's stock, valued at nearly $1 billion at its 1989 peak, was literally worth zero in bankruptcy proceedings. The company, once known for its meteoric rise, became more famous for its dramatic decline, described by *The New York Times* (''Trying a New Shoe on for Size,'' July 18, 2000, C1) as one of the ''industry's most spectacular collapses''.

L.A. Gear's collapse is remarkable because the firm bled enormous amounts of cash for over six years before finally failing to make an interest payment, all the while suffering large losses and dramatically declining revenues. Although L.A. Gear began 1991, its first year under Trefoil, with just $3.3 million in cash, its subsequent cash ''burn rate'' was some $36 million per year for a total cash earnings deficit of $215 million over 1991–1996. The firm raised only $35 million in net new financing, funding $180 million of cash losses via internal sources ($180 million is 80% of L.A. Gear's equity value at year-end 1990). During 1991-1996, Trefoil tried a number of new directions at L.A. Gear, including an emphasis on men's performance athletic shoes and a shift in its distribution channels away from upscale department stores to mass marketers such as Wal-Mart. L.A. Gear's revenues fell from $820 million in 1990 to $196 million in 1996. Its domestic market share fell from 12% in 1990, when it ranked third behind Nike and Reebok,

to 2% in 1996, when it ranked ninth. In late 1997, Trefoil sold its equity stake, for which it had paid $100 million in 1991, for $228,000. One month later, L.A. Gear failed for the first time to pay interest on its debt, and in January 1998 the firm filed for Chapter 11 bankruptcy protection.

L.A. Gear's highly liquid asset structure is the key factor that enabled the firm to meet its debt obligations and keep operating for six years despite its prodigious cash "burn rate". The firm held only a modest amount of cash when its financial troubles began, and so its ability to sustain prolonged losses is not attributable to large cash balances (as hypothesized for firms in general by Opler et al. (1999, p. 44)). Rather, Trefoil subsidized L.A. Gear's ongoing losses by liquidating working capital that was freed up by the decline in the firm's growth opportunities. Trefoil reduced its exposure to bank monitoring by paying off L.A. Gear's bank debt, issuing new covenant-free public debt, and using L.A. Gear's bank credit line almost exclusively to support letters of credit that guaranteed payment to suppliers. As predicted by Smith (1993), the bank set – and reputedly reset – tight covenant terms on the credit line so that further deterioration in L.A. Gear's financial condition would trigger default, allowing the bank to again reassess and renegotiate its loss exposure. L.A. Gear went through 14 different credit agreements that gradually reduced its total credit line from $360 million to $25 million, yet preserved Trefoil's ability to liquidate working capital to subsidize L.A. Gear's ongoing losses.

The L.A. Gear case shows that asset liquidity – broadly construed, not limited to excess cash – can buy time for management to experiment with new operating strategies in adverse circumstances. (Although asset liquidity had negative consequences for L.A. Gear stockholders, it can be beneficial if the time it buys enables management to implement a successful turnaround.[1]) The L.A. Gear case also illustrates that debt covenants sometimes constrain managerial discretion more effectively than does the pressure to meet cash interest obligations emphasized by Jensen (1986). Section 7 of the paper discusses these and other implications of the L.A. Gear case, such as why cash is not appropriately viewed as negative debt, and why debt maturity matters. Section 2 begins the paper with L.A. Gear's operating and stock price performance. Section 3 describes the firm's management and strategic changes over 1985–1996. Section 4 details L.A. Gear's asset structure, its capital structure, and the impact of Trefoil's working-capital liquidation on L.A. Gear's cash flow. Section 5 describes how L.A. Gear's debt covenants tightened as the firm's financial condition deteriorated. Section 6 presents evidence that many public corporations have asset structures which, like L.A. Gear's, are highly liquid and therefore potentially give managers substantial discretion to subsidize losing operations should the need arise.

[1] Shleifer and Vishny (1992) discuss how asset liquidity can yield benefits by expanding corporate debt capacity. For discussions of how asset liquidity can have the opposite effect, see Weiss and Wruck (1998) and Morellec (2001).

2. L.A. Gear's operating and stock price performance

L.A. Gear was founded in 1979 by Robert Greenberg, previously a hairdresser and wig salesman, to market and rent out roller skates in Venice Beach, California. Over the next few years, Mr. Greenberg utilized the firm to market E.T. shoelaces (based on the extraterrestrial movie character) and to open a trendy women's clothing store on Melrose Avenue in Los Angeles. The store achieved great success selling fashionable sneakers in bright and metallic colors with unusual laces, sequins, and other such gimmickry, which Mr. Greenberg arranged to have produced in Asia. In 1984, he hired an advertising executive, Sandy Saemann, to develop a national advertising campaign for L.A. Gear's footwear. Mr. Saemann, working almost entirely in-house, created a brand image of the "Los Angeles lifestyle" that ultimately propelled sales to $820 million. The apparent key to the firm's phenomenal growth from 1985–1990 was the combination of Mr. Greenberg's fashion sense and Mr. Saemann's marketing abilities.

Consistent with its trendy image, L.A. Gear's primary retail outlets were upscale department stores such as Nordstrom. The firm consistently had difficulty gaining retail space in athletic shoe stores such as Foot Locker, which feature more performance-oriented manufacturers. Like most firms in the industry, L.A. Gear outsourced its shoe production to Asian manufacturers. Unlike other firms, L.A. Gear allowed its retail customers to order relatively small quantities throughout the season. This practice, known as "at once" ordering, differs from standard industry practice, a "futures" ordering system whereby retailers order in quantity in advance of the season with limited or no option to reorder once the season is underway. L.A. Gear's "at once" system helped the relatively young firm compete with industry leaders Nike and Reebok. It also required L.A. Gear to hold a larger (than otherwise optimal) inventory, and excess inventory was a recurring problem during the firm's subsequent financial difficulties.

Table 1 describes L.A. Gear's operating performance during its 1985–1990 growth phase (left side of the table) and its 1991–1996 decline (right side of the table).[2] L.A. Gear's revenues rose from $10.7 million in 1985 to $819.6 million in 1990, for an annualized increase of 138% under founder Robert Greenberg. The sales breakdown figures in Table 1 indicate that, while L.A. Gear initially specialized in women's shoes, by 1990 the firm also had substantial sales of men's and children's shoes and a growing international presence. Earnings increased from $0.3 million in 1985 to $55.1 million in 1989, then fell to $31.3 million as the firm's 1990 gross profit margin fell to 34.9% from about 42% in 1986–1989, reflecting the price discounts necessary to move excess inventory.

[2] The Table 1 data are for fiscal years 1985–1996 because L.A. Gear filed annual financial statements with the Securities and Exchange Commission from 1986–1996. Trefoil initially agreed to take control of L.A. Gear in May 1991 and stockholders approved the deal in September, so that L.A. Gear's 1991 operating performance reflects about ten months under Robert Greenberg, with Trefoil in control for the year-end accounting adjustments.

Table 1
Operating performance at L.A. Gear: 1985–1996
Operating data are from annual reports and forms 10-K for fiscal years ended November 30, using the company's restated numbers when applicable. Gross profit margin is sales minus cost of goods sold, divided by sales. SGA is selling and general administrative expense. N.d. is not disclosed.

Year	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Total sales ($millions)	10.7	36.3	70.6	223.7	617.1	819.6	619.2	430.2	398.4	416.0	296.6	196.4
Sales breakdown ($millions):												
Women's shoes (domestic)	n.d.	29.8	50.9	134.6	287.1	285.7	178.5	113.0	82.8	63.2	46.4	38.4
Men's shoes (domestic)	n.d.	2.5	10.8	27.9	117.9	197.0	176.2	104.6	73.1	67.2	35.8	20.4
Children's shoes (domestic)	n.d.	4.0	6.3	37.6	127.3	174.5	134.5	91.0	128.5	165.5	107.6	75.0
Apparel, etc.	n.d.	0.0	0.3	3.1	32.0	4.2	2.5	2.7	2.0	1.7	2.7	2.2
International	n.d.	0.0	2.3	20.5	52.8	158.2	127.5	118.0	112.0	118.4	104.1	60.4
Gross profit margin (%)	31.7	42.5	41.1	42.3	41.9	34.9	27.5	25.3	28.7	29.7	29.9	24.0
SGA to sales ratio (%)	25.5	28.3	28.3	24.1	25.0	27.4	36.2	39.8	37.0	34.6	47.7	44.2
Net income ($millions)	0.3	1.7	4.4	22.0	55.1	31.3	−66.2	−71.9	−32.5	−22.2	−51.4	−61.7

L.A. Gear's 1990 inventory problems stemmed from several strategic blunders under Robert Greenberg. In 1990 the firm began to focus more seriously on men's shoes, which it had sold as a sideline since 1985. Its Catapult line of basketball shoes, endorsed by aging L.A. Lakers star Kareem Abdul-Jabbar, failed to sell. Its Michael Jackson line of buckle-bedecked leisure shoes met a similar fate. In December 1990 a pair of L.A. Gear's sneakers fell apart on national television during a Marquette-Kansas basketball game, causing the player to stumble and fall to the floor before a large audience. At the same time L.A. Gear's women's shoes failed to anticipate the new grunge look of the 1990s, and its "at once" ordering system left the firm with an overabundance of glitzy, eighties style shoes, now distinctly unfashionable. Management's response – to dump these shoes on wholesale distributors that sold them to deep-discount outlets at cut rate prices – dramatically lowered the firm's gross margins and antagonized the firm's major upscale retailers and its customers by tarnishing L.A. Gear's brand name.

