

The Loan Market Response to Dropdown and Uptier Transactions

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Abstract

Two innovative methods of subordinating first-lien lenders to newly issued debt—so-called “dropdown” and “uptier” transactions—have become important options when a restructuring looms. We weigh concerns about borrower power and the loan market’s capacity to produce efficient contracts by examining the extent to which the terms of newly originated loans changed after two salient transactions: J. Crew’s dropdown, in 2016, and Serta Simmons’ uptier, in 2020. Our primary result is a contrast. Loans originated after the Serta transaction became much more likely to block uptiers, suggesting that loan contracts can adjust rapidly to curtail borrower flexibility. Conversely, the frequency of loans susceptible to a dropdown changed little after J. Crew, suggesting that giving borrowers flexibility to re-pledge collateral may be valuable. In a range of loans, the optimal contract may permit borrowers to subordinate lenders by one means but not the other.

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1 Introduction

Hardball recapitalizations have become a major theme in corporate reorganization in recent years (e.g. Ellias and Stark 2020; Mengden 2021; Dick 2021). Since 2016, several dozen distressed companies have claimed a counter-intuitive right unilaterally, or with the support of a handpicked majority of lenders, to issue new debt with priority over existing first-lien loans (Buccola 2023a). The borrowers undertaking these priming or “liability management” transactions are able to access liquidity on favorable terms without a formal bankruptcy. Dismayed lenders have cried foul, asserting in and out of court that the tactics violate the spirit, if not the letter, of their contracts. In this paper, we examine the extent to which the letter of loan contracts has changed to express that avowed spirit.

In the last decade, companies looking to create super-senior debt instruments have relied on generic transactional forms: the dropdown and the non-pro rata uptier exchange (which we refer to simply as the “uptier”). Both allow the companies undertaking them to subordinate existing creditors, but the two transactions rely on distinctive legal mechanics. In a dropdown, the borrower transfers collateral backing its loans to a subsidiary deemed by the credit agreement to be an “unrestricted” subsidiary—that is, a subsidiary not bound by the borrower’s covenants and whose assets are not subject to the lenders’ liens. The unrestricted subsidiary then re-pledges the transferred assets and uses the proceeds of its own borrowing to support the parent company’s cash needs. In an uptier, there is no transfer of collateral. Instead, the loan documents are amended to allow the borrower to issue new debt with a superior claim on the collateral. To procure the necessary consents, the borrower offers a bare majority of lenders the right to swap their existing loans for some of the new debt, allowing the participating lenders in effect to leapfrog members of the syndicate not invited to participate in the deal.

Reactions in the academic and practitioner presses have been overwhelmingly critical and have generally viewed dropdowns and uptiers as variations on a theme (e.g. Ellias and Stark 2020; de Fontenay 2020a, 2020b, 2021; Mengden 2021; Ayotte and Scully 2021; Dick 2021; Buccola 2023a; Schloessmann 2023). From the perspective of borrowers seeking liquidity, the two transactions are close substitutes. Moreover, both likely ran counter to market expectations when first introduced. Only by combining multiple contractual provisions in novel and contentious ways (Ayotte and Badawi 2022) are the transactions putatively permissible, and critics have viewed dropdowns and uptiers as substantively unreasonable whatever the literal terms of the relevant contracts might provide.

It is not obvious, however, that an arrangement in which borrowers have a right to incur priming debt is sub-optimal. Absent the liquidity such debt offers, the path for many distressed companies would run through Chapter 11. Bankruptcy is famously expensive, and it, too, can lead to the issuance of priming debt (11 U.S.C. § 364[d]). Indeed, Ayotte and Skeel (2013) argue that an important rationale for Chapter 11 is precisely that it can provide distressed businesses with incremental liquidity, including by allowing debtors to originate super-priority loans that their contracts would otherwise preclude (see also Triantis 1993). Compared to the relevant alternative, then, the primary significance of dropdowns and uptiers may lie in their dispensing with judicial oversight, which may or may not be valuable (see Casey 2011; Buccola 2019). To be sure, out-of-court and in-court priming transactions have different distributive consequences that might need to be offset with changes to pricing or capital structure, but out-of-court priming capacity might be a valuable option in the optimal contract for many borrowers.

Nor is it obvious a priori that dropdowns and uptiers should have the same efficiency properties. Although both types of transaction allow a borrower to incur debt senior to ostensibly

first-lien loans, they rely on different legal mechanics the full implications of which might produce different expected payoffs. Unrestricted subsidiaries, for instance, can be used not only to create priming debt but also to separate a borrower’s high-growth add-on lines of business from its core enterprise.² Leland (2007) shows theoretically the advantages of allowing a firm to design stand-alone financing arrangements for business lines with disparate risk, size, and other features that bear on the optimal capital structure. In an optimal contracting framework, any anticipated benefits of curtailing loan subordination would have to be weighed against the anticipated costs of dispensing with other uses of unrestricted subsidiaries. The non-pro rata character of uptiers, in contrast to dropdowns, might likewise produce distinctive efficiency properties. To the extent that competition among lenders to be included in a favored group yields deadweight losses—from monitoring and lobbying *ex ante* or from litigating *ex post* (Buccola 2023b)—the uptier could be a relatively costly method of creating priming debt.

In this paper, we document the extent to which syndicated term loans originated after the plausibility of dropdowns and uptiers became evident to market participants, in late-2016 and mid-2020, respectively, adjusted to block the transactions or mitigate their effects. We review the legal prerequisites of each transaction and develop a set of contract features that would fully block them or mitigate their effects. We then read more than 600 leveraged loan contracts executed between January 2016, about a year before J. Crew announced the first phase of its dropdown, and June 2022, two years after Serta Simmons announced its uptier, and record whether the loan blocks or mitigates each form of priming transaction.

² For example, Scientific Games designated its social gaming subsidiaries as unrestricted in 2016. According to the press release accompanying the event, the move was made “with the goal of maximizing growth for the company ... including potential new joint ventures, acquisitions, IPO, and other growth options.” See PR Newswire (2016). The company completed a IPO of a minority stake in SciPlay Corporation in 2019.

The analysis sheds light on two open questions. First, it speaks to whether the types of borrower flexibility that underlie priming transactions are, on balance, valuable or not. Optimal contract theory predicts that, absent bargaining impediments, loan agreements should constrain borrowers in a way that maximizes the parties' expected joint surplus. Given imperfect foresight—that is, parties' inability to foresee all prospective uses of borrower flexibility (see Ayotte and Scully 2021)—many contracts likely inadvertently permitted dropdowns and uptiers. But if the flexibility underpinning the transactions is costly on balance, then, in a responsive market, contract terms should adjust to foreclose it.

Second, our analysis bears on whether the syndicated loan market is in fact highly responsive. One might be tempted to assume that it is, since the dollar stakes are high, and the market is composed of highly compensated intermediaries and sophisticated, repeat-play investors. But empirical research indicates that contract terms in some markets defined by these same features are nevertheless sticky in the face of negative informational shocks. The sovereign debt market is the best-documented example (see e.g. Choi, Gulati & Scott 2017a, 2017b; Gulati & Scott 2013), but it appears not to be unique. Gulati and Kahan (2018), for example, document a striking failure of adjustment in corporate bond terms, which are produced in a similar institutional framework as leveraged loans. That research complements, and renders more plausible, a view widespread among loan-market participants that, whatever optimal-contract theory might predict, in fact the non-price terms of leveraged loan contracts poorly reflect the interests of loan investors, each of whom typically buys a small piece of the total facility.³

³ The best statistical evidence on the responsiveness of leveraged loan terms comes from Talley (2021), who finds that, after the Citibank mistaken-payments debacle of 2020, a new contract term explicitly permitting administrative agents to claw back erroneous payments to lenders proliferated rapidly in newly originated loans and through amendments to existing loans. Although the finding suggests that the syndicated loan market can adjust quickly to protect the interests of the administrative agent, who negotiates contract terms with the borrower, it does

Our primary result is a contrast. For the dropdown, the only way to eliminate the prospect of the transaction is to forswear unrestricted subsidiaries altogether. In our sample, roughly one-half of loans permit the borrower to create unrestricted subsidiaries, and that fraction remained constant throughout the period we study. Investors could limit the magnitude of a potential priming transaction without dispensing altogether with unrestricted subsidiaries by limiting the amount or type of collateral borrowers are allowed to transfer. We find no evidence that contracts have reduced the amount of value borrowers can invest in unrestricted subsidiaries. However, we do find that provisions blocking the dropdown of intellectual property, so-called “IP blockers,” appear increasingly frequently starting in the second half of 2020, three years after the J. Crew transaction but close on the heels of a series of IP dropdowns near the beginning of the Covid pandemic. We infer that creditors object not so much to the general possibility of dropdown transactions but to the fragility of liens on assets that are notoriously difficult to value.

