

ARTICLES

Sponsor Control: A New Paradigm for Corporate Reorganization

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Bankruptcy scholars have long organized their field around a stylized story, a paradigm, of lender control. When lenders extend credit, the story goes, they insist on the borrower agreeing to strict covenants and granting blanket liens on its assets; then, if the borrower later encounters financial distress, they use their bargained-for rights as prods to steer the company toward a resolution favorable to themselves, whether or not that resolution is value maximizing for the investors as a group. As fruitful as the lender-control heuristic has been, however, it no longer corresponds to reality.

This Article introduces a new interpretive paradigm that better accounts for a changed world. Today, more often than not, equity sponsors rather than senior lenders have practical control over the way that distressed companies respond to their financial problems. Lenders no longer hold the big sticks that they once wielded to establish precedence, and the people guiding today's modal large, distressed business have powerful incentives to preserve the value of sponsor investments. The predictable effect of the new locus of control has been to stand familiar restructuring dynamics on their head. Indeed, a number of seemingly unconnected trends in reorganization practice may best be understood as resulting from sponsors' first-order incentives to postpone a reckoning that might crystallize losses. Identifying the dynamics of sponsor control thus promises to shed light on a variety of scholarly and policy debates around corporate reorganization.

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INTRODUCTION

By common account, two contrasting eras have defined large-scale corporate reorganization since the Bankruptcy Code was enacted in 1978.¹ For much of the Code’s first twenty years, incumbent managers dominated the process. They chose when to invoke Chapter 11 on a company’s behalf. They were difficult to unseat once there and, with the help of indulgent bankruptcy judges, could cause proceedings to drag on for years.

Starting in the late 1990s, however, reorganization practice underwent a marked shift. The formal law of bankruptcy had not changed, but Chapter 11 cases were proceeding differently. Incumbent managers were being fired.² Debtors were relying on bankruptcy-specific loans to fund their time in Chapter 11 and could no longer linger indefinitely.³ Cases were concluding more

¹ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended in 11 U.S.C.).

² See Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 522–23 (2009).

³ See David A. Skeel, Jr., *Creditors’ Ball: The “New” New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 923–26 (2003) [hereinafter Skeel, *Creditors’ Ball*]; Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 784–85 (2002) [hereinafter Baird & Rasmussen, *The End of Bankruptcy*].

rapidly, often through a quick sale of the business as a going concern.⁴

To account for these new realities, leading commentators developed a stylized story, or paradigm, centered on lender control.⁵ When advancing credit to a leveraged borrower, senior lenders had begun taking a “blanket” lien on the borrower’s assets and insisting on tightly calibrated covenants designed to be breached at the first sign of trouble. These newly standard terms could be expected to give lenders clout if the borrower’s financial condition were to deteriorate. Lenders would not have de jure power to manage the business, but the prospect of their exercise of remedies would hang like a sword over the borrower and induce management to resolve distress in ways favorable to the lenders. A new pattern in the financing of leveraged but otherwise healthy businesses had thus given rise to a new power dynamic in distress.⁶

Changes in reorganization practice made sense under this lens. In general, a lender whose collateral might deteriorate wants its borrower to resolve distress quickly and in a manner that turns the lender’s claim on an uncertain future into cash today.⁷ For such a lender, the future is to be feared. If the borrower performs well, the lender has little to gain, because it can recover no more than the face amount of its loan. But if the borrower performs poorly, then the lender has everything to lose, because there is no getting blood from a stone.⁸ From this perspective, the emerging pattern of distress resolution—a series of waivers and loan amendments to remedy covenant breaches followed, if necessary, by a speedy bankruptcy directed toward either a sale of the business or a plan extinguishing the claims of junior investors—appeared quite close to what lenders would choose if they

⁴ See Skeel, *Creditors’ Ball*, *supra* note 3, at 925–26; Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 12, 12 (2003); Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 3, at 784–85.

⁵ See, e.g., Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1227–31 (2006) [hereinafter Baird & Rasmussen, *Private Debt*]; see also *infra* notes 42–69 and accompanying text.

⁶ See Skeel, *Creditors’ Ball*, *supra* note 3, at 921–33; Warren & Westbrook, *supra* note 4; Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 3, at 779–85.

⁷ See Anthony J. Casey, *The Creditors’ Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 761 & n.5 (2011).

⁸ See, e.g., Zohar Goshen, Richard Squire & Felix Steffek, *The Law of Corporate Debt: A Unifying Theory* 4–6 (Nov. 24, 2021) (unpublished manuscript) (on file with author) (describing generic creditor-shareholder conflict).

had formal control rights.⁹ The lender-control paradigm thus joined theory with practice, and it has dominated scholarship and set the terms of policy debates ever since.

Over the last decade, however, reorganization practice has once again decoupled from the prevailing model. A move out of court, so to speak, has been the most striking change. Increasingly, distressed companies seek to raise new capital and restructure old debts without recourse to bankruptcy. Such recapitalization transactions are often directly contrary to the interests of senior lenders. The recent vogue for contentious “liability management” transactions that subordinate ostensibly first-lien loans would have been unimaginable fifteen years ago and is impossible to square with a regime of lender control.¹⁰ Trends in Chapter 11 practice likewise signal a shift in the locus of power. For example, the extensive use of multilateral agenda-setting devices known as restructuring-support agreements (RSAs) fits uncomfortably with the notion that lenders tacitly run the show.¹¹

This Article introduces a new organizing paradigm that better explains a broad range of cases. The central observation is that financial sponsors,¹² not lenders, now frequently shape the path by which financially troubled companies resolve distress. By developing an account of the new balance of power—its causes and consequences—this Article helps to explain otherwise inexplicable and seemingly unconnected developments in reorganization practice.

The turn toward sponsor control, like the rise of lender control before it, has been a function primarily of developments in the way leveraged companies are ordinarily financed. One part of the story involves a widely remarked-upon loosening of loan

⁹ See, e.g., Ayotte & Morrison, *supra* note 2, at 520–26; Casey, *supra* note 7, at 782–83.

¹⁰ See *infra* note 137.

¹¹ See *infra* notes 160–71 and accompanying text. RSAs make little sense in a world of lender control because the model assumes that lenders can deploy soft power in an ad hoc fashion.

¹² A financial sponsor is an investor who applies a model of investment typically associated with private equity managers. According to one representative definition, a financial sponsor is an entity “whose principal business activity is acquiring, holding, and selling investments (including controlling interests) in otherwise-unrelated companies that each are distinct legal entities with separate management, books and records, and bank accounts, whose operations are not integrated with one another and whose financial condition and creditworthiness are independent of” one another. Financial Sponsor Definition, LAW INSIDER, <https://perma.cc/Y2KS-4DT3>.

terms.¹³ Weaker covenant packages mean more financial and operating flexibility for distressed borrowers. Lenders simply no longer hold the big sticks that they once wielded to establish precedence.¹⁴

The other part of the story has largely hidden in plain sight. The equity ownership of distressed businesses has transformed in the decades since scholars first called attention to lender control. The quintessential large corporate debtor of the late 1990s and early 2000s was publicly traded.¹⁵ Its board was populated by independent directors who, in distress, sought continuity in the business they superintended and had little reason to hold out for shareholders' distinctive interests. Stringent loan contracts may have been the most remarkable feature of the lender control era, but lender power was always also predicated on the reluctance of the boards of distressed companies to play with fire. Such caution has become the exception rather than the rule. Now, most large businesses encountering distress are controlled by a private equity fund.¹⁶ The strategic decision-makers are not staid part-timers whose fortunes were made and lie elsewhere. They are operators with powerful incentives to ensure that equity investors recover what they can.

At first approximation, the interests of equity sponsors are a mirror image of those of senior lenders. To the shareholders of a distressed company, private equity fund or otherwise, a volatile future is not an enemy but a friend. Shareholders capture most of the upside if a company performs well but, because of limited liability, have little to lose if it performs poorly. For that reason, they are keen—from a social perspective, *excessively* keen—to avoid the kind of realization event that the absolute-priority rule catalyzes.¹⁷ Sponsors have especially strong incentives in this regard. In addition to benefiting from the prospect of future dividends and stock-price appreciation, sponsors typically draw advisory fees from their portfolio companies. A realization event that wipes out equity interests will also turn off the fee spigot. Moreover, in the event of a bankruptcy, sponsors are uniquely likely to face

¹³ See *infra* notes 72–96 and accompanying text.

¹⁴ See *infra* notes 77–94 and accompanying text.

¹⁵ George S. Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.U. J.L. & BUS. 221, 275–77 (2021).

¹⁶ See Mayra Rodriguez Valladares, *Over Half of Rated Company Defaulters Are Owned by Private Equity Firms*, FORBES (July 16, 2020), <https://perma.cc/9QX8-MY4X>.

¹⁷ Cf. Casey, *supra* note 7, 785 & n.107 (noting that junior classes, like shareholders, prefer to delay realization events).

litigation seeking to claw back dividends and other asset transfers, recover for breach of fiduciary duty, and the like.

Sponsors' prominence and effective power may thus help explain important trends in reorganization. For example, it figures that the vogue for liability management emerged only after private equity had taken over a large share of the market and that sponsor-owned companies are responsible for almost every hardball priming transaction to date.¹⁸ Such transactions "extend runway" for the distressed company but heighten litigation risk and the odds of reputational damage to the individuals behind them, a combination well matched to sponsors' incentives. The same incentives can help account for the greater complexity in the capital structures of deeply distressed businesses and for what may be socially excessive delays in invoking Chapter 11 by some companies.

An understanding of sponsor power may also reveal an unappreciated function of prebankruptcy agreements—such as RSAs and debtor in possession (DIP) loan agreements—in sponsor-backed cases destined for Chapter 11. A common (although controversial) feature of the plans contemplated by RSAs in such cases is a broad release from liability for prepetition conduct of the sponsor and its affiliates and representatives.¹⁹ The principal objection to sponsor releases is economic: that they are granted on terms excessively favorable to the sponsors.²⁰ One way to understand a cheap release, however, is as an inducement for the sponsor to capitulate to bankruptcy resolution notwithstanding its first-order incentives—as, in other words, consideration supporting a Coasean bargain between the sponsor and consenting creditors. Viewed in that light, restrictive "milestone" provisions increasingly found in DIP loan agreements appear to be as much a way for sponsors to secure the terms of the bargain as for senior lenders to exercise market power.

This Article proceeds in four parts. Part I sketches the standard account of the history of reorganization under the Bankruptcy Code. Parts II through IV present the Article's central argument. Part II describes the changes in capital markets and financial

¹⁸ See *infra* notes 137–44 and accompanying text.

¹⁹ See *infra* notes 169–72 and accompanying text.

²⁰ There are also legal objections to the release of nondebtors' claims. See, e.g., *Patterson v. Mahwah Bergen Retail Grp., Inc.*, 636 B.R. 641, 680–88 (E.D. Va. 2022) (summarizing the case law on the authority of courts to grant consensual and nonconsensual releases).

contracting that have yielded a new balance of power. Part III sketches sponsor incentives when a portfolio company is in distress. And Part IV considers developments in reorganization practice that are consistent with and possibly attributable to sponsor control.

I. THE MANAGER- AND LENDER-CONTROL PARADIGMS

When the Bankruptcy Code was enacted in 1978,²¹ it began a new era in the reorganization of large, distressed businesses. The Code wrought major structural changes. It did away with the privileged role that Chapter X of the Bankruptcy Act²² had given to the Securities and Exchange Commission (SEC).²³ It revamped the requirements for plan confirmation to reduce the prospect of a minority holdout.²⁴ And perhaps most importantly, by allowing managers and their financial advisors to remain in position during the case—indeed to set the case’s agenda—the new law transformed bankruptcy from a site of capitulation into a viable forum for reorganization.²⁵

According to conventional wisdom, two very different periods of reorganization have marked the interval since the Code’s enactment.²⁶ The first period was dominated by corporate managers. Availing themselves of the new tools that Chapter 11 provided, managers were able to hold creditors at bay and oversee extended negotiations of which they themselves were often the primary beneficiaries. Starting in the late 1990s, however, something changed. The second period was defined by a regime in which senior secured lenders were frequently able to dictate the mode and

²¹ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended in 11 U.S.C.).

²² 11 U.S.C. §§ 501–676 (1970).

²³ See Michael E. Hooton, *The Role of the Securities and Exchange Commission Under Chapter X, Chapter XI and Proposed Amendments to the Bankruptcy Act*, 18 BOS. COLL. INDUS. COM. L. REV. 427, 455–65 (1977) (comparing the SEC’s role under the Bankruptcy Act and under the then-pending Code legislation).

²⁴ See 11 U.S.C. § 1129(a)(8), (b) (providing that a class’s acceptance of a plan waives individual investors’ objections grounded in absolute priority).

²⁵ See 11 U.S.C. § 1107(a) (allowing a debtor in possession to exercise most of the powers of a trustee); 11 U.S.C. § 1121(b) (giving a debtor in possession the exclusive right for 120 days to propose a plan of reorganization).

²⁶ For accounts defining eras of restructuring along a much longer time horizon, see generally Mark J. Roe, *Three Ages of Bankruptcy*, 7 HARV. BUS. L. REV. 187 (2017), and Stephen J. Lubben, *Fairness and Flexibility: Understanding Corporate Bankruptcy’s Arc*, 23 U. PA. J. BUS. L. 132 (2020).

timing of a reorganization and to secure their own recoveries at the expense of junior investors.

A. Manager Control

In the early years of the Bankruptcy Code, large-scale corporate reorganization was defined by a pattern of manager control.²⁷ Chapter 11 offered incumbents a harbor in which they could operate a business free from worry about the exercise of creditor remedies. They could thus use Chapter 11 to prolong tenure and gamble on a turnaround to the detriment of lenders, bondholders, and even shareholders.²⁸ They could also threaten to invoke bankruptcy and so drive the terms of a consensual reorganization.

