Efficacious Answers to the Non-Pro Rata Workout

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ABSTRACT—The lack of any comprehensive response to the emergence of non-pro rata refinancing transactions poses a theoretical as well as practical puzzle. Most investors seem to think that equal treatment of creditors in a bond or loan facility ought to orient workout negotiations, at least in most instances. Yet more than two years after a wave of non-pro rata transactions began, and despite evidence that clever lawyers may be able to circumvent structure-specific contractual "fixes," no effort to rule the transactions out of bounds *generally* has taken hold. Why not? Some see the episode as reason to doubt the debt markets' capacity to self-correct.

This essay offers a more optimistic account of the status quo. The persistence of non-pro rata deals may be a function of there being, ironically, too many, not too few, efficacious answers. Contract drafters, asset managers, and judges alike have the institutional means to put a stop to wealth-destroying non-pro rata transactions. The problem is that it is hard to know *a priori* whether the best responses will prove feasible. Because time can tell, the value-maximizing strategy for actors with the bluntest tools is to wait and see. Inaction—for a while—might thus reflect prudent institutional modesty rather than paralysis. A prediction follows: that courts or contract drafters will soon rule out non-pro rata deals generally if asset managers do not figure out how to deal effectively with such transactions on a case-by-case basis.

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I. Introduction

No recent development has so unsettled the world of distressed debt and restructuring as the non-pro rata workout. In a non-pro rata transaction, as in many conventional workouts, a distressed business seeks permission from creditors in one or more of its loan or bond facilities to incur super-senior debt with which to raise new money or restructure existing claims. The novel feature of non-pro rata deals lies in the inducement. In a conventional workout, the debtor offers consideration to all creditors who consent to the deal; in a non-pro rata transaction, only to a subset of creditors whose consent is sufficient to bind the facility.[1]

Most investors in the leveraged and distressed debt markets seem to think that the costs of non-pro rata transactions outweigh their benefits, at least in most instances. The immediate consequences of any given deal are mixed, of course. From the perspective of a debtor's incumbents and equity investors, the appeal of a discriminatory transaction is clear enough: the debtor gets relief from a liquidity crunch without having to invoke bankruptcy (where equity interests are typically wiped out),[2] and the creditors, as a group, can be expected to take a smaller piece of any refinancing surplus than they would in a pro rata deal.[3] Participating creditors likewise fare better than they could

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1 For excellent discussion of the coalitional dynamics such transactions produce, see Diane Lourdes Dick, Alliance Politics in Corporate Debt Restructurings (Nov. 12, 2022) (unpublished manuscript); and Douglas G. Baird, Financial Distress and Creditor Coalitions (Oct. 4, 2022) (unpublished manuscript).

2 *See* Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporation Reorganization*, 90 U. CHI. L. REV. _, _ (2023). Bankruptcy judges have also confronted non-pro rata tactics in recent years. *See* Phil Anker, Dan Kamensky, Sid Levinson, Jim Millar & Paul Silverstein, *The Peabody Award: Exclusive Opportunism in Bankruptcy*, CREDITOR RIGHTS COALITION (Oct. 23, 2022), https://creditorcoalition.org/the-peabody-award-exclusive-opportunism-in-bankruptcy/; Michael R. Handler, Arthur J. Steinberg & W. Austin Jowers, *The Pitfalls of Unequal Participation Rights in Syndicated DIP Financing*, AM. BANKR. INST. J. 24 (April 2022). Similar economic forces explain the emergence of non-pro rata deals in both contexts, but institutional responses may be quite different. Among other things, bankruptcy law's displacement of contracts lays greater stress on the judicial application of equitable principles. *See* Baird, Creditor Coalitions, *supra* note 1.

3 In principle, the debtor should be able to capture almost the entire surplus if it can effectively auction off between unstable creditor coalitions the right to be chosen as the favored group. *Cf.* Vincent S.J. Buccola, *Unwritten Law and the Odd Ones Out*, 131 YALE L.J. 1559, 1573–74 (2022).

expect to do otherwise. Only the creditors left out of the deal bear losses in the first instance. Nevertheless, there are good reasons—to be discussed—to think that the net effects of most non-pro rata transactions are negative.[4]

Viewed in this light, the failure of a comprehensive response to take hold more than two years after non-pro rata workouts exploded on the scene has caused some to despair. It is not that nothing has changed. Loan contracts originated today are much more likely than before 2020 to include language blocking the kinds of non-pro rata transactions that first appeared in the market.[5] But fatalists conclude, with some evidence, that clever restructuring lawyers will be able to circumvent narrow contractual fixes. On this view, the persistence of non-pro rata deals is indeed puzzling, because there are at least three evident routes by which market participants (broadly construed to include courts sitting in judgment of market activity) could shut down negative-value trades. In the primary market, contract drafters could provide that otherwise-valid amendments are void if the debtor offers an inducement to some but not all creditors in a facility. In distress situations, asset managers could agree with one another not to accede to facility-splitting offers. In litigation, judges could broadly construe long-established doctrines, especially the implied contractual duty of good faith and fair dealing, to rule out non-pro rata refinancings. The fact that none has emerged as part of a responsive equilibrium casts doubt on the debt markets' capacity to self-correct.

