# *Article*

# Debt as Corporate Governance

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*Corporate law is dominated by an equity-only view of corporate governance that centers on management-shareholder dynamics. This Article expands the management-shareholder paradigm by developing a novel integrated theory of corporate governance that fully accounts for the firm's debt. To that end, the Article carries out a comprehensive analysis of debtholders' influence on how the firm runs its affairs. This analysis reveals that debt does not merely function as a discipliner. Rather, debt forms an integral part of the ownership and governance structure of the firm through the covenants that debtholders routinely contract for. These covenants create poison pills and other change-of-control and board restrictions, as well as restrictions on debt incurrence, asset transfers, and cash transfers such as dividends. Armed with these covenants, and the default and refinancing costs the covenants impose on the firm, the debtholders control the firm's operations and management along several dimensions.*

*This Article develops the theoretical underpinnings of debt as corporate governance and then moves on to map out the standard debt covenants and their effect on the firm. Building on this integrated account, this Article updates the narrow equity-only view of the firm and demonstrates that perceiving corporate debt mechanisms as a governance system advances our understanding of pressing issues such as corporate social responsibility, interstate and federal corporate law competition, and the role of institutional investors.*

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## INTRODUCTION

This Article highlights an underappreciated connection between debt and corporate governance. For many of the S&P 500 companies and beyond, corporate governance does not lie entirely between the hands of shareholders and the board. Rather, corporate governance has been contracted away, to a significant degree, to lie between the hands of debtholders and the board. While the disciplinary and signaling impacts of debt have long been observed, as well as the corporate governance impact of debt covenants,[1] a fully-fledged, integrated account of the role of debt in corporate governance has been left to lurk in the shadows of the debt markets. The prism through which academic literature analyzes corporate governance consists predominantly of equity holding as opposed to debt. This prism, identified in this Article as the "equity-only" paradigm, downplays the real-world effect of the firm's debt and debt-covenant packages on corporate governance. Under this conventional paradigm, rather than incorporating debtholders as active, equal, and direct participants in corporate governance, debt is either viewed as a monitoring, disciplinary, or otherwise sporadic force,[2] or, as in the finance literature, is analyzed in the

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1. *See, e.g.*, ASWATH DAMODARAN, APPLIED CORPORATE FINANCE 329 (Joel Hollenbeck et al. eds., 4th ed. 2015) (articulating the disciplinary role of debt over the life cycle of a firm); Victoria Ivashina, Vinay B. Nair, Anthony Saunders, Nadia Massoud & Roger Stover, *Bank Debt and Corporate Governance*, 22 REV. FIN. STUD. 41, 41–77 (2009) (arguing that bank debt has a disciplinary role and is more likely to be found in companies when the likelihood of takeover increases); Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 REV. FIN. STUD. 1713, 1715–16 (2012) (providing empirical evidence that creditors impact corporate governance and enhance firm value); Joseph E. Stiglitz, *Credit Markets and the Control of Capital*, 17 J. MONEY, CREDIT, & BANKING 133, 140–45 (1985) (arguing that shareholders depend, in part, on the debtholder's monitoring of management); George G. Triantis, *The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines*, 16 INT'L REV. L. & ECON. 101, 104–08 (1996) (explaining impacts of debtholders on managers at or near bankruptcy); Eugene F. Fama & Michael C. Jensen, *Organizational Forms and Investment Decisions*, 14 J. FIN. ECON. 101, 113 (1985) (arguing that debt acts as a disciplinary mechanism that reduces agency costs). *See generally, e.g.*, Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984) (noting the impact of debt issuances on the ability to pay dividends); George G. Triantis, *The Motivational Implications of Debt Financing* (Univ. Va. Olin Program in L. & Econ., Working Paper No. 97-10, 1997), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=10489 (arguing that debt usefully provides managers with ex ante goals, but at the expense of potential ex post social harm); Mara Faccio, Larry H.P. Lang & Leslie Young, Debt and Corporate Governance (Jan. 10, 2001) (unpublished manuscript), https://www.researchgate.net/profile/MaraFaccio/publication/228419088_Debt_and_Corporate_Governance/links/0912f51238692e808c000000/Debt-and-Corporate-Governance.pdf (arguing that debt facilitates the exploitation of minority shareholders in European and Asian corporations).

2. For important works that took the first step toward understanding the role of debt in corporate governance, see generally, for example, Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP. L. 641 (2009) (presenting the impact of debt on agency costs and corporate governance as well as how that impact developed over time in various debt structures given the rise in liquidity in the credit markets); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115 (2009) (explaining the pervasiveness and influence of private debt on corporate governance and assessing its impact, even outside of financial distress);

context of agency costs and capital structure.[3] Either way, the conventional paradigm glosses over an important dynamic taking place in every mature company that raises a portion of its capital through debt and not just through equity. A firm's debt is not just a cost mitigator, discipliner, and enforcer, but also an integral part of corporate governance mechanics.

Driven by this insight, this Article develops a novel integrated account of debt as corporate governance. First, this account highlights the critical influence of debt on corporate governance theory and practice. Second, this Article analyzes the covenants that create "poison pills" and impose restrictions on control rights and board composition, as well as covenant restrictions on debt incurrence, asset sales, dividends, and other cash transfers. Building on this integrated account, this Article demonstrates that perceiving corporate debt mechanisms as a corporate governance system advances the understanding of current issues such as corporate social responsibility (CSR); environmental, social, and governance (ESG) initiatives; interstate and federal corporate law competition; and the role of institutional investors. With debt levels that near, meet, or exceed equity levels,[4] many of the S&P 500, along with similarly situated public and private companies, have not only reengineered their capital structure, but have also relinquished much of their control over management to debtholders.

Corporate governance rights and concerns originate from the separation between ownership (shareholders) and control (management).[5] However, as firms mature, incur debt, and refinance over time, they transfer many corporate

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George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073 (1995) (arguing that corporate governance should be viewed as an interactive scheme involving all stakeholders, including debtholders in particular); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006) (calling for a better understanding of how private debt plays into corporate governance).

3. In the finance literature on the agency costs of a corporation, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976), is a seminal work that analyzes the agency costs of a corporation by looking at both equity and debt financing. Jensen and Meckling modeled these costs in an effort to create a method that a firm can use to determine its optimal use of outside equity and debt financing given the agency costs. *See id.* at 305–07. Regarding the implication on corporate governance, however, Jensen and Meckling explain that since their model left voting rights out of the picture, they left stockholder agency costs vis-à-vis outside ownership claims for future research. *Id.* at 351–52. The Jensen and Meckling model paved a path in corporate literature that divided the goals of corporate finance literature and corporate governance literature. While the financial or capital structure literature attempts to solve for all outside financings (both equity and debt), the corporate governance literature attempts to solve for equity financings only. However, as explained below, *see* discussion *infra* Part I.B, this is an incorrect understanding of corporate governance as the contractual rights of debtholders also amount to corporate governance rights. One part of the motivation behind this Article is to unite the corporate governance and corporate finance literature.

4. For more financial ratio information, see *S&P 500 Financial Strength Information*, CSIMARKET, https://csimarket.com/Industry/industry_Financial_Strength_Ratios.php?sp5 (last visited May 12, 2023).

5. *See generally* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Jensen & Meckling, *supra* note 3.

governance rights and powers to debtholders. The more debt a company incurs, the stronger the leverage the debtholder has over the company's management. The power of debtholders lies in the covenants they contract for and in the costs a company must incur when defaulting on or refinancing the debt. While debt contracts are not the same as charter-based governance rights shareholders receive, debt contracts fundamentally differ from a company's day-to-day operation contracts because debt contracts generate substantial governance power and leverage that allow the debtholders to control the firm. If the corporate charter makes up the body of corporate governance, the company's debt contracts determine whether this body will stay alive by controlling the supply of vital financial oxygen to the company.

Driven by the analysis stemming from the separation between ownership and control, the corporate governance literature has centered around examinations of agency costs.[6] Predominately, the agency-cost analysis has focused upon legal mechanics that minimize management-induced costs arising from misalignments between the interests of a company's managers and its ultimate owners: the shareholders.[7] Recently, our understanding of corporate governance has also extended to expressly include the principal costs, namely, the costs brought about by shareholders' ill-taken decisions.[8] The total sum of agency and principal costs can thus be conceptualized as control costs.[9] In tune with this conceptualization, works analyzing control costs and suggestions on how to reduce them fall into the equity-only paradigm of corporate governance.[10] Under this conventional paradigm, a company's governance structure, with all its strengths and weaknesses, is fully determined by what the company's equity holders and their agents do.

This Article revisits and revises the equity-only paradigm by drawing scholars' and policymakers' attention to the fact that control costs—the total sum of the agency and principal costs—are both increased and decreased by the dynamics engendered by the company's debt structure and its underlying contractual mechanisms. Almost all companies have debt, and not just equity. Modern debt facilities, analyzed by this Article, are both pervasive and impactful in mature companies. Those facilities do not simply reduce control costs by imposing limits on what shareholders and management can do. They also interject into the company's governance structure a complex and expansive web of contractual rules and incentives that altogether alter the control-costs analysis.

6. *See* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 769 (2017).

7. *Id.*

8. *Id.* at 770.

9. *Id.*

10. *Id.* at 767–70.

In the pages ahead, this Article carries out a comprehensive analysis of this dynamic. As part of this analysis, the Article examines the standard covenant structures in prevalent corporate debt instruments and their increasingly liquid secondary markets.[11] These core covenant structures include bank credit facilities, secured notes, and senior unsecured notes as well as the subdivision of each across high-yield issuer, investment-grade issuer, and registered and unregistered notes. By unpacking these essential covenant structures, this Article identifies the typical impacts of debt upon corporate governance and develops the analytical tools for carrying out the conceptual integration of debt facilities in governance structures. Specifically, this Article shows how debt facilities influence and constrain the actions of both management and shareholders to protect debtholders' interests, which may or may not align with the interest of the company.

Additionally, this Article demonstrates that the impact of debt and debt facilities on corporate governance explains the declining influence of Delaware and other state laws on a company's affairs[12] and the ever-increasing influence of federal law via banking and securities regulation.[13] This Article also reveals that debt provisions creating "poison pills" and other change-of-control restrictions help explain the ebbs and flows of hostile takeovers.[14] Furthermore, the debt perspective helps explain why the impact of institutional ownership on corporate governance is more pervasive and profound than commonly understood.[15]

These factors and phenomena fall into what this Article identifies as the "debt as corporate governance" paradigm. On the normative side, the debt as corporate governance paradigm provides reasons for defining the corporate purpose as including more than just stockholder value maximization. The pivotal role of debtholders favors the adoption of the broad notion of "stakeholderism"[16] and singles them out as players instrumental for accomplishing pressing CSR and ESG goals. Not only do debtholders act de facto as corporate governance players, but modern debt instruments also have proved particularly useful in

11. This examination is as compared to the period before the development of Rule 144A, 17 C.F.R. § 230.144A (2022), and the advent and resurgence of collateralized loan obligations ("CLOs").

12. For the seminal discussion of this phenomenon, see generally Zohar Goshen & Sharon Hannes, *The Death of Corporate Law*, 94 N.Y.U. L. REV. 263 (2019).

13. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 596–98 (2003).

14. For a recent analysis of the reduction and subsequent uptick in hostile takeovers, see Kai Liekefett, *The Comeback of Hostile Takeovers*, HARV. L. SCH. F. CORP. GOVERNANCE (Nov. 8, 2020), https://corpgov.law.harvard.edu/2020/11/08/the-comeback-of-hostile-takeovers/.

15. For analysis of the impact of institutional ownership on corporate governance, see generally Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89 (2017).

16. *See* Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 108–11 (2020).

bringing about changes beneficial to society at large.[17] The meteoric rise of social and sustainable linked bonds, which in 2020 grew by 29% to a whopping record of $732 billion,[18] illustrates this phenomenon.

This Article proceeds in three Parts. Part I lays out the theoretical foundation of the debt as corporate governance paradigm. Part I also scrutinizes the conventional equity-only paradigm of corporate governance, identifies its limits, and then presents the integrated debt-and-equity model of corporate governance. Part II transitions from theory to description and utilizes the debt as corporate governance paradigm to explain the role of debt and debt facilities in contemporary corporate governance structures. This Part is accompanied with appendices tabularly summarizing the various debt covenants and their associated terms of art. Finally, Part III applies the debt as corporate governance paradigm to explain diverse corporate phenomena such as the decline of state laws, federalization, and the increasing influence of institutional investors. In turn, Part III identifies debtholders' potential to facilitate socially beneficial reconfigurations of the corporate purpose as well as the advancement of CSR and ESG goals.

## I. DEBT AND THE FIRM

Corporate governance law, policy, and scholarship uniformly focus on the separation of ownership and control.[19] This focus manifests in scholars' almost exclusive analysis of the costs originating from the misalignment of interests between the managers of a company and the company's shareholders.[20] Until recently, corporate governance analysis centered around reducing agency costs: the company's and its shareholders' losses brought about by managerial misconduct.[21] This equity-only paradigm was subsequently expanded to account for principal costs: the company's losses brought about by shareholder incompetence and conflicts of interest, which also need to be minimized.[22] This paradigm of corporate governance is unquestionably right in many important respects. Yet it does not capture the entire picture of corporate governance. Specifically, it fails to capture the debt side of the capital structure. Debtholders also exercise powerful and entrenched corporate governance powers due to their operational impact and economic leverage over the firm, which are all contracted for in debt covenants. The debtholder corporate governance control and its private and social costs and benefits must consequently be incorporated into a

17. *See infra* Part III.C.

18. *See Pandemic Helped Push Global ESG Bond Market To Record*, BLOOMBERG NEWS (Jan. 11, 2021), https://www.investmentnews.com/pandemic-helped-push-global-sustainable-bond-market-to-record-201114.

19. *See* sources cited *supra* note 5.

20. *See* sources cited *supra* note 5.

21. *See supra* notes 6–10 and accompanying text.

22. *See* Goshen & Squire, *supra* note 6, at 770.

comprehensive corporate governance model that accounts for both equity and debt.

