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## ARTICLE

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### EFFICACIOUS ANSWERS TO THE NON-PRO RATA WORKOUT

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*The lack of comprehensive response to a recent wave of non-pro rata refinancing transactions poses theoretical as well as practical puzzles. Most market participants seem to think that workout negotiations at least presumptively ought to treat creditors in a bond or a loan facility equally. Yet more than two years after it became clear that debtors would consider non-pro rata deals, and despite evidence that clever advisors might be able to circumvent contractual changes addressed to a specific non-pro rata transactional form, no effort to ensure equal treatment generally has taken hold. Why not?*

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*This essay offers an optimistic account of the status quo. A common, fatalistic attitude supposes that participants in the leveraged debt markets lack the institutional tools to course correct. Ironically, though, the persistence of non-pro rata dealmaking may be a function of there being too many, rather than too few, efficacious answers. Contract drafters, distressed asset managers, and judges each have the means to put a stop to wealth-destroying non-pro rata transactions. The problem is that it is hard to know a priori whether the most targeted responses will prove feasible. Because time will tell, the value-maximizing strategy for actors with relatively blunt tools may be to wait and see. Temporary inaction might thus reflect prudent epistemic modesty rather than institutional paralysis. A prediction follows: courts or contract drafters will soon rule out non-pro rata deals generally if asset managers do not figure out how to sort net-valuable from net-costly transactions on a case-by-case basis.*

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## INTRODUCTION

Perhaps no recent development in financial restructuring has inspired as much cynical eye-rolling as the non-pro rata workout. A non-pro rata transaction, like a conventional out-of-court restructuring, is an agreement between a financially distressed company and its creditors allowing the company access to liquidity that its contracts would preclude. The distinguishing feature lies in the company's method of inducement. In a conventional workout, the company offers ratable consideration to all consenting creditors in a facility whose contractual rights are to be waived or altered. In a non-pro rata transaction, by contrast, the inducement is offered only to a subset of creditors whose consent is sufficient to bind the facility.<sup>1</sup>

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<sup>1</sup> For excellent discussions of the coalitional dynamics such transactions produce, see generally Diane Lourdes Dick, *Alliance Politics in Corporate Debt Restructurings*, 39 EMORY BANKR. DEV. J. 285

The bulk of a voluminous commentary has regarded the emergent, non-pro rata deals with a jaundiced eye. This is not to say that the appeal of such transactions is mysterious. To a debtor's incumbents and equity investors, the advantages are clear enough. The debtor gets relief from a liquidity crunch without having to invoke bankruptcy (where equity interests are typically wiped out),<sup>2</sup> while its creditors, as a group, take less of any surplus attributable to a refinancing than they would in a pro rata deal.<sup>3</sup> Participating creditors likewise fare better than they could expect to in a counterfactual restructuring—only those left out of the deal predictably fare worse than they otherwise might. Nevertheless, there are good reasons to think that most non-pro rata transactions have negative net effects, especially when the dynamic adjustments they presumably inspire are included in the tally.<sup>4</sup>

Viewed in this light, the failure of a comprehensive response to take hold more than two years after non-pro rata dealmaking emerged as a semi-regular practice has caused some both in industry and the academy to despair. It is not that nothing has changed. Loan contracts originated today are more likely than those originated before 2020 to include language blocking the kinds of non-pro rata transactions—so-called “uptier exchanges”—that first appeared in the market.<sup>5</sup> But fatalists conclude, with some evidence, that clever restructuring lawyers will be able to circumvent narrow contractual fixes.<sup>6</sup> On this view, the persistence of non-pro rata deals is indeed puzzling, because there are at least three evident routes by which market participants (a term I use broadly to include courts sitting in judgment of market activity) could shut down negative-value trades. In the primary market, contract drafters could provide that otherwise-valid amendments are void if the debtor offers an inducement to some but not all creditors in a facility. In distress situations, asset managers could agree with one another not to accede to non-pro rata

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(2023), and Douglas G. Baird, *Three Faces of Creditor-on-Creditor Aggression* (Oct. 4, 2022) (unpublished manuscript) (on file with author).

<sup>2</sup> See Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporation Reorganization*, 90 U. CHI. L. REV. 1, 32–35 (2023) (discussing hardball priming transactions in the non-pro rata uptier).

<sup>3</sup> In principle, the debtor should be able to capture almost the entire surplus if they can effectively auction off between unstable creditor coalitions the right to be chosen as the favored group. Vincent S.J. Buccola, *Unwritten Law and the Odd Ones Out*, 131 YALE L.J. 1559, 1573–74 (2022) (explaining how the Bankruptcy Code prevents incumbents from splitting value unfairly or as they choose).

<sup>4</sup> See *infra* notes 45–49 and accompanying text.

<sup>5</sup> See Vincent S.J. Buccola & Greg Nini, *The Loan Market Response to Dropdown and Uptier Transactions* 1, 6–7 (June 2022) (unpublished manuscript), <https://www.law.nyu.edu/sites/default/files/loan%20market%20response%202022%20june%202022.pdf> [<https://perma.cc/2CZ6-RRMV>] (highlighting the uptick in loans that block uptiers).

<sup>6</sup> See, e.g., Samir D. Parikh, *Financial Disequilibrium*, 171 U. PA. L. REV. 1925, 1928–29 (2023) (making explicit a common form of reasoning).

offers. In litigation, judges could construe long-established doctrines, most obviously the implied contractual duty of good faith and fair dealing, to rule out non-pro rata refinancings. The fact that none has emerged as part of a responsive equilibrium casts doubt on the debt markets' capacity to self-correct.

This essay offers a more optimistic interpretation of the status quo. It suggests that the persistence of non-pro rata deals may be a function of there being, ironically, too many, rather than too few, efficacious answers available to market participants. When the feasibility of a first-best solution is uncertain, third-best market dynamics can persist for a while despite readily available second-best alternatives. It need not be that the perfect is interposing as enemy of the good. Learning might just take time. The punch line is that prudent institutional modesty, rather than dysfunctional institutional paralysis, may explain the lack of a comprehensive reaction to non-pro rata workouts.

The account turns on the twin difficulties of heterogeneity and non-verifiability. Non-pro rata deals are heterogeneous in the sense that many are socially costly, but not necessarily all are. Dispensing with an equal-treatment norm has its advantages. For example, a debtor's willingness to favor a subset of creditors can overcome free-riding incentives that bedevil diffuse creditor bodies.<sup>7</sup> Where the advantages of a non-pro rata deal are especially pronounced, favoring some creditors over others, similarly situated creditors may increase a debtor's enterprise value relative to realistic alternatives. Yet it is no easy task to distinguish between scenarios in which a non-pro rata workout is plausibly value-enhancing and those in which it is not. There are no obvious markers on which contracting parties could settle at the time a loan agreement or bond indenture is drafted. Nor are courts well positioned to resolve epistemic doubt.

