Covenant Control: The Case for Treating Uptier Transactions as a Form of Corporate Control

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In recent years, uptier transactions have emerged as a novel way for distressed companies to restructure their debt obligations, resulting in unforeseen and inequitable outcomes for investors in corporate debt. Uptier transactions depend on provisions in credit agreements that permit debtholders with a majority stake in a class of debt to make decisions on behalf of all debtholders. Distressed companies take advantage of these provisions by colluding with a majority of debtholders to shift economic value from the remaining debtholders to themselves. As this Comment demonstrates, these transactions are likely to be value destructive and present an issue for capital markets. Unfortunately, the contractual solutions available to debtholders to prevent uptier transactions either are insufficient or impose substantial costs on parties.

Uptier transactions may be a recent innovation in restructuring, but they are an instance of investor opportunism that is present whenever there is common ownership in property—those with control over common property can exercise that control in a way that benefits themselves to the detriment of other owners. Corporate law has resolved this issue in the equity context by imposing a fiduciary duty of loyalty on controlling shareholders. This Comment proposes treating debtholder control over debt covenants as akin to the control that large shareholders wield over corporations by imposing a waivable fiduciary duty of loyalty on controlling debtholders. The controlling shareholder doctrine in Delaware corporate law provides a useful starting point to consider how courts could enforce a controlling debtholder fiduciary duty in a way that would provide adequate judicial oversight over the most concerning transactions while limiting disruption to productive transactions.

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INTRODUCTION

When companies experience financial distress, they often attempt to restructure their debt obligations to remain solvent and avoid bankruptcy. Traditionally, out-of-court restructuring has required collaboration and consensus among the debtor company, its debtholders, and other stakeholders.[1] In recent years, however, debtors have taken advantage of unclear language in credit agreements to initiate nonconsensual restructuring transactions, leading to unforeseen and inequitable outcomes for debtholders.[2] For example, a debtor company may work with only a bare majority of its debtholders to amend the terms of the credit agreement to permit the company to take on additional debt that has priority over its existing debt.[3] The debtor gains access to new money, and participating debtholders receive repayment priority and the opportunity to fund the new money loan. However, these benefits come at the expense of nonparticipating debtholders who see the value of their claims diminish significantly as a consequence of the transaction.

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1 *See, e.g.*, Diane Lourdes Dick, *Hostile Restructurings*, 96 WASH. L. REV. 1333, 1343–45 (2021); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1227–28 (2006).

2 *See* Dick, *supra* note 1, at 1336–37.

3 The other common form of hostile restructuring—a "dropdown" transaction—involves construing the credit agreement to allow the debtor company to restructure its debts without the consent of its debtholders. *See, e.g.*, Vincent S.J. Buccola & Greg Nini, The Loan Market Response to Dropdown and Uptier Transactions (June 22, 2022) (unpublished manuscript at 10–11) (available at https://perma.cc/NME7-MTNB) (discussing dropdown transactions).

This form of restructuring has been termed an "uptier transaction," and its effect on nonparticipating debtholders can be devastating. In the case of Serta Simmons, the company was able to subordinate the loans of nonparticipating, first-lien lenders to more than $1 billion of new debt secured by only $200 million in new money.[4] Apart from fairness concerns, uptier transactions present a serious problem for capital markets. They waste scarce capital on unproductive transactions, undermine investor confidence, and increase the investment risk of even the most secure debt, which collectively raise the cost and availability of debt financing.

Since June 2020, at least six uptier transactions have led to litigation.[5] While this figure may seem small relative to the ubiquity of corporate debt financing, uptier transactions are concentrated among a significant and growing subset of firms: large, distressed, private equity–controlled companies.[6] The size of the loan market that could be affected by uptier transactions is substantial.[7] There is estimated to be $1 trillion in total leveraged

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[4] *Id.* at 21. The other $875 million was used to exchange participating debtholders' original loans for new loans that received higher priority. *Id.*

[5] Complaint, North Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC, 652243/2020, Dkt. No. 1 (N.Y. Sup. Ct. June 11, 2020) [hereinafter Serta Simmons Complaint]; Complaint, Audax Credit Opportunities v. TMK Hawk Parent, Corp., 565123/2020, Dkt. No. 1 (N.Y. Sup. Ct. Nov. 6, 2020) [hereinafter TriMark Complaint]; Complaint, ICG Global Loan Fund 1 DAC v. Boardriders, Inc., 655175/2020, Dkt. No. 1 (N.Y. Sup. Ct. Oct. 09, 2020) [hereinafter Boardriders Complaint]; *In re* TPC Group Inc., 2022 WL 2498751 (Bankr. D. Del. July 6, 2022); Complaint, SSD Invs. Ltd. v. Wilmington Sav. Fund Soc'y, 654068/2022, Dkt. No. 1 (N.Y. Sup. Ct. Oct. 28, 2022) [hereinafter Incora Complaint]; Complaint, AIMCO CLO 10 Ltd. v. Revlon, Inc., 22-10760, Dkt. No. 1 (Bankr. S.D.N.Y. Oct. 31, 2022) [hereinafter Revlon Complaint]. The term "uptier transaction" has been used to describe a variety of transactions. This Comment refers to restructuring transactions as uptier transactions if they involve an amendment to the credit agreement with less-than-unanimous consent that permits the lien securing the debt instrument to be primed or the collateral to be released if such consent was the result of inducements offered only to a subset of debtholders.

[6] *See generally* Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporate Reorganization*, 90 U. CHI. L. REV. 1 (2023) [hereinafter Buccola, *Sponsor Control*] (observing the increase in private equity sponsorship of large companies and their prevalence in nonconsensual bankruptcies). *See also* Serta Simmons Complaint, *supra* note 5, at 2 (noting that Serta Simmons was privately owned and had over $2 billion in debt); ALLIE SCHWARTZ, JOSEPH B. "J.B." DOYLE, NICK YAVORSKY & DIEGO VEGA, CORNERSTONE RESEARCH, TRENDS IN LARGE CORPORATE BANKRUPTCY AND FINANCIAL DISTRESS 1 (2022), https://perma.cc/MCJ4-BRL4 (observing that an average of only twenty-two companies with assets greater than $1 billion declare bankruptcy every year, some of which are owned by private equity firms).

[7] In the bond market, similar tactics have been used in around 20% of bond restructuring transactions. William W. Bratton & Adam J. Levitin, *The New Bond Workouts*, 166 U. PA. L. REV. 1597, 1601 (2018).

loans outstanding,[8] and syndicated loans used in leveraged buyouts alone reach between $50 billion to $125 billion annually.[9]

Uptier transactions are likely to become increasingly prevalent in the wake of a recent decision that provided greater certainty that uptier transactions are legally valid.[10] In *In re TPC Group*,[11] a Delaware bankruptcy court became the first court to enter final judgment on the merits of an uptier transaction.[12] The court approved the transaction, finding that it did not violate the letter of the applicable agreements.[13] The court declined to look further, stating that while the transaction may have violated what an earlier court called the "all for one, one for all" spirit of a

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8 *See* Seung Jung Lee, Dan Li, Ralf R. Meisenzahl & Martin J. Sicilian, *The U.S. Syndicated Term Loan Market: Who Holds What and When?*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Nov. 25, 2019), https://perma.cc/G6CH-QYAT. Loans are considered leveraged if they are noninvestment grade (BB or lower) and highly leveraged if the issuance spread is 225 basis points or more above LIBOR. The total amount of both leveraged and highly leveraged loans outstanding was over $1 trillion in 2018. *Id.*; *see also* Marina Lukatsky, *US Leveraged Loan Returns Soar in November on Vaccine Hopes, Led by Riskier Debt*, S&P GLOB. MKT. INTEL. (Dec. 1, 2020) (noting that "the total par amount outstanding has remained at roughly $1.2 trillion for the last 13 months").

9 Abby Latour, *Leveraged Loans Fuel Q2 LBOs at Fastest Pace Since Global Financial Crisis*, S&P GLOB. MKT. INTEL. (July 20, 2021), https://perma.cc/38V2-DATK.

10 Nonconsenting debtholders have argued that uptier transactions are prohibited by the terms of the credit agreement or by the covenant of good faith and fair dealing that is implied in every contract. *See, e.g.*, Serta Simmons Complaint, *supra* note 5, at 22–23.

11 2022 WL 2498751 (Bankr. D. Del. July 6, 2022).

12 The earliest judicial decision on uptier transactions denied the plaintiffs' motion for a preliminary injunction, finding that their breach of contract and breach of the implied covenant of good faith and fair dealing claims were unlikely to succeed on the merits. *See* N. Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC, 2020 WL 3411267, at *4–5 (N.Y. Sup. Ct. June 19, 2020). Other decisions concerning the validity of uptier transactions have let breach of contract claims proceed past the motion to dismiss stage given sufficient ambiguity in the terms of the contract, but courts have demonstrated varying levels of receptiveness to plaintiffs' claims for breach of the implied covenant of good faith and fair dealing. *Compare* Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., 2021 WL 3671541, at *12–13 (N.Y. Sup. Ct. Aug. 16, 2021) (dismissing plaintiffs' claim for breach of the implied covenant of good faith and fair dealing), *with* LCM XXII Ltd. v. Serta Simmons Bedding, LLC, 2022 WL 953109, at *7–8, *14–16 (S.D.N.Y. Mar. 29, 2022) (allowing plaintiffs' claim for breach of the implied covenant of good faith and fair dealing to proceed), *and* ICG Global Loan Fund 1 DAC v. Boardriders, Inc., 2022 WL 10085886, at *9 (N.Y. Sup. Ct. Oct. 17, 2022) (same).

13 *TPC Group*, 2022 WL 2498751, at *12. In a decision rendered after *TPC Group*, a Texas bankruptcy court similarly found that an uptier transaction was permitted by the terms of the credit agreement but allowed a claim for breach of the implied covenant of good faith and fair dealing to proceed. Sujeet Indap & Eric Platt, *Big Debt Investors Dealt Blow in Mattress Maker Bankruptcy Ruling*, FIN. TIMES (Mar. 28, 2023), https://www.ft.com/content/3364f0ab-0073-41a0-ad5b-f13cd02ff524. No court has yet ruled that an uptier transaction has violated the implied covenant of good faith and fair dealing, and receptiveness to these claims has been mixed. *See supra* note 12; *see also infra* note 103.

syndicated loan, "[t]here is nothing in the law that requires holders of syndicated debt to behave as Musketeers. To the extent such holders want to be protected against self-interested actions by borrowers and other holders, they must include such protections in the terms of their agreements."[14]

Although the decision in *TPC Group* may be correct as a matter of contract interpretation, it fails to account for the substantial shortcomings of contractual solutions to uptier transactions. The ability for a majority of debtholders to amend the credit agreement serves important functions: it prevents opportunistic holdup behavior by minority debtholders and ensures sufficient flexibility to the debtor in cases where a beneficial restructuring transaction can be achieved. Similarly, the loopholes used to provide exclusive benefits to participating debtholders are included in credit agreements because they also serve useful purposes that would be hindered if contracting parties were forced to remove them. There is also the risk that motivated parties will simply find new loopholes to provide these exclusive benefits to participating debtholders.

