Debt Textualism and Creditor-on-Creditor Violence: A Modest Plea to Keep the Faith

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Abstract

Although debt finance and restructuring rarely command headlines, they collectively comprise some of the most heated corporate battles in recent history. The field's contemporary participants, including private equity sponsors, banks, and distressed debt investors have increasingly become embroiled in cantankerous conflicts over the division of assets and cash flows of distressed firms. Many of those battles resemble multiplayer chess matches, with parties scouring debt contracts for loopholes and landmines that either enrich themselves or undercut their rivals. The costs of these battles have grown precipitously, even as their outcomes have become less predictable—resulting in undesirable consequences for borrowers, lenders, intermediaries, stakeholders, and the economy at large. In this paper, we advance the thesis that much of our ongoing corporate credit conundrum has been aided and abetted by an unlikely co-conspirator: contract law. In particular, we highlight and document courts' progression over fifty years towards a sweeping embrace of textualism to interpret credit agreements, and their concomitant rejection of other interpretive schema. Whatever its merits might have been a half century ago, "debt textualism" has catalyzed and fueled an onslaught of inter-creditor warfare, rendering its continued justification questionable. We propose several prescriptions for addressing the current state of play, ranging from doctrinal reform, to legislative/regulatory intervention, to private contractual innovation. If such measures prove unable to dislodge debt textualism from its entrenched perch, however, we also suggest strategies for marshaling it for the greater good, spotlighting the role that debt textualism might play in securing more credible corporate commitments on decarbonization and climate change.

Keywords: Creditor-on-Creditor Violence; Capital Structure; Distressed Debt; Private Equity; Contracts

JEL Classifications: K00, K12, K22

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Abstract: Although debt finance and restructuring rarely command headlines, they collectively comprise some of the most heated corporate battles in recent history. The field's contemporary participants, including private equity sponsors, banks, and distressed debt investors have increasingly become embroiled in cantankerous conflicts over the division of assets and cash flows of distressed firms. Many of those battles resemble multiplayer chess matches, with parties scouring debt contracts for loopholes and landmines that either enrich themselves or undercut their rivals. The costs of these battles have grown precipitously, even as their outcomes have become less predictable—resulting in undesirable consequences for borrowers, lenders, intermediaries, stakeholders, and the economy at large. In this paper, we advance the thesis that much of our ongoing corporate credit conundrum has been aided and abetted by an unlikely co-conspirator: contract law. In particular, we highlight and document courts' progression over fifty years towards a sweeping embrace of textualism to interpret credit agreements, and their concomitant rejection of other interpretive schema. Whatever its merits might have been a half century ago, "debt textualism" has catalyzed and fueled an onslaught of inter-creditor warfare, rendering its continued justification questionable. We propose several prescriptions for addressing the current state of play, ranging from doctrinal reform, to legislative/regulatory intervention, to private contractual innovation. If such measures prove unable to dislodge debt textualism from its entrenched perch, however, we also suggest strategies for marshaling it for the greater good, spotlighting the role that debt textualism might play in securing more credible corporate commitments on decarbonization and climate change.

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"If you lose money you lose much…If you lose faith you lose all."
Eleanor Roosevelt[1]

"We're all textualists now."
Elena Kagan[2]

I. Introduction

When Justice Kagan first uttered the now-infamous proclamation above, she was no doubt referencing constitutional interpretation. Judges, policy-makers, academics and commentators of all stripes had been embroiled in a decades-long battle over whether, when, and to what degree constitutional reasoning could permissibly wander outside the document's text. Champions of textualism were more than happy to savor this moment of victory: to textualism's proponents (the soon-to-be-late Justice Antonin Scalia among them), Justice Kagan's proclamation was tantamount to capitulation. Textualism had not simply earned a place on the front stage of constitutional interpretation; it now was an undisputed headliner.

Had Justice Kagan's concession been directed instead towards the legal interpretation of *corporate credit agreements*, two predictions would almost certainly follow. First, her audience would have shrunk by at least two thirds. And second, nearly all those remaining would have viewed her statement as less of a dramatic concession than a banal platitude: in the world of corporate debt, we've all been textualists for nigh on half a century.[3] Through a combination of evolutionary forces (some deliberate, some less so), textualism has long dominated the interpretation and enforcement of virtually all major corporate and commercial credit agreements. Although textualism features prominently across many *other* domains of modern contract law too, it typically competes for attention alongside rival approaches, including contextualism, intentionalism, purposivism, and a surfeit of implied duties (such as the duty of good faith and fair dealing, meant to fill gaps in the express prescriptions of a contract). Collectively, these considerations fashion and shape the contours of contracts across many domains, varying somewhat across parties, jurisdictions, and adjudicators. When it comes to creditor protections in corporate debt, however, these traditional rivals become little more than a sideshow, leaving strict textualist interpretations to reign supreme. It is now widely recognized by practitioners and judges alike that credit protections turn critically, if not exclusively, on a close and literalist reading of express terms, leaving little room for alternatives. Should a creditor assert protections that are not expressly and unambiguously codified in a writing, most modern courts overwhelmingly conclude that such protections simply do not exist. Corporate debt's fascination with textualist interpretation has grown so pronounced

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[1] Eleanor Roosevelt, My Day: The Best of Eleanor Roosevelt's Acclaimed Newspaper Columns 1936-62

[2] Harvard Law School, The Antonin Scalia Lecture Series: A Dialogue with Justice Elena Kagan on the Reading of Statutes (Nov. 25, 2015) https://www.youtube.com/watch?v=dpEtszFT0Tg.

[3] There are several similar (but by turns distinguishable) definitions of "textualism" in the contracts literature, and many of them are adequate for our purposes here. But for concreteness, we will ally ourselves with a variant on the definition offered by Daniel Markovitz: That "textualism" in contract law is defined as the view that (a) contractual obligations stem from the objective meaning of the parties' express obligations, (b) writings take precedence over oral communication, and (c) a text's meaning must be inferred from a restricted evidence base (sometimes limited to the "four corners" of the contract itself). *See* Daniel Markovitz, "The Philosophy of Contract Law", in the Stanford Encyclopedia of Philosophy (2021) (available at https://plato.stanford.edu/entries/contract-law/).

and unique, in our estimation, that it deserves its own moniker. In this paper, we refer to it as *debt textualism.*

We are hardly the first to take note of the predominance of textualism within the corporate debt ecosystem.[4] While the phenomenon is now so well established that practitioners take debt textualism for granted, others have flagged the effects that the interpretive approach can have on strategic behavior by parties when they negotiate debt contracts, renegotiate them, perform them, and litigate over breach.[5] This set of strategic behaviors in corporate lending has grown particularly newsworthy and expensive in the last decade, where private equity sponsors have now financed countless corporate acquisitions with a war chest of funds that are dominated by debt securities. This dramatic shift towards leveraged finance caused the dollars at stake to swell to enormous proportions; along with them, the rewards from contractual "strategery" on all sides have grown gargantuan as well.[6]

How did we get here? And should we want to stay? In this paper, we explore the history and key drivers of debt textualism in case law over the last half century. We argue that the jurisprudential shift towards textualism initially grew out of two critical pragmatic realizations. First, many standard tools of contract interpretation (such as divining the shared "intent" of the parties) break down spectacularly when applied to complex credit facilities, which typically are intermediated by dozens—if not hundreds—of players, most of whom have never interacted with one another. Second, the widespread use of boilerplate provisions within debt securities that are widely traded in capital markets strongly counsels for a uniform and transparent interpretation of similar provisions that pop up *across* different debt instruments—securing a predictability that is thought to benefit borrowers, end investors, and all those in between. While textualism is not the solitary candidate to achieve that desired uniformity, it has been a convenient and familiar one. Therefore, even though some creative jurists have episodically spitballed other strategies for achieving uniformity (such as a modified good faith duty, or extending fiduciary duties in the "zone of insolvency"), textualism's gravitational pull simply proved too strong, and most courts and practitioners had embraced it with considerable zeal by the late 20th century.

The judicial embrace of textualism initially made logical sense. There was reason to believe that debt textualism could serve as a capable launchpad for the rapid innovations in credit markets during the 80s and 90s. Although textualism's claims to transparency have always been a little slippery,[7] it *does* enjoy a natural allure for the large, quasi-anonymous, intermediated markets that undergird financial assets; its reliance on a limited constellation of accessible interpretive authorities, moreover, made it an equal opportunity standard for all with a stake in negotiated debt contracts (regardless of whether they were "in the room where it happens"[8]). Moreover, through much of the 20th century, corporate debt

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[4] See, e.g., Ethan J. Leib, Interpretive Divergence Between Statutory And Contract Interpretation: A Case Study In The New York Court Of Appeals (working paper 2022) (summarizing the literature); John C. Coates IV, Why Have M&A Contracts Grown? Evidence from Twenty Years of Deals (2016); Elisabeth De Fontenay, Complete Contracts in Finance, 2020 Wisc. L. Rev. 533 (2020).

[5] See, e.g., Simone M. Sepe, "Directors' Duty to Creditors and the Debt Contract," 1 J. of Bus. & Tech. L. 553, at 553 (2007) ("The adoption of a textualist interpretative rule, which mandates to consider accepted by creditors any risk they have not contractually excluded or limited, would (i) give both parties the right incentives to write more state-contingent contracts; and (ii) reduce uncertainty in legal relationships by ruling out the possibility of *ex post* completion of the contract (and of the duty itself) by the third adjudicator."); Alan Schwartz & Robert E. Scott, Contract Theory and the Limits of Contract Law, 113 YALE L.J. 541, 583 (2003).

[6] See Max Frumes and Sujeet Indap, The Caesars Palace Coup: How a Billionaire Brawl Over the Famous Casino Exposed the Power and Greed of Wall Street 21-29 (2022).

[7] See, e.g., *PG&E v Thomas Drayage*, 442 P.2d 641 (Cal. 1968).

[8] Hamilton, "In the Room Where it Happens" (available at https://www.youtube.com/watch?v=WySzEXKUSZw)

markets had a storied reputation as a genteel community where norms of mutual cooperation predominated, dampening the basest of strategic inclinations.[9] Even if debt textualism was not a perfect regime, then, these norms could – and often did – smooth out the rough edges.

In the last twenty years, however, the pragmatic rationale behind debt textualism has become severely strained, arguably past the breaking point. Contributing to this strain has been the rapid ascendency of returns-seeking private equity funds and their heavy reliance on debt finance, as well as the simultaneous emergence of sophisticated, returns-driven distressed investors who eagerly buy up debt claims. Both groups have increasingly been willing to play iconoclast, thumbing their noses (if not giving the finger) to the *esprit de corps* that traditionally tempered opportunism in the corporate debt community of yesteryear.[10] The end result is to privilege the goal of "winning at all costs" in contemporary debt-restructuring battles. The presumption that actors will moderate opportunism in order to conserve their reputational capital for the future appears to have become little more than a sentimental sucker's play.

In this paper, we argue that debt textualism played a key role in sowing the seeds of our current malaise, encouraging contracts that grew increasingly bloated, complex, and rigid (up to the point of buckling completely). This dense contractual landscape wrought by debt textualism—when freshly populated by a calculating coterie of financial mercenaries—has transformed corporate lending markets into an elaborate and costly contest of *Hunger-Games*-worthy[11] contractual "gotcha", where (a) lenders scour loan agreements for unappreciated loopholes to undercut borrowers; (b) borrowers do the same in an attempt to undercut lenders; and (c) permutated coalitions from both groups conspire to kneecap one another. The end result is bitterly ironic: the current landscape severely undermines the very goals of transparency, uniformity, and predictability that textualism was supposed to deliver, as investors and issuers conduct ceaseless, increasingly costly scavenger hunts through a prolix maze of express contractual terms, hoping to uncover heretofore unknown opportunities to blindside their adversaries. The advertised predictability of debt textualism has thereby devolved into an aleatory parlor game over who happens to be the best (or the luckiest) scavenger. The resulting uncertainties are not just confined to direct participants, however; they also have profound implications for company viability, which affects workers, customers, suppliers, and other corporate stakeholders, and they even spill over to systemic risk concerns, since deleterious dustups over distressed debt provisions are likely to be strongly correlated in an economic downturn (which, as of this writing, appears imminent). The bottom line, we argue, is that our current reality of debt textualism imposes significant, unreasonable burdens on lenders, borrowers, credit markets, and society at large.

But if our diagnosis is correct, what is to be done? We offer a range of possible solutions, from the judicial to the regulatory to the practical. The broad unifying (and eponymous) prescriptive theme of these proposed reforms is to *keep the faith*. Most immediately, courts can play an important role in renewing neglected doctrines that deemphasize textualism in favor of other (reasonably predictable) interpretive tests. A resuscitated implied duty of good faith and fair dealing—itself an early cast-off in debt textualism's conquest—can play an important role if appropriately modified to turn on objectively

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9 *See, e.g.,* James M. Jasper, Mitchel Abolafia and Frank Dobbin, *Structure and Strategy on the Exchanges: A Critique and Conversation about 'Making Markets',* 20 Sociological Forum 473, 475 (2005) ("[Bond] traders are socialized into a culture that values the institution and thus the long run. If they care about their reputations, they act properly.")

10 *See* Frumes and Indap, supra note 8, at 21-29 (describing the colorful intransigence of several Caesar's second-lien distressed investors when the private equity sponsor and other debt holders were attempting to fashion a collective restructuring that would require each of them to make concessions).

11 *See* Talley, *Discharge* (citing https://www.youtube.com/watch?v=oISBveQNkzA).

verifiable metrics. Indeed, a pivotal moment in our star-crossed embrace of debt textualism was the failure to "keep the good-faith" doctrine as a viable contender. Legislators and regulators, too, can play an important role in keeping faith in market integrity, utilizing their regulatory mandate as stewards of systemic risk and investor protection to help define, delineate, and even constrain the practices and payoffs associated with the most destructive incentives of private equity sponsorship and distressed debt investing. Finally, impelled by prudent legal doctrines and regulatory interventions, private contracting can begin once again to favor value creation over rent dissipation.

