INTRODUCTION

# NORMS, LAW, AND CONTRACT IN THE LOAN MARKET

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Even among the battle-hardened veterans of the loan market, the aggressive conduct of both borrowers and lenders over the last few years has been raising eyebrows. What's more—they are getting away with it. While there is little clarity on where to lay blame, all agree that the baseline behavior has changed. Relationships, reputations, and contractual obligations no longer seem to constrain and moderate participants' behavior as they did in prior decades. How should we understand these developments, and what, if anything, can be done about them?

In finance, there are three essential tools to get parties to behave a certain way: norms, law, and contract. This article addresses each of these in turn, showing why they have proven less effective in recent years at constraining opportunistic behavior in the loan market, particularly in the distressed space.

## I. THE DECLINE IN NORMS

### 1. How are Norms Established?

We tend to think of the financial markets as the realm of self-interested behavior, so it may come as a surprise that, historically, much of parties' conduct in the financial markets has been determined simply through norms. And yet that is undeniably the case. Precisely because these norms were so widely observed, they remained largely unnoticed by market participants. There are endless examples: clerical errors are corrected without objection; mistaken payments are returned; defaults of which lenders were aware are not enforced years later; parties do not litigate based on frivolous interpretations of the debt contract; and so forth.

What exactly do we mean by "norm"? A norm exists when we observe a group of people or institutions behaving cooperatively or altruistically—that is, in ways that don't appear to benefit their *immediate* self-interest—when they are not legally or contractually required to do so.

Despite their traditional association with ethics and religion, norms tend to be followed in a commercial context only when there are economic incentives for the parties to do so: one must either expect a benefit from following the norm or punishment from failing to do so. In other words, for norms to be widely adopted and followed, there must still be a carrot, a stick, or both.

A typical "carrot" would be reputational benefits: by observing the norm, the party establishes and maintains a certain reputation for good behavior, and is rewarded in the future with more business. In the bygone era of relationship lending, for example, banks might always choose to negotiate waivers with borrowers in good faith, rather than acting opportunistically, in order to maintain a reputation as a good partner for borrowers. A typical "stick" would be exclusion from the market: other participants band together to exclude the bad actor who violated the norm from the next deal. ("Naming and shaming" is another common approach to punishment for norm violation.) For example, there has never been a law requiring real estate agents to be paid a 6% commission, and yet this figure persisted for a very long time as a norm. Part of the explanation is that other agents were successful at retaliating against agents who defected from this arrangement. (A similar dynamic might be said to exist with the 7% underwriting fee for IPOs.)

The power to reward for good behavior and to punish and exclude for bad behavior are therefore crucial to maintaining norms in a commercial setting. A long literature has found that these two features—reputational benefits and informal enforcement of the norm—tend to work best with a small, tight-knit community or group of actors having very similar incentives. (Diamond dealers are often given as an example.)

### 2. Application to the Loan Market

Unfortunately, none of the above conditions seems to hold in the loan market today, for three reasons.

First, there has been an explosion in the number and types of lenders over the last few decades. The syndicated loan market has evolved from a relatively small group of banks to a vast array of foreign and domestic financial institutions, loan mutual funds, CLOs, distressed debt funds, business development companies (BDCs), and others. This means that lenders are less likely to have interests that are perfectly aligned, and coordination and communication among such a large, disparate group is considerably more difficult. The relative decline in importance of the major underwriters has also played a part, as they often performed precisely this coordinating role in the market. And with borrowers' capital structures growing ever more complicated, the potential for conflicts among the various parties increases.

Second, there are fewer rewards for cooperation in the loan market today. As in most financial markets, there has been a steep decline in long-term relationships among market actors. This is most obvious in the shift from traditional relationship lending to the originate-to-distribute model that characterizes syndication. Thirty years ago, it would not be uncommon for a company to use the same single bank for its financings over multiple decades. Today, each deal comes with an endlessly changing cast of characters, none of which necessarily has any relationship to the others. (Of course, the shift from relationship lending to syndicated lending has surely been a positive development for the economy overall, by lowering companies' cost of capital. The point is not to critique this shift, but simply to note that it makes the enforcement of norms considerably more difficult.) The role of reputation explains why distressed borrowers have always been more inclined to engage in opportunistic and aggressive behavior: in the language of game theory, distressed borrowers are in an end game, rather than a repeated game, so they are not concerned with potential reputational harm from behaving badly. As a general matter, then, the gradual expansion of the syndicated loan market toward borrowers further down the ratings scale means that aggressive behavior is more common.