### A. The Equity-Only Paradigm

Corporate governance starts with the separation between ownership and control.[23] The shareholders own the firm, and the board members (and the officers they appoint) manage the firm. This separation results in both benefits and costs for shareholders and managers. The benefits a corporation accrues from the separation of ownership and control come from the corporation's ability to realize the gains from trade between shareholders and managers.[24] The shareholders can invest their money in a revenue-generating activity managed by experts, and in exchange, the managers can both finance their business and reduce their financial risk in carrying out the business.[25] Corporate governance theory, law, and policy focus rather narrowly on the costs of the separation between ownership and control.[26] These costs stem from both an inevitable and unintended consequence: the interests of the owners and the interests of the managers do not always align.[27] When such a misalignment in interests occurs, and the managers' business decision serves the managerial interest at the expense of shareholders' interests—or, alternatively, when the company must incur costs to prevent such decisions—the costs imposed are called agency costs.[28] For obvious reasons, agency costs reduce the value of the firm.[29]

Accounting for agency costs as affecting the value of the firm is the *ne plus ultra* of corporate law, policy, and scholarship. Over the last fifty years, corporate governance statutes, as well as common law and policy analyses, have

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23. *See* sources cited *supra* note 5.

24. For a more detailed discussion on the benefits of the separation of ownership and control, see Stephen G. Marks, *The Separation of Ownership and Control*, *in* 3 ENCYCLOPEDIA OF LAW AND ECONOMICS: THE REGULATION OF CONTRACTS 694–95 (Boudewijn Bouckaert & Gerrit de Geest eds., 2000).

25. *Id.*

26. *See supra* notes 6–10 and accompanying text.

27. This misalignment in interest has been observed since at least the eighteenth century:

> The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

ADAM SMITH, THE WEALTH OF NATIONS 700 (Edwin Cannan ed., 1937).

28. For the seminal, but not the first, article utilizing the term, see Jensen & Meckling, *supra* note 3, at 308.

29. *Id.* at 313.

focused on developing mechanisms for reducing agency costs.[30] As has long been acknowledged by both policymakers and scholars, reducing agency costs is a delicate process because managers' exercise of their expertise should not be curtailed, and their risk-taking decisions that might be good for the company should not be depressed.[31] The balancing act of corporate governance has thus transformed into an analysis surrounding a common question: how should we reduce agency costs while properly taking into account the right measure of deference to the managers who are the experts at running the firm?

To illustrate, consider the typical problem of short-termism. As is often argued, at times directors of a corporation choose to boost the corporation's revenues in the short term even when it reduces the value of the corporation and shareholders in the long term.[32] This short-termism may, in some cases, be attributable to poorly designed management compensation systems; in other cases, it may be due to irrational or boundedly rational reasons such as managerial myopia.[33] Regardless of the reason underlying the short-termism, it is an undesirable consequence and an agency cost since the managerial decision does not align with the interests of the corporation and its shareholders. Policymakers and commentators have, therefore, proposed a set of corrective measures to reduce this cost.[34]

As indicated in the preceding paragraphs, however, when a lawmaker intensifies shareholder control over corporate affairs to reduce managerial

30. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2023) (prohibiting a provision in a certificate of incorporation that eliminates or limits a director's personal liability due to a breach of the duty of loyalty); Loft, Inc. v. Guth, 2 A.2d 225, 245–46 (Del. Ch. 1938) ("Directors who either through friendship for the president of a corporation or for fear of his displeasure or for any other reason, authorize him to use the corporate resources committed to their management or control for the promotion of his own personal projects, are participants in a fraud."); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 842 (2005) (arguing for a revamp of shareholder power to empower self-protection from managerial decisions).

31. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) ("The business judgment rule . . . is a *presumption* that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." (emphasis added)).

32. *See, e.g.*, Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655, 664 (1989) (arguing that managers may be inefficiently focused on the short term even when operating in efficient capital markets).

33. *See* Goshen & Squire, *supra* note 6, at 788 (discussing managerial competence issues); *see, e.g.*, Alfred Rappaport, *The Economics of Short-Term Performance Obsession*, 61 FIN. ANALYSTS J. 65, 77 (2005) (arguing that incentive fees must be altered in order to encourage long-term thinking on the part of managers).

34. These proposals exist in every article cited herein. Additionally, the following are some of the most recent examples of such proposals as of the time of this Article's publication: Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771, 1772 (2020) (arguing that corporate governance is better when index funds are able to vote their shares); Henry T.C. Hu & John D. Morley, *A Regulatory Framework for Exchange-Traded Funds*, 91 S. CAL. L. REV. 839, 900–34 (2018) (offering an integrated regulatory framework for ETF shareholders); Yaron Nili & Cathy Hwang, *Shadow Governance*, 108 CALIF. L. REV. 1097, 1105–08 (2020) (identifying non-charter-based corporate policy commitments as potentially problematic due to the shareholder's inability to control them).

agency costs, it creates a new set of costs. As mentioned above, a recent and pathbreaking contribution to the corporate governance literature has identified these costs as principal costs.[35] Principal costs ensue when shareholders exercise control over a corporation in a way that does not align with the interests of the corporation as a whole.[36] Revisiting our short-termism example, if we empower shareholders to force managers to reinvest profits for long-term prospects, we may incentivize shareholders' ill-advised preference of long-term profits at the expense of the corporation's value.[37] In some cases, this preference may be motivated by rational and self-interested reasons such as pre-committed holding periods.[38] In other cases, however, shareholders may form this preference on irrational or boundedly rational grounds such as overoptimism and sunk cost motivations.[39]

To sum up, the currently dominant equity-only paradigm of corporate governance accounts for both agency costs and principal costs. Correspondingly, this paradigm focuses corporate governance rules, both external and internal to the company, toward minimizing control costs,[40] the total sum of agency and principal costs. As the next Subpart demonstrates, however, this conception of control costs is incomplete because it fails to account for both the positive and negative impacts of debt covenants on corporate governance.

### B. The Role of Debt in Corporate Governance

Debt facilities and their covenants extensively impact the operations of the firm. Due to debt's economic leverage over many firms, debtholders exercise substantial corporate governance powers across the board. Although the effect of debt on the company's affairs has not gone completely unacknowledged,[41] academic literature has yet to develop an integrated account of how different debt facilities and covenants modify the very structure of corporate governance and the control-costs equation. The reason for this inattention to debt as governance is twofold. First, corporate scholars generally assume a separation

35. *See* Goshen & Squire, *supra* note 6, at 796–808.

36. *Id.*

37. *See, e.g.*, Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1554–1627 (2015) (arguing that managers serving long-term shareholders may destroy firm value more than managers serving short-term shareholders, in some circumstances); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 78 (2003) (arguing that certain shareholders have different time horizons that may conflict with the best interests of the corporation).

38. *See, e.g.*, Fried, *supra* note 37, at 1567–70.

39. *See* Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CALIF. L. REV. 1051, 1091–95, 1124–26 (2000) (discussing overconfidence and sunk costs).

40. *See* Goshen & Squire, *supra* note 6, at 783–89.

41. *See supra* notes 1–6 and accompanying text.

between corporate control rights and corporate cash-flow rights.[42] Second, corporate governance literature tends to pull together all non-charter-based contracts of the company.[43] As a result, it fails to distinguish between run-of-the-mill contracts of operation and non-charter-based *structural agreements*.[44] This inattention has created a gap in the literature that this Article attempts to fill. Debt facilities form a distinct category of the firm's structural agreements: they provide debtholders with contractual rights and powers that give them the economic leverage and operational say-so that transform into de facto corporate control powers. As a matter of legal formality, charter-based control rights and powers take precedence over other contractual entitlements.[45] However, the functional and financial realities of the firm brush all such formalities aside.

Debt facilities are typically contracts for cash injections into the company in exchange for the promise to return the money and pay interest at a later date.[46] The time separating the first cash injection by the debtholder from the last installment repayment by the borrower is the lifetime of the debt facility.[47] As part of the debt contract negotiation, lenders or debtholders negotiate for covenant packages that apply during the lifetime of the debt facility.[48] A debt facility's covenant package determines the facility's operational impact on the firm. The facility's economic leverage on the firm equals the cost the firm incurs when it defaults on the covenant package or, alternatively, when it is forced to

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42. *See, e.g.*, Jennifer Francis, Katherine Schipper & Linda Vincent, *Earnings and Dividend Informativeness when Cash Flow Rights Are Separated from Voting Rights*, 39 J. ACCT. & ECON. 329, 330–31 (2005); Cécile Casteuble & Nadia Saghi-Zedek, Control Rights Versus Cash-Flow Rights, Banks' Shareholders and Bondholders Conflicts: Evidence from the 2007 - 2010 Crisis (Feb. 2015) (unpublished manuscript), https://www.researchgate.net/publication/271828151_Control_rights_versus_cash-flow_rights_banks%27_shareholders_and_bondholders_conflicts_Evidence_from_the_2007-2010_crisis; *cf.* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 811 (2006) ("The coupling of votes and shares makes possible the market for corporate control.").

43. This can be seen from the general lack of corporate governance analysis of contracts other than the certificate of incorporation or bylaws. This is not the case in a recent pioneering article by Jill E. Fisch, which provides the first full analysis of shareholder agreements in this context. *See generally* Jill E. Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering*, 99 WASH. U. L. REV. 913 (2021).

44. *See generally id.*

45. Airgas, Inc. v. Air Prods. & Chems., Inc., 8 A.3d 1182, 1189 (Del. 2010) ("It is settled Delaware law that a bylaw that is inconsistent with the corporation's charter is invalid.").

46. Other forms of debt may also include zero-coupon debt (debt facilities with no interest rates), payment-in-kind facilities (debt facilities where borrowings are repaid in the form of something other than cash), and other, more exotic forms of borrowings. For purposes of illustration and ease of reference, this Article refers to this most basic and typical form of borrowing.

47. DAMODARAN, *supra* note 1, at 140–44.

48. In practice, debt agreements are often negotiated by a representative or an initial debtholder before the debt interest is ultimately transferred to its beneficial owners. The main covenants of corporate bonds, for example, are negotiated via the broker-dealer entity that markets the bonds to bond investors and their counsel. Thereafter, these terms are coupled with a longer set of generally boilerplate provisions, which are subsequently agreed to in an indenture that is negotiated between a trustee and the issuer-borrower.

repay or refinance the debt.[49] More often than not, the firm is either unable or unwilling to incur this cost. To avoid this cost, the firm consequently must comply with the terms set by the covenant packages. The corporate governance impact of debt stems from its demanding, and often intrusive, operational requirements and the tight economic leverage it exerts on the company and its officers.

Operationally, typical debt facilities include covenant packages that restrict board composition and change control events, asset transfers, and cash transfers such as dividend payments.[50] These covenants impact control rights and the composition of the board, its procedures, the management and liquidity of assets, and the firm's total reinvestment rate.[51] The firm's total reinvestment rate is a measure of the firm's ability to choose between reinvesting revenues for future returns, delivering the revenues to equity-holders or debtholders, and holding the revenues on the balance sheet.[52]

The nexus between the firm's total reinvestment rate and corporate governance can thus hardly be overstated. The reinvestment rate indicator can take the firm up, and it can also take it down.[53] Total reinvestment rate is the main proxy for measuring what returns will be provided to investors in the short term versus the long term.[54] This factor makes reinvestment rate the focal point of many of the most impactful corporate governance controversies. For example, going back to the abovementioned short-termism illustration, an investigation as to whether management is exhibiting myopia first begins with an inquiry into the firm's total reinvestment rate. The investor or analyst embarking on that investigation will first figure out how much of the revenue is shared with shareholders on an immediate basis (via dividends[55] or share buybacks) and how much is being reinvested in the firm's future returns (for example, by investments in research and development or capital expenditures). Unsurprisingly, therefore, investors and analysts alike use the firm's total reinvestment rate as one of the most important financial indicators for their

49. This is because it represents the amount of money that it would take to rationally ignore or adhere to the repercussions and demands of the debt facility.

50. *See infra* Part II.

51. *Id.*

52. DAMODARAN, *supra* note 1, at 539.

53. *Id.*

54. This is embedded in the very definition of the rate, which is as follows: *Reinvestment Rate = (Capital Expenditures – Depreciation + Change in Working Capital) / Earnings Before Interest and Tax * (1 – Tax Rate)*. Aswath Damodaran, *The Fundamental Determinants of Growth*, NYU STERN SCH. BUS., http://pages.stern.nyu.edu/~adamodar/New_Home_Page/valquestions/growth.htm (last visited May 12, 2023).

55. For two important works on dividend policies in this context, see generally Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881 (1995); Easterbrook, *supra* note 1.

decisions.[56] These decisions in turn affect the drafting and contents of the debt facility covenant packages.

Together with the impact on control rights, the board, and the firm's assets, the typical modern covenant package contains well-articulated rules and limits on the most important aspects of corporate governance: what a firm may do with its assets and revenues, and who gets to decide—hence, the omnipresent nexus between the firm's debt and its total reinvestment rate. Combining this understanding of the total reinvestment rate with the impact that debt has on control rights and board composition is illuminated by the following statement from the Delaware Chancery Court:

> [C]orporations and their counsel routinely negotiate contract terms that may, in some circumstances, impinge on the free exercise of the stockholder franchise. In the context of the negotiation of a debt instrument, this is particularly troubling, for two reasons. First, as a matter of course, there are few events which have the potential to be more catastrophic for a corporation than the triggering of an event of default under one of its debt agreements. Second, the board, when negotiating with rights that belong first and foremost to the stockholders (i.e., the stockholder franchise), must be especially solicitous to its duties both to the corporation and to its stockholders. This is never truer than when negotiating with debtholders, whose interest at times may be directly averse to those of the stockholders.[57]

In this case, *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, the Delaware Chancery Court, in a decision that was later affirmed by the Delaware Supreme Court,[58] provided a virtually explicit recognition of the tripartite corporate governance system—a system consisting of shareholders, management, and debtholders.[59] This system commendably departs from the conventional equity-only paradigm of corporate governance. Just as importantly, the Chancery Court's holding also acknowledges the costs brought about by the conventional paradigm.[60] The court signaled this recognition as part of its ruling that a board does not necessarily violate its duty of care by adopting a debt indenture provision that deems any change in the majority of directors an event of default on the debt.[61] However, as also explicitly acknowledged by the court, a provision with such a dramatic effect upon corporate governance impedes rights that at first belonged to the

56. *See* DAMODARAN, *supra* note 1, at 531–40.
57. San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc., 983 A.2d 304, 319 (Del. Ch. 2009), *aff'd*, 981 A.2d 1173 (Del. 2009).
58. *Id.*
59. *Id.*
60. *Id.*
61. *Id.* at 318–19.

shareholders[62] and may hold "catastrophic"[63] consequences for the corporation. Considering the impact that debt covenant packages have over the disposition of the company's assets and cash flows makes the problem identified by the court even more acute.