This essay offers a more optimistic interpretation of the status quo. It suggests that the persistence of non-pro rata deals may be a function of there being, ironically, too many, not too few, efficacious answers. When the feasibility of a preferred solution remains to be seen, unsatisfactory market dynamics can persist for a while despite the ready availability of second-best alternatives. One needn't conclude that the perfect is interposing as enemy of the good. Learning might just take time. The punch line is that prudent institutional modesty rather than paralysis may explain the lack of a comprehensive reaction to non-pro rata workouts.

The account turns on the twin difficulties of heterogeneity and non-verifiability. Granting that most non-pro rata deals are socially costly,

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4 *See infra* notes 36–38 and accompanying text (Part IV.A.1).

5 Vincent S.J. Buccola & Greg Nini, The Loan Market Response to Dropdown and Uptier Transactions (June 2022) (unpublished manuscript).

on net, it does not follow that all are. Dispensing with the presumption of equal treatment has advantages. For example, a debtor's willingness to favor a subset of creditors can overcome free-riding incentives that beset diffuse creditor bodies.[6] Where the advantages are especially pronounced, a non-pro rata workout may increase a debtor's enterprise value relative to realistic alternatives. Yet it is no easy task to distinguish between scenarios in which a non-pro rata workout is plausibly value-enhancing and those in which it is not. There are no obvious, verifiable markers on which contracting parties could settle at the time a loan agreement or bond indenture is drafted. Courts asked to weigh a contested transaction's permissibility face different, but still very substantial, epistemic problems.

The reluctance of contract drafters and courts to announce a generic prohibition is explicable to the extent that there is something to be gained from case-specific determination. The most efficacious equilibrium, if it is feasible, involves asset managers evaluating the merits of various possibilities ex post, when the particularities of a distressed situation become relatively clear: electing to participate in, or agreeing with one another to forswear, non-pro rata transactions according to their perceptions of the prospective value of each. Contract drafters and judges in this world do best by doing nothing, in effect deferring to the investors. The problem is that coalition formation may not prove feasible. Bondholders recently formed a cooperation pact in the Carvana case, but that situation may be unusual: the transaction costs of inter-creditor negotiations, even intra-facility, could be insuperable. If ex post agreements cannot produce a reliable signal about the economic merit of a given non-pro rata workout, then contracting parties or courts might preserve value by intervening to rule out the whole class of deals. But it takes time to find out which world is ours. For the institutions with relatively blunt tools, the predicament thus reveals itself to be a kind of optimal stopping problem the solution to which is to wait—for a while—to see whether asset managers' case-specific dealings can do the trick.

II. The Non-Pro Rata Phenomenon

For almost the entire history of tradable debt, the opportunity set for distressed businesses and their advisors has been structured by a

6 *See infra* note 39 and accompanying text (Part IV.A.2).

norm that the claims of creditors within a facility are to receive ratable treatment. A pro rata norm is explicit in bankruptcy reorganizations, where the equal treatment of claims in a class is perquisite to plan confirmation.[7] It is not, however, an invention of bankruptcy law. The laws introducing corporate reorganization to bankruptcy, in the 1930s,[8] largely codified emergent practices in the railroad receiverships,[9] where the bankers and lawyers who sought to restructure bonds solicited them from all holders willing to participate as a matter of course. The pro rata norm in bond workouts survived the Trust Indenture Act with minor exceptions.[10] Ratable treatment likewise became the norm in loan workouts when syndicated loans became an important part of corporate finance. Consent payments and other inducements from a borrower seeking forbearance or additional

7 11 U.S.C. § 1123(a)(4).

8 *See* Act of Mar. 3, 1933, § 77(b)(1) (authorizing plans to modify the claims of railroad creditor by class); Act of June 7, 1934, § 77B(b)(1) (authorizing broader set of corporations to modify the claims of creditor by class); *see also* Chandler Act, June 22, 1938, § 216(1) (carrying forward class-based modification of claims to new Chapter X).

9 For discussion of the legislation, see DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 101–09 (2001). To the extent codification had any effect on workout dynamics, it presumably reinforced the pro rata norm. *See, e.g.*, Jason Roderick Donaldson, Edward R. Morrison, Giorgia Piacentino & Xiabo Yu, Restructuring vs. Bankruptcy (2020) (unpublished manuscript) (providing a model connecting investors' expectations about bankruptcy to their willingness to restructure claims out of court).