The new law was part of the story. Under Chapter X of the Bankruptcy Act, the commencement of a case had ousted the debtor's incumbent managers. A judicially appointed trustee had been handed the reins in their place.²⁹ As a consequence, managers of distressed companies had faced powerful incentives to avoid bankruptcy. Their jobs had depended on persuading creditors to accept a compromise without judicial process.³⁰ Chapter 11 changed all that. It broke radically from the New Dealers' preoccupation with independent expertise. Chapter 11 began instead with a presumption that the incumbent managers would remain in power. It gave them license to run the company on a day-to-day

²⁷ The literature often calls this paradigm "debtor control" or "debtor in control." See, e.g., David A. Skeel, Jr., *Competing Narratives in Corporate Bankruptcy: Debtor in Control vs. No Time to Spare*, 2009 MICH. ST. L. REV. 1187, 1189 (2009) ("Debtor in Control was the standard resolution narrative for large-scale corporate bankruptcies for the first decade after the enactment of the current bankruptcy laws in 1978."). I use the term "manager control" because it more specifically indicates the constituency thought to determine and benefit from the mode in which debtors resolved distress.

²⁸ Critics charged that managers were using their influence over the process to advance their own substantive interests at the expense of the investors whom bankruptcy was supposed to protect. See, e.g., Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 732–39; Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1048–50 (1992). Defenders of the status quo saw advantages to managerial power. See, e.g., Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437, 467–77 (1992).

²⁹ Chandler Act of 1938, Pub. L. No. 75-696, 52 Stat. 840, §§ 156, 158 (codified as amended in scattered sections of 11 U.S.C.).

³⁰ An alternative was to try to shoehorn one's case into Chapter XI, the part of the Bankruptcy Act designed for smaller, private businesses. See Eugene V. Rostow & Lloyd N. Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334, 1337 (1939) (noting that the "tremendous advantages of procedure and of result to corporate management" offered by Chapter XI would "seem specially tempting when contrasted with the closely supervised reorganization system provided by Chapter X").

basis.³¹ It gave them agenda control with respect to extraordinary transactions that required judicial blessing.³² And for the first 120 days of a case it gave them the exclusive right to propose a plan of reorganization.³³

The bankruptcy judges charged with administering Chapter 11 doubled down on the statute's presumption. They deferred to managers on the decision to operate in bankruptcy, even when immediate solvency was not in doubt.³⁴ They granted managers serial extensions of the exclusivity period, even though Congress had suggested four months as an appropriate interval.³⁵ They resisted efforts to unseat managers for whom delay seemed a positive good, even though the statute preserved the court's power to appoint a trustee for cause or for the benefit of the creditors.³⁶ Together, the statute and its judicial application made bankruptcy a decidedly more attractive environment for managers than it had been under the Act.

As important as the new apparatus of Chapter 11 was, manager control was equally a function of the prepetition capital structures that prevailed during the Code's early years. With different financial contracts in place, managers would have lacked access to the liquidity on which their prerogatives always inevitably depend, whatever the law might say. In particular, if liens had been more extensive, secured creditors' right to "adequate protection" of their interests in collateral could have hamstrung managers.³⁷ Debtors in possession have a general right to use encumbered property in the ordinary course of business,³⁸ but that right does not extend to cash. They can use cash collateral only with the secured lenders' consent or on a finding that the lenders' interests are adequately protected.³⁹ When liens blanket a

³¹ See 11 U.S.C. § 1107 (granting debtors in possession most of the rights and powers while saddling them with most of the functions and duties of a trustee).

³² See 11 U.S.C. §§ 363–365.

³³ See 11 U.S.C. § 1121.

³⁴ See, e.g., *In re Johns-Manville Corp.*, 36 B.R. 727, 732–40 (Bankr. S.D.N.Y. 1984).

³⁵ 11 U.S.C. § 1121. Chapter 11 initially allowed the bankruptcy judge to extend the exclusivity period indefinitely. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 1121, 92 Stat. 2549, 2631. In 2005, Congress capped exclusivity at eighteen months. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 411, 119 Stat. 23, 106 (codified at 11 U.S.C. § 1121(d)(2)).

³⁶ See 11 U.S.C. § 1104(a).

³⁷ 11 U.S.C. § 362(d)(1); see also, e.g., 11 U.S.C. § 362(d)(1) (providing that the automatic stay of foreclosure proceedings may be lifted if a creditor's interest in collateral is not adequately protected).

³⁸ 11 U.S.C. § 363(c)(1).

³⁹ 11 U.S.C. § 363(c)(2).

company's assets, all of the cash generated during bankruptcy is collateral and lenders can second-guess its use.⁴⁰

During the Code's early years, however, large corporate debtors typically entered Chapter 11 with substantial unencumbered assets. That meant that cash produced by operations was typically not collateral.⁴¹ Free from the ordinary obligation to service debt, many companies could fund operations indefinitely in Chapter 11 using operating revenues alone. That access to liquidity was crucial to managers' ability to persist in bankruptcy without creditor buy-in (and, therefore, to achieve substantively favorable restructurings).

B. Lender Control

By the early 2000s, leading commentators noticed that something had changed. Cases were being resolved more quickly.⁴² What had taken years now could be finished in months, often with new executives at the helm who lacked allegiance to the incumbents.⁴³ Chapter 11 no longer acted as a standstill, against the background of which investors could begin to earnestly negotiate. Increasingly, Chapter 11 was instead being used simply as a means to sell the debtor's business, repay senior lenders, and distribute any remaining proceeds down the priority ladder.⁴⁴ In 2002, Professors Douglas Baird and Robert Rasmussen declared that the era of corporate reorganizations had "come to an end."⁴⁵ The claim, if hyperbolic, did highlight a remarkable shift in

⁴⁰ See 11 U.S.C. § 363(a); 11 U.S.C. § 552 (providing that property acquired during the pendency of a Chapter 11 case is subject to a preexisting lien on prepetition collateral if it constitutes "proceeds, products, offspring, or profits" of that collateral). For a discussion of the implications of a tracing requirement, see generally Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673 (2018).

⁴¹ See 11 U.S.C. § 552.

⁴² See Skeel, *Creditors' Ball*, *supra* note 3, at 918 ("Chapter 11 no longer functions like an antitakeover device for managers; it has become, instead, the most important new frontier in the market for corporate control, complete with asset sales and faster cases.").

⁴³ See Ayotte & Morrison, *supra* note 2, at 522 (finding in a study of large Chapter 11s filed in 2001 that 70% of companies had replaced their CEO within the two years preceding bankruptcy).

⁴⁴ See Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 3, at 786–88; Warren & Westbrook, *supra* note 4, at 12; Skeel, *Creditors' Ball*, *supra* note 3, at 918; George W. Kuney, *Let's Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy*, 40 HOUS. L. REV. 1265, 1267–68 (2004).

⁴⁵ Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 3, at 753.

reorganization practice.⁴⁶ Large Chapter 11 bankruptcies no longer seemed to vindicate the interests of incumbent managers. Lenders had taken control.⁴⁷

Observers attributed the revolution in large part to a new pattern of debt financing. The Bankruptcy Code had changed little in the twenty years since it was enacted.⁴⁸ What had changed were the capital structures of the large businesses that encountered distress. It had become common for leveraged companies to rely on bank loans and revolving credit facilities backed by security interests in virtually all the borrower's assets.⁴⁹ Two mutually reinforcing features of these deals—tight covenants and blanket liens—gave lenders a pronounced influence over the way a borrower's prospective distress would be resolved.⁵⁰

⁴⁶ Subsequent writers disputed, in particular, the degree to which Chapter 11 had become *just* a glorified auction block. *See generally, e.g.*, Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy*, 56 STAN. L. REV. 645 (2003); Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219 (2004); Jay Lawrence Westbrook, *Bankruptcy Control of the Recovery Process*, 12 AM. BANKR. INST. L. REV. 245 (2004). But no one doubted that an important change had taken place.

⁴⁷ Following Baird and Rasmussen, commentators sometimes use the generic term “creditor control” to refer specifically to the influence of a senior secured lender or small syndicate of lenders. Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 3, at 785; Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675, 684, 698 (2003) [hereinafter Baird & Rasmussen, *Chapter 11 at Twilight*].

⁴⁸ The most notable amendments to the Bankruptcy Code, passed in 1984, principally addressed constitutional doubts raised in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), about the jurisdiction of non-Article III courts. *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (codified at 11 U.S.C. §§ 557–559 and scattered sections of 28 U.S.C.).

⁴⁹ *See* Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 3, at 785 (“[R]evolving credit facilities and the practical control they give lenders over a firm are some of the most striking changes in Chapter 11 practice over the last twenty years.”). Empirical research suggests that companies rely increasingly on secured debt as their leverage, and thus the risk of a default increases. *See* Efraim Benmelech, Nitish Kumar & Raghuram Rajan, *The Decline of Secured Debt* 34 (Apr. 2021) (unpublished manuscript) (on file with author) (finding that “as firms’ credit risk rises, secured loans rise”); Ayotte & Morrison, *supra* note 2, at 518 (observing “an eleven-fold increase in secured debt . . . during the one to two years preceding the bankruptcy filing”); Joshua D. Rauh & Amir Sufi, *Capital Structure and Debt Structure*, 23 REV. FIN. STUD. 4242, 4243–44 (2010) (finding that as credit quality deteriorates, firms increasingly finance operations with secured bank debt rather than unsecured debt); *see also* Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 629 n.15 (1997) (noting the near-total “absence of secured [credit] from the balance sheets of the most creditworthy companies”).

⁵⁰ *See* Baird & Rasmussen, *Private Debt*, *supra* note 5, at 1226–36 (describing each of the mechanisms and their interaction).

1. Tight covenants.

Covenants in the new loan agreements were written to give lenders negotiating leverage at an early stage in a borrower's descent into distress. Maintenance covenants, which oblige a borrower to maintain minimum leverage ratios and other markers of financial health, were central to the logic of the new loans. They were typically written so that even a modest deterioration in the borrower's financial position could trigger default.⁵¹ That would give lenders the option to effectively force a bankruptcy by shutting off access to the borrower's lines of credit and, if necessary, accelerating the obligation to repay principal and foreclosing on collateral.⁵²

2. Blanket liens.

The new loans were frequently supported by security interests in substantially all of a borrower's productive assets.⁵³ A so-called blanket lien allows lenders to block a distressed borrower's access to liquidity from two otherwise-available sources. First, a blanket lien prevents the borrower from raising cash by selling assets or offering them as security for a new loan. Outside bankruptcy, the "first in time, first in right" rule of lien priority implies that providers of new capital would rank behind existing lenders even if the borrower was willing to violate its covenants; debt overhang would have rendered junior financing impossibly expensive in most cases and a positive boon to existing lenders

⁵¹ See Sudheer Chava & Michael R. Roberts, *How Does Financing Impact Investment? The Role of Debt Covenants*, 63 J. FIN. 2085, 2085–87 (2008); Iliia D. Dichev & Douglas J. Skinner, *Large-Sample Evidence on the Debt Covenant Hypothesis*, 40 J. ACCT. RSCH. 1091, 1091–93 (2002).

⁵² See *id.*; David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905, 1905–07 (2004) [hereinafter Skeel, *Past, Present and Future*]; Baird & Rasmussen, *Private Debt*, *supra* note 5, at 1211–13, 23–36.

⁵³ The reasons for this change are not self-evident. Some speculate that changes to Article 9 of the Uniform Commercial Code—which made it easier for lenders to take a security interest in substantially all assets—were at least an enabling part of the story. See, e.g., William W. Bratton & Adam J. Levitin, *The New Bond Workouts*, 166 U. PA. L. REV. 1597, 1642 nn.193–94 (2018); Baird & Rasmussen, *Private Debt*, *supra* note 5, at 1228. For a critical discussion of the amendments, see generally G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 AM. BANKR. INST. L. REV. 3 (2001). For a discussion of the amendments that allowed lenders to more easily take a security interest in bank accounts, see generally Bruce A. Markell, *From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9*, 74 CHI.-KENT L. REV. 963 (1999).

anyway.⁵⁴ In principle, bankruptcy allows borrowers to incur priming liens.⁵⁵ But in practice, the standard for subordinating secured claims over the claim holders' objection is too forbidding to be of much use.⁵⁶ Second, a blanket lien cuts off the borrower's ability to finance an extended bankruptcy with cash flow from operations. When a lien encumbers all a company's assets, revenues are (at least presumptively) the proceeds of collateral as to which lenders can demand adequate protection.⁵⁷ In effect, a blanket lien means that new money has to come from, or with the consent of, existing lenders.

In combination, tight covenants and blanket liens encouraged distressed borrowers to look after lender interests. Bank power was usually tacit.⁵⁸ For example, although covenant breaches became commonplace, lenders only rarely called their loans. In most instances, they waived breaches and modified their agreements to accommodate borrower circumstances.⁵⁹ But

⁵⁴ See Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 147–49 (1977) (providing the canonical explanation of how the existence of senior debt can prevent the financing of even concededly positive-value investments).

⁵⁵ See 11 U.S.C. § 364(d).