The operational impact of debt covenant packages is powered by their economic leverage. To unpack what the Delaware Chancery Court meant by "catastrophic," it is important to understand that debt supplies financial oxygen to virtually all mature companies. To reiterate, many of the S&P 500, which is composed of 500 of the largest publicly listed companies in the United States, have debt levels that near, meet, or exceed equity levels.[64] Fundamentally, a company is financed by both equity and debt.[65] In the ideal Coasian world featuring symmetrical information, rational actors, and zero transaction costs, the choice between equity and debt financing is inconsequential.[66] In the real world, however, the right balance of debt and equity financing is a function of a firm-specific idiosyncratic analysis that depends on the relative costs of debt and equity, and the firm's specific needs and business plans.[67] For our purposes, suffice it to say that many mature companies have at least one dollar of debt for every dollar of equity, and in many cases much more than that.[68] Even in younger and startup firms, there has been a rise in venture and growth debt financings that provide similar covenant packages and yield similar leverage over the company and its managers.[69]

To conclude, debt is an important and economically powerful instrument that has a profound effect on the company's capital structure and governance. Debt's operational impact on corporate affairs therefore ought to be incorporated in any corporate governance model.

As noted in the preceding paragraphs, part of the explanation for why debt has not been incorporated into the conventional corporate governance model has to do with the assumed separation between cash-flow rights and control rights.[70] As the typical story unfolds, debt provides its holders with cash-flow rights over

62. *Id.* at 319.

63. *Id.*

64. *See S&P 500 Financial Strength Information*, *supra* note 4.

65. *See* Jensen & Meckling, *supra* note 3, at 342–43.

66. For the seminal work on this equality between equity and debt, see generally Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

67. *See* DAMODARAN, *supra* note 1, at 324–29.

68. *See, e.g.*, *S&P 500 Financial Strength Information*, *supra* note 4.

69. KYLE STANFORD, Q1 2021 ANALYST NOTE: VENTURE DEBT A MATURING MARKET IN VC 3 (2021). The corporate governance of startup companies is also affected by the covenants of preferred stocks. For the seminal works on this topic, see generally Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155 (2019); Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37 (2006).

70. *See supra* notes 41–42 and accompanying text.

payment-of-interest, principal, and liquidation preferences, while equity confers upon shareholders control rights and cash-flow rights when dividends are declared.[71] In practice, however, cash-flow rights provide debtholders with the economic leverage to contractually create covenant packages that control the governance and operations of the firms they finance. Similar to the way in which shareholders can exercise their voice and exit powers[72] by expressing their views about the company through expanding or selling off their ownership positions,[73] debtholders can exercise their voice and exit powers by expressing their views about the company in the secondary markets.

In the market for corporate bonds, the secondary markets have greatly expanded, starting with the adoption of Rule 144A, which provides a nonexclusive safe harbor for the private resale of securities to qualified institutional buyers ("QIBs"),[74] and continuing with the SEC's subsequent incremental expansions of the definition of QIBs.[75] In the market for corporate loans, the secondary markets have greatly expanded with the advent and resurgence of collateralized loan obligations ("CLOs"): the bundling and selling of units consisting of various risk-adjusted interests in corporate loans.[76] The way in which a company's debt trades in the secondary markets greatly affects the company's ability to issue new debts in the future, as well as the perceptions of the company's equity investors and analysts.[77]

Relatedly, a second hurdle that has kept debt from being integrated into a corporate governance model has been the assumption that ownership rights are charter-based rights with direct voting power, unlike other contractual rights that do not rise to the level of an ownership stake.[78] However, that the rights of debtholders come from contracts rather than the company's charter or bylaws is inconsequential from every practical standpoint. Because debt is part of the firm's capital structure, its holders enjoy economic leverage over the firm's

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71. *See* DAMODARAN, *supra* note 1, at 310–29.

72. *See* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 106–28 (1970).

73. *See generally, e.g.*, Robert Parrino, Richard W. Sias & Laura T. Starks, *Voting with Their Feet: Institutional Ownership Changes Around Forced CEO Turnover*, 68 J. FIN. ECON. 3 (2003) (showing evidence that institutional shareholders tend to sell their shares before a forced CEO change). For a broad and integrated discussion on the separation of the voting right and the economic interest, see Hu & Black, *supra* note 42, at 811–908.

74. 17 C.F.R. § 230.144A (2022).

75. Accredited Investor Definition, 85 Fed. Reg. 64234 (Oct. 9, 2020) (codified at 17 C.F.R. pts. 230, 240 (2022)); Amending the "Accredited Investor" Definition, Securities Act Release No. 33-10824, Exchange Act Release No. 34-89669, 85 Fed. Reg. 64234 (Oct. 9, 2020).

76. *See, e.g.*, RAJAY BAGARIA, HIGH YIELD DEBT: AN INSIDER'S GUIDE TO THE MARKETPLACE 37–42 (2016) (explaining the CLO structure and its market).

77. *See generally, e.g.*, Rick Johnston, Stanimir Markov & Sundaresh Ramnath, *Sell-Side Debt Analysts*, 47 J. ACCT. & ECON. 91 (2009) (finding that bond analysts affect stock prices).

78. *See supra* note 43 and accompanying text.

governance and realize it through the covenants they contract for. Furthermore, equity holders, too, often acquire corporate governance powers from contracts other than the firm's charter and bylaws,[79] and sometimes lack direct voting rights like debtholders.[80] Moreover, the ability of shareholders to influence the board via contractual mechanisms is severely limited as compared to debtholders. It is an essential part of Delaware law that directors have the power and responsibility to manage the corporation.[81] As Delaware courts have made clear, this power may not be curtailed by shareholder bylaws.[82] Since not even shareholder bylaws may wield such influence, shareholders certainly cannot use shareholder agreements in such a manner. Debt contracts, however, are not limited by such statutory limitations.[83]

It is therefore not surprising that the Delaware Chancery Court has recently explicitly treated a debtholder as a controller of a corporation.[84] As the court explained, not only can debtholders use contractual mechanisms to become indistinguishable from a controlling shareholder, but they can also be subject to controller fiduciary duties.[85] While this newfound judicial understanding that debt governance is on equal footing with equity governance is certainly welcome, it remains fraught with legal uncertainties. For example, while we now know that debtholders can sometimes be subject to controller fiduciary duties, the statute authorizing corporate opportunity waivers still only mentions "officers, directors or stockholders."[86]

All this turns the equity-debt distinction for corporate governance into a sheer formality. The essence of corporate governance power, however, does not rest in legal formalities. Rather, it derives from the ability to exercise this power as a matter of fact. Debtholders have the economic leverage to wield and

79. *See id.* (showing how equity holders will often use shareholder agreements for their corporate governance framework).

80. One such example is the case of dual-class shares and the inclusion of nonvoting or "low say" shares. For a broad discussion of this phenomena, see, for example, Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 585–86 (2017) (arguing that such dual-class structures are not sustainable in the long term).

81. DEL. CODE ANN. tit. 8, § 141(a) (2023).

82. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232 (Del. 2008) ("[I]t is well-established that stockholders of a corporation subject to the DGCL may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation. Therefore, the shareholders' statutory power to adopt, amend or repeal bylaws is not coextensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a)." (footnotes omitted)).

83. This is because the law applies to bylaws and not third-party contracts.

84. Blue v. Fireman, No. 2021-0268, 2022 WL 593899, at *16 (Del. Ch. Feb. 28, 2022) ("The fact that it secured that voting power via its creditor-debtor relationship with the Company is inconsequential. Fireman Capital has control because it can vote most of the Company's stock, not because it holds most of the Company's debt.").

85. *Id.* at *17.

86. tit. 8, § 122(17).

exercise corporate governance power, and they do so via the covenant packages they contract for. The firm's debt and covenant packages, therefore, ought to be both analyzed and integrated in the corporate governance model. The next Subpart shows how this incorporation should proceed.

### C. The Integrated Model of Corporate Governance

The integrated model of corporate governance incorporates both the benefits and the costs of debt and has a single, all-important goal: minimization and efficient distribution of all control costs, which encompass managerial agency costs, shareholder principal costs, and debtholder costs. Within this framework, costs resulting from the misalignment between shareholders' and debtholders' interests are, strictly speaking, not a separate category of costs, but rather a cost attributable to either shareholders or debtholders. By incorporating debtholder costs within the control-costs equation, the integrated corporate governance model developed by this Article advances a complete understanding of corporate governance.

In order to fully understand the cost-benefit structures of debt governance, it is important to note the difference in structure between debt and equity governance norms: debt governance provides rule-based instructions that are set ex ante, while equity governance is provided dynamically and gradually through voting and standard-based protections (i.e., fiduciary duties standards).[87] The integrated corporate governance model thus illuminates the governance tradeoffs between debt and equity governance. Similar to the advantages of rules over standards,[88] debt governance instructions are costly to compose[89] but cheaper to enforce and rely upon.[90] Debt governance guidelines are also more expensive to create because it is harder and more time consuming to delineate specifically how a company should manage its revenues, debt, assets, and the board of directors than it is to simply demand that the managers act in good faith and exercise reasonably prudent judgment.[91] For the same reason, the specificity of the instructions also makes debt covenants cheaper to enforce.[92] Under specific instructions, it is much easier for courts to determine whether managers

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87. *See generally* Goshen & Squire, *supra* note 6.

88. *See* Douglas G. Baird & Robert Weisberg, *Rules, Standards, and the Battle of the Forms: A Reassessment of § 2-207*, 68 VA. L. REV. 1217, 1221 (1982); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 379–81 (1985); Gideon Parchomovsky & Alex Stein, *Catalogs*, 115 COLUM. L. REV. 165, 167–81 (2015). For a seminal work on this topic, see generally Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

89. *See* Kaplow, *supra* note 88, at 579–80.

90. *Id.* at 570.

91. See *infra* Part II for a robust discussion of the covenants and the degree to which they are tailor-made to the needs of the company.

92. The development of corporate fiduciary duties in both the courts and academia is full of disagreements and resolutions that evolved over more than a century. *See, e.g.*, *supra* notes 3, 5, 22 and accompanying text.

have answered their mandates.[93] Furthermore, debt governance instructions are advantageous when there is clarity as to the business direction that a corporation should take, but are a less useful governance product than equity when the company's business and financial plan is uncertain.[94] This is because the ability to provide useful specificity to governance guidelines requires an enhanced degree of certainty regarding both the business plan and the state of the market.[95]

It is therefore unsurprising that the usage of debt governance increases when a company is distressed,[96] in the late stages of maturity,[97] or subject to some control by professionalized investors such as venture capital or private equity firms.[98] When a company is distressed or is operationally and financially mature, the business plan itself is far clearer. When there is significant control by investors that specialize in managing companies, the competence of the relevant controlling actors increases.[99] With this governance tradeoff in mind, the following paragraphs provide a full account of the control costs of debt governance.

Realizing their structural advantages, debt covenants work for the benefit of the company in two distinct ways. First, covenants provide companies with guidelines for carrying out financial activities.[100] They also set up rules and limits for the company's management of assets and cash flows, and for the total reinvestment rate.[101] These covenants are often negotiated between expert debt capital markets, leverage-finance bank personnel, or highly specialized teams of counsel and the company's CFO to formulate a covenant package that is both attractive to debt investors and allows the company the right amount of operational flexibility.[102] Second, debt covenants work to minimize control costs by reducing both agency and principal costs. Debt covenants can reduce the company's agency costs by prohibiting and imposing harsh penalties for managerial financial and asset engineering that is not in the best interest of the corporation. This is typically done by the designation of certain depletions of asset and cash as events of default. Debt covenant packages reduce the

93. *See, e.g.*, *supra* notes 3, 5, 22 and accompanying text.

94. *See* Kaplow, *supra* note 88, at 586–90 (discussing rule and standard tradeoffs as they relate to the complexity of the subject matter).

95. *Id.*

96. *See infra* Part II.

97. *See infra* Part II.

98. As of recently, this is also the case in young or start-up companies. *See supra* note 69 and accompanying text.

99. This is so because venture capitalist and private equity personnel are professionals who specialize in identifying companies in which an investment coupled with their expert guidance will yield returns. Also, it should be noted that the choice of debt over equity can be motivated by financial reasons.

100. *See infra* Part II.

101. *See infra* Part II.

102. *See, e.g.*, BAGARIA, *supra* note 76, at 22–24.

company's principal costs by controlling the company's dispositions of assets and cash flows, and by blocking other shareholders' decisions that endanger the company's stability. For example, by limiting the dividends that may be paid out within a given period, debt covenants limit shareholders' ability to force a company into an operational pattern that places undue emphasis on short-term shareholder gains.[103] Lastly, debt covenants reduce principal and agency costs concurrently by minimizing the costs associated with resolving managerial-shareholder conflicts. Because debt covenants set limits on the company's ability to dispose of assets and cash, the covenants effectively preclude costly manager-shareholder conflicts that otherwise would have to be resolved to avoid stalemate and damage to the company. Debt covenants prevent management-shareholder disputes by rendering them pre-settled. In other words, debt covenants seize the power of both principals and agents, and thereby remove a source of conflict or private uses at the firm's expense.

Debt covenants, however, are not cost-free for the company. Debtholder costs originate from three structural misalignments of interest. One of these misalignments is engendered by debtholder and management conflicts. Another costly misalignment originates from internal debtholders' conflicts, and the final misalignment results from the conflicts of interest between the company's debtholders and shareholders.

The misalignment between the interests of debtholders and management is both a curse and a blessing. Given certain circumstances, debtholders will negotiate for terms or actions that are in the best interest of the company and yet encounter pushback from the management team. In other circumstances, the inverse push and pull will ensue. Generally, given a choice within a set of corporate actions, debtholders prefer the action that benefits the corporation if, and only if, the action maximizes their chances of recovering the money they lent and their ability to receive interest payments ("the probability of recovery").[104] Importantly, the debtholder's probability of recovery is not tied to a single tranche of debt. Instead, it integrates, among other relevant factors, any promise by the management for the debtholder to be included in new issues of debt borrowings.

To illustrate, consider the following real-world example: a company in a downward spiral recently bought a competitor, which at this time sits as a subsidiary entity of the company. The parent company is distressed, and both its shareholders and debtholders are suffering. The debtholders would in theory be able to recover enough cash and assets to cover their investment, but the management of the parent company just decided that it is in the best interest of

103. This is so as less, or no dividends, could be paid in the short term.

104. This is because the ability to recoup the lent money is a necessary reason for lending money in the first place.

the company to transfer the parent's profit-bearing assets to the subsidiary entity. This is an issue for debtholders because their debt claim as against the parent company now depends on the parent's equity claim against the subsidiarity entity, which makes the claim junior in right vis-à-vis any direct debt claims on the subsidiary entity. Litigation then ensues over whether the management's actions violated the debt facility's asset and cash covenants. The management's decision to transfer the assets to the subsidiary entity was certainly bad for the debtholders, but was it in the best interest of the corporation? The answer to this question is that it depends. For example, the management's decision was in the best interest of the corporation if it provided the corporation the best chances to avoid bankruptcy. However, it was not in the best interest of the corporation if it was merely a managerial tactic to keep the company alive long enough for the management to collect incentive fees.