Reaction to the uptier, by contrast, was swift and pronounced. Among the loans in our sample that were originated before the Serta transaction, roughly 40% blocked uptiers. Of those, most did so (presumably inadvertently) because they adhered to a pre-financial crisis norm that prohibited a necessary element of the uptier, namely borrowers repurchasing large amounts of their outstanding loans. In the period after Serta, the frequency of uptier blockers increased sharply, rising by the end of our sample period to about 85% of loans. By one measure, the magnitude of change in contractual practice was even larger. The principal contractual adjustment after Serta was to introduce a clause prohibiting a loan’s subordination absent

not directly bear on the loan market’s responsiveness to broader *lender* interests. The barriers to a Coasean bargain are presumably much lower when the negotiating context is bilateral and only one of the two parties has anything at stake. Moreover, a standard amendment rule in leveraged loan contracts allows the borrower and the administrative agent, without the consent of other lenders, to correct any ambiguous contract language, so the costs of clarifying the clawback rule would have been minimal. Since preventing dropdown and uptier transactions benefits the broader set of dispersed lenders, the scope for negotiation failures seems much larger.

unanimous lender consent, which is a necessary element of an uptier. Approximately 10% of loans originated before the Serta transaction had such a clause, but by the end of our sample period, approximately 70% did.

We draw two principal conclusions. First, we reject the hypothesis that syndicated loan contracts fail to adjust when the anticipated burden of a value-destructive term falls on dispersed creditors. The speed with which terms of newly originated loans changed after the Serta Simmons transaction shows that contracts can change quickly to alter suboptimal loan terms. In the case of some terms, such as IP blockers, the market requires an accumulation of evidence before abruptly switching to a new status quo, as in the model of Kahan and Klausner (1997). Contract terms that persist following widespread recognition of their existence and implications should thus be viewed as value-enhancing or at least not importantly value-destructive. Second, we conclude that contractual features permitting the borrower flexibility to access liquidity, including by subordinating first-lien lenders, are part of the optimal loan contract for some borrowers. Despite the salience of dropdown transactions, contracts are just as likely now as before J. Crew to allow borrowers to transfer non-IP assets free and clear of liens to unrestricted subsidiaries. This fact, when viewed in light of the way contracts adjusted after the Serta transaction, suggests that for some kinds of borrowers the utility of the unrestricted subsidiary outweighs the cost to lenders of potential subordination.

2 Institutional Context and Summary of the Transactions

The managers of financially distressed companies often would like to issue debt that has priority over existing claims. When a company's earnings have been weak, it may have to rely on capital markets to fund operating expenses and investment. But distress also means that debt

overhang will often rule out the sale of junior debt or equity (Myers 1977). As a consequence, issuing senior debt may be the only realistic source of liquidity.⁴

Traditionally, companies with a secured loan in place had to get lender approval to issue priming or pari passu debt. Two standard contractual features make the need for consent explicit. First, incurrence covenants prohibit borrowers and their subsidiaries from taking on new debt or permitting the creation of new liens other than specified types and amounts. A borrower seeking to issue debt in defiance of its covenants would face penalty interest rates or even enforcement proceedings. Second, in connection with a loan, borrowers and their subsidiaries often grant liens on substantially all their assets. Potential subsequent lenders therefore know that they would rank behind the existing lenders in a bankruptcy scenario, irrespective of what they or the borrower might intend (Adler and Kahan 2013; Picker 1992). Historically financial maintenance covenants reinforced borrowers' obligation to seek lender approval (see Baird and Rasmussen 2006). Because such covenants were set to be tripped at the onset of distress (e.g. Nini, Smith & Sufi 2009, 2012; Roberts and Sufi 2009), borrowers were discouraged from subordinating lenders even if the loan contract arguably allowed it. The only options to issue priming debt were to get lender consent or to enter Chapter 11.⁵

After the 2008 financial crisis, however, the foundations of lender control began to give way. Term loans, traditionally held by the banks that provided a borrower's revolving credit, were increasingly sold in small increments to non-bank institutions such as CLOs. As syndicates

⁴ Benmelech, Kumar, and Rajan (2022) find that leveraged firms are more likely than investment-grade firms to issue secured debt.

⁵ Even in Chapter 11, it is often difficult to subordinate incumbent lenders without broad consent. In principle, the Bankruptcy Code permits debtors to issue priming debt while in bankruptcy or under the terms of a plan of reorganization. But bankruptcy judges apply stringent standards when determining whether to approve super-priority debtor-in-possession financing or to "cram up" a plan on non-consenting lenders.

became more diffuse and renegotiation more costly, restrictions on borrower activity loosened (Griffin et al. 2023; Ivashina and Vallée 2022). The virtual disappearance of financial covenants from term loan contracts was the most striking development (see e.g. Becker and Ivashina 2016; for a qualification, see Berlin et al. 2020). But borrowers have gained flexibility in a variety of less obvious ways, too, for example through more flexible definitions of operative constraints in the covenants that remain (see e.g. Badawi et al. 2021, p. 37).

The dropdown and uptier are products of the new environment. Neither transaction would have been possible, let alone commercially advisable, under the loan terms that typically prevailed before the 2008 financial crisis. Both are at least arguably permitted by terms commonly found in post-crisis loans. But although the transactions share an historical origin and allow borrowers to achieve similar ends, they work by very different legal logics. The elements of a loan contract that permit borrowers to execute one are conceptually as well as practically independent of the elements that permit the other; so, too, therefore, are the contractual terms lenders can deploy to thwart the transactions.

2.1 The Dropdown

2.1.1 Overview and Mechanics

In a dropdown, the borrower moves valuable assets out of its lenders' collateral package to a so-called "unrestricted subsidiary," which re-encumbers the assets to support its own newly issued debt.⁶ The logic of the transaction is straightforward: collateral for an existing loan is

⁶ The unrestricted subsidiary is a construct of credit agreements rather than a generic legal concept. It is a subsidiary in the ordinary sense—the borrower controls it and holds its equity (directly or indirectly)—but lenders agree to treat it for most purposes as if it were an arm's-length entity. Bond indentures have long used the construct, but it only entered the vocabulary of leveraged loans around the 2008 financial crisis. That change may be explained by inherent uncertainty, at the time a loan is originated, as to whether the borrower will have good cause to move assets out of the restricted group and off the consolidated balance sheet. As the number of lenders in a typical

transferred downstream, free and clear of liens; the downstream entity borrows against the assets and uses the proceeds to relieve an upstream entity's capital needs; upstream creditors are subordinated to the extent of the value of the assets transferred. But the mechanics are subtle. In particular, a borrower's ability to do a dropdown is predicated on two features that are common, but by no means universal, in post-crisis syndicated loan contracts: the power to designate subsidiaries as "unrestricted" and the capacity to transfer valuable assets to those subsidiaries.

We illustrate a generic dropdown transaction in Figure 1. In the example, the borrower has two subsidiaries—"Sub A" and "Sub B." Sub A is a restricted subsidiary and subject to all terms of the loan agreement. The so-called "restricted group" is illustrated by the dotted box containing the borrower and Sub A. Sub B is an unrestricted subsidiary. Its existence creates two opportunities that are central to the dropdown. First, the valid transfer of an asset from the borrower to it causes any lien on the asset to be released. Collateral moved to an unrestricted subsidiary ceases to be collateral for the original loan. Second, because unrestricted subsidiaries are not bound by the covenants of the original loan, they can issue an unlimited amount of debt backed with liens on their assets. Together these features make the dropdown a formal possibility, since collateral that validly passes from a borrower to an unrestricted subsidiary can be re-pledged to support debt issued by the subsidiary. In Figure 1, the new lenders to Sub B are granted a first-priority lien on the collateral transferred from Sub A to Sub B, so they are senior to the lenders to Sub A to the extent of the collateral's value.

For the dropdown to matter as more than a formal possibility, however, a borrower must be able to transfer a substantial amount of collateral to its unrestricted subsidiaries. The power to

leveraged loan syndicate has grown—and the hazard of securing ex post permissions with it—it follows that the value to borrowers of establishing ex ante a right to carve out part of the lenders' collateral would have grown, too.

do so is a function of what are known as the borrower’s “investment baskets.” In modern loan contracts, it is standard for borrowers to covenant that they will not make “investments,” defined to include capital contributions to subsidiaries, unless an enumerated exception, or basket, permits it. Virtually all loans include one or more general investment baskets that give the borrower permission to invest a limited amount in whatever it wants. Some loans also include a basket specifically for investments in unrestricted subsidiaries. A borrower’s unrestricted subsidiary investment capacity is the sum of the amounts available under these and perhaps other relevant baskets. Investment baskets typically allow borrowers to transfer non-cash assets, which are valued according to the borrower’s good-faith estimate (with an arm’s-length valuation opinion sometimes being required). The significance of a potential dropdown transaction therefore varies with the size of a borrower’s investment baskets and its ability or willingness to understate the value of assets it might transfer.