To the extent that case-specific determinations might prove valuable, the reluctance of contract drafters and judges to prohibit non-pro rata workouts generally is explicable within a value-maximization framework. The optimal equilibrium, if it is feasible, involves asset managers evaluating the merits of pro rata as against non-pro rata options when the particularities of a distressed situation become relatively clear: electing to participate in, or agreeing with one another to forswear, a non-pro rata resolution according to their perceptions of the prospective value of each. *Ex post* coalition formation of this sort is possible at least in some circumstances.<sup>8</sup> If asset managers can

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<sup>7</sup> See discussion *infra* subsection III.A.2.

<sup>8</sup> See *Special Situations Insight: The Subtle Art of the Cooperation Agreement*, LEVFIN INSIGHTS, Mar. 9, 2023 (reporting the recent formation of creditor cooperation agreements among bondholders in Carvana and Cooper-Standard and among lenders in Mitel, Travelport, Brand Industrial, and

sort the good from the bad reliably, then contract drafters and judges do best by doing nothing, so to speak, in effect deferring to the investors.

But the process of ex post coalition formation may not be reliable. The transaction costs of intercreditor negotiations, even intra-facility, could be insuperable in many instances. If Coasean bargains do not produce a reliable signal about the capacity of a particular non-pro rata deal to preserve enterprise value, then courts or ex ante contracting parties might rule out the whole class of deals. It takes time to find out which world is ours, however. For the institutions with relatively blunt tools, the predicament thus reveals itself to be a kind of optimal stopping problem, the solution to which is to wait and see whether asset managers' case-specific dealings can do the trick.

One useful feature of the account I offer is that it yields a notionally testable hypothesis about the efficiency of the institutions of leveraged and distressed debt. The pessimistic and optimistic accounts of the status quo are observationally equivalent initially but yield different pictures over time. Both explain why a type of transaction that usually destroys wealth can persist despite plausible remedies. Only one predicts that high-yield debt contracts or judicial decisions, or both, will intervene to nullify the non-pro rata workout if asset managers, having become aware of its costs and benefits, are unable to discriminate reliably.<sup>9</sup> The analysis thus supplies a basis on which to upgrade or downgrade one's view of the fit between an optimization framework (of which the optimistic account is an application) and the institutions of leveraged finance.

## I. THE NON-PRO RATA PHENOMENON

For almost the entire history of tradable debt, the opportunity set for distressed businesses and their advisors has been structured by a norm that the claims of creditors within a facility are to receive ratable treatment. A pro rata norm is explicit in bankruptcy reorganizations, where the equal treatment of claims in a class is a prerequisite to plan confirmation.<sup>10</sup> It is not, however, an invention of bankruptcy law. The laws introducing corporate

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Rackspace); Davide Scigliuzzo & Eliza Ronalds-Hannon, *Apollo, Pimco in Pact to Prevent Creditor Brawl Over Carvana*, BLOOMBERG (Dec. 6, 2022, 7:29 PM), [https://www.bloomberg.com/news/articles/2022-12-07/apollo-pimco-sign-pact-to-prevent-creditor-brawl-over-carvana?sref=5Eoomnkk&leadSource=verify%20wall&mc\\_cid=1234008223&mc\\_eid=a66349ad59](https://www.bloomberg.com/news/articles/2022-12-07/apollo-pimco-sign-pact-to-prevent-creditor-brawl-over-carvana?sref=5Eoomnkk&leadSource=verify%20wall&mc_cid=1234008223&mc_eid=a66349ad59) [<https://perma.cc/K45J-K9RJ>] (discussing such an agreement among Carvana creditors).

<sup>9</sup> The hypothesis is only *notionally* testable because my account doesn't say precisely *when* contracts or judicial policy could be expected to change. For that kind of prediction, one would need to specify parameters (e.g., the value of non-pro rata workouts, the rate at which participants in the leveraged finance markets learn about the feasibility of ex post coalition formation, etc.).

<sup>10</sup> See 11 U.S.C. § 1123(a)(4).

reorganization to bankruptcy in the 1930s<sup>11</sup> largely codified emergent practices in the railroad receiverships,<sup>12</sup> where the bankers and lawyers who sought to restructure bonds solicited them from all holders willing to participate as a matter of course. The pro rata norm in bond workouts survived the Trust Indenture Act with minor exceptions.<sup>13</sup> Ratable treatment likewise became the norm in loan workouts when syndicated loans became an important part of corporate finance. Consent payments and other inducements from a borrower seeking forbearance or additional financial flexibility might be negotiated with a designated “lead bank” but would go to the consenting lenders on a ratable basis. Such was the power of a commercial norm of reciprocity among banks that it scarcely mattered whether pro rata treatment was contractually mandated.<sup>14</sup>

Starting in the late-2010s, however, distressed businesses began to flirt with refinancing transactions that would favor some investors in a credit

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<sup>11</sup> See Act of Mar. 3, 1933, ch. 204, § 77(b)(1), 47 Stat. 1467, 1474 (amending the Bankruptcy Act of 1898 to authorize plans to modify the claims of railroad creditor by class); Act of June 7, 1934, ch. 424, § 77B(b)(1), 48 Stat. 911, 913 (amending the Bankruptcy Act of 1898 to authorize a broader set of corporations to modify the claims of creditor by class); see also Chandler Act, ch. 575, § 216(1), 52 Stat. 840, 985-96 (1938) (carrying forward class-based modification of claims to the new Chapter X).

<sup>12</sup> For discussion of the legislation, see DAVID A. SKEEL, JR., *DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 101–09 (2001). To the extent codification had any effect on workout dynamics, it presumably reinforced the pro rata norm. See Jason Roderick Donaldson, Edward R. Morrison, Giorgia Piacentino & Xiaobo Yu, *Restructuring vs. Bankruptcy* 7–9 (Columbia L. & Econ. Working Paper No. 630, 2020), [https://scholarship.law.columbia.edu/cgi/viewcontent.cgi?article=3710&context=faculty\\_scholarship](https://scholarship.law.columbia.edu/cgi/viewcontent.cgi?article=3710&context=faculty_scholarship) [<https://perma.cc/BLX2-9V6S>] (providing a model connecting investors’ expectations about bankruptcy to their willingness to restructure claims out of court).

<sup>13</sup> Because of the Trust Indenture Act, the restructuring of most publicly traded bonds cannot be accomplished through a consent solicitation alone. Trust Indenture Act of 1939, ch. 411, § 316(b), 53 Stat. 1149, 1173. See generally Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 *YALE L.J.* 232 (1987) (showing how § 316’s prohibition impacts a company’s ability to reorganize outside of bankruptcy). Instead, issuers typically offer to exchange outstanding bonds for new securities with more agreeable terms, and often couple the exchange with amendments stripping any bonds not exchanged of valuable indenture protections. The SEC’s “all holders” rule, which governs tender offers for equity securities, does not apply to offers for debt securities. Exchange Act Regulation 14D, 17 C.F.R. § 240.14d-1(a) (2008). Consequently, distressed issuers have long had the legal ability to effect non-pro rata *bond* restructurings. Nevertheless, the norm has been to make ratable exchange offers except to the extent that some holders’ participation would foreclose an SEC registration exemption. Astute observers saw the possibility that an issuer might abuse its legal authority to offer an exchange on a non-pro rata basis but found no evidence of such abuse actually happening. See, e.g., Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 *NW. U.L. REV.* 281, 306–07 (2009) (noting that the authors, after researching the possibility, “ha[d] found no instances” of an activist fund negotiating superior terms to fellow holders).