Conflicts of interest between debtholders, similar to internal shareholder conflicts of interest, occur when the debtholders cannot agree on what course of action is in their collective best interests. Much like internal shareholder conflicts between competing equity claims,[105] these conflicts come from different classes or tranches of debt, or from within the same tranche of debt. The answer as to which debtholder's position is better for the corporation depends on the particular circumstances of the case. For example, assume that while the debtholders and the parent company in the example above spar over whether the asset and cash transfers to the subsidiary entity were permissible under the covenant package, the subsidiary entity enjoys banner years of growth, and so the company is now ripe for an exit in the form of its first ever initial public offering (IPO). The parent company and their counsel know, however, that they will not be able to complete the IPO while they are under a fierce litigation fight with the debtholders. Consequently, the parent company offers the debtholders a small fee and to increase interest payments if they agree to drop their lawsuits and forego their claims, but the offer only stands for twenty-four hours, or until a majority of the debtholders agree. At first, most of the debtholders do not think that the offer is good for them, but later, after the biggest debtholder accepts the offer, they rush to accept the offer as well. The management has thus placed the debtholders in a classic "prisoner's dilemma."[106] The debtholders would have been better off holding off on the offer, as they had originally decided. However, their fear of fellow defection and

105. Internal shareholder conflicts between controlling and minority shareholders are, of course, an explicit area of corporate law. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 723 (Del. 1971) (seminal case on duty of loyalty of controlling shareholders); Lynch v. Vickers Energy Corp., 383 A.2d 278, 280–81 (Del. 1977) (seminal case on duty of disclosure of controlling shareholders).

106. For the seminal work on such coordination problems, see generally John Nash, *Non-Cooperative Games*, 54 ANNALS MATHEMATICS 286 (1951).

the prospect of foregoing the consenting lenders' benefits made them change their mind. This dynamic made the offer, and subsequently the IPO, successful. Whether this result best serves the corporation is a difficult financial question. In theory, a longer holding-off period coupled with a traditional payoff and settlement of the debt claims might have set the stage for a more successful IPO pricing in the future. This potential opportunity, however, would not have been realized because of the conflict of interests between the debtholders.

Lastly, conflicts of interest between debtholders and shareholders arise due to the following fact: debtholders have a more senior claim in bankruptcy and in other liquidation events, while shareholders enjoy the benefits of dividends and stock price appreciation events.[107] Costs brought about by shareholder-debtholder conflicts come in two varieties. First, some shareholder-debtholder conflicts stem from misalignments in interest that are costly to have and resolve because conflicts in general are costly to resolve, while the actual choice between the shareholders' and debtholders' preferences is inconsequential for the company. This scenario unfolds when the debtholders and shareholders form choices that are equally good for the corporation but differ from each other with respect to the level of risk. For example, the debtholders may prefer a business plan that gives the company a 70% chance of making a $10 million profit, while the shareholders prefer a course of action that has a 7% chance of generating a skyrocketing $100 million profit over the same period of time. The two business strategies have the same expected return for the company: $7 million. Yet they vastly differ in their respective attitudes toward risk. In this and many other cases, the debtholders do not enjoy as much of the upside, and so they generally prefer less risky actions than shareholders do.

Second, shareholder-debtholder conflicts may also damage the corporation, as in cases in which the interests of only one of the two groups—say, the debtholders—align with the corporation's interests. In such cases, the debt covenant package is beneficial for the corporation. However, when the corporation's interests align with that of its shareholders—for example, when the principal costs are zero—the debt covenant package may prove damaging, and sometimes catastrophic, for the corporation.

When analyzing a particular company's control costs and accounting for the costs of shareholder-debtholder conflicts, it is also important to not double count the costs. Thus, when the shareholder-debtholder conflict is merely a reflection of divergent risk attitudes, the cost of resolving the conflict should be attributed pro rata to the shareholders and inter se to the debtholders. To illustrate, consider the example discussed in the preceding paragraph. There, the shareholders' interest is tied to the successful completion of the IPO. If the

107. *See supra* note 1.

settlement with the debtholders and the IPO did not occur, the shareholders would shoulder the risk of being tied to a highly leveraged company that may be unable to cash out on the high growth in its subsidiary entity. The debtholders, on the other hand, are better off rejecting the settlement offer; they do not stand to gain from the IPO, but they do stand to gain from the litigation they initiated to protect their rights. Again, which of the two positions best serves the corporation is hard to tell. What is crystal clear, however, is that the equity and debt financiers of the corporation are destined to split into winners and losers.

The example in this Subpart is the true story of the Chewy IPO.[108] In a multiplayer chess match, described as "one of the seminal Wall Street fights since the financial crisis,"[109] BC Partners—the private equity majority owner of brick-and-mortar PetSmart, which later also acquired the e-commerce Chewy—found themselves in the abovementioned road to an IPO that involved fights with hedge funds and the likes of Apollo Global Management.[110] This example shows that corporate governance is indeed not all puppies and equity, but also includes the economically and operationally powerful impact of debt. Hence, the control costs that each company needs to minimize do not only include managerial agency costs and shareholder principal costs. They also include equally important debtholder costs. Debtholder costs, in turn, are brought about by debtholder-management conflicts, internal debtholder conflicts, and debtholder-shareholder conflicts.

Finally, it is also important to illustrate how the choice of debt facility affects debtholder costs. Credit facilities or loans are typically provided by banks. Until recently, banks held their debt interest to maturity or refinancing and maintained close communications with the borrower. Within this framework, it was easier and cheaper to discuss amendments to or refinancing of the credit facilities with the borrowers. More recently, however, banks have decided not to hold onto their debt interest in the same way as before. Instead, they now sell their exposure to investors in the secondary loan market.[111] As a result, the ownership of the loan becomes dispersed over a far larger number of debtholders. In turn, the dispersion in the banks' debt ownership reduces their ability to coordinate with and among other debtholders to amend credit agreements.[112] That said, although banks are not always in a position to amend credit agreements, credit agreement debt is still far nimbler than bond debt. This

108. For a concise summary of the Chewy IPO story, see Sujeet Indap, *Pet Supplies IPO Follows Dog-Eat-Dog Battle for Debtholders*, FIN. TIMES (May 6, 2019), https://www.ft.com/content/e8afa8bc-6f98-11e9-bf5c-6eeb837566c5.

109. *Id.*

110. *Id.*

111. This is most typically done via CLOs. *See supra* notes 76–77 and accompanying text.

112. *See, e.g.*, Jeremy McClane, *Corporate Non-Governance*, 44 DEL. J. CORP. L. 1, 5 (2020) (arguing and providing empirical evidence that lenders have reduced their role in monitoring management).

is because credit agreements are often managed by a responsible and active bank that acts as an administrative agent, while bonds are administrated by a trustee with mostly clerical responsibilities.[113] The choice of debt facility consequently changes the debtholder cost structure such that certain facilities, such as credit agreements, lead to less internal debtholder coordination issues and reduce the cost of negotiation between debtholders and management, while other debt facilities, such as bonds, require an expensive consent-solicitation process in order to facilitate an amendment.[114] As shown in Part II, however, this backend amendment flexibility of credit agreements often comes at the cost of frontend stiffness in the form of more cumbersome covenants in the original credit agreement.

Armed with this integrated model of corporate governance, the following Part describes the main covenant forms that are being used in modern-day debt facilities. An understanding of these covenant forms provides a toolset for carrying out firm-specific analyses of integrated corporate governance mechanisms.

## II. Debt Facilities' Covenants and Their Effect on Corporate Governance

Debt covenants split into three basic categories. The first category includes covenants that directly impact board composition and change-of-control events. The second category includes covenants directly affecting the management of cash. Last but not least, the third category encompasses covenants that directly affect asset management within the firm. To be sure, there are other covenant types as well, such as procedural covenants that grant the debtholder book-inspection rights. Yet understanding the three basic, or paradigmatic, categories of covenants is the key to understanding the effect of debt facilities on corporate governance. This Part identifies and explains the core features of these covenants and the important differences between the covenant structures of bank credit facilities, secured notes, and senior unsecured notes. Discussion about each structure will explore both the high-yield and investment-grade issuers and, in the case of notes, both registered and unregistered notes.

As a preliminary matter, it is useful to understand how the covenants' power varies across debt facilities and correlates with the riskiness of the debtholders' investment. Generally speaking, bank credit facilities, such as term loans, contain more onerous covenants than notes. That is because credit

113. The identity of bondholders is also more widely dispersed and hard to ascertain. Bonds are almost always traded in book-entry form through Cede & Co., which is a nominee of the Depository Trust Company. *See* Bagaria, *supra* note 76, at 80. Outside the United States, bonds are sometimes traded in book-entry form through Euroclear or Clearstream. *See id.*

114. *Id.*

facilities typically contain “maintenance covenants,” while notes typically contain “incurrence covenants.”[115] The difference between these two types of covenants is this: maintenance covenants are always active whereas incurrence covenants are only triggered by the occurrence of a certain predetermined event. For example, a typical maintenance covenant requires the borrower to maintain a certain debt-to-earnings ratio,[116] verified in regular intervals, while an incurrence covenant only prohibits the borrower from incurring additional debt if the borrower does not meet the threshold debt-to-earnings ratio. An incurrence covenant will not require a borrower to maintain and be tested for the requisite debt-to-earnings ratio when no triggering event has taken place.

Additionally, from a risk perspective, covenant packages are generally more onerous when the probability of default by the borrower is higher. Probability of default is reflected in the ratings provided by agencies such as Moody’s Investor Services, Standard & Poor, and Fitch Ratings when they deem debt obligations and borrowers at the threshold of investment grade or below it.[117] Debt obligations below the investment grade threshold are considered high yield.[118] As a general matter, high-yield covenants are much more onerous for the firm than investment-grade covenants. This is also discussed below, but the essential reason is that lenders have to account for the higher risk with the inclusion of more restrictive covenants. With this general mapping in mind, the following Subparts present the main features of control rights and board-restricting covenants, cash-restricting covenants, and asset-restricting covenants.

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115. The terminology of maintenance and incurrence covenants is the norm for debt lawyers. *See, e.g.*, MAYER BROWN, HIGH-YIELD BONDS: AN ISSUER’S GUIDE (U.S. EDITION) 4 (2016), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2016/12/high-yield-bonds--an-issuers-guide-us-edition/files/download-guide/fileattachment/mb_high_yields_notes_guide_2016.pdf.

116. Earnings are typically measured as “EBITDA” (earnings before interest, tax, depreciation, and amortization) or “adjusted EBITDA” (EBITDA adjusted for certain other metrics that are added back to earnings, referred to as “add-backs,” in order to increase a firm’s value). The definitions of EBITDA and adjusted EBITDA are highly contested and negotiated and often individualized to the particular model of a firm. For a discussion on the variety of EBITDA definitions, see generally Adam B. Badawi, Scott D. Dyreng, Elisabeth de Fontenay & Robert W. Hills, *Contractual Complexity in Debt Agreements: The Case of EBITDA* (Duke L. Sch. Pub. L. & Legal Theory Series, Working Paper No. 2019-67, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3455497.

117. Rating agencies do not simply provide a stamp of investment grade or non–investment grade; instead, they provide a more detailed labeling system. The different rating agencies use different terminology to denote the same or very similar ratings. A rating below investment grade is branded below Baa3 in Moody’s Investor Services’ terminology and below BBB- in Standard & Poor’s terminology, for example. *See Moody’s Rating Terms*, CREDITRISKMONITOR, https://info.creditriskmonitor.com/Help/MoodysGlossary.asp#Outlook (last visited May 12, 2023).

118. *Id.*

### A. Control Rights and Board-Restricting Covenants

There are two types of control rights and board-restricting covenants. The first type includes covenants that provide the debtholders with the ability to sell back or accelerate the repayment of the debt at a premium upon certain changes in the equity or asset ownership of the company ("change-of-control provisions").[119] The second type includes covenants that provide debtholders with the ability to sell back or accelerate the repayment of the debt at a premium upon certain changes in the board composition ("continuing-director provisions").[120] Depending on the context and leverage the relevant debt facility entails, these covenants can, at times, act as a mere tax on board or change-of-control changes and, at other times, act as an effective contractual defense tactic to insulate the composition of the board.[121]

Change-of-control provisions of both credit agreements and bond indentures tend to differ in their articulation based on the credit rating of the issuer.[122] In high-yield debt agreements, change-of-control provisions often[123] take the following form: the debtholders has the right, but not the obligation, to require the issuer or borrower to repurchase the debt at a premium[124] (a) if a person or entity acquires 50% or more of the voting equity of the borrower, (b) if there is a merger or similar transaction resulting in a change in the majority of the equity holders, (c) if the borrower sells all or substantially all of its assets, or (d) if the borrower adopts a plan of liquidation.[125] An investment-grade change-of-control provision, if and when adopted,[126] often includes a "double-trigger" provision: a provision that tracks the high-yield formulation but also stipulates that there be a certain decline in the credit rating of the company before the debtholders become entitled to sell back the debt at a premium.[127]

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119. *See, e.g.*, Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. REV. 931, 933–34 (1993) (describing change-of-control provisions).

120. *See, e.g.*, *San Antonio Fire & Police Pension Fund v. Bradbury et al.*, 26 WESTLAW J. DEL. CORP. L. UPDATE, no. 10, Dec. 16, 2010, at 1 ("The credit agreement contained a 'continuing director' provision essentially stating that a change in control in the Amylin board would constitute an event of default that, if not waived, would effect an acceleration of the debt due under the agreement, the court said.").

121. For a particularly useful account of defense tactics and Delaware law, see *Air Products and Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48, 62 (Del. Ch. 2011).

122. For a discussion on the effects of change-of-control provisions in bond agreements, see Kahan & Klausner, *supra* note 119, at 937–43.

123. As with any covenants described in this Subpart, there are many variations that can be used in the articulation of these covenants. The Article utilizes the most commonly used variations.

124. The premium amount is usually set at 101% of the principal. *See, e.g.*, David Azarkh & Sean Dougherty, *High Yield vs. Investment Grade Covenants Chart*, LEXISNEXIS, https://www.stblaw.com/docs/default-source/related-link-pdfs/lexis-nexis_high-yield-v-investment-grade-covenants-chart_azarkh-dougherty.pdf (last visited May 12, 2023).