Drawing on the protections afforded to shareholders under Delaware corporate law, this Comment suggests that debtholders *should* behave as "Musketeers" in the absence of effective alternative solutions. Historically, shareholders faced risks of opportunism similar to those presented by uptier transactions: shareholders with a controlling stake in a corporation could control corporate assets in a way that benefitted themselves at the expense of minority shareholders. Early in the twentieth century, courts fashioned an equitable solution to address the issue by imposing a fiduciary duty of loyalty on controlling shareholders. This approach continues in Delaware corporate law today and has been extended as a default rule in other areas of Delaware law, such as LLC law, presenting a possible solution to uptier transactions. Specifically, this Comment proposes treating creditor control over debt covenants as akin to the control that large shareholders wield over corporations by imposing on controlling debtholders a waivable fiduciary duty of loyalty owed to other investors in the debt instrument. The controlling shareholder doctrine in Delaware corporate law provides a useful starting point to consider how courts could enforce a similar fiduciary duty in a way that would adequately provide judicial oversight over the

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[14] *TPC Group*, 2022 WL 2498751, at *12 (citing *Audax*, 2021 WL 3671541, at *1).

most problematic transactions while limiting disruption to productive transactions.

Part I of this Comment describes the structure of uptier transactions, explains the problems they pose to capital markets, and details the shortcomings of contractual solutions that are available to debt investors. Part II describes the history, legal basis, and rationale for applying the fiduciary duty of loyalty to controlling debtholders. Part III outlines the potential scope and substance of the duty and how courts could enforce the duty in a way that would benefit parties in a restructuring transaction.

I. THE PROBLEMS WITH UPTIER TRANSACTIONS

A. The Structure of Uptier Transactions

A common form of corporate debt financing is a syndicated loan, which is a loan extended to a borrower by a group of financial institutions (e.g., banks, pension funds, insurance companies) that comprise a loan syndicate.[15] After the loan is originated, shares of syndicated loans can be traded in secondary loan markets to other debt investors.[16] The terms of the loan are governed by a syndicated loan agreement, or credit agreement, which specifies the rights and obligations of the debtor company and the loan holders. For example, when a syndicated loan is secured by a lien (a claim on company assets that receives repayment priority over unsecured claims and lower-priority liens), the credit agreement will usually prohibit the debtor company from issuing new debt secured by a lien that takes priority over the syndicated loan. Bonds are another common form of corporate debt financing that share these same essential features.

1. Amending the credit agreement without unanimous consent.

In general, credit agreements are structured to permit a simple majority of debtholders to amend many of the terms. This allows debtholders to provide the debtor greater flexibility in circumstances where strict compliance may unnecessarily cause the

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[15] *See Syndicated Loan Portfolios of Financial Institutions*, FED. RSRV. (Dec. 16, 2022), https://perma.cc/R9HY-BCPT.

[16] *Id.*

company to default and undermine their recovery.[17] For example, a majority of debtholders may believe that allowing the debtor company to take on new, senior debt will help the company remain solvent, increasing the likelihood that their loans will be paid back in full. Even if a minority of debtholders disagree, there is little reason to think their judgment is more accurate than the majority of debtholders, who have a greater stake in the syndicated loan.[18] Minority debtholders also may have ulterior motives, such as an incentive to withhold their consent to create negotiating leverage, or may have conflicting interests that would be served if the debtor company entered bankruptcy.[19]

The ability to amend the credit agreement without the consent of every debtholder is an essential feature of uptier transactions. In a traditional uptier transaction, the debtor company works with the requisite majority of its debtholders to amend the terms of the credit agreement to permit the company to issue new debt secured by a superior lien (i.e., the new loan takes priority over the existing loan) without the consent of nonparticipating debtholders.[20] As part of the transaction, other covenant protections from the credit agreement may be stripped out as well.[21] In more recent uptier transactions, participating debtholders and debtors have used even more contentious tactics to disadvantage nonparticipating debtholders. Rather than simply subordinating the loans of nonparticipating debtholders, these transactions released the nonparticipating debtholders' liens held against the debtor's collateral entirely, making their claims unsecured.[22] Even more controversially, the participating debtholders originally lacked the requisite majority necessary to amend the original credit agreement, so the debtor companies issued additional

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17 *See TPC Group*, 2022 WL 2498751, at *2–3. It is often infeasible for a credit agreement to specify what the debtor company can and cannot do in advance. Whether the debtor's desired action is productive or opportunistic often depends on the specific circumstances. Strong covenants that can be amended allow debtholders to prevent opportunistic behavior by the debtor while permitting productive behavior by amending the terms of the agreement. *See* Douglas G. Baird, Three Faces of Creditor-on-Creditor Aggression (unpublished manuscript at 19–20) (on file with author).

18 *See* Baird, *supra* note 17 (manuscript at 16–17).

19 *See* Bratton & Levitin, *supra* note 7, at 1606–07.

20 *See, e.g.*, *TPC Group*, 2022 WL 2498751, at *1–2.

21 *See, e.g.*, Boardriders Complaint, *supra* note 5, at 7.

22 Revlon Complaint, *supra* note 5, at 55–59; Incora Complaint, *supra* note 5, at 22–26.

"sham" or "phantom" debt to participating debtholders in order to reach the necessary threshold to amend the credit agreement.[23]

2. Providing exclusive benefits to participating debtholders.

Debtholders participating in an uptier transaction modify the credit agreement not because they sincerely believe it will increase the recovery on the syndicated loan or bond, but because the debtor company has offered to compensate them—and only them—in exchange for intentionally impairing the expected recovery on the syndicated loan or bond. This dynamic distinguishes uptier transactions from other amendments to credit agreements that are made in the ordinary course of business.

Debtor companies clearly benefit from uptier transactions because they gain access to new money that may help the company avoid bankruptcy. In exchange, participating debtholders typically get the opportunity to exchange their existing loans for new loans that have priority over the loans of nonparticipating debtholders. If the company subsequently enters bankruptcy, debtholders who participated in the debt-for-debt exchange will get paid back in full before nonparticipating debtholders can recover anything.[24] This debt-for-debt exchange may be refinanced at face value even when the loan is trading at a discount, meaning that the debtor company effectively buys back the debt from participating debtholders at a premium to its market value.[25] In addition to a debt-for-debt exchange, participating debtholders also usually receive the exclusive opportunity to fund the new money loan on generous terms.[26] This puts them in a strong position for

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[23] Revlon Complaint, *supra* note 5, at 42–54; Incora Complaint, *supra* note 5, at 22–26.

[24] Serta Simmons Complaint, *supra* note 5, at 15–16; TriMark Complaint, *supra* note 5, at 27–28; Boardriders Complaint, *supra* note 5, at 22–23. Unlike other uptier transactions, TPC Group's did not include a debt-for-debt exchange, but the debtor company did promise that a portion of participating debtholders' existing debt would be repaid at 102 cents on the dollar, a premium on its current market value of 88 cents on the dollar. *See* Jared A. Ellias & Elisabeth de Fontenay, *Law and Courts in the Age of Debt*, 171 U. PA. L. REV. (forthcoming 2023) (manuscript at 16) (on file with author).

[25] *See, e.g.*, TriMark Complaint, *supra* note 5, at 27–28. In cases such as *Serta Simmons*, the debt-for-debt exchange was consummated at a $400 million discount, meaning that Serta Simmons was able to reduce its debt burden by $400 million as part of the exchange. Serta Simmons Complaint, *supra* note 5, at 15–16.

[26] *See, e.g.*, *TPC Group*, 2022 WL 2498751, at *5–6; Vincent S.J. Buccola, *Efficacious Answers to the Non-Pro Rata Workout*, 171 U. PA. L. REV. (forthcoming 2023) (manuscript at 9) (on file with author) [hereinafter Buccola, *Efficacious Answers*] (noting that the new

future lucrative lending opportunities, such as the ability to provide debtor-in-possession (DIP) financing if the company enters bankruptcy.[27] In addition to being highly lucrative, the ability to provide DIP financing also ensures that participating debtholders will be in control of the bankruptcy process, increasing their bargaining leverage.[28]

Credit agreements are usually structured to align debtholders' collective interests by limiting the ability of the debtor to discriminate among them, making the debtor's ability to offer exclusive benefits to participating debtholders particularly notable. Pro rata sharing provisions, for example, require that debtholders receive only their proportional share of any distributions of proceeds and that a debtholder turn over any excess distribution they've received from the debtor to the other debtholders.[29] Voluntary prepayment provisions also typically require the debtor company to buy back debt at face value and extend the offer to all debtholders.[30] Given the greater likelihood that these terms could be amended opportunistically to the detriment of nonparticipating debtholders, amendments to these provisions usually require unanimous consent among debtholders. In other words, credit agreements usually require unanimity for amending provisions where the interests of debtholders are antagonistic. Conversely, the rationale for allowing some modifications to the agreement with less-than-unanimous consent, such as allowing the loan to be subordinated, is that debtholders believe that they are similarly situated and can trust the majority to act in everyone's shared economic interest.[31]

Given the existence of provisions that prohibit the debtor from discriminating amongst debtholders in the same class of debt, it may be surprising that debtors are able to offer debt-for-debt exchanges exclusively to participating debtholders in uptier

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money loan in *TPC Group* was funded at an above-market rate); Stephen J. Lubben, *Holdout Panic*, 96 AM. BANKR. L.J. 1, 3–4 (2022).

[27] *See TPC Group*, 2022 WL 2498751, at *5–6; Lubben, *supra* note 26, at 3–4.

[28] *See* Ellias & de Fontenay, *supra* note 24 (manuscript at 14).

[29] *See* Shana A. Elberg, Evan A. Hill & Catrina A. Shea, *Uptier Exchange Transactions Remain in Vogue, Notwithstanding Litigation Risk*, SKADDEN (Feb. 2, 2021), https://perma.cc/6TR7-AZG2; *Serta's, Boardriders' Superpriority Uptier Exchanges Can Likely Be Replicated Under Most Existing Credit Facilities; Simple Drafting Changes Could Block Them in Future Facilities*, REORG RSCH. (Sept. 22, 2020) [hereinafter *Serta's, Boardriders' Superpriority*], https://perma.cc/E62B-S844.

[30] Elberg et al., *supra* note 29; *Serta's, Boardriders' Superpriority*, *supra* note 29.

[31] Dick, *supra* note 1, at 1344–45.

transactions. Uptier transactions have generally relied on a specific exception to the pro rata requirement in many credit agreements that allows for non–pro rata debt buybacks by the debtor on the "open market." While debt-for-debt exchanges aren't completed on the "open market" in any meaningful sense, many credit agreements do not define the term or have specific requirements governing the process.[32]

Debtors' ability to offer exclusive benefits to participating debtholders means that there is no reason to believe that the modifications to the credit agreement are expected to maximize the recovery of the syndicated loan or bond. In these cases, the presumption that the debtholders are similarly situated and can trust the majority to act in everyone's shared interest no longer holds. Unsurprisingly, debtholders have reacted to this misalignment of incentives by modifying credit agreements in a variety of ways, discussed in Part I.C.

B. The Economic Justifications for Preventing Uptier Transactions

Apart from fairness concerns, the ability of distressed companies to engage in uptier transactions imposes significant costs on debt financing. First, uptier transactions can destroy economic value and can lead to inefficient capital allocation, diverting scarce capital away from more productive uses. Second, the inability of parties to credibly commit to abstaining from uptier transactions increases the costs of debt financing, imposing significant direct and indirect costs on debt markets.