<sup>14</sup> Cf. Elisabeth de Fontenay, *The \$900 Million Mistake*: In re Citibank August 11, 2020 Wire Transfers (SDNY 16 February 2021), 16 *CAP. MKTS. L.J.* 307, 312–13 (2021) (pointing out that a decline in reciprocity norms has magnified the problems of incomplete contracting in the leveraged loan context).

facility over others.<sup>15</sup> If a company seeking additional liquidity needs the consent of only 51 percent (by value) of the creditors in a facility, the company's shareholders are self-evidently better off if the 49 percent whose consent is legally irrelevant need not be compensated. The clothier Not Your Daughters Jeans sought to make good on this logic in 2017 when it announced a non-pro rata deal with a bare majority of its lenders.<sup>16</sup> When disfavored lenders filed a complaint, however, the company reversed course and offered a revised deal to its lenders on a ratable basis.<sup>17</sup>

The Covid-19 pandemic marked a decisive break with past practice. In quick succession during the summer of 2020, three companies devastated by the pandemic—Serta Simmons, TriMark, and Boardriders—closed similar non-pro rata refinancings.<sup>18</sup> Two essential features defined these so-called “uptier exchanges”: (1) a bare majority of lenders in each secured facility consented to a loan amendment that would permit the borrower to issue additional debt through a new facility that would subordinate existing liens; and (2) the borrower, in consideration for the favored lenders' consents, agreed to exchange some of the to-be-issued, super-priority loans for existing loans at a ratio implying an above-market price.<sup>19</sup>

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15 Non-pro rata workouts thus emerged as part of a more general trend of aggressive priming transactions, which is already the subject of an extensive literature. *See, e.g.*, Buccola & Nini, *supra* note 5; Buccola, *supra* note 2; Stephen J. Lubben, *Holdout Panic*, 96 AM. BANKR. L.J. 1, 18 (2022) (noting the prevalence of uptier transactions in the 2010s); Diane Lourdes Dick, *Hostile Restructurings*, 96 WASH. L. REV. 1333, 1357 (2021) (discussing the non-pro rata possibilities in the Serta restructuring); Kenneth Ayotte & Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 YALE L.J.F. 363, *passim* (2021) (highlighting J. Crew and Nine West as two case studies in complex bankruptcy cases); Mitchell Mengden, *The Development of Collateral Stripping by Distressed Borrowers*, 16 CAP. MKTS. L.J. 56, 56 (2021) (noting the uptick in stripping collateral from creditors); Robert K. Rasmussen & Michael Simkovic, *Bounties for Errors: Market Testing Contracts*, 10 HARV. BUS. L. REV. 117, 144–48 (2020) (revisiting the J. Crew case study and discussing an iterative approach to crowdsourcing error checking through credit default swaps); Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745, 759–62 (2020) (discussing shifts in Delaware law and their implications on how large firms handle financial distress).

16 *See* Dick, *supra* note 15, at 1359–1362 (discussing Not Your Daughter's Jeans' uptiering transaction with 53% of lenders from the company's senior secured credit facility).

17 *Id.*

18 Buccola, *supra* note 2, at 47 tbl.2.

19 *See* Buccola & Nini, *supra* note 5, at \*18–20 (providing detail on transaction structure). Economically equivalent transactions have been noticed in Chapter 11, as well. *See, e.g.*, Kenneth Ayotte & Alex Zhicheng Huang, *Standardizing and Unbundling the Sub Rosa DIP Loan 2* (Dec. 27, 2022) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4323945](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4323945) [<https://perma.cc/4WMJ-CYTX>] (showing how DIP loans have been used to prefer some pre-petition first-lien lenders to others); Michael R. Handler, Arthur J. Steinberg & W. Austin Jowers, *Pitfalls of Unequal Participation Rights in Syndicated DIP Financing*, AM. BANKR. INST. J. 24, 24 (Apr. 2022) (demonstrating how DIP loans have been used to prefer certain first-lien lenders over others, too); *see also* *The Peabody Award: Exclusive Opportunism in Bankruptcy*, CREDITOR RIGHTS COAL. (Oct. 23, 2022), <https://creditorcoalition.org/the-peabody-award-exclusive-opportunism-in-bankruptcy/> [<https://perma.cc/BJ93-MA33>] (considering non-pro rata plan rights to backstop and

In the two years since, restructuring advisors have engineered formally distinctive transactions with similar economic significance. Incora brought the uptier exchange to the world of secured bonds.<sup>20</sup> TPC Group closed a non-pro rata uptier that lacked an exchange component.<sup>21</sup> As in the earlier transactions, TPC offered a subset of creditors superior treatment in exchange for their consenting to the company's issuance of new, priming debt. But TPC compensated the consenting creditors with an exclusive right to fund the new facility at an above-market rate rather than by offering to exchange their existing debt for new, senior instruments.<sup>22</sup> Envision Healthcare devised a non-pro rata version of the "dropdown" transaction first made infamous by J. Crew.<sup>23</sup> Unlike with J. Crew and other similar cases, however, Envision arguably needed lender support to transfer assets into an unrestricted subsidiary. Without the lenders' support the transaction might not have survived a challenge. A formal amendment of the loan agreement proved unnecessary only because Envision was able to peel off enough of its potentially litigious lenders, by offering them superior rights to participate in the new capital structure, that the result became a *fait accompli*.<sup>24</sup>

Investors have pushed back on non-pro rata workouts in a couple of ways. One way is in the courts. Disfavored creditors, relying on explicit terms of their debt instruments as well as on general legal principles, have challenged the validity of every non-pro rata deal save one (Envision Healthcare).<sup>25</sup> The other way investors have responded to non-pro rata workouts is in the primary loan market. After Serta Simmons, TriMark, and Boardriders,

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subscribe to rights offerings). My analysis focuses on workouts because institutional differences between bankruptcy and non-bankruptcy contexts imply different responsive equilibria. Among other things, bankruptcy law's tendency to displace contracts places greater stress on the judicial application of equitable principles. See Baird, *supra* note 1, at 37 ("Animating the duty of creditors to act in good faith . . . presents a strikingly different challenge in bankruptcy").

<sup>20</sup> See Complaint at 1-2, *SSD Invs. Ltd. v. Wilmington Sav. Fund Soc'y*, FSB, No. 654068/2022 (Sup. Ct. N.Y. Oct. 31, 2022).

<sup>21</sup> See *Bayside Cap. Inc. v. TPC Grp. Inc. (In re TPC Grp. Inc.)*, No. 22-10493, 2022 WL 2498751, at \*1-6 (Bankr. D. Del. July 6, 2022) ("[T]he majority holders here retained their positions in the old (now junior) loan, rather than selling those loans back to the debtors and thus exiting the junior tranche.").

<sup>22</sup> *Id.* at \*1. For an extensive discussion of the transaction and ensuing litigation, see Jared A. Ellias & Elisabeth de Fontenay, *Law and Courts in an Age of Debt*, 171 U. PA. L. REV. 2025, 2041-2055 (2023).

