
ARTICLE

LAW AND COURTS IN AN AGE OF DEBT

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Judges perform very different analyses when investors ask for protection. When the petitioning party is a shareholder, the court will deploy broad equitable doctrines with an eye towards reaching a fair result. On the other hand, creditors typically find a much less sympathetic ear, as courts typically march through technical analyses such as examining whether the offending party violated a contract term, with far less concern for whether the outcome is fair. In an era where many firms are highly leveraged, the end result is that the role of the courts in regulating investor opportunism and creating boundaries for “market” conduct has been greatly diminished, with consequences for both real-world corporate behavior and the development of the law.

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INTRODUCTION

Over the past several decades, American companies have increasingly funded their activities with debt instead of equity.¹ While no single factor drove this shift, innovations in debt financing such as “junk bonds,” syndicated lending, and securitization played an important role in increasing the supply of debt capital for large corporations.² On the demand side, the rise of private equity ownership of U.S. companies has translated into an insatiable appetite for debt capital to fund acquisitions and boost returns.³ Some consequences of this shift from equity to debt financing are widely understood. For example, large companies are more likely to file for Chapter 11 bankruptcy when financed with debt instead of equity, and large firms may pay lower taxes than they would otherwise thanks to favorable tax treatment of debt.⁴

In this Article, we discuss an underappreciated aspect of the rise of debt finance for American capitalism: a shift in the relationship between large corporations and the law. While the rise of corporate debt has meant many

¹ See John R. Graham, Mark T. Leary & Michael R. Roberts, *A Century of Capital Structure: The Leveraging of Corporate America*, 118 J. FIN. ECON. 658, 659 (2015) (“[D]ebt gradually substituted for preferred equity between 1920 and 1960, when relatively little preferred equity remained.”).

² See Jeremy I. Bulow, Lawrence H. Summers & Victoria P. Summers, *Distinguishing Debt from Equity in the Junk Bond Era* (discussing strip financing nonequity securities with equity to converge interests of equity and debt holders), in DEBT, TAXES, AND CORPORATE RESTRUCTURING 135, 144-45 (John B. Shoven & Joel Waldfogel eds., 1990).

³ See Cem Demiroglu & Christopher M. James, *The Role of Private Equity Group Reputation in LBO Financing*, 96 J. FIN. ECON. 306, 306-09 (2010) (finding that reputable private equity groups are well positioned to exploit “favorable credit market conditions for [leveraged buyouts]” and earn a significant return when ultimately selling that company).

⁴ See, e.g., Stewart C. Myers, *The Capital Structure Puzzle*, 39 J. FIN. 575, 579 (1984) (“[A]ny tax-paying corporation gains by borrowing; the greater the marginal tax rate, the greater the gain.”).

things, it has fundamentally not changed a fact of nature: Investors often have conflict with the corporations that imperfectly steward their capital and with other investors who behave opportunistically.⁵ Courts are often asked to mediate and resolve these disputes. In this Article, we show that the bodies of law that courts bring to bear are very different when the investment is structured as debt instead of equity.⁶

In particular, the transition from equity to debt finance means that many disputes that might have been adjudicated using equitable doctrines like fiduciary duty law instead become breach-of-contract disputes, governed by the policy goals of contract law, which can lead to very different outcomes.⁷ Moreover, because debt increases bankruptcy risk, many of these disputes are swept into bankruptcy courts, where the transactional focus of bankruptcy practice can bias judicial processes towards settlement and a fresh start.⁸ In

5 Indeed, capital structure complexity may exacerbate conflicts between investors and increase agency frictions. *See, e.g.*, Kenneth Ayotte & Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 YALE L.J.F. 363, 367 (2021) (exploring how “capital-structure complexity can make a bankruptcy more costly and contentious” through a case study of Nine West).

6 The tools that judges use to protect creditors have changed over time. *See* Jared A. Ellias & Robert J. Stark, *Delaware Corporate Law and the “End of History” in Creditor Protection*, in FIDUCIARY OBLIGATIONS IN BUSINESS 207 (Arthur B. Laby & Jacob Hale Russell eds., 2021).

7 While fiduciary duty law has been of little help to creditors in the past decade, this was not always the case. *See, e.g.*, *Geyer v. Ingersoll Publ’ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) (noting that a firm’s insolvency “creates fiduciary duties for directors for the benefit of creditors”); *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, Civ. A. No. 12150, 1991 WL 277613, at *23 (Del. Ch. Dec. 30, 1991) (“[W]hile contracting parties are not fiduciaries for each other, there are outer limits to the self-seeking actions they may take under a contract.”). These cases were heavily criticized by scholars. *See, e.g.*, Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1345 (2007) (“Bankruptcy law was ignored in *Credit Lyonnais* . . . which seems quite odd given that the concept of insolvency is central to the duty shifting doctrines. That myopia, failing to see the close connections between corporate law and bankruptcy law at the insolvency border, explains much of the confusion created by those doctrines.”); Frederick Tung, *Gap Filling in the Zone of Insolvency*, 1 J. BUS. & TECH. L. 607, 610 (2007) (“[A]t least for commercial creditors, fiduciary duties that include such creditors are unnecessary and may be counterproductive.”). The Delaware courts reversed course in the late 2000s and ended the “duty shifting” doctrine. *See* N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) (declaring that creditors do not get fiduciary duties, but are rather “afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, [and] bankruptcy law”); *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 174 n.4 (Del. Ch. 2014) (“In *Gheewalla*, the Delaware Supreme Court discarded the zone [of insolvency] . . .”). For more, see generally Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745, 750 (2020), which argues that Delaware courts overestimate creditors’ ability to protect themselves through contract and bankruptcy law.

8 *See* Ellias & Stark, *supra* note 7, at 771-78 (providing two examples where managers “play[ed] bankruptcy hardball in defiance of the bargained-for protections of creditors and equitable principles”); Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale*, 39 YALE J. ON REGUL. 1, 5 (2022) (explaining how bankruptcy courts have allowed certain senior creditors to capture the process to reach their preferred outcomes, at the expense of other creditors and of overall firm value); Anthony J. Casey, *Chapter 11’s Renegotiation Framework and the Purpose of Corporate Bankruptcy*,

short, the rise of debt financing has changed the role of judges, who now intervene in many corporate disputes to make sure the rules were followed instead of ensuring that the outcome is the right one.⁹ Stated differently, the growth of debt financing is an underappreciated reason why investor disputes are increasingly adjudicated by judges who police procedure, rather than search for substantive fairness.¹⁰

In this brief Article, we discuss the drivers and consequences of the shift. In Section I, we present the traditional theoretical framework for the protection of shareholders and creditors, respectively. We then briefly describe the core difference between the legal tools that judges deploy to protect shareholders and creditors and contrast their focus. In Section II, we offer two motivating case studies that demonstrate this contrast in practice. We examine how judges treat an allegation by a minority investor that a majority investor has unfairly appropriated value that should have been shared, under both regimes. As an illustrative dispute among *shareholders*, we examine the fairness-centered judicial approach in the 2021 “squeeze out merger” case of *Empire Resorts, Inc.*¹¹ As a dispute among *creditors*, we examine the formalist analysis in the 2022 bankruptcy case, *In re TPC Group Inc.*¹²

120 COLUM. L. REV. 1709, 1711 (2020) (“[C]ontrary to the prevailing view, the purpose of bankruptcy law is not to vindicate or mimic some hypothetical ex ante bargain among creditors.”).

⁹ See Elisabeth de Fontenay, *Windstream and Contract Opportunism*, 15 CAP. MKTS. L.J. 443, 448 (2020) (describing the significant shift over time from the use of standards and equitable remedies in debt disputes toward formal interpretation of the debt contract).

¹⁰ To be sure, bankruptcy law retains elements of its traditional search for fairness, but lawyers are currently pushing the law to become more process-oriented through, for example, the use of restructuring support agreements (“RSAs”). See, e.g., Anthony J. Casey, Frederick Tung & Katherine Waldock, *Restructuring Support Agreements: An Empirical Analysis 1* (Jan. 2022) (unpublished manuscript) (on file with author) (“[RSAs] now appear in nearly half of all large corporate bankruptcies.”); Douglas G. Baird, *Bankruptcy’s Quiet Revolution*, 91 AM. BANKR. L.J. 593, 593 (2017) (“The principal business of Chapter 11 is the bargaining over a plan of reorganization A new device—the restructuring support agreement—has transformed the plan-formation process over the last few years.”); Edward J. Janger & Adam J. Levitin, *Badges of Opportunism: Principles for Policing Restructuring Support Agreements*, 13 BROOK. J. CORP. FIN. & COM. L. 169, 174 (2018) (seeking to articulate principles to distinguish the “good from the bad” RSAs). The push for so-called “independent directors” provides another example of a process-orientated reform in bankruptcy law. See, e.g., Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. 1083, 1095 (2022) (highlighting the change in bankruptcy law in which now “[i]ndependent directors that join boards shortly before filing for bankruptcy increasingly make important decisions during the bankruptcy process that judges endorse”).

¹¹ Telephonic Rulings of the Court on Defendants’ Motions to Dismiss, MH Haberkorn 2006 Tr. v. Empire Resorts, Inc., No. 2020-0619 (Del. Ch. July 23, 2021) [hereinafter Rulings] (denying Empire Resorts’ motion to dismiss on a breach of fiduciary duty claim following the business’s take-private acquisition by the majority shareholder).

¹² No. 22-10493, 2022 WL 2498751 (Bankr. D. Del. July 6, 2022) (ruling that per “commercial norms,” a 2021 Intercreditor Agreement did not violate any rights held by noteholders under a 2019 Indenture).

In Section III, we argue that these contrasting approaches lack justification, given what we know of the debt markets today. In a world of concentrated shareholder power on the one hand, and dispersed creditors on the other, the traditional rationales for treating shareholder and creditor disputes differently lose their force. We close by considering and critiquing potential alternative approaches to disputes among creditors, including a revival of older contract law doctrines, such as the implied duty of good faith and fair dealing, or changes to judges' default approach in interpreting debt contracts, when the "four corners of the contract" lead to results that are deeply at odds with investor expectations.

I. EQUITY VS. DEBT: THE TRADITIONAL VIEW

A. *The Traditional View in Corporate Finance Theory*

How firms behave is driven, in part, by how they are financed. Among other reasons, this is because a firm's investors decide and determine how the firm will be governed.¹³ A family-owned company may behave very differently from a public company with a large and dispersed shareholder base, even if the two are in the same industry and comparable in size. Similarly, a debt-laden company may behave very differently from a comparable company with no financial creditors.