Beyond these suggestions, and most speculatively, even if we are unable to achieve escape velocity from debt textualism's gravitational pull, there may be more creative ways to use its rigidity and complexity for the greater good. We tentatively spotlight one use case: climate finance. Symbolic commitments by CEOs and boards, or even shareholder undertakings to "go green" are potentially vulnerable to mission drift, greenwashing, and changed priorities. Policies that encourage and/or subsidize more green commitments in debt finance, however, may make it less possible (or at least more costly and inconvenient) to neglect or abandon articulated decarbonization goals, since such decisions are sure to trigger protest by litigious distressed investors kvetching about a default.

An important caveat warrants mention before proceeding. Our focus here is largely devoted to contract law and doctrine (and potentially regulations that enable and regulate contracting). We do not devote much time to topics that often animate post-filing bankruptcy proceedings, such as equitable subordination, fraudulent conveyance, the Chapter 11 process, and so forth. That is in large part deliberate, since (a) bankruptcy scholars have developed a rich and helpful literature around these topics[12]; and (b) most of the significant current debates even in bankruptcy contexts concern contracts and recapitalizations that occur outside of and prior to (or instead of) the filing of bankruptcy. Here, bankruptcy courts are largely left attempting to apply ordinary contract principles themselves, too.[13]

Our analysis proceeds as follows. Section II chronicles the rise of debt textualism starting in the early 1980s, as courts increasingly were forced to confront a contractual landscape that necessitated modifications of traditional "intent"-based contract interpretation approaches. We describe how textualism prevailed over plausible alternatives (such as a modified version of good faith) by the early 2000s as a means for pursuing uniformity and predictability. The Section closes by examining a recent case study (involving the now-bankrupt Revlon corporation) where debt textualism spawned nearly intractable deadlocks among increasingly dyspeptic participants. Section III then turns to a normative assessment of debt textualism, arguing that while the approach may have attracted many adherents four decades ago, the evolution of debt markets and market participants since then reveals substantial drawbacks. Section IV explores several pragmatic, doctrinal and regulatory reforms that provide a way to "keep the faith" in uniform, predictable, *and non-opportunistic* debt markets by (among other things) rediscovering neglected non-textualist approaches, and imposing stronger regulatory guardrails to regulate opportunism and systemic risk. The Section closes by suggesting a second-best path forward under a debt textualist regime through which socially beneficial climate commitments can be made durable. Section V concludes.

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[12] *See* Frumes and Indap, supra note 8 (collecting references)..

[13] *See* text accompanying notes 98-104, *infra*.

II. The Emergence and Evolution of Debt Textualism

To better understand why and how debt textualism emerged on the scene, it is important first to understand how we came to inherit it to begin with. Indeed, while textualism has a role to play in all areas of contracts, it has not generally gained (or at least has not preserved) the central role it seems to enjoy in corporate debt arrangements. What occasioned this evident branching of contract law's evolutionary tree? To set the stage, we first need to recap a few key common law precepts for contract interpretation. Contractual disputes about meaning are of course nothing new, and courts have long been required to play a central role in both interpreting express terms and filling out contractual gaps using implied duties. Both tasks are central to contract interpretation, and we discuss each in turn.

Consider first the standard approach for interpreting an express term to which the parties ascribe inconsistent meanings. How should a court adjudicate such a dispute? This question—a staple of first-year contracts classes—has generated a familiar pecking order by which courts might attempt to glean meaning, and which represent a hodge-podge of textualism, contextualism, intentionalism, purposivism, functionalism, and other approaches. Sitting atop the hierarchy is intentionalism: If the evidence dispositively shows that the parties ascribed the same meaning to a disputed term at the time of contract formation, that shared intent governs regardless of other objective indicia.[14] Moreover, even when the parties subjectively attach inconsistent meanings to a term, but one party (and only one) reasonably knows her counterpart's interpretation, disputes are settled in favor of the less informed party's interpretation.[15]

In many cases, dispositive evidence of shared subjective intent proves unavailing, and the parties' competing interpretations are metaphorical ships passing in the night.[16] Contract interpretation doctrine gamely adapts to these scenarios, instructing courts to shift gears to decipher an "objective" meaning for the disputed term. Animating this approach is an overarching admonishment for the court to interpret the terms based on the facts and circumstances of the case, giving great weight to the "principal purpose" of the term (if ascertainable).[17] This mandate in mind, courts are instructed to work through a hierarchical "pecking order"[18] of tests, starting with a textualist undertaking to asses generally prevailing plain meaning,[19] moving next to course of performance,[20] then to course of dealing,[21] and finally to trade usage.[22] If none of these approaches gets any traction—and the disputed term is material—then the

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[14] *See, e.g,* Restatement 2nd of Contracts § 201(3) ("Except as stated in this Section, neither party is bound by the meaning attached by the other, even though the result may be failure of mutual assent.").
[15] *See, e.g,* Restatement 2nd of Contracts § 201(2).
[16] Sometimes they are literal ones too. *See* Raffles v Wichelhaus [1864] EWHC Exch J19; Eric L. Talley, *Peerless* (May 16, 2022). Available at SSRN: https://ssrn.com/abstract=4116830)
[17] *See, e.g,* Restatement 2nd of Contracts § 202(1).
[18] *See,* Frigaliment Importing Co. v. B. N. S. Int'l Sales Corp. - 190 F. Supp. 116 (S.D.N.Y. 1960).
[19] *See, e.g,* Restatement 2nd of Contracts § 202(3); UCC § 2-208(2).
[20] *See, e.g,* Restatement 2nd of Contracts § 202(4); UCC § 2-208(2).
[21] *See, e.g,* Restatement 2nd of Contracts § 202(5); UCC § 2-208(2).
[22] *Id.*

contract may simply be deemed void.[23] That said, if the disputed term is a minor one, courts may instead deploy a default term to fill the gap.[24]

On this score, gap filling plays an even broader role in contract interpretation. Contracts are generically and unavoidably incomplete, riddled with gaps where express terms simply fail to prescribe what is required for certain contingencies. Contractual incompleteness emanates from many causes, including bounded foresight, transaction costs, linguistic limitations, and even deliberate ambiguity, i.e., leaving it to courts rather than bargaining to decide certain open questions. In every case, however, a court wishing to enforce a contract is required to deploy a "gap-filling" rule to assess and adjudicate the parties' obligations. As a result, a vast number of contractual gap fillers have been generated over the years (too many, in fact, to catalog here). Nevertheless, the most important of them is the *duty of good faith and fair dealing* – an implied obligation that applies to the performance and enforcement of every contract.

Substantively, the duty of good faith and fair dealing ("good faith" for short) requires both sides to the contract to behave in a manner that is consistent with shared intent, so as not to deprive their counterparty of the "fruits" of the contract or undercut its principal purpose.[25] As described by a notable Ninth Circuit opinion:

> This covenant [of good faith and fair dealing] not only "requires each contracting party to refrain from doing anything to injure the right of the other to receive the benefits of the agreement," "but also [imposes] the duty to do everything that the contract presupposes that he will do to accomplish its purpose."[26]

In many respects, the duty of good faith can be thought of as an "anti-loophole" mandate, prohibiting parties from opportunistically seizing upon contractual lacunae or ambiguities that *arguably* give them the discretion to take actions that benefit themselves, if doing so would be inconsistent with the common purpose that the parties envisioned when executing their agreement.

Because good faith duties elevate the "spirit" or "common purpose" of an agreement above potential textual loopholes, the contours of the doctrine typically vary from contract to contract. Consequently, many courts have observed that precise articulations of the standard are elusive if not impossible.[27] Furthermore, given the doctrine's dependence on context, parties can (and often do) adopt express contractual terms intended to shed light on purpose, and therefore shape the judicial application of the good-faith doctrine itself. This gives good faith at least some of the trappings of a standard "default"

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[23] *See, e.g,* Raffles v Wichelhaus [1864] EWHC Exch J19; Frigaliment Importing Co. v. B. N. S. Int'l Sales Corp. - 190 F. Supp. 116 (S.D.N.Y. 1960); Restatement 2nd of Contracts § 201(3) ("Except as stated in this Section, neither party is bound by the meaning attached by the other, even though the result may be failure of mutual assent.").

[24] *CITE.*

[25] *See, e.g.,* Francis C. Amendola et al., "Implied contractual duty of good faith and fair dealing", Corpus Juris Secundum, CONTRACTS § 454 (2022) ("The implied covenant or duty of good faith and fair dealing requires a party to a contract to refrain from doing anything that will destroy or injure the other party's right to receive the benefits or fruits of the agreement").

[26] Los Angeles Memorial Coliseum Comm'n v NFL, 791 F2d 1356, 1361 (9th Cir1986), cert den 484 US 826 108 S Ct 92, 98 LEd2d 53 (1987) (citations omitted).

[27] See, e.g., City of Rome v Glanton, 958 FSupp 1026, 1038 (EDPenn1997) ("The obligation to act in good faith in the performance of contractual duties varies somewhat with the context and is impossible to define completely, but it is possible to recognize certain strains of bad faith which include: evasion of the spirit of the bargain; lack of diligence and slacking off; willful rendering of imperfect performance; abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance").

rule. Nevertheless, parties are not permitted to waive or disclaim good faith duties *writ large*, and the existence of good faith (as opposed to its precise content) is decidedly an immutable rule.[28] The duty of good faith, like the other interpretation tools for express terms mentioned above, are common in all contracts. Well, almost all of them.

A. The Evolution of Corporate Debt Markets and the Waning Duty of Good Faith

Although the origin story of credit agreements is firmly rooted in the common law of contracts, they developed along a unique path likely driven by how these contracts were situated in the economy. In the latter twentieth century, debt contracts grew from bespoke arrangements into fungible financial commodities, produced *en masse* with highly similar boilerplate terms, and frequently traded on anonymous public exchanges. Additionally, each contract was tied to a complex web of originators, underwriters, trustees, intermediary purchasers, and secondary market purchasers. The presence of increasingly interconnected power players in any one debt contract created the practical impossibility of realistically divining the "intent of the parties." There were simply too many of them, connected in too many complex ways.

A watershed moment in the evolution of debt textualism in U.S. contract law is the late Judge Ralph Winter's celebrated opinion in *Sharon Steel v. Chase Manhattan Bank*.[29] Although *Sharon Steel* is over 40 years old, the facts giving rise to the case are not that dissimilar from what we see today. Sharon Steel Corp. was the nominal defendant in the case, having acquired the assets of U.V. Industries ("UV"), its predecessor in interest. At the time of the asset sale, UV had issued several interest-bearing public debentures with fixed-rate coupons that ranged between 5.375% to 9.25% per annum.[30] Most of these bonds were issued in the late 1960s through mid 1970s, when prevailing interest rates were relatively low. However, by the end of the 1970s, interest rates had skyrocketed: prevailing rates for corporate borrowing were far in excess of the rates UV was paying on the bonds. As a consequence, UV bonds were trading at a steep discount to their face value.

While a steep discount can sometimes be a tell of financial distress, here it was substantially (if not wholly) due a precipitous spike in benchmark interest rates, as shown in Figure 1. In such situations, a legacy fixed-rate borrower is placed in a particularly advantageous position, with payment obligations that now look cheap by comparison. Lenders, in contrast, lose out, sitting on investments that yield far less than competitive rates, which in turn induces the pricing discount (since yields and prices move in opposite directions). As a result, lenders are typically itching to find a way to free up and redeploy the principal, while borrowers do everything in their power to keep the debt contract in place.

[28] *See* UCC § 1-102(3) ("The effect of provisions of this act may be varied by agreement…except that the obligations of good faith, diligence, reasonableness and care prescribed by this act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.").
[29] 691 F.2d 1039 (2d. Cir. 1982).
[30] *Sharon Steel v. Chase Manhattan Bank*, 691 F.2d 1039, 1042 (2d Cir. 1982).

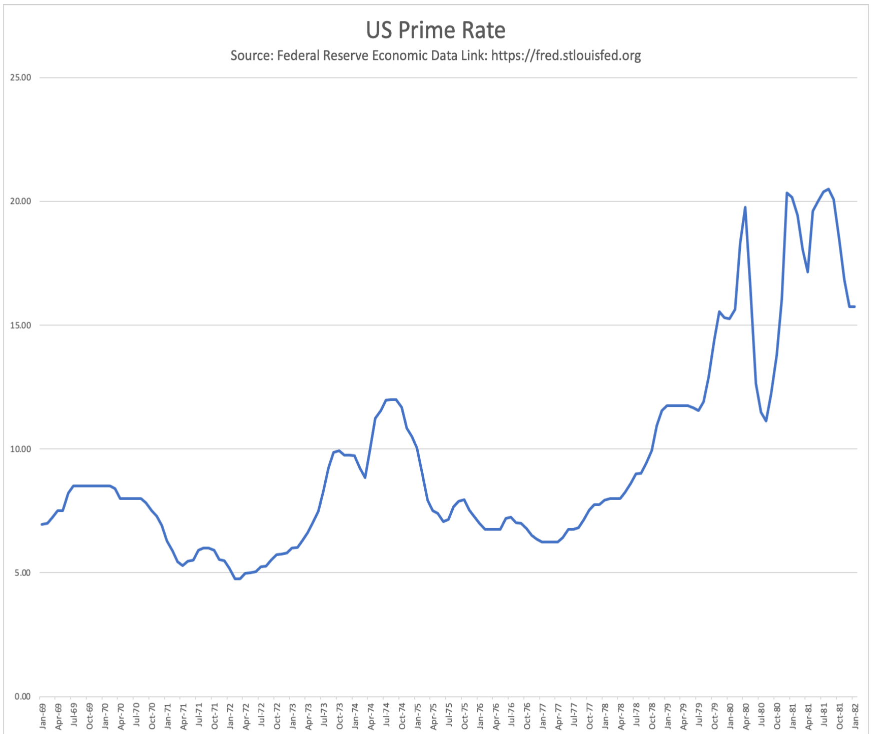

Figure 1: U.S. Prime Rate, 1969-1982

Ultimately, it was just such a dynamic that fed the central dispute in *Sharon Steel*. For a variety of unrelated reasons, UV deemed it prudent to sell its business to a third party(ies), and it needed to do so within one year's time. One of the key "assets" that UV controlled was (ironically enough) its debt, now featuring below-market-rate coupon obligations and trading at a sizable discount. All else constant, both UV and its successor in interest would want to keep the bonds deployed as long as possible. However, UV also had three major operating subsidiary divisions that were also intended to be the main part of the deal[31]; and because of the tight transaction deadline set by UV, the sales process required some flexibility—particularly in finding willing buyers to onboard the various assets in a sale. UV was quickly able to find takers for two of its operating divisions, and it promptly closed sales with them, unloading the first for $345 million, and then the second for $150 million. After issuing a dividend to shareholders of around $150 million, UV was left holding the remaining cash, one last operating division, and the below-market-rate debt. Sharon Steel then entered the fray to purchase what was left.