125. *Id.*

126. *Id.* For highly rated investment-grade bonds, change-of-control provisions are not always included. *Id.*

127. *Id.*

Whether change-of-control provisions help or hurt the corporation is a firm-specific question. Debtholders are virtually always willing to pay for the benefit of including a change-of-control provision,[128] which can enhance the firm's value by reducing the cost of capital. On the other hand, a change-of-control provision may reduce the firm's value by increasing the cost of a beneficial takeover. This is because a change-of-control provision may strengthen the common managerial-debtholder interest in maintaining the current ownership structure even when equity holders would benefit from a buyout.[129] Lastly, a change-of-control provision may sometimes be inconsequential. This scenario unfolds when a change-of-control event is unlikely, or when a debt is traded at a sufficiently high price in the secondary markets such that the exercise of the debtholder's sell-back right is also unlikely.

Continuing-director provisions predominantly come in two formulations and can be present in both indentures and credit agreements, but mostly in indentures and credit agreements of publicly held companies.[130] The first formulation provides debtholders with the right to sell back or accelerate the repayment of the debt at a premium if there is a change in the composition of the board such that the majority of the directors are not "continuing directors" ("dead hand proxy put").[131] The term "continuing directors" is defined to include the individuals who served as directors at the time the debt was originated.[132] The second and more typical formulation of the continuing-director provision is the "proxy put," which alters the dead hand proxy put to count directors *approved* by a majority of the directors serving at the time the debt was originated as continuing directors.[133] The essential difference between the two formulations is that the "dead hand" feature, when included, does not allow directors who were on the board when the debt was issued to approve new directors and thereby avoid triggering the continuing-director provision.[134] For example, a typical proxy put provision will take the following form: the continuing-director provision is triggered when

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128. *See, e.g.*, Kahan & Klausner, *supra* note 119, at 935 (finding that change-of control provisions can enhance firm value when debtholders are willing to accept lower interest rates in exchange).

129. *See, e.g.*, John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1519–21 (1990) (arguing that change-of-control provisions can reflect a management-debtholder coalition that at times comes at the expense of shareholder protection).

130. *See, e.g.*, John Lawlor, *Continuing Director Change of Control Provisions in Debt Agreements: Potential Issues for Borrowers and Lenders*, LEXOLOGY (Jan. 28, 2015), https://www.lexology.com/library/detail.aspx?g=02ee5488-264a-4b90-942a-e04d616b0c4e&g=02ee5488-264a-4b90-942a-e04d616b0c4e.

131. *See, e.g.*, F. William Reindel, Stuart H. Gelfond, Daniel J. Bursky & Gail Weinstein, *"Dead Hand Proxy Puts"—What You Need To Know*, HARV. L. SCH. F. CORP. GOVERNANCE (June 10, 2015), https://corpgov.law.harvard.edu/2015/06/10/dead-hand-proxy-puts-what-you-need-to-know/.

132. *Id.*

133. *Id.*

134. *See, e.g.*, Sean J. Griffith & Natalia Reisel, *Dead Hand Proxy Puts and Shareholder Value*, 84 U. CHI. L. REV. 1027, 1040–41 (2017).

> [a] majority of the members of the board of directors . . . cease to be composed of individuals (i) who were members of that board . . . on the first day of such period, (ii) whose election or nomination . . . was approved by [a majority of incumbent board members] . . . or (iii) whose election or nomination . . . was approved by [a majority of incumbent board members or successors approved by them].[135]

The dead hand feature will either remove clauses (ii) and (iii) or otherwise designate directors who were approved in the face of an actual or threatened proxy contest as noncontinuing directors.[136] Effectively, the dead hand feature is an explicit prohibition on the ability of the current board to approve a nominated slate of directors for the purpose of avoiding the triggering of the change-of-control provision.[137]

While Delaware law has warned of the potential infringement that a continuing-director provision may bring upon traditional shareholder rights, it does not ban such provisions outright.[138] Delaware law does hold that, in the case of a proxy put, the existing board should avoid triggering the proxy put and approve the nominated directors unless doing so would violate the existing director's duty of loyalty to the corporation and the shareholders.[139] This is because the board should facilitate a director vote without fear of adverse financial consequences due to debt repayment at a premium, if possible.[140] Further, approving a director slate for the purpose of neutralizing the proxy put does not preclude the existing board from subsequently acting against such a nomination.[141] Delaware law has also made it clear that a dead hand proxy put, while not unlawful per se, can be challenged in court not only when the provision is invoked, but also when it is adopted by the debtholder and the firm.[142] Lastly, when challenging a board's adoption of a dead hand proxy put, shareholders may also assert an aiding-and-abetting claim against the lenders who negotiated for the provision.[143]

Depending on firm-specific considerations, continuing-director provisions may at times be helpful for a corporation and at other times damage its interests. On one hand, a continuing-director provision may enhance the firm's value by

135. *Id.* at 1040 (citing San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc., 983 A.2d 304, 309 (Del. Ch. 2009)).

136. *See, e.g.*, Reindel et al., *supra* note 131.

137. *See, e.g.*, Griffith & Reisel, *supra* note 134, at 1043.

138. *See supra* notes 45–49 and accompanying text.

139. Kallick v. Sandridge Energy, Inc., 68 A.3d 242, 246 (Del. Ch. 2013).

140. *Id.*

141. *Id.* at 261.

142. Transcript of Oral Argument on Defendants' Motions to Dismiss and Rulings of the Court at 73, Pontiac Gen. Emps. Ret. Sys. v. Ballantine, No. 9789-VCL (Del. Ch. Oct. 14, 2014), 2014 WL 6388645.

143. *Id.* at 71–72, 78–79.

reducing the cost of capital and deterring ill-motivated activist investors.[144] On the other hand, a continuing-director provision may reduce the firm's value by entrenching directors who should otherwise be replaced.[145]

The existing formulations and legal treatment of control rights and board-restricting covenants reveal the extent of debtholders' ability to exercise corporate governance powers over the equity base and board composition of a corporation. Cash-restricting covenants, discussed in the next Subpart, have an analogous effect.

## B. Cash-Restricting Covenants

Cash-restricting covenants serve as guidelines for both external and internal cash management. Externally, covenants that impact cash management restrict the ability of a corporation to move cash away from the corporation and its subsidiaries. Internally, cash-management covenants determine how cash may move within the corporation and its subsidiaries. The covenants bring about these effects by imposing contractual limitations not only on the corporate entity that incurs the debt, but also on some of its subsidiaries.[146] The debt industry identifies the group of subsidiary entities captured by the covenant package as "restricted subsidiaries," while subsidiary entities not captured by the covenant package are tagged as "unrestricted subsidiaries."[147] Together, the corporation and those subsidiary entities that are captured by the covenant package are referred to as the "credit group."[148] Under the resulting debt structure, the cash covenants restrict cash from flowing outside the credit group, with far less cumbersome limitations applied within the credit group.[149]

The structure of cash-management covenants correlates with both the riskiness of the corporation and the debt, as well as whether the debt facility is a loan or a bond. The following paragraphs describe the typical covenants in both loans and bonds, as well as the difference between high-yield or leveraged borrowers and investment-grade or low-debt borrowers.

In leveraged loan facilities, such as credit agreements for highly leveraged companies, cash-restricting covenants predominantly assume the form of

144. *See* Griffith & Reisel, *supra* note 134, at 1051–64 (providing empirical evidence that dead hand proxy put may, at times, enhance firm value for these very reasons).

145. *See supra* notes 120–21 and accompanying text.

146. *See* Mayer Brown, *supra* note 115, at 3.

147. *Id.*

148. "Credit group" is a term used by practitioners when discussing the general structure of a credit agreement or indenture. *See, e.g.*, *id.* at 2. However, the contracts themselves often use the definition of "borrower" or "issuer" to include the restricted subsidiaries as well as any guarantors, if any. *See, e.g.*, *id.*

149. Within a credit group, some or all of the entities are usually designated as guarantors. *See, e.g.*, *id.* Debtholders are far less concerned with restricting the cash movement between the issuer and guarantors as, unlike with non-guarantor-restricted subsidiaries, the debtholders will have a direct claim on the subsidiary by virtue of that subsidiary's guarantee of the debt. *See, e.g.*, *id.* at 4–6.

maintenance covenants.[150] These covenants require the borrower to meet and maintain strict financial ratios that demonstrate financial health.[151] Financial ratios are measurements of the relative value of certain financial metrics. The oft-used financial ratios measure the firm's earnings or EBITDA[152] as compared to the firm's total issuance of debt, ability to pay the existing debts' interest payments, and the payments of charges such as dividends and taxes.[153] Broadly speaking, these covenants aim to limit the amount of cash that goes out of the credit group, as well as to limit the cash that comes into the credit group when it increases the riskiness of the loan (e.g., cash in the form of debt that is not junior in claim to existing loans). Common maintenance covenants in leveraged loans often include limits on the following three ratios:

(i) the ratio of the total funded debt to EBITDA ("leverage ratio") designed to limit the space between earning and debt, with variations that replace funded debt with senior debt or reduce the ratio by the amount of cash on hand;

(ii) the ratio of EBITDA to interest expense ("interest coverage ratio"), a useful limit and measure of the company's ability to service interest payments on an ongoing basis; and

(iii) the ratio of EBITDA to fixed charges ("fixed charge coverage ratio"), which limits the difference between money coming into the company and the money regularly coming out of the company, where the fixed charges include dividends, interest payments, and cash taxes.[154]

Leveraged loans are currently a commonplace mode of corporate borrowing. In the first quarter of 2021, the amount of leveraged loans tripled in size as compared with the last quarter of 2020, to a startling $308 billion in gross institutional loans.[155] A large proportion of these loans, however, do not include maintenance covenants. Instead, over 80% of these loans are "covenant-lite" loans.[156] Covenant-lite loans typically take the form of high-yield bonds and are structured around incurrence covenants.[157]

The cash-management covenants of high-yield bonds and covenant-lite leveraged loans include two facially simple limitations with two respective sets of complex exceptions. The facially simple limitations are the limitation on

150. *Id.*

151. *Id.*

152. "EBITDA" is short for earnings before interest, taxes, depreciation, and amortization. For a discussion on the definition of EBITDA or adjusted EBITDA, see *supra* note 116 and accompanying text.

153. *See, e.g.*, MAYER BROWN, *supra* note 115, at 9.

154. *See, e.g.*, BAGARIA, *supra* note 76, at 83–84.

155. Mayra Rodriguez Valladares, *Institutional Leveraged Loan Issuance Tripled First Quarter 2021*, FORBES (Apr. 14, 2021, 5:37 PM), https://www.forbes.com/sites/mayrarodriguezvalladares/2021/04/14/institutional-leveraged-loan-issuance-tripled-first-quarter-2021/?sh=4ecc7cdd34d7.

156. *Id.*

157. *See supra* notes 123–27 and accompanying text.

making certain enumerated payments or "restricted payments," and the limitation on the incurrence of debt.[158] The complex sets of exceptions for each limitation delineate carefully crafted financial scenarios that are handpicked to be permissible for the corporation.[159] The market-standard term for these narrowly crafted permissible scenarios is the notorious "baskets," which are the meat and potatoes of the high-yield market and negotiation.[160] In other words, high-yield bonds and covenant-lite loans contain covenants that "prohibit raising additional debt or making cash payments," with a laundry list of exceptions called "baskets."[161] The particular exceptions are firm-specific and tailor-made for the corporation.

The baskets to the limitation on debt incurrence typically include exceptions for debt issuances that do not bring the firm's fixed-charges coverage ratio, the ratio of EBITDA to fixed charges,[162] above a certain figure; debt issuances used for the ordinary course of operations, which often include lines of credit for workers' compensation and certain insurance obligations; borrowings for nonspeculative hedging transactions; and finally capped debt issuances for capitalized leases and mortgages.[163]

Additionally, borrowers often negotiate for bespoke exceptions that make sense for the particular needs of the company. For example, a company with foreign operations may negotiate a basket for a capped amount of debt issued under a foreign subsidiary entity.[164]

The baskets included with the limitation on making restricted payments typically include exceptions for payments in amounts that equal a certain percentage (e.g., 50%) of net income in a given period, specified loans to officers and directors, capped investments in joint ventures, dividends paid by the restricted subsidiaries to third parties, and enumerated hedging transactions.[165] Additionally, borrowers often negotiate for firm-specific exceptions that may include baskets, such as repurchases of management stock under particular circumstances, and certain payments that can be categorized as de minimis.[166] Lastly, is it also worth noting that high-yield bonds and covenant-lite loans will

158. *See, e.g.*, MAYER BROWN, *supra* note 115, at 8, 11.

159. *Id.*

160. *See, e.g.*, *id.* at 5 (defining "baskets" and providing a general overview of their role in debt agreements).

161. Understanding the list of baskets also requires a methodical read through the definitions section of the debt agreements. While certain permissible actions may not appear on the face of the baskets, they are included in definitions of terms such as "permitted debt," "permitted restricted payments," and "permitted investments," which are also highly negotiated. *See, e.g.*, *id.* at 9, 13.

162. BAGARIA, *supra* note 76, at 83–84.

163. *See, e.g.*, MAYER BROWN, *supra* note 115, at 9–10.

164. *See, e.g.*, *id.*

165. *See, e.g.*, *id.* at 11–15; MARK B. TRESNOWSKI & GERALD T. NOWAK, THE HIGH-YIELD OFFERING: AN ISSUER'S PERSPECTIVE 43–45 (2004) (ebook).

166. *See, e.g.*, MAYER BROWN, *supra* note 115, at 13.

also include a "limitation on dividend stoppers covenant" that bans prohibitions on the ability of subsidiaries to transfer cash to the issuer or borrower (i.e., by form of upstream dividends or intercompany debt repayment).[167] These are designed to ensure that the complex sets of covenants do not prevent the borrower from being able to pay the interest payments on the debt.[168]

The cash-management covenants of leveraged loans and high-yield bonds thus operate as highly intrusive sets of guidelines for the company. This holds true, in varying degrees, both in the context of maintenance covenants and in the context of incurrence covenants. In the market for investment-grade or low-leverage borrowers, the covenant packages are far less intrusive. The covenant package for these borrowers will generally not include a limitation on indebtedness or restricted payments (except that, at times, there will be a limitation on the incurrence of debt by the subsidiaries of the issuer). Instead, covenant packages for investment-grade and low-leverage borrowers will typically retain a part of the limitation on debt incurrence as a "limitation on sale and leaseback," which prohibits the renting of fixed assets that were sold to a bank or institutional investor.[169]

Equipped with this understanding of how debt covenants impose guidelines and limitations on cash management, the following Subpart discusses the effect of these covenants on asset management.