As a result of these strategic blunders, in January 1991 L.A. Gear reported its first quarterly loss, putting the firm in default of a covenant that prohibited losses in the $360 million credit line the firm had signed just one month earlier with the Bank of America. The bank first lowered the credit line to $300 million, and then to $200 million later in 1991, following L.A. Gear's second quarterly loss and contemporaneous with Trefoil's purchase of operating control for $100 million in redeemable preferred stock (34% of L.A. Gear's equity). Two weeks after the Trefoil agreement was announced, Sandy Saemann resigned. Robert Greenberg left in January 1992. Upon shareholder approval in September 1991, Trefoil named as president/COO Mark Goldston, a former Reebok marketing executive and author of *The Turnaround Prescription*, a book on managing troubled firms. Stanley Gold, Trefoil's president, became chairman of L.A. Gear, and remained so until late 1997 when Trefoil sold its then 45% stake.

Table 1 indicates that L.A. Gear's operating performance in the transition year 1991 was considerably worse than in 1990. Sales fell from $819.6 million to $619.2 million, with decreases in every product category, and gross profit margins fell from 34.9% to 27.5%. Selling and general administrative (SGA) expense increased from 27.4% to 36.2% of sales, and the firm reported a net loss of $66.2 million. During the subsequent five years 1992–1996, sales declined in every year but one (1994), falling from $619.2 million in 1991 to a low of $196.4 million in 1996. Sales of almost every product category declined in virtually every year after 1991, except for children's shoes in 1993 and 1994, when L.A. Gear's children's lighted shoes were a temporary fashion hit. L.A. Gear incurred a net loss in every year 1991–1996 under Trefoil. As Table 1 shows, these losses were attributable to declining sales and profit margins and increased SGA expense, which peaked in 1995 at an alarming 47.7% of sales.

For 1986–1997, Fig. 1 reports L.A. Gear's raw (unadjusted) stock return, its raw return minus the contemporaneous return on the CRSP value-weighted market index, and its raw return minus the contemporaneous return on a value-weighted portfolio of stocks in the same industry (based on Compustat's primary SIC classification). L.A. Gear's share price performance has four distinct phases. The first

phase runs from L.A. Gear's July 1986 IPO, which was one of the hottest deals of the 1980s, to early 1988.[3] L.A. Gear's stock then experienced a period of tepid performance, underperforming both the market and the industry through early 1988. During the second phase, from early 1988 through mid-1990, L.A. Gear was a popular growth stock that substantially outperformed both the market and the industry. L.A. Gear had the third largest percentage gain among NASDAQ common stocks in calendar 1988, and the largest appreciation among NYSE common stocks in 1989. At its peak, the stock traded at more than 1,300% above the IPO offer price.

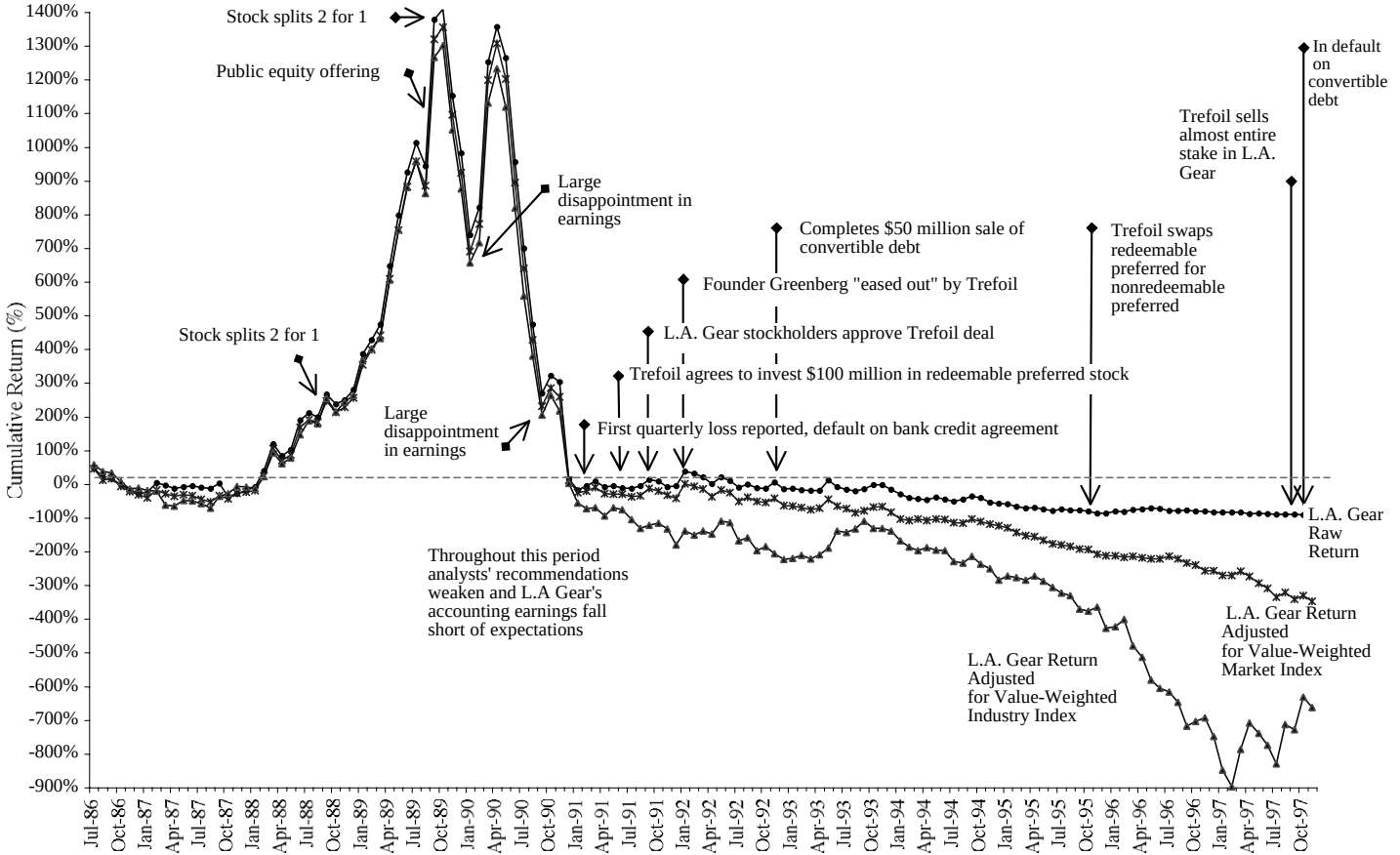
In the third phase, from mid-1990 through early to mid-1991, earnings disappointments punished L.A. Gear's stock, removing all of the 1988–1989 price appreciation, and leaving the firm once again an underperformer, relative to both the market and the industry. The fourth phase, from mid- to late 1991 until delisting in late 1997, is a period of protracted financial adversity. During this time, Trefoil experimented with a series of radical new strategies, each of which failed to return L.A. Gear to profitability, and the firm's shares underperformed the market and industry by large amounts. By 1997, L.A. Gear shares that had sold for $11.50 in the 1986 IPO were trading at roughly one-tenth that price, and would soon be rendered totally worthless in the firm's 1998 bankruptcy proceedings.

3. L.A. Gear's management and strategic changes under Trefoil

Table 2 reports L.A. Gear's strategic emphasis and other elements of its operating policy under the three Trefoil presidents (1991–1996, lower portion of the table) and, as a benchmark, under founder Robert Greenberg (1986–1991, upper portion). Although L.A. Gear grew rapidly under Mr. Greenberg, with the number of employees increasing from 84 in 1986 to 1,502 in 1990 (column (1)), its strategic emphasis and operating policies remained relatively stable. During these years Mr. Greenberg was the sole top officer, the firm's strategic emphasis was on women's shoes (with increasingly important sales of men's and children's shoes) and, except for a brief period in 1986, it produced all advertising in-house (per columns (2)–(5)). Domestically, L.A. Gear sold its products via independent distributors until 1988; internationally it used independent distributors throughout Mr. Greenberg's tenure (columns (6) and (7)). Until the firm's 1990 inventory problems prompted it to turn to mass-marketers, its primary retailers were department stores, which it serviced via an "at once" ordering system (columns (8) and (9)).

Under Trefoil, L.A. Gear became a virtual revolving door for top operating management (column (2) of Table 2). Its strategic emphasis changed repeatedly, from women's fashion footwear to men's performance athletic shoes, and back again, with children's shoes becoming a strategic priority in 1992 when the firm's

[3] Ritter (2000) reports that, during the 1980s, L.A. Gear was one of only seven non-penny stock IPOs to at least double in value on its first trading day. L.A. Gear had the fourth largest initial return of the decade (106.5%), placing it slightly ahead of Genentech (103.6%) and close to all other "doubling" stocks except Home Shopping Network (165.3%).


Cumulative Return (%)
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1200%
1100%
1000%
900%
800%
700%
600%
500%
400%
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200%
100%
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Jan-97
Apr-97
Jul-97
Oct-97
Stock splits 2 for 1
Public equity offering
Large disappointment in earnings
Stock splits 2 for 1
Large disappointment in earnings
Completes $50 million sale of convertible debt
Founder Greenberg "eased out" by Trefoil
L.A. Gear stockholders approve Trefoil deal
Trefoil agrees to invest $100 million in redeemable preferred stock
First quarterly loss reported, default on bank credit agreement
Trefoil swaps redeemable preferred for nonredeemable preferred
Trefoil sells almost entire stake in L.A. Gear
In default on convertible debt
Throughout this period analysts' recommendations weaken and L.A Gear's accounting earnings fall short of expectations
L.A. Gear Raw Return
L.A. Gear Return Adjusted for Value-Weighted Market Index
L.A. Gear Return Adjusted for Value-Weighted Industry Index

lighted shoes were popular (column (3)). Instability also characterized L.A Gear's policies regarding advertising, sales force structure, product marketing channels, and inventory ordering under Trefoil. During the six years 1991–1996, L.A. Gear engaged a total of four different advertising agencies (column (5)). It maintained its own domestic sales force through 1996, when it started to also employ independent agents (column (6)). In 1993, it began to purchase its overseas distributors, a strategy it soon abandoned and ultimately overturned (column (7)). Hoping to lure back upscale retailers, L.A. Gear in 1992 eliminated its mass-market sales, then reversed course in 1993 to dispose of excess inventory. Once it began to sell to Wal-Mart, L.A. Gear became primarily a mass-market supplier (column (8)). A "futures" ordering system that it tried to implement in 1992 never stuck (column (9)).