2.1.2 Salient Event: The J. Crew Transaction

The dropdown came to widespread attention in a transaction executed by J. Crew in two stages beginning December 2016. At a high level, the aim and mechanics of the transaction were straightforward. The company used its unrestricted subsidiary investment capacity to create super-priority notes backed by its iconic brands, which had theretofore been part of its lenders’ collateral, and then exchanged the new notes for junior, but maturing, unsecured notes (for more detail, see Ayotte and Scully 2021). The immediate consequences were to protect the equity sponsors’ investment while allowing junior creditors to become senior to the existing first-lien lenders. Beyond its impact on J. Crew’s investors, though, the transaction revealed practically, and perhaps legally, the extent to which distressed borrowers could use unrestricted subsidiaries to subordinate first-lien lenders without broad-based consent.

This is not to say that the transaction lacked antecedents. In the twelve months before it, both iHeart Media and Claire’s Stores had used unrestricted subsidiaries to move value away from bondholders. Claire’s had even primed first-lien bonds (although with only a minimal, negative impact on them).⁷ But J. Crew was the first to use the unrestricted subsidiary to prime a loan facility, and in so doing it upset conventional norms and expectations. Indeed, the J. Crew transaction is so (in)famous in leveraged finance circles that the company’s name has become a synonym for the dropdown and, more broadly, for aggressive out-of-court priming transactions. It is not unusual to hear of lenders being “J. Crewed.”⁸

2.1.3 Subsequent Developments (Bearing on Legality and Economic Significance)

For several years after J. Crew, copycat transactions were relatively rare despite dropdowns being much discussed in leveraged finance circles. Neiman Marcus used an unrestricted subsidiary to strip collateral from its lenders in 2018.⁹ Revlon did likewise in 2019. Then in the second quarter of 2020, as Covid uncertainty and lockdowns threatened many businesses, five big-name distressed companies—Golden Nugget, Revlon (again), Travelport, Cirque du Soleil, and Party City—executed dropdowns as others threatened to do the same. Several more dropdowns followed in 2022 and 2023.

The legality of a generic dropdown has not been seriously questioned. Although lenders have expressed a combination of surprise and outrage at borrowers’ use of unrestricted subsidiaries to subordinate unwilling lenders, the contractual permissions underpinning the

⁷ See Reorg (2016), which notes that the price of first-lien loans dropped 45 basis points on announcement of the transaction.

⁸ See Bloomberg (2019).

⁹ PetSmart, also in 2018, executed a controversial lien-stripping transaction that involved an unrestricted subsidiary. But the transaction did not create priming debt, and its aims could have been accomplished without an unrestricted subsidiary at all.

transaction are relatively clear. Lenders have challenged the validity of several dropdowns, starting with J. Crew itself (see *Eaton Vance Mgmt. v. Wilmington Savings Fund Society* [2018 WL 1947405, N.Y. Sup. Ct.]), but principally on case-specific grounds, and disputes have always settled. No judicial decision has addressed the dropdown’s essential permissibility.

2.1.4 Contractual Responses

The dropdown’s mechanics and history suggest three ways loan agreements could curtail J. Crew-type dropdowns if market participants wished to do so. The first and most direct response would be to prohibit unrestricted subsidiaries outright. Distressed borrowers cannot create priming debt through a subsidiary—even a non-guarantor—if all the significant subsidiaries are subject to debt and lien covenants. Eschewing unrestricted subsidiaries would be a blunt response and would entail costs of its own if, as we have suggested, they can provide valuable financing flexibility. But doing without unrestricted subsidiaries is hardly unimaginable. After all, the construct was unknown to syndicated loan deals as recently as fifteen years ago (Bellucci and McCluskey 2017).

Two alternative responses could limit the magnitude or significance of a potential dropdown rather than do away with it altogether. The simplest way would be to reduce the size of the baskets borrowers can use to transfer assets to unrestricted subsidiaries. The tighter a loan’s investment baskets are, the smaller is the amount by which a dropdown can subordinate lenders. After J. Crew, leading law firms developed another approach focused on the type of assets that borrowers can transfer to unrestricted subsidiaries. The “IP blocker” is language that prevents unrestricted subsidiaries from owning intellectual property material to a borrower’s

business.¹⁰ Two considerations explain the particular focus. First, intellectual property is prone to abuse. As an asset class, it is notoriously difficult to value accurately. A borrower strategically underestimating the value of its IP might move \$500 million of value out of the lenders' collateral pool under investment baskets that on their face allow only, say, \$100 million. Second, IP has in fact proved to be the asset class of choice for borrowers undertaking contentious dropdowns.¹¹

2.2 *The Uptier*

2.2.1 *Overview and Mechanics*

An uptier creates super-priority debt by amending the relevant loan documents to permit it explicitly. No assets are moved, so the possibility of (unrestricted) subsidiaries is irrelevant. Instead, the borrower offers a majority of its lenders, but only them, the ability to swap into newly created, senior instruments in exchange for their consent to the creation of a new facility with a superior lien or that is senior in right of payment to the existing loan.

Notionally, then, there are two parts to the transaction, which we illustrate with a contrived example in Figure 2. One is the amendment itself. A common debt covenant limits the amount of debt borrowers can incur and requires that new debt be, among other things, junior in repayment priority. (A limited amount of *pari passu* debt is often permitted.) Liens on the enterprise's productive assets are governed by a rule of first-in-time-first-in-right, so borrowers cannot create priming debt even if they are willing to violate covenants (Adler and Kahan 2013). In combination, these features mean that a borrower can create priming debt only if it can

¹⁰ Reuters (2018) claims that lenders "are now including language in loan documents, known as the 'J Crew blocker,' to stop companies transferring intellectual property."

¹¹ Loans could prohibit the drop down of other kinds of difficult-to-value assets. Occasionally they do. For example, we found one loan (to a communications company) prohibiting the dropdown of FCC licenses and two loans that allow only cash to be dropped down. But such provisions are rare.

procure an amendment relaxing the debt and lien covenants and altering the repayment waterfall or authorizing subordination of the existing lien. It has long been standard for loan contracts to condition the outright *release* of liens on unanimous lender consent, but a bare majority of lenders have usually been allowed to *subordinate* the lien and relax the covenants. In Figure 2, Lender B, which funds 60% of the existing loan, can agree to amend the credit agreement to permit a new lien that is senior (labeled “super-priority” in Figure 2) to the existing first lien.

The other part of an uptier is securing majority consent, which is challenging because traditional loan contracts make it difficult for borrowers to funnel value to favored lenders. A borrower cannot, for example, offer to pay some lenders, but not others, for their consent. Loan contracts direct the borrower to channel all payments through the administrative agent. So-called pro rata sharing provisions, which usually can be amended only with unanimous lender consent, require any lender who nonetheless recovers directly from the borrower to share the value it recovers ratably with fellow lenders (Bellucci and McCluskey 2017, p. 637). In our example in Figure 2, the borrower must find a tactic to compensate Lender B for agreeing to the amendment.

The approach that uptiering borrowers have settled on is to *buy*, at an attractive price, the favored lenders’ loans using (some of) the newly created super-priority debt as consideration. Even this move is not legally straightforward, however. Until recently, most loan contracts prohibited lenders from assigning their loans to the borrower or its affiliates. To the extent that a lender did so anyway, the pro rata sharing provision would expressly require the assigning lender to share proceeds pro rata with other lenders. Although a bare majority of lenders could have amended the contract to allow assignments to the borrower, pro rata sharing provisions usually could not be so easily amended. It was thus just not possible for borrowers to offer to repurchase from select lenders on preferential terms.

In recent years, however, some loan contracts began to establish exceptions to the general rule prohibiting assignments to the borrower (Bellucci and McCluskey 2017, pp. 640–643). These exceptions sought to replicate bond issuers’ longstanding ability to repurchase debt trading below par. Two common exceptions declare that, notwithstanding a general prohibition on borrower repurchases, the borrower or its affiliates can buy loans on a non-pro rata basis through (1) an auction procedure open to all lenders (typically run by the administrative agent) or (2) what are called “open market” repurchases. Crucially, the contracts that allow repurchase through auction or open market transactions also carve out from the general pro rata sharing rule the proceeds of such exceptional repurchases. In Figure 2, Lender B provides \$40M of new money in exchange for a new super-priority loan with a face value of \$70M. The borrower repurchases B’s \$30M share of the original loan, leaving Lender A’s original \$20M loan contractually subordinated to the new newly created debt.

2.2.2 *Salient Event: The Serta Simmons Transaction*

The first completed uptier transaction was executed by Serta Simmons in June 2020. Serta had first- and second-lien term loans trading at distressed prices, and the company sought restructuring proposals from its lenders. On June 8, it announced that it had entered a transaction support agreement with a bare majority of first- and second-lien lenders that would see Serta incur more than a billion dollars of incremental, super-priority debt: \$200 million to be issued for new money and \$875 million to swap for the consenting lenders’ existing loans. Minority lenders not invited to participate in the exchange sought to enjoin the transaction, but the trial court denied the request, and the transaction closed on June 22 (*North Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC* [2020 WL 3411267, N.Y. Sup. Ct.]).