⁵⁶ See *id.*

⁵⁷ See, e.g., Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 810–13 (2004) (calling attention to the distinctive power of what he called a “dominant secured party,” namely a lender with a blanket lien on a business's assets). There is academic controversy about whether this is the right way to think about proceeds. See, e.g., AM. BANKR. INST., COMM'N TO STUDY THE REFORM OF CHAPTER 11, at 233–34 (2014). Professors Melissa Jacoby and Ted Janger have been among the most prominent critics of the common wisdom about the significance—even the logical possibility—of a blanket lien. See Jacoby & Janger, *supra* note 40, at 710–21; see also Michelle M. Harner, *The Value of Soft Variables in Corporate Reorganizations*, 2015 U. ILL. L. REV. 509, 511–13 (arguing that “soft variables” on which liens cannot be asserted are part of going-concern value). See generally Edward J. Janger, *The Logic and Limits of Liens*, 2015 U. ILL. L. REV. 589 [hereinafter Janger, *The Logic and Limits of Liens*]. But they acknowledge that their view has not been reflected in practice. See Janger, *The Logic and Limits of Liens*, *supra*, at 600–08; Jacoby & Janger, *supra* note 40, at 682–84. For further discussion on this controversy, see Douglas G. Baird, *The Rights of Secured Creditors After Rescap*, 2015 U. ILL. L. REV. 849, 858, and Barry E. Adler, *Priority in Going-Concern Surplus*, 2015 U. ILL. L. REV. 811, 811–12.

⁵⁸ See Baird & Rasmussen, *Private Debt*, *supra* note 5, at 1212 (“When a business enters financial distress, the major decisions—whether the CEO should go, whether the business should search for a suitor, whether the corporation should file for Chapter 11—require the blessing of the banks.”); see also Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 140–60 (2009).

⁵⁹ See Michael R. Roberts & Amir Sufi, *Renegotiation of Financial Contracts: Evidence from Private Credit Agreements*, 93 J. FIN. ECON. 159, 160 (2009) (reporting that over 90% of public companies' credit agreements with stated maturities of one year or longer were renegotiated before maturity); David J. Denis & Jing Wang, *Debt Covenant Renegotiations and Creditor Control Rights*, 113 J. FIN. ECON. 348, 349 (2014) (finding

lenders got something for their forbearance. Research focusing on periods between the late 1990s and the global financial crisis of 2008 has shown that defaulting borrowers often began immediately taking steps to protect lender interests even when bankruptcy was only a distant concern.⁶⁰

When necessary, lenders could also apply pressure in Chapter 11 proceedings.⁶¹ The power that managers had enjoyed in bankruptcy during the era of manager control stemmed from their ability to ride out an extended process with internal financing. The new loans cut off that ability, making existing lenders the only realistic source of bankruptcy financing in many cases.⁶² Lenders frequently formalized and even extended their influence in bankruptcy with a DIP loan agreement.⁶³ But usually the writing was already on the wall.⁶⁴

Loan terms were not the whole story, however. A submissive attitude among the directors of distressed companies was essential to the form of lender control that prevailed.⁶⁵ Banks only rarely sought to exercise their state law remedies. Foreclosure of liens would have been a massively destructive and costly exercise.

that restrictive or financial covenants are modified in 53% of debt contracts); Michael R. Roberts, *The Role of Dynamic Renegotiation and Asymmetric Information in Financial Contracting*, 116 J. FIN. ECON. 61, 62 (2015) (finding that over 75% of covenant breaches are followed by renegotiation).

⁶⁰ See generally Chava & Roberts, *supra* note 51 (finding diminished capital investment); Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights and Firm Investment Policy*, 92 J. FIN. ECON. 400 (2009) [hereinafter Nini, Smith & Sufi, *Firm Investment Policy*] (finding diminished investment); Roberts & Sufi, *supra* note 59 (finding a decline in allowable borrowings and an increase in the interest spread); Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 REV. FIN. STUD. 1713 (2012) [hereinafter Nini, Smith & Sufi, *Corporate Governance*] (finding a decline in distributions to shareholders).

⁶¹ See Skeel, *Past, Present and Future*, *supra* note 52, at 1916–21.

⁶² See Ayotte & Morrison, *supra* note 2, at 525 (finding that the vast majority of priming liens “involve[d] the DIP lender priming itself”).

⁶³ See, e.g., Harvey R. Miller, *Chapter 11 in Transition—From Boom to Bust and into the Future*, 81 AM. BANKR. L.J. 375, 390 (2007) (“By controlling terms of the DIP agreement, creditors substitute the judgment and decision-making of the debtor-in-possession, who is supposed to serve as an independent fiduciary, with that of a self-interested creditor who uses the process to protect its interests.”).

⁶⁴ See Stephen J. Lubben, *The Board’s Duty to Keep Its Options Open*, 2015 U. ILL. L. REV. 817, 821 (noting a concern about lender control authorized by DIP financing agreements but concluding that no feasible alternative is usually realistic by the time a case is filed because “the lender has a virtual stranglehold on the debtor’s operations coming into bankruptcy by virtue of a lien on all of the debtor’s assets and possession of all of the debtor’s cash”).

⁶⁵ The role of boards of directors is often ignored in accounts of lender control. For an important exception, see Baird & Rasmussen, *Chapter 11 at Twilight*, *supra* note 47, at 693–99.

Banks instead relied on extracting concessions from debtors by threatening to shut off liquidity.

At first glance, it might seem obvious that directors would throw in the towel. Capitulation was typically the surest way to maximize enterprise value and preserve the livelihoods of as many employees and contractual partners as possible. On examination, though, it is not at all obvious that directors would adopt a supine posture. The board of a hopelessly insolvent debtor playing hardball with lenders to secure value for shareholders is a story as old as corporate reorganization.⁶⁶

By the turn of the new millennium, however, most boards had no reason to hold out for shareholders. The Delaware Court of Chancery had recently outlined a new vision of fiduciary obligation.⁶⁷ Directors of companies “in the vicinity of insolvency” were advised that they could face personal liability for failing to honor creditor interests sufficiently.⁶⁸ Even if the prospect of having to pay damages was remote, it was not worthwhile for the directors of large, distressed businesses to court that risk. These businesses were for the most part publicly traded. Their boards were populated by independent directors with reputations to protect and no particular allegiance to the various mutual funds and others that happened to hold shares at any given time.⁶⁹ The average director

⁶⁶ See, e.g., *R.R. Co. v. Howard*, 74 U.S. (7 Wall.) 392, 393–96 (1869) (describing how a debtor’s board conditioned its willingness to authorize a value-maximizing asset sale on a distribution to shareholders).

⁶⁷ See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, 1991 WL 277613 at *34, (Del Ch. Dec. 30, 1991) (announcing that the fiduciary duties of such directors no longer run solely to shareholders “where a corporation is operating in the vicinity of insolvency”).

⁶⁸ Chancellor William Allen offered his dictum on shifting duties in the context of a judgment that exonerated directors from a shareholder challenge. See *id.* The duty to creditors was meant to be a shield, not necessarily a sword. But commentators recognized immediately that the decision’s logic would open directors to liability in creditor suits. At least a dozen articles on the matter appeared in just the first couple of years after the decision was announced. See C. Robert Morris, *Directors’ Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais*, 19 J. CORP. L. 61, 61 n.2 (1993) (collecting scholarship). In any case, the decision appears to have affected board decision-making. See Bo Becker & Per Strömberg, *Fiduciary Duties and Equity-Debtholder Conflicts*, 25 REV. FIN. STUD. 1931, 1993–35 (2012).

⁶⁹ The trend toward independent boards predated Sarbanes-Oxley. By 2000, more than 80% of public company boards were majority composed of independent directors. See Vidhi Chhaochharia & Yaniv Grinstein, *The Changing Structure of US Corporate Boards: 1997–2003*, 15 CORP. GOVERNANCE 1215, 1217 tbl.1 (2007). For the story of “the rise of the independent director,” see Yaron Nili, *The Fallacy of Director Independence*, 2020 WIS. L. REV. 491, 495–502.

had every reason to cooperate with the banks who seemed to hold all the cards anyway.

* * *

What began as an explanatory account of changing bankruptcy practices in the early 2000s has structured serious thinking about corporate reorganization ever since. Lender control is the interpretive paradigm through which scholars and elite practitioners still, for the most part, organize their concrete observations of the field. For a generation, this paradigm has set the agenda of empirical scholarship and grounded far-ranging normative debates. Much impressive work has sought to clarify and measure the significance of the various channels through which lenders are supposed to exercise their power.⁷⁰ And the premises of lender control underlie almost every important reform-oriented debate of the last fifteen years. Arguments about the terms of DIP financing, about the rules around § 363⁷¹ going-concern sales, about forum shopping, and about the absolute-priority rule can all be understood as proxy arguments about the desirability of lender control and the legal system's capacity to address its shortcomings.

II. (FINANCING) CAUSES OF SPONSOR CONTROL

Two developments in the financing of large, leveraged businesses have shifted the balance of power in many distress situations. The first is a trend toward more borrower-friendly loan

⁷⁰ See generally, e.g., Sandeep Dahiya, Kose John, Manju Puri & Gabriel Ramírez, *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. FIN. ECON. 259 (2003); Upinder S. Dhillon, Thomas Noe & Gabriel G. Ramírez, *Debtor-in-Possession Financing and the Resolution of Uncertainty in Chapter 11 Reorganizations*, 3 J. FIN. STABILITY 238 (2007); Greg McGlaun, *Lender Control in Chapter 11: Empirical Evidence* (Feb. 5, 2007) (unpublished manuscript) (on file with author); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1 (2007); Ayotte & Morrison, *supra* note 2; Nini, Smith & Sufi, *Firm Investment Policy*, *supra* note 60; Roberts & Sufi, *supra* note 60; Becker & Strömberg, *supra* note 68; Nini, Smith & Sufi, *Corporate Governance*, *supra* note 60; Barry E. Adler, Vedran Capkun & Lawrence A. Weiss, *Value Destruction in the New Era of Chapter 11*, 29 J.L., ECON., & ORG. 461 (2012); B. Espen Eckbo, Karin S. Thorburn & Wei Wang, *How Costly Is Corporate Bankruptcy for the CEO?*, 121 J. FIN. ECON. 210 (2016); Denis & Wang, *supra* note 59; Frederick Tung, *Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis*, 37 YALE J. REG. 651 (2020); Kenneth Ayotte & Jared A. Elias, *Bankruptcy Process for Sale*, 39 YALE J. REG. 1 (2022); B. Espen Eckbo, Kai Li & Wei Wang, *Loans to Chapter 11 Firms: Contract Design and Pricing* (Apr. 2022) (unpublished manuscript) (on file with author).

⁷¹ 11 U.S.C. § 363.

terms. As has been widely observed, leveraged borrowers today are bound by weaker covenants and offer more porous collateral packages than in the 1990s and 2000s. The sources of soft power that were instrumental to the lender-control framework have thus deteriorated. The second development is a transformation in the equity ownership of distressed companies. Now, unlike twenty years ago, most large leveraged businesses are controlled by a financial sponsor. The directors and senior executives of sponsor-backed firms are responsive to shareholders' interests—which often conflict with lenders' interests—in a way that the managers of public companies are not. Together these changes mean that the modal large, distressed company has more flexibility and is more apt to use it for the benefit of its shareholders.

A. Borrower-Friendly Loan Terms

Loans are as important to the financing of leveraged companies as they were twenty years ago.⁷² Indeed, the funded debt of many leveraged companies consists of nothing else.⁷³ But with respect to governance, loans are not what they once were. Rapid growth in demand for corporate loans from nonbank financial institutions, especially collateralized loan obligations (CLOs), drove important changes in standard terms.⁷⁴ Before the “originate to distribute” model was perfected, a small group of banks would provide loan capital and monitor borrower performance. Now, by contrast, two hundred or more institutions, including CLOs, loan mutual funds, private credit funds, and hedge funds, may each hold a piece of a given loan.⁷⁵ In this environment, where monitoring is apt to be illusory, the theoretical justifications for tight loan agreements are lacking. At the same time, the costs of

⁷² See Benmelech, Kumar & Rajan, *supra* note 49, at *10, 49 figs. 8a and 8b, 52 fig. 13.

⁷³ Cf. Jonathan Hemingway, *US Leveraged Loan 2022 Outlook: After Record Year, a Tough Act to Follow*, S&P GLOB.: MKT. INTEL. (Dec. 20, 2021), <https://perma.cc/3X2F-SZ6S> (detailing the growth of the leveraged loan market).

⁷⁴ See Jeremy McClane, *Reconsidering Creditor Governance in a Time of Financial Alchemy*, 2020 COLUM. BUS. L. REV. 192, 221–24 (2020); Sarah Paterson, *The Rise of Covenant-Lite Lending and Implications for the UK's Corporate Insolvency Law Toolbox*, 39 OXFORD J. LEGAL STUD. 654, 662–64 (2019) [hereinafter Paterson, *The Rise of Covenant-Lite Lending*]; Elisabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 J. CORP. L. 725, 738–41 (2014) [hereinafter de Fontenay, *Do the Securities Laws Matter?*].

⁷⁵ See Mitchell Berlin, Greg Nini & Edison G. Yu, *Concentration of Control Rights in Leveraged Loan Syndicates*, 137 J. FIN. ECON. 249, 261 tbl. 6 (2020) (showing that the average institutional term loan has 191 lenders).

inflexibility are greater because the difficulty of renegotiation is magnified. The development of an institutional-investor base thus heralded more borrower-friendly loan terms.⁷⁶ Indeed, it is only a slight exaggeration to say that today's syndicated loans resemble traditional bond indentures as much as they do the restrictive loans of the 1990s or 2000s.⁷⁷ Two dimensions of change are important to understand for present purposes: looser covenants and more fragile liens.