Third, and finally, there are fewer penalties today for lack of cooperation. This is primarily due to the extraordinarily low interest rate environment that has persisted far longer than anyone had predicted. Recall that a typical punishment for norm violation is the ability to exclude the bad actor from future transactions. But with interest rates near zero, borrowers face a seemingly unlimited supply of capital from lenders desperate for yield. As a result, borrowers are well aware that they are unlikely to face any penalty (in the form of a higher cost of capital) in future financings if they misbehave in the current one. The private equity sponsors who engage in the most aggressive restructurings of their portfolio company debt, for example, do not appear to have any trouble finding capital for subsequent deals.

To conclude, when it comes to norm observance, the loan market is in some sense a victim of its own success. Due to its extraordinary growth and overabundance of capital, it is no longer the small, clubby community that marked its beginnings. It is no surprise, therefore, that the strong norms that existed in the market at inception have weakened considerably or disappeared altogether.

If norms can no longer be counted on to regulate parties' behavior, however, then this puts more pressure on the two remaining tools—law and contract.

## II. LAW IS NOT THE ANSWER

For the law to function well at incentivizing desirable behavior or proscribing undesirable behavior, two things (at least) are required: (1) good substantive legal rules; and (2) good enforcers of these rules. This has posed a problem for the loan market, because the substantive protections for lenders have been watered down over time, and judges are increasingly reaching unexpected outcomes in financing disputes. (For simplicity's sake, this article addresses only legal protections outside of bankruptcy. While there has been a similar rise in aggressive maneuverings within bankruptcy proceedings, the explanations for this devolution are slightly different.[1])

### 1. Caveat Lender

In theory, the law could mandate all manner of protections for creditors, prohibit various behavior deemed especially opportunistic, and provide for rules that encourage and reward coordination and cooperation. Because it is so difficult to determine in advance what behavior should be considered desirable or reprehensible in context, however, a common approach to dealing with the problem of opportunistic behavior is implied legal *standards* of conduct, rather than precise legal rules. For example, rather than dictating precisely what corporate directors and officers should do under all circumstances, the law instead subjects them to "fiduciary duties"—essentially, a broad and vague admonition to act in the best interests of the firm. In addition, all contracts, including credit agreements and indentures, are subject to a legally imposed "implied covenant of good faith and fair dealing," which could theoretically prohibit contract parties from behaving opportunistically, in contravention of the "spirit" of the deal.

In practice, however, these two mechanisms provide little to no protection today for creditors in deals involving only sophisticated parties. Over time, courts examining debtor-creditor disputes outside of bankruptcy have taken increasingly firm positions on two key issues: first, that directors' and officers' fiduciary duties are solely for the benefit of the company and its shareholders, and *not* for the benefit of creditors; and, second, that there is no actual substantive bite to the implied covenant of good faith and fair dealing in debt contracts among sophisticated parties.

In other words, creditors are on their own. Worse still, when in doubt judges will (1) favor borrowers over creditors and (2) assume that all borrower conduct is permitted unless it is expressly and specifically prohibited in the contract.

It is not hard to understand why judges have come to espouse this view: because financing deals have become so complex (as we will discuss below), judges do not want to have to decide on their own what is "fair" or "good faith" when sophisticated parties are involved. They prefer for the parties to spell out precisely what they expect in all circumstances.