What, then, are the options for financing a company? In practice, they are too numerous to list, but corporate finance theory tends to group them into only two categories: equity and debt.¹⁴ In layman's terms, equity is often described as "ownership" of the business—that is, the right to control the company and to pocket any profits—while debt is described as money loaned in exchange for an enforceable promise by the company to repay the loan, usually with interest.¹⁵

Although these lay descriptions correctly capture the basic features of equity and debt, financial economists prefer to describe them as two different types of claims on a firm's assets and cash flows. Debt is a relatively *fixed* claim: When a firm borrows money, it agrees to pay back specified amounts

¹³ See Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 473-74 (1992) (developing a model for how the desired allocation of control rights within the firm drives the choice of equity or debt financing).

¹⁴ See JEAN TIROLE, *THE THEORY OF CORPORATE FINANCE* 75 (2010) (noting that firms have, in terms of financing, two "main financial instruments: debt and equity, in their different varieties").

¹⁵ See WILLIAM T. ALLEN, REINIER KRAAKMAN & VIKRAMADITYA S. KHANNA, *COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION* 167-72 (6th ed. 2021) (explaining the primary differences between debt and equity in corporate finance).

(of principal and interest) at specified times.¹⁶ Equity, by contrast, is a highly *contingent* claim: shareholders in a large public company, for example, do not know what payout, if any, they will receive from the firm, nor when they will receive it.¹⁷ Because, speaking generally, the company must satisfy the fixed claim of the debtholders before distributing profits to the equityholders, the latter are referred to as “residual claimants” of the firm: They are entitled to whatever is left after the firm’s other claims have been satisfied.¹⁸

Under the traditional view, these differing claims on the firm—and the differing incentives that they create—are thought to justify the differing *governance rights* given to equityholders and debtholders in practice. Because shareholders are a corporation’s residual claimants, the argument goes, they have the strongest incentives to maximize the value of the firm: they will seek to make the “residual” as large as possible.¹⁹ Creditors, by contrast, only care about the value of the firm up to the amount of their fixed claim, as they do not benefit from any appreciation of the firm beyond that amount.²⁰ Therefore, equityholders should be—and in practice, they are—rewarded with the right to control the firm: Stockholders in a corporation, for example, have the right to elect the board of directors and to vote on certain fundamental transactions affecting the corporation, while creditors have no such rights.²¹

B. *The Traditional View in Law: A Background on the Legal Regimes that Protect Equity and Debt Investors*

To restate the preceding discussion, equity generally provides investors with the right to a future portion of the firm’s profits (if any) and control

16 For the original theory of corporate securities as contingent claims, see Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973), which lays out the seminal model to price an options contract and Robert C. Merton, *On the Pricing of Corporate Debt: The Risk Structure of Interest Rates*, 29 J. FIN. 449, 455 (1974), which models corporate debt as an option.

17 See Black & Scholes, *supra* note 16, at 637.

18 See Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. ECON. 327, 328 (1983) (describing residual claimants as the economic agent who has the sole remaining claim on the corporation’s net cash flows).

19 See *id.*

20 See *id.*

21 See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 63, 67 (1991) (“[W]hy do shareholders alone have voting rights? . . . The reason is that shareholders are the residual claimants to the firm’s income.”); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001) (explaining why corporate law tends to impose on managers the duty to maximize the value of the firm for the benefit of shareholders).

rights over the firm's board.²² Debt generally provides investors with fixed payments on a defined schedule that is calibrated to provide the investor with a return of their capital and a pre-determined profit.²³

However, debt and equity investors can expect to receive very different treatment if disputes arise among investors or between investors and the managers who make the day-to-day decisions at the corporation. Most importantly, shareholders receive the protection of fiduciary duty law, which acts as a constraint on both managerial opportunism and negligence, as well as expropriation of value by controlling shareholders.²⁴ Creditors, on the other hand, are typically left with the protections they negotiated in their contracts, as well as certain statutory or common law protections, such as bankruptcy law and fraudulent transfer law.²⁵

As a result, the analysis is very different when courts are asked to protect investors. Shareholders look to doctrines that are rooted in equity and the law's fundamental desire to provide parties with fair treatment.²⁶ For example, a shareholder can file a lawsuit asking the judge to intervene because a controlling shareholder is looting the corporation.²⁷ A creditor in an analogous situation can only bring a claim against the controlling shareholder if the looting violates the creditor's contract or would constitute a fraudulent transfer.²⁸ In short, in disputes among investors, shareholders are entitled to be treated fairly, while creditors are entitled to a judicial analysis to determine whether their contract rights were technically violated.

As we discuss in the next section, these divergent judicial approaches can be outcome-determinative and dramatically alter the *ex-ante* shadow of the law as investors consider their strategy *vis-à-vis* other investors. In Section III, we argue that these divergent judicial approaches rest on longstanding

22 See David Yermack, *Shareholder Voting and Corporate Governance*, 2 ANN. REV. FIN. ECON. 103, 104 (2010) ("The rights of shareholders to choose members of the board of directors, approve mergers and acquisitions, authorize new equity issues, and amend the firm's articles of organization give them ultimate power over important corporate decisions.").

23 For a comprehensive discussion of debt and its place in corporate governance, see George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073 (1995).

24 For a discussion of the nature of the fiduciary duties of directors and officers to shareholders, see Andrew S. Gold, *Dynamic Fiduciary Duties*, 34 CARDOZO L. REV. 491, 493 (2012).

25 See generally Ellias & Stark, *supra* note 7.

26 See, e.g., *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 110 (1952) ("Since [the majority stockholder and its nominated directors] stand on both sides of the transaction, they bear the burden of establishing its entire fairness, and it must pass the test of careful scrutiny by the courts.").

27 See *id.*

28 See Ellias & Stark, *supra* note 7, at 762 ("[C]reditor protection rests on the idea that creditors are sufficiently protected through contract law, with fraudulent transfer law and bankruptcy law hovering in the background.").

empirical assumptions about the archetypal equity and debt investors that are no longer justified.

II. HOW THE LAW REGULATES EQUITY INVESTOR OPPORTUNISM VS. DEBT INVESTOR OPPORTUNISM

In this Section, we demonstrate with two case studies how the difference in investment structure between debt and equity leads to very different legal analyses and outcomes in the very same type of dispute. We focus on disputes where the majority investor takes actions that result in a non-consensual transfer of value from dissenting minority investors. First, on the equity side, we briefly discuss a recent Delaware freeze-out case: *Empire Resorts Inc.*²⁹ On the debt side, by contrast, we focus on an example of a transaction that has recently become popular, a so-called “uptiering” deal.³⁰ Although both disputes involve allegations of opportunistic behavior by a majority investor against minority investors, they unfold very differently in the courtroom.

A. Shareholder Value Extraction: Freeze-Out Transactions and the Example of Empire Resorts

In general, Delaware corporate law goes to great lengths to protect minority shareholders against value appropriation by majority shareholders.³¹ Controlling shareholders owe minority shareholders a fiduciary duty.³² When controlling shareholders stand to extract a benefit from the minority shareholders, minority shareholders have the right to sue and the burden will be on the majority shareholder to prove that the transaction was “entirely fair” with respect to minority shareholders, a standard that is challenging to satisfy, functioning somewhat similarly to “strict scrutiny” in a constitutional law setting.³³

²⁹ Telephonic Rulings of the Court on Defendants’ Motions to Dismiss, MH Haberkorn 2006 Tr. v. Empire Resorts, Inc., No. 2020-0619 (Del. Ch. July 23, 2021) [hereinafter Rulings].

³⁰ See Vincent S.J. Buccola & Greg Nini, The Loan Market Response to Dropdown and Uptier Transactions 18 (June 22, 2022) (unpublished manuscript), <https://ssrn.com/abstract=4143928> [<https://perma.cc/E4SN-ERSM>] (“In an uptier transaction, the borrower persuades a majority of lenders to amend the loan contract to allow the issuance of new debt backed by a superior lien.”).

³¹ See *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 109-10 (Del. 1952) (discussing the strictures of Delaware corporate law and the protections it provides stockholders, especially minority stockholders).

³² See *id.* (“Plaintiffs invoke the settled rule of law that Hilton as majority stockholder of Mayflower and the Hilton directors as its nominees occupy, in relation to the minority, a fiduciary position in dealing with Mayflower’s property.”).

³³ See *e.g.*, *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (observing that the standard of “intrinsic fairness involves both a high degree of fairness and a shift in the burden of proof” rather than the deferential business judgment rule).

The Delaware courts have recently moved in the direction of allowing controlling shareholders to “earn” a more favorable standard of review for conflicted transactions using the more deferential business judgment rule standard if they follow a designated procedure for negotiating a deal and obtaining shareholder approval.³⁴ The hallmarks of this procedure include, among other things, (1) appointing a truly “independent and fully-empowered” board committee to investigate the transaction on behalf of the minority shareholders, and (2) requiring an uncoerced and informed vote of the majority of minority shareholders in support of the transaction.³⁵ However, courts do not merely look to see whether these technical requirements were satisfied; they also study the details of the compliance to ensure the transaction was fair, as we will illustrate with the example below.³⁶

For a recent example of how this works in practice, consider Chancellor McCormick’s ruling on the lawsuit that Empire Resorts’ minority shareholders filed against Empire Resorts’ board and majority shareholder.³⁷ The minority shareholders there requested judicial help after the controller sought to buy their shares at a price that they believed to be unfairly low.³⁸ The controller was well-advised by sophisticated counsel and attempted to implement the transaction through a strategy that complied with what Delaware corporate law demands of a controller buyout with an independent board committee and a vote of the majority of minority shareholders.³⁹ However, Chancellor McCormick looked past the form of the transaction to its substance and identified many red flags that suggested that the minority shareholders might win on their claims.⁴⁰ As further explained below, the minority shareholders were able to use her analysis—centered on questions of fairness and not on procedural compliance—to extract a favorable settlement from the controller.

Prior to the lawsuit, Empire Resorts, a New York-based casino company, sought to allow the controlling shareholder, who already owned 88.7% of the firm’s outstanding stock, to buy the remaining stock at the price the controller

³⁴ See *In re MFW S’holders Litig.*, 67 A.3d 496, 535 (Del. Ch. 2013) (enumerating the requirements for *MFW* cleansing to thus obtain the more favorable and deferential business judgement rule), *aff’d sub nom.* Kahn v. M&F Worldwide Corp. (*MFW*), 88 A.3d 635 (Del. 2014).

³⁵ *MFW*, 88 A.3d at 642.