10 Because of the Trust Indenture Act, § 316(b), the restructuring of most publicly traded bonds cannot be accomplished through a consent solicitation alone. *See generally* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987). Instead, issuers typically offer to exchange outstanding bonds for new securities with more agreeable terms and often couple the exchange with amendments stripping any bonds not exchanged of valuable indenture protections. The SEC's "all holders" rule, which governs tender offers for equity securities, does not apply to offers for debt securities. Exchange Act Reg 14D. Consequently, distressed issuers have long had the legal ability to effect non-pro rata *bond* restructurings. Nevertheless, the norm has been to make ratable exchange offers except to the extent that some holders' participation would foreclose an SEC registration exemption. Astute observers saw the possibility that an issuer might abuse its legal ability to offer an exchange on a non-pro rata basis but found no evidence of it happening. *See, e.g.*, Marcel Kahan & Edward B. Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. U. L. REV. 281, 306–07 (2009) (noting that the authors, after researching the possibility, "ha[d] found no instances" of an activist fund negotiating superior terms to fellow holders).

financial flexibility might be negotiated with a designated "lead bank" but would go to the consenting lenders on a ratable basis. Such was the power of a commercial norm of reciprocity among banks that it scarcely mattered whether pro rata treatment was contractually mandated.[11]

Starting in the late-2010s, however, distressed businesses began to flirt with refinancing transaction that would favor some investors in a credit facility over others.[12] If a company seeking additional liquidity needs the consent of only 51 percent (by value) of the creditors in a facility, the company's shareholders are self-evidently better off if it the 49 percent whose consent is legally irrelevant needn't be compensated. The clothier Not Your Daughters Jeans sought to make good on this logic in 2017, when it announced a non-pro rata deal with a bare majority of its lenders.[13] When disfavored lenders filed a complaint, however, the company reversed course and offered a revised deal to its lenders on a ratable basis.[14]

The Covid-19 pandemic marked a decisive break with past practice. In quick succession during the summer of 2020, three companies devastated by the pandemic—Serta Simmons, TriMark, and Boardriders—closed similar non-pro rata refinancings.[15] Two essential features defined these so-called "uptier exchanges": (1) a bare majority of lenders in each secured facility consented to a loan amendment that would permit the borrower to issue additional debt through a new facility that would subordinate existing liens; and (2) the borrower, in consideration for the favored lenders' consents, agreed to exchange

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11 Elisabeth de Fontenay, *The $900 Million Mistake:* In re Citibank *August 11, 2020 Wire Transfers (SDNY 16 February 2021)*, 16 Cap. Mkts. L.J. 307 (2021).

12 Non-pro rata workouts thus emerged as part of a more general trend, already the subject of an extensive literature, of aggressive priming transactions. *See, e.g.*, Buccola & Nini, *supra* note 5; Buccola, *Sponsor Control*, *supra* note **Error! Bookmark not defined.**; Stephen J. Lubben, *Holdout Panic*, 96 AM. BANKR. L.J. 1 (2022); Diane Lourdes Dick, *Hostile Restructurings*, 96 WASH. L. REV. 1333 (2021); Kenneth Ayotte & Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 YALE L.J.F. 363 (2021); Mitchell Mengden, *The Development of Collateral Stripping by Distressed Borrowers*, 16 CAP. MKTS. L.J. 56 (2021); Robert K. Rasmussen & Michael Simkovic, *Bounties for Errors: Market Testing Contracts*, 10 HARV. BUS. L. REV. 117, 141–48 (2020); Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745, 759–62 (2020).

13 *See* Dick, *Hostile Restructurings*, *supra* note 12.

14 *Id.*

15 *See* Buccola, *Sponsor Control*, *supra* note **Error! Bookmark not defined.**.

some of the to-be-issued, super-priority loans for existing loans at a ratio implying an above-market price.[16]

In the two years since, restructuring advisors have engineered formally distinctive transactions with similar economic significance. Incora brought the uptier exchange to the world of secured bonds.[17] TPC Group closed a non-pro rata uptier that lacked an exchange component. As in the earlier transactions, TPC offered a subset of creditors superior treatment in exchange for their consenting to the company's issuance of new, priming debt. But TPC compensated the consenting creditors with an exclusive right to fund the new facility at an above-market rate rather than by offering to exchange their existing debt for new, senior instruments.[18] Envision Healthcare devised a non-pro rata version of the "dropdown" transaction first made infamous by J. Crew. Unlike in J. Crew and other, similar instances, however, Envision needed lender support to transfer assets into an unrestricted subsidiary. Without support the transaction might not have survived a challenge. In the event, a formal amendment of the company's loan agreement proved unnecessary. Envision was able to peel off enough of its potentially litigious lenders, by offering them superior rights to participate in the new capital structure, that the result became a fait accompli.[19]

Investors have pushed back on non-pro rata transactions in a couple of ways. One way is in the courts. Disfavored creditors, relying on explicit terms of their debt instruments as well as on general legal principles, have challenged the validity of every non-pro rata deal save one (Envision Healthcare). The other way is in the primary loan market. After Serta Simmons, TriMark, and Boardriders, lenders began flyspecking new contracts for their susceptibility to an uptier exchange. A study of publicly available leveraged loan contracts found

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16 *See* Buccola & Nini, *supra* note 5, at _ (providing detail on transaction structure).