<sup>23</sup> Max Frumes, *Envision Rewrites Book on Liability Management Exercises*, LINKEDIN (Sept. 12, 2022), <https://www.linkedin.com/pulse/envision-rewrites-book-liability-management-exercises-max-frumes> [<https://perma.cc/CYX5-H5B4>].

<sup>24</sup> *Id.* Envision also executed an uptier exchange. *Id.*

<sup>25</sup> See Ryan Schloessmann, Comment, *Covenant Control: The Case for Treating Uptier Transactions as a Form of Corporate Control*, 91 U. CHI. L. REV. 1197, 1199 n.5 (2023) (collecting cases filed before 2023); Complaint, *Ocean Trails CLO VII v. MLN TopCo Ltd.*, No. 651327/2023 (N.Y. Sup. Ct. Mar. 14, 2023) (Mitel).



lenders began flyspecking new contracts for their susceptibility to an uptier exchange. A study of publicly available leveraged loan contracts found that the fraction of new loans blocking that particular transaction nearly doubled, to approximately seventy percent, in the year after Serta.<sup>26</sup>

Nevertheless, an air of resignation, a sense of inevitability about a future in which intra-facility coalition formation is an important feature of workouts, is palpable in the leveraged finance world. Litigation has failed so far to produce decisive judgments that might chasten distressed borrowers. The TriMark and Revlon cases settled,<sup>27</sup> challenges to the TPC Group and Serta Simmons uptiers were rejected on the merits (although the Serta decision is on appeal),<sup>28</sup> and the other disputes are still pending. Meanwhile, contractual changes do not articulate broad principles. New terms may effectively rule out one specific transactional form at a time, but the concern remains that modern loan contracts are full of loopholes just waiting for a clever lawyer to exploit.<sup>29</sup> The fact that multiple structures have already been devised to accomplish similar aims underscores the sense that contractual “patches” may start to resemble so many Maginot Lines. Dispirited investors don’t care about blocking any one transactional form. They want to arrest the dynamics that underlie non-pro rata refinancings generally.

## II. THREE PLAUSIBLE ANSWERS

From a theoretical perspective, the status quo presents a puzzle. If so many in the market believe, as they seem to, that non-pro rata workouts are, in general, socially costly, why do they persist? The status quo would be explicable if potential remedies were outlandish. But there are at least three

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<sup>26</sup> Buccola & Nini, *supra* note 5, at \*49 (fig. 3).

<sup>27</sup> *TriMark USA Announces Resolution of Litigation with Its Lenders*, PR NEWSWIRE (Jan. 7, 2022, 4:40 PM), <https://www.prnewswire.com/news-releases/trimark-usa-announces-resolution-of-litigation-with-its-lenders-301456561.html> [<https://perma.cc/7XG4-2Q7S>]; Dietrich Knauth, *Revlon Reaches Lender Settlement, Sends Bankruptcy Plan to Vote*, REUTERS (Feb. 21, 2023, 1:51 PM), <https://www.reuters.com/markets/deals/revlon-reaches-lender-settlement-sends-bankruptcy-plan-vote-2023-02-21/> [<https://perma.cc/KzTC-TAXU>].

<sup>28</sup> *Bayside Capital Inc. v. TPC Group Inc. (In re TPC Group)*, No. 22–10493, 2022 WL 2498751, at \*12 (Bankr. D. Del. July 6, 2022) (holding that the indenture did not entitle noteholders to participate in new financing opportunities pro rata); *Serta Simmons Bedding, LLC, v. AG Centre St. P’Ship (In re Serta Simmons Bedding, LLC)*, No. 23–90020, 2023 WL 3855820 (Bankr. S.D. Tex. June 6, 2023).

<sup>29</sup> The underlying concern is that essential features of modern debt contracts have unleashed what David Skeel calls “synthetic” collective-action problems that can manifest in a variety of concrete forms. David Skeel, *Bankruptcy’s Identity Crisis*, 171 U. PA. L. REV. 2097, 2100 (2023). For a model in which loopholes are an inevitable byproduct of contractual complexity, see Kenneth Ayotte & Adam B. Badawi, *Loopholes in Complex Contracts 3* (May 17, 2022) (unpublished manuscript) (on file with author).

plausible ways that institutional actors with a stake in the leveraged finance world could address non-pro rata transactions generally.

### A. *Ex Ante Contracts*

First, loan agreements and secured bond indentures could deploy broad language to rule out non-pro rata workouts altogether. The simplest way to do so would be to require the debtor to offer ratably to all creditors in a facility any inducement it wishes to offer to any creditor for the purpose of procuring consent to an amendment or waiver. The practice of favoring a subset of creditors arises only because a debtor needs a facility's approval to accomplish its goals. Suppose the existing contract doesn't allow the debtor to incur new, senior debt, and the cheapest way to get approval is to seek it from as few creditors (by value) as possible. Ruling out this means of procuring consent would unwind the whole dynamic.

A proof of concept exists in high-yield bond indentures. Many high-yield bond indentures require the issuer to offer consent payments to all holders willing to consent on an equal basis. Indeed, a 1993 study of the privately placed notes found such a rule in approximately sixty percent of issuances.<sup>30</sup> Standard terms supply a rough-and-ready template:

The Company shall not, and shall not permit any of its Restricted Subsidiaries to, directly or indirectly, pay or cause to be paid any consideration to or for the benefit of any Holder of Notes for or as an inducement to any consent, waiver or amendment of any of the terms or provisions of this Indenture or the Notes unless such consideration is offered to be paid and is paid to all Holders of the Notes that consent, waive or agree to amend in the time frame set forth in the solicitation documents relating to such consent, waiver or agreement.<sup>31</sup>

Creditors may even prefer broader language. Typical indenture language covers only *payments* to creditors.<sup>32</sup> It does not obviously cover other, functionally similar forms of inducement, such as an exclusive right to fund a new loan or securities offering at an attractive price or an offer to exchange for a new instrument that embeds favorable terms. Contract drafters aiming

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<sup>30</sup> Marcel Kahan & Bruce Tuckman, *Private v. Public Lending: Evidence from Covenants 19* (July 1, 1993) (unpublished manuscript), <https://escholarship.org/uc/item/1xw4w7sk#main> [<https://perma.cc/K34P-ZMDJ>]. The authors saw the economic rationale clearly: “Intra-claim conflicts can explain this prohibition for, *without the prohibition, an issuer can reach an agreement with a few large lenders and pay only them for consenting. All non-participating lenders, while bound by the covenant changes, would receive no compensation.*” *Id.* (emphasis added).

<sup>31</sup> This language is taken from one of Windstream's indentures. Indenture, Windstream Corporation, 6 3/8% Senior Notes Due 2023, § 4.17 (Jan. 23, 2013).