³⁶ See *Marchand v. Barnhill*, 212 A.3d 805, 824 (Del. 2019) (discussing *Caremark*’s requirement that “board[s] make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation’s central compliance risks,” and finding that defendant failed to do so under the circumstances).

³⁷ See *Rulings*, *supra* note 11, at 26-31 (applying the *MFW* standard to a controlled merger).

³⁸ See *id.* at 34.

³⁹ *MFW*, 88 A.3d at 34.

⁴⁰ *Id.*

was willing to pay.⁴¹ To comply with Delaware law, the board of Empire Resorts appointed a special committee of independent directors—directors with no connection to the controlling shareholder—“to evaluate an acquisition of the company by a related party.”⁴² The goal of appointing the special committee was to win judicial deference for the outcome of the sale process and to ensure that any subsequent lawsuit was reviewed for compliance with Delaware law’s expectation of a fair process as opposed to having to survive a probing judicial examination of the “entire fairness” of the transaction to minority shareholders.⁴³

However, this independent board committee was undermined from the start by the controlling shareholder’s aggressive conduct. About a month after the independent committee was appointed, the controller wrote a public letter sharing that it “no longer believed that Empire was viable as a stand-alone company,” “threaten[ed] to cease providing equity financing,” and indicated its interest in making an acquisition proposal.⁴⁴ When the controller did make a formal offer to buy the company, it refused to budge in any respect from its opening bid of \$9.74 a share⁴⁵—less than 2% above the pre-offer market price⁴⁶—and also refused to consider voting its majority shares in favor of any other offer,⁴⁷ putting the special committee in a position where they had no bargaining power whatsoever.

The board then gave up on their attempts to negotiate and agreed to approve the controller’s opening bid, but they based their decision to sell the firm on a questionable record.⁴⁸ For example, as is typical, the board relied on a fairness opinion prepared by the company’s financial advisor in voting to sell the company.⁴⁹ Curiously, the fairness opinion used by the board was based on revised management projections of future firm performance that were inexplicably lower than management’s prior predictions about how well the firm would do in the future.⁵⁰

Subsequently, a majority of the minority shareholders voted to approve the transaction.⁵¹ However, the “yes” vote relied on the votes of a minority

41 See Rulings, *supra* note 11, at 5.

42 *Id.* at 11.

43 *Id.* at 31.

44 *Id.* at 12-13.

45 *Id.* at 13.

46 *Id.* at 14. The bid was also below the lowest of the valuations that had been privately produced for the controller, which ranged from \$9.79 to \$15.95 per share. *Id.* at 12.

47 *Id.* at 17.

48 See *id.* at 20.

49 See *id.* at 20-21.

50 The new projections inexplicably eliminated a significant potential revenue stream in all but one scenario and reduced EBITDA across the board. See *id.* at 21.

51 *Id.* at 23.

shareholder that also was involved in a joint venture with Empire Resorts.⁵² Without those votes, the minority shareholders would have voted to reject the sale.⁵³

In reviewing the lawsuit, Chancellor McCormick found that the transaction as implemented should be analyzed using the entire fairness standard to determine whether the majority shareholder violated the fiduciary duty it owed to the minority shareholder.⁵⁴ She indicated that the controller's attempt to earn a more deferential review by building an ideal negotiating process failed, because the special committee was not empowered enough to negotiate.⁵⁵ She also faulted the shareholder vote, which relied on the votes of the potentially conflicted minority shareholder.⁵⁶

Chancellor McCormick then found evidence of unfairness in analyzing the sale process and the sale price.⁵⁷ She identified problems in the process that led to the sale, noting that the controller had threatened to cut off financing for Empire Resorts and "rushed the special committee by imposing deadlines."⁵⁸ She raised questions about the price, noting that the controller may have attempted to depress the stock price by making negative public statements.⁵⁹ She also faulted the reliability of the fairness opinion given to the board with the mysteriously reduced projections of future firm revenue and profit.⁶⁰ Accordingly, she denied a motion to dismiss the fiduciary duty claims from the lawsuit.⁶¹ The controller then settled the claims, paying an extra \$12 million to minority shareholders,⁶² a 20% increase to the merger consideration they would have received.⁶³

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.* at 26.

⁵⁵ The *MFW* cleansing standard requires that approval of the conflicted transaction be "irrevocably" delegated to the special committee. Rulings, *supra* note 11, at 28 (quoting *In re Dell Techs. Inc. Class V S'holders Litig.*, No. 2018-0816, 2020 WL 3096748, at *15 (Del. Ch. June 11, 2020)). This requirement was not met in *Empire Resorts*. Rulings, *supra* note 11, at 29.

⁵⁶ Rulings, *supra* note 11, at 30–31.

⁵⁷ *Id.* at 31.

⁵⁸ *Id.* at 32.

⁵⁹ *Id.* at 34.

⁶⁰ *Id.* at 34–35.

⁶¹ *See id.* at 54 ("To sum it up, Empire's motion to dismiss is granted.").

⁶² Jeff Montgomery, *\$12M Chancery Deal Sought for \$335M NY Casino-Resort Suit*, LAW360 (June 14, 2022, 4:35 PM), <https://www.law360.com/articles/1502651/-12m-chancery-deal-sought-for-335m-ny-casino-resort-suit> [<https://perma.cc/J5UJ-W7FF>].

⁶³ *See* Empire Resorts, Inc., Current Report (Form 8-K) (Nov. 15, 2019) (reporting the aggregate merger consideration to be paid was approximately \$58 million).

B. Debt Market Value Extraction: “Uptiering” and the Example of the TPC Group

In this Section, we contrast the result for minority shareholders in *Empire Resorts* with the result for minority creditors when the majority similarly seeks to expropriate value and control of the firm—in this case, through an “uptiering” transaction. We first describe this type of transaction more generally, then discuss a recent example from the TPC Group bankruptcy case.

1. Background on “Uptiering” and Priming Loans

While uptiering deals take different forms, the thrust of the transaction is that a subset of existing creditors provides the borrower with a new loan that ranks senior to the firm’s existing debt—a so-called “priming” loan.⁶⁴

A priming loan is best defined with a simple example. A large company borrows \$100 from a bank and pledges all its assets as collateral for the loan. If the company later files for bankruptcy, the bank is entitled to receive the first \$100 in value before any other creditor or shareholder receives anything. In other words, the collateral pledge gives the bank “first priority” against the firm’s assets. Now imagine that the company decides to borrow \$50 from Finco and promises to repay Finco before the bank receives anything. Assuming that this promise is legally binding, Finco has “primed” the bank. In bankruptcy, Finco will now get the first \$50 in value, and only after Finco is paid in full will the bank receive anything.

Uptiering transactions have become popular because the basic deal structure offers benefits to both the borrower and to the investors who provide the priming loan.⁶⁵ The borrower gets new financing to pay its bills and the borrower’s shareholders avoid a potential bankruptcy and economic losses. The creditors that make the priming loan get to participate in a potentially lucrative financing, as well as to protect themselves in the event of a bankruptcy filing by taking a first position.⁶⁶

Controversially, in the “hostile” uptiering transactions that have become popular, it is usually a subset of the firm’s existing creditors who make the priming loan, often with a deal structure that allows their existing debt to “jump ahead” of the creditors who did not make the priming loan.⁶⁷ To

⁶⁴ See Buccola & Nini, *supra* note 30, at 2-3 (describing the strategy behind uptiering transactions which ultimately creates a surplus that subordinates the minority shareholders).

⁶⁵ *Id.* at 3.

⁶⁶ *Id.*

⁶⁷ See, e.g., *Bayside Cap. Inc. v. TPC Group Inc. (In re TPC Group Inc.) (TPC I)*, No. 22-10493, 2022 WL 2498751, at *1 (Bankr. D. Del. July 6, 2022) (noting the recent barrage of litigation over transactions that take advantage of the technical constructions in loan documents, such as the uptiering phenomenon).

illustrate, imagine a company that owes \$100 under a single debt contract to a group of creditors who collectively have claims with the same priority in bankruptcy. The majority of the creditor group—those owed \$51—join together and make a priming loan that involves \$20 in new money (which the company needs to survive) but which also requires the debtor to agree that the \$51 that the majority of the existing creditor group is already owed now has priming priority. The result of this loan is that the minority creditors (those originally owed \$49 under the original debt contract) now sit behind \$76 dollars in “senior” priming claims. The TPC Group example we profile below has a somewhat different structure that is economically similar, where the “priming” creditors structured the deal in a way that was meant to reallocate value to their existing debt (and thus protect their downside) while also providing the company with new capital.

While, at the time of publication of this Article, there are few recorded decisions on this type of transaction, the courts that have considered the issue have restricted their analysis to determining whether the contested transaction was allowed by the credit documents.⁶⁸ Creditor attempts to proceed under mushier doctrines of the “implied covenant of good faith and fair dealing” or “tortious interference with contract” have not been successful.⁶⁹

2. TPC Group

a. Summary of TPC Group Uptiering Transaction

To summarize what we describe in greater detail below, TPC Group was a distressed oil company that executed an uptiering transaction in which the majority of the first lien creditors—who we refer to as the “majority noteholders”—provided the company with a new loan that primed the existing debt. But that loan was far more than a mere extension of credit. In

⁶⁸ The TPC opinion discussed below was the first judicial decision that addressed the merits of an uptiering transaction. See *As Market Volatility Accelerates, Judicial Ruling Approving TPC’s Superpriority Lien Transaction, Based on Four-Corners Rule, Could Accelerate Exploitation of Weak Creditor Protections in Debt Documents*, REORG (July 15, 2022, 8:37 AM), https://app.reorg.com/v3#/items/intel/8491?item_id=184334 [<https://perma.cc/PQR8-UD3G>] [hereinafter *Judicial Ruling*] (“TPC Group’s superpriority note issuance was just the latest in a series of high-profile liquidity-enhancing superpriority debt issuances What was unique, however, was that the minority holders’ lawsuit concluded in a judicial opinion that could form the basis of adjudicating the propriety of future transactions by borrowers and issuers that avail themselves of the ever-increasing loosening documentary terms and conditions in debt documents.”).