The Table 2 data show that Trefoil's three management teams had wide discretion to pursue, and in fact did pursue a series of new directions at L.A. Gear. Trefoil's first president, Mark Goldston, had overseen the marketing of Reebok's Pump, a men's performance athletic shoe, and he attempted to repeat this success at L.A. Gear. The wisdom of this approach was questionable, since L.A. Gear had recently failed quite publicly with its men's performance shoes, and its brand name as a marketer of fashionable women's sneakers gave it limited appeal to serious male athletes. Mr. Goldston also discontinued L.A. Gear's apparel business, contracted for more reliable shoe production, and tried to institute a "futures" ordering system. [This attempt failed, in part because inadequate planning left L.A. Gear's sales force unable to obtain samples of its new designs during the transition between Asian manufacturers.] Working to woo back L.A. Gear's upscale retailers, Mr. Goldston stopped selling to mass-market channels, costing the firm an estimated $100 million per year in lost sales ("Getting Beyond a Market Niche," *Forbes*, November 22, 1993, p. 106)), and opened L.A. Gear outlet stores to dispose of excess inventory.

Mr. Goldston's major accomplishment – and L.A. Gear's only real product success under Trefoil – was the 1992 introduction of children's shoes with lights in the heels. These shoes attracted national publicity when they enabled rescuers to find a little girl and her dog who were lost in the woods, and when they helped police apprehend a drug dealer fleeing in the dark ("Light Footed" *Time*, April 19, 1993). [In 1994 L.A. Gear's lighted shoes were discovered to contain mercury and their popularity subsequently waned.] L.A. Gear's attempts to extend their success to men's and women's lighted shoes failed and, in 1993, the firm once again found itself with excess inventory. As before, management chose to dump these shoes on

Fig. 1. L.A. Gear's cumulative raw return, market-adjusted return, and industry-adjusted return from its July 1986 IPO through November 1997. L.A. Gear was delisted in December 1997 and filed for Chapter 11 in January 1998. L.A. Gear's raw return is the buy and hold return from the IPO price of $11.50 through the end of each month. The market-adjusted stock return equals L.A. Gear's raw return minus the corresponding buy and hold return for the CRSP value-weighted market index. Similarly, the industry-adjusted stock return equals L.A. Gear's raw return minus the corresponding buy and hold return for a value-weighted index of all public firms in L.A. Gear's four-digit Compustat SIC code. Stock returns data are from CRSP. Key events are based on reports in *The Wall Street Journal* and other business and news publications.

Table 2
Strategic emphasis and other elements of operating policy for L.A. Gear: 1986–1996
Data are drawn from company annual reports, Forms 10-K, and various financial press reports about L.A. Gear. Management refers to the identity of the top one or two company officials. Strategic emphasis refers to the firm's main footwear product emphasis, while other operations refers to secondary product lines. An "at once" ordering system allows vendors to buy products from the firm at the time they want to take delivery. A "futures" ordering system requires vendors to place orders in advance of delivery, which allows the firm to observe demand before producing a specific quantity of goods. On the last day of the 1996 fiscal year (November 30, 1996), L.A. Gear had 314 employees, but immediately thereafter reduced employment to 150, which is the figure reported below.

Year	(1) Number of employees	(2) Management	(3) Strategic emphasis	(4) Other operations	(5) Advertising agency	(6) Sales force	(7) Overseas distribution	(8) Retail outlets	(9) Ordering system
1986	84	Greenberg	Women's fashion and aerobic	None	Ogilvy-Mather, None	Independent distributors	Independent distributors	Primarily department store	At once
1987	196	Greenberg	Women's fashion and aerobic	Casual apparel	None	Independent distributors	Independent distributors	Primarily department store	At once
1988	488	Greenberg	Women's fashion and aerobic	Casual apparel + accessories	None	Captive	Independent distributors	Primarily department store	At once
1989	1,008	Greenberg	Women's fashion and aerobic	Casual apparel + accessories	None	Captive	Independent distributors	Primarily department store	At once
1990	1,502	Greenberg	Women's fashion and aerobic	Casual apparel + accessories	None	Captive	Independent distributors	Dept. store + mass market outlets	At once
1991	900	Greenberg, Goldston	Women's fashion, Men's athletic	None	BBDO, Ogilvy-Mather	Captive	Independent distributors	Dept. store + mass market outlets	At once
1992	753	Gold, Goldston	Men's athletic, Children's	None	Ogilvy-Mather	Captive	Independent distributors	Firm reduces mass market emphasis	At once and futures
1993	798	Gold, Goldston	Men's athletic, Children's	Outlet stores	Ogilvy-Mather	Captive	Firm buys some foreign distributors	Firm increases mass market emphasis	At once and futures
1994	726	Gold, Benford	Women's, Children's	Outlet stores	Chiat/Day	Captive	Some distributors owned, some not	Primarily mass market	At once and futures
1995	509	Gold, Benford	Women's, Children's	None	Saatchi + Saatchi	Captive	Some distributors owned, some not	Primarily mass market	At once and futures
1996	150	Gold, MacGregor	Multiple branding	None	Saatchi + Saatchi	Captive and independent agents	Firm replaces owned distributors with independent agents	Primarily mass market	At once and futures

wholesale distributors that sold to deep-discount outlets, thereby further alienating the upscale retailers the firm had just tried to win back at considerable expense. In 1994, L.A. Gear agreed to sell its shoes to Wal-Mart, effectively turning itself into a mass-market supplier. By this time, CFO William Benford had replaced Mark Goldston as president.

Mr. Benford abandoned Mr. Goldston's focus on men's performance athletic shoes to return L.A. Gear to its "heritage" as a women's brand, while continuing to "capitalize on the strength of our children's business". He formed a marketing joint venture to promote the firm's shoes in Asia, where the L.A. Gear brand name was relatively untarnished. He closed the outlet stores opened by Mr. Goldston. Under Mr. Benford, L.A. Gear attempted to acquire Ryka Inc., a maker of premium women's athletic footwear and a "cause-marketing" firm. [Ryka's founder and CEO was raped at gunpoint, and was able to recover her self-esteem through aerobics. Many observers pointed out that the brand images of the two firms were radically inconsistent, and the acquisition eventually fell through due to Ryka's deteriorating financial condition.] The Wal-Mart agreement failed to halt L.A. Gear's sliding sales, as hoped, because the firm failed to meet the sales targets that would ensure an ongoing purchase commitment by Wal-Mart.

In 1996, as L.A. Gear's operating performance continued to decline, Mr. Benford was replaced by Bruce MacGregor, a marketing executive, whose strategy seemed largely to consist of removing the L.A. Gear name from some of the firm's shoes to attract customers who were turned off by the brand. Mr. MacGregor also abandoned the joint venture to market shoes in Asia initiated by Mr. Benford. Still, L.A. Gear's losses continued to deepen (see Table 1). In October 1997, Trefoil sold almost all of its then 45% stake to a Los Angeles investment partnership for $228,000 and all Trefoil directors resigned, as did Mr. MacGregor. In November 1997, L.A. Gear failed to pay interest on its debt, and in January 1998 it filed for bankruptcy protection. In June, the court confirmed the reorganization plan, eliminating the existing common stock, and in November 1998 L.A. Gear emerged as a licensor, with just ten employees.

Overall, Trefoil tried various strategies to return L.A. Gear to profitability, and their rapid and sometimes inconsistent strategic changes give the impression of a lurching, out-of-control set of managerial policies. Our reading of financial press reports indicates that independent observers doubted the wisdom of Trefoil's strategic changes at L.A. Gear at the time they were announced, even before their disastrous results became evident.[4] Perhaps Trefoil over-estimated its ability to

[4]For example, some observers viewed Mr. Goldston's attempt to change L.A. Gear's focus from women's shoes to men's performance athletic shoes as an ex ante flawed branding strategy. *The Wall Street Journal* (*WSJ*, December 17, 1991) said that "L.A. Gear's efforts to penetrate the lucrative men's athletic shoe market have been sorely hurt by the company's beginnings as a maker of candy-colored aerobics shoes for teen-age girls. Try as it might, L.A. Gear hasn't been able to shed its image as sneaker maker to the teeny-bopper set". The *WSJ* later (January 27, 1992) noted that "…some marketing experts question whether the move from fad-driven style to performance shoes – going head to head with the market leaders – will cure L.A. Gear's problems or worsen them". Observers also criticized L.A. Gear's attempts to extend its success with children's lighted shoes to adult versions. *Business Week* (December 21, 1992)

resuscitate L.A. Gear due to hubris or managerial over-optimism (Roll, 1986; Heaton, 2000), or perhaps they were just unlucky.[5] Whatever the reasons underlying Trefoil's failures at L.A. Gear, it is clear that Trefoil continued to have wide discretion over L.A. Gear's strategies despite six full years of large losses and dramatically declining revenues. What was the source of that discretion?