1. Covenant slack.

Much has been made of the relatively weak covenants found in today's syndicated loans.⁷⁸ The retreat of financial maintenance covenants has been the starkest change.⁷⁹ At the height of the lender-control era, financial covenants were ubiquitous and tightly set.⁸⁰ These amounted to a freestanding option for lenders to call the loan.⁸¹ As recently as 2010, more than 90% of newly originated leveraged loans were not considered "covenant-lite."⁸² Now, though, about 90% are covenant-lite.⁸³ Maintenance covenants are still common in revolving loan facilities,⁸⁴ but they are

⁷⁶ See *id.* at 221–23. For a discussion of alternative explanations, see Paterson, *The Rise of Covenant-Lite Lending*, *supra* note 74, at 659–62, and Sarah Paterson, *Covenant Loose Loans and Interacting Agency Problems 6–7* (May 27, 2022) (unpublished manuscript) (on file with author).

⁷⁷ See, e.g., de Fontenay, *Do the Securities Laws Matter?*, *supra* note 74, at 738–57 (detailing the convergence of the loan and bond markets with respect to investor base, pricing, liquidity, credit features, and the absence of tight covenants and close monitoring).

⁷⁸ For a useful overview, see McClane, *supra* note 74, at 221–24.

⁷⁹ See, e.g., de Fontenay, *Do the Securities Laws Matter?*, *supra* note 74, at 744–46; see also Paterson, *The Rise of Covenant-Lite Lending*, *supra* note 74, at 664–79 (exploring the significance for reorganization of an analogous trend in U.K. loans).

⁸⁰ See Roberts & Sufi, *supra* note 59, at 165 (finding that 95% of loan agreements contain at least one financial covenant); Chava & Roberts, *supra* note 51, at 2094–95 (finding, in a sample of loans originated between 1994 and 2005, that ratio and net-worth thresholds were set on average just 1.1 and 0.7 standard deviations above their respective values at the start of the loan).

⁸¹ Thomas P. Griffin, Greg Nini & David C. Smith, *Losing Control? The 20-Year Decline in Loan Covenant Violations 37* (Dec. 2021) (unpublished manuscript) (on file with author) (showing that, among SEC-reporting companies, the proportion of companies publicly reporting a breach of a financial covenant dropped from nearly 20% in 2001 to less than 6% after the global financial crisis).

⁸² Abby Latour, *Covenant-Lite Deals Exceed 90% of Leveraged Loan Issuance, Setting New High*, S&P GLOB.: MKT. INTEL. (Oct. 8, 2021), <https://perma.cc/4XLY-QDZY>.

⁸³ *Id.*; see also Bo Becker & Victoria Ivashina, *Covenant-Light Contracts and Creditor Coordination 32* fig. 6 (Mar. 2016) (unpublished manuscript) (on file with author).

⁸⁴ Berlin et al., *supra* note 75, at 250–52. Revolving lenders can therefore decline to fund undrawn commitments, or even enforce remedies, if a borrower cannot satisfy them.

frequently designed to spring into effect only when a certain percentage of the revolver has been drawn, and there is little reason to think that they do much to protect institutional term lenders.⁸⁵ In most cases, therefore, a borrower's poor financial performance no longer allows lenders to convene negotiations from a position of strength.

Lenders' power to block specific transactions that might weaken their credit has also atrophied. Explicit carveouts from standard incurrence covenants—known as “baskets”—give borrowers more freedom than in the past to incur incremental *pari passu* debt, which dilutes lender claims, and to make distributions to junior creditors and shareholders, which shrink the asset base from which lenders can expect to recover.⁸⁶ Some such baskets are available for the borrower's use as long as it is not in default.⁸⁷ With no (or only loosely written) maintenance covenants to satisfy, that condition can be achievable even when the borrower is facing serious financial problems. Other baskets, which typically allow the borrower to incur unlimited debt or distribute unlimited value, are available only if the borrower achieves specified financial ratios after giving *pro forma* effect to the proposed transaction.⁸⁸ But those thresholds often permit substantial leverage.

To compound matters, the restrictions that covenants seem to announce on their face have become easier for borrowers to finess. The most common metrics on which covenant thresholds are set—leverage ratios and interest-coverage ratios—use earnings before interest, taxes, depreciation, and amortization (EBITDA) in the denominator. But loan contracts now frequently define EBITDA to allow the borrower to adjust earnings on the basis of speculative projections and subjective characterizations

See Frederick Tung, *Do Lenders Still Monitor? Leveraged Lending and the Search for Covenants*, 47 J. CORP. L. 153, 183–87 (2021).

⁸⁵ See Paterson, *The Rise of Covenant-Lite Lending*, *supra* note 74, at 661–62.

⁸⁶ The change is hard to quantify because there is no standard metric for comparing the incurrence of covenant slack across loans. Cf. Victoria Ivashina & Boris Vallée, *Complexity in Loan Contracts* 9–11, 21–23, 31–32 (May 6, 2022) (unpublished manuscript) (on file with author) (inferring a loosening of covenants from an increasing number of baskets).

⁸⁷ These are sometimes called “free and clear baskets” (or “freebies”). See XTRACT RSCH., COV 101: GLOSSARY OF COMMONLY USED TERMS IN US LOANS 5 (2021).

⁸⁸ These are sometimes called “ratio baskets.” See, e.g., *id.* at 6 (defining the “Incremental Leverage Ratio Basket”).

of onetime costs.⁸⁹ A borrower's power to adjust and announce so-called add-backs to earnings, although finite, gives borrowers additional flexibility on the margin. If leverage and interest-coverage ratios ever were hard measures, they no longer are.

2. Lien fragility.

In recent years, syndicated loans have also become less likely to place a robust blanket lien on the borrower's assets. Recall that the blanket lien was an important part of the lender-control paradigm—perhaps not in the foreground as much as tight covenants, but still crucial to preventing borrowers from circumventing covenants or using a bankruptcy filing to sunder floating security interests.⁹⁰

The point of the general rule that liens follow property out of the debtor's hands is to discourage transfers likely to diminish the value of secured-creditors' collateral.⁹¹ But syndicated loans now give borrowers a number of ways to transfer assets free and clear of liens. Many asset-sale covenants allow liens to be destroyed merely on the condition that a sale fetches fair value, even if the sale is to an affiliate of the borrower.⁹² Liens can often be destroyed to enable what is effectively incremental borrowing through a sale-and-leaseback transaction.⁹³ And liens are released when a borrower transfers assets to a nonguarantor subsidiary.⁹⁴ Unrestricted subsidiaries, which are not bound by the borrower's covenants, were unheard of in the syndicated loan market in 2000.⁹⁵ Now about half of secured loans allow borrowers to create and transact through unrestricted subsidiaries.⁹⁶

⁸⁹ See Adam B. Badawi, Scott D. Dyreng, Elisabeth de Fontenay & Robert W. Hills, Contractual Complexity in Debt Agreements: The Case of EBITDA 1–2, 37 fig. 1 (May 2021) (unpublished manuscript) (on file with author).

⁹⁰ See *supra* notes 53–57 and accompanying text.

⁹¹ See U.C.C. § 9-315(a)(1) (AM. L. INST. & UNIF. L. COMM'N 2021) (codifying the general rule for security interests in personal property).

⁹² Many loan agreements condition the sale of especially valuable assets on the borrower receiving a minimum percentage of the proceeds, often 75%, in cash. Cash sweeps—requirements that a borrower use some of the excess cash it receives to repay principal—put a limit on a borrower's ability to raise new money with an asset sale.

⁹³ See MICHAEL BELLUCCI & JEROME MCCLUSKEY, THE LSTA'S COMPLETE CREDIT AGREEMENT GUIDE 381 (2d ed. 2017).

⁹⁴ See *id.* at 301–03.

⁹⁵ Cf. *id.* (mentioning the migration of the unrestricted-subsi-dary construct from bond indentures to loan agreements).

⁹⁶ See Vincent S.J. Buccola & Greg Nini, The Loan Market Response to Dropdown and Uptier Transactions 33–34, 37 (June 2022) (unpublished manuscript) (on file with author) (finding that approximately half of leveraged loans to SEC-filing borrowers

Borrowers thus can destroy liens if and to the extent that they can locate basket capacity to transfer assets to an unrestricted subsidiary. Outside bankruptcy, such flexibility can allow borrowers to access liquidity (by, in effect, repledging collateral) without negotiating with lenders; inside bankruptcy, it threatens to undermine lenders' distinctive rights with respect to the debtor's cash.

B. Equity Sponsorship

While commentators have paid much attention to changing loan terms, a parallel development no less important to the reorganization calculus has largely escaped notice. Private equity sponsors now predominate as the owners of large, distressed businesses.

The growth of private equity's role in distress over the last two decades is hard to overstate. Since the global financial crisis, the share of companies on Moody's B3 Negative and Lower Corporate Ratings List owned by a private equity sponsor has increased by 25%.⁹⁷ Approximately 70% of such companies were sponsor owned.⁹⁸ The change in ownership of distressed businesses may reflect a more general trend in the U.S. (and indeed global) economy.⁹⁹ Between 2000 and 2017, the number of companies controlled by a private equity sponsor increased nearly five-fold, while the number of listed companies dropped by a third.¹⁰⁰ The bottom line is that private equity ownership of distressed assets has gone from the exception to the rule.

Equity sponsorship is important because it shapes the priorities of those who exercise immediate control of distressed businesses. The boards of sponsored companies are totally different in character from those of comparable, widely held public firms. Public company boards are populated overwhelmingly with directors whose economic stakes in the businesses they govern are minimal and who, therefore, are supposed to be free from the CEO's influence.¹⁰¹ Public company directors also tend to be at the

contemplate unrestricted subsidiaries and noting that loans to private borrowers are more likely to entertain the construct).

⁹⁷ Valladares, *supra* note 16.

⁹⁸ *Id.*

⁹⁹ See Georgiev, *supra* note 15, at 275–77.

¹⁰⁰ *Id.* at 313 fig.A-2.

¹⁰¹ See e.g., Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 268–72, 275 (1997).

tail end of distinguished careers. They tend for that reason to be risk averse. For them, as Professors Ronald Gilson and Jeffrey Gordon put it, “the downside of reputational embarrassment . . . generally exceeds the potential financial gains.”¹⁰² When it comes to resolving distress, most public company directors thus have only very weak financial incentives to adopt the kind of aggressive, risky postures that shareholders might prefer and much stronger personal reasons to steer a safer course that ensures continuity of enterprise.

The boards of private equity-owned companies are constituted on a different logic. Portfolio-company boards are relatively small.¹⁰³ The directors, as a group, are deeply knowledgeable about the business and committed to shareholder interests.¹⁰⁴ The CEO typically has a seat alongside two or more representatives of the sponsor—often employees with differential expertise in the financial and operational aspects of the business—and perhaps an outside advisor with experience in the relevant industry. Professors Gilson and Gordon summarized a common structure:

One board member will be, in effect, the lead director, who will drive the PE firm’s engagement with the portco [(portfolio company)]. This person will have substantial personal financial gain/loss on the line, not only from portco-specific payoffs in an IPO or private exit but also in terms of his/her career within the PE firm. This “empowered lead director” can marshal the full analytic capacity of the PE firm to assess the strategic and operational questions facing the portco. Analysts from the PE firm will be able to access portco-specific information in their work. The annual time commitment that the PE senior staff and analysts will devote to monitoring the portco’s performance is in the thousands of hours.¹⁰⁵

Not even the most ardent proponent of shareholder primacy could imagine public company directors so singularly

¹⁰² Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0—An Introduction*, 74 BUS. LAW. 351, 357 (2019).

¹⁰³ *Id.* at 359; Elizabeth Pollman, *Team Production Theory and Private Company Boards*, 38 SEATTLE U. L. REV. 619, 635 (2015).

¹⁰⁴ See Gilson & Gordon, *supra* note 102, at 359.

¹⁰⁵ *Id.* (synthesizing the academic literature and results of interviews with leading private equity firms).

motivated.¹⁰⁶ Nor is distress likely to change portfolio-company directors' orientation. The private board is a far cry from a "mediating hierarch."¹⁰⁷ It is structured to ensure that the sponsor takes as much as possible from any reorganization.

One might expect corporate fiduciary principles to check directors' sponsor-oriented proclivities. Corporate directors owe obligations of good faith and loyal service.¹⁰⁸ In conditions of financial health, the law arguably instructs them to look after shareholders' interests. When a company becomes financially distressed, however, preferring shareholder interests at the expense of the company's enterprise value won't do.¹⁰⁹ The Delaware courts have made it clear that creditors can, on a derivative basis, sue directors for acts of disloyalty that were calculated to benefit shareholders at the company's expense.¹¹⁰ The prospect of having to pay damages, if nothing else, might focus a board's attention. Moreover, to neutralize the threat of judicial second-guessing, portfolio companies deep in distress sometimes appoint new directors with weaker ties to the sponsor and retain bankers and lawyers to support them.¹¹¹ At least in principle, independent

¹⁰⁶ This was Professor Michael Jensen's rationale for thinking that the public company would be superseded—which, to some extent, it has been. *See generally* Michael C. Jensen, *Eclipse of the Public Corporation*, 67 HARV. BUS. REV. 61 (1989).

¹⁰⁷ *Cf.* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 276–86 (1999) (characterizing the boards of public corporations as "mediating hierarchs"). Indeed, precisely because of the effective shareholder power in private companies, Professors Margaret Blair and Lynn Stout explicitly limited their account of the board as mediating hierarch to the context of public companies. *Id.* at 281. However, this does not mean that private boards cannot solve *some* analogous team production issues. *See* Pollman, *supra* note 103, at 635–46.

¹⁰⁸ *See* HOLGER SPAMANN, SCOTT HIRST & GABRIEL RAUTERBERG, CORPORATIONS IN 100 PAGES 35–36, 38, 43 (2d ed. 2021).