The Serta uptier had little precedent. Distressed companies have long sought creditor permission to borrow on a priming basis while threatening non-participating creditors with subordination (e.g. Bratton and Levitin 2018, p. 1639; Donaldson et al. 2021). Traditionally, though, consent inducements were offered pro rata. The closest precursor to the Serta uptier was a transaction that specialty clothier NYDJ contemplated in 2017. In form, the transaction NYDJ proposed would have been quite similar to the 2020 transactions (Dick 2021). But after minority lenders complained and a judge expressed displeasure with what he viewed as an inappropriate process, the company invited all lenders to participate in funding a new facility on a pro rata basis (Affirmation, Exh. B, *Octagon Credit Investors LLC v. NYDJ Apparel, LLC* [No. 656677/2017, N.Y. Sup. Ct. Mar. 13, 2018]). NYDJ could have revealed a latent weakness in some credit documents, but perhaps because it was a relatively small company and the transaction did not close, the affair did not capture public attention in the way the Serta Simmons and follow-on transactions did.

2.2.3 *Subsequent Developments (Bearing on Legality and Economic Significance)*

The Serta transaction proved to be the first of many uptiers. Two followed quickly on its heels: Boardriders executed an uptier on August 31, 2020, and TriMark did the same two weeks later. More have been executed in 2022 and 2023.

At one point, litigation might have been expected to put an end to the uptier, because its permissibility was doubtful in a way that the permissibility of a generic dropdown was not. The most glaring infirmity was with the notion that a borrower's repurchase of loans as part of a negotiated, multi-step transaction could be the kind of "open market" purchase that some contracts permit. Minority lenders brought damages actions in relation to each of the three uptiers executed in 2020, and in each instance the trial court denied the transaction proponents'

motion to dismiss (*ICG Global Fund 1 DAC v. Boardriders, Inc.* [2022 WL 10085886, N.Y. Sup. Ct.]; *LCM XXII LTD. v. Serta Simmons Bedding, LLC* [2022 WL 953109, S.D.N.Y.]; *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.* [150 N.Y.S.3d 894, Sup. Ct. 2021]). But no final decision has held the transaction unlawful, and the bankruptcy judge in Serta’s eventual Chapter 11 case found that the transaction complied with contract terms and was consistent with the duty of good faith and fair dealing (In re *Serta Simmons Bedding, LLC* [Dkt. 1071, No. 23-90020, Bankr. S.D. Tex. June 14, 2023]).

2.2.4 Contractual Responses

A loan contract can block an uptier by preventing either of the transaction’s two parts—the subordination of a lien by a bare majority of lenders or the discriminatory inducement (i.e., the non-pro rata loan repurchase). Prohibiting subordination absent unanimous or supermajority lender consent is the technically simpler option. An additional clause in the Amendments section, in the list of lenders “sacred rights,” is all that is needed. The other way to block an uptier is to prohibit or otherwise limit a borrower’s ability to repurchase debt from favored lenders only. The traditional terms of syndicated loan contracts frequently accomplish this incidentally, by forbidding assignments to the borrower and requiring (absent unanimous lender consent) that the proceeds of any such assignment be shared ratably. Loans that follow the traditional approach or that route non-pro rata repurchases through an auction or other mechanism open to all lenders would make uptiers impossible.

3 Hypotheses and Research Design

We try to answer whether and how loan contracts changed after it became evident that loan subordination via dropdowns and uptiers was a serious risk. We use the salience of the J. Crew and Serta Simmons transactions as events that alerted market participants to weaknesses in

existing contract language and to the possibility that borrowers would use that language to issue priming debt.

We posit that contracting parties will write terms that they anticipate will maximize the joint surplus of their agreement net of contracting costs. Contracts are incomplete because it is impossible, or prohibitively costly, to anticipate every contingency and negotiate desirable state-contingent outcomes in advance (Ayotte and Scully 2021; Aghion and Bolton 1992). Although parties may fail to anticipate remote contingencies, we expect that when an economically significant contingency becomes salient, parties will reassess contract language and eliminate options expected to destroy value. Although priming transactions have undoubtedly always been a risk for lenders, the public response to the J. Crew and Serta Simmons transactions suggests that the risk of these specific types of subordination became much more prominent in late-2016 and mid-2020, respectively. We test the null hypothesis of no change in contracts against the alternative that contracts updated to prevent these transactions.

3.1 The Null Hypothesis

There are two reasons why loan contracts might not have changed. First, the contractual features that permit a dropdown or uptier may provide benefits sufficient to make them sensible components of some credit agreements despite the prospect of borrower opportunism. As we have suggested, unrestricted subsidiaries may provide certain borrowers with valuable flexibility to develop, account for, and finance separately new high-growth lines of business. Eliminating the construct altogether might be too costly. Alternatively, it may be efficient to have a non-bankruptcy mechanism for subordinating loans, particularly in an era when syndicated loans are held by many dispersed investors (Bord and Santos 2012). Even if dropdowns and uptiers are not strictly speaking the surplus-maximizing methods by which a distressed borrower's access to

liquidity can be metered, their similarity to the methods on offer in Chapter 11 (irrespective of the terms of the debtor's loan contract) might lead investors to conclude that the difference in expected firm value is negligible. That is, contract drafters might reasonably conclude that the difference between a borrower's issuing priming debt outside and inside bankruptcy is more a matter of distribution, which adjustments to loan pricing can fully offset, rather than surplus.

The second reason why loan contracts may not change, at least in the short-run, is that commercial contracts can be sticky. Legal scholars have noted several examples of debt contracts not updating despite a salient event that one might think would have spurred a change in the optimal contract (e.g. Gulati and Scott 2013; Choi et al. 2017a, 2017b; Gulati and Kahan 2018). This research suggests that frictions in the negotiation or drafting process can, in some contexts, prevent contracts from updating to reflect parties' assessments of the costs and benefits of salient terms (see also Clayton 2022).

3.2 *The Alternative Hypothesis*

The alternative hypothesis is that loan contracts updated to prevent dropdowns and uptiers, which we expect if blocking the priming transactions is a preferred contract feature *and* syndicated loan contracts adjust. It is a joint hypothesis since both legs must be true for us to observe a change in contract language. Stated differently, failing to reject the null hypothesis does not let us distinguish between whether allowing the priming transactions is perceived to be efficient or whether loan contracts simply have not adjusted to the new information.

There are reasons to believe that syndicated loan contracts can update quite quickly in response to a salient event. Borrowers and lenders are sophisticated parties, and there is a lot of money at stake. Talley (2021) studies the effect of a judicial decision that assigned to administrative agents the risk of accidental disbursement of funds, after Citibank, the

administrative agent on a loan to Revlon, mistakenly wired the full principal amount of the loan to lenders who were in a dispute with the borrower. Bucking market convention, some lenders refused to return the funds, and a judge held that they were justified in holding onto the erroneously wired funds. Talley (2021) documents that loan contracts were quickly amended to clarify that mistaken disbursements must be returned to the administrative agent. Of course, the situation explored by Talley (2021) may be unique since administrative agents are active participants in drafting loan contracts and have incentive to protect their own interests. It remains an open question whether (and how quickly) the loan market updates in response to practices that implicate the broader set of lenders.

It is also reasonable to suspect that the contract provisions that permit borrowers to prime lenders are not features of the optimal contract; instead, dropdowns and uptiers represent purely opportunistic borrower behavior lenders had not foreseen. For the uptier, in particular, the non-pro rata mechanism results in intra-facility conflicts that syndicated loan contracts generally try to minimize. Such conflict could seemingly be avoided while preserving the ability of a borrower with broad-based lender support to access priming debt outside Chapter 11. For example, a straightforward alternative would allow a borrower to issue priming debt with simple majority support from lenders but require that every lender be allowed to participate pro rata in the new priming loan.¹²

Putting these ideas together we get the following syllogism. If after 2016 (2020), syndicated term loans change to block dropdowns (uptiers), then the flexibility to do a dropdown

¹² So-called “amend and extend” provisions work this way. Since 2008, many syndicated loan contracts allow borrowers to extend the maturity of a loan with the consent of only lenders willing to provide the extension, often in exchange for a higher interest rate. However, the amendment requires that all lenders be given the opportunity to participate in the extension. See Bellucci and McCluskey (2017, p. 64).

(uptier) is not perceived to be part of an efficient contract *and* the loan market adjusts in response to lender interests. Conversely, if contract terms do not change, then *either* the relevant type of borrower flexibility can be part of an efficient contract *or* non-price loan terms are insensitive to lender interests.