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[32] *See* Elberg et al., *supra* note 29; *Serta's, Boardriders' Superpriority*, *supra* note 29. In *TPC Group*, the debtor did not offer a debt-for-debt exchange; rather, the company promised that a portion of participating debtholders' existing debt would be repaid. *See supra* note 26. In the case of *Serta Simmons*, a Texas bankruptcy court found that the debt-for-debt exchange fit within the meaning of an open market purchase. Indap & Platt, *supra* note 13. In other uptier transactions, courts have allowed cases to proceed past the motion to dismiss stage given the ambiguity of the open market provision. *See* Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., 2021 WL 3671541, at *9–10 & *12 n.9 (N.Y. Sup. Ct. Aug. 16, 2021); *LCM XXII Ltd.*, 2022 WL 953109, at *7–8; *Boardriders*, 2022 WL 10085886, at *9.

1. Lost economic value and inefficient capital allocation.

While the shift of value between parties that occurs in an uptier transaction does not directly implicate efficiency considerations,[33] these transactions (1) are likely to be value *destructive* and (2) divert scarce capital away from more productive enterprises that could have used the same capital to generate economic value. Uptier transactions are likely to be value destructive because their attendant costs are borne by the nonparticipating debtholders whose dissent is immaterial. Instead, these transactions need only create value for the participating parties, even if they create less value for participating parties than the value lost by nonparticipating debtholders.[34]

The following illustration demonstrates how uptier transactions allow for value-destructive transactions. Consider a distressed company worth $100 that has an existing debt burden of $125 and must choose between two options. It can either (1) liquidate its assets for $100, or (2) pursue a plan that has a 50/50 chance of making the firm worth either $180 or $60,[35] if its existing debtholders allow it to issue $25 in new, senior debt.[36] Pursuing the plan destroys value, as the extension of $25 in new money only increases the value of the firm by $20 in expectation.[37] This net loss can also be observed by looking at the expected value (EV)

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[33] *But see infra* Part I.B.2. Transaction and monitoring costs would render even a zero-sum uptier transaction value destructive.

[34] There is some debate over whether uptier transactions actually destroy value in practice. For example, Professor Douglas Baird believes this concern may be exaggerated. *See* Baird, *supra* note 17 (manuscript at 22–23); *see also* Buccola, *Efficacious Answers*, *supra* note 26 (manuscript at 19–20) (suggesting that non–pro rata treatment may be value generating in some circumstances). Ultimately this is an empirical question that would benefit from additional research. However, the fact that parties have altered the terms of credit agreements to prevent uptier transactions suggests that informed actors do not view these transactions as beneficial. *See infra* Part I.C. Further, the inability to readily differentiate between value-generating and value-destructive uptier transactions suggests that judicial oversight may be warranted.

[35] For example, a company may believe that it can ride out a temporary downturn in the economic cycle. If it outlasts the downturn, then it may be worth more than it would have been if it had liquidated. If the downturn lasts longer than anticipated, then the company may be forced to liquidate anyway and lose substantial value in its failed attempt to avert bankruptcy.

[36] A creditor in this case would almost certainly be unwilling to lend money to the firm if it had lower priority than the existing debt, since it would have a 50% chance of not getting paid back. This situation, referred to as "debt overhang," is a common situation for distressed companies.

[37] The expected value (EV) of the firm is $0.5 \times \$180 + 0.5 \times \$60 = \$120$, which is $20 more than the liquidation option.

accruing to the debtor and existing debtholders under both options. The EV accruing to the debtor increases from $0 if the company sells its assets to $15 if it pursues the plan.[38] However, the benefit to the debtor is more than offset by the decline in debtholders' EV from $100 to $80.[39] Accordingly, the company's debtholders will refuse to amend the credit agreement even if the debtor is willing to share its gains, because its gains of $15 are not sufficient to offset $20 in losses to them. From the standpoint of economic efficiency, this is the optimal outcome since pursuing the plan destroys value in expectation.

On the other hand, if the debtor company only needs to share its gains with a bare majority of debtholders, as is the case in an uptier transaction, then the transaction could occur even though it destroys value in the aggregate. The decline in value from pursuing the transaction for a bare majority of debtholders is only a little over $10,[40] which can be more than offset by the $15 gain in value accruing to the debtor, who can share its gains by granting participating debtholders the exclusive opportunity to fund the new money loan on generous terms. Uptier transactions go a step further by concentrating debtholder losses on nonparticipating debtholders through a debt-for-debt exchange. By prioritizing the newly exchanged debt owned by participating debtholders over nonparticipating debtholders' existing debt, 90% of the $20 loss in EV to debtholders under the plan will be borne by nonparticipating debtholders despite the fact that they own only 49% of the debt.[41] Participating debtholders will therefore have an expected loss of less than $2 under the plan—which can easily be offset by

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38 The post-transaction EV for the debtor is $0.5 \times (\$180 - \$150) = \$15$. This calculation reflects a 50% chance that the plan will fail and all remaining value will go to repaying debtholders and a 50% chance that the plan will succeed and the company will be worth $30 after the two loans are repaid.

39 The post-transaction EV for the debtholders is $0.5 \times \$125 + 0.5 \times (\$60 - \$25) = \$80$. This calculation reflects full recovery on the loan if the plan succeeds and partial recovery on the loan if the plan fails, taking into account that the loan gets repaid only after the new, senior loan.

40 The EV accruing to a bare majority of debtholders is $0.51 \times (0.5 \times \$125 + 0.5 \times (\$60 - \$25)) = \$40.8$. This is approximately $10 lower than the $51 that 51% of debtholders would receive if the company liquidated for $100.

41 The EV accruing to a bare minority of debtholders is $0.49 \times (0.5 \times \$125) = \$30.63$. This is over $18 less than the $49 that 49% of debtholders would receive if the company liquidated. In the case where the firm is only worth $60, the nonparticipating debtholders would receive nothing because their lien is inferior to the $25 new money loan and the loans of participating debtholders with a face value of $63.75 ($0.51 \times \$125$).

the $15 gain in value accruing to the debtor.[42] As a result, both the debtor and the participating debtholders would be in favor of the uptier transaction even though it destroys value, because losses are concentrated among nonparticipating debtholders. The economic loss from pursuing the plan is also compounded by the fact that the $25 in new money could have been used to create value in another investment that now won't get funded because the capital has been inefficiently allocated to this value-destructive transaction. Given how effectively the participating parties can concentrate losses on nonparticipating debtholders (in this example, nonparticipating debtholders experienced over $18 in lost EV while the debtor and participating debtholders were able to increase their EV by over $13) many value-destructive uptier transactions may be worth pursuing for participating parties, wasting scarce capital and reducing wealth.

2. Increased costs of debt financing.

The second issue with uptier transactions is their detrimental effect on the cost of debt financing. The risk to debtholders of having their loans subordinated in an uptier transaction can be devastating, particularly for secured debtholders that value certainty of repayment and have priced that certainty into the terms they extended to the debtor. Consider the example from the previous section: nonparticipating debtholders expected to recover 80% of their loan if the company liquidated,[43] but after the uptier transaction their expected recovery dropped to only 50% and was subject to extreme volatility—a 50% chance of no recovery and a 50% chance of complete recovery.[44] The possibility of disadvantaging secured debtholders to such an extent without requiring their consent may seriously undermine investor confidence in the safety of their investments.[45] Companies receive loans on better

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[42] The EV accruing to a bare majority of debtholders is $0.51 \times (0.5 \times \$125) + 0.5 \times \$35 = \$49.38$. This is less than $2 less than the $51 that 51% of debtholders would receive if the company liquidated. In the case where the firm is only worth $60, the participating debtholders would receive $35 because the new money loan receives $25 and minority debtholders' claim is junior to participating debtholders.

[43] All debtholders equally recover their share of the $125 loan from the $100 liquidation.

[44] If the plan fails, then the new money loan ($25) and participating debtholders (holding $0.51 \times \$125 = \$63.75$) receive the remaining value of the company ($60), with nothing left for nonparticipating debtholders. If the plan succeeds and the company is worth $180, then all of the debtor's loans, which total only $150, can be repaid.

[45] *See, e.g.*, Dick, *supra* note 1, at 1373.

terms when they grant lenders a lien against their assets because of the lower perceived investment risk of the loan. The ability to impair secured lenders' lien rights and payment priority reduces the benefit that liens traditionally afforded these investors. Debtholders are likely to respond to increased investment risk by requiring greater compensation or by exiting the debt market altogether, reducing the size and liquidity of the secondary loan market. Both would raise the costs of debt financing.

Further, in response to the risk (or opportunity) of uptier transactions, parties are also likely to engage in wasteful actions to block (or engage in) an uptier transaction.[46] For example, in an effort to block an uptier transaction, debtholders may expend resources trying to close loopholes found in prior credit agreements, monitor other parties to ensure that they are not preparing to conduct an uptier transaction, and either buy up loans or coordinate with other debtholders to ensure that they have sufficient support to block such a transaction. Conversely, parties seeking to engage in an uptier transaction may allocate resources to search for loopholes in the credit agreement and to coordinate with other debtholders and the debtor to reach the requisite majority. These activities are expensive—likely involving teams of lawyers poring over every provision of each agreement—and wasteful because uptier transactions likely do not generate any value in the first place. As a result, this rent-seeking behavior is likely to work its way into the costs of debt financing.

C. Contractual Solutions to Uptier Transactions Are Insufficient

As the Delaware bankruptcy court suggested in *TPC Group*, if parties can adequately protect themselves from uptier transactions when contracting, then there is no need for judicial intervention.[47] Professors Vincent Buccola and Greg Nini have found that debtholders have in fact responded to the threat of uptier transactions by altering the terms of credit agreements.[48] This Section evaluates the two kinds of contractual solutions assessed by Buccola and Nini: (1) raising the voting threshold required to allow the loan to be subordinated, and (2) restricting the ability

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[46] *See, e.g.*, Dick, *supra* note 1, at 1375–76; *see also* Baird, *supra* note 17 (manuscript at 36).

[47] *TPC Group*, 2022 WL 2498751, at *12 (citing *Audax*, 2021 WL 3671541, at *1).

[48] Buccola & Nini, *supra* note 3 (manuscript at 41).

for debtor companies to compensate participating debtholders, either through the "open market" loophole or by other means.[49] Both potential solutions involve substantial trade-offs that undermine their efficacy: they are either overly restrictive and prevent productive restructurings or too lenient and insufficient to prevent uptier transactions.

One proposed contractual solution to prevent uptier transactions has been to require a higher voting threshold or even complete unanimity for amendments that permit lien subordination.[50] This has been the preferred market response to the initial flurry of uptier transactions.[51] However, this approach has two drawbacks. First, it is not a complete solution: uptier transactions are still possible with a supermajority threshold, as the restructuring of TPC Group and Incora demonstrate.[52] Second, higher voting thresholds encourage opportunistic behavior by debtholders who hold relatively small amounts of debt, which can derail productive restructuring transactions. In fact, the ability to approve a restructuring plan by a simple majority vote is a fairly recent trend intended to facilitate beneficial restructuring transactions.[53] In cases where unanimity or a supermajority is required, small debtholders can prevent valuable restructuring transactions from occurring, forcing companies into bankruptcy unnecessarily either because they want to leverage their bargaining power in order to extract greater concessions (i.e., the holdout problem), or because they have conflicting interests that would benefit from the debtor company entering bankruptcy.[54] Contracting parties are thus faced with a dilemma: set the voting threshold too low and invite opportunistic behavior by the controlling majority to harm the individual rights of the remaining debtholders, or set the voting threshold too high and invite opportunistic behavior by smaller debtholders that derails what otherwise could be a successful reorganization.[55]

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49 *See id.* (manuscript at 41–42).