<sup>32</sup> See, e.g., *id.*

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

### B. *Ex Post Agreements*

Second, asset managers with investments in a facility at risk of being split could agree with one another not to participate in any refinancing agreement unless its benefits are open to all on a pro rata basis. Fear is one reason creditors might consent to such a deal. Absent coordination, a creditor generally opposed to a non-pro rata deal may worry that the alternative to being included in a favored subset of creditors is simply to be excluded from it. A deal binding each relevant creditor not to defect from a pro-rata norm could bring certainty.<sup>33</sup>

Cooperation agreements of this sort have an impeccable Coasean logic.<sup>34</sup> To object to a non-pro rata transaction on the ground that it is commercially unreasonable is to insist that another way of resolving the debtor's financial distress could be expected to yield an enterprise of greater value. Perhaps, for example, a bankruptcy process could reset the company's capital structure or operational footprint in a way that a kick-the-can transaction cannot. In any case, the premise of the commercial objection implies that a latent surplus is available to be split among creditors if they can resist the impulse to defect.

### C. *Principled Judicial Doctrines*

Third, judges presiding in cases challenging the validity of refinancing transactions could invoke relatively abstract doctrines to cabin some or all non-pro rata workouts.

The most promising doctrine is the implied duty of good faith and fair dealing.<sup>35</sup> Lenders suing over the troika of uptier exchanges executed in the

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<sup>33</sup> For a discussion of the terms of some such agreements, see Samir D. Parikh, *Creditors Strike Back: The Return of the Cooperation Agreement 17–19* (2023) (unpublished manuscript) (on file with author).

<sup>34</sup> Cf. Vincent S.J. Buccola, Jameson K. Mah & Tai Zhang, *The Myth of Creditor Sabotage*, 87 U. CHI. L. REV. 2029, 2047–61 (2020) (developing an analogous argument in the context of net-negative CDS plays).

<sup>35</sup> Three other principled doctrines might offer relief but are less promising. First, fraudulent conveyance law allows creditors to avoid transfers or obligations designed to delay, hinder, or defraud them. Liens granted to secure new debt offered on a non-pro rata basis are arguably voidable insofar as they benefit a distressed company's shareholders only because, and to the extent that, they reduce the prospect of some creditors' full recovery. But there are important obstacles to a good fraudulent conveyance challenge. Among other things, well-counseled directors should in most instances be able to testify plausibly that they believe a non-pro rata refinancing would maximize enterprise value, not just transfer value from disfavored creditors to favored creditors and shareholders.

Summer of 2020 asserted just that as one sufficient reason to invalidate the transactions in their respective cases. The judges in two instances, *Serta Simmons* and *Boardriders*, denied motions to dismiss the theory without opining ultimately on the argument's merits.<sup>36</sup> The precedential force of a decision (or series of decisions) subsuming some kind of pro rata norm in a contractual debtor's duty of good faith and fair dealing would blunt the non-pro rata trend—especially if judges not only award damages but express willingness to enjoin non-pro rata transactions.

Existing law does not, to be sure, compel a construction of the duty of good faith and fair dealing robust enough to do the trick. The modern judicial approach is wary of principle-based intervention, including under the heading of good faith and fair dealing, into commercial transactions that have

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Second, existing theories of directorial fiduciary duty might be stretched to comprehend non-pro rata transactions but are not an obvious fit. Under existing Delaware law, corporate directors have no obligation to preserve the value of particular creditors' claims unless failing to do so would harm the corporation by the same token. *See* Parikh, *supra* note 6, at 1965-66 (explaining one implication of the Delaware Supreme Court's rejection of "direct" fiduciary duties to creditors). Judicial expansion of fiduciary obligation would run counter to the trend. *See* Skeel, *supra* note 29, at 2119. Delaware judges, at least, have expressed skepticism about yoking the machinery of fiduciary litigation to creditor-specific theories. *See* Elias & de Fontenay, *supra* note 22, at 2030-31 (noting that while shareholders receive fiduciary duty protections, creditors receive only protections negotiated in their contracts); Sneha Pandya & Eric L. Talley, *Debt Textualism and Creditor-on-Creditor Violence: A Modest Plea to Keep the Faith* 17-18 (Eur. Corp. Governance Inst., Working Paper No. 673/2023, 2023) (noting that the Delaware Supreme Court has held that creditors have no rights under fiduciary law). Moreover, creditors lack standing to assert fiduciary claims altogether when a debtor is organized as an LLC. *See* David Kurtz, *The Rise of the Sponsor-in-Possession and Implications for Sponsor (Mis)behavior* 8 (Jan. 9, 2023) (unpublished manuscript) (on file with author) (noting that the Delaware Supreme Court has determined creditors of an LLC do not have standing even while insolvent). Finally, Ryan Schloessmann suggests that courts could recognize a kind of duty of loyalty binding upon creditors with effective control of a facility's voting power. *See* Schloessmann, *supra* note 25, at 20-30 (explaining that creditors can expect other loan holders to vote in their shared interests). The prospect of fiduciary relationships deriving from debt ownership is intriguing but, absent an explicit contractual grounding, would require a freewheeling judicial style long since out of favor. Moreover, even on its own terms, the proposal would not seem to cover the many situations in which no single creditor has a controlling stake.

<sup>36</sup> *LCM XXII Ltd. v. Serta Simmons Bedding, LLC*, No. 21-3987, 2022 WL 953109, at \*14-16 (S.D.N.Y. Mar. 29, 2022); *ICG Glob. Loan Fund 1 DAC v. Boardriders, Inc.*, No. 655175/2020, 2022 WL 10085886, at \*23-24 (N.Y. Sup. Ct. Oct. 17, 2022). The judge in the *TriMark* case dismissed a good faith and fair dealing theory but did so on the ground that the relief such a claim would allow would duplicate the relief available to the plaintiffs on a sound theory of a specific contractual obligation. *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.*, 150 N.Y.S.3d 894, 2021 WL 3671541, at \*13 (N.Y. Sup. Ct. Aug. 16, 2021). *Serta Simmons* subsequently filed for Chapter 11 relief, staying state-court litigation indefinitely. *Amelia Pollard & Luca Casiraghi, Serta Simmons Files for Bankruptcy Amid Financing Controversy*, BLOOMBERG (Jan. 23, 2023, 11:47 PM), <https://www.bloomberg.com/news/articles/2023-01-24/mattress-maker-serta-simmons-files-for-chapter-11-bankruptcy> [<https://perma.cc/9WVE-5X3J>].

a highly articulated contractual substructure.<sup>37</sup> Indeed, a couple of important decisions in the bond context cast doubt on the idea that the doctrine embeds any notion of equal treatment. In one such case, then-Vice Chancellor Strine reasoned that, because some indentures include an explicit covenant barring discriminatory consent payments, judges should not impute an equivalent rule to indentures that are silent on the matter.<sup>38</sup>

That said, the doctrinal footing for such a judgment is secure even if not inevitable. No less a commercial law legend than Chancellor Allen suggested in a pair of important bond restructuring cases that an equal-treatment principle may give content to the obligation of good faith and fair dealing.<sup>39</sup> In *Katz v. Oak Industries*,<sup>40</sup> Allen famously approved the emerging use of exit consents to facilitate bond restructurings, over a challenge by disappointed investors grounded in the duty of good faith and fair dealing.<sup>41</sup> Few remember, however, that in doing so he reserved judgment on a hypothetical *Oak Industries* did not itself present. Allen concluded that exchange offers conditioned on an exit consent were consistent with an issuer's obligation of good faith and fair dealing only if "the inducement is offered on the same

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<sup>37</sup> See Pandya & Talley, *supra* note 35, at 5–22 (describing a "textualist" turn in debt-contract interpretation); see also Elisabeth de Fontenay, *Complete Contracts in Finance*, 2020 WISC. L. REV. 533, 548–50 (attributing the length and complexity of modern debt contracts to judicial aversion to abstract interpretive principles); Lubben, *supra* note 15 (arguing that over time, the balance of power in restructuring law has tipped toward majorities, at the expense of minority holdout rights).