4. L.A. Gear's asset liquidity was the source of Trefoil's discretion

L.A. Gear's asset liquidity provided the internal funds to subsidize the firm's ongoing losses, and thereby gave Trefoil the discretion to run its strategic experiments without having to raise material amounts of external capital. Section 4.1 shows that L.A. Gear's asset structure was highly liquid. Paradoxically, although the firm had little cash when its troubles began, its cash position subsequently improved and the company remained flush for more than six years (until just before bankruptcy). As for external funds, Section 4.2 shows that net new capital contributions yielded only a modest cash inflow during L.A. Gear's financial distress. Section 4.3 documents L.A. Gear's steady and substantial cash losses over 1991–1996, and shows that the firm's $215 million cumulative cash loss under Trefoil was financed primarily through an ongoing, $250 million working-capital liquidation. It was this systematic drawing down of liquid assets that subsidized L.A. Gear's enormous cash losses and generated high cash balances until the very end – when the firm's resources were so depleted that its equity was worthless.

4.1. L.A. Gear's asset structure and asset-based interest coverage

Table 3 describes L.A. Gear's asset structure and asset-based interest coverage over 1985–1996. Rows 1 though 5 of the table respectively report year-end balances of cash, accounts receivable, inventory, current and total assets. Row 1 indicates that L.A. Gear began 1991 with just $3.3 million in cash and that, after an initial decline

(*footnote continued*)
reported that "… the shoemaker can take some comfort from a couple of hits, including L.A. Lights, a kids' shoe with a heel light that flashes with each step. Critics scoff, however, at L.A. Gear's attempt to use the same gimmick in a high-performance training shoe". Regarding L.A. Gear's agreement to market its footwear at Wal-Mart, *International Business* (December 1994) said that "this deal is big, but it contradicts the upscale marketing strategy Mr. Gold initially said he wanted to pursue. It even smacks of the old discounting strategy that nearly buried L.A. Gear in the past…. no type of Nike or Rebook sneakers is sold at Wal-Mart."

[5] Consider, for example, Trefoil's decisions to "ease out" founder Robert Greenberg and to move L.A. Gear away from women's fashion footwear toward men's performance athletic shoes. These decisions played to an area of demonstrable strength for Trefoil, given Mark Goldston's prior success in men's athletic shoes at Reebok. However, by playing to its own strength, Trefoil also may have under-estimated the importance of Mr. Greenberg's fashion sense in identifying successful products for L.A. Gear. In 1992 Mr. Greenberg and his son founded another fashion-oriented shoe firm, Skechers, whose brand image and asset composition are strikingly similar to L.A. Gear's. Skechers went public in June 1999 and, at least as of this writing, the firm has been quite successful, with 2000 sales of $675 million and a market capitalization of $965 million in March 2001.

Table 3
Asset structure and asset-based interest coverage for L.A. Gear: 1985–1996
Items 1 through 5 and 9 are in $millions. Cash includes marketable securities. Item 4 is the sum of items 1–3 plus other current assets (not shown). Working capital is current assets minus current liabilities. Net assets is the sum of working capital and long term assets. Interest expense for 1985–1989 includes factoring expense. Rounding implies that entries listed as 0.0 are not literally equal to zero, but instead are small positive amounts. All data are from company annual reports or forms 10-K for fiscal years ended November 30.

Year	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
1. Cash	0.0	11.1	3.3	4.2	0.4	3.3	1.4	84.0	27.8	49.7	36.0	34.2
2. Accounts receivable	0.7	2.7	15.1	49.5	100.7	156.4	111.5	56.4	73.2	77.3	46.6	23.9
3. Inventory	2.0	13.8	15.8	66.6	139.5	160.7	141.1	61.9	109.8	57.6	51.7	32.8
4. Current assets	2.9	28.0	35.2	123.7	257.2	338.4	297.1	230.1	219.8	194.4	138.0	92.9
5. Total assets	3.4	28.7	36.8	128.8	266.6	364.0	325.6	249.5	254.6	224.5	159.6	101.0
6. Cash/total assets (%)	0.8	38.7	8.9	3.3	0.1	0.9	0.4	33.7	10.9	22.1	22.5	33.9
7. Current assets/total assets (%)	85.7	97.5	95.6	96.0	96.5	93.0	91.2	92.2	86.3	86.6	86.5	92.0
8. Working capital/net assets (%)	<0	95.9	92.6	87.5	94.4	87.6	87.7	89.6	82.3	83.1	82.8	85.3
9. Interest expense	0.5	0.7	1.1	4.1	12.3	18.6	13.2	1.4	4.0	4.4	4.2	4.1
10. Cash/interest expense	0.1×	16.2×	2.9×	1.0×	0.0×	0.2×	0.1×	59.1×	7.0×	11.2×	8.6×	8.3×
11. Current assets/interest expense	5.5×	40.8×	31.7×	30.1×	20.9×	18.2×	22.6×	161.9×	55.6×	43.8×	33.1×	22.6×
12. Working capital/interest expense	<0	24.8×	18.5×	8.8×	12.9×	9.7×	15.4×	118.3×	40.9×	33.3×	24.9×	11.3×

to $1.4 million at year-end 1991, its cash balances increased dramatically under Trefoil, averaging $46 million, or 25% of total assets over 1992–1996 (calculated from data in rows 1 and 6). Surprisingly, although Section 4.3 shows that L.A. Gear sustained large cash losses in every year beginning in 1991 and that these losses cumulated to some $215 million over 1991–1996, the firm nevertheless ended 1996 with $34.2 million in cash, which represents 33.9% of L.A. Gear's total assets at that time (rows 1 and 6 of Table 3).

The Table 3 data collectively imply that L.A. Gear was able to create and maintain a strong cash position in the face of protracted distress by drawing down its highly liquid asset structure. Row 4 of the table indicates that current assets declined from $338.4 million at the beginning of 1991 to $92.9 million at the end of 1996. This large liquidation of noncash current assets was made possible by the firm's large inventory and accounts receivable beginning balances, with declines in these two items together fully accounting for the overall decline in current assets (rows 2 and 3). [A large portion of L.A. Gear's assets were current assets because it, like other athletic shoe "manufacturers", contracted out all production and thereby functioned primarily as a marketing and distribution entity.]

In general, asset liquidity provides a source of marketable assets that can be monetized to fund operating losses and buy time for management of firms that experience a decline in growth opportunities. Rows 6 through 8 of Table 3 lists three possible measures of asset liquidity: cash to total assets (row 6), current to total assets (row 7), and working capital to net assets (row 8), whose numerators are respectively based on cash, current assets, and current assets minus current liabilities.[6] By our best available measure (see footnote 6), working capital to net assets, L.A. Gear exhibits a high degree of asset liquidity in virtually all years reported in the table, and the same holds for current to total assets. Table 3 indicates that L.A. Gear's working capital was with one exception (1985) substantial, always above 80% of net assets, and sometimes above 90%. Its current assets were uniformly very high, always above 85% of total assets, and sometimes above 95%. The key implication here is that, once L.A. Gear's growth opportunities declined, Trefoil could easily free up cash simply by failing to replace the firm's substantial working-capital assets as they were liquidated in the normal course of business.

[6] Cash understates asset liquidity because (1) it fails to include current assets that can be liquidated relatively quickly, such as accounts receivable and inventory, and (2) it fails to include long-term assets that are easily separable and readily marketable. Ignoring these omissions, cash overstates asset liquidity because (3) some portion of the asset is necessary to maintain normal operations. Current assets and working capital are superior measures of asset liquidity because they do not suffer from limitation (1) above, although they do suffer from limitations (2) and (3). Current assets and working capital overstate asset liquidity if liquidation values for accounts receivable and inventory are lower than these assets' book values, but this effect is limited by GAAP's required use of the lower of cost or market rule. Working capital seems to be the best of the three measures of asset liquidity because it is broader than cash but, unlike current assets, it provides for the satisfaction of all current liabilities. A limitation of working capital, however, is that it assumes that current assets must first be used to satisfy current liabilities while, in reality, management has the discretion to use them in other ways and, for this reason, working capital can understate asset liquidity (as it also can for reason (2) above).

The last four rows of Table 3 show why pressure to improve operations to generate cash for debt payments (Jensen, 1986) was not a binding constraint for Trefoil. L.A. Gear's long-term debt did not mature until 2002. In the interim the firm could satisfy creditors by meeting its contractual interest obligations, which were easily covered despite ongoing losses because the firm's liquid assets were large relative to its interest expense. In 1996, for example, L.A. Gear's cash balances were over eight and one-half times interest expense, and by then the firm had sustained six consecutive annual losses! At the 1992 peak, cash/interest expense was 59.1 times, current assets/interest expense was an amazing 161.9 times, and working capital/interest expense was 118.3 times. Although these ratios subsequently deteriorated, they remained reasonably high even in 1996. L.A. Gear's substantial asset liquidity provided ample interest coverage for many years, shielding Trefoil from creditor interference as it experimented with various strategies to return L.A. Gear to profitability. (Even if interest payments are small relative to liquid assets, debt covenants can impose material constraints on management, as we discuss in Section 5 below.)

4.2. L.A. Gear's capital structure and external sources of funds

Table 4, which describes L.A. Gear's capital structure from 1985 to 1996, shows that the firm almost completely stopped using bank debt once Trefoil acquired control. [L.A. Gear continued to maintain its B of A credit line, which it used almost exclusively to support letters of credit.] Rows 1 through 5 of Table 4 report the book values of outstanding bank and public debt, redeemable and non-redeemable preferred stock, and common stock in each year from 1985 to 1996. Rows 6 and 7 contain the ratios of long term debt (including minor current amounts) to total capital at book value, with row 6 treating Trefoil's redeemable preferred stock as equity, and row 7 treating it as debt. [Total capital is the sum of the book values of long-term debt, interest-bearing short-term debt, and stockholders' equity.]