⁶⁹ See, e.g., *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.*, No. 565123/2020, 2021 WL 3671541, at *2 (N.Y. Sup. Ct. Aug. 16, 2021) (granting the Defendant’s motion to dismiss claims for both the breach of implied covenant of good faith and fair dealing, and tortious interference with contract).

making the loan, the majority noteholders acquired significant protection for their existing debt, as TPC Group promised to repay part of their debt—and only their debt—in full, at a time when the debt was trading at a deep discount to par. The majority noteholders also protected their downside, as by making the most senior loan (and blocking the company from priming the new priming loan), they put themselves in the driver's seat to provide the financing in any bankruptcy case. In Chapter 11, the majority noteholders would use their bargaining power as bankruptcy lenders to obtain management's agreement to implement their preferred restructuring transaction, resulting in the majority noteholders becoming majority owners of the company.⁷⁰

Taken together, the transactions described below amount to a series of maneuvers that allowed the majority noteholders to capture a corporate opportunity—making a series of new money investments to restructure TPC Group—without sharing them equally with the minority noteholders. The end result is that the majority noteholders deployed approximately \$245.5 million in capital to earn approximately \$118.5 million in profit, a return of 48% over a very short period of time.⁷¹

In substance, the transaction was economically equivalent to a “minority shareholder squeeze out,” which we discussed *supra*, as the minority noteholders would not participate in the restructuring transaction on the same terms as the majority noteholders. However, the ability of the minority investors to obtain judicial help was much more limited in this uptiering transaction because the minority investors here were minority investors under a debt contract rather than minority shareholders.

b. *The Design of a Hostile Uptiering Transaction*

Prior to its 2019 bankruptcy filing, TPC Group, Inc. was a leading petrochemical company that had been purchased in a leveraged buyout

⁷⁰ See Ayotte & Elias, *supra* note 8, at 5 (describing how uptiering helps creditors achieve “their preferred restructuring transaction”).

⁷¹ We calculate this number by adding together the investment (\$202.5 million in uptiering debt plus \$43 million in bankruptcy financing) and the pay-off from the investment from the plan of reorganization and the bankruptcy financing order (\$238 million paid on account of the uptiering debt, \$43 million returned to repay the DIP loan in full and \$83 million in backstop fees). The investment here was \$245 million and the pay-out on account of that investment was \$364 million. See Jeremy Sherby, *TPC Group Supporting Ad Hoc Group Would Own Nearly 85% of Reorganized Company, Recover 84% on Prepetition Secured Note Claims Due to Direct Allocation and Backstop Fees Under Proposed Plan*, REORG (July 14, 2022, 11:50 AM), https://app.reorg.com/v3#/items/intel/8947?item_id=184209 [https://perma.cc/Y28Q-BJ4P] (providing the projected pay-outs under the proposed plan).

(LBO) in 2012.⁷² The Houston-based company owned various oil pipelines and processing and logistics assets throughout Texas and Louisiana and employed about 500 people.⁷³ The leveraged buyout valued the firm at more than \$900 million,⁷⁴ and was financed with \$454.6 million in equity and \$655 million in new debt, which was borrowed through a first lien secured bond.⁷⁵ Assuming that the purchase valuation accurately appraised the assets at the time, the company, at the time of the LBO, could be thought of as majority owned by the creditors (whose \$655 million corresponded to approximately 70% of a \$900 million valuation) with shareholders who would have received approximately \$245 million had the firm been liquidated immediately after the LBO. In 2019, the firm refinanced the LBO debt with \$930 million in a new first lien secured bond.⁷⁶

In late 2020, TPC Group realized it needed additional money after a series of disasters—an explosion at a chemical plant, a global pandemic, and a winter storm in Texas—left the company struggling under its debt load.⁷⁷ The company faced a near-term cash flow crisis, as, in addition to the bond debt,

⁷² *TPC Group Announces \$655M of Secured Bonds to Back LBO*, S&P GLOB. MKT. INTEL. (Dec. 4, 2012, 2:50 PM) [hereinafter *TPC Announcement*], <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/high-yield-bond-news/tpc-group-announces-655m-of-secured-bonds-to-back-lbo> [<https://perma.cc/M5AW-TGXX>]. See generally David Gray Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73 (1985) (providing a detailed account of leveraged buyouts in corporate acquisitions).

⁷³ *Bayside Cap., Inc. v. TPC Group Inc. (In re TPC Group Inc.) (TPC II)*, No. 22-10493, 2022 WL 2952518, at *4 (D. Del. July 26, 2022).

⁷⁴ *S&P: TPC Group Ratings Remain on Watch Negative*, REUTERS (Dec. 4, 2012, 5:30 PM), <https://www.reuters.com/article/idUSWNA051020121204> [<https://perma.cc/6ZPL-ZM3Z>].

⁷⁵ *TPC Announcement*, *supra* note 72.

⁷⁶ *Primary: TPC Group Plans to Sell \$930M 5-Year Senior Secured Notes to Pay Down 2020 Notes, Riverstone Term Loan and ABL; Whispers Mid-10%*, REORG (July 12, 2019, 11:19 AM), https://app.reorg.com/v3#/items/intel/8947?item_id=78615 [<https://perma.cc/U2KB-UMP3>]. The first lien secured bond indenture gave the noteholders a first lien in substantially all of the firm's assets, *TPC I*, No. 22-10493, 2022 WL 2498751, at *2 (Bankr. D. Del. July 6, 2022), with the exception of accounts receivable and inventory and other current assets, which were pledged to the lenders under an asset-based lending facility, *id.* at *4.

⁷⁷ See *TPC I*, 2022 WL 2498751, at *4 (“Many factors contributed to [TPC’s financial condition deteriorating] including an explosion at a TPC chemical plant . . . a decrease in the demand of the debtors’ products at the outset of the pandemic; and outages in the company’s boilers following Winter Storm Uri.”); Eliza Ronalds-Hannon & Allison McNeely, *Troubled Chemical Firm TPC Preps for Debt Talks as Payments Loom*, BLOOMBERG (Jan. 11, 2022, 5:14 PM), <https://www.bloomberg.com/news/articles/2022-01-11/troubled-chemical-firm-tpc-preps-for-debt-talks-as-payments-loom> [<https://perma.cc/G6BQ-PNPH>] (“The Houston-based company faced a plant explosion in 2019 and a fire in 2020 that blanketed southwest Houston in smoke. Texas’s February 2021 winter storm caused additional damage.”).

it had also borrowed \$70 million from a private equity fund, which would be due in late 2021.⁷⁸

Accordingly, TPC Group retained a financial advisor and began to explore an uptiering transaction to borrow additional money. The uptiering structure was necessary because TPC Group's first lien secured notes were trading at a sizable discount to par at the time, making it highly unlikely that the company would be able to raise new junior debt or equity capital without some sort of restructuring of the existing debt.⁷⁹ For reasons explained in greater detail below, the company needed the support of approximately two thirds of its noteholders to execute a priming transaction. The company eventually reached agreement with the bare minimum of necessary noteholders—the holders of about 66.7%, who were collectively owed about \$620 million—in which this majority group of noteholders would provide the company with \$153 million (which a later borrowing would increase to \$202.5 million) in new secured priming notes that would prime existing noteholders.⁸⁰ As part of the deal, the company agreed to use approximately \$850 million in anticipated insurance payouts to buy back approximately \$462 million, or about half, of the existing amount owed to the majority noteholders that funded the priming notes.⁸¹ The offer to buy the existing debt of the majority noteholders was at 102 cents on the dollar, a significant premium to the market price of 88 cents at the time the transaction was announced.⁸²

This financing disadvantaged the minority noteholders in at least four ways. First, they were not offered the opportunity to participate in a lucrative financing, which is something that matters a lot to investors in an era where high-quality investment opportunities are challenging to identify.⁸³ Second, in the event that TPC Group had not filed for bankruptcy, the majority noteholders would have effectively exchanged part of their debt for more senior debt as the priming debt would rank higher than the firm's pre-transaction debt and a portion of the majority noteholders' existing claims under the original debt contract would be bought back at a premium to the

78 Millie Dent & Harvard Zhang, *TPC Group Noteholders Organize with Stroock as Company Considers Priming Refinancing of \$70M Apollo Loan Due August 2021*, REORG (Dec. 7, 2020, 8:21 PM), https://app.reorg.com/v3#/items/intel/8947?item_id=126293 [<https://perma.cc/5YC8-5D4W>].

79 See *id.* (noting that the notes were trading at about 77 cents on the dollar).

80 Conor Skelding & Harvard Zhang, *TPC Ad Hoc Bondholder Group Funds New Priming Notes, Negotiates Split of Insurance Proceeds Between Retention by Company, Offer to Repurchase 10.5% Notes*, REORG (Feb. 9, 2021, 12:32 PM), https://app.reorg.com/v3#/items/intel/8947?item_id=131965 [<https://perma.cc/59RZ-HJCB>].

81 *Id.*

82 *Id.*

83 As *PETITION* notes, much of the conflict between the creditors in this case involved their interest in earning money through providing financing. See *TPC Group Brings the Drama*, *PETITION* (June 5, 2022), <https://petition.substack.com/p/tpcgroupdrama> [<https://perma.cc/L5NF-EG32>].

market price. Third, the priming notes had a “make whole” provision that was meant to give the majority noteholders an even larger claim in the event of a bankruptcy by requiring the debtor to pay all unaccrued interest.

Fourth, and perhaps most importantly, the uptiering transaction meant that the majority noteholders would be able to use their priming notes, with its new position at the top of the capital structure, to take control of any future bankruptcy filing without having to share any control with the minority noteholders.⁸⁴ Under bankruptcy law, a firm’s existing senior creditor is in the best position to provide debtor-in-possession financing and to use the terms of that loan to take control of the bankruptcy case.⁸⁵ The majority noteholders would go on to engage in bankruptcy maneuvering that would leave them nearly all of the post-bankruptcy equity as well as a 48% return on the new money they put to work restructuring TPC Group,⁸⁶ including the uptiering loan and the financing for the firm to reorganize and exit bankruptcy.⁸⁷

⁸⁴ See generally Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 513-15 (2009) (discussing creditor conflict); Mark Jenkins & David C. Smith, *Creditor Conflict and the Efficiency of Corporate Reorganization 1* (May 2014) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2463700 [<https://perma.cc/E8MH-R8SE>] (analyzing the incentives senior claimants have “to force inefficient liquidations”); Jared A. Ellias, *The Law and Economics of Investing in Bankruptcy in the United States* 3.2.1.1 (Feb. 10, 2020) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3578170 [<https://perma.cc/A785-CV6H>] (describing the advantages that existing senior creditors have in competing to provide DIP loans).