<sup>38</sup> *In re Loral Space & Commc'ns Inc.*, No. 2808, 2008 WL 4293781, at \*3 (Del. Ch. Sept. 19, 2008) ("The implied covenant in a bond indenture is not a license for judges to invent market terms that should act as a default rule simply because plaintiffs or the judge think that would be a good thing. Bond indentures are carefully negotiated instruments filled with many restrictions. Therefore, courts should be chary in assuming that there are gaps to be filled, particularly when parties actually considered the question and the agreement ultimately reached incorporated no restriction on the rights of the issuer to bargain with a large holder for its consent."). More recently, in 2016, a decision out of the Southern District of New York held that a bond exchange offer open only to investors meeting the SEC's definition of a Qualified Institutional Buyer or who were non-U.S. persons was consistent with the implied covenant. *Waxman v. Cliffs Nat. Res. Inc.*, 222 F. Supp. 3d 281, 295–96 (S.D.N.Y. 2016).

<sup>39</sup> *Katz v. Oak Indus.*, 508 A.2d 873, 881 (Del. Ch. 1986); *Kass v. E. Air Lines, Inc.*, 1986 WL 13008, at \*5 (Del. Ch. Nov. 14, 1986). The judicial pedigree for overriding a debt instrument's explicit terms, in favor of a pro rata norm, is more than a century old. See, e.g., *Linder v. Hartwell R.R. Co.*, 73 F. 320, 324 (C.C.N.D. Ga. 1896); *Cochran v. Pittsburg, Shawmut & N. R.R. Co.*, 150 F. 682, 683 (C.C.W.D.N.Y. 1907) ("In the circumstances it may be fairly presumed, I think, that a strict demand in accordance with the provisions of the mortgage was not only impossible of performance by the complainant, but by the acts of the trustee was rendered unnecessary."); *Wier v. Bauer*, 286 P. 936, 944 (Utah 1930) ("To thus hold the restrictive provision effective is to deny the plaintiff all remedy to vindicate and protect his rights in the premises, and to oust jurisdiction of the courts.").

<sup>40</sup> 508 A.2d 873, 881 (Del. Ch. 1986).

<sup>41</sup> An exit consent refers to a practice in which an issuer conditions a bondholder's eligibility to participate in an exchange offer on its consent to an amendment stripping covenants from the indenture *on its way out*, so to speak.

terms to each holder of an affected security.”<sup>42</sup> Six months later, in *Kass v. Eastern Air Lines Inc.*, Allen again heard from a bondholder seeking to restrain an issuer from offering cash payment for an amendment—this time not in the context of an exchange offer. Allen said it was no violation of good faith and fair dealing to offer cash for an amendment but opined that bondholders *could* have blocked the transaction if Eastern Airlines had “not made its offer to all bondholders on the same terms, but had . . . privately paid money to sufficient holders to carry the election.”<sup>43</sup>

### III. ACCOUNTING FOR THE STATUS QUO

It is puzzling that none of the three approaches has taken hold more than two years after the Serta Simmons transaction shocked much of the distressed world. One explanation, popular with many market participants, is essentially pessimistic: financial markets are made of the same crooked timber as man—they are sites for the application of power as much as reason—and consequently only a rube would expect wealth-maximizing norms to emerge from them.

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

Two propositions underlie this account and are worth exploring. First, the economics of non-pro rata workouts are ambiguous, even if on average the transactions are socially costly. And second, the likelihood that the most effective responses, especially requiring coordination among asset managers, will be brought to bear is not obvious *a priori*.

#### A. *The Ambiguous Economics of Non-Pro Rata Workouts*

The difficulty in locating an optimal response starts with the ambiguous economic logic of non-pro rata dealings. An equal-treatment norm has important advantages. They are probably significant enough to justify at least

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<sup>42</sup> Katz, 508 A.2d at 881.

<sup>43</sup> Kass, 1986 WL 13008, at \*5.

a presumption that similarly situated creditors be allowed to participate in a refinancing pro rata. But some non-pro rata transactions may have net social benefits. If that is so, then a first-best world would allow the socially advantageous transactions to close and block the rest.

### 1. Advantages of Insisting on a Pro Rata Norm

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

Ameliorating creditor incentives to jockey for position is perhaps the most obvious benefit of an equal-treatment norm. Distributional disparities are inherent to non-pro rata refinancings, regardless of whether any particular non-pro rata transaction might maximize a debtor's enterprise value.<sup>44</sup> By definition, favored creditors do better than disfavored ones. That being so, creditors have good reason to compete to be in a favored group, or at least to avoid being in a disfavored group. In a world of non-pro rata workouts, asset managers must devote substantial resources to locating contractual threats and opportunities, assembling coalitions, and lobbying debtor management for favorable treatment.<sup>45</sup> From a social perspective, this is pure deadweight loss.

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

The third virtue of an equal-treatment norm is subtler but might be the most important of all: namely, the norm serves as a kind of epistemic filter, permitting to close only those refinancing transactions that can be expected

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<sup>44</sup> See *infra* subsection III.A.2 (discussing the possibility of non-pro rata transactions maximizing the debtor's enterprise value).

<sup>45</sup> The Serta Simmons litigation revealed the kind of lobbying that has become standard. See *N. Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC*, No. 652243/2020, 2020 WL 3411267, at \*2 (N.Y. Sup. Ct. June 19, 2020) (noting that plaintiff lenders challenging the uptier exchange had previously proposed a refinancing transaction from which they themselves would have benefited non-ratably).

to increase the debtor's enterprise value relative to the likely counterfactual (a Chapter 11 reorganization, for example). A non-pro rata workout can "succeed" even if it destroys enterprise value.<sup>46</sup>

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

Suppose first a scenario in which the company faces a simple liquidity problem. The business will be worth \$800 if it must liquidate but either \$1,300 or \$800 (with equal probability) if it can raise \$200 of new, senior money to avoid bankruptcy. The investment thus can be expected to create \$50 of economic value.<sup>47</sup> The bondholders' lien creates a debt overhang, however. New financing is impossible unless a majority of the holders agree to modify or surrender their lien. The pro-social result is a deal to do just that. Moreover, such a deal can be accomplished through a ratable offer, because the company can offer each consenting bondholder a new security worth between \$8.00 and \$8.50 and it is in each holder's interest to accept the offer.

Contrast that happy case with a scenario in which the company's economic prospects are bleak. If it can raise the \$200 to postpone and perhaps avoid bankruptcy, the business will be worth either \$1,100 or \$800 (with equal probability). Now, the pro-social result is liquidation. Continuation is expected to cause a loss of \$50.<sup>48</sup> Nor is a restructuring incentive compatible if the company must offer consideration to the bondholders ratably. The maximum pro rata offer it can make is a security worth \$7.50.