### C. Asset-Restricting Covenants

Asset-restricting covenants, similar to cash-restricting covenants, serve as limits for both external and internal asset management. Externally, covenants that impact asset management restrict the ability of a corporation to move assets from the credit group to outside parties.[170] Internally, cash-management covenants determine how assets may move within a corporation and its subsidiaries.[171]

Except for limited exceptions noted below, debt covenants are not typically branded as "cash" or "asset" related. Instead, covenants almost always impact both cash and assets concurrently. The distinction between asset-restricting covenants and cash-restricting covenants is a conceptual tool used in this Subpart to explain the complex nature of these covenants in a way that is both analytically palatable and consistent with generally accepted accounting principles. Like cash-restricting covenants, asset-management covenants differ in structure depending on the riskiness of the corporation's ventures and the

167. *Id.* at 14.
168. *See, e.g.*, *id.*
169. *See, e.g.*, Azarkh & Dougherty, *supra* note 124.
170. *See, e.g.*, Mayer Brown, *supra* note 115, at 2–3.
171. *Id.*

debt, and whether the debt facility is a loan or a bond. This Subpart introduces the structure and main asset covenants in both loans and bonds. It also explains the difference between high-yield, or leveraged borrowers, and investment-grade, or low-debt borrowers, in both loans and bonds.[172]

It is useful to discuss the covenants as separately affecting cash or asset management for several reasons. First, it provides analytical tools for understanding the covenant package consistently with accounting principles. That is the case as investors, bankers, boards, and C-suite executives must, as part of their ongoing job obligations, be able to distinguish between assets and cash based on the three basic financial statements of a firm (typically prepared in accordance with generally accepted accounting principles), and as used in every discounted cash-flow valuation of a firm.[173]

Second, distinguishing between cash covenants and asset covenants helps us understand how debtholders analyze their interests: the riskiness of a debt investment depends not only on the overall financial health of the firm, but also on the debt's relative power compared with other cash-flow claims on the firm.[174] When a debt claim is to be satisfied only after another claim in a zero-sum situation, it is subordinated to that claim. The first type of subordination, "structural subordination," was already introduced in the Chewy example in Part I.C, and it is the subordination that occurs due to the structural nature of the firm.[175] Typically, subordination occurs because a debt claim on a parent borrower is a junior claim on a subsidiary, structurally, compared to a direct debt claim on that subsidiary (unless there are guarantees). This means that a debt claim on a parent will recover from a subsidiary only after the direct debt claims on the subsidiary.[176] The second type of subordination is "contractual subordination." Contractual subordination occurs when a claim is subordinated to another by the explicit terms of the relevant loan or bond agreements.[177] Lastly, the third type of subordination is "lien subordination."[178] Lien

172. It is also important to note that the limitations on debt incurrence and restricted payments sometimes overlap with asset-restricting covenants. For example, the limitation on "sale and leaseback covenants," which may appear as an independent covenant in investment-grade deals or as an interwoven covenant in high-yield deals, is also a limitation on asset management. This is because the covenant limits the ability to sell and subsequently lease back fixed assets under the prescribed circumstances. *See, e.g.*, Azarkh & Dougherty, *supra* note 124. Similarly, the asset-sales covenant also doubles as a cash-management covenant when it prescribes how the company must handle cash proceeds received from permitted sales. *See, e.g.*, MAYER BROWN, *supra* note 115, at 16.

173. *See, e.g.*, DAMODARAN, *supra* note 1, at 167–71 (discussing the measurements of earnings and cash flows); *id.* at 271–74 (discussing accounting earnings analysis); *id.* at 516–62 (introducing the foundations of a discounted cash-flow valuation).

174. *See, e.g.*, MAYER BROWN, *supra* note 115, at 7–8.

175. *See supra* Part I.C.

176. *See, e.g.*, MAYER BROWN, *supra* note 115, at 7.

177. *Id.* at 6–7.

178. *Id.* at 7–8.

subordination occurs when liens provide collateral priority rights for certain claims over others via securitized interests in assets.[179] Armed with this understanding of the three types of subordination, the following paragraphs describe the main asset-management covenants.

In all leveraged loans, secured bonds, and unsecured bonds for both high-yield and investment-grade issuers, a "liens covenant" will normally also be established.[180] A liens covenant restricts the borrower's or issuer's ability to provide future liens on the assets of the company.[181] Alternatively, the liens covenant permits the incurrence of liens securing assets up to a certain capped amount.[182] In bond deals, the liens covenant will not permit the incurrence of liens securing assets unless the bonds would be equally and ratably secured, which would place the bonds on equal footing with the secured claim.[183] Moreover, in investment-grade bond offerings, the allowable capped value of the assets secured will generally be a large percentage of total assets or EBITDA.[184] Additionally, the liens covenant will often include exceptions in the form of "permitted liens."[185] Typical exceptions include liens for purchase money and acquired property that were not part of an acquisition.[186]

The liens covenant, as the name suggests, mainly uses the liens-subordination mechanism.[187] Asset-management covenants also work through the structural subordination mechanism, as exemplified by the asset-sales covenant. In principle, the selling of assets as well as the stock of subsidiary entities will not affect debtholders unless the consideration received from the sale is either inadequate or placed in a subsidiary entity in a way that makes the debt claim structurally subordinated. Consequently, the asset-sales covenant does not prohibit the sale of assets and subsidiary stock per se. Rather, it provides guidelines and limitations for the type and use of the consideration received.[188] Leveraged loans and high-yield bonds will often require a certain percentage of the consideration received (oftentimes 75% to 85%) to be in cash or "deemed cash," which are items that are sufficiently similar to cash such that the debtholder's probability of recouping its investment remains unaffected.[189] For

179. *Id.*

180. *See, e.g.*, TRESNOWSKI & NOWAK, *supra* note 165, at 45.

181. *See, e.g.*, MAYER BROWN, *supra* note 115, at 15.

182. *See, e.g.*, Azarkh & Dougherty, *supra* note 124, at 2.

183. *See, e.g.*, MAYER BROWN, *supra* note 115, at 15.

184. Some high-yield bonds will have a provision that alters the liens covenant to mirror the investment-grade formulation upon a certain improvement in the credit rating. *See, e.g.*, Azarkh & Dougherty, *supra* note 124.

185. *See, e.g.*, MAYER BROWN, *supra* note 115, at 15.

186. *Id.*

187. *See id.*

188. *Id.* at 16.

189. *Id.*

example, account receivables (i.e., cash and items owed to the borrower) of items that can be converted into cash within 180 days will often be defined as "deemed cash."[190] Exceptions to this covenant often include asset sales that are ordinary course transactions such as routine sales of inventory and asset sales that are less than a negotiated amount of fair market value.[191] As indicated above, investment-grade debt facilities do not typically include the asset-sales covenant, but they do include the limitation on sale and leaseback covenants.[192]

Asset-restricting covenants thus impose guidelines and limitations upon the management of assets that profoundly affect the operational and financial planning of the firm. Understanding the ways in which typical debt facilities and covenant packages affect the management of the firm's assets is consequently essential for understanding the present-day corporate governance landscape.

The categorization of covenants into control rights and board-restricting covenants, cash-restricting covenants, and asset-restricting covenants sets up a distinct analytical framework that must be incorporated into an integrated account of corporate governance. Additionally, it is important to note that corporations will likely have other debt covenants that will not fit into these three main covenant categories. A notable example of such a covenant is the "reporting covenant," which is a covenant that requires the borrower to provide the debtholders with access to books and records as well as to material nonpublic information such as financial projections.[193] This covenant is typically found in leveraged loans and high-yield facilities and varies in its reach depending on whether a company is a public reporting company or not.[194] Another notable example of a covenant that falls outside of this Article's categories is the "limitation on affiliate transactions covenant."[195] In the leveraged loan and high-yield area, this covenant prescribes that any transaction the borrower or any of its restricted subsidiaries makes with affiliates should be made on terms as favorable as the terms that are available for unrelated third parties in similar transactions.[196] The idea here is to prevent the dilution of corporate assets and money in a manner that may adversely affect the debtholder.[197] For that reason, such covenants may well be categorized as either asset- or cash-restricting—a

190. *Id.*
191. *Id.*
192. *See, e.g.*, Azarkh & Dougherty, *supra* note 124, at 3.
193. *Id.* at 2.
194. *See id.* at 2–3.
195. *Id.* at 2.
196. *See id.* at 2–3.
197. *See id.*

categorization that would place them within one of the main categories identified in this Article.[198]

## III. DEBT AND CORPORATE AFFAIRS

The integrated model of corporate governance helps explain important contemporary developments in the corporate arena. First, viewing corporate governance through the lens of an integrated model allows us to understand the full extent to which state and federal laws affect corporate governance. Considering corporate governance through an integrated model also allows us to decipher the transformative impact of institutional investors. Finally, the integrated model helps us to reveal and fully appreciate the importance of debt in the ongoing debate over the corporate purpose. Specifically, debt as corporate governance helps explain the declining role of state laws and the federalization of corporate governance, the increasing influence of institutional investors, and debtholders' aptness in pursuing pressing CSR and ESG goals. The integrated model of corporate governance thus provides an essential explanatory tool of core corporate affairs, as well as descriptive and normative reasons for defining the corporate purpose as including more than just stockholder value maximization.

### A. THE ROLES OF STATE AND FEDERAL LAWS

Corporate law has traditionally been a matter of state rather than federal law.[199] Specifically, more than half of publicly traded companies in the United States are governed by Delaware law.[200] While Delaware is the most important provider of corporate law, other states, in particular Nevada, have also become significant players in the market for corporate charters.[201] The market for corporate charters is fueled by states competing for the economic benefits and tax income received by a state when a company chooses it for incorporation.[202]

198. For ease of reference and further research, the Appendix provides tabular summaries of both the paradigmatic debt covenants that affect corporate governance, *see infra* Table I, and a glossary of the important terms of art, *see infra* Table II.

199. *See, e.g.*, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1438, 1442–43 (1992) (describing the development of U.S. corporate law through the states).

200. *About the Division of Corporations*, DEL. DIV. OF CORPS., https://corp.delaware.gov/aboutagency/ (last visited May 12, 2023).

201. *See generally* Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935 (2012).

202. *See, e.g.*, Stephen M. Bainbridge, *Fee-Shifting: Delaware's Self-Inflicted Wound*, 40 DEL. J. CORP. L. 851, 869–70 (2016) (describing Delaware's tax benefits from incorporation).

The debate among corporate law scholars and practitioners focuses on whether this state competition is beneficial or detrimental for firm value.[203]

This debate has subsequently been expanded by the understanding that the federal government also interferes with and influences corporate law.[204] With the introduction of the Sarbanes-Oxley Act of 2002,[205] it became clear that the federalization of corporate law has transitioned into a direct incursion of Congress into the affairs of the corporation.[206] In an effort to understand the roles of state and federal laws on corporate governance, the corporate law literature addressing this phenomenon has sought to understand the following questions: (1) In what manner does state competition impact the value of a firm? (2) To what extent does state competition influence firm value? (3) Finally, does the actual and potential federalization of corporate law change the answers to the aforementioned questions, and if so, how? The following Subpart addresses and attempts to answer these questions. This discussion demonstrates that proper understanding of debt as corporate governance alters the answers given to these questions in the literature. Specifically, it shows that the extensive federal regulation of debt federalizes corporate law more pervasively than commonly acknowledged.

The competing narratives about the impact of state competition for incorporation are the "race to the top" and "race to the bottom" theories.[207] The "race to the top" narrative tells us that state competition over the incorporation of firms drives corporate law toward enhancement of firm value, while the "race to the bottom" narrative tells us the exact opposite.[208] Typically, "the race to the top or to the bottom" debate has been framed as a question of whether state competition produces laws that incentivize incorporation in the states that give shareholders greater power.[209] There is, however, no necessary correlation

203. *See, e.g.*, Bebchuk, *supra* note 199, at 1458 (arguing that state competition results in an ill-advised service of managerial interest); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 665–66 (1974) (proposing a uniform federal standard to solve for the hurtful impact of state law); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 533 (2001) (finding that Delaware law improves shareholder value); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 748 (2002) (arguing that there is no state competition because Delaware has monopoly powers over corporate law).

204. *See* 17 C.F.R. § 240.13a-14 (2022) (requiring that both the principal executive and the principal financial officer of a reporting company certify annual and quarterly filings). For the seminal work theorizing the federalization of corporate law, see generally Roe, *supra* note 13.

205. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 and 18 U.S.C.).

206. For a detailed description and analysis of this federalization process, see Roe, *supra* note 13, at 607–32.

207. *See, e.g.*, *id.* at 595–96.

208. *See* Cary, *supra* note 203, at 666.

209. *Id.* (arguing that state competition results in bodies of law that provide managers with too much opportunity to abuse their control of the corporation); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259, 275 (1980) (arguing that state competition provides shareholders excess return from incorporation decisions).

between shareholders' power and the benefit of the firm. In principle, one could reverse both the "race to the top" and the "race to the bottom" narratives on the theory that state competition produces laws that increase firm value by enhancing managerial discretion that reduces principal costs.

Consider, for example, the recent Nevada Supreme Court decision, *Guzman v. Johnson*.[210] In this case, the court ruled that a Nevada statute codifying the "business judgment rule" preempts the previously operative—and more stringent—"inherent fairness standard."[211] Specifically, the court decided that, under Nevada law, a mere allegation that a director was an interested party in a transaction with a corporation does not change the standard of review from "business judgment" to "inherent fairness."[212] In contrast, under Delaware law, the standard of review shifts from "business judgment" to "entire fairness" when a director is an interested party in a transaction with a corporation and is consequently suspected of self-dealing.[213] The difference between Delaware's "business judgment rule" and its "entire fairness standard" is similar to the difference between Nevada's "business judgment rule" and its "inherent fairness standard."[214] This difference represents the shift from the presumption favoring management ("business judgment rule") to the presumption in favor of the plaintiff ("inherent fairness" and "entire fairness" standards).[215] Whether the new Nevada precedent reflects the race-to-the-top or race-to-the-bottom theory depends on the following questions: (1) Is the added managerial deference provided by Nevada law good or bad for the firm? (Here, focusing solely on managerial agency costs would lead to the answer of "bad," yet accounting for the principal costs as well may lead to a different answer) (2) And, empirically, how does the change in the legal regime impact the incorporation rate of Nevada, as compared with Delaware?