### 2. Generalist Judges

For the same reasons, however, there appears to be an increasing mismatch between the types of financing disputes that arise and the ability of judges to decide them in a predictable fashion—that is, in line with market expectations. The judges that decide the vast majority of major financing disputes outside of bankruptcy are generalist judges—most often federal judges in New York, who handle far more criminal law and constitutional law cases than commercial and contract law ones. At the same time, the cases that they are being asked to resolve are ever more complex, and involve more parties with conflicting interests. As a result, these judges are to some extent being set up to fail. The result is an increasing gap between the actual outcomes reached by the judges in these cases and the outcomes that the market as a whole had anticipated. A notorious recent example involves Citibank's $900 million mistaken payment to the Revlon lenders, in which the trial court ruled that the lenders who were paid in error were entitled to simply retain the funds.[2]

The crucial takeaway from this decline in norms and law is that the only place lenders can look to for help is their own contracts. Any protections that the parties want must be specifically negotiated for in advance in the documentation. As we will see, however, achieving this is significantly more difficult than judges seem to appreciate.

## III. CONTRACTS ARE ALWAYS INCOMPLETE

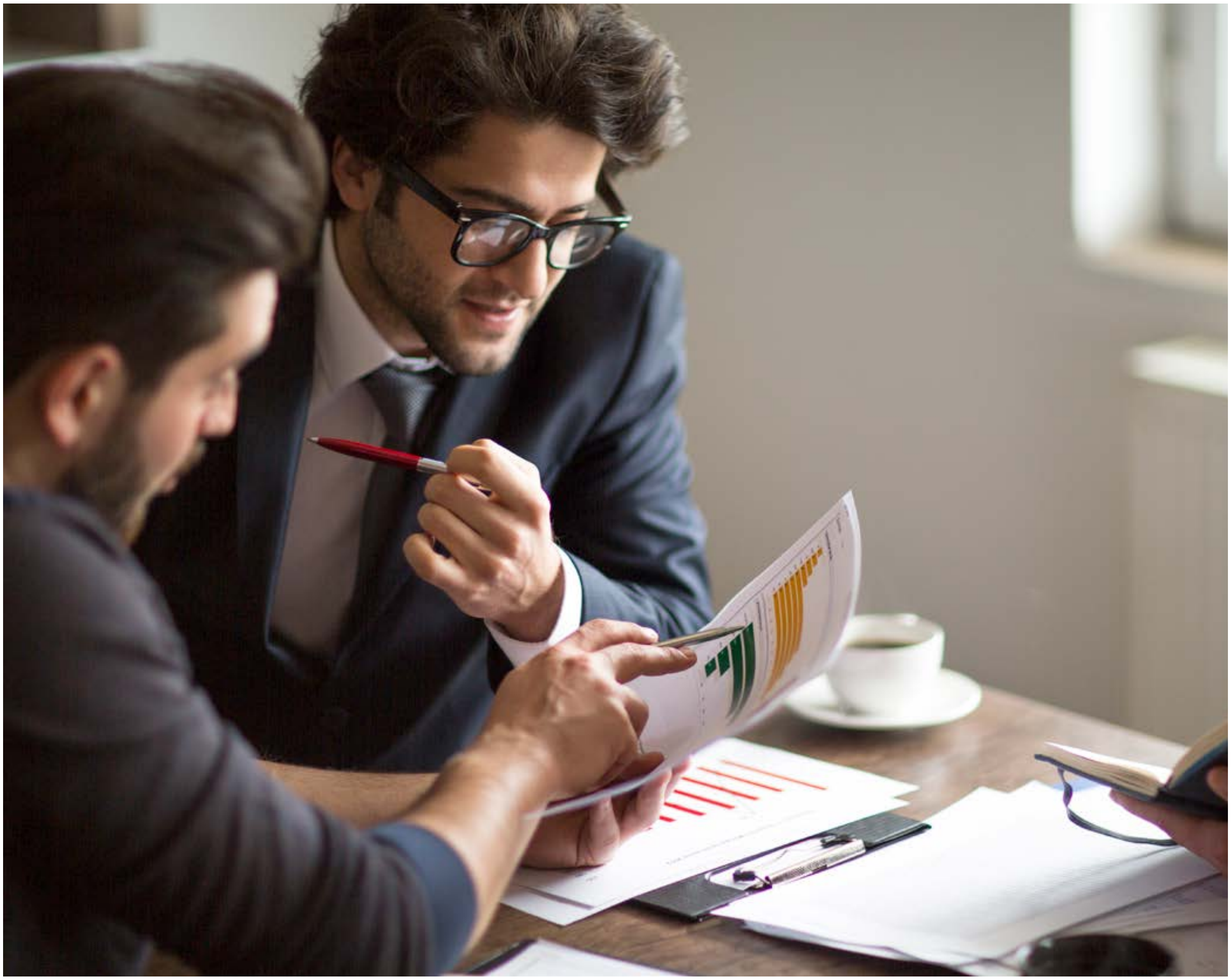
The failure of norms and law to prevent opportunistic behavior in the loan market puts enormous pressure on loan documentation to pick up the slack. And yet, debt contracts appear to be failing in this regard as well, primarily for two reasons: (1) market conditions and (2) the rise in complexity of loan transactions.