17 Complaint, SSD Investments Ltd. v. Wilmington Savings Fund Society, FSB, Sup. Ct. N.Y. (New York County) (Oct. 31, 2022).

18 Bayside Cap. Inc. v. TPC Grp. Inc. (*In re* TPC Grp. Inc.), 2022 WL 2498751, at *1–6 (Bankr. D. Del. July 6, 2022).

19 Max Frumes & Evan DuFaux, Envision Rewrites Book on Liability Management Exercises 3–4 (Sept. 12, 2022). Envision also did a standard uptier exchange. *Id.* at 5–6.

that the fraction of new loans blocking that particular transaction nearly doubled, to approximately 70 percent, in the year after Serta.[20]

Nevertheless, many market participants seem resigned to a future in which intra-facility coalition formation is an important feature of workouts. Litigation has failed so far to produce decisive judgments that might chasten distressed borrowers. The TriMark case settled;[21] the challenge to TPC Group's uptier was rejected on the merits;[22] the other disputes are still pending. Meanwhile contractual changes do not articulate broad principles. New terms may effectively rule out one specific transactional form at a time, but the concern remains that modern loan contracts are full of loopholes just waiting for a clever lawyer to exploit.[23] The fact that multiple structures have already been devised to accomplish similar aims underscores the sense that contractual "patches" may start to resemble so many Maginot Lines. Dispirited investors don't care about blocking any one transactional form. They want to arrest the dynamics that underlie non-pro rata refinancings generally.

III. Three Plausible Responses

From a theoretical perspective, the status quo presents a puzzle. If so many in the market believe, as they seem to, that non-pro rata workouts are, in general, socially costly, why do they persist? The status quo would be explicable if potential remedies were outlandish. But there are at least three plausible ways that institutional actors with a stake in the leveraged finance world could address non-pro rata transactions generally.

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20 Buccola & Nini, *supra* note 5, at *35 (fig. 3).

21 TriMark USA Announces Resolution of Litigation with Its Lenders, PR Newswire (Jan. 7, 2022), https://www.prnewswire.com/news-releases/trimark-usa-announces-resolution-of-litigation-with-its-lenders-301456561.html.

22 Bayside Capital Inc. v. TPC Group Inc. (*In re* TPC Group), No. 22-10493 Adv. Proc. No. 22-50372 (CTG) (Bankr. D. Del. July 6, 2022) (holding that no provision of the indenture entitled noteholders to participate in new financing opportunities pro rata).

23 For a model in which loopholes are an inevitable byproduct of contractual complexity, see Kenneth Ayotte & Adam B. Badawi, Loopholes in Complex Contracts (May 17, 2022) (unpublished manuscript).

A. Ex Ante Contracts

First, loan agreements and secured bond indentures could deploy broad language to rule out non-pro rata workouts altogether. The simplest way to do so would be to condition the validity of proposed amendments on the debtor offering any inducement to all affected creditors in a facility on a pro rata basis. The practice of favoring a subset of creditor arises only because a debtor needs a facility's approval to do what it wants. The existing contract doesn't allow the debtor to incur new, senior debt, say, and the cheapest way to get approval is to seek it from as few creditors (by value) as possible. Ruling out that means of procuring consent would unwind the whole dynamic.

A proof of concept exists in high-yield bond indentures. Many indentures require the issuer to offer consent payments to all holders willing to consent on an equal basis. Indeed, a 1993 study of the privately placed notes found such a rule in approximately 60 percent of issuances.[24] Standard terms supply a rough-and-ready template:

> The Company shall not, and shall not permit any of its Restricted Subsidiaries to, directly or indirectly, pay or cause to be paid any consideration to or for the benefit of any Holder of Notes for or as an inducement to any consent, waiver or amendment of any of the terms or provisions of this Indenture or the Notes unless such consideration is offered to be paid and is paid to all Holders of the Notes that consent, waive or agree to amend in the time frame set forth in the solicitation documents relating to such consent, waiver or agreement.[25]

Broader language might be preferred. Typical indenture language covers only *payments* to creditors. It does not obviously cover other, functionally similar forms of inducement, such as an exclusive right to fund a new loan or securities offering at an attractive price or an offer to exchange for a new instrument that embeds favorable terms. Contract drafters aiming to end the non-pro rata workout would want

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[24] Marcel Kahan & Bruce Tuckman, *Private v. Public Lending: Evidence from Covenants* 19 (Anderson Graduate School of Management Working Paper 13-93, 1993). The authors saw the economic rationale clearly: "Intra-claim conflicts can explain this prohibition for, *without the prohibition, an issuer can reach an agreement with a few large lenders and pay only them for consenting*. All non-participating lenders, while bound by the covenant changes, would receive no compensation." *Id.*

[25] This language is taken from one of Windstream's indentures. Section 4.17, Windstream Corp. 6-and-3/8% Senior Notes, Indenture (Jan. 23, 2013).

to be capacious. But the point is clear enough: contract drafters have a conceptually simple means with a track record of adoption by which they could end non-pro rata workouts altogether.