¹⁰⁹ In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. Dec. 30, 1991), Chancellor Allen famously opined that directors' fiduciary duties to the corporate enterprise may embrace creditor interests when a company is in "the vicinity of insolvency." *Id.* at *34 & n.55. Although many commentators have taken issue with language suggesting a *shifting* obligation, *see, e.g.*, Morris, *supra* note 68, at 61 n.2, 67, the Chancellor's opinion is best understood to mean only that the identity of the primary economic beneficiaries of sound stewardship change with the degree of the company's solvency. So understood, *Credit Lyonnais* is consistent with subsequent cases to which it is sometimes contrasted, such as *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007) (denying the existence of a fiduciary duty to creditors qua creditors), and *Quadrant Structured Products Co. v. Vertin*, 102 A.3d 155 (Del. Ch. 2014) (conditioning creditors' standing to assert fiduciary violations on the company's insolvency).

¹¹⁰ *See Quadrant*, 102 A.3d at 172; *Gheewalla*, 930 A.2d at 102.

¹¹¹ *See* Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors* 1–3 (Feb. 2022) (Eur. Corp. Governance Inst. Working Paper) (on file with author) (working paper).

directors could address concerns about a portfolio-company board's willingness to sacrifice expected enterprise value for a sponsor's benefit.

In practice, however, neither the threat of litigation nor the interposition of (nominally) independent directors has much bite. By design, judicial enforcement of directors' fiduciary duties aims to target only the most egregious decisions.¹¹² Delaware courts, at least, have made clear that their review is no more searching while a corporation is insolvent than while it is solvent.¹¹³ In both situations, the business-judgment rule insulates the vast majority of decisions for which directors can articulate a plausible rationale.¹¹⁴ Independent directors often seem to be appointed only when a bankruptcy, with its concomitant scrutiny of conflicted transactions, is inevitable. Their prosecution of claims against former directors and controlling sponsors in that forum does not always appear to be as vigorous as it could be.¹¹⁵ Indeed, the appearance of a number of "bankruptcy directors" hired repeatedly by sponsored companies has led some to question whether the real function of independence isn't precisely to enforce fiduciary law's laxity.¹¹⁶ The essential weakness of fiduciary law thus has ensured that sponsor-backed distressed businesses today use the flexibility they now have under their loan contracts to the advantage of their private equity owners.

III. SPONSOR INCENTIVES

If the shifting locus of power in many distressed firms has changed restructuring dynamics, it must be because equity sponsors have different incentives than senior lenders. What exactly do sponsors want? This Part addresses that question in two steps. First, it develops an account of how sponsors are apt to think about distress in a vacuum, so to speak, where other parties'

¹¹² See, e.g., E. Norman Veasey, *New Insights into Judicial Deference to Directors' Business Decisions: Should We Trust the Courts?*, 39 BUS. LAW. 1461, 1464 (1984) (discussing the deferential business-judgment rule).

¹¹³ See *Quadrant*, 102 A.3d at 192 (emphasizing that the risk profile of a board's strategic choice is not a ground for challenging the application of the business-judgment rule absent self-dealing or another conflict of interest).

¹¹⁴ See *id.* For a sustained argument that the fiduciary-duty regime protects creditors only on the margin, see Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745, 759–62 (2020).

¹¹⁵ See, e.g., Ellias, Kamar & Kastiel, *supra* note 111, at 1–2 (describing the role of independent directors in the Nine West bankruptcy).

¹¹⁶ See, e.g., *id.* at 1–4.

interests are not brought to bear. It then considers how reputational concerns and Coasean bargaining might moderate or qualify the first approximation. The punch line is that, in general, sponsors are biased against resolving distress in Chapter 11—they want portfolio companies to use and extend their runway even when a bankruptcy resolution is socially optimal—but this generic disposition can be overcome if creditors who would benefit from bankruptcy are able to credibly promise a sponsor value for relenting.

A. Sponsor Incentives in a Vacuum

Financial distress is a crisis of liquidity. A distressed business is one that risks failing to meet its economic potential because it lacks sufficient cash. The dramatic threat is a premature collapse of the business following a creditor run.¹¹⁷ The prosaic, if perhaps more important, threat is a slow decline owing to underinvestment.¹¹⁸ If a company is short on cash, then it has to prioritize current expenses over capital investments calculated to pay off in the long run. Over time, failure to make cost-justified investments is a recipe for value destruction.

Bankruptcy offers a cure for illiquidity. Indeed, the influential “creditors’ bargain” literature justifies bankruptcy law precisely because—but only to the extent that—it allows investors to overcome rigidities that might prevent a distressed company from gaining access to an appropriate amount of liquidity.¹¹⁹

Not every company facing a liquidity constraint should opt for Chapter 11, however. The bankruptcy process is expensive in indirect as well as out-of-pocket terms.¹²⁰ A voluntary transaction

¹¹⁷ See, e.g., Thomas H. Jackson, *Bankruptcy, Non-bankruptcy Entitlements, and the Creditors’ Bargain*, 91 YALE L.J. 857, 864–65 (1982). If a company cannot pay its debts as they mature, disappointed creditors may foreclose or otherwise levy on assets essential to the business. Moreover, the mere possibility that they might do so can cause a business to unravel, as investors without fixed claims (or with claims not soon maturing) seek to exit while they can. See *id.*

¹¹⁸ See Kenneth M. Ayotte & David A. Skeel, Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1567–72 (2013).

¹¹⁹ See, e.g., Vincent S.J. Buccola, *Bankruptcy’s Cathedral: Property Rules, Liability Rules, and Distress*, 114 NW. U. L. REV. 705, 711–20, 724–27 (2019).

¹²⁰ Indirect costs are difficult to quantify but may be quite high. See, e.g., Samuel Antill & Megan Hunter, *Consumer Choice and Corporate Bankruptcy* 24–25 (May 6, 2022) (unpublished manuscript) (on file with author) (estimating the impact of diminished consumer appetite for Hertz rental cars due to the company’s Chapter 11 case). Presumably costs are much lower in prepackaged bankruptcies. For an argument that at least some bankruptcy cases might not be much costlier than analogous out-of-court transactions, see

may be able to accomplish everything that a bankruptcy could at a fraction of the price.¹²¹ Moreover, some loss attributable to illiquidity must be accepted. Since even the most efficient restructuring process is costly, the optimal real costs of financial distress are strictly positive. In principle, a company's managers should reorganize in Chapter 11 when doing so can be expected to save more by relieving the real costs of distress than the process itself imposes—no sooner and no later.

At first approximation, however, equity sponsors will tend to do best if their portfolio companies avoid bankruptcy even when a resolution of distress in Chapter 11 would be cost justified. There are three main considerations.

First, bankruptcy law is at odds with the interest that sponsors, like all equity investors, have in preserving the option value of equity. When a company is insolvent, the equity is “out of the money.” This means that if the business were sold, or if creditors' claims to asset value were otherwise crystallized, the equity would be wiped out. Chapter 11 is designed to crystallize claims in just this way.¹²² The absolute-priority rule, arguably the single most important notion in corporate bankruptcy,¹²³ provides that a plan of reorganization may not return anything to equity unless every impaired class of creditor consents.¹²⁴ Such unanimity is hard to achieve, and consequently distributions to equity are rare. If a distressed company can avoid a crystallization event, however, there is no immediate significance to equity's being out of the money. Fortunes could improve. If they do, junior investors

Stephen J. Lubben, *Protecting Ma and Pa: Bond Workouts and the Trust Indenture Act in the 21st Century*, 44 CARDOZO L. REV. (forthcoming) (manuscript at 64–74) (on file with author).

¹²¹ For example, creditors' voluntary forbearance or acceptance of an extended maturity schedule are as effective at preventing a run as the automatic stay and the rules of plan confirmation. And creditors' willingness to swap their claims for equity or to allow new priming debt is as effective at overcoming debt overhang as is any coercive intervention that bankruptcy might offer. See, e.g., Sinclair Broad. Grp., *Diamond Sports Group Enters into Agreement with Creditors on Liquidity Enhancing Transaction* (Jan. 13, 2022), <https://perma.cc/GKX7-ZXEJ> (summarizing a transaction in which lenders agreed to be subordinated by newly created debt so that a borrower could raise \$600 million of new money).

¹²² See Casey, *supra* note 7, at 784–89.

¹²³ See, e.g., Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 786 (2017) [hereinafter Baird, *Priority Matters*] (describing the rule as “the organizing principle of the modern law of corporate reorganizations”).

¹²⁴ See 11 U.S.C. § 1129(b).

are the primary beneficiaries. Thus, equity is worth something as long as the company can persist as a going concern.

Second, bankruptcy cuts off management fees. It is a common practice for sponsors to contract with their portfolio companies to offer advisory services for a fee. The amounts at stake can be large. For example, the successor in interest of Toys “R” Us alleged that over twelve years the company’s sponsors received some \$250 million in advisory fees not tied to any particular service.¹²⁵ There is nothing inherently improper with such an arrangement. But a Chapter 11 filing would almost certainly end such a flow of cash payments.

Finally, bankruptcy produces litigation risk for sponsors and their representatives. At the outset of a Chapter 11 case, the U.S. trustee is tasked with establishing a creditors’ committee to protect the interests of the general body of unsecured creditors. A principal function of the committee is to look for ways to recover value for the estate.¹²⁶ That often entails counsel for the committee (or for a successor trust) asserting claims for breach of fiduciary duties, receipt of fraudulent transfers, and otherwise.¹²⁷ Sponsors have proved to be attractive targets. They have deep pockets and, as often as not, years of extensive and inherently conflicted financial dealings with portfolio companies that wind up in Chapter 11. In principle, creditors could bring analogous claims outside bankruptcy. In practice, though, a variety of obstacles to instituting and funding challenges make Chapter 11 a hotbed for creditor litigation. Recently, some sponsors have tried to blunt committees’ practical power by having independent directors appointed to portfolio companies’ boards in anticipation of bankruptcy.¹²⁸ But from a sponsor’s perspective, the threat of litigation remains an important downside of entering Chapter 11.

B. Sponsor Incentives with Feedback

Sponsors do not exist in a vacuum, of course. Their preferences are shaped in part by others’ reactions (or anticipated

¹²⁵ See Second Amended Complaint, TRU Creditor Litig. Tr. v. Brandon (*In re Toys “R” Us U.S., Inc.*), 17-34665, Dkt. No. 146, at *21 (Bankr. E.D. Va. Apr. 30, 2021).

¹²⁶ See 11 U.S.C. §§ 1102–1103. Section 1103 specifically allows committees to, among other things, “investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, [and] the operation of the debtor’s business.” 11 U.S.C. § 1103.

¹²⁷ This can also be done after bankruptcy by a trustee who succeeds to the committee’s rights under the terms of a plan of reorganization.

¹²⁸ See *Ellias, Kamar & Kastiel*, *supra* note 111, at 1–4.

reactions) to portfolio-company conduct. Two feedback channels are especially prominent: sponsor reputation and Coasean bargaining. In theory, either channel could completely unwind the first-order incentives described above. Realistically, they are likely to moderate or qualify sponsor incentives but not to undo or reverse their direction.

1. Anticipated effects on sponsor reputation.

A private equity sponsor evaluating how it wants its portfolio companies to deal with financial distress is not facing a one-shot game. Sponsors are repeat players. They control multiple companies and hope to buy and control more in the future. And those companies will need credit. Concern for the terms on which their portfolio companies will be able to borrow should discipline a sponsor's willingness to burn creditors today.

Indeed, in a world of informationally efficient markets, a profit-maximizing sponsor with an infinite time horizon would never sacrifice a portfolio company's enterprise value to increase the value of its own investment in the company. If credit markets incorporate all relevant information, a sponsor would expect future lenders to take account of its proclivity to deal evenhandedly with creditors. Such lenders presumably would demand a higher coupon or tighter nonprice terms from the portfolio companies of sponsors known to steer the companies they control away from value-maximizing realization events such as bankruptcy. The incremental cost of debt capital would translate to weaker earnings at the portfolio-company level or force the poor-reputation sponsor to use less leverage. Either way, the sponsor's returns would predictably suffer.¹²⁹

There is empirical support for the idea that sponsor reputation matters, at least to some extent. For example, sponsored firms are widely believed to borrow on more flexible terms than otherwise-similar nonsponsored firms. Sponsor reputation is one explanation that has been proffered.¹³⁰ At least during the period before the global financial crisis, companies owned by

¹²⁹ For elaboration of this basic logic, see Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 148–60 (2013), and Andrey Malenko & Nadya Malenko, *A Theory of LBO Activity Based on Repeated Debt-Equity Conflicts*, 117 J. FIN. ECON. 607, 613–18 (2015).

¹³⁰ See Victoria Ivashina & Anna Kovner, *The Private Equity Advantage: Leveraged Buyout Firms and Relationship Banking*, 24 REV. FIN. STUD. 2462, 2462–65 (2011) (concluding that sponsor relationships with banks lead to more flexible and cheaper loans).

high-reputation sponsors seem to have borrowed at narrower spreads and to have been permitted more leverage.¹³¹ Likewise, during the same period, the holders of defaulted bonds issued by sponsored companies seem to have fared no worse than holders of defaulted bonds issued by nonsponsored but otherwise similar companies.¹³²

For several reasons, though, reputation effects are unlikely to do more than moderate or dampen the sponsor incentives described above. First, it is not clear whether (or to what degree) primary-loan markets actually reflect information about sponsor reputation. If sponsors do not believe that lenders distinguish between loans on that basis, then the whole mechanism falls apart. It is hard to believe that lenders don't "punish" aggressive sponsors at all. But some market participants express a view that institutional lenders such as CLOs do not. In any case, an open empirical question remains: To what degree have the portfolio companies of sponsors who have behaved especially aggressively relative to their creditors in fact been punished?