The way that UV had conducted the sales process, however, posed a problem for preserving the bonds. As a general matter, when a corporate borrower liquidates, so too do its general obligations, and they must be satisfied immediately. However, most bond indentures also include a carve-out from this usual rule via a "successor obligor" provision, which allows a bona fide purchaser to keep the debt intact *so long as* they have purchased "all or substantially all" of the assets of the seller. Here, however, because two of UV's major operating subsidiaries had already been sold off, the appearance of a liquidation posed an inconvenient obstacle for structuring any UV-Sharon Steel sale that kept the debt intact. Their solution

[31] These consisted of the Federal Pacific Electric Company (accounting for 60% of revenue and 81% of operating profits); a variety of oil & gas properties (2% of revenues; 6% profits) and the Mueller Brass Corp. (38% operating revenues; 13% profits).

was (1) to simply treat the cash they had received for the earlier divisional sales as an "asset" of UV; (2) to couple that cash "asset" with remaining operating subsidiary; and then (3) to sell off the subsidiary *and* the pile of cash in return for a *different pile of cash* paid to them by Sharon Steel. This cash-for-cash "sale" of UV to Sharon Steel was in many ways Kabuki theater, whereby the parties bi-directionally exchanged hundreds of millions of dollars, all for the end of dressing up the transaction to look like a "sale of all or substantially all" UV's assets, thereby allegedly triggering the carve-out.

After Sharon Steel consummated these moves and declared its intent to keep UV's legacy bonds intact, bondholders (led by Chase Manhattan) cried foul, arguing that regardless of how the deal was adorned, it was functionally the last stage of a piece-by-piece liquidation of UV, and not a "sale of all or substantially all assets" pursuant to the bond indenture. Consequently, they argued, UV had defaulted, which required its successor Sharon Steel to answer for either (a) the $411 million acceleration of face value of the loans due and payable immediately, or (b) a "deemed redemption" of the bonds, which would require Sharon Steel to pay that same face value *plus* a premium. After the district court ruled in Chase's favor on summary judgment and ordered accelerated payment of the face value on the bonds, Sharon Steel appealed to the Second Circuit.

Unfortunately for Sharon Steel, its second bite at the apple not only failed, but it even worsened its fate. Writing for a unanimous panel, Judge Ralph Winter strongly affirmed the trial court's summary ruling on liability; the court also increased the damages, finding that UV's maneuver triggered the redemption provision in the bonds which required payment of a premium beyond face value.[32]

The liability portion of Winter's opinion made at least two significant contributions that would kickstart a four-decade-long evolution in contract law doctrine governing corporate credit. The first was to underscore that while the interpretation of bondholder protections is a matter of common law contract, applying those principles gets tricky when the terms at issue are the product of a highly intermediated contract containing boilerplate provisions that recur (almost verbatim) across countless bond indentures that trade in public exchanges. Judge Winter made a strong play for uniform interpretations in such settings, positing that predictability was perhaps even more important than accuracy:

> Whereas participants in the capital markets can adjust their affairs according to a uniform interpretation, regardless of whether it is correct or not as an initial proposition, the creation of enduring uncertainties as to the meaning of boilerplate provisions would essentially decrease the value of all debenture issues and greatly impair the efficient working of capital markets. Such uncertainties would vastly increase the risks and, therefore, the costs of borrowing with no offsetting benefits either in the capital markets or in the administration of justice. Just such uncertainties would be created if the interpretation of boilerplate provisions were submitted to juries sitting in every judicial district in the nation.[33]

The upshot of this now-famous excerpt was that, at least for corporate debt cases, the panel comfortably jettisoned any theory of contract interpretation that would require a factfinder to embark on a vision quest for the shared intent of the parties. Such divinations were logically incoherent exercises, inevitably destined to fail. Instead, the court held that interpretation questions such as these should be treated entirely as issues of law and not of fact.[34]

[32] 691 F.2d 1039, 1045-6.
[33] *Sharon Steel*, 691 F.2d at 1048.
[34] *Id.*

The second of Judge Winter's contributions went beyond endorsing some abstract uniform rule; Judge Winter decided to push onstage his own candidate as an oracle for interpretation in the form of a revised duty of good faith and fair dealing. Although traditional incarnations of the good faith doctrine are based on divining the parties' shared intent (a near impossibility here), it *was still possible* to conjure up a modified version based on more objective and verifiable calculus. Judge Winter floated exactly this idea for adjudicating between competing interpretations of the term "all or substantially all assets," writing:

> [W]here contractual language seems designed to protect the interests of both parties and where conflicting interpretations are argued by the parties, the contract should be construed to sacrifice the principal interests of each party as little as possible. An interpretation that sacrifices a major interest of one of the parties while furthering only a marginal interest of the other should be rejected in favor of an interpretation which sacrifices marginal interests of both parties in order to protect their major concerns.[35]

By introducing an explicit tradeoff of interests, Judge Winter's modified good-faith duty squares substantially and intuitively with economic welfare calculus, reminiscent even of Learned Hand's similar pronouncement in tort law three decades earlier,[36] which similarly prescribed a comparison of benefits and burdens.

After the court set up this doctrine, the opinion proceeded to conclude that applying its test was "not difficult" and "not…even close."[37] Judge Winter wrote that protecting the entire pool of assets standing behind an indenture was a major interest of bondholders. Were Sharon Steel/UV allowed to treat *this* transaction as a sale of all or substantially all assets, it would render these protections nearly valueless, while prohibiting such treatment would honor the significant interest of lenders in ensuring the "continuity of assets" in the business that is obliged to service the loan.[38] On the other hand, the motivation to preserve low-interest debt was not only less significant, but nearly absurd: if Sharon Steel's claim was correct that its cash-for-cash transaction had represented a sale of all or substantially all of its assets, then in reality UV industries *still* had not sold off all its assets; it had simply converted them into another pile of cash.[39]

At its core, Judge Winter's proposed reformulation of good faith deemphasized the parties' *actual* intent in contracting with an *imputed* common purpose that commercial parties are presumed to share: maximizing the expected joint economic surplus available to the parties. Such a goal makes considerable sense regardless of how that surplus is distributed between the parties, since they can reallocate the now-maximized pie by adjusting pricing formulas to divide the spoils. Accordingly, contracting parties pursuing this goal would jointly favor a rule that deems a discretionary act by a party (here UV's structuring of the sale to Sharon Steel) to be consistent with good faith so long as it passes muster under a cost-benefit calculus. To put it simply, Judge Winter's good-faith formulation boils down to a single imperative: *Don't Shrink the Pie (DSP).*

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35 *Id.* at 1051.
36 *See* US v Carroll Towing, 159 F.2d 169 (2nd Cir. 1947).
37 *Sharon Steel,* 691 F.2d at 1051.
38 *Id* at 1050.
39 *Id* at 1051.

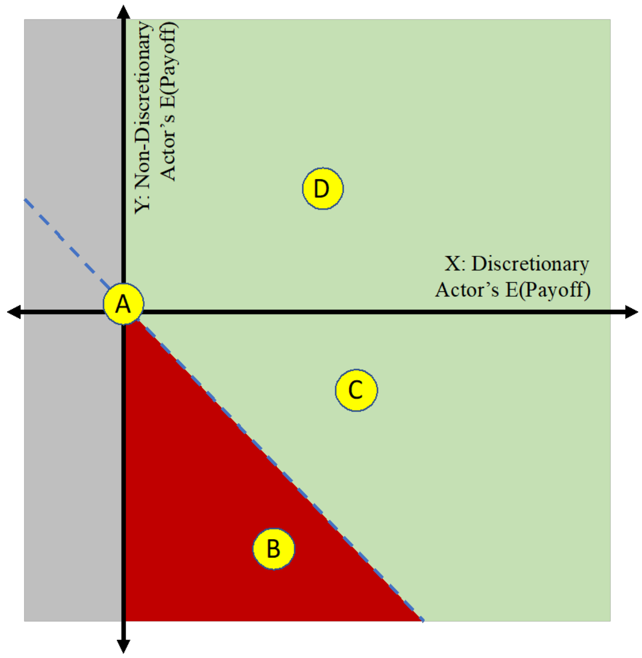

Figure 2: Judge Winter's *Don't Shrink the Pie* Conception of Good Faith & Fair Dealing

Judge Winter's DSP account of good faith is illustrated conceptually in Figure 2. The Figure presupposes that two parties, X and Y, disagree over whether their contract permits one of them (here X, shown on the horizontal axis) to take a discretionary action assumed to serve X's interests, when the act also affects the interests of the other contracting party (here Y, on the vertical axis). The dispute could, in theory, concern either a disagreement over whether an express provision allows the disputed act (so that good faith serves to arbitrate between competing interpretations); or, it might concern whether an implied obligation allows the disputed behavior when the writing is simply silent on the issue (so that good faith functions as a gap filler).[40] Point A is the designated baseline in the diagram, representing the parties' expected payoffs when X is prohibited from taking the contemplated action (and normalized to be situated at the origin). Points B, C and D represent three alternative scenarios for payoffs that might obtain when X is permitted to take the contemplated discretionary action.[41] Judge Winter's conception of good faith essentially asks whether any adverse costs imposed on Y are justified by the benefit accruing to X. In the diagram, if X's action would result in Point B emerging (or any other point in the dark shaded region where Y's expected detriment exceeds X's expected benefit), the DSP standard would interpret the contract to prohibit X from acting. Alternatively, if X's action would shift payoffs to either Point C (where X's gain exceeds Y's detriment) or Point D (where both parties expect a benefit), the DSP standard would countenance X's action. A textualist approach, by contrast, would permit X to act in *all*

[40] Note that it was the former question—interpreting an express successor obligor provision—that animated the *Sharon Steel* dispute. It is not altogether clear whether Winter would have extended the DSP approach to a situation that required gap filling. Id. at 1049 ("Short of bankruptcy, the debt security holder can do nothing to protect himself against actions of the borrower which jeopardize its ability to pay the debt unless he ... establishes his rights through contractual provisions set forth in the debt agreement or indenture.") (quoting American Bar Foundation's Commentaries on Indentures (1971) at 1-2).

[41] The Figure suppresses consideration of actions by X that result in a *negative* expected payoff to X, implicitly assuming that X will act rationally in the interests of maximizing their own expected payoff.

cases (including Point B), since there is by hypothesis no unambiguous express prohibition of the disputed action.[42]

The downward-sloping boundary separating the regions represents a "zero-sum" scenario where X's expected benefit exactly offsets Y's expected detriment. While seemingly an edge case for Winter's test, this is an important scenario in financial contracting, since financial contracts serve principally to divide cash flows across specified future contingencies (a zero-sum transfer payment by construction). Even here, however, the payoff structure need not be zero sum when assessed *ex ante* (where prospective risk premiums and incentives also come into play). Therefore, even financial contracts may not regularly fall on this zero-sum boundary, at least when one incorporates *ex ante* considerations, rather than focusing on *ex post*. In any event, even when a bona fide edge case emerges, practicality dictates that the non-discretionary party—such as the one conventionally alleging default—must ordinarily bear the burden of showing a lack of good faith by the other party, pushing the edge case in favor of X's discretion.

Notwithstanding the myriad possibilities presented by the DSP standard in *Sharon Steel*, the suggestion was largely overshadowed in succeeding years by the *first* contribution of the opinion detailed above. By a fair margin, the most oft-cited excerpt of Judge Winter's contributions is his first insight: that boilerplate provisions in corporate debt agreements must have a uniform interpretation. Indeed, it is hard to find a contract interpretation opinion involving corporate debt that *does not* haul out the above block quote or throw in a string cite to Judge Winter's pronouncement on this score. In fact, that prescription has since become *Sharon Steel*'s main calling card. The DSP standard for measuring good faith, in contrast, has made less of an impact in subsequent case law.[43] To the contrary, an important line of cases after *Sharon Steel* came to embrace a different approach for achieving "uniformity": textualism, *i.e.,* construing express provisions strictly against the creditor, while allowing little or no margin for good faith and fair dealing beyond those strictly construed boundaries.

B. Private Equity and the Leveraged Buyout Market

Just as the *Sharon Steel* opinion dropped, the leveraged buyout (LBO) market in the United States was beginning to take off. Fueled in part by a revolution of various types of fixed income bonds, such as high-yield "junk" bonds (famously created and propounded by Drexel Burnham and Michael Milkin), several private equity (PE) firms began setting their sights on buying "underpriced" public companies and pulling them off of public markets. The implications of this "leveraged buyout" (LBO) wave—both for the economy and for the evolution of debt textualism—were appreciable.

[42] Though not a central focus of this paper, Figure 2 is also helpful for understanding how the DSP conception of good faith may be distinguished from more exacting fiduciary duties of X. If X owed Y a fiduciary duty, then X cannot use her discretion to enrich herself *unless* she can demonstrate that doing so is "entirely fair" to Y. This more rigorous obligation would rule out both Point B and Point C (where X's action harms Y). Point D might be allowed, however, under the theory that X's action benefits Y, is therefore substantively fair, and accordingly passes muster under the entire fairness test. See, e.g., In re Trados Inc. Shareholder Litigation, 73 A.3d 17 (Del. Ch. 2013); In Re Tesla Motors Inc. Stockholders Litigation, 2022 WL 1237185 (Del. Ch. 2022).

[43] To take one measure, as of this writing, Westlaw's metric of headnote citations reports that *Sharon Steel* has been cited in 29 subsequent judicial opinions for the proposition that boilerplate provisions should be subject to uniform interpretations, but only 5 times for its articulation of the DSP standard.