50 *See, e.g.*, Dick, *supra* note 1, at 1379–80; *Serta's, Boardriders' Superpriority*, *supra* note 29; Buccola & Nini, *supra* note 3 (manuscript at 32–33).

51 Buccola & Nini, *supra* note 3 (manuscript at 41–42).

52 *TPC Group*, 2022 WL 2498751, at *1–3; Incora Complaint, *supra* note 5, at 2.

53 *See* Dick, *supra* note 1, at 1344.

54 *See id.* at 1345; Bratton & Levitin, *supra* note 7, at 1606–07. Smaller debtholders may also disagree in good faith with the potential benefits of the transaction, but there is little reason to think their judgment is more accurate than that of the majority of loan holders, who have a greater stake in the syndicated loan.

55 *See* Lubben, *supra* note 26, at 15.

The second proposal for preventing uptier transactions is to limit the ability for debtor companies to compensate participating debtholders. One possible way to do this is to limit the scope of the "open market" exception or prohibit non–pro rata purchases of debt entirely.[56] However, this loophole highlights one of the practical constraints of contractual solutions to uptier transactions: it is nearly impossible to differentiate between some forms of productive and opportunistic behavior by the debtor in advance, making it impractical to specify exactly what debtors may and may not do in the credit agreement.[57] Contracting parties are thus faced with another dilemma: write strict terms to ensure no opportunistic behavior is possible but prevent some productive actions in the process, or write looser terms to ensure the debtor company can take productive actions but permit some opportunistic behavior in the process. With respect to debt-buyback provisions, Buccola and Nini found that parties have *not* made changes to these terms because "participants perceive borrowers' ability to repurchase loans at least sometimes to be a valuable feature of leveraged loan deals."[58]

More generally, there is also the risk that motivated parties will simply find another way of compensating participating debtholders. In the case of *TPC Group*, participating debtholders were given the exclusive opportunity to issue the new money loan on generous terms and to provide DIP financing after the company entered bankruptcy.[59] Legal practitioners have also suggested offering the new money loan opportunity and the debt-for-debt exchange to all lenders but providing an outsized

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56 *See* Dick, *supra* note 1, at 1379.

57 *See* Buccola, *Efficacious Answers*, *supra* note 26 (manuscript at 21) (noting that contract drafters who want to block value-destructive transactions are stuck with broad propositions that also block value-generating transactions). For example, permitting the debtor to take on a new money loan that takes priority over existing debt may be beneficial if existing debtholders believe the company can use the new money to create substantial value, but the same transaction can be value-destructive if the company intends to use the new money in a speculative endeavor that risks existing debtholders' recovery to try to save the company. It is difficult for debtholders to write an agreement *ex ante* that permits the first action but not the second.

58 Buccola & Nini, *supra* note 3 (manuscript at 41).

59 *TPC Group*, 2022 WL 2498751, at *5–6; Ellias & de Fontenay, *supra* note 24 (manuscript at 17–18); Buccola, *Efficacious Answers*, *supra* note 26 (manuscript at 9) (noting that the new money loan in *TPC Group* was funded at an above-market rate). This ultimately led to these debtholders acquiring nearly all of the equity in the company after it emerged from bankruptcy. *See* Ellias & de Fontenay, *supra* note 24 (manuscript at 17–18). In contrast, nonparticipating debtholders recovered roughly 50 cents on the dollar. *Id.*

economic benefit to "backstop lenders" (i.e., participating lenders).[60] This mechanism has been used to provide side payments to favored lenders in the bankruptcy context.[61]

Ultimately, while any of these specific loopholes can be addressed by the contracting parties, several scholars have questioned whether parties "are simply too skilled in the perpetual cat and mouse game not to find loopholes and ways around even the best contractual language."[62] The possibility that debtors will find new loopholes undermines the case for trying to close specific loopholes in the agreement. Value-destructive transactions will still be possible, investors will continue to lack confidence that they will be protected from uptier transactions, and parties will continue to expend resources looking for possible loopholes.

This cat and mouse dynamic may be even more pronounced given recent trends in the industry that have altered the incentives of various actors. In a recent paper, Buccola documented the related trends of increasing private equity ownership of distressed firms, increasing distribution of syndicated loans on the secondary loan market to more passive investors, and increasing borrower-friendly loan terms.[63] Debtor companies, which are increasingly owned by sophisticated, repeat-player private equity firms, have every incentive to find loopholes in credit agreements to protect their investments.

Arguably, these private equity firms may have a second-order incentive to establish a reputation for treating their debtholders fairly and refusing to engage in uptier transactions. As parties that continually require additional debt financing, firms with positive reputations would presumably be able to command more favorable loan terms given the lower investment risk. However, Buccola found that private equity firms may not care about their reputation among lenders for several reasons: it is not clear whether loan markets reflect information about firm reputation,

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60 Elberg et al., *supra* note 29.

61 *See* Lubben, *supra* note 26, at 21–24.

62 Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745, 787 (2020); *see also* Dick, *supra* note 1, at 1380 n.271; Kenneth Ayotte & Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 YALE L.J.F. 363, 366 (2021) ("Sophistication does not result in optimally drafted contracts. Instead, it magnifies the impact of a contract's inevitable flaws. Sophisticated parties use these flaws to reallocate value from one coalition to another."); Buccola, *Efficacious Answers*, *supra* note 26 (manuscript at 10) (noting a concern that modern loan contracts are full of loopholes that can be exploited).

63 *See generally* Buccola, *Sponsor Control*, *supra* note 6.

the short-term considerations of managers may outweigh longer-term reputational harm to the firm, and private equity firms may be more concerned about their reputation with equity investors than debt investors.[64] As a result, any second-order reputational incentives are unlikely to be sufficient to deter uptier transactions.

In contrast, the role of the banks that originate these syndicated loans has increasingly changed from an originate-and-hold model to an originate-to-distribute model where their economic stake in the loan is sold to investors in secondary loan markets who ultimately bear the investment risk.[65] This means loan originators have a reduced incentive to ensure that there are no loopholes in the credit agreement and a greater incentive to maintain good relationships with private equity firms to continue getting their business. While banks also have an incentive to maintain a good reputation among debt investors, increasingly passive and dispersed debt investors do not have the proper incentives to differentiate between loans on the basis of highly technical loan provisions.[66] One notable example of this skewed bargaining dynamic may be the designated counsel arrangement, whereby private equity firms select and pay the law firms that represent the *lenders* in negotiations.[67] Such an arrangement undermines confidence that loan covenants are being aggressively negotiated by lenders.

Relying on loan-specific, contractual solutions to uptier transactions requires significant trade-offs by contracting parties that either fail to adequately prevent uptier transactions or go too far and prevent productive transactions from occurring. These proposals are also unduly burdensome in a secondary loan market increasingly characterized by dispersed investors, light monitoring, and high liquidity—attributes that are traditionally associated more with equity markets.[68] There are simply too few

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64 *Id.* at 29–30.

65 Elisabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 J. CORP. L. 725, 738–44 (2014); Buccola, *Sponsor Control*, *supra* note 6, at 17–18.

66 For example, collateralized loan obligations (CLOs) make up as much as 60% of the market and are designed to take pieces of many loans and package them together to diversify risk. These passive investment vehicles are unlikely to conduct due diligence on the loan originator or the intricacies of the credit agreement. *See* de Fontenay, *supra* note 65, at 738–44; *see also* Baird, *supra* note 17 (manuscript at 25–27).

67 Matt Levine, *The SEC Comes for Crypto Custody*, BLOOMBERG (Feb. 16, 2023), https://perma.cc/5XS4-AU8E.

68 de Fontenay, *supra* note 65, at 740; Ellias & de Fontenay, *supra* note 24 (manuscript at 26–27).

incentives for debt investors to differentiate between debt instruments based on highly technical provisions that may or may not allow for rent-seeking behavior. As secondary debt markets increasingly resemble equity markets, the case for more uniform investor protections becomes more compelling.[69]

II. THE LEGAL BASIS FOR IMPOSING FIDUCIARY DUTIES

Fiduciary obligations find their basis in the law of agency. Agency law concerns the relationship between a principal and an agent who mutually agree that the agent will act on behalf of the principal and subject to their control.[70] In this role, the agent owes a fiduciary duty to the principal to act loyally for the principal's benefit.[71] This fiduciary relationship has long applied to corporate officers and directors, who assent to act as agents for the corporation and its shareholders.[72] However, Delaware corporate law does not confine fiduciary duties solely to traditional principal-agent relationships. Instead, it has taken a more functional approach that considers whether there is "a separation of control and ownership"[73] and imposes fiduciary duties on those who control the corporation for the benefit of those who own it. This Part illustrates this functional, evolving approach and demonstrates why it can and should extend to common ownership in debt instruments such as syndicated loans.

A. Delaware's Approach to Corporations and LLCs

The controlling shareholder doctrine demonstrates the functional approach Delaware takes when imposing fiduciary obligations. Unlike corporate officers and directors, shareholders with a controlling stake in a corporation cannot reasonably be said to

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69 *See* Ellias & de Fontenay, *supra* note 24 (manuscript at 26–27).

70 RESTATEMENT (THIRD) OF AGENCY § 1.01 (AM. L. INST. 2006).

71 *See* RESTATEMENT (THIRD) OF AGENCY § 8.01 (AM. L. INST. 2006).

72 *See, e.g.*, Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. . . ."); *see also* Jackson v. Ludeling, 88 U.S. 616, 624–26 (1874); Lofland v. Cahall, 118 A. 1, 3 (Del. 1922).

73 N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007). Delaware corporate law's approach to debtholders' ability to sue corporate officers for breach of fiduciary duty is emblematic of this functional approach. *See id.* at 102 (granting debtholders standing to sue for breach of fiduciary duty on behalf of the corporation only once the corporation is insolvent and debtholders have become the residual beneficiaries of the corporation).

have assented to act on behalf of, and under the control of, minority shareholders. However, Delaware corporate law imposes fiduciary obligations on controlling shareholders all the same—focusing on the functional control they wield rather than the formal relationship they have with respect to the corporation: "[W]hen a shareholder presumes to exercise control over a corporation, to direct its actions, that shareholder assumes a fiduciary duty of the same kind as that owed by a director to the corporation."[74] By imposing fiduciary duties on controlling shareholders, Delaware corporate law seeks to ensure that the value of the corporation accrues to all shareholders, rather than only those that have a controlling stake and could use their control to "loot" corporate assets absent such obligations. This approach provides reassurance to small, passive investors that their property rights in the corporation will be protected.