The screening logic does not hold, however, absent an equal-treatment norm. To subordinate the existing lien, the company needs the consent of, and thus must be able to offer more than \$8.00 to, only six of the bondholders (epsilon more than fifty percent). There is an easy solution. The company can

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46 To be sure, an equal-treatment norm is not a perfect screen. The theoretical possibility of a so-called "coercive" restructuring offer is well known. See generally John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207 (1991) (discussing the problem of bondholder coercion and its extension beyond extortion by the issuer). But that seems to be a second-order problem, at worst. See Sris Chatterjee, Upinder S. Dhillon & Gabriel G. Ramirez, *Coercive Tender and Exchange Offers in Distressed High-Yield Debt Restructurings: An Empirical Analysis*, 38 J. FIN. ECON. 333, 334 (1995) ("Coercion . . . may benefit claim holders by helping the firm to restructure outside the bankruptcy process.").

47 The expected value of the investment is equal to the difference between the mean value of the enterprise if the investment is made  $[(0.5)(1300-200) + (0.5)(800-200) = \$850]$  and the value of the business (\$800) if it is not.

48 The expected value of the investment is equal to the difference between the mean value of the enterprise if the investment is made  $[(0.5)(1100-200) + (0.5)(800-200) = \$750]$  and the value of the business (\$800) if it is not.



seek consent to create two new tranches of debt supported by a priming lien: a first-out tranche for the new-money commitment and a second-out tranche to be exchanged for the cooperating holders' bonds. A deal is incentive-compatible if the company offers to exchange each of the six existing bonds for a new, second-out bond with a face value between \$8.00 and \$11.66.<sup>49</sup> The disfavored bondholders eat the social loss. Before the transaction, their bonds were worth 80 cents on the dollar. Now, depending on the terms of the deal, they can expect to recover 50–63 cents. Indeed, the fact that the disfavored bondholders do worse in the case of a “successful” restructuring than they would do in liquidation implies that the *favored* bondholders might accept securities worth less than \$8.00. It is better to be in the in-group and have something worth, say, \$7.00 than to be stuck in the out-group with a bond worth \$5.00.

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

## 2. Advantages of Dispensing with a Pro Rata Norm

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

One advantage is that non-pro rata deals can ameliorate a free-rider problem that may plague some creditor bodies when a facility's debt is widely held. Negotiations between a debtor and one creditor, or a small group of creditors, are cheaper than multilateral negotiations. Investors can economize on out-of-pocket costs by deputizing one or a small committee of creditors to represent the relevant facility. That has worked reasonably well in the past; loan syndicates, for example, relied on a “lead bank” to monitor the borrower and decide when and under what circumstances a waiver or modification of the loan was appropriate.<sup>50</sup> But monitoring and renegotiation are costly tasks. In an era of reciprocity, when one banker could take the lead on one deal and another banker could take the lead on another, the reputational value of a job well done offsets the expense. Now, though, when any given lending syndicate may be composed of several hundred lenders that are heterogeneous with

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<sup>49</sup> One way to think about the significance of class splitting is to see that the debtor turns as many of its creditors as possible into “legacy” investors. See Buccola, *supra* note 3, at 1573–79 (discussing treatment of legacy claims).

<sup>50</sup> See Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1244 (2006) (“Most large loans are arranged by a lead bank, but financed by a syndicate of banks. This allows banks to spread their risk.”).

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

Non-pro rata refinancings can also unwind incentives that may lead to underinvestment. It is tempting to suppose that the alternative to a non-pro rata workout is a conventional out-of-court transaction or, failing that, perhaps a Chapter 11 reorganization. Certainly, from a balance-sheet perspective, these alternatives can be expected to lead to similar outcomes. But they may have very different distributional implications. In particular, a non-pro rata workout will often present the best outcome for a distressed company's shareholders. To the extent that a company's managers seek to preserve the value of equity investments, they may seek to avoid a restructuring altogether if a non-pro rata transaction is off the table. Restructuring financial debts is only one way to preserve a company's liquidity. Another way is to reduce capital investment. To the extent a distressed business is looking out for the interests of an equity sponsor or other controlling shareholder, it may prefer reducing (even Net Present Value-positive) investments to bankruptcy.<sup>51</sup> Insisting on an equal-treatment norm can thus be expected to cause some companies to disinvest inefficiently.

Finally, in the bond context specifically, a non-pro rata exchange offer can save the time and money that would otherwise be needed to register new securities with the SEC. An exchange offer in which an issuer's outstanding bonds are to be swapped for newly created instruments is considered a securities offering. Rule 144A and Regulation S furnish oft-used exemptions to the registration requirement that applies to public offerings.<sup>52</sup> The rules allow issuers to treat an exchange offer as a private placement not subject to registration if it is open only to qualified institutional buyers (QIBs) and non-U.S. holders.<sup>53</sup> But that implies that U.S. holders other than QIBs must be left out of the transaction.

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<sup>51</sup> See Buccola, *supra* note 2, at 37–39 (“[S]ponsor-owned companies . . . tend to underinvest—to turn down positive expected value opportunities—when the liquidity profile of investment threatens to force a realization event such as bankruptcy.”).

<sup>52</sup> See WACHTELL, LIPTON, ROSEN & KATZ, *DISTRESSED INVESTING, MERGERS & ACQUISITIONS: AN OVERVIEW OF THE LEGAL LANDSCAPE FOR ACQUIRORS AND INVESTORS* 14 (2022) (“In practice, to avoid the need for registration, distressed exchange offers are usually made pursuant to such an exception, specifically to QIBs under Rule 144A of the Securities Act and non-U.S. holders pursuant to Regulation S.”).

<sup>53</sup> *Id.*

B. *The Uncertain Feasibility of the Most Efficacious Answers*

The best way to address non-pro rata workouts, assuming it is feasible, is for the holders of distressed debt to decide on a case-by-case basis whether the advantages of dispensing with a presumption of equal-treatment outweigh the costs. Asset managers have good information with which to make that judgment. And by Coasean logic, they have good incentives, too. If a non-pro rata refinancing can be expected to decrease a debtor's enterprise value while lining the pockets of the equity investors and participating creditors, then there is a latent deal to be struck between creditors to abstain from participating in a non-pro rata refinancing. No such deal exists (even latently), however, when a non-pro rata refinancing can be expected to *increase* the debtor's enterprise value. To be sure, non-pro rata transactions impose systemic externalities that the parties to any particular deal do not bear directly. The incentive they create for future creditors of other companies to flyspeck debt contracts is an example. Asset managers may thus be willing to participate in more non-pro rata workouts than would be strictly optimal. At the same time, though, the world of specialized distressed investors is small enough that the significant players also expect to *be* later-in-time investors. Their incentives, while imperfect, are not terrible, and they are well-situated to make sound judgments about value.