B. Ex Post Agreements

Second, asset managers with investments in a facility at risk of being split could agree with one another not to participate in any refinancing agreement unless its benefits are open to all on a pro rata basis. Fear is one reason creditors might consent to such a deal. Absent coordination, a creditor generally opposed to a non-pro rata deal may worry that the alternative to being included in a favored subset of creditors is simply to be excluded from it. A deal binding each relevant creditor not to defect from a pro- rata norm could bring certainty.

Cooperation agreements of this sort have an impeccable Coasean logic.[26] To object to a non-pro rata transaction on the ground that it is commercially unreasonable is to insist that another way of resolving the debtor's financial distress can be expected to yield an enterprise of greater value. Perhaps a bankruptcy could reset the company's capital structure or operational footprint in a way that a kick-the-can transaction cannot. In any case, the premise of the commercial objection implies that a latent surplus is available to be split among creditors if they can resist the impulse to defect. Holders of Carvana unsecured notes recently agreed to a deal of this sort.[27]

C. Principle-Based Judicial Doctrines

Third, judges presiding in cases challenging the validity of refinancing transactions could invoke principle-based doctrines, most obviously the implied duty of good faith and fair dealing, to cabin some

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[26] *Cf.* Vincent S.J. Buccola, Jameson K. Mah & Tai Zhang, *The Myth of Creditor Sabotage*, 87 U. CHI. L. REV. 2029, 2047–61 (2020) (developing analogous argument in the context of net-negative CDS plays).

[27] Davide Scigliuzzo & Eliza Ronalds-Hannon, "Apollo, Pimco in Pact to Prevent Creditor Brawl over Carvana," BLOOMBERG (Dec. 6, 2022), https://www.bloomberg.com/news/articles/2022-12-07/apollo-pimco-sign-pact-to-prevent-creditor-brawl-over-carvana?sref=5E0omnkx&leadSource=uverify%20wall&mc_cid=1234008223&mc_eid=a66349ad59

or all non-pro rata workouts.[28] Lenders challenging the troika of uptier exchanges executed in the Summer of 2020 have asserted a good-faith-and-fair-dealing theory in their respective cases. The judges in two instances, *Serta Simmons* and *Boardriders*, have denied motions to dismiss the lenders' broad logic but have not opined on the merits.[29] The precedential force of a decision (or series of decisions) subsuming some kind of pro rata norm in a contractual debtor's duty of good faith and fair dealing would blunt the non-pro rata trend—especially if judges not only award damages but express willingness to enjoin non-pro rata transactions.

Existing law does not obviously compel a broad pronouncement, to be sure. The modern judicial approach is wary of principle-based intervention, including under the heading of good faith and fair dealing, into commercial transactions that have a highly articulated contractual

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[28] Two other principled doctrines might offer relief but are less promising. Fraudulent conveyance law promises to avoid transfers or obligations designed to delay, hinder, or defraud creditors. It's not crazy to argue that liens granted to secure new debt offered on a non-pro rata basis are voidable insofar they can benefit a distressed company's shareholders only because they reduce the prospect of some creditors' full recovery. But there are important obstacles to a good fraudulent conveyance challenge. Among other things, well-counseled directors should in most instances be able to testify plausibly that they believe a non-pro rata refinancing would maximize enterprise value, not just transfer value from disfavored creditors to favored creditors and shareholders. Fiduciary duty claims are likewise possible but also not an obvious fit. First and foremost, Delaware courts have no fundamental problem with company treating investors in a class differently. *See* Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). Second, it might prove costly and time-consuming just to get through the gating function that allows creditor suits only if the company is insolvent. *See* N. Am. Catholic Educ. Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007). Judges would have to buck a trend here. *See* Jared A. Ellias & Elisabeth de Fontenay, *Law and Courts in an Age of Debt*, 171 U. PA. L. REV. ___ (forthcoming 2023) (arguing that courts have largely closed the doors on fiduciary-styled claims raised by financial creditors, channeling such grievances through contract law).

[29] LCM XXII Ltd. v. Serta Simmons Bedding, LLC, No. 21 Civ. 3987 (KPF), 2022 WL 953109 *14–16 (S.D.N.Y. Mar. 29, 2022); ICG Global Loan Fund 1 DAC v. Boardriders, Inc., No. 655175/2020, 2022 WL 10085886 *23–24 (N.Y. Sup. Ct. Oct. 17, 2022). The judge in the TriMark case dismissed a good faith and fair dealing theory but did so on the ground that the relief such a claim would allow would duplicate relief available to the plaintiffs on a sound theory of a specific contractual obligation. Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., 150 N.Y.S.3d 894, 2021 WL 3671541 *13 (N.Y. Sup. Ct. Aug. 16, 2021).