⁸⁵ See Ellias, *supra* note 84, at 3.2.1.1 (discussing the fact that lenders usually require priming liens, which are difficult for new creditors to obtain); Ayotte & Ellias, *supra* note 8, at 5 (“[S]enior creditors can steer the bankruptcy case towards their preferred restructuring transaction with little competition from rival lenders”); Barry E. Adler, Vedran Capkun & Lawrence A. Weiss, *Value Destruction in the New Era of Chapter 11*, 29 J.L. ECON. & ORG. 461, 462 (2013) (“[T]he creditors that have come to control the bankruptcy process often are secured creditors with a lien on all or almost all assets and enormous clout.”); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 784 (2002) (“The control that the lender has over cash collateral makes it hard to enter into a financing agreement without its explicit blessing.”); David A. Skeel, Jr., *Creditors’ Ball: The “New” New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 919 (2003) (“The fate of an asset or division of the company, even the terms of a transfer of control, has been spelled out as terms in a debtors’ DIP financing agreement.”); Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 12, 12 (2003) (analyzing how secured creditors have become increasingly protected by bankruptcy law); George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 901 (1993) (describing how a DIP “can finance its ongoing operations and investments by issuing a new debt that enjoys any one of various levels of priority, all of which rank higher than the firm’s prepetition unsecured debt”).

⁸⁶ See Objection of the Ad Hoc Group of Non-Consenting Noteholders to Debtors’ Motion for Entry of Interim and Final Orders Approving DIP Financing at 4-5, *TPC I*, No. 22-10493, 2022 WL 2498751 (Bankr. D. Del. July 6, 2022) (describing what benefits the majority noteholders received through their maneuvering).

⁸⁷ See Jeremy Sherby, *TPC Group Supporting Ad Hoc Group Would Own Nearly 85% of Reorganized Company, Recover 84% on Prepetition Secured Note Claims Due to Direct Allocation and Backstop Fees Under Proposed Plan*, REORG (July 14, 2022, 11:50 AM),

To summarize, the priming transaction left the majority noteholders in a much-improved position, if things went well or if the firm wound up in Chapter 11. The majority noteholders were still owed \$620 million as part of the original debt, but they were now also owed \$202.5 million in priming debt.⁸⁸ This was an investment of \$202.5 million in new money, but it bought the majority noteholders an option to take control of a Chapter 11 proceeding if TPC Group's prospects did not improve enough to repay all of the debt.⁸⁹ Chapter 11 would also provide lucrative financing opportunities which the majority noteholders would not need to share equally with the minority noteholders. Additionally, TPC Group had promised to buy back \$462 million of the original debt at a premium to the market price of the debt.⁹⁰ For their part, the minority noteholders found their debt sitting behind the new priming debt and in a difficult position in any bankruptcy or restructuring scenario, as the majority noteholders would be able to pursue their own bankruptcy strategy without regard for the interests of the minority noteholders.

Figure 1 plots the market price of the bond debt for the priming notes and the non-priming notes over time, with the priming transaction and eventual bankruptcy settlement date identified.

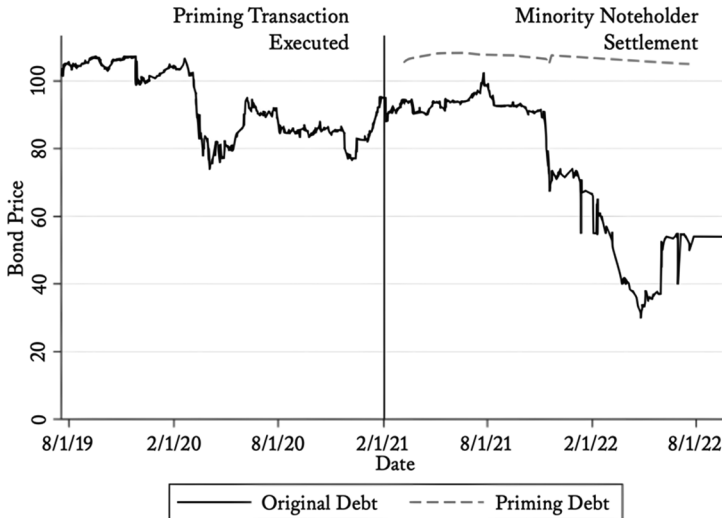
https://app.reorg.com/v3#/items/intel/8947?item_id=184209 [<https://perma.cc/Y28Q-BJ4P>] (noting that upon exiting bankruptcy under the proposed plan, TPC Group would own around 85% of the reorganized company).

⁸⁸ Conor Skelding & Harvard Zhang, *TPC Ad Hoc Bondholder Group Funds New Priming Notes, Negotiates Split of Insurance Proceeds Between Retention by Company, Offer to Repurchase 10.5% Notes*, REORG (Feb. 9, 2021, 12:32 PM), https://app.reorg.com/v3#/items/intel/8947?item_id=131965 [<https://perma.cc/59RZ-HJCB>].

⁸⁹ *See id.*

⁹⁰ *See id.*

FIGURE 1: MARKET PRICES OF TPC GROUP PRIMING AND ORIGINAL BOND DEBT.



Source: TRACE

Implementing this transaction required finding a way to do so that complied with the debt contract. Like all bond indentures, the credit documents supporting the original \$950 million secured loan were designed to balance investors' rights to be repaid with flexibility in the event that the firm ran into financial trouble.⁹¹ TPC Group and the majority noteholders devised a transaction structure that would require a vote of a bare supermajority of the firm's outstanding secured debt to prime those claims.⁹² This was accomplished by (1) TPC Group entering into an agreement with the majority noteholders to issue new debt; and (2) exploiting features in the bond indenture that would allow the majority of creditors to amend the document, leaving the new priming debt senior to the original debt.⁹³

⁹¹ See *TPC I*, 2022 WL 2498751, at *2 (“Syndicated loan agreements . . . [commonly] prohibit individual holders from insisting on strict compliance with the loan terms in circumstances in which a majority believes it more appropriate to afford the borrower greater flexibility.”).

⁹² See *TPC I*, 2022 WL 2498751, at *5 (discussing how the firm's supermajority sought to amend the 2019 Indenture).

⁹³ This was accomplished by executing a new intercreditor agreement. See *TPC I*, 2022 WL 2498751, at *5 (outlining the terms and features of the new intercreditor agreement); see also Ad Hoc Group of Non-Consenting Noteholders' Motion for Summary Judgment 4-8, *TPC I*, No. 22-10493 [hereinafter *TPC Noteholders' Motion*] (describing the amendments). To be more specific, the parties entered into a “2021 intercreditor agreement” that made the 2021 debt contractually senior to the 2019 debt in allocating the proceeds of the collateral. *Id.* at 5. The majority noteholders also amended the existing bond indenture to change references to “intercreditor agreement” to “intercreditor agreements.” *Id.* The 2021 intercreditor agreement that created the new liquidation waterfall

c. *TPC Group Files for Bankruptcy*

After TPC Group filed for bankruptcy in 2022, about sixteen months after the priming transaction, a group of minority noteholders immediately filed a lawsuit seeking a court order invalidating the purported seniority of the priming debt.⁹⁴ They framed the question as strictly one of contractual interpretation: Did the original debt contract permit the various amendments that were purportedly enacted to enable the seniority of the priming debt?⁹⁵ The heart of their argument was that the contract required unanimous consent for certain types of amendments and a majority vote for others.⁹⁶ In particular, they argued that the priming debt violated a provision that required unanimous consent for any amendment of the indenture that “make[s] [a] change in the provisions of the Intercreditor Agreement or this Indenture dealing with the application of proceeds of Collateral that would adversely affect the Holders.”⁹⁷ This clause is commonly referred to in trade usage as a “ratable distribution clause,” which forbids the indenture trustee under the bonds from favoring some lenders at the expense of others.

Judge Goldblatt of the Bankruptcy Court for the District of Delaware issued an opinion on the question soon after TPC Group entered bankruptcy protection.⁹⁸ The question turned on how broadly the contractual language was read.⁹⁹

The majority noteholders advocated a narrow reading, where the language only governed *the money that was paid by TPC Group on account of the original debt*.¹⁰⁰ In that framing, all that mattered was whether the money that TPC Group paid on account of the original debt was distributed equally to all the original debt’s lenders pro rata. In this interpretation, the only payments by TPC Group that were governed by the ratable distribution clause were checks

expressly stated that it superseded the 2019 intercreditor agreement in the event of a conflict. *Id.* at 6.

⁹⁴ *TPC Noteholders’ Motion*, *supra* note 93, at 11.

⁹⁵ *See id.*

⁹⁶ *See TPC Noteholders’ Motion*, *supra* note 93, at 8. TPC and the majority noteholders made various procedural counterclaims in response that might have barred the minority noteholders from contesting the transaction, but Judge Goldblatt held that the contract gave the minority noteholders the right to raise the contractual interpretation question. *See TPC I*, 2022 WL 2498751, at *9 (“[I]t does not appear that any party contends that the no-action clause operates to preclude the objecting noteholders from advancing their principle argument . . .”).

⁹⁷ *TPC I*, 2022 WL 2498751, at *9.

⁹⁸ *See generally TPC I*, 2022 WL 2498751 (upholding the legality of TPC’s issuance of uptiering notes).

⁹⁹ David Skeel refers to the bargaining problems created by ambiguities in contractual interpretation as a “synthetic collective-action problem.” *See* David Skeel, *Bankruptcy’s Identity Crisis*, 171 U. PA. L. REV. 2097, 2100 (2023).

¹⁰⁰ *See TPC I*, 2022 WL 2498751, at *10 (describing the arguments put forth by the majority noteholders for a narrow reading of the applicable language).

the company explicitly designated as being meant to satisfy their obligations under the original debt contract. As such, to the extent there was a new, senior priming loan, it was irrelevant and did not implicate a provision of the original loan contract that required unanimous consent because the creation of new, senior debt did not change the “application of proceeds of Collateral” under the original loan.¹⁰¹ This remained true, the majority noteholders asserted even if the creditors under the new loan contract were a subset of the firm’s pre-existing creditors.¹⁰²

The minority noteholders argued that this language should instead be read broadly, and that “a change that would put new debt ahead of them with respect to the right to recover out of the collateral ‘deals with the application of proceeds of Collateral.’”¹⁰³ In this interpretation, the ratable distribution clause governed all payments made to the various creditors under the original debt contract, even if there was now a new debt contract that created a new and separate relationship between the majority noteholders and TPC Group. Stated differently, the majority noteholders argued that the contractual language only governed money distributed to the now-subordinated secured bondholders, while the minority noteholders maintained that the contractual language governed all money distributed by TPC Group to the creditors whose relationship with TPC Group had its roots in the original debt contract, even if they now had a new and purportedly separate relationship as creditors who had made a priming loan.¹⁰⁴

Judge Goldblatt agreed with the company and the majority noteholders that the provision should be read narrowly, and that unanimous consent was not necessary for the well-designed priming transaction that TPC Group had executed.¹⁰⁵ In holding so, Judge Goldblatt relied on traditional methods of contractual interpretation. He noted that New York law required reading contractual language “through the lens of ‘the customs’” of lending.¹⁰⁶ He found that this was a ratable distribution clause that is normally understood to require equal treatment of all lenders under the loan contract, not an anti-subordination clause having to do with other loan contracts.¹⁰⁷ In other words, standard contractual language existed that would have explicitly blocked this

¹⁰¹ See *TPC I*, 2022 WL 2498751, at *3.