3.3 *Empirical Design*

Our empirical analysis is a form of an event study. Using data on the contractual provisions that block the priming transactions, we ask how the frequency of dropdown and uptier blockers changed following announcement of the J. Crew and Serta Simmons transactions. We define the event dates as the end of 2016 (12/31/2016) and the middle of 2020 (6/30/2020). This is not to suggest that the end of 2016 and middle of 2020 were uniquely informative moments. Transactions take time to execute and involve multiple parties. At least some market participants must have contemplated the possibility of dropdowns and uptiers before J. Crew and Serta announced their respective deals. Likewise, subsequent events—later transactions and litigation outcomes—may have helped market participants to calibrate their views about future subordination transactions and, therefore, about the utility of blocking them.¹³ J. Crew and Serta did, however, alert a broad segment of market participants—lawyers as well as investors—to the logic of dropdowns and uptiers and to the fact that well-advised borrowers might try to execute one. We thus use December 2016 and June 2020 to partition our sample into three broad periods: (1) a baseline period with contracts originated before the priming transactions became salient, (2) a period following the J. Crew transaction when salience of the dropdown increased, and (3) a period following the Serta Simmons transaction when the salience of the uptier increased. Our

¹³ The secondary-market prices of J. Crew (Ivashina and Vallée 2022) and Serta (Badawi, Buccola and Nini 2024) loans fell sharply on announcement of the respective priming transactions.

null hypothesis is that the frequency of blockers remained constant across the periods, and we test this hypothesis against the alternatives that the frequency of dropdown blockers increased in period 2 and that the frequency of uptier blockers increased in period 3.

4 Data

4.1 The Practical Law Sample

We draw a sample of loan contracts from Thomson Reuters' Practical Law (PL) service. PL provides access to roughly 700 corporate credit agreements per year through their Comprehensive Deal Database, which compiles agreements taken from SEC filings. We begin with 4,318 contracts from January 1, 2016, through June 30, 2022, that have non-missing data on the amount of the loan. Using data provided by PL, we exclude 670 contracts that are marked as amendments to original agreements, leaving us with a sample of 3,648 loan contracts.

The PL sample appears comprehensive and representative of the full set of leveraged loans made to SEC-reporting borrowers over this period. To assess the representativeness of the PL contracts, we compare the PL sample with a sample of loans taken from Dealscan, which is a database of loans used by Thomson Reuters to generate league tables and other summaries of the loan market. Figure OA1 in the Online Appendix plots the aggregate amount of loans covered in each of the samples. The figure shows that the PL sample includes roughly \$500 billion of loans per year, which varies between 40 percent and 50 percent of the Dealscan sample. We believe the difference in sample sizes reflects the fact that Dealscan covers a larger set of financing events. As discussed in Roberts (2014), observations in Dealscan correspond to loan

originations, amended and restated contracts, and loan amendments.¹⁴ Although PL includes amended and restated agreements, we exclude all amendments.

Table 1 provides some summary statistics on the borrowers and loans covered by PL and Dealscan. The top three sets of rows show that the distributions of loan size, spread, and maturity are quite similar across the two groups. On average, loan spreads are slightly smaller in the PL sample, but the difference is driven by the tails of the distribution; the median loan spread is very similar across the groups. The bottom four sets of rows compare the frequency of borrowers across industries based on the Fama and French (1997) classification of SIC codes into five broad groups. Together they show that the distributions of borrowers, by industry, in the Dealscan and PL samples are nearly identical. We infer that the samples are taken from the same underlying set of borrowers.

The advantage of the PL data is that we have easy access to the underlying credit agreements, since PL provides the URL of the underlying SEC filing in EDGAR. We use this link to extract the contract so that we can read and code contract provisions that are not available in existing datasets such as Dealscan. To focus on loans most susceptible to a dropdown or uptier, we make several restrictions to the PL sample, which are summarized in Table 2. Although the restrictions substantially reduce the sample, there are two useful benefits. First, the restrictions produce a more homogenous sample of loans that expose lenders to the highest risk of an aggressive recapitalization. Second, the restrictions can all be implemented using data from PL, which reduces the amount of reading required.

¹⁴ There is, unfortunately, no easy way to distinguish among the types of contracts.

We begin with the full sample of new credit agreements and exclude debtor-in-possession loans, second-lien loans, and asset-based loans based on the logic that these loans have unique collateral packages.¹⁵ We follow convention by dropping loans to firms in financial services since many of these firms will be regulated and have unique capital structures. Finally, we drop a small number of loans with a maturity less than one year or granted in a currency other than U.S. dollars. Lenders with a short maturity are unlikely to face much risk of being primed, and the currency restriction helps create a more homogeneous sample. Of the remaining 2,795 contracts, we make two additional restrictions. First, we remove loans that PL labels unsecured, since priming of first-lien loans is an essential ingredient in the transactions we study. We also drop the few secured loans granted to investment-grade borrowers to create a more homogeneous sample of loans. Second, we exclude loans with initial principal less than \$50 million, since smaller loans are more likely to be funded by small syndicates that permit restructuring without priming. As shown in the last two columns of the table, the removed loans very rarely include the terms “unrestricted subsidiary” or “open market,” which we determine based on an automated search of the full sample of contracts. Since the ability to create an unrestricted subsidiary is necessary for a firm to complete a dropdown transaction, this term is necessary for a loan to permit a dropdown. Similarly, since the right to repurchase loans through an open market purchase suggests that lenders have contemplated the possibility of non-pro rata assignment to the borrower, this term make is much more likely that a loan could permit an uptier. In our final analysis sample, the frequencies of these terms are 49% and 36%, confirming that the excluded loans are indeed quite different.

¹⁵ The remaining loans we study are “cash-flow” loans having a lien on substantially all assets of the firm. The broad collateral pool creates the most scope for priming transactions.

For each of the remaining 1,160 contracts, we read the contract and make two further restrictions. First, we exclude contracts that contemplate only a line of credit. Revolving facilities of syndicated loans are usually funded by a small group of banks (Berlin et al. 2020) who have a relationship with the borrower, so revolving lenders are unlikely to participate—and to this point have not participated—in a non-pro rata deal. And because revolving lenders still typically benefit from financial maintenance covenants (Berlin et al. 2020), they (as a group) will typically have an effective veto of a transactions, such as a dropdown, that a borrower may notionally have a right to pursue but which would injure the revolving loan. Term loans have thus proved to be uniquely susceptible to priming transactions. Second, we exclude any loan that we determine was not broadly syndicated, since single-lender and club loans provide no opportunity for priming within the lending group. These last two restrictions further reduce the sample to 664 contracts, which we refer to as our analysis sample.

4.2 *Contract Data*

For each contract in the analysis sample, we code a set of provisions necessary to determine if the contract blocks the dropdown and uptier transactions. For dropdowns, any contract that allows the creation or existence of an unrestricted subsidiary will permit the borrower to conduct a dropdown transaction, since every such contract in our sample provides at least some basket exception to the negative investment covenant. We code any contract that does not permit an unrestricted subsidiary as fully prohibiting a dropdown. However, among loans that allow unrestricted subsidiaries, there are two contract provisions that limit the magnitude of any potential dropdown. First, the contract can prevent IP from being invested into an unrestricted subsidiary, which we term an “IP blocker.”¹⁶ Second, we code the size of the general

¹⁶ We include in this category two contracts that permit the transfer of cash and cash-equivalents only.

investment and unrestricted subsidiary baskets. Since basket capacity is cumulative, we add them together and standardize by the size of the loan. Smaller baskets restrict the amount of assets that can be moved away from existing lenders.

For uptiers, we code the two approaches to blocking the transaction. For each contract, we determine whether the contract requires unanimous or supermajority consent to subordinate existing loans. If so, the contract blocks an uptier by preventing the subordination step of the transaction. We also determine if the contract prohibits the lender from repurchasing debt on a non-pro rata basis, which can be accomplished in two ways. First, the contract can prohibit lenders from assigning any loan to the borrower or its affiliates and preclude amendment of the anti-assignment rule without unanimous or affected-lender consent. Second, the contract can require that the proceeds of any assignment to the borrower or its affiliates be shared among lenders pro rata and preclude amendment of the sharing rule. We also code whether the contract explicitly permits the borrower to repurchase the loan on a non-pro rata basis, either through an open market purchase or a Dutch auction.

Table 3 summarizes the results of this exercise for the full analysis sample of contracts. Across the years 2016-2022, 51% of contracts prohibit a dropdown transaction, meaning that the unrestricted subsidiary construct is present in about half of leveraged loan contracts. Only 21% of contracts that permit unrestricted subsidiaries block the transfer of IP, but as we will show below, these blockers have become much more common in recent years. About one-half (49%) of loan contracts in our sample block an uptier exchange, with the majority of the uptier blockers operating via prevention of discriminatory assignment. We will show, however, that contracts have evolved to prevent uptier transactions via an anti-subordination provision.