substructure.[30] Indeed, a couple of important decisions in the bond context cast doubt on the idea that the doctrine embeds any notion of equal treatment. In one such case, then-Vice Chancellor Strine concluded from the fact (discussed above) that some indentures include a covenant barring discriminatory consent payments that judges should beware finding an analogous principle underlying textual silence.[31]

That said, the doctrinal footing for such a judgment is secure even if not inevitable. There is a long tradition in American law of judges applying equitable principles sounding in pro-rata treatment to override explicit terms in debt instruments.[32] No less a commercial law legend than Chancellor Allen suggested in a pair of important bond restructuring cases that that an equal-treatment principle may give content to the obligation of good faith and fair dealing. In *Katz v. Oak Industries*,[33] a creditor challenged the emerging practice of exit consents—that is, an issuer's conditioning eligibility to participate in an exchange offer on a bondholder's consent to stripping covenants from the indenture *on its way out*, so to speak. Allen famously upheld the exit consent. Few remember, however, that in doing so he reserved judgment on a hypothetical not presented. Allen concluded that

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30 *See* Lubben, *supra* note 12 (arguing that over time the balance of power in restructuring law has tipped toward majorities, at the expense of minority holdout rights).

31 *In re* Loral Space & Commc'ns Inc., No. CIV.A. 2808-VCS, 2008 WL 4293781, at *3 (Del. Ch. Sept. 19, 2008) ("The implied covenant in a bond indenture is not a license for judges to invent market terms that should act as a default rule simply because plaintiffs or the judge think that would be a good thing. Bond indentures are carefully negotiated instruments filled with many restrictions. Therefore, courts should be chary in assuming that there are gaps to be filled, particularly when parties actually considered the question and the agreement ultimately reached incorporated no restriction on the rights of the issuer to bargain with a large holder for its consent."). More recently, in 2016, a decision out of the Southern District of New York held that a bond exchange offer open only to investors meeting the SEC's definition of a Qualified Institutional Buyer or who were non-U.S. persons was consistent with the implied covenant. Waxman v. Cliffs Nat. Res. Inc., 222 F. Supp. 3d 281, 295–96 (S.D.N.Y. 2016).

32 For example, there is a long history of judges setting aside clearly drafted "no action" clauses on the ground that their enforcement would allow some creditors in a facility to recover more than others. *See, e.g.*, Linder v. Hartwell R. Co., 73 F. 320 (Cir. Ct. N.D. Ga. 1896); Cochran v. Pittsburg, Shawmut & Northern R. Co., 150 F. 682 (Cir. Ct. W.D.N.Y. 1907); Wier v. Bauer, 286 P. 936 (Utah 1930).

33 508 A.2d 873 (Del. Ch. 1986).

transactions like the one at issue in *Oak Industries* were consistent with an issuer's obligation of good faith and fair dealing only if "the inducement is offered on the same terms to each holder of an affected security."[34] Six months later, in *Kass v. Eastern Airlines*, Allen again heard from a bondholder seeking to restrain an issuer from offering cash payment for an amendment—this time not in the context of an exchange offer. Allen said it was no violation of good faith and fair dealing to offer cash for an amendment but opined that holders *could* have blocked the transaction if Eastern had "not made its offer to all bondholders on the same terms, but had [] privately paid money to sufficient holders to carry the election."[35]

IV. ACCOUNTING FOR THE STATUS QUO

A more optimistic account of the institutions of leveraged finance can also explain the status quo. On this account, contract drafters and judges are sensibly—perhaps even optimally—waiting for information about the efficacy of asset managers' "ex post" interventions. The core idea is reminiscent of an optimal stopping problem. Everyone can see that the ideal approach to non-pro rata workouts would involve asset managers coordinating on a case-by-case basis, but contract drafters (and perhaps judges) are unsure whether such coordination is practically realistic. Only time can tell, and for that reason optimal response for less nimble actors may be to wait and see.

Two propositions underlie the account and are worth exploring: first, that the economics of non-pro rata workouts are ambiguous, even if on average the transactions are socially costly; and second, the efficacy of the various responses described above, especially those of the asset managers, are not immediately clear.

A. Ambiguous Economics of Non-Pro Rata Workouts

The difficulty in locating an optimal response starts with the ambiguous economic logic of non-pro rata dealings. An equal treatment norm has important advantages. They are probably significant enough to justify such a norm *in general*. But some non-pro rata refinancings

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34 508 A.2d at 881.

35 Kass v. Eastern Airlines, Inc., 1988 WL 13008 at *5 (Del. Ch. Nov. 14, 1986).

may have net social benefits. If that is so, then a first-best world would allow the socially advantageous transactions to close and block the rest.

1. *The Advantages of a Pro Rata Norm*

A world in which debtors seeking relief from financial constraints must compensate consenting creditors in a facility pro rata entails a number of benefits relative to a world in which agreement with a subset of creditors can bind a whole facility. Three items stand out and together probably justify a presumption that workout offers ought to be pro rata.