¹⁰² *Id.*

¹⁰³ *Id.* at *9.

¹⁰⁴ See *id.* at *9-10 (outlining the positions taken by both sides).

¹⁰⁵ See *id.* at *12 (“[T]he Court concludes that [the provision] is primarily directed at protecting the holders’ rights to ratable treatment and should not be read as an anti-subordination provision in disguise.”).

¹⁰⁶ *Id.* at *11.

¹⁰⁷ See *id.* at *12 (“[T]he need to infuse a borrower with new money in order to protect the value of existing collateral might well provide a sound reason why lenders would agree that a majority . . . may bind a class of holders to a decision to subordinate their lien.”).

transaction and the original bond indenture did not use it. He also noted the logic of the amendment structure of the contract, with some amendments permissible by mere majority vote, some requiring a supermajority and a small number requiring unanimous consent. He held that subordination was “[a] less drastic intrusion on the rights of an individual holder” than the actions that explicitly required unanimous consent.¹⁰⁸

Judge Goldblatt also took the opportunity to emphasize that loan contracts are built to allow some investors to act without unanimous consent.¹⁰⁹ In language that was perhaps deliberately crafted to invoke the diction of Judge Cardozo’s famous *Meinhard v. Salmon* decision, Judge Goldblatt emphasized “[t]here is nothing in the law that requires holders of syndicated debt to behave as Musketeers.”¹¹⁰ Commentators observed that Judge Goldblatt’s decision could embolden other borrowers to exploit weak credit documents for similar transactions.¹¹¹

To some extent, the absence of firm judicial intervention puts the onus on the “loan market” to settle the question. While most loan contracts have not adopted so-called “anti-uptiering” language, some have, and the dominant response is to require that all lenders be allowed to participate in a priming loan.¹¹²

III. RETHINKING THE JUDICIAL APPROACH TO EQUITY AND DEBT DISPUTES

In this Section, we take stock of the contrasting judicial approaches to investor disputes among stockholders and among creditors, respectively. First, we argue that this divergence in legal treatment has contributed to a surge in opportunistic behavior in the debt markets, and that creditors cannot perfectly protect themselves from this behavior through contract. Next, we show that the contrasting judicial treatment of equity and debt disputes is no longer justified given the profound changes to the debt markets in recent decades. Finally, we consider potential alternatives within the common law, such as reinvigorating equitable doctrines in debt disputes.

¹⁰⁸ *Id.* at *12.

¹⁰⁹ *See id.* at *11 (“[The] agreement created a hierarchy of consents needed for particular amendments.”).

¹¹⁰ *Id.* at *12.

¹¹¹ *See Judicial Ruling, supra* note 68, at 2 (stating that borrowers and issuers are “finally armed with a favorable judicial precedent” for advantageous behavior).

¹¹² *See TriMark’s Settlement with Lenders Could Pave the Way for Next Round of Attack on Lender Protections*, REORG (Jan. 12, 2022, 3:59 PM), https://app.reorg.com/v3#/items/intel/8491?item_id=165668 [https://perma.cc/D33F-Q4GL] (stating that the “vast majority” of credit agreements in the loan market allow uptiering, but also noting other credit agreements where lenders are protected from being primed).

A. Expecting the Unexpected in Debt Disputes: The New Normal

The corporate debt markets are experiencing an era of intense investor infighting, of which the uptiering deals described in Section II.B are only the tip of the iceberg. Opportunistic behavior by some creditors against others—including within the same class—is rampant.¹¹³ This aggressive behavior, designed to shift value *ex post* from one set of creditors to another, has shocked even the most experienced market participants.¹¹⁴ This surge in attempts to transfer wealth among creditors is particularly remarkable in that it accelerated sharply during the last five years—a period characterized by historically low interest rates and flush capital markets.¹¹⁵

Why should we care? Few would shed tears for the affected creditors, all of whom are relatively sophisticated institutional investors. Moreover, to the extent creditor opportunism is instigated by distressed borrowers seeking to cut the most favorable deal, it arguably helps borrowers escape financial distress faster and at lower cost.¹¹⁶ Instead, the concern is that the proliferation of opportunism and uncertainty in the debt markets *ex post* is bad for the market *ex ante*: it may distort creditors' incentives to work together to preserve the borrower's value, generate wasteful offensive and defensive maneuvering, and increase companies' cost of capital.¹¹⁷ To illustrate the change that creditor opportunism has wrought: data from 2007 indicates that a senior lender to a large corporation could safely assume that, even if the borrower experienced severe financial distress, it would recover somewhere in the range of 90% of the money that it loaned to the company.¹¹⁸ Today, however, a senior lender faces a far greater degree of risk, with considerably lower recoveries when other creditors were able to jump ahead

¹¹³ See Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745, 750 (2020) (noting “remarkable instances of control opportunism” among creditors).

¹¹⁴ See Elisabeth de Fontenay, *Norms, Law, and Contract in the Loan Market*, LOAN SYNDICATIONS & TRADING ASS'N: LOANS MAG., Summer 2021, at 10 <https://www.lsta.org/content/norms-law-and-contract-in-the-loan-market/> [<https://perma.cc/DS59-KCJ9>] (“Even among the battle-hardened veterans of the loan market, the aggressive conduct of both borrowers and lenders over the last few years has been raising eyebrows.”).

¹¹⁵ See *id.* at 11 (remarking that the low interest rate environment “persisted far longer than anyone had predicted”).

¹¹⁶ See Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporate Reorganization*, 90 U. CHI. L. REV. 1, 3 (2023) (“In general, a lender whose collateral might deteriorate wants its borrower to resolve distress quickly and in a manner that turns the lender's claim on an uncertain future into cash today.”).

¹¹⁷ See de Fontenay, *supra* note 9, at 449-52 (describing how formal interpretation of debt contracts exacerbates opportunism and uncertainty).

¹¹⁸ See Moody's Investor Service, *Ultimate Recovery Database* at 6 (Exhibit 6), <https://www.moody.com/sites/products/defaultresearch/2006600000428092.pdf> [<https://perma.cc/XX4U-G4TP>].

in priority.¹¹⁹ With the market moving from relatively conservative risk levels to far greater uncertainty in individual deals, we should expect creditor behavior to have changed in response.

One might reasonably wonder why this is occurring today. Vicious battles between debtors and creditors have always existed, as have battles between different types or classes of creditors, especially in bankruptcy or zone of insolvency contexts. What is novel today is the “lender-on-lender violence” or “intra-creditor class warfare,” in which creditors *within the same class* turn on one another—typically in collusion with the borrower—in a desperate attempt to increase the priority of their claims (and to avoid others doing the same to them), as we have seen in the TPC Group case study.¹²⁰ The primary cause of this change is that the courts are increasingly firm both in sticking to the four corners of the contract in such disputes and in siding with the borrower in close cases, thereby encouraging and reinforcing opportunistic behavior by distressed borrowers with little to lose.¹²¹ In other words, the increasingly sharp contrast described in Section I in the treatment of debt and equity disputes has emboldened actors in the corporate debt markets to engage in non-cooperative behavior. At the same time, a large segment of the economy has tilted from equity financing toward debt, largely due to the prolonged period of low interest rates over the last few decades. As a result, both the likelihood of such intra-creditor disputes and the stakes involved

¹¹⁹ See Buccola & Nini, *supra* note 30, at 25 (describing borrowers’ recent maneuvers to subordinate existing lenders as a “serious risk” to such lenders).

¹²⁰ See Marc S. Kirschner, Manish Kumar, Kana’i Hanohano, James H. Millar & Andrew N. Page, *A Market Based Theory to Demonstrate Lack of Reasonably Equivalent Value for Abusive Debt Exchange Offers*, 2022 NORTON ANN. SURV. BANKR. L. 229, 230-31, 234 (2022) (defining lender-on-lender violence); Natalie Blanc, *Lender-on-lender Violence: Could US-style Liability Management Techniques be Applied in the European Market?*, ROPES & GRAY LLP <https://insights.ropesgray.com/post/102hyod/lender-on-lender-violence-could-us-style-liability-management-techniques-be-appl#:~:text=Lender%2Don%2Dlender%20violence%20refers,the%20expense%20of%20another%20subset> [<https://perma.cc/EJ7T-MYSB>] (stating that lender-on-lender violence has become “commonplace” in the US market); ‘Creditor-on-Creditor Violence’ Lands Big Managers in Court, INSTITUTIONAL INV. <https://www.institutionalinvestor.com/article/b1pbjxp892zp1x/Creditor-on-Creditor-Violence-Lands-Big-Managers-in-Court> [<https://perma.cc/6MZU-BP3D>] (“A growing number of credit agreement amendments are pitting corporate lenders against each other . . .”); *Intra-Creditor Class Warfare Symposium*, CREDITOR RTS. COAL. & LOAN SYNDICATIONS & TRADING ASS’N (LSTA), <https://creditorcoalition.org/wp-content/uploads/2022/06/slides.whatisclasswarfare.pdf> [<https://perma.cc/XC28-8M45>] (referring to “aggressive” distressed liability management raising concern about creditor protections); Douglas S. Mintz, Ned S. Schodek & Peter J. Amend, *Recent Challenges to Uptiering Transactions*, AM. BANKR. INST. J., December 2022, at 32, 32 (referring to the “era of ‘creditor-on-creditor violence’”).

¹²¹ See Elisabeth de Fontenay, *Complete Contracts in Finance*, 2020 WIS. L. REV. 533, 543 (“In disputes between corporate borrowers and their creditors . . . courts frequently revert to the mantra that creditors should have protected themselves from the disputed outcome by contract, and therefore their failure to do so implies that the borrower should carry the day.”).

have increased significantly.¹²² Judicial formalism in debt disputes matters a great deal when debt is a vastly larger share of the capital structure for many U.S. companies than in prior decades. It suggests that a large proportion of disputes among investors today will be resolved under contract law (and formal interpretation), rather than under equitable principles.