Row 1 of Table 4 shows that L.A. Gear's outstanding bank debt declined from $94 million to $20 million in 1991, when Trefoil acquired control, and then to zero in 1992, after growing dramatically in prior years. The minor amounts of bank debt at each fiscal year-end from 1993 to 1995 were borrowings by international subsidiaries. With one exception, L.A. Gear did not tap its available B of A credit line in 1992–1996, and in 1996 it paid off all foreign debt as well. The exception is 1994, when L.A. Gear borrowed an average of $200,000 under its credit line, which the firm had paid off by fiscal year-end.

During its financial difficulties, L.A. Gear raised external funds from three sources: Trefoil's 1991 investment, new public debt, and new equity. Row 3 of Table 4 shows Trefoil's $100 million in redeemable preferred stock, for which the firm received $92.5 million net cash proceeds (not shown in the table). Net of the $24.5 million in cash dividends it paid Trefoil intermittently over 1991–1994, L.A. Gear received $68 million ($92.5 million minus $24.5 million) in cash from Trefoil. Row 2 shows that in fiscal 1993 L.A. Gear sold $50 million (face value) of publicly traded

Table 4
Capital structure and leverage ratios for L.A. Gear: 1985–1996
Items 1–5 are in $millions and are stated at book value (as are the ratios, i.e., items 6 and 7). Bank debt includes (minor) current amounts. From 1991 to 1995, Trefoil held the redeemable preferred stock, which in 1996 it exchanged for the nonredeemable preferred stock. Total capital is the sum of the book values of long-term debt, interest-bearing short-term debt, and stockholders' equity. All data are from company annual reports and forms 10-K for fiscal years ended November 30.

Year:	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
1. Bank debt	0.1	2.6	7.1	57.2	37.4	94.0	20.0	0.0	3.7	0.6	1.2	0.0
2. Public debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	50.0	50.0	50.0	50.0
3. Redeemable preferred stock	0.0	0.0	0.0	0.0	0.0	0.0	100.0	100.0	100.0	100.0	107.7	0.0
4. Nonredeemable preferred stock	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	115.5
5. Common stock	0.2	17.7	22.1	41.3	168.2	205.9	131.7	87.5	46.8	18.1	−40.6	−111.0
6. Long term debt/total capital (LTD/TC) (%)	39.1	12.6	24.4	58.1	18.2	31.3	7.9	0.0	26.8	30.0	43.3	91.7
7. LTD/TC, with redeemable preferred as debt (%)	39.1	12.6	24.4	58.1	18.2	31.3	47.7	53.3	76.7	89.2	134.3	91.7

convertible debt, for which the firm received net cash proceeds of $47.7 million (not shown in the table). In 1992, L.A. Gear sold $14 million of common stock to a new international distributor. These three capital infusions gave L.A. Gear a total of $129.7 million in external funds, $94 million of which was used to pay off bank debt, leaving just $35 million of net new financing to subsidize the firm's operations as Trefoil attempted a turnaround.

The initial consequence of L.A. Gear's new capital structure under Trefoil was to reduce the long term debt-to-total capital ratio from 31.3% in 1990 to 7.9% in 1991 and, further, to zero in 1992 (row 6 of Table 4). However, L.A. Gear's debt ratio deteriorated in every year thereafter, in 1993 from the issuance of public debt and, on an ongoing basis, from reductions in the book value of equity (row 5) due to persistent large losses. By 1994, L.A. Gear's debt ratio was back to where it had been in 1990 under Robert Greenberg and, by 1996, it had reached 91.7%. If we treat Trefoil's redeemable preferred stock as debt, L.A. Gear's debt ratio is much higher in five of the six years under Trefoil, ranging from 47.7% in 1991 to 134.3% in 1995.[7] Although these debt ratios are high by conventional standards, the pressure to meet ongoing interest obligations remained low, as shown by the Table 3 asset-based interest-coverage ratios, because L.A. Gear's interest expense was miniscule relative to the magnitude of its liquid assets.

4.3. Cash losses over 1991–1996 and internal sources of funds

Table 5 shows that under Trefoil L.A. Gear racked up cumulative cash losses of $215 million, which it financed internally by liquidating some $250 million in working capital. Rows 3 though 5 of the table report cash earnings for each year 1985–1990 and cumulative cash earnings, where the two cumulation periods are 1985–1990 under Robert Greenberg and 1991–1996 under Trefoil. The table also reports operating cash flow (row 8), cumulative working-capital investment/liquidation (rows 9 and 10), and cumulative operating cash flow (rows 11 and 12). Cash earnings are accounting earnings adjusted for depreciation and all other noncash items reported in the firm's cash flow statements. Because all noncash items have been eliminated, cash earnings are a good measure of the operating shortfall that Trefoil needed to finance to keep L.A. Gear afloat, including interest expense on debt.[8]

[7] Concerns that investors viewed the redeemable preferred as debt contributed to a 1996 capital restructuring in which Trefoil exchanged redeemable for nonredeemable preferred (compare rows 3 and 4 of Table 4). The major reason for this restructuring, however, was that L.A. Gear was obligated to redeem $35 million of the redeemable preferred stock plus accrued dividends in August 1996. By this time, the firm was in sufficiently poor financial condition that such a large payout would have impaired its ability to continue operating.

[8] Cash earnings differ from free cash flow in that they do not include capital expenditures or investments in working capital. Operating cash flow, also reported in Table 5, is cash earnings less investments in working capital. Capital expenditures, not reported in the table, totaled just $32.4 million in the six years under Trefoil, reflecting debt covenants (see Section 5) and the facts that the firm was shrinking and that all manufacturing was outsourced.

Table 5
Cash earnings, working capital investment/liquidation, and operating cash flow for L.A. Gear: 1985–1996
Cash earnings are defined as accounting earnings net of depreciation and other adjustments for non-cash items as reported in the cash flow statement. Operating cash flow equals cash earnings adjusted for investment or liquidation of working capital. Cumulative cash earnings, working capital investment or liquidation, and operating cash flow are reported separately for the years under management by Robert Greenberg (1985–1990) and under Trefoil (1991–1996). All data are from company annual reports.

Year	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
1. Accounting earnings	0.3	1.7	4.4	22.0	55.1	31.3	−66.2	−71.9	−32.5	−22.2	−51.4	−61.7
2. Depreciation and other non-cash items	0.1	0.0	0.1	0.4	1.8	3.4	29.7	26.3	9.2	8.8	11.4	6.0
3. Cash earnings	0.4	1.8	4.5	22.5	56.8	34.7	−36.5	−45.6	−23.3	−13.4	−40.0	−55.7
4. Cumulative cash earnings, 1985–1990	0.4	2.2	6.7	29.2	86.0	120.7						
5. Cumulative cash earnings, 1991–1996							−36.5	−82.1	−105.4	−118.8	−158.9	−214.6
6. Cash earnings	0.4	1.8	4.5	22.5	56.8	34.7	−36.5	−45.6	−23.3	−13.4	−40.0	−55.7
7. Working capital investment (−) and liquidation (+)	0.1	−8.1	−14.0	−69.2	−104.3	−75.8	31.2	135.0	−43.5	41.8	28.8	56.3
8. Operating cash flow	0.6	−6.3	−9.5	−46.7	−47.5	−41.0	−5.3	89.4	−66.8	28.4	−11.2	0.6
9. Cumulative working capital investment, 1985–1990	0.1	−7.9	−21.9	−91.1	−195.5	−271.2						
10. Cumulative working capital liquidation, 1991–1996							31.2	166.1	122.7	164.5	193.3	249.6
11. Cumulative operating cash flow, 1985–1990	0.6	−5.7	−15.2	−61.9	−109.4	−150.4						
12. Cumulative operating cash flow, 1991–1996							−5.3	84.1	17.3	45.7	34.5	35.1

Although cash earnings were positive in each of the six years under Mr. Greenberg, they were negative in each of the six years under Trefoil (row 3 of Table 5) and the cumulative cash loss under Trefoil totaled $215 million (row 5). Table 5 also shows that Trefoil was able to finance the $215 million cumulative cash earnings shortfall entirely with internal funds. The table reports cash earnings (row 6) and the change in working capital (row 7), which together comprise operating cash flow (row 8) as reported in L.A. Gear's cash flow statements. During its 1985–1990 growth phase, L.A. Gear's cash earnings are positive, but its operating cash flow is generally negative, as the firm invested some $271 million in working capital to support its high sales growth rate (row 9). The opposite occurs during the firm's decline under Trefoil – cash earnings are negative, but operating cash flow is positive in half the years 1991–1996 because the firm liquidated some $250 million in working capital as sales declined precipitously over the period (row 10).

The difference between L.A. Gear under Robert Greenberg and L.A. Gear under Trefoil is that the growth opportunities the firm enjoyed under the former had declined substantially by the time the latter acquired operating control. Thus, under Trefoil L.A. Gear no longer required the high level of working capital it had carried under Robert Greenberg. Generally, managers of firms whose growth opportunities decline can finance a subsequent cash earnings shortfall by simply failing to replace inventories and accounts receivable as they are sold or collected. Asset liquidity provides a readily available source of internally generated cash to fund losing operations and satisfy interest obligations – provided working-capital liquidations are not prohibited by contract.