Ameliorating creditor incentives to jockey for position is the most obvious benefit of an equal treatment norm. Distributional disparities are inherent to non-pro rata refinancings, whether or not in some cases they might maximize a debtor's enterprise value (on the possibility of which, see more below). By definition, the favored creditors do better than the disfavored ones. That being so, creditors have good reason to compete to be in a favored group, or at least to avoid being in a disfavored group. In a world of non-pro rata workouts, asset managers must devote substantial resources to locating contractual threats and opportunities, assembling coalitions, and lobbying debtor management for favorable treatment.[36] From a social perspective, this is pure deadweight loss.

For related reasons, an equal treatment norm allows small and illiquid investors to participate in distressed situations. If a company is inclined to do a non-pro rata refinancing, it is easiest to make the deal with a small number of investors who not only can muster the votes to bind their facility but also can supply new money to fund any need for cash. There is no reason for the company or a nascent creditor coalition to include a two-bit hedge fund. Funds lacking the clout or personal relationships to be an attractive coalition partner thus may exit the distressed investing landscape if non-pro rata transactions become frequent.

The third virtue of an equal treatment norm is subtler but might be the most important of all: namely, the norm serves as a kind of

[36] The Serta Simmons litigation revealed the kind of lobbying that has become standard. *See* North Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC, 2020 WL 3411267, *2 (N.Y. Sup. Ct. June 19, 2020) (noting that plaintiff lenders challenging the uptier exchange had previously proposed a refinancing transaction from which they themselves would have benefited nonratably).

epistemic filter, permitting to close only those refinancing transactions that can be expected to increase the debtor's enterprise value relative to the likely counterfactual (a Chapter 11 reorganization, for example). A non-pro rata workout can "succeed" even if destroys enterprise value.

An illustration can make the intuition concrete. Consider a company with a single equity investor with effective control and a single tranche of debt—100 bonds each with a face value of $10, secured by a lien on all of the company's assets. The bonds are maturing, and the company lacks the cash to retire them.

Suppose first a scenario in which the company faces a simple liquidity problem. The business will be worth $800 if it has to liquidate but either $1300 or $800 (with equal probability) if it can raise $200 of new, senior money to avoid bankruptcy. The bondholders' lien creates a debt overhang. New financing is impossible unless a majority of the holders agree to subordinate their lien. The pro-social result is a deal: the refinancing carries an expected value of 50. And a ratable deal is compatible with each investor's self-interest. A transaction in which the company offers consenting bondholders a new security worth between $8–$8.50 is a Pareto improvement.

Contrast that happy case with a scenario in which the company's economic prospects are bleak. If it can raise the $200 to postpone bankruptcy, the business will be worth either $1300 or $800 (with equal probability). The pro-social result is liquidation. Continuation is expected to cause a loss of $50. And no deal is possible if the company must make offer the bondholders consideration pro rata. The maximum pro rata offer it can make is $7.50.[37]

The screening mechanism logic does not hold, however, absent an equal treatment norm. To subordinate the existing lien and thereby access new money, the company needs the consent of—needs to be able to offer more than $8 to—only six of the bondholders (epsilon more than 50 percent). There is an easy solution. The company seeks

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[37] To be sure, an equal treatment norm is not a perfect screen. The theoretical possibility of a so-called "coercive" restructuring offer is well known. *See, e.g.*, John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207 (1991). But that seems to be a second-order problem, at worst. *See* Sri Chatterjee, Upinder S. Dhillon& Gabriel G. Ramirez, *Coercive Tender and Exchange Offers in Distressed High-Yield Debt Restructurings: An Empirical Analysis*, 38 J. FIN. ECON. 333 (1995).

consent to create two new tranches of debt supported by a priming lien: a first-out tranche for the new-money commitment and a second-out tranche to be exchanged for the cooperating holders' bonds. A deal is incentive compatible if the company offers to exchange each of the six existing bonds for a new, second-out bond with a face value between \$8–\$11.66.[38] The disfavored bondholders eat the social loss. Before the transaction, their bonds were worth 80 cents on the dollar. Now, depending on the terms of the deal, they can expect to recover 50–63 cents. Indeed, the fact that the disfavored bondholders do worse in the case of a "successful" restructuring than they would do in liquidation implies that the *favored* bondholders might accept securities worth less \$8. Better to be in the in-group and have something worth, say, \$7 than to be stuck with the out-group and a bond worth \$5.

It does not, of course, follow that all non-pro rata workouts disguise a negative-value continuation. But verification can be difficult. Dispensing with an equal treatment norm means doing without the value of its information-producing properties.

2. *Its Potential Costs*

On the other hand, non-pro rata refinancing transactions offer at least three possible benefits that could make such a transaction value-maximizing in some circumstances.