5 Testing the Hypothesis

5.1 *Visualizing the Time Series of Blockers in Leveraged Loans*

We begin by exploring the time series of the unconditional frequency that contracts block dropdowns and uptiers. Panel A in Figure 3 plots the half-year frequency of contracts that lack an unrestricted subsidiary construct, along with 95% confidence intervals indicated by the vertical capped lines. Announcement of the J. Crew transaction is denoted by the vertical line during the second half of 2016. The use of unrestricted subsidiaries did not decrease thereafter. Instead, the frequency of contracts contemplating unrestricted subsidiaries remained roughly constant, at about one-half, throughout the seven-year sample period. Similarly, panel B, which plots the average sum of a contract's general investment basket and unrestricted subsidiary basket (if any) scaled by the size of the loan, shows no discernible trend in the average cumulative amount that borrowers can invest into unrestricted subsidiaries. Panel C does, however, show a slow but steady increase over time in the frequency of contracts that contain an IP blocker. IP blockers were non-existent before the J. Crew transaction and did not appear until a couple years after the initial dropdown. Usage increased rapidly following the Serta transaction, and in the most recent periods the majority of new loans that contemplate unrestricted subsidiaries prohibit the investment of material IP. The combined evidence suggests that granting borrowers the ability to make investments in unrestricted subsidiaries remains a sensible component of credit agreements but allowing the transfer of IP assets provides too much borrower discretion that is subject to abuse. The evidence also shows a slow evolution of contract terms that accelerated following the Serta transaction.

Figure 4 provides a similar graphical analysis of uptier blockers. Panel A reports the time series of uptier blockers and shows that the frequency of blockers increased sharply following

the Serta transaction (denoted by the vertical line during the first half of 2020). In years prior to Serta, roughly 40% of contracts would block an uptier exchange. This frequency increased to about 75% by the middle of 2021, just one year after the Serta transaction was announced, and to over 85% by the middle of 2022. The increase is due to a sharp rise in the frequency of contracts that make lien and payment priority a sacred right. Panel B shows that, before Serta, the vast majority of contracts that blocked uptiers did so because they prohibited non-pro rata loan repurchases and that the frequency of prohibiting such repurchases did not increase after Serta. Among loans originated after Serta, however, there is a sharp rise in the propensity of contracts to condition loan subordination on lenders' unanimous consent, or at least on the unanimous consent of lenders affected by the amendment. The rate of this provision is about eight times the rate prior to 2020. The sharp change suggests a concerted effort to prevent the uptier exchange. In the Online Appendix figure OA2, we plot the frequency of contracts permitting the borrower to repurchase loans on a non-pro rata basis. The figure shows that the frequency did not decrease following the Serta transaction. Instead, contracts continue to sometimes permit borrowers to repurchase outstanding loans but now typically restrict borrowers' ability to compensate selling lenders with new super-senior debt.

5.2 *Multivariate Analysis of Blockers in Leveraged Loans*

In this section, we confirm the patterns in Figures 3 and 4 by estimating a regression that controls for additional factors that might explain the use of contract terms that block the transactions. By incorporating a set of control variables in a regression, we can rule out the possibility that the trend shown in the figures is caused by changes in the composition of the sample over time. The regressions also allow us to formally test the null hypothesis that the

propensity of contracts to block dropdowns and uptiers has remained constant over time. We estimate regressions of the following form:

$$y_{it} = \alpha + \beta_1 \mathbf{I}(1/1/2017 < t < 6/30/2020) + \beta_2 \mathbf{I}(6/30/2021 \leq t) + \beta_3 X_{it} + \varepsilon_{it} \quad (1)$$

where y_{it} is a feature of the contract to firm i initiated during half-year t and X_{it} is a set of characteristics related to the loan and borrower. The important variables are the two indicator variables— $\mathbf{I}(1/1/2017 < t < 6/30/2020)$ and $\mathbf{I}(6/30/2021 \leq t)$ —which denote that the loan was originated between the J. Crew and Serta transactions or after the Serta transaction, respectively. The excluded group consists of loans originated before the J. Crew transaction, so the coefficients β_1 and β_2 provide an estimate of how the contract feature changes during these periods relative to the period prior to J. Crew.

We build the set of explanatory variables in X using observable characteristics of the borrower and the loan that could plausibly be correlated with the contract provisions that might block a dropdown or an uptier. We construct the variables using data provided by PL, Compustat, and the underlying loan agreements. PL provides data on several features of the loan and borrower, which we supplement with some data collected by hand from the credit agreements. Compustat provides accounting data for the borrower which we merge to PL using the borrower's CIK number. We use data on the borrower's total liabilities, book value of assets, and earnings before interest, taxes, depreciation, and amortization (EBITDA) measured as of the quarter-end immediately following the loan origination date.¹⁷ We construct a measure of the firm's market value of assets as the sum of the borrower's total liabilities and the market value of

¹⁷ We match 635 of the loans to Compustat and lose a few additional observations due to missing data on EBITDA and the market value of equity.

equity, and we measure of the firm's intangible assets as the book value of total assets less the book value of property, plant, and equipment (PPE), inventory, receivables, and cash.

Table 4 reports the frequency of blockers for several subsamples of contracts. The top portion of the table splits the sample according to the size of the loan as reported by PL, with buckets corresponding to the smallest quarter, middle 50%, and largest quarter of loans. We conjecture that larger loans are less likely to contain blockers due to higher renegotiation costs associated with larger lending syndicates and more complex firm operations and capital structures. Indeed, the data reveal a clear pattern; relative to small loans, large loans are much less likely to block either a dropdown or an uptier. Across the full sample period, only about one-quarter of the largest loans prohibit a dropdown, likely because the flexibility provided by unrestricted subsidiaries is particularly valuable for large firms. Similarly, the largest loans are less likely to include an uptier blocker. Small loans are much less likely to permit borrower repurchases, so many small loans incidentally blocked uptiers prior to Serta Simmons.

The second panel in Table 4 splits the sample by borrower leverage, measured as the ratio of the borrower's total liabilities to the market value of the borrower's assets. Since we are examining a sample of leveraged loans, all borrowers have fairly high leverage. Nevertheless, the evidence suggests that the least leveraged firms are slightly more likely to face both types of blockers. The next panel in Table 4 splits the sample by borrower profitability, measured as the ratio of the borrower's EBITDA to assets, which we label ROA. There is no evidence that blockers vary with the borrower's profitability. The fourth panel splits the borrowers into groups by the nature of the borrower's operations. Since intellectual property has been a popular asset to move away from existing creditors, we conjecture that firms with more intangible assets might face a blocker more often. We measure the intangibility of the borrower's assets as 1 minus the

ratio of tangible assets to total assets, where tangible assets are the sum of PPE, inventory, receivables, and cash. In the sample, the ratio varies between 1% and 97%, has a standard deviation of 27%, and is much larger for technology firms. We do not observe much difference across the buckets, though firms with a smaller share of intangible assets are less likely to face an IP blocker. The next panel splits the sample based on whether the borrower is backed by a private equity sponsor, as determined by PL. Roughly 20% of the firms in our sample have a private equity sponsor. Sponsored firms are much more likely to be able to designate unrestricted subsidiaries and slightly less likely to face an uptier blocker; they are, however, more likely to face an IP blocker. The bottom panel in Table 4 splits the loans based on the type of lender that serves as administrative agent on the loan, which we determine from the underlying credit agreement. We classify each agent as a large bank (which includes Bank of America, J.P. Morgan, Citigroup, and Wells Fargo), some other bank, or a nonbank. The bottom panel suggests that loans with nonbank agents are less likely to include uptier and dropdown blockers.

Table 5 presents estimates of the parameters in equation (1) for an indicator that the contract eschews unrestricted subsidiaries altogether, permits unrestricted subsidiaries but has an IP blocker, and has as uptier blocker. For each outcome, we estimate a specification with no control variables and a specification including controls for the variables in Table 4: the size of the loan (the natural log of the amount of the loan), the borrower's leverage, the borrower's ROA, the percentage of the borrower's assets that are intangible, an indicator that the borrower has a private equity sponsor, indicators that the lenders' agent is a small bank or a nonbank, and

a set of industry fixed effects based on the Fama and French (1997) classification of the borrower's SIC code into 12 broad industries.¹⁸

The first two columns of Table 5 confirm that there is no evidence that leveraged loan contracts are any more likely to prohibit a dropdown than they were before J. Crew. If anything, incorporating control variables shifts the point estimates in column (2) more negative than column (1), but we have no reason to reject the null hypothesis that the frequency of dropdown blockers has remained constant across our sample. Similarly, including control variables has no impact on the inferences we draw regarding the evolution of IP blockers. Based on the estimates in columns (3) and (4), the frequency of IP blockers increased by about 6 percentage points during the post-J. Crew period and by about 50 percentage points following the Serta transaction. Columns (5) and (6) confirm that the trend documented in Figure 4 is not attributable to changes in loan composition. The propensity of otherwise similar contracts to block uptiers increased sharply after the Serta transaction. Compared to prior periods, the estimate in column (6) shows that contracts are about 37 percentage points more likely to block an uptier transaction during the years following the Serta transaction.

In the Online Appendix, Figure OA3 displays estimates of half-year indicator variables used in place of the broad period indicator variables in equation (1). For IP blockers, the point estimates confirm the slow evolution following J. Crew and acceleration following Serta, similar to the pattern in Figure 3. For uptier blockers, the figure shows a sharp increase following the Serta transaction rather than a slowly increasing trend. These patterns help substantiate the

¹⁸ The number of observations in the regressions varies because some of the Compusat variables are missing for some observations.

inference that the Serta transaction, perhaps along with other transactions in 2020, sparked the change in contract language.