5. Debt covenants and policy constraints at L.A. Gear

Although L.A. Gear generated sufficient cash to meet its interest obligations until the very end, debt covenants were an ongoing source of disciplinary constraint throughout its protracted distress. L.A. Gear had relied heavily on bank borrowing during its growth phase under founder Robert Greenberg. The firm's first quarterly loss in early 1991 violated a covenant in its then one-month-old bank credit agreement that ultimately led to the transfer of control to Trefoil. Athough Trefoil soon paid off L.A. Gear's bank debt, the firm maintained a credit line with the Bank of America that it used almost exclusively to support letters of credit.[9] As we document next, that credit line subjected L.A. Gear to a broad set of covenants that were regularly renegotiated as the firm's financial condition deteriorated, following the pattern hypothesized by Smith (1993, pp. 301–302). The net result was that the bank was able to limit its own risk exposure, but Trefoil nonetheless retained

[9] Letters of credit enabled L.A. Gear to continue operating because the bank guaranteed payment to suppliers for goods delivered to what was clearly a seriously troubled firm. L.A. Gear's outstanding letters of credit ranged from $23.6 million in 1995 to $45.6 million in 1991. Section 4.2 shows that L.A. Gear used Trefoil's cash infusion and the external capital it subsequently raised from other sources primarily to pay off its bank debt. The non-Trefoil external capital consisted mainly of $50 million (face value) public debt sold in fiscal 1993 to various institutions, with a ten-year maturity and no accounting-based covenants.

substantial discretion to liquidate L.A. Gear's working capital to subsidize the firm's losing operations for many years.

Table 6 summarizes the main covenants in L.A. Gear's credit agreements with the Bank of America, beginning in December 1990 (just before the firm's first covenant violation) and ending in February 1997. This summary includes new credit agreements and their main amendments, and excludes temporary default waivers. Column (1) of the table gives the date of each credit agreement/amendment and primary new fee arrangements. Column (2) describes the maximum limits on credit line usage (cash borrowing plus letters of credit) and on cash borrowing per se, and also notes other debt-policy related constraints. Columns (3) and (4) respectively describe covenants specifying minimum net worth and earnings levels, while column (5) summarizes a variety of asset- and payout-related constraints.

Table 6 shows that L.A. Gear and the Bank of America entered into 14 different contractual specifications of L.A. Gear's bank credit line (column (1)). While these 14 arrangements employ a number of financial covenants, they almost always stipulate minimum net worth and frequently specify minimum earnings, e.g., they prohibit quarterly losses (columns (3) and (4)). Only the November 1992 agreement fails to include both earnings and net worth constraints, and that agreement is a pure letter of credit facility that allows no cash borrowing. Net worth and earnings constraints are closely related, since absent an equity infusion, larger losses translate dollar for dollar into lower net worth. Both types of covenants set minimum standards for operating performance (and help ensure that the cash for interest payments comes from operations); neither can be satisfied, for example, by liquidating working capital.

As L.A. Gear's financial difficulties deepened and impending covenant violations forced the firm to renegotiate its credit line in order to maintain its access to letters of credit, the bank ratcheted down its own loss exposure. Table 6 (column (2)) shows that L.A. Gear's total credit limit fell from $360 million in 1990 to $300 million in early 1991, $200 million in mid-1991, $75 million in 1993, $50 million in 1996, and $25 million in 1997. The limit on cash borrowing fell even more radically, settling in the $10 to $20 million range over 1995–1997. The bank also protected itself by assessing fees and penalties that effectively charged a risk premium for access to credit (column (1)). For example, the November 1993 credit agreement carried a $750,000 up-front charge, while the up-front charge for the September 1996 amendment was $250,000. The bank also sought protection through other financial covenants and policy constraints (see especially columns (2) and (5)).

Overall, the pattern of credit arrangements documented in Table 6 conforms to Smith's (1993, pp. 301–302) "dynamic flexible monitoring" view, in which lenders set covenants tight enough to ensure an ongoing ability to quickly lower their risk exposure should a troubled borrower's financial performance deteriorate. [L.A. Gear's year-end tangible net worth was never more than 6.2% above the minimum specified value which, as Table 6 indicates, declined from $200 million in late 1990 to $40 million in early 1997.] In Smith's view, each technical default or the anticipation thereof (as was the case at L.A. Gear under Trefoil) forces the borrower to disclose the latest performance deterioration to the lender, giving the lender an opportunity

Table 6
Line of credit agreements between the Bank of America and L.A. Gear: December 1990 through February 1997
The table presents our judgment of the main borrowing terms and covenants in 14 credit agreements and main amendments thereof (excluding temporary waivers of default) between the Bank of America and L.A. Gear. To conserve on space, the table describes only the principal changes effected by each amendment to an earlier agreement. Column (1) gives the date of each credit agreement and major new loan fees, when applicable. Column (2) gives the maximum credit line limit for the sum of cash borrowing and letters of credit, as well as any cap on cash borrowings per se. It also notes when the usable credit line amounts are contractually tied to levels of accounts receivable and inventory, and describes other debt-related covenants including interest rates, restrictions on new borrowings and restrictions on the company's leverage ratio. The leverage ratio is defined as (total liabilities plus outstanding letters of credit less book value of in-transit inventories)/tangible net worth. Columns (3) and (4) respectively describe covenants setting minimum acceptable levels of tangible net worth and net income, while column (5) summarizes the main covenants constraining asset utilization, restrictions on the quick ratio, the payment of dividends and limits on annual capital expenditures. The quick ratio is (cash and cash equivalents plus receivables)/current liabilities. Capital expenditures are defined to include capitalized leases. For purposes of brevity, the table omits other covenants (e.g., standard terms dealing financial reporting requirements or subordination clauses) that we judged to be less important or unique to the bank's dealings with L.A. Gear. In addition, all debt agreements restricted asset sales to those arising in the regular course of business. All data are drawn from Forms 8-K, Forms 10-K, and company annual reports. Millions of dollars are denoted by m. Lower and upper bounds are noted by $>$ and $<$, respectively.

Date of agreement or amendment	Borrowing limits	Tangible net worth	Income-based covenants	Asset and asset disposition-based covenants
12/90 credit agreement	Maximum \$360m line limit, \$300m cap Usable line function of accounts receivable and inventory New borrowing $<$\$5m Leverage ratio $<$ 1.25–1.90 (depending on quarter)	Minimum \$200m Minimum grows from \$200m by 75% of (positive) future net income	Quarterly net income >0 Interest coverage >1.25 (previous quarter), 3.5 (average previous four quarters)	Quick ratio >0.70–0.85 (depending on quarter) Dividents $<10\%$ of prior quarter's earnings Capital expenditure limit $<$\$20m per annum
3/91 amendment	Maximum reduced to \$300m line limit, \$250m cap Leverage ratio temporarily adjusted details n.a.	Minimum redefined to \$192.5m, additional temporary adjustments details n.a.	Interest coverage temporarily adjusted, details n.a.	Dividends prohibited Capital expenditure limit temporarily adjusted details n.a.
8/91 amendment	Maximum reduced to \$200m line limit, \$150m cap Interest rates increased New borrowing reduced to $<$\$20m Leverage ratio reduced to <1.0	Minimum redefined, increased to \$240m Definition changed to include book value of preferred stock, reflecting Trefoil's \$100m capital infusion	Quarterly net income covenant dropped New penalty based on quarterly net losses	Quick ratio increased to >1.0 Dividends can be paid on preferred stock if no default Capital expenditure limit reduced to $<$\$15m per annum

Table 6 (*continued*)

Date of agreement or amendment	Borrowing limits	Tangible net worth	Income-based covenants	Asset and asset disposition-based covenants
2/92 amendment	Maximum reduced to \$150m line limit, \$100m cap Interest rates increased Usable line reduced	Minimum redefined, reduced to \$225m, grows \$240m by 8/93 Definition changed to include accrued but unpaid dividends to preferred stock		Quick ratio decreased, to as low as >0.80 (depending on future quarter) Dividends can be paid on preferred stock if income $>$ dividends Capital expenditure limit reduced to $<$\$10m per annum
11/92 letter of credit facility	Maximum \$50m	None	None	Collateralization cash on a \$1/\$1 basis for domestic and \$1.5/\$1 for foreign letters of credit
8/93 amendment Upfront fee \$100K	Maximum reduced to \$40m New default interest penalty prime + 2.5% on amounts in default, due on demand New usable amount function of accounts receivable New additional borrowing $<$\$3m	New minimum \$185m	New quarterly net income 9 month net loss ending 8/93 >-18m	New quick ratio >1.25 Collateralization temporarily suspended, to resume 10/93 on previous cash basis
11/93 credit agreement Upfront fee \$750K	Maximum \$75m Usable line function of accounts receivable and inventory No new borrowing	Minimum \$175m, definition excludes \$50m face value public debentures issued in 6/93 from liabilities		Current liabilities none >45 days overdue Capital expenditure limit reduced $<$ \$10m for 1994, $<$ \$5m for 1995, 1996 Dividends prohibited
5/94 amendment		Minimum reduced to \$169.5m, increases to \$175m on 2/95	New quarterly net income covenant if tangible net worth is $<$ \$175m, then quarterly net income must be $>$\$5.047m for 8/94 and $>$\$1.069m therafter	

8/94 amendment		Minimum reduced to \$165m New quarterly penalty based on tangible net worth from \$0 to \$50K	Quarterly net income covenant dropped	
1/95 amendment \$75K upfront fee		Minimum reduced to \$160m		
3/95 amendment	Interest rates increased Usable line reduced	Minimum reduced to \$150 m Modify quarterly penalty based on tangible net worth from \$0 to \$125K	Reinstated quarterly net income covenant minimum levels reduced	Dividends can be paid if quarterly earnings targets met (see cell to the left)
7/95 amendment \$125K upfront fee	Maximum reduced to \$75m line limit, \$10m cap Interest rates increased	Minimum reduced, declines over time from \$155m for 5/95 to \$103m for 12/95 and each month therafter.	Revised and reduced quarterly net income covenant to minimum \$6m loss with specific minimum depending on the quarter	
2/96 amendment		Minimum reduced to \$97m	Quarterly net income covenant dropped	
9/96 amendment \$250K upfront fee	Maximum \$50m line limit, \$20m cap Usable line reduced	Minimum reduced to \$80m for quarters ending 8/96 and 11/96, \$70m for each quarter thereafter		Dividends can be paid if tangible net worth is > \$85m (11/96) and > \$80m all quarters thereafter Capital expenditure limit < \$2.5m per annum
2/97 amendment \$50K monthly maintenance fee	Maximum reduced to \$25m line limit, \$10m cap Usable line reduced	Minimum reduced to \$40m		

to renegotiate contractual terms or to terminate the agreement. Thus, dynamic (iterative) monitoring enables lenders to maintain ongoing disciplinary oversight of financially troubled borrowers and allows the firms themselves to continue operating, albeit with credit facilities whose terms are tightened regularly as company circumstances worsen. [See Dichev and Skinner (2001) for large sample evidence that private lenders often set tight debt covenants to facilitate ongoing monitoring of borowers.]