Second, sponsors do not act as though they have an infinite time horizon. The principals of the management companies at the center of sponsor complexes may wish to maximize long-term value, but that is only the start of the matter. As in any organization, agency costs imply that the interests of day-to-day decisionmakers will influence sponsor behavior. The interests of those who act on a sponsor's behalf are only imperfectly aligned with principals' presumptive desire to maximize the sponsor's brand value. Sponsor employees often do best in terms of salary, bonus, and prestige by maximizing short-run returns on the companies to which they are personally assigned.

Third, as Professor Sarah Paterson has suggested, sponsors may be able to raise more new capital, or raise capital on more attractive terms, by trading off reputation with lenders for improved returns for its investors.¹³³ Sponsor principals do not solely (or even primarily) seek to maximize long-run returns on the capital they manage; they also seek to manage a lot of capital. One might even say that for most sponsors the former goal is instrumental to the latter. Retaining and indeed growing assets under

¹³¹ See Cem Demiroglu & Christopher M. James, *The Role of Private Equity Group Reputation in LBO Financing*, 96 J. FIN. ECON. 306, 320–22, 324–25 (2010).

¹³² See Edith S. Hotchkiss, David C. Smith & Per Strömberg, *Private Equity and the Resolution of Financial Distress*, 10 REV. CORP. FIN. STUD. 694, 727–28 (2021).

¹³³ Paterson, *The Rise of Covenant-Lite Lending*, *supra* note 74, at 660–61.

management entails a perpetual marketing process aimed at pensions, endowments, and other institutions. The returns that a sponsor has realized on its past and current funds are an important part of the pitch. Realization events that force the sponsor to mark down a troubled investment may thus carry a marketing cost far in excess of the associated economic loss. If potential investors knew that some of a fund's returns were attributable to sponsor initiatives with negative expected value—and if they believed that such behavior would increase future interest costs of the sponsor's portfolio companies—in theory, they would discount past performance accordingly. But that level of transparency is unrealistic.¹³⁴ Consequently, sponsors focused on their own bottom line may not fully internalize the reputational consequences of sharp practice.

2. Coasean bargaining.

The possibility of cutting a deal with negatively affected creditors might lead sponsors to internalize the social costs of their aversion to loss crystallization even if anxiety about reputation does so only weakly. Creditors bear the burden in the first instance of a company's reluctance to enter bankruptcy. Where the anticipated benefits of Chapter 11 exceed anticipated costs, there is, by tautology, a surplus to be had if the affected creditors can credibly offer to share the net value of a Chapter 11 resolution with the controlling sponsor. The Coasean insight is that sponsors should *want* a reckoning for a distressed portfolio company when a reckoning would maximize its enterprise value, provided only that transaction costs are small.¹³⁵

The trouble is that transaction costs are often not small. Two related sources of friction can prevent a mutually advantageous deal from emerging. One is a version of the standard holdout problem. A schematic way to effect a deal would involve the creditors "taxing" themselves an appropriate sum and then handing over the proceeds to the sponsor. But large companies have many different kinds of debts and many different creditors holding them. There is no mechanism by which each creditor can be forced to contribute new money in proportion to the marginal benefits it is likely to realize from a bankruptcy. Indeed, there is no

¹³⁴ Even well-informed limited partners (LPs) may have heterogeneous views about the desirability of sponsor aggressiveness in defending investments.

¹³⁵ See R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 9–19 (1960).

mechanism to compel contributions of new money at all. Raising a fund is not realistic in most instances.

A more plausible way for creditors to offer value to a sponsor is through the bankruptcy process itself. Most obviously, creditors could promise to gift the sponsor part of the proceeds of a going-concern sale (if there is to be a sale) or securities of the reorganized company (if there is to be a reorganization). Such a deal would not involve the institutional complications that go with trying to raise new money. But bargaining frictions do not disappear just because a deal invokes Chapter 11. Heterogeneity of creditor interests and generic holdout incentives persist. The absolute-priority rule gives each impaired creditor class veto power with respect to any plan under which a sponsor receives value for its equity.¹³⁶ And the prospect of a veto means that creditor promises regarding what a sponsor will be allowed in bankruptcy are potentially illusory unless every class's support is lined up in advance of a filing. But prepackaged plans are realistic only in a subset of cases.

This is not to say that creative deals cannot be struck. In some instances, as we shall see, willing creditors may be able to credibly promise a sponsor value that the law does not treat as a distribution subject to the absolute-priority rule. In such cases, the opportunity to deal qualifies the first-order incentives described above.

IV. (REORGANIZATION) CONSEQUENCES OF SPONSOR CONTROL

Sponsor prominence in so many instances of corporate financial distress can help to explain otherwise puzzling, practical changes in distress resolution. Consistent with the discussion of incentives above, one should expect sponsor control to contribute to two important and widely observed trends: first, more lavish efforts by potential reorganizers to “extend the runway”—that is, to increase the time a cash-strapped company has to operate before illiquidity forces a bankruptcy reckoning; and second, weightier reliance on multilateral agreements negotiated outside bankruptcy to direct the course of proceedings in Chapter 11.

¹³⁶ See 11 U.S.C. § 1129(a)(8), (b).

A. Emphasis on Runway

Private equity sponsors have always had reason to prefer that their portfolio companies avoid bankruptcy, all else equal. But in recent years, as sponsors have occupied a more pronounced role in the distressed environment, and as loan contracts have given borrowers more flexibility, the desire to find liquidity outside Chapter 11 has been brought to bear on an expanded opportunity set. The fruits of this impulse may be discerned in a variety of artifacts of reorganization practice that might appear unconnected: the wave of contentious, out-of-court recapitalization transactions; the complexity of the capital structures common to many highly distressed companies; and perhaps, although proof is harder to discern, the relatively beleaguered condition of some companies that eventually do end up in bankruptcy.

1. Hardball priming transactions.

Among the most striking developments in reorganization during the last decade has been a proliferation of hardball priming transactions.¹³⁷ These are out-of-court deals in which a distressed company creates new senior secured debt that subordinates (previously) first-lien obligations with minimal support from the affected creditors. The company can use the newly created, “super senior” debt capacity to raise new money for its operating needs or as fodder to swap for other, maturing debts the company would struggle to refinance. Either way, the aim is to secure liquidity for the company without having to resort to Chapter 11, where subordinating and restructuring existing debts is quotidian business but where equity interests usually go to heaven.

Two transactional forms have proved especially fit for this purpose: the dropdown and the non-pro rata uptier. In a dropdown, the distressed company transfers collateral to a

¹³⁷ The trend has been widely discussed in practitioner circles. See, e.g., Loan Syndications & Trading Assoc., *Liability Management Transactions* (Sept. 30, 2020), <https://perma.cc/Y342-SUEZ> (summarizing a webinar on the subject). It has also been discussed in the academic literature. See generally Buccola & Nini, *supra* note 96; 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); Ellias & Stark, *supra* note 114. For an additional discussion, see Robert K. Rasmussen & Michael Simkovic, *Bounties for Errors: Market Testing Contracts*, 10 HARV. BUS. L. REV. 117, 141–48 (2020).

subsidiary outside the credit group and, in effect, *reuses* the collateral to support new debt. The crux of the transaction is the company's right, under its credit documents, to invest assets into subsidiaries that it designates as "unrestricted."¹³⁸ Covenants restricting a company's right to create new debt do not bind its unrestricted subsidiaries, and liens are automatically released from assets validly transferred to them.¹³⁹ Thus, to the extent a company has the will and the capacity under its credit documents to invest collateral into an unrestricted subsidiary, it can have the subsidiary create new debt with structural and lien priority over what it had previously dubbed first-lien debt.

In a non-pro rata uptier, the distressed company procures an amendment to its credit documents that allows it to incur new debt backed by new, super senior liens. An uptier involves no shuffling of assets around the debtor's corporate group. It works through creditor consent. But the consent is of a special kind. Until the last few years, standard practice for a company seeking relief from creditors—compelled by market norms if (arguably) not law—was to offer an inducement to creditors within an affected facility on a pro rata basis. If a creditor did not consent to giving relief, it might find itself in an inferior position, but it was still given a chance to participate. In a non-pro rata uptier, by contrast, the distressed company offers inducement only to a favored subset of affected creditors. It might offer to roll up the favored creditors' claims into a new, superpriority facility or else might simply allow the favored creditors to fund new-money debt contemplated by the transaction on above-market terms. In so dividing the affected creditors, the company reduces the price of obtaining permission to create priming debt and increases the chance that it will be able to obtain permission at all.¹⁴⁰

Before the 2008 financial crisis, neither type of priming transaction was a plausible tactic for dealing with illiquidity. For one thing, neither would have been compatible with the black

¹³⁸ In principle, a distressed company could alternatively execute a dropdown by transferring value into a nonguarantor "restricted" subsidiary. The transfer of collateral to any nonguarantor causes liens to be released. But restricted subsidiaries are not practical tools in most circumstances, because they are subject to lien and indebtedness covenants and thus will not usually be able to incur new debt without causing the borrower to default.

¹³⁹ See BELLUCCI & MCCLUSKEY, *supra* note 93, at 301–03.

¹⁴⁰ Shana A. Elberg, Evan A. Hill & Catrina A. Shea, *Uptier Exchange Transactions Remain in Vogue, Notwithstanding Litigation Risk*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Feb. 2, 2021).

letter terms that then prevailed in syndicated loan contracts. Precrisis loans did not contemplate unrestricted subsidiaries and prohibited borrower repurchases. Tight financial covenants also meant that any technical permissions that a distressed borrower might find in its loan contracts were always implicitly subject to lender veto. Quite apart from contractual limitations, dropdowns and especially non-pro rata uptiers would have been unthinkable under precrisis commercial norms. Lending syndicates of the 1990s and 2000s tended to present as united groups, at least within a tranche. Lenders were fewer in number and mostly banks, repeat players in an industry where relationships are everything.¹⁴¹ Deference to the “lead bank” that had arranged a loan and put together the syndicate was the norm.¹⁴² Liquidity strategies that depended on splitting a syndicate could not have succeeded until, at a minimum, syndicates grew in number and heterogeneity, as they did in the 2010s. Even with respect to bonds, the terms of which were never so tight and the holders of which never so tethered to an equality norm, the kinds of priming transactions that have become commonplace would have been hard to contemplate.

The conspicuous variable in almost every hardball-priming transaction to date is a private equity sponsor. Table 1 is a list of dropdowns executed since 2015. It shows that twelve of thirteen such transactions have been executed by sponsor-backed companies. The lone exception is Party City. Notably, Party City’s transaction is one of six dropdowns the legality of which creditors declined to challenge in litigation. Table 2 is a list of non-pro rata uptiers executed since 2015. It shows that all six have been executed by sponsor-backed companies. Taken together, then, sponsor-controlled companies are responsible for eighteen of the nineteen hardball priming transactions executed as of June 2022.¹⁴³

¹⁴¹ 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); de Fontenay, *supra* note 74, at 736–42.

¹⁴² See, e.g., Amir Sufi, *Information Asymmetry and Financing Arrangements: Evidence from Syndicated Loans*, 62 J. FIN. 629, 629–33 (2007).

¹⁴³ Drawing a line between “hardball” and other liquidity-preserving transactions is, at the limit, unavoidably arbitrary. Owing to its contentious aftermath, one might wish to label as hardball an uptier transaction pursued by the family-owned (but nonsponsored) Murray Energy. In 2018, Murray offered all lenders a pro rata opportunity to participate in a proposed super senior facility. See *Black Diamond Com. Fin., L.L.C. v. Murray Energy Corp. (In re Murray Energy Holdings Co.)*, 616 B.R. 84, 87–89 (Bankr. S.D. Ohio 2020). Hence, the deal does not qualify by the standards I have employed. But Murray did rely

The fact that sponsor influence has been closely associated with the execution of dropdowns and uptiers makes sense. Priming transactions allow distressed companies to access liquidity that might otherwise be available only in and through bankruptcy. But they also often hinge on dubious claims of legal right and almost always flout well-established norms. They therefore invite costly litigation that may bear negatively on a distressed company's expected enterprise value, and they pose reputational risk for the managers and directors who acquiesce to them. Prudent business leaders with relatively low-powered incentives to avoid Chapter 11 may understandably wish to curtail these risks.¹⁴⁴

2. Complex capital structures.

An emphasis on extending the runway can help to explain the complex capital structures that some deeply distressed companies now have. Relatively hierarchical capital structures used to be the norm. A large company entering bankruptcy would have multiple classes of financial debt, but creditors of each class would typically have a claim on the enterprise as a whole.¹⁴⁵ The sources of potential conflict with respect to a reorganization were thus limited. Senior creditors might argue for a low enterprise valuation so that their claims would be entitled to a relatively larger percentage of the reorganized business. Junior creditors might do the opposite. But the number of creditor groups that might conflict were few, and negotiations were correspondingly straightforward. How the waterfall broke was in doubt, but there was a waterfall.

In recent years, however, horizontally fragmented capital structures have marked many large Chapter 11 cases. One

on a very aggressive reading of its contractual rights, *see id.* at 89–103, so reasonable minds could differ on how best to characterize the deal. Other instances in which a distressed company has persuaded first-lien creditors to allow a super senior facility—Cineworld, Bioscrip, McDermott, and CPI Card Group—were pro rata deals and insufficiently controversial to generate litigation.

¹⁴⁴ This is not to say that dropdowns and uptiers will always predict sponsorship. If priming transactions come to be seen as legally permissible, ordinary-course responses to illiquidity, even relatively staid public company boards will presumably consider them. The observation here is about the willingness of private equity sponsors to accept legal risk and pioneer norm change.