Including control variables related to characteristics of the loan and borrower has very little impact on the estimated trend in any of the blockers. However, Table 5 does suggest a strong relationship between the presence of a dropdown blocker and the size of the loan, the presence of a private-equity sponsor, and the type of entity serving as administrative agent. Given that about one-half of loans block a dropdown transaction, the estimated coefficients in column (2) on size, sponsorship, and agent type are quite large. A one standard deviation increase in the loan amount is associated with a 19.6 percentage point reduction in the likelihood of a dropdown blocker. Compared with non-sponsored loans, sponsored loans are 28.7 percentage points less likely to block dropdowns, and loans with a nonbank agent are 17.6 percentage points less likely to do so. Larger loans and loans with a nonbank agent are also less likely to block an uptier transaction.

6 Discussion

Our empirical analysis is a formal test of the null hypothesis that the frequency of provisions bearing on borrowers' ability to execute dropdowns and uptiers has remained constant over time. That hypothesis rests on at least one of two premises being correct. Either (1) the contractual provisions that permit dropdowns and uptiers are valuable components of some syndicated loan contracts (in the sense that the benefits to borrowers of terms that allow for priming debt issuance exceed the costs to lenders of potential subordination) or else (2) they are not but non-price terms fail to adjust quickly to reflect lender interests.

Our findings allow us to reject the null hypothesis with respect to uptiers. Terms adjusted rapidly after the Serta transaction was announced. Within a year, the frequency of contracts that

block uptiers had nearly doubled. We conclude that market participants view the threat of an uptier as value-destructive and that contract terms in the leveraged loan market can adjust rapidly to lender sentiment. Of course, the frequency of uptier blockers did not immediately increase to 100 percent. One can infer either that flexibility to do an uptier is a valuable component of some contracts or, as we suspect, that the mechanisms by which terms change are imperfect. If our supposition is correct, uptier blockers, accomplished by making lien subordination a sacred right, should eventually become the norm for nearly all leveraged loan contracts.

The *way* contracts changed in response to uptiers allows us also to conclude that market participants perceive borrowers' ability to repurchase loans at least sometimes to be a valuable feature of leveraged loan deals. Contracts could have adjusted to the uptier by returning to the pre-financial crisis rule that made non-pro rata repurchases impossible. That is not what happened, however. Contracts are just as likely after as before Serta to permit borrowers and their affiliates to repurchase loans. Instead, borrowers have given up what was once a ubiquitous power to subordinate a loan's lien and payment priorities with majority lender consent.

Our conclusions with respect to the uptier shape our interpretation of the evidence on dropdown blockers. With respect to dropdowns, our findings do not allow us to reject the null hypothesis. The propensity of contracts to eschew unrestricted subsidiaries did not change after J. Crew. Nor did the magnitude of borrower capacity to invest in them. Because contract terms adjusted rapidly in response to the uptier, we are reluctant to attribute the persistence of unrestricted subsidiaries and associated basket capacity to a putatively non-responsive loan market (premise 2 above). Contracts could adjust to prevent dropdowns but did not. We thus interpret the evidence to suggest that, in some contexts, the unrestricted subsidiary—and

therefore a borrower's ability to subordinate lenders—is a feature of the optimal loan contract (premise 1 above).

The pattern of change in the use of IP blockers is more mysterious. Although an IP blocker is less restrictive than elimination of unrestricted subsidiaries or reduction in basket capacity, it nevertheless limits borrowers' ability to conduct a dropdown. But the timing of the change is puzzling. For a while following the J. Crew transaction, the use of IP blockers barely budged. We only observe a large increase starting in the second half of 2020. Why did contracts not change quickly after J. Crew, but only later? We propose that a flurry of dropdown transactions executed between April and July 2020 caused lenders to update their views on the likelihood that future borrowers would take advantage of contractual flexibility specifically by carving out of the collateral pool a type of asset the value of which is easy to understate. As stated previously, five distressed companies announced dropdowns as the initial revenue shocks from Covid fallout hit corporate treasuries. All of them used IP. Other companies are rumored to have threatened to do likewise. We cannot rule out the possibility that it took several years for the loan market to respond to the J. Crew transaction, but such a lag would be in tension with the market's responsiveness to the uptier. A better explanation is that the events of 2020 revealed new information to lenders about expected costs of borrower flexibility to drop down IP specifically.

Going forward we expect more priming transactions, as borrowers use unrestricted subsidiary capacity to finance new debt. Lenders seem content to allow borrowers the flexibility needed to do so even if it may decrease loans' expected recoveries in some cases. Splitting lender classes via uptier transactions will be very uncommon, however, as the vast majority of new contracts will prohibit borrowers from subordinating existing loans without unanimous or

affected-lender consent. More broadly, our evidence suggests that the loan market can update quickly when borrowers exploit contract terms in ways that lenders had not foreseen.

Conversely, when one observes the persistence of provisions that seemingly allow borrowers to undermine lender expectations, one should therefore look to the countervailing benefits of borrower flexibility rather than market failure or borrower “power.”

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Table 1. Understanding the Practical Law Sample

The table reports summary statistics for a sample of loans from Dealscan and the sample of contracts in Practical Law. The Dealscan sample includes loans to U.S. borrowers that can be matched to financial statement data in Compustat within 180 days of the origination date of the loan. Data on loan size is from Dealscan for the Dealscan sample and from Practical Law for the Practical Law Sample. Data on loan spread and loan maturity are from Dealscan and reported for the sample of Practical Law deals that can be merged to Dealscan. Panel B reports the distribution of firms by industry, based on the Fama-French classification of SIC code.

	Mean	25th Percentile	50th Percentile	75th Percentile	N
Loan size (\$ millions)					
Dealscan	960	200	480	1,000	8,454
Practical Law	924	145	440	1,000	3,648
Loan spread (bps)					
Dealscan	200	125	150	225	7,612
Practical Law	186	113	143	200	1,778
Loan maturity (years)					
Dealscan	4.2	3.0	5.0	5.0	8,386
Practical Law	4.1	3.0	5.0	5.0	1,902
Consumer Durables, NonDurables, Wholesale					
Dealscan	19%				8,454
Practical Law	19%				3,648
Manufacturing, Energy, Utilities					
Dealscan	27%				8,454
Practical Law	27%				3,648
Business Equipment, Telephone, Television					
Dealscan	18%				8,454
Practical Law	17%				3,648
Healthcare, Medical Equipment, Drugs					
Dealscan	6%				8,454
Practical Law	10%				3,648

Table 2. Understanding the Analysis Sample

The table summarizes the process for generating the contracts that comprise the analysis sample. The sample begins with the unique credit agreements originated between January 1, 2016, and June 30, 2022, taken from Practical Law. We initially exclude the following loans, as determined by Practical Law: debtor-in-possession (DIP) loans, second-lien loans, asset-based loans, borrowers from any financial services industry, loans with maturity less than one year, and loans not denominated in U.S. dollars. We then exclude unsecured loans, loans to borrowers with an investment-grade rating, and loans less than \$50 million, as determined by Practical Law. Of the remaining contracts, we exclude the following based on our reading of the agreements: deals without a term loan and loans not broadly syndicated. The columns “Search of excluded group” report the frequency that an automated search program finds the phrases “Unrestricted Subsidiary” and “Open Market” in the contracts of the excluded group. Among the contracts in the analysis sample, the frequencies of the phrases “Unrestricted Subsidiary” and “Open Market” are 49% and 36%, respectively.

	Remaining Contracts	Search of excluded group	
		"Unrestricted Subsidiary"	"Open Market"
Contracts that are not amendments	2,795		
Removing unsecured and investment-grade	1,412	7%	3%
Removing loans < \$50M	1,160	13%	9%
Contracts that we read	1,160		
Removing revolver only	765	30%	8%
Removing single lender	664	25%	7%

Table 3. Understanding Dropdown and Uptier Blockers

The table summarizes the provisions in credit agreements that block dropdown and uptier transactions. The analysis sample is described in Table 2.

	Mean	25th Percentile	75th Percentile	N
<i>Dropdown Related Provisions</i>				
Blocks a dropdown transaction	51%			664
IP blocker	21%			325
Investment basket / loan amount	19%	8%	24%	325
<i>Uptier Related Provisions</i>				
Blocks an uptier transaction	49%			664
Via subordination blocker	27%			664
Via assignment blocker	33%			664
Permits discriminatory repurchases	41%			664
Permits repurchase, prohibits uptier	34%			273

Table 4. Dropdown and Uptier Provisions and Loan/Borrower Characteristics

The table reports the frequency of credit agreements that block a dropdown transaction or an uptier transaction, split by characteristics of the loan or borrower. Loan size is the principal amount of the loan. ROA is the ratio of the borrower's EBITDA to assets. Intangible assets % is 1 minus the ratio of tangible assets to the market value of total assets, where tangible assets are the sum of PPE, inventory, receivables, and cash. Large banks include Bank of America, J.P. Morgan, Citigroup, and Wells Fargo.