The federal government has also created laws that affect corporate governance.[216] An important work by Professor Mark Roe has shown that both threatened and actual federal intervention in corporate law and the ensuing "competition" between Delaware law and federal law best explain many corporate law developments.[217] Specifically, his work demonstrates that federal government interferes with corporate affairs by laying down rules that govern proxy voting, going private transactions, dual-class recapitalizations, and the

210. 483 P.3d 531 (Nev. 2021).
211. *Id.* at 533–34.
212. *Id.*
213. Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993).
214. *Compare id.*, *with Guzman*, 483 P.3d at 537.
215. *See Nixon*, 626 A.2d at 1376; *Guzman*, 483 P.3d at 533–34.
216. *See, e.g.*, *supra* notes 204–06.
217. *See generally* Roe, *supra* note 13.

disclosure and committee structure of reporting companies.[218] These and other rules have displaced state laws.[219] Hence, to fully understand the role and impact of corporate law on firm value, one must understand the combined operation of state and federal laws. The extent to which this federalization casts doubt on the usefulness of state competition theories falls outside the scope of this Article. For this Article's purposes, suffice it to say that federalization both plays a significant role in the development of corporate law and affects firm value.[220]

Enter debt. Accounting for corporate debt and the dynamics involving debtholders and their entitlements changes the foregoing analysis along several dimensions. Under the integrated model of corporate governance, control over managerial decisions and actions is shared by both shareholders and debtholders. Correspondingly, laws that govern corporate bond and loan contracts introduce changes in corporate law generally. Critically, laws that govern bond and loan contracts both in the primary and secondary markets are predominantly federal. Bank loans, for example, are shaped by federal banking regulations that cap the amount of loans that banks may provide, determine which banks may act as lenders and under what circumstances, and define what secondary market instruments are permissible.[221] On the bonds side, it is federal law that prescribes who may buy a bond security both in the primary and secondary markets.[222] Furthermore, debt securities, unlike equity securities, are enforced under the terms of the underlying indenture contract as opposed to a corporate charter.[223] The indenture, in turn, is governed by the Federal Trust Indenture Act for both registered and unregistered bond offerings that contain the obligation of future registration.[224] Among other requirements, the Trust Indenture Act prohibits certain changes to the underlying indenture without court approval.[225] Even in the case of unregistered bonds without registration obligations, bond investors

218. *See id.* at 607–24. *See generally* Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491 (2005); Mark J. Roe, *Delaware's Shrinking Half-Life*, 62 STAN. L. REV. 125 (2009) [hereinafter Roe, *Delaware's Shrinking Half-Life*].

219. Roe, *Delaware's Shrinking Half-Life*, *supra* note 218, at 149.

220. As of recently, overseas jurisdictions also compete with Delaware for the charters of American corporations. *See generally* William J. Moon, *Delaware's New Competition*, 114 NW. U. L. REV. 1403 (2020) (arguing for a theory that incorporates international jurisdictions in the model market for corporate law).

221. For a general overview of the banking regulations, see RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF FINANCIAL INSTITUTIONS 103–48 (6th ed. 2017).

222. Securities offerings must be registered pursuant to the Securities Act of 1933 or otherwise be exempt from registration. *See* Securities Act of 1933, 15 U.S.C. §§ 77a–77z-3, 77aa. Most typically in the market for unregistered bonds, the securities will be sold by the issuer to a broker-dealer pursuant to a section 4(a)(2) exemption, and the broker-dealer will subsequently sell the bonds to qualified institutional buyers pursuant to Rule 144A, or to offshore investors pursuant to Regulation S. *See* 17 C.F.R. § 230.144A (2022); 17 C.F.R. §§ 230.901–.905 (2022).

223. The corporation's certificate of incorporation must include the type and number of stocks. *See* DEL. CODE ANN. tit. 8, § 102(a)(4) (2023).

224. *See* 15 U.S.C. § 77ddd(a)(9).

225. *Id.* §§ 77eee–77fff.

typically require that the offering materials be held to similar disclosure standards as federally required[226] and that the indenture largely copy the requirements of the Trust Indenture Act.[227]

The integrated model of corporate governance thus transforms the analysis of the respective roles of state and federal law. With much of corporate governance lying in the hands of debtholders, an even greater part of corporate governance has already been federalized. Future analyses of how state and federal law and state competition affect firm value must consequently account for the enhanced, debt-induced process of federalization.

Again, both state and federal law affect corporate behavior. It is not clear, however, to what degree these laws translate to primary corporate behavior. In fact, an important article by Professors Zohar Goshen and Sharon Hannes has declared that corporate law is "dead," and that corporate governance is dominated instead by institutional investors.[228] The following Subpart revisits this important insight from the debt perspective by analyzing the effect of the integrated corporate governance model on the roles and incentives of institutional investors.

### B. THE ROLES OF INSTITUTIONAL INVESTORS

The rise of institutional ownership is a sixty-year process that transformed the equity markets in the United States.[229] In the 1960s, institutional investors—those who own multiple securities on behalf of other people—owned about 14% of the country's equity.[230] Today, institutional investors own about 80% of the United States equity market.[231] In the world of institutional investors, "the big three" (Blackrock, State Street, and Vanguard) stand out in size and influence.[232]

226. For example, the issuer of unregistered bonds will still typically provide a Rule 10b-5 representation that the offering materials are true in all material respects and do not contain any material omission. *See* LATHAM & WATKINS LLP, THE BOOK OF JARGON: US CORPORATE & BANK FINANCE (2d ed. 2014), https://www.lw.com/admin/upload/Documents/BoJ_US_Corporate_and_Bank_Finance-locked-March-2015.pdf; 17 C.F.R. § 240.10b-5 (2022).

227. Comm. on Tr. Indentures & Indenture Trs., Am. Bar Ass'n, *Annotated Trust Indenture Act*, 67 BUS. LAW. 977, 982–83 (2012) ("[I]ts terms are broadly important since they also are adopted in the drafting of indentures that are not subject to the TIA.").

228. *See generally* Goshen & Hannes, *supra* note 12.

229. For one of the seminal works on this change, see generally Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013). For a description of this historic process, see Zohar Goshen & Doron Levit, *Agents of Inequality: Common Ownership and the Decline of the American Worker*, 72 DUKE L.J. 1, 12–16 (2022).

230. *See* Goshen & Levit, *supra* note 229, at 13.

231. Jacob Greenspan, *How Big a Problem Is It That a Few Shareholders Own Stock in So Many Competing Companies?*, HARV. BUS. REV., https://hbr.org/2019/02/how-big-a-problem-is-it-that-a-few-shareholders-own-stock-in-so-many-competing-companies (Feb. 22, 2019).

232. *See* Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 723 (2019).

By one estimation, the big three will hold 40% of the voting stocks of S&P 500 companies in the next two decades (on average).[233]

The rise of institutional ownership changes the corporate governance analysis in three principal ways. First, the rise of highly competent institutional investors facilitates shifting corporate governance from being law driven to being market driven.[234] Second, the concentration of ownership in a smaller group of investors means that the investors are, in principle, better equipped to coordinate and effectuate changes in managerial policy.[235] Third, the ascendance of institutional ownership creates a new set of agency costs: costs originating from the misalignment between the interests of institutional investors and the stock's ultimate beneficiaries.[236] This Subpart analyzes these dynamics and then demonstrates how understanding debt as corporate governance alters this analysis. Specifically, the analysis demonstrates that the dominance of institutional investors in the secondary debt markets reveals that they are more powerful, active, and controlling than commonly understood.

There is persuasive evidence indicating that, given the current state of the market for corporate control, the laws that govern corporate governance are far less influential than before.[237] Instead, institutional investors, by way of private ordering, have taken over much of corporate governance.[238] For example, while Delaware law provides that takeover defense tactics such as poison pills and staggered boards are largely permissible,[239] corporations have actually shifted away from using these tactics.[240] As part of this dynamic, private orderings developed by pension funds, and contributed to by the Shareholder Rights Project (a program led by Professor Lucian Bebchuk), have effectively reduced the number of staggered boards in large public companies by 100 over a two-year period.[241]

233. *Id.* at 741.

234. *See generally* Goshen & Hannes, *supra* note 12.

235. *See, e.g.*, Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 61–64 (2019) (explaining the governance benefits of ownership concentration).

236. *See, e.g.*, Gilson & Gordon, *supra* note 229, at 889 (describing the agency costs of institutional investors and beneficial owners).

237. *See, e.g.*, Goshen & Hannes, *supra* note 12, at 277–89 (providing a full description of the changed role of Delaware law).

238. *Id.* at 282.

239. *Id.* at 277 (describing the Delaware case law addressing these defense tactics).

240. *Id.* (describing the decline in the use of these tactics).

241. *Id.* at 278; *see also* Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 26, 2013), https://corpgov.law.harvard.edu/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/ (criticizing initiatives that empower equity holders and addressing Professor Lucian Bebchuk); Goshen & Hannes, *supra* note 12, at 278 & n.75 (citing Lipton, *supra*).

The ability of institutional investors to effectuate change outside of the courtroom is hardly surprising. In fact, this consequence is predicted by the basic corporate governance model outlined in Part I.A.[242] When ownership is concentrated rather than dispersed, shareholders can coordinate their efforts more effectively and at a lower cost.[243] Some scholars and practitioners have noted, however, that this potential for effective corporate governance remains largely unrealized.[244] While concentrated ownership allows for coordinated efforts for change, institutional investors such as passive index funds have an incentive to stay uninvolved and uniformed.[245] This view is debatable.[246] Arguably, index funds have an incentive to compete with other funds (such as activist hedge funds) and retain their investors through the adoption of potent corporate governance strategies.[247]

Institutional ownership affects the value of the firm not only directly, but also via conflicts that arise between the institutional investors and their ultimate beneficiaries. Institutional investors may, for example, make investment decisions or adopt governance initiatives that benefit their relationship with management at the expense of the ultimate beneficiaries of the fund.[248] Such scenarios are possible because the ultimate beneficial owners tend to be locked into their investment in the fund.[249] For similar reasons, institutional investors may act in ways that benefit their affiliate active funds at the expense of the funds' ultimate beneficiaries.[250]

The integrated model of corporate governance changes this picture. First, as far as the composition of actors affecting corporate governance is concerned, it is critical to consider the debtholders together with, rather than in isolation from, the institutional shareholders. Most bond owners are institutional investors such as mutual funds, pension funds, and insurance companies.[251] As explained

242. *See* Fisch et al., *supra* note 235 and accompanying text.

243. *See, e.g.*, *id.* at 61–63.

244. *See, e.g.*, Bebchuk et al., *supra* note 15 (arguing that index funds have poor incentives to engage in governance improving activities); Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 495 (2018) (arguing that passive institutional investors do not have sufficient incentives to make informed decisions).

245. Lund, *supra* note 244, at 495.

246. *See, e.g.*, Fisch et al., *supra* note 235, at 43 (arguing that index funds do in fact effectuate governance changes). *See generally* Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771 (2020) (arguing that both index funds and activist hedge funds play an important and active role in corporate governance).

247. Kahan & Rock, *supra* note 246, at 1774.

248. *See, e.g.*, Fisch et al., *supra* note 235, at 65.

249. *Id.*

250. *Id.*

251. *See, e.g.*, BAGARIA, *supra* note 76, at 36 (discussing investor base of high-yield bonds); ORGANISATION FOR ECON. CO-OPERATION & DEV., CORPORATE BOND MARKET TRENDS, EMERGING RISKS AND MONETARY POLICY 6 (2020), www.oecd.org/corporate/Corporate-Bond-Market-Trends-Emerging-Risks-and-Monetary-Policy.htm (discussing investor base of investment-grade notes).

in Part I, loans are typically no longer held entirely at the issuing bank.[252] By and large, they come in the form of investment vehicles identified as CLOs and are held by mutual funds, pension funds, and insurance companies.[253] Hedge funds also participate in both the bond and loan markets, although, as in the equity markets, they are typically minority investors.[254]

Second, given that institutional investors are also large and concentrated owners of corporate debt, they effectuate corporate governance changes through their debt interests and underlying contracts rather than just as equity investors—as under the incomplete, and hence inaccurate, equity-only paradigm. Indeed, there is strong evidence suggesting that institutional investors attempt to effectuate governance changes through debt contracts. For example, while institutional investors only acquire their debt interest through the bank arranging the loan or the broker-dealer reselling the bonds, their participation is evidenced by the inclusion of "market flex" provisions.[255] Market flex provisions are pre-negotiated changes to the terms of the debt contract in case it proves helpful to the lender or broker-dealer in syndicating or reselling the debt interest.[256] Furthermore, there is evidence indicating that hedge fund owners of debt are particularly active in the enforcement of bondholder rights.[257] On top of all this, debt investors effectuate corporate governance changes through their investment decisions.[258]

Last but not least, future investigations into the potential conflicts of interest between institutional investors and the fund's ultimate beneficiaries will also have to account for the policies these investors pursue from their debt positions. Specifically, it should be investigated whether the governance policies that institutional investors promote through their debt positions align with the governance policies pursued from their equity positions. To the extent there is a conflict between these two sets of policies, it is important to ascertain whether it hurts or benefits the firm. To that end, policymakers and scholars should use the integrated model of corporate governance, which accounts not only for agency and principal costs, but also for debtholders' costs. The debt as corporate governance perspective is therefore critical to understanding the true role

252. *See supra* notes 111–13 and accompanying text.

253. Emily Liu & Tim Schmidt-Eisenlohr, *Who Owns U.S. CLO Securities?*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (July 19, 2019), https://www.federalreserve.gov/econres/notes/feds-notes/who-owns-us-clo-securities-20190719.htm.

254. *See, e.g.*, BAGARIA, *supra* note 76, at 36; *see also* ORGANISATION FOR ECON. CO-OPERATION & DEV., *supra* note 251, at 21.

255. *See Market Flex*, JONES DAY, https://www.jonesday.com/-/media/files/publications/2019/02/market-flex/market-flex.pdf (last visited May 12, 2023).

256. *See id.*

257. *See* Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. U. L. REV. 281, 283 (2009).

258. *See, e.g.*, *supra* notes 57–69 and accompanying text.

institutional investors play in corporate governance. With all this in mind, the following Subpart evaluates the impact of debt on the corporate purpose.