Table 6 (column (5)) shows that during Trefoil's tenure debt covenants consistently curtailed L.A. Gear's ability to sell assets and to move into new lines of business. These constraints are commonly believed to curtail managers' ability to engage in unproductive risk shifting or asset substitution during financial distress, but they inherently leave an unconstrained gray area when managers' decisions fall within the normal scope of business (Smith and Warner, 1979). This gray area remains because outsiders – whether creditors, stockholders, or academic researchers – cannot determine easily whether managers' chosen policies are the best available choices. [If such assessments were easy, external monitoring and private contracts would eliminate virtually all agency problems and managerial mistakes.] Since Trefoil's strategic experiments at L.A. Gear were all operating policy shifts within the athletic shoe industry, they fell within the scope of acceptable activities under L.A. Gear's debt covenants. In this respect, the L.A. Gear case is similar to Esty's (1997) clinical study of risk shifting at Twin City Savings and Loan, a stockholder-owned Louisiana thrift that failed in the 1980s. The policy shifts at Twin City – which ex post turned out to generate large losses – were within the scope of activities appropriate for financial institutions, and thus were not prohibited either by ex ante contracting or by regulatory mandate.

L.A. Gear's debt covenants clearly did not eliminate Trefoil's ability to liquidate working capital to fund its various strategic experiments. One possible reason is that the bank had used early covenant violations to renegotiate credit terms to cap its own losses at a low level (and L.A. Gear had in fact done almost no bank borrowing during its troubled times). The bank accordingly had limited incentives to cut off the working-capital flows that allowed the firm to continue operating.[10] A complementary explanation is that working-capital liquidations fall into a gray area that is difficult to constrain in a productive way, since they are not an outright sale of assets but are instead decisions made in the routine course of business not to replace liquid assets as they are drawn down. Since lenders would seem to be at a disadvantage to management in determining the optimal level of working capital for a given firm, they have little reason to retain the right to set this aspect of corporate operating policy.

Overall, we find that bank debt covenants were regularly binding during L.A. Gear's protracted financial distress, although these constraints left Trefoil with

[10] This fact suggests that holders of L.A. Gear's covenant-free public debt were not able to fully free-ride on the monitoring efforts of the bank. The bank was apparently focused on managing the risk that it faced, and not on monitoring the situation to ensure more favorable returns for all creditors as a group (or for all debt and equity claimants as a group).

ample scope to liquidate working capital and therefore to subsidize L.A. Gear's substantial losses for many years. L.A. Gear easily met its interest obligations to holders of its covenant-free public debt with the cash raised from its ongoing working-capital liquidation. In this respect, debt covenants were clearly a more relevant constraint on Trefoil's ability to operate L.A. Gear as it wished than was the contractual promise to pay interest, which L.A. Gear easily met until two months before it filed for Chapter 11 bankruptcy protection.

6. Asset liquidity and managerial discretion: evidence for other firms

An interesting question raised by the L.A. Gear case is: to what extent do public corporations in general exhibit highly liquid asset structures which potentially give managers substantial discretion to subsidize losing operations? To address this question, Tables 7 and 8 report for larger samples of public corporations the three asset-liquidity measures and three interest-coverage measures reported in Table 3 for L.A. Gear. These measures are the ratios of (1) cash to total assets, (2) current assets to total assets, (3) working capital to net assets, (4) cash to interest expense, (5) current assets to interest expense, and (6) working capital to interest expense. Table 7 contains histograms of these ratios for the Compustat population in 1998, while Table 8 reports each ratio for the twenty largest U.S. public corporations at year-end 1998, ranked in the order of the Fortune 500 market value tabulation.

Consistent with the findings of Harford (1999) and Opler et al. (1999), cash is 6.8% of total assets for the median Compustat firm (column (1) of Table 7). Current assets are more than half (55.0%, per column (2)) of the median firm's total assets, much more than one would expect if the typical Compustat firm held primarily "bricks and mortar" assets. Reinforcing this point, working capital is more than one-third (36.0%, per column (3)) of the median firm's net assets. At the seventieth percentile, almost one-third of Compustat firms hold cash balances of at least 20.5% of total assets (column (1)), which cover interest expense by 9.7 times or better (column (4)). At the eightieth percentile, one-fifth of Compustat firms hold cash balances equal to or greater than 33.5% of total assets (column (1)), which cover at least 27.0 years of interest expense (column (4)). By all measures in Table 7, a substantial subset of Compustat firms has a highly liquid asset structure, with ample cash to cover interest expense for many years.

Table 8 shows that many of the largest firms in the U.S. economy have highly liquid asset structures. The pattern is most evident among computer firms (Microsoft, Intel, Dell, and Cisco) and pharmaceutical companies (Merck, Bristol Myers Squibb, Johnson & Johnson, and Eli Lilly). Microsoft, Intel, Dell, and Cisco all have large cash balances and substantial current assets, and their working capital is a large fraction of net assets. Intel and Dell hold enough cash to cover interest expense a remarkable 190.7 and 122.3 times, while Microsoft and Cisco are debt-free, and thus are in even stronger positions (see column (4)). Among the pharmaceutical firms, Merck, Pfizer, Bristol Myers Squibb, and Johnson & Johnson have enough cash to cover interest expense between 27.5 and 14.2 times (and enough

Table 7
Asset liquidity and asset-based interest coverage: histograms for Compustat firms in 1998
The sample consists of all firms with asset and interest expense data reported on Compustat for 1998. Cash includes marketable securities. The cash balance coverage ratio in column (4) indicates the number of times that annual interest expense is covered by cash plus marketable securities. The current asset coverage ratio (column (5)) and the working capital coverage ratio (column (6)) respectively indicate the number of times that current assets and working capital cover annual interest expense.

Percentile	Cash/ total assets (1)	Current assets/ total assets (2)	Working capital/ net assets (3)	Cash/ interest expense (4)	Current assets/ interest expense (5)	Working capital/ interest expense (6)
10th	0.5%	15.8%	−5.8%	0.1 ×	3.6 ×	−2.8 ×
20th	1.3%	27.7%	4.6%	0.3 ×	7.0 ×	0.0 ×
30th	2.3%	37.5%	14.9%	0.7 ×	10.9 ×	2.0 ×
40th	4.0%	46.9%	25.3%	1.2 ×	16.2 ×	4.9 ×
Median	6.8%	55.0%	36.0%	2.3 ×	22.8 ×	8.7 ×
60th	12.1%	62.7%	47.3%	4.6 ×	34.0 ×	14.7 ×
70th	20.5%	70.0%	58.5%	9.7 ×	53.5 ×	25.7 ×
80th	33.5%	77.2%	69.5%	27.0 ×	99.9 ×	52.1 ×
90th	53.6%	86.1%	83.8%	122.7 ×	348.1 ×	214.4 ×
N	5,569	5,466	5,464	4,724	4,621	4,619

Table 8
Asset liquidity and asset-based interest coverage: the 20 publicly traded firms with the largest stock market capitalization at year-end 1998
Company ranking is based on the market value of common stock at December 31, 1998 and is taken from the Fortune 500 ranking for that year. Asset composition and interest expense data are from Compustat.

Rank	Company Name	Cash/ total assets (%) (1)	Current assets/ total assets (%) (2)	Working capital/ net assets (%) (3)	Cash/ interest expense (4)	Current assets/ interest expense (5)	Working capital/ interest expense (6)
1	General Electric	1.2	68.5	47.6	4.9 ×	276.1 ×	115.6 ×
2	Microsoft	62.3	71.1	61.1	Infinite	Infinite	Infinite
3	Intel	24.2	42.8	29.9	190.7 ×	336.9 ×	191.8 ×
4	Wal-Mart	3.8	42.3	13.1	2.2 ×	25.2 ×	5.2 ×
5	Exxon	1.6	19.0	−2.5	2.6 ×	30.8 ×	−3.2 ×
6	Merck	10.5	32.1	16.1	16.3 ×	49.8 ×	20.2 ×
7	IBM	6.7	49.2	11.2	7.8 ×	57.2 ×	7.5 ×
8	Coca-Cola	9.4	33.3	−21.5	6.5 ×	23.0 ×	−8.2 ×
9	Pfizer	21.5	54.3	24.7	27.5 ×	69.4 ×	19.2 ×
10	Bristol-Myers Squibb	15.5	54.0	28.5	16.4 ×	57.0 ×	19.4 ×
11	AT&T	5.3	23.7	−3.0	5.1 ×	22.6 ×	−2.1 ×
12	MCI WorldCom	2.0	12.3	−7.7	2.6 ×	16.2 ×	−8.2 ×
13	Philip Morris	6.8	33.8	8.8	3.6 ×	17.7 ×	3.4 ×
14	Dell Computer	46.3	92.2	83.1	122.3 ×	243.8 ×	101.7 ×
15	Procter & Gamble	7.8	34.2	6.1	4.4 ×	19.3 ×	2.4 ×
16	Johnson & Johnson	9.8	42.5	16.5	14.2 ×	61.5 ×	16.4 ×
17	SBC Communications	1.0	16.7	−7.0	0.4 ×	7.2 ×	−2.3 ×
18	Cisco Systems	19.0	42.2	27.9	Infinite	Infinite	Infinite
19	Eli Lilly	12.7	42.9	10.0	8.1 ×	27.3 ×	4.0 ×
20	BellSouth	8.1	22.1	−1.5	3.8 ×	10.4 ×	−0.5 ×

working capital to cover interest expense between 20.2 and 16.4 times). While the ratios are less dramatic than for the computer firms, these pharmaceutical firms also have considerable asset liquidity.