¹⁴⁵ Asset-based loans (ABLs) are an exception. ABLs use only select assets as collateral. But, because ABLs tend to be overcollateralized and use assets with low specificity to the debtor's business—especially inventory and accounts receivable—they are rarely implicated in bankruptcy disputes.

creditor group might have a claim on only intellectual property; another might have a residual claim on intellectual property but a first lien on certain hard assets; another might have a first claim on the profits of certain physical locations; and so on.

Professor Ken Ayotte has shown that excessive fragmentation can result from differences of opinion among investors.¹⁴⁶ Suppose a company's productive process depends on two assets, *X* and *Y*. If investors disagree about the relative contribution of *X* and *Y* to the business, then, even if they agree on total enterprise value and agree that the assets are worth more together than apart, the company might be able to minimize its cost of capital by selling claims against *X* and *Y* severally. The upshot is that CFOs may rationally wish to sell investors fragmented claims against the company in ways that will predictably create conflict in the event of distress.¹⁴⁷

But what accounts for the change in capital-structure complexity if investors disagree about the world today as much as they did in the past? Sponsor control offers one explanation. Complexity is a frequent byproduct of sequential efforts to create liquidity. An important strategy for creating liquidity involves carving select assets out of an integrated business and then selling financial claims against them while retaining their productive use. The dropdown is one example of this strategy at work: the company seeking liquidity transfers legal title to some of its productive assets to a newly created subsidiary—and uses the subsidiary to create claims with priority to those specific assets—without changing the operating footprint of the business. Less esoteric transaction forms have a similar logic. Sale leasebacks and related-party-asset sales, for example, are well-understood transactions that companies can use to raise cash, contracts permitting; but they are useful because, and only to the extent that, they produce horizontally fragmented claims.¹⁴⁸

*In re Caesars Entertainment Operating Co.*¹⁴⁹ offers an especially vivid illustration of the way a patchwork capital structure can emerge from staged liquidity-preserving transactions designed to protect sponsors' investments. The machinations of

¹⁴⁶ Kenneth Ayotte, *Disagreement and Capital Structure Complexity*, 49 J. LEGAL STUD. 1, 4–5 (2020).

¹⁴⁷ *Id.* at 3–4.

¹⁴⁸ For a discussion of how these transactions work, see BELLUCCI & MCCLUSKEY, *supra* note 93, at 381.

¹⁴⁹ *Caesars Ent. Operating Co. v. Bokf (In re Caesars Ent. Operating Co.)*, 1:15-BK-01145 (Bankr. N.D. Ill. filed Jan 15, 2015).

Apollo and TPG in *Caesars* are too numerous and complicated to document adequately here. Happily, the better part of an excellent book by journalists Max Frumes and Sujeet Indap is devoted to the cause.¹⁵⁰ The punch line is that jury-rigged responses to impending illiquidity crises created a capital structure rife with conflicts by the time of *Caesars*' eventual bankruptcy.¹⁵¹

3. Tardy bankruptcy filings.

Two recent high-profile bankruptcies have spawned litigation alleging that the debtors' boards delayed commencement of Chapter 11 proceedings to benefit sponsors to whom they were in thrall. In one case, stemming from the Toys "R" Us bankruptcy, a trust representing unsecured creditors argued that the company's directors breached their fiduciary duties by paying Bain, KKR, and Vornado almost \$20 million in advisory fees over several years after they should have put the company in Chapter 11.¹⁵² Six of the eight directors were appointed by the company's sponsors (Bain, KKR, and Vornado), and the CEO, Dave Brandon, was on his second gig as chief executive of a Bain-owned company (Domino's Pizza being the first).¹⁵³ In a motion for summary judgment, the directors argued, among other things, that Toys "R" Us was solvent during the relevant period and that directors of solvent companies "can take actions that benefit the owners to the detriment of the company."¹⁵⁴ The bankruptcy judge denied summary judgment,¹⁵⁵ and the case settled on terms that remain confidential.¹⁵⁶ Creditors in the Sears bankruptcy pursued a similar claim, arguing that the company's board allowed its equity sponsor, ESL, to syphon value from the company for years rather than resolve distress as it should have in bankruptcy.¹⁵⁷ That claim resulted in a global settlement in which ESL and Sears' insurers

¹⁵⁰ See MAX FRUMES & SUJEET INDAP, *THE CAESARS PALACE COUP* 47–145 (2021).

¹⁵¹ *Id.* at 149–219.

¹⁵² See Second Amended Complaint, *In re Toys "R" Us U.S., Inc.*, 17-34665, Dkt. No. 146, at *4 (Bankr. E.D. Va. Apr. 30, 2021).

¹⁵³ See *id.* at *3, *13, *15.

¹⁵⁴ Defendants' Motion and Memorandum of Law for Summary Judgment, *In re Toys "R" Us U.S., Inc.*, 17-34665, Dkt. No. 315, at *27–30 (Bankr. E.D. Va. Dec. 13, 2021) (citing *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 102 A.3d 155, 184 (Del. Ch. 2014)).

¹⁵⁵ See Memorandum Opinion, *TRU Creditor Litigation Trust v. Raether et al.*, 20-03038, Dkt. No. 444, at *23–25 (Bankr. E.D. Va. June 27, 2022).

¹⁵⁶ See Motion for Entry of Order Approving Settlement Agreement, *In re Toys "R" Us U.S., Inc.*, 17-34665, Dkt. No. 7617 (Bankr. E.D. Va. Sept. 21, 2022).

¹⁵⁷ See Complaint, *Sears Holding Corp. v. Lampert (In re Sears Holding Corp.)*, No. 18-23538, Adv. Pro. 19-08250, at *1–10, 106–07 (Bankr. S.D.N.Y. Apr. 17, 2019).

agreed to pay \$175 million to resolve claims about mismanagement in the years before the company's Chapter 11 case.¹⁵⁸

It is hard to know what, if anything, to make of these (historically anomalous) cases. Two cases hardly make a trend, and the plaintiffs' claims might not even be valid. Showing that loyal directors would have filed a company for bankruptcy at a particular moment is no simple task. It entails proving not only a counterfactual world likely subject to considerable doubt but also that the directors understood the probabilistic-decision matrix in which they found themselves and consciously disregarded the value-maximizing route. On the other hand, difficulty of proof may suggest the existence of other cases with broadly consistent fact patterns that will never be observed because the cost of litigation exceeds expected recovery.

In any case, to the extent that the cases signal a change in practice, the dynamics of sponsor control can make sense of it. In general, there are two ways for a company to create liquidity. One is to raise new money. Doing so in distress is a challenge, however: debt overhang can make new equity investment uneconomical, and a combination of liens and contractual restrictions can make new debt investment impossible. The priming transactions described above are a way around the challenge. The other way to create liquidity is to reduce cash burn. A dropdown or uptier can help on this score, too, if the company can roll maturing debts into newly created, super senior debt with a longer time to maturity. But another and relatively straightforward way to conserve cash is to reduce capital investment. Investment requires cash today and returns cash only later.

A corollary of the idea that sponsor-owned companies put a premium on runway is that they tend to underinvest—to turn down positive expected value opportunities—when the liquidity profile of investment threatens to force a realization event such as bankruptcy. Indeed, the crux of one of the more plausible criticisms of the private equity industry is that sponsors' tendency to underinvest has an extractive character vis-à-vis employees and nonadjusting—typically junior—creditors.¹⁵⁹ It follows that

¹⁵⁸ Alex Wolf, *Sears' \$175 Million Bankruptcy Deal with Ex-CEO Lampert Approved*, BLOOMBERG L. (Aug. 31, 2022), <https://perma.cc/74GA-H78N>.

¹⁵⁹ See, e.g., Edward J. Janger, *Private Equity & Industries in Transition: Debt, Discharge & Sam Gerdano*, 71 SYRACUSE L. REV. 521, 523–29 (2021) (defending Senator Elizabeth Warren's proposed anti-private equity legislation, the Stop Wall Street Looting Act, on this ground).

sponsor control should produce cases in which directors could have maximized enterprise value by using Chapter 11 to address liquidity needs but chose not to. How pronounced such an effect is likely to be, and whether Toys “R” Us or Sears are examples, are for now matters of conjecture.

B. Sponsor Releases and “Contractual” Bankruptcy

One of the most notable trends in Chapter 11 practice over the last decade has been toward a process defined by prebankruptcy contracting.¹⁶⁰ Agreements reached between a distressed company and select investors in anticipation of a filing now frequently set the agenda for, and to a substantial degree limit the practical possibilities of, Chapter 11 proceedings. Two kinds of agreements are at the center of the trend. A restructuring support agreement (RSA) is a contract between a company and any number of its investors, usually from multiple classes, by which the parties commit to backing a specified approach to resolving distress (often via bankruptcy).¹⁶¹ A debtor-in-possession (DIP) loan agreement is a contract by which lenders, usually drawn from a company’s existing first-lien creditors,¹⁶² agree to provide cash to fund the business during a bankruptcy. Although RSAs and DIP loan agreements serve different functions, they often work hand in hand. An RSA will contemplate a particular mode of financing for the bankruptcy case, and milestones and covenants in a DIP loan agreement will reflect or indeed further the aims of an RSA.¹⁶³

¹⁶⁰ See generally David A. Skeel, Jr. & George Triantis, *Bankruptcy’s Uneasy Shift to a Contract Paradigm*, 166 U. PA. L. REV. 1777 (2018).

¹⁶¹ For documentation of increasing use, see Anthony J. Casey, Frederick Tung & Katherine Waldo, *Restructuring Support Agreements: An Empirical Analysis* (Jan. 2022) (unpublished manuscript) (on file with author).

¹⁶² For a variety of reasons, there has traditionally been little competition among potential lenders to fund DIP loans. See, e.g., Ayotte & Skeel, *supra* note 118, at 1579–84 (explaining the adverse selection issue); Kenneth Ayotte, Anthony J. Casey & David A. Skeel, Jr., *Bankruptcy on the Side*, 112 NW. U. L. REV. 255, 286–90 (2017) (explaining the contractual prohibition of junior-lender competition).

¹⁶³ In an instructive recent article, Professors Ken Ayotte and Jared Ellias documented changes over three decades in the influence that DIP loan agreements exercise on the bankruptcy process. See generally Ayotte & Ellias, *supra* note 70. They report a trend that can be described as a tale of two periods. In the early period, DIP loans frequently set a drop-dead date for the debtor getting out of bankruptcy but did not seek to dictate much about what the process would entail. See *id.* at 14–15; see also Eckbo, Li & Wang, *supra* note 70, at 1–2, 19, 36 fig.2 (documenting supracompetitive interest rates as well as frequent use of milestones, etc., and describing a modest *increase* in the DIP loan–interest rate spreads over the past twenty years). In recent years, that has changed. Now DIP loans

The causes and normative significance of the trend are a matter of substantial debate.¹⁶⁴ Critics focus on the capacity of prebankruptcy agreements to undermine statutory elements of bankruptcy designed to protect minority-creditor classes and other outsiders.¹⁶⁵ On the other hand, prebankruptcy agreements have obvious advantages. Chapter 11 is expensive in implicit and out-of-pocket terms. Deference to prebankruptcy agreements can shorten a case's duration substantially. It can also simplify dealmaking in a world of robust secondary-market trading of debt instruments.

The dynamics of sponsor control suggest another, heretofore unappreciated function of RSAs in sponsor-backed cases. Precisely because and insofar as an RSA can practically influence the substantive terms of a bankruptcy resolution, it can support a credible promise of value to a sponsor in exchange for capitulation to the interests of creditor signatories. In other words, it is a vehicle for concluding Coasean bargains.

If the RSA is a good vehicle for conveying value, a broad liability release is ideal cargo. In many instances, it would be practically impossible for signatory creditors to promise a sponsor a distribution under a plan. The absolute-priority rule lets any dissenting class of creditor veto a plan that would offer value to equity without paying the objecting creditors in full.¹⁶⁶ Unless sufficient support from every creditor class can be lined up before a filing, therefore, any prebankruptcy deal to compensate a sponsor directly entails risk of upset. But a decree releasing the sponsor from liability for money fraudulently transferred from the debtor or for conduct in relation to the debtor's management is not a distribution subject to the absolute-priority rule.¹⁶⁷

RSAs in sponsor-backed cases in fact often contemplate broad releases. The term sheet attached to the RSA in *In re TPC Group*

are more likely to condition credit on the debtor's progress toward a *particular* reorganization transaction. See Ayotte & Elias, *supra* note 70, at 14–15.

¹⁶⁴ For critical evaluation, see generally Edward J. Janger & Adam J. Levitin, *The Proceduralist Inversion—A Response to Skeel*, 130 YALE L.J.F. 335 (2020) [hereinafter Janger & Levitin, *Proceduralist Inversion*], David A. Skeel, Jr., *Distorted Choice in Corporate Bankruptcy*, 130 YALE L.J. 366 (2020), Edward J. Janger & Adam J. Levitin, *Badges of Opportunism: Principles for Policing Restructuring Support Agreements*, 13 BROOK. J. CORP. FIN. & COM. L. 169 (2018), Skeel & Triantis, *supra* note 160, and Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593 (2017).

¹⁶⁵ Janger & Levitin, *Proceduralist Inversion*, *supra* note 164, at 339–40.

¹⁶⁶ See 11 U.S.C. § 1129(a)(8), (b).

¹⁶⁷ For a discussion of the rule's limited doctrinal reach, see Stephen J. Lubben, *The Overstated Absolute Priority Rule*, 21 FORDHAM J. CORP. & FIN. L. 581, 584–85 (2016).