## C. THE CORPORATE PURPOSE

The debate over the corporate purpose has recently resurged as a top priority for scholars and practitioners alike.[259] The two camps comprising the debate are those who support "shareholderism" and those who favor "stakeholderism."[260] Shareholderism posits that management should direct its efforts toward maximization of profits for the corporation and its shareholders.[261] Stakeholderism, on the other hand, maintains that management should act on behalf of the firm to benefit other constituents as well.[262] These constituents typically include employees, local communities, the environment, and even society at large.[263] Stakeholderism can be subdivided into two distinct positions, aptly described by Professors Lucian Bebchuk and Roberto Tallarita as instrumental and pluralistic stakeholderism.[264] Instrumental stakeholderism is a theory that promotes the consideration of other stakeholders merely as a means for enhancing shareholder value.[265] Pluralistic stakeholderism, in contrast, is geared toward advancing the interests of the firm's other stakeholders as ends in and of themselves.[266] Also woven into the debate over the corporate purpose is the push for corporations to pursue CSR goals and to do so in measurable

259. *See, e.g.*, LYNN STOUT, THE SHAREHOLDER VALUE MYTH 24–46 (2012) (providing arguments against shareholder primacy). *See generally, e.g.*, Bebchuk & Tallarita, *supra* note 16 (arguing that governance models that support stakeholderism are not likely to be useful and will likely impose unintended costs); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932) (seminal work on stakeholderism); Lucian A. Bebchuk, Kobi Kastiel & Roberto Tallarita, *For Whom Corporate Leaders Bargain*, 94 S. CAL. L. REV. 1467 (2021) (finding that directors did not pursue stakeholder goals even when they had the discretion to do so); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (arguing that directors should take into account stakeholders other than shareholders); Jens Dammann & Horst Eidenmüller, *Corporate Law and the Democratic State*, 2022 U. ILL. L. REV. 963 (arguing for the benefits of giving employees a say on director elections); Lisa M. Fairfax, *Easier Said Than Done? A Corporate Law Theory for Actualizing Social Responsibility Rhetoric*, 59 FLA. L. REV. 771 (2007) (arguing for a corporate law theory that takes socially responsible rhetoric into account); Press Release, Bus. Roundtable, Statement on the Purpose of a Corporation (Aug. 19, 2019), https://s3.amazonaws.com/brt.org/BRT-StatementonthePurposeofaCorporationOctober2020.pdf (documenting an announcement by a group of CEOs of the largest corporations stating they are committing to stakeholderism); Klaus Schwab, *Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution*, WORLD ECON. F. (Dec. 2, 2019), https://www.weforum.org/agenda/2019/12/davos-manifesto-2020-the-universal-purpose-of-a-company-in-the-fourth-industrial-revolution/ (encouraging corporations to pursue stakeholderism).

260. Bebchuk & Tallarita, *supra* note 16, at 94.

261. *See, e.g.*, *id.* at 97.

262. *Id.* at 105.

263. *Id.*

264. *Id.* at 97.

265. *Id.* at 108–11.

266. *Id.* at 114–21.

impacts on ESG metrics.[267] This push has been incorporated into both state corporate laws and federal securities law—including, importantly, by way of imminent reform to ESG disclosure requirements for publicly traded companies.[268]

This Subpart shows that this debate can benefit from the integration of the debt as corporate governance paradigm. Specifically, it demonstrates that the role of debt in the corporate purpose debate, while very much a part of positive corporate law, has been largely ignored. Yet debt is in fact an invaluable catalyst for evaluating the authenticity and extent of the firm's commitment to CSR and ESG goals.

As a matter of positive law, management has fiduciary duties to debtholders when a company becomes insolvent.[269] When a corporation is insolvent, the fiduciary duties of directors broaden to include debtholders in addition to the corporation and shareholders.[270] Under Delaware law, the fiduciary duties of directors of a company in the "zone" or "vicinity" of insolvency do not broaden to include debtholders.[271] In other words, as a matter of ordinary course, debtholders are not a part of the corporate purpose. However, there are built-in corporate law mechanisms for the insertion of debtholders into the corporate purpose under certain conditions amounting to insolvency.

Under current law, the corporate purpose thus includes debtholders' interests only in a small subset of circumstances. Yet debtholders have continually been influential and active catalysts for CSR and ESG goals. On the bond side, this phenomenon is illustrated by the rise of social and sustainability linked bonds, which in 2020 grew by 29% year-over-year to a high of $732 billion.[272] For example, Apple has been able to raise $4.7 billion in green bonds as part of its efforts and committed, stated purpose to reach carbon neutrality across its entire carbon footprint.[273] Furthermore, evidence reveals that bondholders provide better financing terms for firms with gender-diverse

267. For a comprehensive analysis of these definitions, see generally Elizabeth Pollman, *The Making and Meaning of ESG* (Eur. Corp. Governance Inst., Working Paper No. 659, 2022), https://ssrn.com/abstract=4219857.

268. For a robust and complete description of these two verticals, see generally Thomas Lee Hazen, *Corporate and Securities Law Impact on Social Responsibility and Corporate Purpose*, 62 B.C. L. REV. 851 (2021).

269. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613, at *33–34 & n.55 (Del. Ch. 1991) (seminal Delaware decision on this doctrine).

270. N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 100–02 (Del. 2007).

271. *Id.* at 101.

272. *See supra* note 18.

273. Stephen Nellis, *Apple Inc Spending from 'Green Bonds' Hits $2.8 Billion*, REUTERS, https://www.reuters.com/article/apple-environment-int/apple-inc-spending-from-green-bonds-hits-2-8-billion-idUSKBN2B90RG (Mar. 17, 2021, 12:05 AM).

boards.[274] On the loan side, the aggregate market for both green and sustainability linked loans (commonly referred to as "SLLs") has also boomed to a $167 billion market in 2019, which is a 150% increase from 2018.[275] The difference between "green" and "social" or "sustainability" linked loans or bonds is that a green loan or bond has a defined use of proceeds that will be placed into a green project.[276] Sustainability linked debt deviates from this "use of proceeds" structure and instead places contractual incentive terms that reward companies' "good behavior."[277] A company's "good behavior" is monitored by the inclusion of sustainability performance targets, which are measured by key performance indicators ("KPIs").[278] KPIs may include, for example, measures of energy efficiency, provision of affordable housing, and, as stated by the Loan Syndications and Trading Association, "[i]mprovements in the borrower's 'management of the relationship between businesses and the communities in which they operate, including, but not limited to, management of direct and indirect impacts on core human rights and the treatment of indigenous people.'"[279]

The fact that debtholders have proved to be highly productive agents for both CSR and ESG bolsters the explanatory power of the debt as corporate governance paradigm and the integrated corporate governance model. As importantly, it also provides normative reasons to reject shareholderism and adopt stakeholderism.

From a normative standpoint, the governance pressure of debtholders and their push for the advancement of CSR and ESG goals support both instrumental and pluralistic stakeholderism. For those who support instrumental stakeholderism, the fact that including debtholders in the governance of a corporation enhances the availability of financing and better financial terms for the corporation provides reasons to adopt debtholders as beneficiaries of the corporate purpose. For those who support pluralistic stakeholderism, the reason for adopting debtholders as constituents of the corporate purpose comes from

274. *See* Renee M. Oyotode-Adebile & Zubair Ali Raja, *Board Gender Diversity and US Corporate Bonds*, 15 INT'L J. MANAGERIAL FIN. 771, 786–87 (2019).

275. Kenneth Chin & Jefferson Lai, *United States: An Introduction to Sustainability Linked Loans*, MONDAQ (Apr. 15, 2021), https://www.mondaq.com/unitedstates/financial-services/1058258/an-introduction-to-sustainability-linked-loans.

276. *Id.*

277. *See, e.g.*, James Hardy, Jeremy Duffy & Mindy Hauman, *Sustainability-Linked Loan or Green Loan: Which? When? Why?*, WHITE & CASE LLP (May 28, 2020), https://www.whitecase.com/publications/alert/sustainability-linked-loan-or-green-loan-which-when-why.

278. *See, e.g.*, *Sustainability-Linked Loan Principles: Supporting Environmentally and Socially Sustainable Economic Activity*, LOAN SYNDICATIONS & TRADING ASS'N (Mar. 31, 2022), https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/ [https://web.archive.org/web/20230106133008/https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/].

279. *Id.*

the fact that debtholders prove to be useful agents and financiers of many diverse interest groups, such as local communities and environmental groups.

The doctrinal basis of debt in the corporate purpose also provides legal tools for the future inclusion of other stakeholders. The future incorporation of stakeholders into the corporate purpose may usefully borrow from the way debt fiduciary law has developed. For example, one potential avenue for the legal inclusion of stakeholders could be the establishment of social and sustainability fiduciary duties when the corporation is in "social insolvency." A stronger articulation may also require the inclusion of other stakeholders when the corporation is in the "zone of social insolvency."

## CONCLUSION

Balki Bartokomous of *Perfect Strangers* once said "I am in debt. I am a true American."[280] While it is doubtful that Balki had the American corporation in mind, this saying is a spot-on description of our corporate law and governance.

This Article has demonstrated that the currently prevalent equity-only model of corporate governance is incomplete. Viewing American corporations through the paradigm of debt as corporate governance, advocated in this Article, addresses this shortfall and captures all control costs: agency costs, principal costs, and debtholder costs.

Based on this paradigm, this Article has shed light on the role of debt as corporate governance and provided a complete analytical organization of typical debt facilities and their covenants. In doing so, it has mapped out the covenant package as control rights and board-restricting covenants, asset-restricting covenants, and cash-restricting covenants across high- and low-debt companies, as well as public and private companies. Building on the debt as corporate governance paradigm and utilizing the mapping of covenant packages uncovers the implications and usefulness of the integrated model of corporate governance as a tool for analyzing contemporary corporate affairs, which include federalization and the ascendance of the institutional investor. In that context, debtholders play a vital role in matters of corporate social responsibility.

280. EXPERIAN, THE ABCS OF CREDIT REPORTING: LESSON PLAN, PARTICIPANT MATERIALS AND ANSWER KEYS 1 (2017), http://www.experian.com/assets/consumer-education-content/brochures/abcs-of-credit-reporting-lesson-plan.pdf.

## APPENDIX

### TABLE 1: COVENANTS

| **Covenant** | **Definition** | **Notes** |
|---|---|---|
| Asset-Sales | Covenants that prescribe the consideration to be received from the selling of assets and subsidiary stock. | Asset Sales are not common in investment-grade bonds. |
| Change-of-Control | Covenants that provide debtholders the ability to sell back or accelerate the repayment of the debt at a premium upon certain changes in the equity or asset ownership of the company. | In investment-grade or low-debt facilities, the covenant often includes a "double trigger" provision, which also requires the occurrence of a credit decline in the credit rating of the company. |
| Continuing-Directors | Covenants that provide debtholders with the ability to sell back or accelerate the repayment of the debt at a premium upon certain changes in board composition. | Continuing directors are much more prevalent in public reporting companies than in private companies. |
| Dead Hand Proxy Put | A continuing-director provision that does not exclude noncontinuing directors approved by the current board. | Dead hand proxy put is less common than proxy puts; it provides debtholders with the sole waiver right over the designation of the board change as an event of default. |
| Liens Covenant | Covenants that restrict the borrower's ability to provide future liens securing the assets of the company. | Liens covenants are often structured to permit a capped number of liens securing assets. The capped amount is usually significantly larger in investment-grade or low-debt companies. |
| Limitation on Affiliate Transactions | Covenants requiring that any transaction the borrower or its restricted subsidiaries makes with affiliates is made on terms that are as favorable as the terms available for unrelated third parties in similar transactions. | Limitations on affiliate transactions are not common in investment-grade or low-debt companies. |

| | | |
|---|---|---|
| Limitation on Debt Incurrence | An incurrence covenant restricting the ability of the borrower or the issuer to raise additional debt. | Limitations on debt incurrence is not common in investment-grade or low-debt companies, except that sometimes debt-incurrence limitations will be imposed upon subsidiaries. |
| Limitation on Dividend Stoppers | Covenants that prevent prohibitions on the ability of subsidiaries to transfer cash to the issuer or the borrower. | Limitations on dividend stoppers are typically designed to ensure that upstream dividends or intercompany debt repayments can reach the debt-incurring entity. |
| Limitation on Restricted Payments | An incurrence covenant restricting the ability of the borrower to make payments such as dividends. | Limitations on restricted payments are not common in investment-grade or low-debt companies. |
| Limitation on Sale and Leaseback | Covenants that prohibit the renting of fixed assets that were sold to a bank or institutional investor. | In noninvestment grade debt, this limitation is typically part of the limitation on debt incurrence. |
| Maintenance Fixed Charges Coverage Ratio | A maintenance covenant requiring that the borrower maintain a certain ratio of EBITDA to fixed charges. | Maintenance fixed charges coverage ratio is only common in leveraged loans. |
| Maintenance Interest Coverage Ratio | A maintenance covenant requiring that the borrower maintain a certain ratio of EBITDA to interest expense. | Maintenance interest coverage ratio is only common in leveraged loans. |
| Maintenance Leverage Ratio | A maintenance covenant requiring that the borrower maintain a certain ratio of total funded debt to EBITDA. | Maintenance leverage ratio is only common in leveraged loans. Variations of this ratio replace funded debt with senior debt or otherwise reduce the ratio by the amount of cash on hand. |
| Proxy Put | A continuing-director provision that excludes noncontinuing directors who were approved by the current board from the definition of the default scenario. | Proxy puts are more common than dead hand proxy puts. Proxy puts provide both management and debtholders with the ability to designate a board change that would otherwise trigger an event of default with a waiver right. |

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|---|---|---|
| Reporting Covenant | Covenants that require a borrower or issuer to provide the debtholders with access to books and records as well as to material nonpublic information such as financial projections. | The provision differs in articulation depending on whether the company is a public reporting company. Reporting covenants are typically more demanding in private companies. |

TABLE 2: TERMS OF ART

| **Term** | **Definition** |
|---|---|
| Baskets | Negotiated financial exceptions to incurrence covenants such as the limitation on indebtedness and the limitation on restricted payments. |
| Contractual Subordination | Contractual subordination occurs when a debt claim is junior to another claim by virtue of the terms of the relevant contract. |
| Credit Group | The aggregate of the entity issuing or incurring the debt and its restricted subsidiaries. |
| Incurrence Covenant | A covenant that does not require active actions on the part of the borrower or issuer but instead requires that if a certain action is undertaken, it must pass muster under prescribed conditions. |
| Lien Subordination | Lien subordination occurs when a claim is junior to another claim by virtue of collateral priority rights and securitized interests in assets. |
| Maintenance Covenant | A covenant that requires active actions on the part of the borrower or issuer as well as the testing of compliance with the covenant in regular intervals. |
| Restricted Subsidiaries | The subsidiaries designated as bound by the covenant package. |
| Structural Subordination | Structural subordination occurs when a claim is junior to another claim by virtue of the structural nature of the firm. Most typically in the debt context, a debt claim on a parent borrower is a junior claim on a subsidiary, structurally, compared to a direct equity or debt claim on that subsidiary. |
| Unrestricted Subsidiaries | All subsidiaries not defined by the relevant debt document as a “restricted subsidiary.” |

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