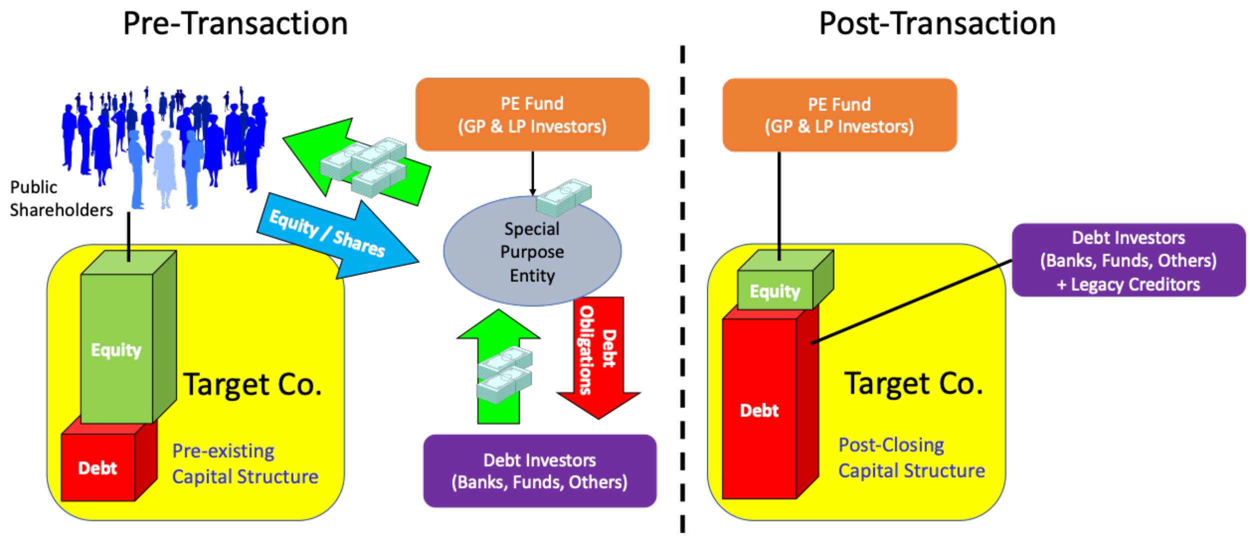

Figure 3: Canonical Leveraged Buyout Structure

In a standard take-private transaction (see Figure 3), a private equity fund contributes a modest amount of capital into a special purpose entity (SPE), which is usually a corporation created solely to execute the transaction, and then causes the SPE to raise additional capital through loan commitments from various debt capital investors (see left panel). This is done to execute a cash acquisition of an existing public company. In many cases, the public target carries some legacy debt, but the PE sponsor aims to increase that debt load further, thereby taking advantage of both tax benefits and juiced returns for the private equity fund. Consequently, the PE firm couples its limited partners' investments with significant third-party debt commitments in order to buy out the target's public shareholders, paying them a hefty premium. When the PE firm's special purpose acquisition vehicle merges with the public target, both entities' assets and liabilities are also merged by operation of law. The result is a substantial windfall for departing shareholders and a successful takeover by the PE firm. The deal also results in a company that is characterized by a capital stack that is heavily saddled with debt (see right panel).

As the LBO market developed, Judge Winter's guideposts from *Sharon Steel* were cemented. The question of bondholder rights, either express or implied, took center stage in the infamous buyout of RJR Nabisco in the late 1980s. There, the storied private equity firm Kohlberg Kravis Roberts & Co. (KKR) prevailed in a competitive bidding process against incumbent management of RJR in a deal valued at over $25 billion (gargantuan even by 2023 standards).[44] The new PE lenders taking on the debt side of the deal were sophisticated parties who knew that once the deal closed, the company would be heavily leveraged and present a potential insolvency risk. These were contingencies they had presumably priced into their loan agreements. However, the *legacy* public bondholders of RJR were not so lucky, having purchased bonds long before RJR was an LBO target. Although the existing bondholders had some protections (for example, their claims could not be subordinated to those of new creditors), the indentures

[44] For additional context on KKR's practices in conducting LBOS in the 1980s, *see* Allen Kaufman & Ernest J. Englander, *Kohlberg Kravis Roberts & Co. and the Restructuring of American Capitalism*, 67 Bus. History R. 52 (1993). For contemporaneous reporting on the KKR acquisition of RJR, *see* Jerry Knight, *KKR Using Only $15 Million of Its Own in Nabisco Buyout*, Wash. Post (Dec. 2, 1988), https://www.washingtonpost.com/archive/politics/1988/12/02/kkr-using-only-15-million-of-its-own-in-nabisco-buyout/1e733dd9-9b4e-432e-85c6-5fc594668a0a/.

did not provide strong protections against additional indebtedness of equal or lesser priority. At this point, their claims were among a crowded creditor pool who would try to collect in the event of insolvency—a prospect that looked increasingly likely with the added debt that the LBO had caused RJR to take on. As a result, the market value of the legacy bonds plummeted.

Metropolitan Life Insurance (MetLife) and other legacy bondholders of RJR sued, alleging breach of contract and fraud.[45] Although some of plaintiffs' fraud claims were allowed to go forward, Judge Walker of the Southern District of New York dismissed the breach of contract claim. More specifically, the court dismissed the good faith allegation that MetLife had advanced: if MetLife (or more likely the underwriter) didn't negotiate express provisions prohibiting this type of leveraged buyout, he held, there was no reason for the court to ride to the rescue now. In support of that conclusion, Judge Walker also echoed an ABA commentary on indentures:

> [T]he significant fact, which accounts in part for the detailed protective provisions of the typical long-term debt financing instrument, is that the lender (the purchaser of the debt security) can expect only interest at the prescribed rate plus the eventual return of the principal.… *Short of bankruptcy, the debt security holder can do nothing to protect himself against actions of the borrower which jeopardize its ability to pay the debt unless he ... establishes his rights through contractual provisions set forth in the debt agreement or indenture.*[46]

The court reasoned that in the absence of any explicit prohibition in the bond indenture, RJR and KKR were free to structure the transaction as they saw fit. The court conceded that while the indenture did not *explicitly prohibit* LBO transactions such as this one, neither did it *expressly permit* them.[47] Rather, it was simply silent on the issue. Nevertheless, Judge Walker found that it was the absence of prohibitions in the contract that would receive the heaviest thumb on the scale, suggesting that, at least in his view, the indenture should be construed to allow such transactions.

The court's review of the KKR buyout served as a template for other courts channeling Judge Winter's opinion in *Sharon Steel*. While a strong majority of courts agreed with Judge Winter's first prescription (that boilerplate language necessitated uniform interpretations), later opinions discounted or ignored his second proposition (using a DSP formulation of good faith to assess the permissibility of discretionary acts). A consensus version of good faith and fair dealing began to emerge in debt cases that diverged from Judge Winter's proposal: if corporate creditors failed to secure an unambiguous, express provision protecting them, courts were loath to supply one of their own through implied terms regardless of whether the pie would grow or shrink as a result.[48] At core, this definition of good faith was in reality the negation of the concept.

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[45] *See* Metropolitan Life Insurance v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989).

[46] *Id.* at 1518 (quoting American Bar Foundation's Commentaries on Indentures (1971) at 1-2).

[47] *Metropolitan Life Insurance v. RJR Nabisco, Inc*., 716 F. Supp. at 1519 ("There admittedly is not an explicit indenture provision to the contrary of what plaintiffs now claim the implied covenant requires. That absence, however, does not mean that the Court should imply into those very same indentures a covenant of good faith so broad that it imposes a new, substantive term of enormous scope.").

[48] The facts of the case may have also contributed to Walker's decision, since several of the MetLife debentures had previously had covenants that would have precluded a leveraged buyout of the type KKR pulled off, but those provisions had been renegotiated with bondholders' consent. Moreover, MetLife itself was aware of the risks, and had already experienced LBO transactions that had wiped out their debt position (though by hedging through equity positions they were left unscathed). CITE.

C. The Effects of LBOs on Debt Restructuring Law

One prominent development contemporaneous with the KKR buyout was in debt restructuring law, where since the 1980s, financially-distressed corporate borrowers have been experimenting with strategic ways to pit their creditors against one another, all to the borrowers' benefit. A particularly significant development here was in (so-called) "exit-exchange" offers in public debt restructuring.

When a company falls into financial distress, it is by definition on the brink of insolvency. While the company is still able to satisfy claims, distressed firms are on their last remaining lifeline and often operating very close to the margin. Those holding debt claims in these firms are aware of potential insolvency, since they are subject to the pain upon default. As a result, shareholders running the company would like nothing better than to restructure their debt. Their creditors *might* want them to do so as well, but most creditors would rather avoid making concessions themselves – they would rather have the pain of debt restructuring be taken out on *other* creditors. Since this is a uniform tendency among lenders, no one creditor ever volunteers to take one for the team, which in turn makes debt restructuring more difficult to accomplish.

Due in part to this complex calculus, measures to facilitate debt restructuring have a Schrodinger's Cat quality – simultaneously representing features and bugs. On the one hand, restructuring provides avenues for relief by breaking the creditor logjam for debtors who are underwater either because of unfortunate circumstances or bad luck. On the other hand, the option to restructure is also a tempting safety net for the moral hazards of borrowers who assume they can just restructure down the road; this can incentivize borrowers to make risky decisions or divert value to themselves (or both). Corporate finance debates converge along how "easy" versus "impossible" it should be in a given circumstance to pull off a debt restructuring.

The Trust Indenture Act (TIA), a Depression-era statute, adds yet another institutional twist to the story line. Generally, publicly-traded debt securities (as well as non-publicly traded debt obligations that do not qualify for an exemption) are bound to a series of mandatory rules, including governance by an indenture administered by a trustee, under the Act.[49] Section 316(a) of the Act further imposes a *de facto* unanimity requirement if a borrower wishes to alter the "central terms" of an indenture, defined as principal or interest.[50] Therefore, if a borrower wanted to get the consent of bondholders to restructure the contract's central terms, the borrower cannot "cram down" this kind of change on any note holders who oppose it. In essence, this creates a veto right for any holdouts.

At the same time, the TIA does not impose a unanimity requirement on debtors who wish to alter other terms or modify other content of the contract that fall outside of "core" terms regarding principal or interest. Many indentures typically allow bond holders to remove certain covenants by a majority (or supermajority) vote.[51] In the mid-1980s, distressed debtors figured out how to manipulate this framework. Instead of adjusting the core terms of a given series of debt, debtors would offer to enter an exchange transaction with creditors whereby they would receive new debt securities with lower aggregate face value that stood higher up in the debt stack, allowing them to cut the line against those creditors who did not consent to the exchange. While most indentures, even relatively lax ones, have covenants that

[49] Indenture and Indenture Trustee: Governing Laws by Practical Law Corporate & Securities

[50] "Notwithstanding any other provision of the indenture..., the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture ... shall not be impaired or affected without the consent of such holder." (TIA § 316(a)).

[51] (See Model Indenture §9.02).

prohibit this type of subordination, these covenants could usually be waived by a majority vote of the bondholders. The exit-exchange offer therefore exploits the possibility of waiver by majority.[52] Significantly, only those debt holders who consent to the restructuring are eligible to participate in the offer. Consenting bond holders are asked to vote to change the rules to allow people to "cut the line" ahead of them to collect; in exchange, they are given first dibs on the right to cut the line. This proposition ingeniously side-steps the TIA's prohibitions on non-unanimous changes to core terms. However, it creates a potential collective action problem where note holders could rush the exits, based on fears that other creditors will edge them out and cut the line before them.

This type of offer created a problem of "structural coercion" for debtholders.[53] In *Katz v. Oak Industries*, defendant Oak Industries executed one of these transactions with its distressed bondholders.[54] When Katz, a nonconsenting holdout, sought to preliminarily enjoin the offer, the Delaware Court of Chancery denied his request. The court followed the reasoning in *Metropolitan Life*, and put an even finer point on the notion that ordinary contract claimants are not entitled to the same type of special treatment that shareholders enjoy.[55] Chancellor Allen, writing alone, did not cite Sharon *Steel* but effectively rejected Judge Winter's utilitarian "don't shrink the pie" rationale. Instead, the court approved the idea that borrowers may oftentimes try to use their discretion to pursue their own gains at creditors' loss. Even accepting that as a potential problem, it is outside the courts' control:

> [The plaintiff's complaint] that "the purpose and effect of the Exchange Offers is to benefit Oak's common stockholders at the expense of the Holders of its debt"—does not itself appear to allege a cognizable legal wrong. It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders; that they may sometimes do so "at the expense" of others … does not for that reason constitute a breach of duty. It seems likely that corporate restructurings designed to maximize shareholder values may in some instances have the effect of requiring bondholders to bear greater risk of loss and thus in effect transfer economic value from bondholders to stockholders. . . . But if courts are to provide protection against such enhanced risk, they will require either legislative direction to do so or the negotiation of indenture provisions designed to afford such protection.[56]

Katz is representative of a discernible trend towards debt-textualism that grew among courts during the 1980s and 90s. The approach prescribed that credit agreements and indentures should be subjected to strict textual interpretation, and that most ambiguities in obligation beyond the central terms of principal and interest should favor the borrower (and derivatively, its shareholders). If a creditor

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[52] Such restructuring proposals first offer the creditor an "exchange" option, permitting them to tender their securities back to the firm in exchange for some other security (usually smaller but more senior debt). In doing so, the debt holder also grants their "exit consent" via a vote to weaken/negate various financial covenants that would otherwise prohibit the exchange. See generally, Antonio Bernardo & Eric Talley, Investment Policy and Exit-Exchange Offers Within Financially Distressed Firms, 51 J. Finance 871 (1996).

[53] See, e.g., In Re Dell Class V Stockholders Litigation, Consol. C.A. No. 2018-0816-JTL at 58-63 (Del. Ch. 2020).

[54] 508 A.2d 873 (Del. Ch. 1986).

[55] "Under our law— and the law generally—the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature.... Arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders." *Id.* at 879.