Historically, corporate law took a more formalistic approach to controlling shareholders. Until the early twentieth century, corporate law did not impose fiduciary duties on controlling shareholders because they weren't agents who had assented to act on behalf of, and under the control of, minority shareholders. In one leading case at the time, *Windmuller v. Standard Distilling & Distributing Co.*,[75] the court held that there was no support for the idea that a "stockholder is in any sense a trustee for other stockholders, or that he is debarred from voting on his stock according to what he may conceive to be his interest, or in a way which may result in a benefit to himself, and which other stockholders may not enjoy."[76]

However, faced with an increasing number of cases claiming that controlling shareholders had mismanaged corporate property for their personal benefit and to the detriment of minority shareholders, courts began to take a more functional approach to imposing fiduciary duties.[77] One early, representative case was *Wheeler v. Abilene National Bank*,[78] where the court stated that, as a general matter, common ownership in property creates a "fiducial relation" that makes it inequitable for one owner to manage the property "for their own profit, to the detriment of others

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74 Harris v. Carter, 582 A.2d 222, 234 (Del. Ch. 1990).

75 114 F. 491 (C.C.D.N.J. 1902).

76 *Id.* at 494; *see also* Jerry B. Helwig, *The Fiduciary Duty of Controlling Shareholders*, 7 CASE W. RSRV. L. REV. 467, 469–70 (1956).

77 Helwig, *supra* note 75, at 470–71.

78 159 F. 391 (8th Cir. 1908).

who have the same rights."[79] Applying this reasoning to the controlling shareholder, the court found that his "power to control and direct the action of the corporation places him in its shoes, and constitutes him the actual, if not the technical, trustee for the holders of the minority of the stock."[80] This reasoning was applied by Delaware courts in *Allied Chemical & Dye Corp. v. Steel & Tube Co. of America*,[81] where the Chancery Court of Delaware analogized majority voting power to the power of corporate directors to control the corporation:

> When the majority of stockholders [vote], they are, for the moment, the corporation. Unless the majority in such case are to be regarded as owing a duty to the minority such as is owed by the directors to all, then the minority are in a situation that exposes them to the grossest frauds and subjects them to most outrageous wrongs.[82]

Rather than continue to confine fiduciary duties to principal-agent relationships, corporate law recognized that the same rationale applied to those who exercise effective control over the corporation, regardless of whether they had assented to act for the benefit of all shareholders.

To protect the property rights of minority shareholders, Delaware corporate law has even extended fiduciary duties to cover shareholders' sale of their *individually owned* shares.[83] As a general rule, Delaware courts have acknowledged that shareholders may legitimately sell their controlling stake in a corporation at a premium relative to the underlying value of the shares.[84] A buyer's willingness to pay a premium for corporate control can reflect one of two considerations: (1) the buyer believes that with control it can increase the overall value of the corporation beyond the premium it paid for control, or (2) the party intends to "loot" the company, inequitably shifting value from the remaining

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79 *Id.* at 393. *Wheeler* was a federal equity case that had no binding effect on Delaware courts. *See* Bratton & Levitin, *supra* note 7, at 1669. However, *Wheeler* and other federal equity cases were used as persuasive precedent by Delaware courts. *See* Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am., 120 A. 486, 491–92 (Del. Ch. 1923) (citing *Wheeler* as precedent for imposing fiduciary duties on controlling shareholders).

80 *Wheeler*, 159 F. at 393–94.

81 120 A. 486 (Del. Ch. 1923).

82 *Id.* at 491.

83 *See, e.g.*, Ford v. VMware, Inc., 2017 WL 1684089, at *10 (Del. Ch. May 2, 2017).

84 *See, e.g.*, Mendel v. Carroll, 651 A.2d 297, 305 (Del. Ch. 1994).

shareholders to itself in breach of its fiduciary obligations. Minority shareholders benefit in the former case since they share in the benefits of more effective management. In the latter case, Delaware corporate law imposes a fiduciary duty of care on controlling shareholders to protect the property rights of minority shareholders.[85] Specifically, if a controlling shareholder sells its stake to a buyer that it knows or reasonably should know intends to loot the corporation and the buyer goes on to loot the corporation, the controlling shareholder will be liable to minority shareholders for breach of fiduciary duty.[86]

The sale of a controlling interest in the corporation is understood to involve the same corporate control considerations that led to extending fiduciary duties to controlling shareholders in the first place, despite the absence of both a traditional principal-agent relationship and common ownership in the shares themselves.[87] The imposition of fiduciary obligations on controlling shareholders—even in the sale of their own shares—represents a significant expansion of fiduciary duties beyond their relatively narrow origins in agency law and the formal approach taken in *Windmuller*. Courts should be willing to extend this approach to the common ownership of debt instruments in the face of uptier transactions.

Imposing default fiduciary duties is also consistent with how Delaware courts have enforced and interpreted some contracts. Where a contracting party reasonably expects another to act in their interest, the implication is that the acting party will not use its discretion in a way that harms the other. This reasoning is analogous to credit agreements, which are contracts that entrust some control over the debt instrument to debtholders with a majority stake under the expectation that they will act in the interests of the group as a whole.

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85 *See, e.g.*, *Ford*, 2017 WL 1684089, at *10.

86 *Id.*

87 *See, e.g.*, *Harris*, 582 A.2d at 234:

> Equally well established is the principle that when a shareholder presumes to exercise control over a corporation, to direct its actions, that shareholder assumes a fiduciary duty of the same kind as that owed by a director to the corporation. . . . A sale of controlling interest in a corporation, at least where, as is alleged here, that sale is coupled with an agreement for the sellers to resign from the board of directors in such a way as to assure that the buyer's designees assume that corporate office, does, in my opinion, involve or implicate the corporate mechanisms so as to call this principle into operation.

Limited liability companies (LLCs) are governed by contract under Delaware law. The Chancery Court of Delaware has stated that LLCs "are creatures of contract, 'designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.'"[88] The language of the LLC agreement "defines the scope, structure, and personality of limited liability companies,"[89] and, "as with any contract, the Court must look to the language of the LLC Agreement to determine the potential liabilities of the parties."[90]

However, despite the treatment of LLCs as "creature[s] of contract," Delaware courts have interpreted the Delaware LLC Act to imply default fiduciary duties to managing members and controllers of an LLC unless such duties have been clearly disclaimed by the agreement.[91] In *Auriga Capital Corp. v. Gatz Properties*,[92] the Chancery Court of Delaware distinguished the contractual relationship between managers of the LLC and its members from other more straightforward commercial relationships.[93] The manager of an LLC has been vested with discretionary power to manage the LLC, which comes with the expectation that (absent clear language to the contrary) they will act in the interests of the LLC and its members.[94] In contrast, there is no

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88 TravelCenters of America, LLC v. Brog, 2008 WL 1746987, at *1 (Del. Ch. Apr. 3, 2008) (quoting *In re* Grupo Dos Chiles, LLC, 2006 WL 668443, at *2 (Del. Ch. Mar. 10, 2006)).

89 Fisk Ventures LLC v. Segal, 2008 WL 1961156, at *1 (Del. Ch. May 7, 2008).

90 Kuroda v. SPJS Holdings, LLC, 971 A.2d 872, 881 (Del. Ch. 2009).

91 *See* Beach to Bay Real Est. Ctr. LLC v. Beach to Bay Realtors Inc., 2017 WL 2928033, at *5 (Del. Ch. July 10, 2017, *revised* July 11, 2017); Mohsen Manesh, *Creatures of Contract: A Half-Truth About LLCs*, 42 DEL. J. CORP. L. 391, 425–29 (2018).

92 40 A.3d 839 (Del. Ch. 2012), *judgment entered sub nom.*, Auriga Capital Corp. v. Gatz Properties, LLC (Del. Ch. 2012), *aff'd*, 59 A.3d 1206 (Del. 2012).

93 *Id.* at 850. The Supreme Court of Delaware considered this portion of the opinion to be dictum without any precedential value because it was unnecessary for the court's decision. *See* Gatz Properties, LLC v. Auriga Cap. Corp., 59 A.3d 1206, 1218 (Del. 2012). However, later cases affirmed that a fiduciary duty is implied by default. *See, e.g.*, *Beach to Bay Real Estate*, 2017 WL 2928033, at *5.

94 *Auriga Cap. Corp.*, 40 A.3d at 850–51. Notably, this reasoning may indicate a point of convergence with the implied covenant of good faith and fair dealing in contract law, which some courts find to be violated when a discretionary contract right is exercised in bad faith and deprives the other party of the benefit of the bargain. *See* ICG Global Loan Fund 1 DAC v. Boardriders, Inc., 2022 WL 10085886, at *9 (N.Y. Sup. Ct. Oct. 17, 2022) (citing Shatz v. Chertok, 180 A.D.3d 609, 609–10 (N.Y. App. Div. 2020)). Courts disagree on whether the implied covenant of good faith and fair dealing may be implicated by uptier transactions. *See supra* note 12. More generally, the scope of the implied covenant is "notoriously unclear" and has caused courts "intractable difficulty." Paul MacMahon, *Good Faith and Fair Dealing as an Underenforced Legal Norm*, 99 MINN. L. REV. 2051, 2051–52, 2066 (2015) (citations omitted). In contrast, the controlling shareholder doctrine

expectation that one party will act in the interests of another in straight-forward commercial relationships.[95]

The distinction the court drew in *Auriga* between these two kinds of contractual relationships further highlights the extent to which Delaware law applies a functional analysis when considering whether to impose fiduciary obligations. Where a contracting party has been given discretionary control and can be reasonably expected to use that control to act in another contracting party's interest, Delaware courts are willing to impose fiduciary duties absent clear language to the contrary. The essential question is whether there is a reasonable expectation that the party with discretionary control will act in the interests of another. As the next Section argues, this reasoning applies with equal force to parties in control of credit agreements.

B. Applying the Same Reasoning to Controlling Debtholders

Like controlling shareholders, debtholders participating in an uptier transaction cannot reasonably be said to have assented to act on behalf of, and under the control of, minority debtholders when voting to amend the credit agreement. There is no traditional principal-agent relationship. However, the same equitable principles that weigh in favor of imposing fiduciary duties on controlling shareholders under Delaware corporate law also apply to controlling debtholders. Debtholders have common ownership in an asset, a debt instrument, where control over the asset has been separated from ownership rights (i.e., minority debtholders lack control over many terms of the credit agreement that affect the value of their ownership rights). The separation of control, in the absence of fiduciary obligations, has been abused by controlling debtholders to benefit themselves to the detriment of minority debtholders, undermining investor confidence in their property rights. If courts were to impose fiduciary obligations on controlling debtholders, judicial oversight would ensure that the value of the debt instrument accrues to all owners rather than only those that have a controlling stake and could otherwise "loot" the asset. This oversight would reassure minority investors that their interest in the common property will be protected.

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in Delaware corporate law provides a well-established doctrinal framework for applying a controlling debtholder fiduciary duty. *See infra* Part III. For another reason that imposing fiduciary duties on controlling debtholders may be preferable to a stronger application of the covenant of good faith and fair dealing, see *infra* note 152.

95 *Auriga Capital Corp.*, 40 A.3d at 850.