Not all firms in Table 8 have a high proportion of cash, current assets, and working capital, combined with high asset-based interest-coverage ratios. For example, the cash balances of Wal-Mart, Exxon, MCI WorldCom, Philip Morris, SBC Communications, and Bellsouth cover only a few years of interest expense. These companies seem to fit the traditional view of firms with significant "bricks and mortar" assets and correspondingly lower current assets, whose debt obligations are meaningful constraints in the short to intermediate term. Of course, these firms may be less constrained than they appear based on the Table 8 ratios if they have separable long-term assets that can be sold readily to generate cash, as we discuss in footnote 6, or if they can readily raise new capital in adverse circumstances.

Overall, Tables 7 and 8 suggest that the substantial asset liquidity that enabled L.A. Gear to subsidize large, ongoing losses characterizes a reasonable number of firms. An important caveat is that the extent to which any firm can use its asset liquidity to delay the day of financial reckoning also depends on the maturity structure of its debt, its contractually specified interest payments, any sinking fund or other mandatory debt paydown provisions, the debt's conditions for technical default, and the volatility of growth opportunities. Obviously, an examination of the latter characteristics for the firms described in Tables 7 and 8 is beyond the scope of a single clinical study. Our data nonetheless suggest that the role of asset liquidity in resolving or prolonging financial distress merits further investigation.

7. Implications of the L.A. Gear case

Opler et al. (1999, p. 44) conclude their study of corporate cash balances by noting that "an important area for future research is whether, when a firm runs into difficulties, excess cash allows management to avoid making required changes, using up the firm's cash to finance losses". The L.A. Gear case illustrates the importance of the general phenomenon described by Opler et. al., but it also shows that it is not cash balances per se that create the opportunity for a troubled firm to delay the day of financial reckoning. In the L.A. Gear case, it is asset liquidity – specifically, the ongoing ability to liquidate working capital – that subsidized the firm's substantial losses for over six years, ultimately rendering its equity worthless once its assets were so depleted that it could no longer meet its cash obligations to debtholders.

The L.A. Gear case suggests that asset liquidity (broadly construed, not limited to excess cash) is an important determinant of managerial discretion, the scope of possible agency problems, and corporate capital structures. In the remainder of this section, we use this observation to identify a number of hypotheses about corporate financial decisions that are suggested by the L.A. Gear case. For example, Jensen (1986) emphasizes the importance of cash obligations to creditors as a disciplinary device that imposes ongoing pressure on management to improve operations. Yet

L.A. Gear was easily able to generate cash to satisfy debt obligations by liquidating working capital. Thus, one implication of the L.A. Gear case is:

> The disciplinary pressure of debt is materially undercut by highly liquid asset structures. This problem is particularly acute when firms experience a decline in growth opportunities, but it is also present when firms have liquid assets (e.g., high cash balances or easily separated and readily marketable divisions) that are not essential to maintain company operations. Managers of troubled firms can utilize excess assets to fund losses and meet interest payments, while experimenting with risky strategies that might (or might not) turn out to be profitable. Excess liquid assets are particularly good for this purpose because they are readily converted to cash that enables managers to delay the day of reckoning with creditors, perhaps for many years.

This last point is related to Hart and Moore's (1995) argument that by themselves short-term debt obligations do not put meaningful free cash flow disciplinary pressure on management (see also Hart (1993) and Shleifer and Vishny (1992) on asset sales by troubled companies). These authors argue that a firm's capital structure must also include future period debt obligations to create a debt overhang that limits management's ability to issue new securities and thereby circumvent free cash flow disciplinary pressure in the current period. However, the ability to raise funds in the capital market is not the only means of subverting the disciplinary pressure of debt. As the L.A. Gear case shows, working-capital liquidations can yield sufficient cash to subsidize large operating losses and meet all required payments to creditors. In fact working-capital liquidations have an advantage over fixed asset sales for this purpose since, as Smith and Warner (1979) indicate, debt covenants commonly allocate the proceeds from asset sales to creditors, but they do not typically constrain the proceeds from working-capital liquidations.

More generally, early proponents of agency theory (Jensen and Meckling, 1976; Smith and Warner, 1979) emphasized the role played by accounting-based debt covenants in disciplining managerial behavior. More recent contributions to the literature have tended to downplay the importance of debt covenants, emphasizing instead Jensen's (1986) argument that the contractual commitment to deliver cash places strong disciplinary pressure on management. L.A. Gear, however, was easily able to meet its interest obligations, yet was almost continually in danger of violating its debt covenants, requiring management to renegotiate its bank credit line 13 separate times in a six-year period. Therefore, another principle illustrated by the L.A. Gear case is:

> Accounting-based debt covenants are sometimes stronger disciplinary mechanisms than are contractual obligations to make periodic cash payments to debtholders. Excess liquid assets can be used to satisfy a firm's short- to intermediate-term cash obligations and buy time without improving operations, whereas accounting-based debt covenants (e.g., minimum earnings and net worth constraints) require operating improvements.

This reasoning helps explain why, as Smith and Warner (1979) document, debt contracts typically constrain accounting earnings and/or net worth and not, as one might suppose ex ante, operating (or free) cash flow.[11] The L.A. Gear case provides a sensible economic rationale for this empirical regularity. L.A. Gear reported large cumulative accounting losses under Trefoil while, at the same time, the firm had positive cumulative operating cash flow (per Table 5). The difference between the two numbers is the cumulative working-capital liquidation. Debt covenants reasonably do not constrain operating (or free) cash flow because managers of troubled companies can readily evade such covenants by simply failing to replace current assets such as inventories and receivables as they are liquidated in the normal course of business. Such evasion, moreover, makes lenders strictly worse off by lowering their expected proceeds in a formal liquidation or other settlement such as bankruptcy.

Opler et al. (1999) point out that cash balances are often treated as negative debt in received theories of optimal capital structure. This treatment is perhaps most notable in the pecking order theory (Opler et al., p. 5), but it also implicitly characterizes models that trade off tax savings and financial distress costs. The L.A. Gear case shows that cash balances are not equivalent to negative debt because the greater the cash held (more generally, the more liquid the asset structure), the more discretion is available to corporate decision-makers. This reasoning suggests the following:

> From a managerial discretion viewpoint, cash balances are not fully equivalent, nor are other highly liquid assets approximately equivalent, to a negative debt obligation. Cash balances (and other liquid assets) can be drawn down to meet periodic debt obligations, thus they expand the time horizon over which managers have the discretion to set corporate policies. For a given amount of net debt (present value of debt minus liquid asset holdings), a larger liquid asset balance conveys the ability to satisfy a greater number of future interest payments, hence to buy more time to exercise control over the firm's policies without interference from creditors.

The L.A. Gear case also suggests a capital market discipline-based argument that explains why corporate debt maturity matters, and that is distinct from arguments based on the familiar under-investment problem (see Barclay and Smith (1995) for a discussion of arguments connecting debt maturity to the under-investment problem):

> Debt contracts with shorter maturities give managers less scope to buy time by using liquid assets to meet interest payments, thereby satisfying their current debt obligations without improving operations. At maturity, the firm must pay the full outstanding principal and not simply current interest. If the firm wants to "roll over" its debt principal at maturity, it must obtain the agreement of lenders, who can and will impose more stringent credit terms if operating performance has

[11] It also helps explain why, as Gilson and Warner (2000) document, firms sometimes accept higher cash obligations to debtholders in exchange for weaker covenants.

deteriorated. Hence, shorter debt maturities imply more frequent oversight by suppliers of debt capital. This logic predicts that capital structures exhibit shorter debt maturities when managers have greater scope to use the firm's liquid assets to evade the disciplinary pressures of debt.

This line of reasoning can be viewed as the debt market analog to Easterbrook's (1984) argument that a disciplinary benefit of a high dividend payout policy is to force management to go to the capital market more frequently for validation if it wants to continue to invest. Our argument also helps explain why debt contracts sometimes include sinking fund and other mandatory debt paydown provisions that effectively shorten the time between initial borrowing and subsequent required principal repayments.

Overall, the L.A. Gear case suggests that asset liquidity can be an important determinant of corporate capital structures. While we obviously cannot generalize from one case, our evidence for the Compustat population and the 20 U.S. firms with the largest market capitalizations reveals that many firms have asset structures that exhibit a high degree of liquidity. This is especially true for computer and drug firms, but it is also reasonably characteristic of at least one-third of the Compustat population and of many of the 20 largest U.S. public corporations. Our findings may help explain why, as Jensen (1993, Section IV) emphasizes, firms that have experienced substantial past growth often take a painfully long time to adjust when growth disappears due to changes in technology or demand. The L.A. Gear case suggests the hypothesis that a high degree of asset liquidity is a key factor that gives managers substantial latitude to postpone making needed changes when firms face such financial difficulties. Whether asset liquidity plays such a role in many or few firms is an interesting question for future research.

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