[56] *Id.* at 879.

wished for greater protection, the duty of good faith and fair dealing was no longer going to ride to the rescue; only express provisions could do the job. In light of this movement, creditors began to explore other avenues by which to win back some judicial love. In each instance, what looked like early signs of victory ultimately proved fleeting.[57]

Most notably, creditors pursued a decade-long effort to obtain rights that are more commonly identified with shareholders: fiduciary obligations. Traditionally, a debt holder's fiduciary claim is strongly at odds with the corporate law template, whereby only *shareholders* can benefit from fiduciary duties, and other stakeholders need not apply. It was these same considerations that undergirded Chancellor Allen's assessment in *Katz* that *of course* boards could do everything in their power to augur the fortunes of shareholders, even if it came at creditors' expense.

Nevertheless, small gaps had opened up in the shareholder/creditor distinction in the late twentieth century, giving debt holders some hope for change. For example, creditors found opportunity in disputes between shareholders and junior creditors regarding corporate actions taken when the disputed business was in the so-called "zone of insolvency" – not yet insolvent, but one bad earnings report from crossing over. For firms in financial distress, the tradeoff between shareholder value and debt holder protection presents a stark choice, because both constituencies can legitimately assert that they are "residual claimants" on firm value. Under these circumstances, it became an open question as to whether corporate directors should be obliged to maximize a firm's total value in such situations, or if directors are still permitted, if not required, to focus solely on maintaining shareholders' interests. This confusion arose out of a famous footnote in the 1991 Delaware case, *Credit Lyonnais v. Pathe Communications*.[58] Chancellor Allen, the same author of the *Katz* opinion, wrote for the court in dicta that once a firm is inside the zone of insolvency, directors' fiduciary obligations move beyond shareholder primacy, and instead expand to cover the "community of interests that the corporation represents," even if the corporate actions necessary to advance these interests are inconsistent with actions that maximize shareholder returns.[59]

For more than 15 years, courts then grappled with the meaning of the *Credit Lyonnais* footnote, as lenders repeatedly brought fiduciary claims against firms in the zone of insolvency to challenge corporate decisions that benefited shareholders at the expense of creditors. It took until 2007 for the Delaware Supreme Court to finally settle the debate.[60] In *North American v. Gheewalla*, the court reversed course and held that creditors have no rights under fiduciary law as long as the distressed firm is not yet actually insolvent. Specifically, the court held that:

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[57] In recent years, the contours of the TIA been put in a multiple-year state of flux. In *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp., 846 F.3d 1 (2d Cir. 2017), reh'g denied, No. 15-2124 (2d Cir. Mar. 21, 2017*), the Second Circuit—in reversing a federal district court—declined to extend TIA protections to a restructuring that allegedly interfered with a "core term" or "sacred right" enjoined by the lenders. The Southern District of New York's had previously deemed the refinancing to impair "central terms" under the TIA, employing a broad reading of noteholders' rights. *See Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 75 F. Supp. 3d 592, 610 (S.D.N.Y. 2014). In reversing, the split Second Circuit panel found that such a broad reading ran counter to the legislative text of the TIA, thereby reestablishing the more narrow interpretation that had long preceded the case.
[58] No. CIV. A. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).
[59] *Id.* at 36.
[60] As it turns out, this was not quite the end of the debate, since the exact same difficulties have re-emerged in a series of recent cases pitting common against preferred shareholders, where the corporation is in the "zone of liquidation preference" for preferreds. See Sanga, Sarath and Talley, Eric L., *Don't Go Chasing Waterfalls: Fiduciary Duties in Venture Capital Backed Startups* (Oct. 31, 2020). European Corporate Governance Institute - Law Working Paper No. 634/2022, Available at SSRN: https://ssrn.com/abstract=3721814.

When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.[61]

Gheewalla thus resolved the debt-equity conflict simply by ruling out directors' fiduciary obligations to creditors outside of insolvency. What had once seemed like a promising avenue for distressed creditors to get protection through implied duties and equitable protections was ultimately little more than jurisprudential vaporware.

D. Debt Textualism Brewing in Private Credit Markets

Initially, debt textualism developed primarily in cases involving public bond markets, given that a large fraction of corporate debt existed in these markets. By the turn of the 21st century, however, an increasing amount of debt became privately held either through syndicated/leveraged loans or various types of asset-backed collateral pools, and typically it was not traded on public exchanges. Some of this debt was not even subject to the TIA, because it was exempted from general securities regulations requirements. Since then, though a relatively small slice of the market, private debt facilities have grown rapidly.

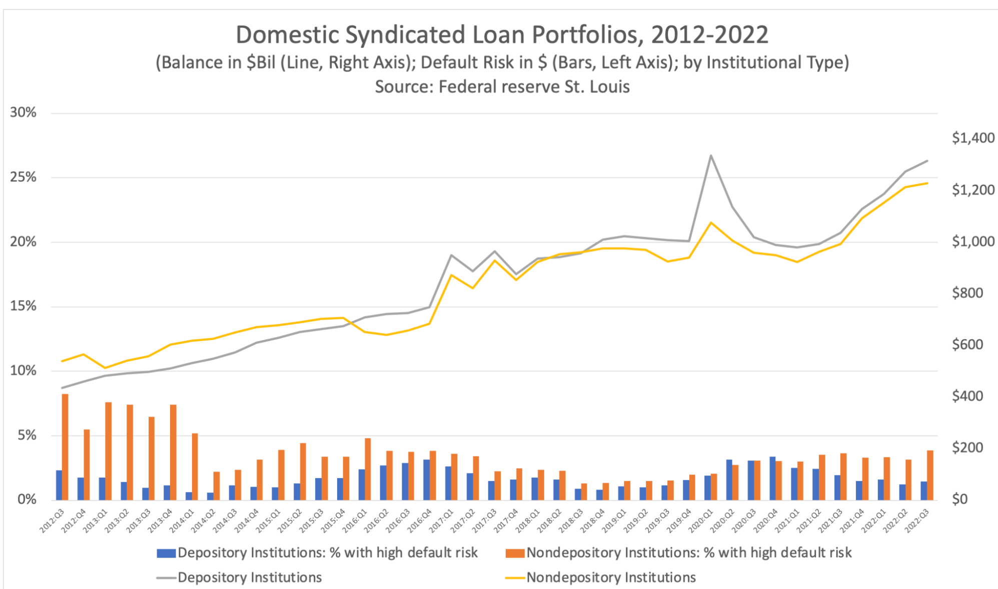

Figure 4: Syndicated Loan Market Size and Risk Characteristics[62]

These financial tools are especially prominent in the LBO and leveraged recap contexts today, such as private equity deals, distressed debt offerings, and public company recapitalizations. The rapid

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[61] *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

[62] Data come from the Fed. Reserve St. Louis ("FRED") database. https://www.federalreserve.gov/releases/efa/ efa-project-syndicated-loan-portfolios-of-financial-institutions.htm

proliferation of complex lending facilities is one vestige of the cataclysmic growth of private capital markets since the early 2000s. It is now typical to place a "private" syndicated debt offering in the hands of hundreds (if not thousands) of investors and/or funds. This market has grown substantially in the last decade, as illustrated in Figure 4. Outstanding balances have been consistently held in roughly equal proportions by both depository banks and non-depository institutions, including investment banks and funds, each clocking in comfortably at over $1 trillion today. Unsurprisingly, non-depository institutions, which face less regulatory oversight, also tend to hold the riskiest loan balances – holding nearly twice the fraction of highly risky or in-default loans as held by depository institutions.[63]

In theory, the expansion of private debt presented another opportunity for courts to confront interpretational challenges; in particular, courts could consider whether the approach in this context would differ from publicly traded bonds. Intuitively, the benefits of uniform interpretation would seemingly be lower in private debt contexts, where secondary trading markets are traditionally smaller and less liquid, with fewer financial intermediaries. While these differences might have supported a differentiated version of implied duties for private debt instruments, it soon became clear that judicial interpretations of private debt instruments would largely mimic their public counterparts.[64] Accordingly, debt textualism seamlessly infiltrated the jurisprudence around leveraged and syndicated loans, smuggling in with it additional consequences of contractual bloat, complexity and rigidity (as detailed below).

E. The Wages of Debt Textualism: Revlon Roulette

The structure of debt textualism explicitly encourages parties to credit agreements to scour express terms for loopholes, land mines, and hooks for opportunism. Metaphorically, each of these activities has helped provide a foundational leg supporting an elaborate chess board that makes up the game of debt contracting. Over time, participants in the credit game figured out ways to manipulate the pieces on the board to their advantage. A particularly juicy and extensive chess game between private equity sponsors and lenders is the one involving the now-bankrupt Revlon and its 2016 term loan facilities. While Revlon's relationship with its creditors is perhaps best known for the nearly $1 billion mistaken payment that Citibank dispatched to Revlon lenders in 2020 (and which itself launched extensive litigation),[65] the wellspring for that cataclysmic snafu was an epic battle of gamesmanship among distressed borrowers and distressed debt investors, all amply enabled by debt textualism.

In 2016, Revlon took out a $1.8 billion term loan from a syndicate of several sophisticated counterparties in connection with its strategic acquisition of high-end cosmetics retailer Elizabeth Arden. It was a 180-page term loan agreement that spelled out a structure in considerable detail in which the loans would be backed by a variety of assets consisting substantially of intellectual property (IP) owned by Revlon's chief operating subsidiary, Revlon Consumer Products Corporation (RCPC).[66] The note

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[63] For purposes of Figure 4, "highly risky" refers to loan balances estimated to face at least a 25% probability of default.

[64] See, e.g., Jamie Sec. Co. v. The Ltd., Inc., 880 F.2d 1572, 1576 (2d Cir. 1989); Chesapeake Energy Corp. v. Bank of N.Y. Mellon Trust Co., No. 15-2366-CV, 2016 WL 4895581, at *3 (2d Cir. Sept. 15, 2016); Lockheed Martin Corp. v. Retail Holdings, N.V., 639 F.3d 63, 69 (2d Cir. 2011); White v. Cont'l Cas. Co., 878 N.E.2d 1019, 1021 (N.Y. 2007); First Lincoln Holdings, Inc. v. Equitable Life Assurance Society, 164 F.Supp.2d 383, 393 (S.D.N.Y.2001); Bank of New York Mellon v. Realogy Corporation, 979 A.2d 1113 (Del. Ch. 2008).

[65] *See infra* III.B.

[66] These IP assets included, inter alia, those assets associated with the newly-acquired Elizabeth Arden line.

agreement also stipulated that Revlon had to make periodic interest payments up until 2023, when the loan and the balance became payable.[67]

In early 2020, Revlon fell into financial difficulties and needed additional capital infusions. Taking a page from the exit-exchange offers playbook of four decades ago, Revlon executed a maneuver with its term loan investors that is commonly known as an "up-tier" transaction, pictured in Figure 5. This transaction involves a highly leveraged company that has a substantial amount of secured first-lien loans backed by valuable collateral. The up-tier proposal is a type of exchange offer where select first-lien lenders get the opportunity to tender their claims in exchange for a newly issued obligation.[68]

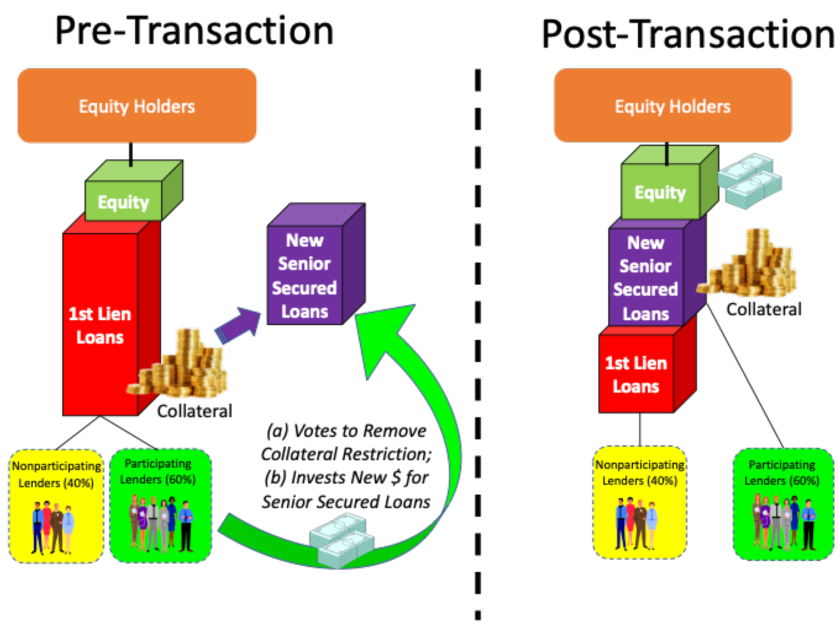

Figure 5: Canonical "Up-Tier" Restructuring Transaction

But two features of the transaction involve a considerable amount of financial hardball, as illustrated in Figure 5. First, in a typical up-tier transaction, the new debt security is usually not swapped straight up, but the participating lenders must make concessions on face value, interest and tenor, and (increasingly) an additional financial investment. A concomitant to this exchange is that the participating lenders must vote to remove financial covenants that would otherwise restrict or prohibit the transaction; this means that collateral protections will be stripped out from the first-lien loans, enabling the collateral to be redeployed as security for the new debt issuance. Second, unlike traditional exit-exchange offers, the up-tier is not open to all debt holders ratably; instead the borrower plays favorites and recruits only a sufficient number of lenders as needed to authorize a vote for covenant removal (in the Figure, for

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[67] Revlon contracted with Citibank, N.A. (Citi), who was designated the administrative agent for processing periodic payments and making appropriate bank transfers.