Some may question the soundness of equating control over corporations with control over covenants in credit agreements. Admittedly, the range of discretion conferred in the two cases is substantially different. One concerns the active management of an ongoing business that requires competent oversight to generate value for investors. The other merely relates to the power to amend an agreement that passively entitles investors to certain returns. However, these two forms of control over a common asset are similar in one key respect: the extent to which control can impair the ownership rights of minority investors in the absence of legal protections. Indeed, a recent uptier transaction highlights the value that investors attribute to covenant control when such control can be used to "loot" the common asset: the market value of Incora's debt soared nearly 25% as two groups of debtholders raced to establish control over the credit agreement.[96] This substantial control premium is similar to the premium that buyers are willing to pay for corporate control—but more notable because there are few, if any, legitimate ways an investor can create substantial value by controlling the terms of the credit agreement.[97] In contrast, control premiums for corporations may reflect a sincere belief that the corporation has been mismanaged and that a change in control can substantially increase the value of the corporation.

Another substantial difference between corporate control and covenant control is that debt agreements are governed by contract law rather than corporate law. However, Delaware law's approach to LLCs demonstrates that the logic that underlies imposing fiduciary duties can also apply in the contracting context—at least to the extent that the fiduciary duties are waivable. Similar to the reasoning in *Auriga*, the relationship between members of a loan syndicate extends beyond a mere arm's-length relationship, and minority debtholders do expect majority debtholders to vote in their collective interest. The rationale for allowing amendments to the credit agreement with less-than-unanimous consent is that loan holders *can* expect other loan holders to vote in a way that benefits them because they have a mutual economic interest in maximizing the value of their common property.[98] While the

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96 Incora Complaint, *supra* note 5, at 31–32; *see also* Matt Levine, *Mergers Aren't Always Fair*, BLOOMBERG (Nov. 2, 2022), https://perma.cc/5DGJ-9P66.

97 *See supra* Part I.B.

98 Dick, *supra* note 1, at 1344–45.

court in *TPC Group* may be correct that there is nothing in existing contract law that requires debtholders to act in an all-for-one, one-for-all spirit,[99] debtholders *do* try to structure their credit agreements in ways that align their collective interests.[100] For example, the loan terms are the same for each member of the syndicate,[101] and the credit agreement is structured to prevent the debtor company from treating lenders in the syndicate differently.[102] Members of a loan syndicate usually give a large amount of deference to the lead arranger, who is responsible for establishing a relationship with the debtor company, negotiating the terms of the loan, and monitoring the company.[103] The term "syndicate" itself connotes an understanding of joint effort and mutual interest. To the extent that a credit agreement represents nothing more than an arm's-length relationship, it is one between the borrower and the loan syndicate, not within the syndicate itself.

The history of the controlling shareholder fiduciary duty also reveals the functional similarities between controlling shareholders and controlling debtholders. Notably, the reasoning that gave rise to imposing a fiduciary duty on controlling shareholders stemmed from a case concerning *bondholders*. In *Jackson v. Ludeling*,[104] cited favorably by the courts in *Wheeler*[105] and *Allied Chemical*,[106] the Supreme Court applied the same general reasoning with respect to bondholders that would later be echoed by the court in *Wheeler* with respect to shareholders: "When two or more persons have a common interest in a security, equity will not allow one to appropriate it exclusively to himself, or to impair its worth to the others. Community of interest involves mutual obligation."[107] Although the Supreme Court did not couch the bondholder's duty in fiduciary terms, the Chancery Court of Delaware in *Allied Chemical* referred to the duty imposed in *Ludeling* as one "of a fiduciary nature," and relied on the case as support for imposing a fiduciary duty on controlling shareholders.[108]

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99 *TPC Group*, 2022 WL 2498751, at *12.

100 *See supra* Part I.A.2.

101 Amir Sufi, *Information Asymmetry and Financing Arrangements: Evidence from Syndicated Loans*, 62 J. FIN. 629, 633 (2007).

102 *See supra* Part I.A.2.

103 Sufi, *supra* note 101, at 632–33; Buccola, *Sponsor Control*, *supra* note 6, at 34.

104 88 U.S. 616 (1874).

105 *See* 159 F. at 393–95.

106 *See* 120 A. at 494.

107 *Ludeling*, 88 U.S. at 622.

108 *Allied Chemical*, 120 A. at 494.

The parallel reasoning in *Ludeling* and *Wheeler* emphasizes the essential point: uptier transactions are merely a form of investor opportunism that is present whenever there is common ownership in property. Delaware corporate law has fashioned a solution to protect equity investors, but debt investors receive no such protection. Historically, debt investors may not have needed the same legal protections as equity investors because of differences between equity markets and loan markets.[109] Loans were illiquid and held by a small syndicate of banks that had long-term, reputational incentives not to harm other lenders in the syndicate.[110] In this environment, nonconsensual restructuring transactions would have been "unthinkable."[111] However, as the loan markets have become more liquid, and loans are increasingly held by dispersed, passive, and predominantly nonbank investors, the distinction between the loan markets and equity markets has receded, and with it the case for treating debt and equity investors differently.[112]

III. THE SCOPE AND SUBSTANCE OF THE PROPOSED FIDUCIARY DUTY

The efficacy of a controlling debtholder fiduciary duty ultimately depends on how it would be enforced by courts. Granting courts the authority to intervene in time-sensitive transactions may create uncertainty and impose real costs on businesses in distress. If the fiduciary duty extends too broadly, the ability of parties to effectuate restructuring out of court may become effectively impossible. Without the ability to gain access to new money

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[109] *See, e.g.*, Ellias & de Fontenay, *supra* note 24 (manuscript at 25–27). Admittedly, bond markets have traditionally more closely resembled equity markets. *See* de Fontenay, *supra* note 65, at 738–44. Given similar market conditions, it is reasonable to wonder why a contemporary controlling-bondholder fiduciary duty does not exist, particularly in light of historical precedent. Professors William Bratton and Adam Levitin have suggested several reasons for the diminished significance of this duty among bondholders after *Ludeling* and its progeny. Bratton & Levitin, *supra* note 7, at 1668–69. Specifically, they point to the passage of the Trust Indenture Act of 1939, Pub. L. No. 76-253, 53 Stat. 1149 (codified as amended at 77aaa–77bbbb), which shifted a substantial portion of bond restructuring activity into bankruptcy and out of federal receivership, and the end of general federal common law after *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), which left these federal equity receivership cases as "homeless precedents." Bratton & Levitin, *supra* note 7, at 1668–69.

[110] *See* Buccola, *Sponsor Control*, *supra* note 6, at 34; de Fontenay, *supra* note 65, at 739.

[111] Buccola, *Sponsor Control*, *supra* note 6, at 34.

[112] de Fontenay, *supra* note 65, at 738–44; Ellias & de Fontenay, *supra* note 24 (manuscript at 26–27).

quickly, distressed businesses may become insolvent and have no real alternative other than to enter costly bankruptcy proceedings. To ensure that a controlling debtholder fiduciary duty becomes an effective solution to uptier transactions, its scope and substance should be well defined and provide a reasonable degree of certainty to parties hoping to restructure their debts without getting haled into court. This Part will consider potential ways to draw on Delaware corporate law's controlling shareholder doctrine to clarify and confine the scope and substance of the proposed duty.

A. Scope: When the Controlling Debtholder Fiduciary Duty Applies

Providing clarity on the scope of the controlling fiduciary duty is essential to ensure that debtholders have sufficient notice of when they are acting as a fiduciary. There are two primary considerations that affect the scope of a controlling debtholder fiduciary duty. The first consideration concerns which transactions implicate the controlling debtholder fiduciary duty. The second concerns who counts as a "controlling" debtholder in the first place. In other words, *when* are debtholders acting as fiduciaries, and *which* debtholders are fiduciaries?

1. Acting in a fiduciary capacity.

Since the legal basis for applying fiduciary duties arises out of control over a common asset, the fiduciary duty should not extend further than amendments to, and waivers of, provisions of the credit agreement that affect the property rights of all debtholders but require less-than-unanimous consent. For example, restructuring transactions that involve agreements with only certain debtholders but do not require amendments to the credit agreement, such as agreements to provide a new money loan permissible under the existing credit agreement, would not trigger fiduciary duties even if the transactions treat debtholders differently. In this case, participating debtholders are not using their control over the credit agreement to participate in the transaction and therefore are not operating in their capacity as a fiduciary. Similarly, there is no separation of ownership and control when unanimous consent is required to modify the credit agreement, so the rationale for imposing fiduciary duties does not exist.

Narrowing the scope of the fiduciary duty in this manner provides certainty to parties so they are aware when they are operating in a fiduciary capacity. An additional benefit is that it encourages parties to be clearer in their agreements concerning what actions are permissible under the credit agreement. If controlling debtholders want to avoid fiduciary liability, they can ensure that the credit agreement permits transactions without requiring amendment, which provides greater notice to minority debtholders.

2. Defining "controlling" debtholders.

The controlling shareholder doctrine in Delaware corporate law provides a useful starting point for deciding when debtholders have control over the credit agreement. This assessment has two main considerations in the context of restructuring transactions: (1) what constitutes control, and (2) when are a group of investors operating as a control group.

Under Delaware law, a majority of the company's voting power constitutes control under the controlling shareholder doctrine.[113] Majority voting power is sufficient to establish corporate control because many of the most fundamental corporate changes (such as mergers, consolidations, dissolutions, significant asset sales, and the election of directors) require approval by a majority vote.[114]

Absent majority voting power, a shareholder may still be considered "controlling" if they exercise actual control over the corporation's conduct via "a combination of potent voting power and management control such that the stockholder could be deemed to have effective control of the board without actually owning a majority of stock."[115] Such domination and control could be over the board or deciding committee with respect to the transaction at issue, or over the majority of the board more generally.[116] The analysis of whether a minority shareholder exerts actual control or domination over the corporation is fact intensive and the

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[113] *See* Weinstein Enters. v. Orloff, 870 A.2d 499, 507 (Del. 2005).

[114] *See id.*

[115] Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 307 (Del. 2015); *Weinstein Enterprises*, 870 A.2d at 507; *see also* Note, *Controller Confusion: Realigning Controlling Stockholders and Controlled Boards*, 133 HARV. L. REV. 1706, 1708 (2020) [hereinafter *Controller Confusion*].

[116] *See In re* Tesla Motors, Inc. Stockholder Litig., 2018 WL 1560293, at *13 (Del. Ch. Mar. 28, 2018).

subject of some confusion in the case law.[117] Actual voting power appears to be a secondary consideration in more recent cases, coming after factors like relationships with directors and managers.[118]

Given the absence of directors and managers ("mediating fiduciaries") in most syndicated loans, the analytic framework for control over credit agreements is more straightforward. An assessment of control can focus solely on voting power and be specific to the voting threshold required for the transaction at issue. For example, if a covenant requires two-thirds support to amend, then a debtholder with 51% voting power would not be considered a controlling debtholder for the purposes of the transaction.

The second challenge when defining controlling debtholders is how to classify a group of debtholders that is acting in concert. Syndicated loans and bonds usually do not have a single debtholder with sufficient voting power to exercise control over the terms of the agreement. Consequently, uptier transactions have generally required the coordination of at least a handful of institutional investors to reach the requisite voting threshold.[119] Delaware corporate law sometimes treats a set of shareholders as a "control group" for purposes of its controlling shareholder analysis. But while Delaware corporate law's approach to control groups provides some useful guidance, it doesn't neatly map onto the debt context because of the absence of mediating fiduciaries. This Comment proposes two ways of extending the application of control group.