Primary-market investors and judges are not in a comparable position to discriminate. For investors, the issue is one of information. Par buyers of a company's bonds or loans cannot plausibly know as much about what the company's prospects will be, conditional on its encountering distress, as the investors who actually hold its bonds or loans will know in the event. Nor are there obvious verifiable criteria that investors could use to create a state-contingent option. In other words, the difference between positive and negative-value non-pro rata refinancings is, at best, weakly contractible when a leveraged capital structure is established. Contract drafters and courts who want to block value-destroying non-pro rata workouts are stuck with *more or less* broad propositions that also block value-increasing transactions.<sup>54</sup>

Judges, unlike investors negotiating a loan or indenture, have the advantage of being called on to act only when the latent possibility of a company's distress has become patent in all its particularity. The timing of litigation leaves open the theoretical possibility that courts might deploy a facts-and-circumstances version of the duty of good faith and fair dealing. But such an approach would be costly and error-prone for the same reasons

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<sup>54</sup> Contractual solutions might also rule out other useful flexibilities in contracts. The rule I suggest—invalidating otherwise valid amendments if inducement is not offered pro rata to all creditors in a facility—stops every form of non-pro rata workout, but it may create obstacles for amendments pursued for very different reasons.

that make *ex ante* contracting a decidedly second-best approach: the criteria separating net-valuable from net-costly refinancings are elusive. Judges are not professional investors, and, by design, they come to new cases without any specific information about the parties' business prospects. They could not hope to distinguish commercially sensible from insensible transactions as accurately or as cheaply as investors. The conclusion is that only asset managers can reasonably be expected to curtail negative-value non-pro rata deals without sacrificing the advantages of positive-value deals.<sup>55</sup>

Contract drafters and judges who seek to maximize enterprise value should thus do nothing if they think Coasean bargaining among asset managers can produce a reliable signal of value. If they intervene in a necessarily categorical fashion—contractually by conditioning amendments on pro rata inducement or judicially by construing the duty of good faith and fair dealing broadly—they swear off some number of positive-value deals. Acting categorically might, of course, be worth doing, but only if the theoretically possible case-by-case approach is practically infeasible.

In August 2020, however, and for some time thereafter, neither contract drafters nor judges could have had much confidence in their feasibility judgments. The Coasean logic of the *ex post* dealmaking solution was (and is) impeccable, but the obstacles to actual deals would have appeared non-negligible. The sheer number of creditors in some facilities could prove a fatal barrier, with all the familiar bargaining and holdout problems that multilateral contracting dynamics can entail. Moreover, the norms of reciprocity that once characterized the world of leveraged lenders, at least, have largely broken down.<sup>56</sup> The only way to know how effectively asset

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<sup>55</sup> A comparison between contractual and judicial interventions suggests an analogous hierarchy. Because of inevitable incompleteness, contract drafters will never be able to distinguish between value-increasing and value-destroying transactions as finely as asset managers acting *ex post* can; but, on the other hand, they can potentially make finer distinctions than a judge plausibly could. Whether one wants judges to bar non-pro rata transactions under the duty of good faith and fair dealing (or other doctrines) thus ought to depend—setting aside questions of judicial legitimacy—on whether one thinks a reasonable degree of contractual specification is feasible. Bankruptcy judges for this reason are *more* justified in barring analogous non-pro rata transactions that a debtor might undertake in Chapter 11. The idea is not that bankruptcy courts face a fundamentally different task from courts of general jurisdiction. *See generally* Jonathan M. Seymour, *Against Bankruptcy Exceptionalism*, 89 U. CHI. L. REV. 1925 (2022). Rather, bankruptcy courts face a different balance because the Bankruptcy Code to a great extent displaces the bespoke governance terms of prepetition debt contracts. *See Baird, supra* note 1, at 37 (“In contrast to a credit agreement that provides an elaborate mechanism to limit the debtor’s freedom of action, the only explicit directive for the judge is a provision of the Bankruptcy Code that requires the judge to determine whether, in a particular case, the debtor’s plan provides the ‘same treatment’ for each claim.”).

<sup>56</sup> Adding to the difficulty is that some of the costs of a non-pro rata transaction are externalized, in the sense that the transaction degrades trust in other future credits. Some of the players can expect to be repeat players in the industry, so perhaps they internalize some of the expected costs. But it is not obvious how this plays out.

managers could reach case-specific judgments about the value of non-pro rata refinancings would be to wait and see. Creditor cooperation agreements have in fact been formed in a number of recent cases,<sup>57</sup> but it was not obvious in 2020, and to some extent still may not be obvious, just how feasible such coordination would prove.

Viewed in the light of this uncertainty, the failure of contract drafters and judges until now to rule out non-pro rata transactions looks like a function of epistemic modesty as much as institutional paralysis. Indeed, optimal stopping theory teaches that “wait and see,” for a while, is the expected value-maximizing strategy when one expects to learn about uncertain parameters. Just how long optimizing contractors and judges should be ready to wait is not clear. The calculus optimizers would need to undertake depends on the values of a number of unobservable variables.<sup>58</sup> But that should not deter us. It would be remarkable if the interactions of many diffuse investors and judges were to yield singularly efficient decision paths. The point is just that inaction may well be a sign of healthy rather than sclerotic market institutions.

#### CONCLUSION

Are the leveraged debt markets efficient or not? Are loan and bond contracts optimal or not? Are their non-price terms calibrated, in light of existing institutional practices, to maximize the expected joint surplus of capital providers and borrowers or not? As phrased, these are trivial questions, because no serious analyst thinks real-world practices mimic chalkboard models of economic organization. Serious analysts do, however, differ in their views of the degree to which optimization models usefully characterize the markets.

The emergence of non-pro rata workouts and the failure of market participants to eradicate their possibility offer a useful case study. It is tempting to take the experience of the last few years as evidence of the fundamental irrationality of leveraged debt markets, precisely because the widespread view among knowledgeable commentators—that an equal-treatment norm is generally superior—is seemingly justified. If loan and bond markets were characterized by Coasean bargaining, the logic goes, then non-pro rata workouts would never have been possible and, in any case, would have been broadly condemned as soon as their possibility became salient.

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<sup>57</sup> See LevFinInsights, *supra* note 8 (documenting instances of creditor cooperation agreements).

<sup>58</sup> For a (humorous) statement of the problem applied to bankruptcy decisionmaking, see Douglas G. Baird, *Bankruptcy from Olympus*, 77 U. CHI. L. REV. 959, 959–61 (2010).

My account suggests that such an interpretation is, at least, premature. If a pro rata norm is generally preferable to non-pro rata bargaining, then it does follow that the emergence of non-pro rata workouts implies an *imperfect* bargaining environment. Innovators can sometimes exploit contracts, at least in the short run. But what does one make of the relatively modest contractual responses that emerged after the summer of 2020?

My contention that the path of institutional response so far can be modeled within an optimality framework (in which information is costly and sometimes unavailable) is not meant to suggest that markets really *are* optimal. Plainly they are not. But the account can help those who care about leveraged finance update their priors on the *degree* to which market practices fail to maximize expected surpluses. If non-pro rata workouts continue unabated, more skepticism of the institutions of leveraged finance will be warranted. If, on the other hand, asset managers figure out how to discriminate on a case-by-case basis, or if they fail to do so but contracting parties or courts soon rule out non-pro rata refinancing categorically, we ought to be a little more sanguine.