[68] Although we spotlight the Revlon up-tier transaction here, it is worth noting that these sorts of battles have become almost the norm in distressed companies, either through similar up-tier structures or similar variations, such as drop-downs and spin-offs. Similar battles have ensnared J. Crew, Serta-Simmons, Caesar's, the TPG Group, Sears, and countless others. See Diane L. Dick, Hostile Restructurings, 96 Washington Law Review 1333 (2021); Vincent Buccola & Gregory Nini, The Loan Market Response to Dropdown and Uptier Transactions (SSRN working paper 2022).

example, that number is 60%). These additional maneuvers are particularly cruel for the remaining (or "non-participating") lenders left behind. The maneuvers force those lenders backward in line and vacuum out the critical collateral protections that made the investments attractive in the first place. The up-tier transaction nevertheless recruits only the bare minimum of a needed majority to remove the collateral. In Revlon's case, the up-tier allowed consenting lenders to exchange their claims for the right to purchase newly-issued debt securities that had less attractive financial terms. However, participating lenders enjoyed protection from the Elizabeth Arden IP collateral, which was removed from the term loan protections pursuant to the covenant vote. In other words, creditors who voted to approve the restructuring were going to be permitted to "cut the line" to collect ahead of any holdouts.

Anticipating these hardball moves, non-participating lenders quickly realized that they could only find protection through safety in numbers: if they could collectivize enough creditor claims, they would be able to outmaneuver the up-tier by locking up a majority of no-votes. Several large creditors managed to coordinate with each other and executed a mutual cooperation agreement where they collectively agreed to vote against the planned May 2020 restructuring. This effort proved effective, and it seemed by mid-spring 2020 that the up-tier was not going to garner sufficient support to go through.

But Revlon fought back with considerable chutzpah of its own. Facing mounting collective resistance from non-participating lenders, Revlon devised a devious counter-attack: in late spring 2020, the company entered into several new revolving lines of credit, all with existing term lenders who had already manifested support for the restructuring plan. This new borrowing had little to do with Revlon's capital needs – it was all about manufacturing votes. Hidden within the 2016 term loan agreement was a provision that bestowed additional votes on new "revolving commitments" extended to any existing term lender, which were votes that the lenders were entitled to cast alongside their existing claims for purposes of consenting to a restructuring. By entering into such "sham" transactions with a hand-picked posse of favored creditors, non-participants argued, Revlon had guilefully bought the vote. When the dust settled in May 2020, Revlon's counter-strategy paid off: the majority of 2016 term loan creditors, joined by the new votes tied to the revolvers, narrowly approved the restructuring proposal by a bare half of one percent. This narrow victory enabled the collateral removal and significantly undermined the remaining value of the 2016 term loans.

Outmaneuvered in the ballot box, the non-participating lenders proceeded to the jury box, drafting a complaint that alleged,[69] among other things: (a) that the refinancing had breached the 2016 term loan agreement; (b) that the new revolvers also abrogated the agreement; (c) that the restructuring was invalid; (d) that all of this had been done with Citi's active assistance and encouragement; and (e) that the principal balance on the term loans was immediately due and payable. It was this dispute—born out of a monumental standoff between creditors and borrowers effectively playing "gotcha" with the text of their loan agreement—that provided the dramatic backdrop for Citi's mistaken payment while acting as an administrative agent for the loans and attempting to roll up participating lenders into their new debt securities. While we have covered the details of this latter snafu elsewhere,[70] we recount this background to show how Citi's infamous "mistaken payment" imbroglio is difficult to appreciate without knowledge of the cantankerous jockeying that preceded it, which was largely facilitated by the incentive structure wrought by debt textualism.

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[69] UMB Bank – a purported assignee of several objecting lenders – filed the 117-page complaint detailing their objections to August 12, 2020 transactions that effectively undercut the collateral backing the loan. See Eric Talley, "Discharging the Discharge for Value Defense," 18 NYU J. L. Bus. 147 (2021) (hereinafter *Discharging*).
[70] See Pandya & Talley 2021; Talley, *Discharging*.

The Revlon saga underscores the fact that debt textualism can visit significant collateral damage that transcends the legal and financial brinkmanship of contemporary distressed debt battles. True to form, the controllers and term note holders angled continually (and at considerable cost) to devise clever tactics to outmaneuver each other. Eventually those tactics drew in other participants, including Citi and pretty much every other stakeholder at Revlon: as the term loan parties duked it out with one another across multiple courts, the company was sinking ever deeper into distress. And in the process, everyone was playing hot potato with a significant portion of Revlon's debt, insistently disclaiming ownership and stewardship of those claims. By the time Revlon finally declared bankruptcy in the summer of 2022, what was already looking like a challenging insolvency had become a Byzantine maze—one that courts are still attempting to sort through. At its core, much of Revlon's current troubles owe their existence to a debt landscape where the parties were more obsessed with fighting over shares of a shrinking pie than attempting to grow it (or even preserve it).[71]

Not only has our growing commitment to debt textualism fed the state of play evinced by the Revlon dispute, but such situations are in many ways harder to break than ever. The expansion of debt finance, fueled by a two-decade explosion of private equity and distressed debt investors, has pushed a mountainous stack of chips into the middle of the table and eroded traditional extra-legal norms of cooperation, providing an appreciable incentive for parties to fight things out to the death, time and again. This current state of affairs raises important normative questions. And it is to these questions we now turn.

III. Evaluating Debt Textualism through a Normative Lens

Up until this point, we have traced the evolution of debt-textualism in state and federal courts largely as a descriptive matter. Given courts' investment in the practical outcome of predictability around assets traded in capital markets, it is not surprising that the judiciary coalesced around abandoning "intent-based" tests for traded debt claims. It is only slightly surprising that this philosophy transcended its roots in public bond markets and now generally pervades almost all corporate debt markets.[72] But it is most surprising, in a sense even alarming, that courts embraced this form of uniformity. Rather than adopt Judge Winter's "don't shrink the pie" standard for the duty of good faith and fair dealing, courts have largely chosen to shrink the good faith doctrine to virtually nothing, rendering it toothless. Instead, courts tend to hew closely to the plain meaning of express terms in interpreting creditors' rights in a contract; if courts cannot find an express protection, there will be no such protection under an implied duty. The absence of evidence concerning creditor protections written into a contract *really does* count as evidence of absence in the universe of corporate debt.

In this section, we step back from this positivist account and instead consider the normative implications of debt-textualism. Specifically, we ask whether a debt textualist approach is able to maximize the ratio of social benefits to social costs. We conclude that even if adherence to debt textualism led to acceptable outcomes four decades ago, it is less clear whether this is a socially beneficial framework under conditions and markets that have moved sufficiently further from giving rise to earlier cases.

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[71] All of this behavior ran counter to Judge Winter's contribution in *Sharon Steel*. He passed away at the end of 2020, right in the middle of the Revlon-Citi showdown.

[72] This is only slightly more surprising because much of the syndicated debt and leveraged loan markets are also traded in OTC markets even if not on the exchanges. (cite)

A. Benefits of a Debt Textualist Approach

There is a reason we are all textualists now in corporate debt contracts. Although some dismiss the normative case for textualist approaches writ large, it is important to appreciate some of the distinct advantages it carries in corporate financial markets. This is because debt textualism is a plausible way to effectuate the strong call for uniformity and predictability of provisions in credit agreements. By excluding virtually all creditor protections beyond those clearly articulated in express terms of a contract, courts may well avoid creating more uncertainties that tend to occur when judicial actors apply "squishy" standards to address implied duties such as the duty of good faith and fair dealing. Even Judge Winter's alternative "don't shrink the pie" approach to good faith—while avoiding Quixotic quests for shared intent—can create unpredictability as courts attempt to quantify whether an exercise of discretion affects major and minor interests of either party.

Predictability remains an important goal, moreover, because it is helpful for both litigants and transactional lawyers – it allows parties to a contract to consider the likely implications of each boilerplate term they include *ex ante*. As lawyers develop more and more boilerplate terms, each grounded by a (hopefully) predictable textualist application, the system may enable parties to tailor their contracts based on the selection of terms available. Parties can then "choose their own adventure" in each contract by choosing from permutations of express, boilerplate terms. The availability of menu-based options for boilerplate terms could further sow the seeds for growth, development, and evolution of contractual norms and forms, even supporting experimentation with mutations on boilerplate, many of which may be adapted and/or adopted on a wide-scale basis.[73]

B. Drawbacks of Debt Textualism

While debt textualism posits key benefits, it also imposes costs upon parties and the system. We focus on three particular drawbacks: (1) contractual bloat, (2) complexity, and (3) rigidity.

First, consider contractual bloat. Debt textualism places a heavy interpretive thumb on the scale that ostensibly serves borrowers. If creditors want protection, implied duties are of little use, and creditors are best served by extracting express protections. Many creditors have done exactly that, stacking express provisions on top of express provisions in any one contract. In many ways, lenders and underwriters have no current alternative. The moment of execution of the deal might be their last best hope to lock in any downstream rights. But the incentive to write down every foreseeable protection into the contract has obvious implications for the sheer size of debt agreements. As creditors grew wary of *not* including express provisions in recent decades, the terms of a standard debt contract grew exponentially.[74]

Next, we consider the increasing complexity of contracts: as indentures and loan agreements have grown longer year after year, so too has their internal complexity.[75] The specific provisions of a new

[73] See Matthew Jennejohn, Julian Nyarko & Eric Talley, Contractual Evolution, 89 U. CHI. L. REV. 901 (2022).
[74] *See, e.g,* James Green, Longer and longer the sequel: bonds follow the trend, European Leveraged Finance Client Alert Series: September 2020 White and Case Client Alert 30 September 2020. https://www.whitecase.com/insight-alert/longer-and-longer-sequel-bonds-follow-trend.
[75] Some have defined contractual complexity not in textual terms, but in economic terms based on the interactions between the borrower and creditor. Under those terms, the relationship between cov-lite loans and contractual complexity is inverse. ("Cov-lite' loans are covered by credit agreements where financial covenants do not have an automatic periodic verification but are checked only upon incurrence of certain actions by the borrower. . . . We find

express term, for example, may import considerable complexity in variations and definitions, which presents a challenge for textualist courts. For example, scholars have documented the growth in prevalence and complexity of EBITDA-related debt covenants in contracts now than two decades ago, and the growing uncertainties about how to interpret the term, particularly when the very definition of EBITDA[76] has become technical, unclear, and even internally conflicting within the contract.[77] But complexity is even more…complex…than an *intra*term phenomenon. Not only must each provision be discerned standing by itself, but legal actors must attempt to discern how different express terms interact with one another. When, for example, does one provision take precedence over, or submit to, another provision that appears to prescribe an inconsistent outcome? As the sheer number of express provisions in a contract grows, the number of mutual interactions between provisions expands in turn.

Finally, we consider rigidity: the growth in length and complexity of credit agreements has also made it riskier (not to mention downright unpleasant) to move out of accepted, tried and true structures. It can be difficult to anticipate how changing a single term in a long, complex writing might alter courts' assessment of the provision. While transactional lawyers are theoretically empowered to choose their own adventure, they can be disinclined to rock the boat by adopting provisions whose "plain meaning" has yet to be tested before the courts, or provisions that may alter a court's interpretation of *other* provisions in the deal that the drafter did not intend to alter. This makes debt market participants risk averse to experimentalism. When this rigidity combines with the tendency of courts to use debt textualism, it creates a new sort of parlor game: parties scavenge the language of agreements for hidden inconsistency, loopholes, or imperfections, and engineer novel strategies to exploit those imperfections to maximal advantage for their clients. It is a lucrative practice when the stakes are high and the hunting ground is dense and vast, making leveraged loan agreements a perfect site for contractual expansion and rigidity. As leveraged finance has expanded in the last two decades, these opportunities have become more tempting.

At the same time, both sides can play this parlor game and both have significant incentives to "lawyer up" in order to do it. By this stage, neither party is overly concerned about creating value as much as forcing transfers of economic rents. As a result, most of the efforts put into rejiggering a contract are socially wasteful. Even worse is the fact as the outcome of the game has also grown decidedly volatile, with shifting coalitions and ever-more complex scavenger hunts producing results that can be difficult to predict and are hardly uniform. It is worth acknowledging that the chess game of mutual rent extraction that debt textualism spawns is not new. Many of the costs discussed above have been criticisms of debt textualism since its very inception. Nevertheless, we advance the argument that the stakes have grown considerably in debt restructuring in the last twenty years the battles have become more pitched, more expensive, and less predictable. While the advantages of uniformity, transparency and predictability remain appreciable (and perhaps even have grown), debt textualism seems ultimately to have delivered the opposite: a landscape that is less uniform, less transparent, and chronically unpredictable. Evidently, its once-vaunted features have metamorphosized into a monstrous bug.[78]

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that contractual complexity is positively correlated with covenant weakness: everything else equal, contracts that are cov-lite, have fewer financial covenants, and have more slack, are more complex." Victoria Ivashina & Boris Vallee, "Complexity in Loan Contracts," (SSRN Working Paper 2022).

[76] "EBITDA" is a term that measures the profitability of a business. It is shorthand for "earnings before interest, taxes, depreciation and amortization." See, e.g., https://www.youtube.com/watch?v=d4vXr-Clvuw.

[77] Badawi et. al, 2021.

[78] *See generally* Franz Kafka, Metamorphosis, Ch. 1 (1915).

IV. Reforming Debt Textualism and Keeping the Faith

As we argued above, debt textualism's key role in shaping incentives in corporate debt markets has become questionable over the last two decades, plausibly to the point where its burgeoning costs are no longer justified by its benefits. To the extent that the case favoring debt textualism is losing its holding power, the logical next step is to consider whether there is anything we can (and should) do about it. In this section, we offer a variety of approaches: (a) let market practices develop a solution; (b) push for judicial intervention; and (c) legislative/regulatory intervention. Notwithstanding appearances, none of them is mutually exclusive with any other.[79]

A. Leave It to the Market?

A first possible strategy is simply to give market forces room to devise private solutions to the problem of debt textualism. If we are correct that the system has progressively introduced more costs than benefits, then market participants presumably have an incentive to take on those problems with their own contractual innovations.[80] Most obviously, if parties collectively dislike the judicial abandonment of good faith, nothing prevents them from baking their own *express* good-faith duties into their credit agreements, through which they contractually instruct a court (even a textualist court) to deploy Winterian good-faith calculus in the face of debt restructuring strategery. To the extent that market participants bear most or all of the substantial costs visited by debt textualism, one can expect that they would make this move of their own accord (perhaps with some modest prodding).[81] Put even more simply, if our above criticisms hold water, why haven't private actors in credit markets already responded to the problem?