Thus, the shift from equity to debt, combined with judicial formalism and deference to borrowers in debt disputes, has opened the door to increasingly opportunistic behavior. Most often, this opportunism harms “minority” creditors—that is, the holders of the company’s debt that lack the size, bargaining power, or sophistication to cut a favorable deal with the borrower and its favored creditors.

B. Equity vs. Debt Revisited: The Flawed Assumptions Underlying the Traditional View

Although we described the contrasting judicial treatment of investor disputes involving equity and debt in Sections I and II, we did not properly account for it. Why is it that, under the common law, shareholders are owed fiduciary duties by directors and officers on the one hand, and by majority shareholders on the other, while creditors are left to fend for themselves in contract? This divergent legal treatment is not required or entailed by corporate finance theory. Rather, we argue that it stems from longstanding assumptions about archetypal equity and debt investors. In this Section, we describe those traditional archetypes, then show why they are no longer useful in today’s capital markets.

1. The Archetypal Equity and Debt Investors

For nearly a century now, corporate law doctrine has been singularly focused on the problem of “the separation of ownership and control”¹²³—the concern that while shareholders hold the major economic stake in the firm, managers run the firm in practice and may not faithfully advance the interests of shareholders.¹²⁴ The archetype of large public companies with widely dispersed, passive shareholders typify the concern: Managers or controlling shareholders can extract value from the firm, because the remaining

¹²² See *TPC I*, 2022 WL 2498751, at *1 (“There has been a flurry of litigation in recent years over transactions that seem to take advantage of technical constructions of loan documents in ways that some view as breaking with commercial norms.”).

¹²³ Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. ECON. 301, 301 (1983).

¹²⁴ See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 277 (1933) (“[W]e have reached a condition in which the individual interest of the shareholder is definitely made subservient to the will of a controlling group of managers.”).

shareholders are powerless to stop them due to severe collective action and information problems. Judicially imposed fiduciary duties have traditionally been justified as a means to protect such passive shareholders from opportunism by directors and officers or by majority shareholders.¹²⁵

Creditors have received no such protection, as we have seen, on the theory that they are perfectly able to protect themselves.¹²⁶ Here the courts have had a very different archetype in mind: that of a company desperate for capital borrowing from a single bank. In this picture, a highly experienced bank carefully selects a borrower to lend to, drafts a credit agreement replete with restrictions on the borrower to protect the bank's interests, and actively monitors the borrower throughout the life of the loan.¹²⁷ In such a world, judicial intervention to protect creditors would be superfluous, at best, and unfair to borrowers, at worst.

2. The New Equity and Debt Markets

Unfortunately, the sweeping changes experienced by the capital markets in the last few decades have rendered these archetypes obsolete, if not plainly misleading. On the equity side, a material proportion of U.S. firms are owned by private equity funds, rather than public shareholders.¹²⁸ For all intents and purposes, these firms have only a single shareholder—one that is highly sophisticated, incentivized, and informed, and that actively manages the firm.¹²⁹ Even companies that remain public rarely fit the historical archetype today: their stockholder base is increasingly concentrated, institutional, and activist.¹³⁰

¹²⁵ See HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 60 (1996) (listing a range of institutions that enforce managers' fiduciary duties to shareholders in the United States).

¹²⁶ See, e.g., *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1522 (S.D.N.Y. 1989) (“[C]ourts are properly reluctant to imply into an integrated agreement terms that have been and remain subject to specific, explicit provisions, where the parties are sophisticated investors, well versed in the market's assumptions, and do not stand in a fiduciary relationship with one another.”).

¹²⁷ See Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 *REV. ECON. STUD.* 393, 393 (1984) (developing theory of financial intermediation and financial monitoring with baseline scenario examples).

¹²⁸ See Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 *J. ECON. PERSPS.* 121, 131 (2009) (noting the outsized role private equity firms play in a study of recent take-private transactions).

¹²⁹ See *id.* (noting the reporting structure and fees paid to the management team of private equity companies). To complicate matters, however, some of the largest private equity fund sponsors such as Blackstone, Apollo, and KKR, are themselves publicly traded. See Sung Eun (Summer) Kim, *Typology of Public-Private Equity*, 44 *FLA. ST. U.L. REV.* 1435, 1481-82 (2016) (listing these fund sponsors among public-private equity fund sponsors).

¹³⁰ See Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 *COLUM. L. REV.* 863 (2013) (describing the major shift in the ownership of public companies); Zohar Goshen & Richard Squire, *Principal Costs:*

On the debt side, credit extended to the firm by a single bank has been replaced by loans syndicated to a dispersed group of passive investors, including non-bank investors such as loan mutual funds and private credit funds.¹³¹ Such loans may be further pooled together with other loans and securitized to reach an even broader array of passive investors, none of which participates directly in the negotiation of the loan terms or actively monitors the borrower.¹³²

In this new world, it is creditors who are the passive investors and who face severe collective action and information problems, often far more so than shareholders.¹³³ Creditors' ability to protect themselves from the borrower and from one another is therefore contestable. For this reason, the empirical assumptions underlying the divergent legal treatment of equity and debt disputes no longer hold, which requires a rethinking of the divergence. We turn to this task in Section III.C below.

Today, the traditional finance theory of equity and debt is on as shaky ground as the legal distinction between the rights of equityholders and creditors, again due to the rise of debt financing in U.S. companies. Historically, firms have been reluctant to take on significant debt loads, due to some combination of (1) moral qualms over being a debtor, (2) risk aversion (both by undiversified investors and managers afraid for their jobs),¹³⁴ and (3)

A New Theory for Corporate Law and Governance, 117 COLUM. L. REV. 767, 805 (2017) (describing a "spectrum" of capital structures in today's economy).

¹³¹ See Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP. L. 641, 643 (2009) (observing increase in diversity of capital structures with emphasis on the rise of syndicated loans and credit liquidity); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 381–82 (describing the largest banks' change in business model from relationship banking to syndicated lending and securitization).

¹³² See Whitehead, *supra* note 131, at 661–75 (discussing changing debt governance practices as debt evolves and observing that "most loan buyers expect monitoring to decline after a loan has been sold").

¹³³ See Steven A. Dennis & Donald J. Mullineaux, *Syndicated Loans*, 9 J. FIN. INTERMEDIATION. 404, 409 (2000) ("The loan syndication market invites potential agency problems involving both adverse selection and moral hazard."); Victoria Ivashina, *Asymmetric Information Effects on Loan Spreads*, 92 J. FIN. ECON. 300, 300–01 (2009) (explaining rise of information asymmetry between lead bank and members of lending syndicate); Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 231–34 (2008) (arguing that agency costs have shifted away from shareholders in light of the rise of large private equity institutions).

¹³⁴ See Ulf Axelson, Tim Jenkinson, Per Strömberg & Michael S. Weisbach, *Borrow Cheap, Buy High? The Determinants of Leverage and Pricing in Buyouts*, 68 J. FIN. 2223, 2242 (2013) ("Given that LBO transactions rely on the ability of the company to take on debt, it is likely that private equity sponsors select targets within an industry and region that have particularly high debt capacity.").

the insufficient and costly supply of debt financing.¹³⁵ Each of those hindrances has dissipated over time. Financial economics has taught generations of corporate managers and investors that debt, like equity, is simply an alternative for financing a firm.¹³⁶ Moreover, adding debt to a firm's capital structure can significantly enhance stockholders' returns (along with risk)—an attractive proposition for today's increasingly diversified investors.¹³⁷ Finally, now that debt is no longer limited by banks' ability and willingness to lend, as described above, the dam holding back the supply of debt has broken.¹³⁸

Private equity funds in particular have seized on this approach to debt financing: their business model turns on having the firms that they acquire take on as much debt as the market will supply, whether in the form of senior secured bank debt, unsecured high-yield bonds, or private credit supplied by investment funds.¹³⁹ In this world, companies no longer take on debt for *operational* reasons—such as to smooth the firm's seasonal variation in revenues and expenditures—but for *shareholder* reasons. The resulting proliferation of highly leveraged firms, particularly in industries with regular cash flows and pledgeable assets for collateral,¹⁴⁰ muddies the contrast in traditional finance theory between shareholders as risky, contingent claimants, on the one hand, and creditors as relatively safe, fixed claimants on

135 See Allison A. Taylor & Ruth Yang, *Evolution of the Primary and Secondary Leveraged Loan Markets* (explaining the origin and growth of the syndicated loan market), in *THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING* 21, 23-24 (Allison Taylor & Alicia Sansone eds., 2007).

136 See Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 *AM. ECON. REV.* 261, 263 (1958) (deriving the proposition that the relative proportion of debt and equity financing in a firm's capital structure is irrelevant to the value of the firm).

137 See Ulf Axelson, Per Strömberg & Michael S. Weisbach, *Why Are Buyouts Levered? The Financial Structure of Private Equity Funds*, 64 *J. FIN.* 1549, 1556 (2009) (describing the incentives for investors to favor high leverage).

138 See Whitehead, *supra* note 131, at 643 (“The last two decades, in fact, witnessed an increase in private credit liquidity—as illustrated by the rise in syndicated loans and credit derivatives—fueled by change in the traditional bank-borrower relationship and the entry of new investors into the credit market.”).

139 See Axelson, Jenkinson, Strömberg & Weisbach, *supra* note 134, at 2235 (highlighting the different types of debt used in LBOs, as a percent of total debt, rate of return and paydown rates); Ruchir Sharma, *How Private Markets Became an Escape from Reality*, *FIN. TIMES* (Dec. 19, 2022), <https://www.ft.com/content/7416159d-fa24-4c97-b4a7-302696cdoede> [https://perma.cc/7ER9-RW32] (“The typical company owned by a private equity firm has debts of more than five times its earnings, versus one to three times for publicly traded companies.”).

140 See Kaplan & Strömberg, *supra* note 128, at 131 (noting the trends in how American private equity firms use debt, based on a collection of 43 leveraged buyouts from 1996 to 2004).

the other. In many leveraged firms, creditors are in fact contingent claimants from the outset.¹⁴¹

C. Adjudication in the Age of Debt: A Better Way Forward?

If the current approach is failing to curtail costly opportunism in the debt markets, it is worth considering whether judges should adopt alternative approaches.