	N	Dropdown Blockers		
		Dropdown Blocker	IP Blocker	Uptier Blocker
<i>Overall</i>	664	51%	21%	49%
<i>Loan size</i>				
Bottom 25%	167	78%	27%	60%
Middle 50%	337	50%	25%	49%
Top 25%	160	26%	13%	36%
<i>Borrower liabilities / assets</i>				
Bottom 25%	159	62%	36%	60%
Middle 50%	318	47%	21%	47%
Top 25%	158	47%	12%	47%
<i>Borrower ROA</i>				
Bottom 25%	155	49%	29%	45%
Middle 50%	308	49%	17%	50%
Top 25%	154	53%	22%	51%
<i>Intangible assets %</i>				
Bottom 25%	159	53%	15%	50%
Middle 50%	318	49%	24%	51%
Top 25%	158	53%	22%	49%
<i>Borrower sponsored</i>				
No	526	57%	18%	50%
Yes	138	30%	29%	43%
<i>Admin agent</i>				
Large bank	341	50%	21%	53%
Other bank	162	41%	21%	38%
Nonbank	148	63%	18%	52%

Table 5. Blockers across Periods

The table reports coefficient estimates from OLS regressions of contract provisions on indicators that the loan was originated during the period 1/1/2017-6/30/2020 (“Post J. Crew, Pre Serta”) and during the period 7/1/2020-6/30/2022 (“Post Serta”); the excluded category is loans originated between 1/1/2016 and 12/31/2016 (“Pre J. Crew”). In columns (1) and (2), the dependent variable is an indicator that the contract fully blocks a dropdown transaction; in columns (3) and (4), the dependent variable is an indicator that the contract prevents the borrower from investing intellectual property (IP) in the unrestricted subsidiary, and the sample is restricted to loans that permit a dropdown transaction; in columns (5) and (6), the dependent variable is an indicator that the contract blocks an uptier transaction. The regressions in columns (2), (4), and (6) include additional control variables, which are standardized, and a set of industry fixed effects based on the Fama and French (1997) classification of the borrower’s SIC code. Robust standard errors are reported in parentheses. ** and * denote statistical significance at the 1% or 5% level, respectively.

	Blocks a dropdown transaction		IP Blocker		Blocks an uptier transaction	
	(1)	(2)	(3)	(4)	(5)	(6)
Post J. Crew, Pre Serta	-0.014	-0.049	0.060**	0.063*	0.065	0.011
	(0.054)	(0.053)	(0.019)	(0.031)	(0.051)	(0.055)
Post Serta	-0.058	-0.079	0.542**	0.497**	0.430**	0.373**
	(0.059)	(0.058)	(0.048)	(0.057)	(0.054)	(0.059)
Ln(loan amount)		-0.196**		-0.054		-0.099**
		(0.019)		(0.028)		(0.021)
Borrower debt / assets		-0.022		-0.01		-0.052
		(0.026)		(0.033)		(0.028)
Borrower ROA		-0.003		-0.003		0.029
		(0.018)		(0.026)		(0.019)
Intangible assets %		-0.018		0.025		-0.055
		(0.027)		(0.029)		(0.030)
Borrower sponsored		-0.287**		-0.011		-0.07
		(0.045)		(0.053)		(0.054)
Agent: small bank		0.079		0.019		-0.024
		(0.047)		(0.055)		(0.049)
Agent: nonbank		-0.176**		0.032		-0.138**
		(0.047)		(0.048)		(0.050)
Industry fixed effects	No	Yes	No	Yes	No	Yes
R-squared	0.002	0.260	0.331	0.363	0.126	0.209
N	664	576	325	288	664	576

Figure 1. The Dropdown

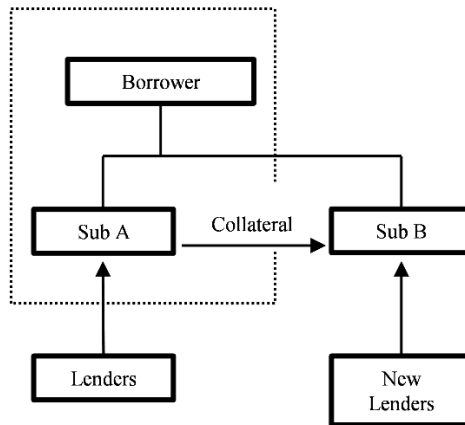


Figure 2. The Uptier

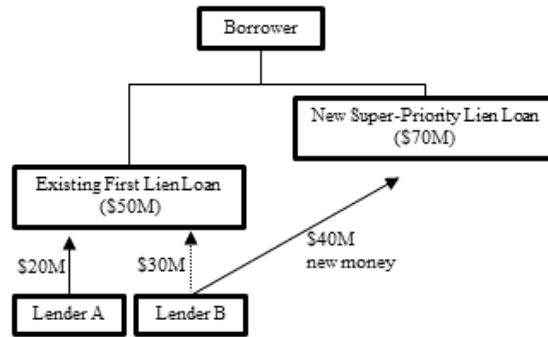


Figure 3. The Evolution of Dropdown Blockers

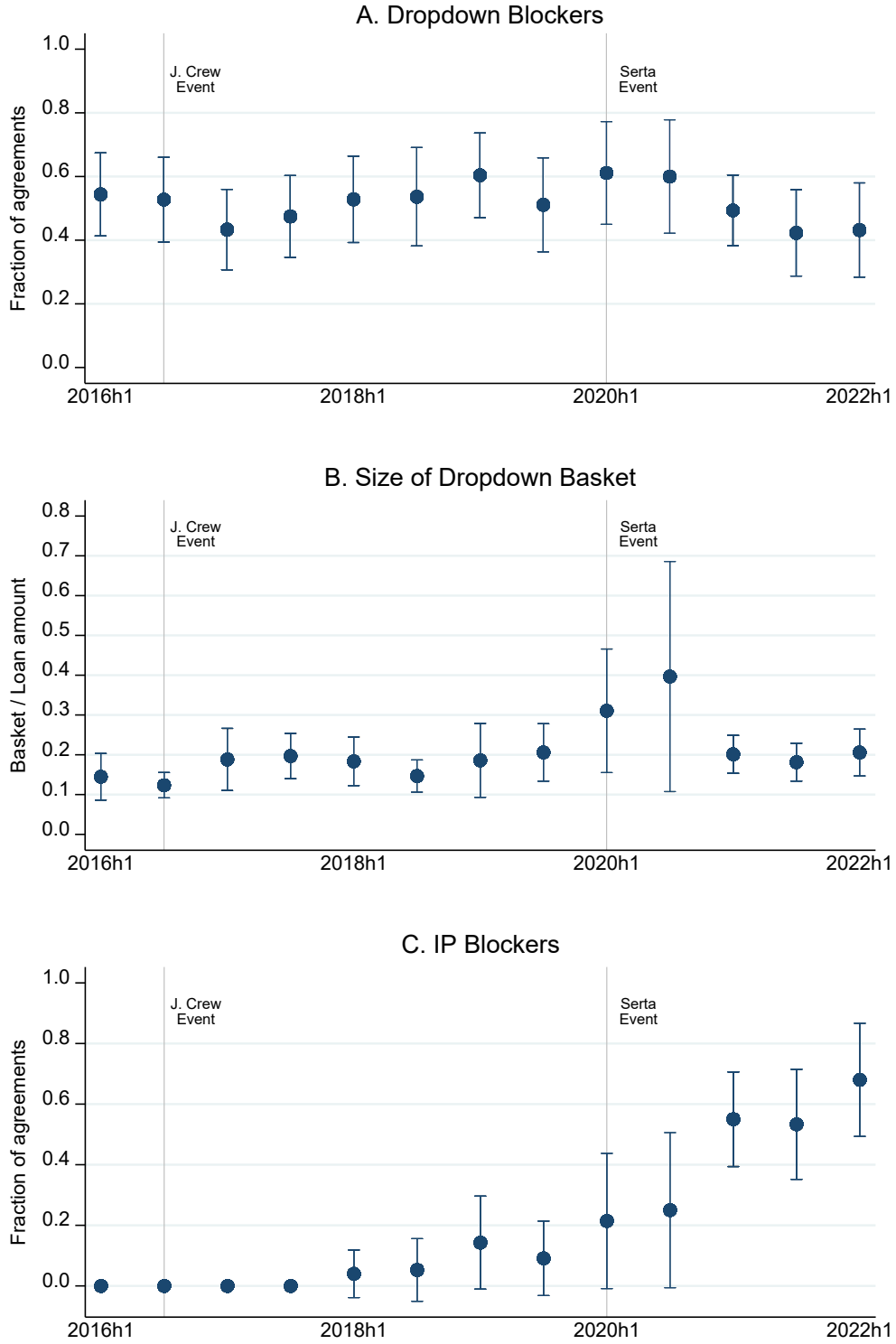


Figure 4. The Evolution of Uptier Blockers