This is an important question to ask, especially since both good-faith and "efforts" provisions can and do work their ways into a variety of commercial contracts – even, at times, in credit agreements.[82] Nevertheless, several factors cast doubt on whether unalloyed market forces are sufficient to counter the worst ills of debt textualism. First, a contractual choice *ex ante* by the *parties* to embrace an express good faith provision does not guarantee that the *ex post judicial factfinder* will play along with that choice.[83] There are many examples where courts have simply refused to meaningfully enforce behavior standards (such as in efforts and good-faith clauses), notwithstanding their express inclusion.[84] Consequently, the parties would be disinclined to bear the costs of negotiating and drafting a good faith provision anticipating a potentially uncooperative court. Second, even if a judge were willing to enforce a good faith provision, there is currently not a lengthy track record that shows how the court will go about doing it in corporate debt cases. Predictability of outcomes is essentially a game with network externalities, and

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[79] Even the approach of leaving things to the market does not preclude concomitant judicial/legislative/regulatory interaction, since interventions on market structure establish the background foundational conditions upon which markets are then built and operate.

[80] See Jennejohn et al., *supra* note 74 (developing a model of contractual innovation in corporate transactional contexts).

[81] For example, English common law's longstanding rejection of the implied duty of good faith has spawned a cottage industry of express good faith provisions in English contracts. See Richard Cumbley and Peter Church, "Contracts: good faith" Practical Law (2022).

[82] See note 83, infra.

[83] See Charles Goetz & Robert Scott, "The Limits of Expanded Choice: An Analysis of the Interaction Between Express and Implied Contract Terms, 73 Calif. L. Rev. 261, 283-86 (1985).

[84] Id.

term innovators of new terms are often reluctant to serve as the proverbial canary in the coal mine unless joined by a larger cohort of participants who collectively establish predictable conventions and case law. Third, there are agency costs that can also distort economic incentives. As detailed above, corporate debt markets are highly intermediated, and while borrowers are typically represented at the negotiation table, the end holders of the debt usually are not. The arrangers/underwriters who negotiate, presumably on end purchasers' behalf, are unlikely to act in order to maximize creditors' payoff but rather their own payoffs. Finally, even in the absence of agency costs, the deal between the borrower and lender will not generally internalize a variety of external costs, ranging from legacy lenders to employees to customers. More broadly, the prevalence of boilerplate terms suggests that corporate debt arrangements can channel systemic risks into the economy through a heightened correlation of debt securities tied together by boilerplate terms. Therefore, while market forces should play some role in reforming debt textualism, prudent interventions will also be necessary to alter the baseline conditions for market interaction.

Another potential complication of leaving things wholly to the market is the puzzling cyclicity of debt contracts over time. Indeed, debt contracts regularly cycle through various "covenant-lite" (cov-lite) fads depending on the receptivity of the institutional investing crowd. The movement towards cov-lite loans, which contain few financial covenants by borrowers/debtors, has been episodically broad and robust in recent decades.[85] Cov-lite loans grew across the leveraged lending market just prior to the 2008 financial crisis, mostly concentrated among private equity sponsors.[86] Once issued, these loans entail far less control or disclosure to the creditor, leaving lenders more in the dark than with more heavily covenanted instruments that mandate default-related disclosures.[87] The shift to a predominantly cov-lite lending framework in leveraged loans has been explained by some as a concerning development occasioned by the disincentivization of efficient monitoring by banks and other holders of debt.[88]

In some sense, cov-lite cycles may provide a "reboot" to address contractual bloat – the reduction in the number of covenants effectively cleans up and shortens credit agreements. While this can be potentially beneficial, simply removing financial covenants while leaving the debt textualist regime intact is a game of Russian Roulette, leaving behind dangerously few creditor protections which courts will interpret as permitting virtually any discretionary actions by the borrower with no tenable duty of good faith. As a result, the role of cov-lite loans in financial downturns presents a complicated proposition. On the one hand, cov-lite may represent a potential salve from a credit crisis, providing flexibility to borrowers in real-time to keep the cash flowing.[89] On the other hand, this flexibility imposes costs on others: cov-lite loans are minefields for creditors, who in a time of crisis likely need to be able to manage (or at least comprehend) their losses more quickly.[90] A movement back to cov-lite structures would

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[85] *See* Edison Yu, *Banking Trends: Measuring Cov-Lite Right*, Federal Reserve Bank of Philadelphia (2018), https://www.philadelphiafed.org/the-economy/banking-and-financial-markets/banking-trends-measuring-cov-lite-right. *See also* M. Konrad Borowicz, *The Mechanisms of Loan Market Efficiency*, 41 Rev. Banking & Fin. L. 195, 221 (2021) ("By the end of 2018, 85% of all leveraged loans were cov-lite.").
[86] *See* Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. Corp. L. 641, 662 (2009).
[87] Mark Laber & John Yozzo, *Covenant-Lite Leveraged Loans: Time-Tested or Time Bomb?*, Am. Bankr. Inst. J., October 2017, at 26, 26. ("Such remedies, whatever form they take, provide a lender with some actionable recourse before a credit deteriorates badly, or compensate the lender for a loan that unexpectedly becomes riskier.").
[88] *See id.*
[89] For early reporting on markets' reliance upon cov-lite loans at the beginning of the COVID-19 pandemic, *see* https://www.reuters.com/article/virus-puts-cov-lite-loans-to-the-test/virus-puts-cov-lite-loans-to-the-test-idUSL8N2BK5LI.
[90] Whitehead, *supra* note 86, at 676.

therefore likely be short-lived amid economic slow-downs, and even higher rates and spreads can make cov-lite loans nail-biting lottery tickets. Relying on cov-lite indentures is more common under strong economic times, when credit is free flowing and more accessible; but it also may be a type of market failure, as lenders (or arrangers) discount the odds of future distress excessively. Cov-lite lending is thus a practice that develops in a low-interest rate environment, and reliance on it during periods of financial growth can harm creditors under a debt textualist regime as market conditions worsen, inviting future waves of opportunism.

All told, then, the advantages of simply leaving things to current market forces (without a coordinating effort on other fronts) seem pretty limited. Other complementary interventions are likely to be necessary too.

B. Judicial Intervention

An alternative avenue for change than doing nothing may come from how courts apply and/or reform the doctrine they created. Contract interpretation is a matter of law, at least in the first instance, so courts are uniquely positioned to play a role in interpreting express provisions and filling evident gaps in contractual language out of necessity. As discussed above, the now-standard approach to debt textualism is to interpret express language strictly, placing a heavy thumb on the scale favoring the borrower (the primary trigger for current creditor-on-creditor violence), employing gap fillers stingily. That strategy now has largely collapsed on itself, as we have shown above; but below we offer several ways that judges may play important roles in reforming the application of debt textualism. The first and easiest step for courts to take would be to compensate on the margins for debt textualism's unintended consequences, bending other doctrinal analyses to implement ad hoc corrections. A second, and perhaps more durable response for courts would simply be to reassess the underlying rationale for debt textualism, enhancing creditors' protections while still preserving some measure of transparency, uniformity and predictability. Here, judges may wish to revisit Judge Winter's prescriptions from forty years ago, reviving a more generous conception of good faith and fair dealing. We briefly consider each in turn.

First, courts may be able to combat the ills of debt textualism by deploying back-door, *sub rosa* equitable interventions from other (seemingly unrelated) areas of corporate and commercial law. Take, for example, *In re Citibank*, discussed above. In his trial court opinion, Judge Furman laid down a nearly impossible prescription for those in Citibank's position wanting to avoid future exposure under the discharge-for-value doctrine: "[B]anks could—and perhaps after this case, will—take other relatively costless steps to both minimize the risk of errors and increase the probability of clawing back erroneous payments. . . the banking industry could–and would be wise to–eliminate the risk altogether by taking these or similarly modest steps."[91] While we disagreed with Judge Furman's proclamation that it would be "costless" for the parties to anticipate and avoid <u>every possible future outcome</u> involving a mistaken payment in a debt contract,[92] a more charitable view is that Judge Furman was deploying a back-door check on opportunism by Revlon and its erstwhile Citi, who worked together to implement the up-tier transaction spawning the initial dispute. Applying the discharge-for-value doctrine was a stretch—and a

[91] *In re Citibank*, 520 F. Supp. 3d 390, 450-51 (S.D.N.Y. 2021).

[92] The authors have commented extensively on facets of the SDNY opinion and the subsequent developments in contract law that it triggered. *See* Talley, *Discharging,* at 147; *see also* Sneha Pandya & Eric Talley, How the Litigious Bird Caught the (Banque) Worm, CLS BLUE SKY BLOG (Feb. 24, 2021), https://clsbluesky.law.columbia.edu/2021/02/24/how-the-litigious-bird-caught-the-banque-worm/.

risky one at that. For better or for worse, New York state courts developed the discharge-for-value defense doctrine for the limited purpose of increasing finality in electronic funds transfer so as to not present roadblocks to dealmaking, not so much as a sanction for carelessness or a punishment for opportunism. That said, the discharge-for-value doctrine is a highly equitable doctrine that evolved from the also highly equitable principles in restitution.[93] Given the history of the doctrine, Judge Furman may well have been attempting to deploy the courts' equitable discretion to impose on Citi a type of "pay-back" for having facilitated the opportunistic restructuring of Revlon's debt.[94] In other words, if Citi was going to reap significant fees from its opportunistic Revlon up-tier, then it could also be made to pay for the costs, no matter how high, of a calamitous payment mistake in administering the loans. The district court's holding might thus be read to illustrate how courts can use their equitable powers in ad hoc ways to deter or punish socially wasteful behavior, even if doing so is difficult to pull off directly under a debt textualism regime.[95]

There are some obvious limitations to this *sub rosa* strategy, however: most notably, the types of logical stretches needed to apply compensatory equitable decisions can be appealed, and here Citi was ultimately vindicated by the Second Circuit.[96] However, even before it was reversed, Judge Furman's intervention itself quickly fell prey to textualist countermeasures, as transactional lawyers rapidly adapted to Furman's holding by incorporating (so-called) "Revlon Blockers" into new financings that explicitly rejected the discharge-for-value defense (in some cases disclaiming the *Citibank* opinion by name).[97] Consequently, the judicial use of equitable actions as a "backstop" to check debt textualism still relies on a combination of conditions, such as: (1) the potential for remaining "gaps" (*i.e.,* situations not expressly covered by the clauses); (2) maintaining a link between meaning and function in the process of interpretation, through which the meaning of a clause is inherently linked to what the clause does; and (3) a court's overarching requirement that contractual allocations remains fair (or at least not wasteful).[98] When these conditions are satisfied, however, courts can be well-suited to engage in such *sub rosa* strategies, since they are typically already engaged in restructuring or bankruptcy proceedings, and therefore able to intervene along multiple margins.[99]

A more linear alternative to the back-door approach would be for courts to confront debt textualism directly, deemphasizing its role in interpreting credit agreements. One obvious method would be to embrace (or re-embrace) Judge Winter's "don't shrink the pie" formulation of the duty of good faith and fair dealing in *Sharon Steel*. As we previously discussed, courts strayed from engaging Winter's test as they progressively embraced debt textualism; but now that this chosen course has led us into a dead end, it may be worth assessing whether a DSP-style good-faith doctrine might be put back into service.

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[93] Talley, *Discharging*, at 166-69.
[94] Typically, the underwriter on the original debt placement stays to act as administrative agent on the loans. See Iñaki Aldasoro, Sebastian Doerr, & Haonan Zhou, Non-bank Lenders In the Syndicated Loan Market, BIS Quarterly Review, 2022, at 15 (available at https://www.bis.org/publ/qtrpdf/r_qt2203c.pdf).
[95] At the same time, debt-textualism is still prominent (see 2d Cir. decision declining the DFV defense. Scholars agree that textualism has its benefits in reigning in the courts' discretion as well: "The adoption of a textualist interpretative rule. . . would eliminate the risk of value-decreasing judicial errors in the enforcement of the debt contract." (Sepe 2007).
[96] [Cite 2nd Cir Opinion]
[97] See Talley, *Discharging*, at 200-205..
[98] David Ramos Munoz, "Can Complex Contracts Effectively Replace Bankruptcy Principles?: Why Interpretation Matters," Am. Bankruptcy L. J. (2018).
[99] *Id.*

Limiting parties' use of discretion only to acts that do not shrink the pie arguably places parties in the situation they would reasonably prescribe ex ante, and it imposes a standard that is less susceptible to opportunistic scavenger hunts through borrower covenants and creditor rights. While the DSP account of good faith concededly represents more of a standard than it does a rule, it need not dramatically undermine predictability for at least two reasons: (1) Judge Winter's articulation of the test was fairly precise and rooted in objective forms of evidence of burdens vs. benefits; and (2) the shenanigans we regularly witness under debt textualism among borrowers and lenders have already introduced a costly and uncertain environment that would be challenging to aggravate.[100]

Furthermore, our call for a return to a workable good faith standard has the potential to be met with at least some acceptance in the courts. In several pending cases that involve up-tier transactions, for example, plaintiffs have included that have raised good faith claims, and in at least some instances have shown a willingness to entertain them. A pair of ongoing cases, for example, involve an up-tier transaction by Serta Simmons Bedding LLC (Serta Simmons) – one before the New York State Supreme Court and the other before the U.S. District Court for the Southern District of New York. Certain non-participating lenders sued in state court arguing that the up-tier transaction ran against a waterfall provision in the contract because it impacted the *pro rata* share payouts written into the agreement, and other non-participating lenders sued in federal court arguing that the transaction breached the contract agreement. On the first, the state court refused to grant a preliminary injunction; but on the second, the federal court allowed the case to go forward past the motion to dismiss stage. The court focused on plaintiffs' argument that the transaction was not authorized under the "open-market purchase exception" and found the language was sufficiently imprecise as to block a decision in an early stage of litigation. More significantly, the court also found that the implied breach of covenant claims could proceed because the complaint sufficiently alleged that Serta Simmons "deprived [plaintiffs] of the benefit of their bargain in bad faith."[101] In so doing, the court directly opened the door to revive Judge Winter's proposition that the duty of good faith and fair dealing could have teeth in protecting creditors.