For controlling shareholders, Delaware corporate law distinguishes between a "control group where those shareholders are connected in some legally significant way—e.g., by contract, common ownership, agreement, or other arrangement—to work together toward a shared goal"[120] and situations where there is

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[117] *See, e.g.*, Ann M. Lipton, *After* Corwin*: Down the Controlling Shareholder Rabbit Hole*, 72 VAND. L. REV. 1977, 1987–90 (2019); *Controller Confusion*, *supra* note 115, at 1712–16.

[118] Lipton, *supra* note 117, at 2001–02; *Controller Confusion*, *supra* note 115, at 1713–16.

[119] *See, e.g.*, Serta Simmons Complaint, *supra* note 5, at 7–8 (identifying at least four lenders participating in the transaction); TriMark Complaint, *supra* note 5, at 15–20 (identifying five lenders participating in the transaction); Boardriders Complaint, *supra* note 5, at 11–15 (identifying fifteen lenders participating in the transaction). Individual lenders rarely own a controlling stake in syndicated loans. The primary purpose of syndicated loans is to distribute risk among a number of lenders.

[120] van der Fluit v. Yates, 2017 WL 5953514, at *5 (Del. Ch. Nov. 30, 2017) (quoting Frank v. Elgamal, 2012 WL 1096090, at *8 (Del. Ch. Mar. 30, 2012)).

merely a "concurrence of self-interest among certain stockholders,"[121] which is not considered sufficient to establish a control group. For example, in *In re PNB Holding Co.*,[122] a corporation was considering converting to an S corporation, which required reducing the number of stockholders down to seventy-five.[123] The remaining shareholders would be cashed out at a 6% premium to market value.[124] Notably, all ten of the company's officers and directors and twenty-seven of their relatives qualified to remain as shareholders, some of whom were gifted shares to ensure they reached the two-thousand share threshold to qualify.[125] Collectively, this group held 59.5% of the stock.[126] However, despite the differential treatment afforded to minority shareholders who did not qualify to remain as shareholders, the court refused to consider this group of thirty-seven individuals to be a control group because they "were not bound together by voting agreements or other material, economic bonds to justify treating them as a unified group."[127] Rather, they all merely had similar self-serving interests for voting for the transaction.

In the context of restructuring transactions, participating debtholders sometimes sign transaction support agreements that clearly indicate that they are acting as a control group.[128] Even in the absence of a transaction support agreement, courts could reasonably consider debtholders that contemporaneously sign agreements to amend the credit agreement, participate in the new money loan, and participate in a debt-for-debt exchange—that other debtholders are excluded from—to be working in concert and connected in a legally significant way.[129] However, if a debtor company independently offers participation in an uptier transaction to a subset of debtholders that collectively make up a major-

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[121] *Id.* (quoting *In re* Crimson Expl. Inc. Stockholder Litig., 2014 WL 5449419, at *15 (Del. Ch. Oct. 24, 2014)); *see also* Lipton, *supra* note 117, at 1997.

[122] 2006 WL 2403999 (Del. Ch. Aug. 18, 2006).

[123] *Id.* at *4–5.

[124] *Id.* at *6–7.

[125] *Id.* at *13.

[126] *Id.* at *1.

[127] *PNB Holding*, 2006 WL 2403999, at *1.

[128] *See, e.g.*, Serta Simmons Complaint, *supra* note 5, at 7–8, 15.

[129] *See, e.g.*, Boardriders Complaint, *supra* note 5, at 5 (alleging the secret execution of various interrelated agreements); Frank v. Elgamal, 2012 WL 1096090, at *8 (Del. Ch. Mar. 30, 2012) (finding that contemporaneously entering into voting agreements, exchange agreements, and employment agreements was sufficient to make shareholders a control group).

ity of debtholders, they may not be considered a control group under Delaware corporate law's approach because they all vote independently, though self-interestedly, for the same (or a similar) offer. Such an outcome would create an easy way to avoid the imposition of fiduciary duties.

There is good reason for defining control group more broadly in the debtholder context given the absence of mediating fiduciaries. Even though the court did not consider the directors and their relatives to be a control group in *PNB Holding*, the court still found that they had breached their fiduciary duties to minority shareholders in their role as directors.[130] The directors owed a fiduciary duty to all shareholders when they voted to approve the transaction, affording the minority shareholders who were shut out of the transaction some protection. Given the absence of mediating fiduciaries in the debt context, a more liberal application of the control group test is sensible to adequately protect the interests of minority debtholders who cannot rely on mediating fiduciaries to look out for their interests.

One potential way to expand the definition of control group would be to include any debtholder who receives an inducement (i.e., a benefit that is not offered to the loan syndicate as a whole) that is contingent on their participation in the restructuring transaction. If the voting power of those receiving an inducement is greater than the voting threshold, participating debtholders would be considered a control group and owe a fiduciary duty to minority debtholders. While there may be no direct coordination among participating debtholders, this approach emphasizes the implicit, indirect coordination among participating debtholders via agreements with the debtor company, not dissimilar to hub-and-spoke conspiracies,[131] and prevents debtholders from evading fiduciary duties by working independently with the debtor company. Such an approach draws from the criminal law of conspiracy, which does not require explicit agreement among the relevant parties if intent can be inferred from the circumstances,

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130 *PNB Holding*, 2006 WL 2403999, at *11–12, *33.

131 United States v. Newton, 326 F.3d 253, 255 n.2 (1st Cir. 2003) ("In a 'hub-and-spoke conspiracy,' a central mastermind, or 'hub,' controls numerous 'spokes,' or secondary co-conspirators. These co-conspirators participate in independent transactions with the individual or group of individuals at the 'hub' that collectively further a single, illegal enterprise.").

including unusual profits from the transaction.[132] "It [is] enough that, knowing that concerted action was contemplated and invited, the [independent companies who did not communicate with each other] gave their adherence to the scheme and participated in it."[133]

Another possible approach would be to consider any debtholder who votes to amend the credit agreement or waive certain terms of the credit agreement to be acting in a fiduciary capacity on behalf of the loan syndicate. This approach, while overbroad, would provide clear guidance to parties of when they are acting in a fiduciary capacity and would instead rely on varying standards of judicial review—discussed in the next Section—to minimize the costs and disruption of litigation.

In sum, the absence of mediating fiduciaries in the debt context suggests a need to define controlling debtholders more broadly than controlling shareholders under Delaware corporate law. Rather than requiring a legally significant agreement *among debtholders*, the controlling debtholder doctrine could also consider legally significant agreements independently made *with the debtor* to be sufficient to establish a debtholder as a member of the control group if the agreement involves an inducement. Alternatively, the meaning of control group could be expanded to encompass all debtholders who vote in favor of modifying the credit agreement and rely on varying the standards of judicial review to provide the main protection against disruptive, meritless litigation.

B. Substance: The Standard of Judicial Review

Another essential consideration when imposing a fiduciary duty is how thoroughly courts will review the conduct of fiduciaries. Delaware corporate law concentrates its judicial resources on the most problematic transactions by using a risk-based approach that varies the standard of judicial review depending on the circumstances of the transaction. This allows courts to efficiently dismiss—and deters litigants from bringing—many cases that pose few concerns of inequity by applying deferential review,

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[132] *See, e.g.*, People v. Lauria, 59 Cal. Rptr. 628, 633 (Cal. App. 2d Dist. 1967) (finding that intent to engage in a conspiracy can be inferred from knowledge when a party unusually profits from the venture).

[133] Interstate Cir. v. United States, 306 U.S. 208, 226 (1939).

while ensuring that the most problematic transactions receive exacting review. This approach also provides a useful model for the restructuring context that could help ensure judicial oversight is focused on the most concerning transactions—such as uptier transactions—while ensuring that more traditional restructuring transactions are not subject to onerous judicial review.

Delaware courts will apply one of three standards of review when evaluating the decision-making of corporate fiduciaries.[134] The default standard of review is the business judgment rule. The court applies the business judgement rule in the absence of evidence that corporate fiduciaries were uninformed, interested, or acted in bad faith. If the rule applies, the court will merely look to see whether the corporate fiduciary acted rationally—an extremely deferential standard that is easy for fiduciaries to overcome. This standard ensures that judges do not challenge the reasoned business judgment of professionals in the absence of a reason to be suspicious of their motives.

In cases of potential conflicts of interest, Delaware courts will apply an intermediate standard of review, "enhanced scrutiny."[135] Enhanced scrutiny is applied in cases where "the realities of the decisionmaking context can subtly undermine the decisions of even independent and disinterested directors," such as sales of the corporation and hostile takeovers where the job security of corporate officers and directors is at risk.[136]

Finally, in the presence of actual conflicts of interest, Delaware courts apply an onerous standard of review, entire fairness, which requires that fiduciaries show that the transaction was the product of fair dealing and fair price:[137]

> The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations . . . including all relevant factors: assets, market value, earnings,

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134 *In re* Trados Inc. Shareholder Litig., 73 A.3d 17, 43 (Del. Ch. 2013).

135 *Id.* at 43–44.

136 *Id.*

137 *Id.* at 44.

> future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.[138]

Fair dealing also encompasses a duty of candor.[139]

Notably, the choice of which standard of review to apply is often outcome determinative "[b]ecause the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting."[140] Because entire fairness review is an exacting standard that can be difficult to overcome even when a transaction is in the best interest of shareholders, Delaware corporate law has created exemptions from entire fairness review when corporate fiduciaries apply certain procedural safeguards to the transaction. For example, controlling shareholders can receive such an exemption if they condition the transaction on the approval of (1) an independent special committee empowered to freely select its own advisors and to say no definitively to the transaction and (2) a well-informed and noncoerced majority of the minority stockholders.[141] These steps ensure any extant conflicts of interests do not influence the decision-making process.

Delaware corporate law's approach to selecting the appropriate standard of review for actions taken by controlling shareholders is particularly relevant for restructuring transactions. Under Delaware law, entire fairness review is limited to transactions where the controlling shareholder causes the corporation to act in such a way that the controlling shareholder receives something "to the exclusion of, and detriment to, the minority stockholders."[142] For example, in the case of *Sinclair Oil Corp. v. Levien*,[143] minority shareholders alleged that the majority shareholder forced the corporation to (1) pay out dividends because of the controlling shareholder's own liquidity needs, denying the corporation the ability to expand, and (2) allow an affiliate of the controlling shareholder to breach its contractual obligations to the company.[144] With respect to the first allegation, the court found

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138 Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

139 *Id.*

140 AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986).

141 Kahn v. M & F Worldwide Corp., 88 A.3d 635, 645–46 (Del. 2014).

142 280 A.2d 717 (Del. 1971).

143 *Id.* at 720.

144 *Id.* at 720–23.

that the business judgment rule should apply because the dividends were paid out proportionately to all shareholders: "[the controlling shareholder] received nothing from [the corporation] to the exclusion of its minority stockholders. As such, these dividends were not self-dealing."[145] The motives for the dividend payments were considered immaterial unless they amounted to waste.[146] However, with respect to breaches of a contract by an affiliate of the controlling shareholder, the court found that it did constitute self-dealing since any benefit the controlling shareholder received by allowing its affiliate to breach the contract came at the expense of minority shareholders.[147] Since the controlling shareholder was able to benefit at the expense of minority shareholders, the court subjected this transaction to more onerous judicial oversight to ensure it was fair to minority shareholders.