*Inc.*¹⁶⁸ is typical.¹⁶⁹ The term sheet does not propose to have the sponsors contribute anything of value to the bankruptcy estate, yet it would release them and their representatives from all claims that the debtors or the debtors' creditors might have in relation to prepetition conduct.¹⁷⁰

A broad release in an RSA is by no means a foolproof device. The deal binds only signatories. Nothing stops nonparty creditors from objecting to a proposed plan—whether or not the terms are consistent with an RSA—or from seeking the court's leave to pursue a sponsor in litigation. But an agreement among a substantial number of important constituents creates momentum that may be difficult for a bankruptcy judge to resist.¹⁷¹

In loose terms, one can think of the RSA—whether it promises value to a sponsor through a release or otherwise—as a way to resuscitate the “relative priority” regime that once held sway in corporate reorganizations. In the railroad receiverships of the late-nineteenth and early-twentieth centuries, shareholders typically received equity in the reorganized business even though creditors were not paid in full.¹⁷² The shareholders had too much going for them to be left out. They might have had tacit knowledge about how to run the railroad. They often had procedural rights which, if exercised, could prevent a value-maximizing disposition of the business.¹⁷³ Relative priority, whatever its flaws—and they are real¹⁷⁴—could induce cooperation calculated to make all investors better off. One lesson of the discussion above is that, in many respects, financial sponsors today are situated similarly to nineteenth-century railroad shareholders. It follows that the lure

¹⁶⁸ *In re* TPC Group Inc., 22-10493 (Bankr. D. Del. filed June 1, 2022).

¹⁶⁹ Decl. of Robert A. Del Genio in Support of Debtors' Chapter 11 Petitions and First Day Motions, Exhibit A, *In re* TPC Group Inc., 22-10493, Dkt. No. 27-1, at *67–102 (Bankr. D. Del. June 1, 2022).

¹⁷⁰ *See id.* at *83–86.

¹⁷¹ *See* Vincent S.J. Buccola, *Unwritten Law and the Odd Ones Out*, 131 YALE L.J. 1559, 1572–79 (2022) [hereinafter Buccola, *Unwritten Law*].

¹⁷² Janger and Levitin, *Proceduralist Inversion*, *supra* note 164, at 339–40.

¹⁷³ *See, e.g.*, *R.R. Co. v. Howard*, 74 U.S. (7 Wall.) 392, 393–94 (1869) (discussing a transaction in which shareholders received approximately 10% of the sale price of a railroad despite mortgage bondholders recovering just over 70% of what was due them, because shareholders could have interposed defenses to foreclosure that would have blocked the deal).

¹⁷⁴ Justice William O. Douglas was an early advocate of the absolute-priority rule precisely because he perceived relative priority to be susceptible to insider abuse. J. Ronald Trost, *Corporate Bankruptcy Reorganizations: For the Benefit of Creditors or Stockholders?*, 21 UCLA L. REV. 540, 542–44 (1973).

of relative priority would reemerge, as well perhaps as its dangers.¹⁷⁵

This way of looking at things should cause one to rethink the significance of process-oriented DIP loan agreements as well as RSAs. Bankruptcy scholars have long thought of the DIP loan as a tool with which a debtor's senior lenders can exercise control.¹⁷⁶ On the conventional view, therefore, the increasingly tight control DIP loan agreements seem to exercise over bankruptcy process is taken as evidence of a consolidation of lender power.¹⁷⁷ At least in sponsor-backed cases, however, a different interpretation might be warranted. If an RSA is the site of a Coasean bargain between a company's equity sponsor and a subset of its creditors (including those who seek to provide the DIP financing), then the sponsor as well as the proposed DIP lenders have an interest in a quick resolution tracking agreed-upon terms. Indeed, a sponsor might benefit from aggressive milestones more than the DIP lenders do, since the last thing a sponsor wants is a deliberative process with drawn-out investigations of prepetition conduct. In that sense, process-oriented DIP loan agreements might, in some cases, amount less to a sale of flexibility by the debtor and more to a collusive arrangement between lenders and sponsor.¹⁷⁸

* * *

My aim in this Part has been to connect financial sponsors' generic interest in delaying realization events—and the conflict that that interest is apt to create with creditors—to a handful of widely observed but otherwise apparently unrelated developments in reorganization practice. The developments discussed in this part are illustrations of the wide-ranging concrete effects that a shift toward sponsor power may be having on the resolution of financial distress. How far to attribute a causal effect of

¹⁷⁵ For a critical discussion of absolute and relative priority, see Baird, *Priority Matters*, *supra* note 123, at 789–806; Barry E. Adler & George Triantis, *Debt Priority and Options in Bankruptcy: A Policy Intervention*, 91 AM. BANKR. L.J. 563, 572–88 (2017), AM. BANKR. INST., FINAL REP. & RECOMMENDATIONS, *supra* note 57, at 207–24; Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1966–70 (2006). See generally Casey, *supra* note 7.

¹⁷⁶ See, e.g., Skeel, *Creditors' Ball*, *supra* note 3, at 923–26; Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 3, at 784–85.

¹⁷⁷ See Ayotte & Elias, *supra* note 70, at 9–15. Their view is consistent with common wisdom. See, e.g., Skeel, *Past, Present and Future*, *supra* note 52, at 1916–21.

¹⁷⁸ Cf. Buccola, *Unwritten Law*, *supra* note 171, at 1572–79 (explaining how incumbent managers collude with senior secured lenders via quick going-concern sales).

sponsorship is, in each instance, an open question and a provocation to empiricists.

CONCLUSION

A theme of corporate reorganization over the last forty years is the contrast between the law's formal stability and its functional fluidity. The Bankruptcy Code persists unaltered, but its uses and therefore its economic significance shift with trends in the capital markets.

The transition from an era of manager control to one of lender dominance is a generally acknowledged illustration of this process of change. The pace of Chapter 11 accelerated and going-concern sales proliferated not because Congress so decreed, but because new loan terms produced an equilibrium in which the interests of incumbent managers no longer mattered as much. Because that equilibrium defined corporate reorganization for the better part of two decades, a corresponding heuristic—the lender-control paradigm—proved a durable guide for understanding the practice.

Now the norms of leveraged finance have turned again. With looser loans and a more prominent role for financial sponsors has come a new characteristic power dynamic and, therefore, a new set of practices when large firms encounter distress. The lawyers and financiers who inhabit the world of distress have adjusted. The conceptual apparatus with which scholars make sense of the field should adjust, too.

A paradigm oriented around sponsor control can harmonize otherwise discordant trends on Wall Street and in the bankruptcy courts. More specifically, like the lender control paradigm did in the early 2000s, it can explain new patterns of reorganization as a function of the prevailing capital structures of leveraged businesses. The trend toward out-of-court liquidity transactions, in particular, makes perfect sense in light of the interaction between more flexible loan contracts and sponsors' incentives to avoid bankruptcy.

Insofar as the sponsor-control paradigm can help to order thinking about modern practice, it also poses new questions. These include a variety of empirical questions about the new dynamics' significance—about the effects on investors' ex post recoveries, on the terms of their ex ante contracts, and on the efficiency of the new dynamics relative to alternatives. They include questions about the future. If sponsorship reliably predicts an

aggressive use of borrower discretion under its contracts, and if market participants perceive that tendency to be wealth destroying, then one might expect contracts to change—to tighten for sponsored borrowers. They also include policy questions about how, if at all, the legal system should adjust in response. In that sense, the contribution of sponsor control, like any new paradigm, may be to highlight what is interesting but unknown as much as it is to explain otherwise inexplicable facts.

TABLE 1: TRANSACTIONS EXECUTED BETWEEN 2015 AND THE END OF Q2 2022

Year	Debtor	Sponsored?	Sponsor(s)	Litigation?
2015	iHeart ¹⁷⁹	Y	Bain / T.H. Lee	Y
2016	Claire's Stores ¹⁸⁰	Y	Apollo	N
2017	J. Crew ¹⁸¹	Y	TPG / L. Green	Y
2017	Neiman Marcus ¹⁸²	Y	Ares	Y
2018	PetSmart ¹⁸³	Y	BC	Y
2019	Revlon ¹⁸⁴	Y	M&F	Y
2020	Golden Nugget ¹⁸⁵	Y	Landry's	N
2020	Cirque du Soleil ¹⁸⁶	Y	TPG	N
2020	Travelport ¹⁸⁷	Y	Elliott / Siris	N
2020	Revlon ¹⁸⁸	Y	M&F	Y
2020	Party City ¹⁸⁹	N		N
2020	Hornblower ¹⁹⁰	Y	Crestview	N

¹⁷⁹ See Franklin Advisors, Inc. v. iHeart Commc'n Inc., 2017 WL 4518297, at *1–2 (Tex. App. Oct. 11, 2017).

¹⁸⁰ See Emma Orr, *Retail's Creditors Left Grasping as Brands Are Put Out of Reach*, CHI. TRIB. (Feb. 23, 2017), <https://perma.cc/NN5T-PEK7>.

¹⁸¹ See Ayotte & Scully, *supra* note 137, at 368–73; *see also* Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y, FSB, 2018 WL 1947405, at *1–5 (N.Y. Sup. Ct. Apr. 25, 2018).

¹⁸² See Complaint, UMB Bank, N.A. v. Neiman Marcus Group, Inc., 654509/2019, Dkt. No. 1, at ¶¶ 56–75 (N.Y. Sup. Ct. Aug. 8, 2019).

¹⁸³ See Complaint, Argos Holdings Inc. v. Citibank, N.A., 18-CV-05773, Dkt. No. 1, at ¶¶ 17–35 (S.D.N.Y. June 26, 2018).

¹⁸⁴ See Complaint, UMB Bank, N.A. v. Revlon, Inc., 20-CV-06352, Dkt. No. 1, at ¶¶ 60–77 (S.D.N.Y. Aug. 12, 2020).

¹⁸⁵ See *Frequently Discussed Liability Management Transactions*, KING & SPALDING 13, <https://perma.cc/2M4Q-ADFE>.

¹⁸⁶ See Andrew Willis, *Cirque du Soleil Asset Transfer Angers Creditors*, THE GLOBE & MAIL (May 15, 2020), <https://perma.cc/436S-6XGQ>.

¹⁸⁷ See Sean O'Neill, *Travelport Strikes Deal with Creditors That for Now Could Save It from Bankruptcy*, SKIFT (July 22, 2020), <https://perma.cc/5RY5-9JTR>.

¹⁸⁸ See Complaint, UMB Bank, N.A. v. Revlon, Inc., 20-CV-06352, Dkt. No. 1, at ¶¶ 78–102 (S.D.N.Y. Aug. 12, 2020).

¹⁸⁹ See Press Release, *Party City Seeks to Exchange Unsecured Notes for 1L Notes at Existing Issuer, 2L Notes at New Unsub and Equity; Intends to Raise \$100M of 1L Notes at New Unsub*, REORG RSCH. (May 29, 2020), <https://perma.cc/YU73-53Z6>.

¹⁹⁰ See Claire Boston & Katherine Doherty, *NYC Ferry's Hornblower Taps Niagara Falls Assets for Cash*, BLOOMBERG (Oct. 7, 2020), <https://www.bloomberg.com/news/articles/2020-10-07/nyc-ferry-operator-gets-rescue-financing-from-niagara-transfer#xj4y7vzkg>.

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¹⁹¹ See Alexander Saeedy & Jodi Xu Klein, *KKR's Envision Sparks Lender Dispute with Centerbridge, Angelo Gordon Deal*, WALL ST. J. (May 2, 2022), <https://perma.cc/2MM5-U5K5>.

TABLE 2: NON-PRO RATA UPTIER TRANSACTIONS EXECUTED
BETWEEN 2015 AND THE END OF Q2 2022

Year	Debtor	Sponsored?	Sponsor(s)	Litigation?
2017	NYDJ ¹⁹²	Y	Crestview / Maybrook	Y
2020	Serta Simmons ¹⁹³	Y	Advent	Y
2020	Boardriders ¹⁹⁴	Y	Oaktree	Y
2020	TriMark ¹⁹⁵	Y	Centerbridge / Blackstone	Y
2021	TPC Group ¹⁹⁶	Y	First Reserve / SK / Sawgrass	Y
2022	Incora ¹⁹⁷	Y	Platinum	Y

¹⁹² After preliminary hearings in litigation concerning the transaction's legality, the company changed course and invited the creditors that it had sought to subordinate to participate on a pro rata basis. Dick, *supra* note 137, at 1359–62 (discussing the transaction).

¹⁹³ See LCM XXII Ltd. v. Serta Simmons Bedding, LLC, 2022 WL 953109, at *3–4 (S.D.N.Y. Mar. 29, 2022).

¹⁹⁴ See Complaint, ICG Global Loan Fund 1 DAC v. Boardriders, Inc., 655175/2020, Dkt. No. 1, at 49–70 (N.Y. Sup. Ct. Oct. 9, 2020).

¹⁹⁵ See Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., 2021 WL 3671541, at *2–6 (N.Y. Sup. Ct. Aug. 16, 2021).

¹⁹⁶ See Bayside Cap. Inc. v. TPC Grp. Inc. (*In re* TPC Grp. Inc.), 2022 WL 2498751, at *1–6 (Bankr. D. Del. July 6, 2022).

¹⁹⁷ See Rachel Butt, Eliza Ronalds-Hannon & Sridhar Natarajan, Silver Point, *Pimco Cook Up a Distressed Debt Deal That Has Rival Creditors Fuming*, BLOOMBERG (Apr. 5, 2022), <https://www.bloomberg.com/news/articles/2022-04-05/silver-point-pimco-cook-up-credit-trade-that-has-rivals-fuming#xj4y7vzkg>.