Additionally, in *ICG Global Loan Fund 1 DAC v. Boardriders Inc.*, the New York State Supreme Court agreed with the Southern District of New York's reading of the "open-market purchase exception" – it was open to additional interpretations, so the case could proceed past the motion to dismiss stage. No. 655175/2020 (N.Y. Sup. Ct. Oct. 9, 2020) (D.I. 160). The court specifically noted that it looked beyond the single provision to read the contract in full. Importantly, the court followed the Southern District of New York in *Serta Simmons* by upholding an implied duty claim on the basis of defendants actions "work[ing] in concert and in secret to deprive plaintiffs of the benefit of their bargain."[102]

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[100] At the same time, a return to good faith would affect at least one dimension of predictability: it would reduce the dependability with which strategic lenders and borrowers participate as players in the debt textualism chess game that they so gleefully price into their agreements. In the long run, however, more socially beneficial outcomes justify the sacrifice. The promise of a functionalist framework guided by the express terms of the contract, and running against them only if it will leave the parties better off, helps avoid the irrational outcome that courts are expected to hew so closely to a contract by expecting it will include every possible anticipated outcome as Judge Furman sought.

[101] Douglas S. Mintz, Ned S. Schodeka and Peter J. Amenda, "Recent Challenges To Uptiering Transactions," 41 American Bankruptcy Institute J. 32 (December, 2022). *North Star Debt Holdings LP v. Serta Simmons Bedding LLC*, No. 652243/2020 (N.Y. Sup. Ct. June 20, 2020) (D.I. 88). *LCM XXII LTD. v. Serta Simmons Bedding LLC*, 2022 WL 953109 (S.D.N.Y. Mar, 29, 2022).

[102] Mintz et al., supra note 101; *ICG Global Loan Fund 1 DAC v. Boardriders Inc.*, No. 655175/2020 (N.Y. Sup. Ct. Oct. 9, 2020) (D.I. 160)).

However, not all courts have manifested a renewed receptivity to hearing claims about good faith obligations. In *In re TPC Group Inc.*, non-participating lenders challenged a pre-bankruptcy up-tier transaction in the U.S. Bankruptcy Court for the District of Delaware. Lenders there similarly alleged both express and implied claims. As to the former, they argued that the up-tier impermissibly undercut their "sacred rights" associated with the waterfall procedures in the indenture. The bankruptcy court was not convinced by this claim, noting that while the plaintiff's proffered interpretations of the waterfall provision were plausible, the textualist approach would win out because "New York law provides that contractual language must be understood through the lens of the customs as generally understood in the particular business."[103] As to the implied good faith and fair dealing claims, the court dismissed them out of hand, finding that they were indistinguishable from a breach-of-contract claim.[104]

To the extent that courts continue to be more receptive to employing a good faith calculus in debt restructuring disputes, their efforts may also catalyze and facilitate private contracting endeavors too. As judges produce more case law applying a reconstituted duty of good faith and fair dealing, their collective efforts can establish a useful baseline for parties to assess whether (and how) to design their own express good faith obligations, potentially auguring further expansion and refinements of jurisprudence in the area.

C. Legislative and Regulatory Intervention

A third avenue for reform is through legislative and regulatory oversight. We argue that private equity's next phase will be defined by firms entering into increasingly complex debt contracts that ascribe to the principles of debt-textualism. If courts are able to intervene at the level of deciding which express terms are equitable in debt contracts, then there is an opportunity for Congress and financial regulators to intervene on the basis of which parties invest in private equity funds that then engage in highly leveraged transactions, i.e. the greatest drivers of the current rise in debt financing. Congress can expand regulatory agencies' authority to monitor debt markets and private-equity arrangements under both systemic risk and investor protection aims.

First, Congress and financial regulators are charged with protecting the public and the financial system from excessive and/or systemic risk. In the same way that the interconnectedness of financial institutions deemed "too big to fail" can lead to across the board economic downturns as one failing firm brings the others down, some similarities may carry over here: here in the form of common boilerplate contract terms for complex deals between and involving these institutions. Legislators and regulators are equipped with unique intervention points in the financial system, so long as the political will to act is present. Boilerplate language that is copied and pasted across most, if not all, debt deals presents the risk that when one deal is tied up with the money of a large syndicate of lenders triggers a default, liquidity dries up quickly throughout the rest of the system. Increased avenues for borrower opportunism here leaves creditors (those same large financial institutions) at the whim of borrowers manipulating those same contract terms. The existence of these readily manipulable terms is by definition a form of systemic risk; the strategic manipulation of a boilerplate term in a single contract involving any major institution has automatic effects on the interpretation of the same term in other indentures. Congress and financial

[103] *In re TPC Grp. Inc.*, No. 22-10493 (CTG), 2022 WL 2498751 (Bankr. D. Del. July 6, 2022), at *11.
[104] For a more thorough description, *see* Randall Klein, "Lender Liability Management: Restoration of the Duty of Good Faith," Goldberg Kohn (Apr. 22, 2022), available at https://www.goldbergkohn.com/newsletter-138.html.

regulators should focus on the possibility of infected terms in one indenture impacting the status of other indentures so as to reduce systemic risk before it bubbles over.

The broader conversation about private equity's role in increasing systemic risk to the financial system centers on its fast and loose management practices and keen focus on increasing its payout through dividends without protecting workers in the companies these firms acquire and manage. It is a seemingly private practice – the purchase, management, and eventual sale of companies that take on distressed debt for the private equity firm – with a public impact on working families.

However, scholars have suggested that the public may be more involved with private equity transactions than is traditionally understood in the form of pension plans' investment in private equity funds.[105] Public pension plans have grown to be the largest investors in private equity, seeking a return in what has been a low-interest rate environment. The uniquely public nature of pension plans, guaranteed by taxpayers, has introduced greater government scrutiny into the activities of private equity funds and opened the door for regulators to analyze excessive risk-taking in the market.[106] These funds are in many ways tied to the retirement funds of average people, in addition to public pension plans, and retail investors by way of mutual funds investing in firms that utilize corporate debt to conduct risky transactions are also impacted in the event of a market downturn.

Corporate debt is a complex product of uncoordinated market forces responding to the courts' embrace of debt-textualism. Corporate debt is also subject to the limits imposed by legislators and regulators who can define and coordinate the permissible bounds of risk-taking by companies raising their funds through institutional and large public investors. In a market where even senior corporate debt, a supposedly safe vehicle for risk-intolerant investors, might be no less risky than transparently speculative bets (much of which is used for leveraged buy-outs by private equity firms),[107] Congress has a role to play to protect the public interest. The *Stop Wall Street Looting Act*, introduced in the Senate by Senators Warren, Brown, and Baldwin, is one attempt to address excessive risk-taking and gaming of the financial system by private equity firms.[108]

Additionally, investor protection is another policy mandate that legislators and regulators should prioritize to evaluate risk accumulation in debt markets. While borrowers entering into syndicated and private loan agreements are generally sophisticated institutional investors, these instruments have operated outside the scope of disclosure requirements that apply to other financial instruments for a long time. This is in part by design – disclosure requirements apply to instruments labeled as "securities" and applying that label to complex debt instruments would upend lending as we know it.[109] At the same time, with little to no sunlight to disinfect this market of excessive risk-taking (whose market actors are the same ones that helped spawn shadow banking) investors are left in the dark about how much risk these

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[105] *See* William W. Clayton, *How Public Pension Plans Have Shaped Private Equity*, 81 Md. L. Rev. 840 (2022).
[106] New proposed rulemaking by the SEC seeks to address investor protection for pension funds. *See* https://www.sec.gov/news/press-release/2022-19.
[107] Regulators have also focused on systemic risk arising out of the syndicated loan market in recent years. *See* https://www.ft.com/content/04352e76-d792-11e8-a854-33d6f82e62f8.
[108] For a summary of the proposed bill text and section-by-section analysis, *see* https://www.warren.senate.gov/newsroom/press-releases/warren-baldwin-brown-pocan-jayapal-colleagues-reintroduce-bold-legislation-to-fundamentally-reform-the-private-equity-industry.
[109] This is a live question – the Millennium Health case is still being decided on appeal. *See also* Joel Crank, *Note: Rethinking* Kirschner v. J.P. Morgan: *How Securities and Banking Laws Should Apply to Syndicated Loans*, 93 Col. L. Rev. 1095 (2022).

investments actually entail and exactly how intertwined these loans are with the financial future of particular firms and companies.

While publicly-traded companies regularly disclose contract terms as offered in new instruments, whose details are available on EDGAR,[110] no comparable requirements exist for privately-traded companies. Congress providing a new category of instruments or companies subject to such disclosure, either by expanding the scope of the term "security" to cover this form of debt or requiring some similar disclosure requirements for private companies, would open the door for investors (many of which are public entities) to better monitor risk-taking behavior *ex ante* rather than *ex post* through bankruptcy proceedings. Regulatory scrutiny has the potential to help stabilize the cycle of leveraged lending to leveraged buyouts and would allow investors, even highly sophisticated ones, to better assess the nature and vulnerabilities of their front-end investments.

Of course, congressional and executive oversight of the debt markets could lead to further confusion and unpredictability for investors, creditors, and borrowers. Additional requirements by Congress and regulators could be viewed as burdensome express contractual fixes and invite disputes about their interpretation – addressing the problem in the short/medium term, but inviting later opportunism and greater borrowing costs by market participants as they learn to outflank legislative and regulatory mandates.

D. Marshal Debt Textualism for the Greater Good

Even when it is in judges' and policymakers' jurisdiction, legal and policy changes take time. More often than not, a lot of time. It would be exceedingly optimistic (and borderline naive) to believe that courts, legislators or regulators will act with alacrity and immediacy to disarm debt textualism. As a consequence, we may be stuck functionally with the first option for reform delineated above to "doing nothing" and let markets solve the problem. It is worth considering how the dysfunctions of debt textualism might be deployed for a greater, if somewhat uneasy, good.

We will briefly take a far more speculative turn before closing with a conjecture about one area where the intractability of debt textualism may be a catalyst for progress: climate change commitments. Climate advocates and commentators have for years advanced hopeful arguments that corporate actors may take it upon themselves to reduce greenhouse gas emissions, urging institutional investors, corporate officers, and securities regulators to help contribute to the effort. Animating much of this effort is the view that outside providers of capital have strong and consistent preferences to invest in companies that balance generating returns with environmental stewardship. Skeptics, however, have repeatedly noted that climate-change commitments by for-profit corporations are often little more than toothless greenwashing. Even when commitments have real teeth, they are only as durable as the green interests of their equity investors – prone to buckling easily if shareholders experience a weakness of the will or mission drift and begin to (once again) emphasize investment returns.[111]

Anticipating these problems of shareholder and corporate commitment, commentators have suggested structural means by which meaningful commitments to decarbonization can also be made durable, by way of a contractual incentive (or "green pill") that visits adverse consequences on a

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[110] See, e.g., Talley, *Discharging,* at 200-5 (chronicling the rise of "Revlon Blocker" provisions in corporate loan agreements and bond indentures).

[111] See, e.g., Lucian Bebchuk & Roberto Tallarita, The Illusory Promise of Stakeholder Governance 105 Cornell Law Review 91 (2020).

corporation if it fails to meet its climate reduction goals.[112] Certain types of green pills seem to be easily frustrated – particularly when entered into with corporate shareholders, who may later change their allegiances to maximizing returns, and thereby become complicit in undoing the corporation's commitments. A far better beneficiary of a green pill, in our view, is a third party whose incentives, augured by institutional reinforcement, are to hold corporate actors rigorously accountable to the very letter of their climate pledges.[113] Climate-related covenants baked into corporate debt (via so-called "green" bonds), may have a leg up on equity-related commitments, precisely because of the intractability that debt textualism foments. Returns-oriented hedge funds might be anxious to take a position in such instruments, *particularly* if they believe that the borrower corporations are prone to changing their mind later. It is exactly that prospect that gives the holders of the climate-covenanted debt a credible threat. While nothing prevents debt holders from coming back to the table to cut climate commitments out of their contracts, the current strategic posturing that surrounds, and often frustrates, such restructuring efforts may be a beneficial source of friction when it comes to climate undertakings. Encouraging effective green covenants in corporate debt instruments (such as subsidizing the activity with tax incentives) may be one of the most effective paths to their durability—one salvaged by the most unlikely of heroes: debt textualism.[114]

V. Conclusion

The increasing complexity and fractiousness of credit markets (fueled in no small part by private equity and distressed debt investing) are a major cause for concern among direct market participants as well as broader corporate and economic stakeholders. In this paper, we identify an important doctrinal co-conspirator that we argue helped bring about our current state of affairs: the embrace and wide scale acceptance of debt textualism as the principal means for interpreting corporate debt contracts. Sophisticated financial actors have devised decades-in-the-making strategies predicated on gaming textualism, and their interactions increasingly play out beyond public scrutiny and introduce appreciable costs and systemic risk concerns with potentially large private and public implications. Our contribution has aimed to go beyond merely isolating debt textualism as a key driver of this trend, but also to suggest various arenas for reform and even a way to salvage some additional benefits of debt textualism in its current state. Even if we're all textualists now—at least *for the moment*—we still have the tools at our disposal to free ourselves from this interpretive regime and to regain some semblance of (good) faith.

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112 See, e.g., Armour, John and Enriques, Luca and Wetzer, Thom, Green Pills: Making Corporate Climate Commitments Credible (December 1, 2022). European Corporate Governance Institute - Law Working Paper No. 657/2022, Available at SSRN: https://ssrn.com/abstract=4190268.

113 See Armour et al, *supra,* at 41-32; Nakita Cuttino, Private Debt for Public Good (2022 working paper).

114 It is worth noting the caveat that even as debt textualism invites strict enforcement by the holders of debt, it may also invite strategic manipulation by borrowers (particularly for instruments affected by financial distress). See text accompanying notes 66-72, *supra*. Such a fate could also theoretically befall credit agreements with climate covenants, too. Viewed from this perspective, debt textualism may be most helpful in green finance for companies that are not bordering on distress, or alternatively for more senior tranches of debt with strong anti-subordination prohibitions and collateral protections.

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