One possibility would be to narrow the gap between disputes involving stockholders and creditors by leaving more room for equitable doctrines and remedies in debt disputes. This would not require a wholesale shift from the contract law that governs debt disputes to the fiduciary law that governs disputes among equity holders. While some have proposed extending to creditors the fiduciary duties that corporate insiders currently owe to stockholders, there are good reasons not to do so.¹⁴² Instead, contract law itself includes equitable doctrines that could be deployed to limit borrower and creditor opportunism. Like the judicially created (and defined) fiduciary duties applicable to corporate insiders, the “implied covenant of good faith and fair dealing” in contract law is an equitable doctrine that imposes a broad *standard* of behavior.¹⁴³ Here, the covenant would bind the parties to the debt contract, namely the borrower and the creditors. As with any legal standard, courts may use it to police opportunistic behavior *ex post*, by deciding what conduct is too unfair to receive judicial blessing.¹⁴⁴

In debt disputes going back several decades, however, Delaware jurisprudence has drastically limited the scope of the implied covenant of

¹⁴¹ See Axelson, Jenkinson, Strömberg & Weisbach, *supra* note 134, at 2239 tbl.4 (finding that private equity-owned firms have twice the leverage—measured by debt to enterprise value—of otherwise comparable public companies in a matched sample).

¹⁴² See, e.g., Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1209 (2006) (“Traditional approaches to corporate governance focus exclusively on shareholders and neglect the large and growing role of creditors.”); Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1364-67 (2007) (suggesting that existing creditor law suffices to “adjudicat[e] heterogeneous interests”); Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 864-68 (2008) (arguing against fiduciary duty protections for sophisticated creditors).

¹⁴³ See RESTATEMENT (SECOND) OF CONTRACTS § 205 (AM. L. INST. 1979) (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”). While the precise obligations imposed by the covenant are unclear, they appear to include both subjective honesty and commercial fair dealing. U.C.C. § 2-103(1)(b) (AM. L. INST. & UNIF. L. COMM’N 2017).

¹⁴⁴ See Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814, 820 (2006) (describing how contracting parties can enforce standards of behavior through the bargaining process).

good faith and fair dealing.¹⁴⁵ Today, it is typically deemed to cover the parties' behavior only leading up to and including the signing of the debt contract, such that it would not reach opportunistic behavior after the money had been loaned to the borrower.¹⁴⁶ For example, a borrower that engaged in fraud in order to induce lenders to extend credit would be viewed as having breached the implied covenant of good faith and fair dealing, while a borrower that sought to subordinate certain of its creditors in a restructuring, contrary to their fundamental understanding of the deal, likely would not, so long as the restructuring did not violate the express terms of the debt contract.¹⁴⁷ The rationale for limiting the doctrine in this way appears to be that once the parties have reached a deal, the contract language itself should govern their relationship entirely. But as we have seen, there are serious theoretical and practical problems with the judicial faith that parties can prevent all opportunism with contractual language.¹⁴⁸ Judges would therefore need to explicitly extend the scope of the implied covenant of good faith and fair dealing to actions by the parties after the contract becomes effective. In fact, certain judges already appear to be moving in this direction.¹⁴⁹

Would a revival and extension of this equitable doctrine be good for the debt markets? We are cautious about making such a prediction. While doing so would relieve the considerable (and unrealistic) pressure currently placed on contract language, it would instead transfer considerable power to judges to decide what behavior is or is not fair. While judges appear perfectly capable of doing so in disputes among stockholders, generalist judges may be less

¹⁴⁵ See *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1522 (S.D.N.Y. 1989) (“[C]ourts are properly reluctant to imply . . . terms that have been and remain subject to specific, explicit provisions.”).

¹⁴⁶ See Albert H. Choi, *Deal Protection Devices*, 88 U. CHI. L. REV. 757, 788-94 (2021) (describing operation of implied covenant of good faith and fair dealing in commercial contracts); Albert H. Choi & George Triantis, *Designing and Enforcing Preliminary Agreements*, 98 TEX. L. REV. 439, 441 (2020) (“The current scholarly explanation is that the enforcement of a good faith obligation protects such investment from opportunistic holdup by the noninvesting party in subsequent stages of negotiation.”).

¹⁴⁷ See, e.g., *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.*, No. 565123/2020, 2021 WL 3671541, at *10 (N.Y. Sup. Ct. Aug. 16, 2021) (granting the borrower’s motion to dismiss creditors’ claim of breach of the implied covenant of good faith and fair dealing in an uptiering transaction, on the grounds that “the implied covenant cannot be used to impose obligations or restrictions going beyond what is set forth in the contract”).

¹⁴⁸ See, e.g., *Ellias & Stark*, *supra* note 7, at 750 (“[E]ven where creditors can foresee control opportunism, clever lawyering and the evolving circumstances of financial distress can help managers disable or evade enforcement of even the most skillfully crafted contractual covenants.”).

¹⁴⁹ See e.g., *LCM XXII LTD. v. Serta Simmons Bedding, LLC*, 21 Civ. 3987, 2022 WL 953109, at *15 (S.D.N.Y. Mar. 29, 2022) (refusing to grant the borrower’s motion to dismiss on lenders’ claim of a breach of the implied covenant of good faith and fair dealing in an uptiering transaction); *ICG Global Loan Fund 1 DAC v. Boardriders Inc.*, No. 655175/2020, at 25 (N.Y. Sup. Ct. Oct. 9, 2020) (D.I. 160) (allowing a suit with a claim based on the implied covenant of good faith and fair dealing to survive the motion to dismiss).

successful at making such determinations in the extraordinarily complex and fast-moving world of debt transactions.¹⁵⁰

A different approach—one that would not necessarily grant additional power to judges—would be to flip one of the default rules of interpretation commonly used by judges for debt contracts. Currently, judges claim to resolve disputes among financial debt creditors by looking only to the language of the debt contract.¹⁵¹ This suggests a degree of determinism that does not exist. In most such disputes, the allegedly opportunistic conduct is not explicitly addressed in the contract. Courts therefore typically (though implicitly) apply an additional rule of interpretation in this context, namely that *everything that is not explicitly prohibited by the contract is permitted*. In practice, however, this means resolving all disputes that are not explicitly covered by the language of the debt contract *in favor of the borrower*, because debt contracts place prohibitions primarily on the borrower, rather than the creditors.¹⁵²

There are several reasons to challenge this approach. First, the traditional justification for siding with the borrower in all close cases or cases not covered by the language of the relevant debt contract is the interpretive canon of *contra proferentem*: the notion that all contractual ambiguities should be resolved against the drafter, particularly where the drafter is the more sophisticated party.¹⁵³ Because debt contracts were historically drafted by *the lenders*,¹⁵⁴ *contra proferentem* meant that all ties would go to *the borrower*. The historical argument no longer applies, however, in a world where (1) both sides are highly experienced and sophisticated and (2) borrowers often draft the debt contracts.¹⁵⁵

Second, the default approach of siding with the borrower is of questionable merit when borrowers in financial distress have considerably more incentive and more opportunities to behave opportunistically than do

¹⁵⁰ See Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 583 (2003) (claiming that sophisticated commercial parties typically prefer judges to interpret their agreements narrowly, using a textualist approach).

¹⁵¹ See *id.* (“The case in which the parties’ payoffs are continuous in the space of a court’s possible interpretations covers a lot of the ground. . . . Firms in the continuous-payoff case ordinarily prefer courts to follow a textualist Interpretive style.”).

¹⁵² See Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 130, 152 (1979) (describing the use of debt covenants in bond indentures to mitigate the agency problem between borrowers and creditors).

¹⁵³ See 5 TIMOTHY MURRAY, CORBIN ON CONTRACTS § 24.27 (MATTHEW BENDER); E. ALLAN FARNSWORTH, CONTRACTS 518-19 (2d ed. 1990).

¹⁵⁴ See PRACTICAL LAW FINANCE, SPONSOR/LENDER NEGOTIATING ISSUES IN ACQUISITION FINANCE 11 (2015), West Practical Law, Article 7-381-0292 (detailing the historic debt contract drafting process).

¹⁵⁵ See *id.* (noting that sophisticated borrowers today may provide the first draft of the credit agreement).

their creditors as a group. Borrowers control the cash flows and the collateral, after all. Therefore, if opportunistic behavior continues to worsen in the debt market, despite contract language carefully crafted by highly sophisticated parties, then perhaps it is time to abandon this default interpretive rule in favor of a more even-handed inquiry into the parties' reasonable expectations at the time of contracting as to whether the disputed conduct would be permitted.

A third option would be to take some debt disputes out of judges' hands entirely. Creditors may reach the point where they would prefer arbitration before a panel of capital markets experts to trial before a generalist judge, whether that judge applies equitable doctrines seeking fair outcomes or instead limits the analysis to the four corners of the debt contract. Of course, circumventing judicial resolution is impossible for companies in Chapter 11 bankruptcy.

We do not seek to resolve in this Article which approach, if any, would be optimal for the debt markets. To the contrary, there are no easy answers in a world of highly complex capital structures, where all parties are driven by conflicting incentives. Instead, our goal is to call attention to the fundamental change in the relationship between firms and the law that results from the shift from equity financing to debt financing. When intra-investor disputes are increasingly resolved through contract law and contract language, rather than through judicial standards and fiduciary duties, we should expect significantly more opportunistic behavior and greater uncertainty for all parties.

CONCLUSION

American corporations can now tap into a capital market that would have been unrecognizable to a prior generation of corporate managers. While firms continue to raise equity capital, the capital markets now feature a range of debt capital options that allow corporations to borrow for nearly any corporate purpose and that provide nearly any level of risk for the creditors. In this Essay, we have argued that this transformation of investment structure has also changed both the relationship between investors and the legal system, and the role of courts in corporate governance. Disputes among shareholders have long been resolved by the courts applying fiduciary duty doctrines, which are grounded in equity. By contrast, judges hear disputes involving creditors using contract interpretation canons, which are more grounded in law.

This contrast matters a great deal, now that debt is crowding out equity in so many firms, and yesterday's fiduciary duty lawsuits have become today's contract disputes. The complex debt structures that are now common in firms

create opportunities for value expropriation and agency problems that can undermine corporate decision-making and destroy firm value. Contrary to the prevailing judicial view, these problems cannot be fully addressed in contract.

This stark contrast in the legal treatment of equity and debt is no longer justified in today's capital markets. Theories of corporate governance draw clear distinctions between the protection that the law provides to investors in "debt" as opposed to "equity" and the role that debtholders and shareholders are expected to play in corporate decision-making. We have argued that these distinctions rest on an antiquated paradigm of a single bank lender and dispersed shareholders and incorrect assumptions about the risk tolerance of creditors versus shareholders. Today's capital markets look very different, and the law must adapt to the new world of debt finance.

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