One advantage is that non-pro rata deals can ameliorate a free-rider problem that may plague some creditor bodies when a facility's debt is widely held. Plainly negotiations between a debtor and one creditor, or a small group of creditors, are cheaper than multilateral negotiations. Investors can economize on out-of-pocket costs by deputizing one or a small committee of creditors to represent the relevant facility. That has worked reasonably well in the past. Loan syndicates, for example, relied on a "lead bank" to monitor the borrower and decide when and under what circumstances a waiver or modification of the loan was appropriate. But monitoring and renegotiation are costly tasks. In an era of reciprocity, when one banker could take the lead on one deal and another on another, the reputational value of a job well done offset the expense. Now, though, when any given lending syndicate may be

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[38] One way to think about the significance of class splitting is to see that the debtor turns as many of its creditors as possible into "legacy" investors. *See* Buccola, *Unwritten Law*, *supra* note 3, at 1573–79 (discussing treatment of legacy claims).

composed of several hundred lenders, heterogeneous institutionally and with respect to investment strategy, reciprocity cannot be expected to work as it once did. Under a pro rata norm, each lender has an incentive to free ride on the deal another makes. But monitoring and dealmaking are valuable. One justification for refinancing transactions that treat some similarly situated creditors better than others is that they are not *identically* situated. Non-pro rata transactions can be used to compensate more active creditors for their work.

Non-pro rata refinancings may preserve valuable capital investment in some instances. It is tempting to suppose that the alternative to a non-pro rata workout is a pro rata workout or, failing that, perhaps a Chapter 11 reorganization. The question becomes the relative merits of each. But the relevant counterfactual might be something quite different. Restructuring financial debts and raising new capital are not the only ways for a financially stressed company to enhance liquidity. Reducing capital investment is another way. To the extent a distressed business is looking out for the interests of an equity sponsor or other controlling shareholder, it may prefer reducing (even NPV-positive) investment to bankruptcy.[39] Insisting on an equal treatment norm can thus be expected to cause some companies to disinvest inefficiently.

Finally, in the bond context specifically, a non-pro rata exchange offer can save the time and money that would be needed to register new securities with the SEC. An exchange offer in which an issuer's outstanding bonds are to be swapped for newly created instruments is a securities offering. Rule 144A and Reg S furnish oft-used exemptions to the registration requirement that applies to public offerings.[40] The rules allow issuers to treat an exchange offer as a private placement not subject to registration if it is open only to qualified institutional buyers and non-U.S. holders. But that implies that U.S. holders other than QIBs must be left out of the transaction.

B. Uncertain Feasibility of the Most Efficacious Answers

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39 *See* Buccola, *Sponsor Control*, *supra* note **Error! Bookmark not defined.**, at _.

40 *See, e.g.*, WACHTELL, LIPTON, ROSEN & KATZ, DISTRESSED INVESTING, MERGERS & ACQUISITIONS: AN OVERVIEW OF THE LEGAL LANDSCAPE FOR ACQUIRORS AND INVESTORS 14 (2022).

1. The best way to address non-pro rata workouts, assuming it is feasible, is for asset managers to decide on a case-by-case basis whether the advantages of dispensing with an equal treatment presumption outweigh the costs.

Par buyers of a company's bonds or loans have less information about the company's prospects, conditional on distress, than do the investors holding the bonds or loans when the company actually faces distress. Judges, for their part, are better positioned than par investors, in the sense that they act ex post, but facts-and-circumstances litigation is both costly and error prone.

Contract drafters and courts who want to block value-destroying non-pro rata workouts are thus stuck with *more or less* broad propositions that also block value-increasing transactions. (There is some wiggle, but to say they have a binary option is okay at first approximation.)

2. Contract drafters or judges who seek to maximize enterprise value (minimize the cost of high-yield debt capital) should do nothing if they think asset managers can reliably produce a more precise signal of value.

There is a Coasean bargain in which asset managers agree not to participate in non-pro rata negotiations when they perceive that the costs of such a transaction outweigh benefits. (Whether such a deal is a cooperation agreement backed by formal sanctions or a tacit norm backed by informal sanctions is not important.) And, again per Coase, there is no such bargain to be struck when the conditions are vice versa.

It follows that if contract drafters and judges anticipated a zero-transaction-costs world, they would not want to intervene.

3. But contract drafters and judges don't know how significant the obstacles to asset managers are likely to be.

The hurdles to deal making are non-negligible.

If it is infeasible for asset managers to produce a reliable signal, then another institution will want to intervene with a relatively broad (and thus insensitive) rule.

4. If contract drafters and judges expect to learn about the feasibility of a case-by-case approach, their optimal strategy is to wait and see for a while.

Optimal stopping theory is all about this kind of decision.

How long they should wait isn't obvious. It depends on their estimate of the frequency of value-enhancing transactions, the magnitude by which they are better than the alternative (when they are better), and the sensitivity of a case-by-case signal.

I'm not contending that anyone has worked out a formal model. The point is just that *inaction* for a few rounds of distress resolution may well be a sign of market efficiency rather that, as many suppose, its opposite.

V. CONCLUSION

[...]