The analysis in *Sinclair Oil Corp.* has been referred to as the "advantage/disadvantage test" because it requires the controlling shareholder to receive a benefit to the exclusion and detriment of minority shareholders before applying entire fairness review.[148] More recent cases in Delaware corporate law have eliminated the detriment prong of the advantage/disadvantage test and required only that minority shareholders are excluded from a benefit received by the controlling shareholder.[149] Regardless of which version of the test courts apply, this test would allow courts to quickly dismiss challenges to straightforward restructuring transactions without delving into the underlying motives of each debtholder, while providing a venue for protecting the property rights of minority debtholders in cases of disparate treatment.

The advantage/disadvantage test would be an effective, clear way for courts to decide what level of scrutiny to apply in the case of restructuring transactions. When restructuring transactions involve a debt-for-debt exchange offered to an exclusive group of debtholders to encourage them to amend the credit agreement, entire fairness review would clearly apply. The transaction comes at the expense of nonparticipating debtholders. In contrast, a

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145 *Id.* at 721–22.

146 *Id.* at 722.

147 *Sinclair Oil Corp.*, 280 A.2d at 723.

148 Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27, 50 (1999).

149 *Id.* at 67–70.

debt-for-debt exchange offered to all debtholders on the same terms would likely receive deferential business judgment review.

Whether an exclusive opportunity to provide a new money loan triggers entire fairness review is a closer question that would likely depend on which version of the advantage/disadvantage test is applied. Participating debtholders can argue that the new money loan does not, at least on its face, harm nonparticipating debtholders even if they are excluded from the opportunity. Nonparticipating debtholders would have to show that the new money loan reduced the expected recovery of their loan. For those who believe uptier transactions may be beneficial in at least some circumstances,[150] the version of the test that includes the detriment prong may be a good compromise that would allow less aggressive uptier transactions to receive deferential business judgement review. Under the version of the test that requires only exclusion, any disparate treatment among debtholders would trigger entire fairness review, providing more judicial scrutiny for potentially opportunistic behavior.

In cases where entire fairness review is applied, the transaction may still be approved by Delaware courts if it is the product of fair dealing and fair price. In the context of restructuring transactions, the fair dealing prong of entire fairness could require an open, transparent negotiating process where all debtholders are invited to participate in any opportunities on equal terms. Similarly, the fair price prong of entire fairness could require that any new money loan or other investment opportunity reflect an arm's-length transaction rather than provide lucrative terms to participating debtholders. Further, an exemption to entire fairness review modeled on the one available to controlling shareholders under Delaware corporate law could also ensure that productive restructuring transactions are not derailed by aggressive judicial scrutiny. In the context of credit agreements, there are no mediating fiduciaries, so it would make sense to exempt transactions from entire fairness review if a majority of nonparticipating debtholders vote for the amendment, are fully informed, and not coerced—consistent with the second prong of the controlling shareholder exemption.

In sum, Delaware corporate law provides meaningful mechanisms to limit the substance of a controlling debtholder fiduciary

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[150] *See, e.g.*, Baird, *supra* note 17 (manuscript at 18); Buccola, *Efficacious Answers*, *supra* note 26 (manuscript at 19–20).

duty. If a restructuring transaction treats all debtholders equally or receives approval from a majority of nonparticipating, informed debtholders, then the scope of judicial oversight should be minimal. Further, if the benefit provided to participating debtholders does not demonstrably harm nonparticipating debtholders, then the scope of judicial oversight should also be minimal under one version of the advantage/disadvantage test. In all other cases, courts will provide meaningful oversight to ensure those amending the credit agreement are being entirely fair to minority debtholders.

C. Waivable Duty

As a general rule, corporations cannot opt out of the fiduciary duty of loyalty.[151] However, in other business organizations that provide more contractual flexibility, such as LLCs, fiduciary duties are merely default rules that parties can opt out of.[152] As credit agreements are creatures of contract law to an even greater extent than these business organizations, it would be sensible to allow a newly imposed fiduciary duty of loyalty to be waivable by a clear statement in the credit agreement. Allowing parties to waive the controlling debtholder fiduciary duty would ensure that if empirical findings demonstrate that uptier transactions are beneficial in some contexts,[153] or if parties discover a contractual solution that is more effective than the duty, they are not constrained by this doctrine. Making the fiduciary duty waivable respects parties' abilities to tailor their contracts to their specific circumstances and ensures parties won't be trapped if the legal standard becomes unworkable or is seen as inefficient. Even if parties choose to opt out of fiduciary duties, there are at least two reasons to change the default rule to imposing them: (1) it provides greater certainty to the parties, and (2) the default may prove to be sticky.

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[151] *See, e.g.*, Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1077–78 (2017) (noting that the one recent exception has been for corporate opportunities).

[152] *See, e.g.*, Stone & Paper Inv'rs, LLC v. Blanch, 2021 WL 3240373, at *24 (Del. Ch. July 30, 2021). The only duties that Delaware does not allow to be waived are bad faith violations of the implied covenant of good faith and fair dealing. *See id.* This is one reason that imposing a new fiduciary duty to address uptier transactions may be more conservative than expanding the scope of the implied covenant of good faith and fair dealing to prohibit uptier transactions.

[153] *See supra* note 35.

One possible critique of this proposal is that if fiduciary duties can be waived, why bother to impose them to begin with? Requiring explicit waiver of fiduciary duties would provide debt investors with clear notice of whether they are at risk of an uptier transaction. This would give them the information necessary to accurately assess the investment risk of loans and demand greater compensation for the ones that allow for uptier transactions. The ability to accurately price in this investment risk would also provide an incentive to stick with the new default rule—companies will know that waiving fiduciary duties would mean they must pay a higher interest rate or abide by stricter loan terms. In the absence of this default rule, debtholders lack certainty regarding whether uptier transactions are possible under existing credit agreements given the potential for loopholes.[154] As a result, debtholders cannot easily differentiate among credit agreements.[155] Switching the default rule to imposing a fiduciary duty would shift both the bargaining power and expectations of the parties. Once fiduciary duties have been imposed, debtor companies would have to explain to debtholders why they should modify credit agreements to waive these duties and why they want to be able to engage in nonconsensual transactions that are likely to harm nonconsenting debtholders.

A second possible critique is that parties to a credit agreement could write a duty into the contract similar to the one proposed by this Comment.[156] If parties are choosing to respond to uptier transactions by increasing voting thresholds rather than imposing contractual duties,[157] then contracting parties may not believe that imposing duties is an effective solution.[158] First, if the costs associated with changing the default rule are greater than the costs from uptier transactions, then it may not be worthwhile for parties to insist on changes to the contract even if the current

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154 *See supra* Part I.C.

155 The inability to differentiate between the quality of credit agreements is an instance of the lemons problem. *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). If debt investors cannot distinguish the protections included in credit agreements, they will discount both good and bad credit agreements equally, removing the incentive for firms to commit not to engage in uptier transactions.

156 Of course, contracting parties could include a fiduciary duty in credit agreements as an alternative to having courts or legislatures impose one. The basis for, and utility of, imposing a fiduciary duty in the credit agreement would be similar to this Comment's proposal.

157 *See supra* Part I.C.

158 *See* Baird, *supra* note 17 (manuscript at 28–29).

default is suboptimal.[159] Second, contracting parties may be at a disadvantage when drafting standards-based clauses compared to courts or legislatures. If contracting parties draft the language, there will be variation across contracts and added uncertainty regarding how courts will interpret and apply them.[160] The uncertainty that could result from a lack of uniformity in language and interpretation is at odds with the purpose of imposing a fiduciary duty, which is to increase the certainty debtholders have in their property rights. In contrast, judicial imposition of a fiduciary duty would create a single standard with a single doctrinal approach, reducing variation in how the duty would be applied across credit agreements and transactions. For instance, participating debtholders would know that their uptier transaction would not be prevented by the courts if they passed the advantage/disadvantage test or qualified for the exemption from entire fairness review. If parties were to write standards-based clauses, their scope and substance would provide much less certainty. Provisions in a commercial contract can also be slow to change due to frictions in the negotiation and drafting process, "despite a salient event that one might think would have spurred a change in the optimal contract."[161] While Buccola and Nini have observed changes in credit agreements in response to uptier transactions, these changes have involved more straightforward, minor alterations to the voting threshold. Including a new, untested standard would be a more substantial change that may create too much uncertainty to justify breaking away from the current default, even if the current default is suboptimal. Of course, it could also mean the parties do not see the fiduciary obligation solution as helpful—in which case they can always opt out.

CONCLUSION

Uptier transactions are recent efforts by debtor companies and participating debtholders to transfer value from nonparticipating debtholders to themselves by issuing new debt that takes priority over the debt held by nonparticipating debtholders. These

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[159] The risk of default may be a third-order concern for many debt investors. *See* Baird, *supra* note 17 (manuscript at 25–26).

[160] *See, e.g.*, *Best Efforts, Commercially Reasonable Efforts, and Reasonable Efforts Provisions in Commercial Contracts*, LEXISNEXIS (May 23, 2019), https://perma.cc/WC5U-38XU.

[161] Buccola & Nini, *supra* note 3 (manuscript at 26) (citing other sources).

transactions are a form of investor opportunism that is inequitable, economically inefficient, and undermines investor confidence, contributing to less efficient capital markets. As the opinion in *TPC Group* demonstrates, contract law currently lacks an effective mechanism to prevent such opportunistic behavior.[162] Further, the solutions available to contracting parties to prevent uptier transactions are suboptimal—they may either prevent beneficial restructuring transactions and unnecessarily send some businesses into bankruptcy, or merely plug loopholes in a continuing cat and mouse game with debtor companies who will continue to search for the next loophole.

Historically, equity investors faced the same risks of investor opportunism that debt investors are facing now: those with a controlling stake in corporations could control corporate assets in a way to benefit themselves at the expense of minority shareholders. However, courts found an equitable solution: impose a fiduciary duty of loyalty on controlling shareholders owed to the corporation and minority shareholders. This solution continues in Delaware corporate law to this day and presents a possible solution to the recent investor opportunism witnessed in uptier transactions. Specifically, this Comment proposes treating debt investor control over covenants as akin to the control large equity investors wield over corporations by imposing a waivable fiduciary duty of loyalty on controlling debtholders.

The imposition of fiduciary duties on controlling debtholders would provide greater security to investors, avoid inefficient transactions, and reduce the costs of debt financing. While the scope and substance of any new duty presents uncertainty, legal doctrines in Delaware corporate law provide useful starting points to consider how courts could enforce this new fiduciary duty in a way that would provide parties with greater certainty of their rights, limit judicial intervention, and prevent transactions involving debt-investor opportunism. If the doctrine proves to be unworkable or inefficient, parties could opt out by waiving these fiduciary duties. As traditional differences between loan markets and equity markets fade, the rationale for applying wholly different legal regimes fades as well.

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[162] *TPC Group*, 2022 WL 2498751, at *12 (citing Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., 2021 WL 3671541, at *1 (N.Y. Sup. Ct. Aug. 16, 2021)).