### 1. Market Conditions

Market conditions play a major role in explaining recent opportunistic behavior by distressed borrowers,

[1] See, e.g., Adam J. Levitin, *Purdue's Poison Pill: The Breakdown of Chapter 11's Checks and Balances* (forthcoming, TEX. L. REV. 2021), available at ssrn.com/abstract=3851339; Jared A. Ellias & Robert Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745 (2020).

[2] See In re Citibank Aug. 11, 2020 Wire Transfers, No. 20-CV-6539 (JMF), 2021 WL 606167 (S.D.N.Y. Feb. 16, 2021).



including attempts to play lenders off against one another. Due to the persistence of historically low interest rates, lenders desperate to deploy their capital routinely agree to terms that leave the door open for borrowers to change the deal down the road. Industry reports and academic research both clearly document a major decline in covenant protections over time in syndicated loans, with the proliferation of covenant-lite deals only the tip of the iceberg. When lenders fund deals with extraordinarily permissive adjustments to EBITDA, endless exceptions to negative covenants, and flexibility for the borrower around refinancings and restructurings, it is surely predictable that things will go poorly for most lenders in the event that the borrower experiences financial distress. (Much of this borrower-friendly innovation in contract provisions has been driven by the largest private equity sponsors, who have every incentive to maximize the flexibility for highly leveraged borrowers.)

The first time that a borrower employs an aggressive restructuring technique, lenders can perhaps be forgiven for failing to predict it. After that, however, if underwriters and lenders fail to request changes to the documentation, judges will deem that they are implicitly making a trade-off between (1) the risks they face in a downside scenario and (2) the opportunity cost of missing out on the current deal. As a result, they will find little sympathy in the courtroom.

**2. Contractual Complexity**

Because the decline in covenants is so closely tied to market conditions, we should expect it to slow down or reverse course somewhat if and when market conditions change. Just as the global financial crisis of 2008-2009 led to a brief, but meaningful, tightening of underwriting standards, another recession or an increase in interest rates may yield covenants that are somewhat more lender-friendly.

Yet that is only part of the concern with loan-market documentation. Unfortunately, the second problem is arguably more pernicious, and is unlikely to be reversed. It is the fact that highly complex debt contracts not only fail to prevent opportunistic behavior by the parties; they may actually exacerbate it. As discussed above, because generalist judges are uncomfortable deciding what behavior should and should not be permitted in financing arrangements, they expect parties to spell everything out in the debt contract. The problem is that this is an impossible goal for parties to achieve. Contract theory, the branch of economics devoted to studying contractual arrangements, has long recognized that all contracts are necessarily *incomplete*. It is impossible to predict all possible future states of the world, and even if it were, it is either too difficult or too costly to address each one through enforceable contract language. Moreover, parties' incentives change over time, so it is not always clear exactly what outcome they would even want under every circumstance.

Nonetheless, because judges expect debt contracts to be complete in this way, parties desperately try to achieve that level of detail. *Credit documentation has grown exponentially longer and more complex in the last two decades*, with detailed provisions replacing flexible standards. Ironically, the length and complexity of documentation today does not appear to have led to more predictable outcomes for creditors. If anything, it may be making the problem worse, because it creates new opportunities for opportunism by the parties. Down the road, a particular provision that is highly complex (or the interaction between several different complex provisions) can be used by a party to engage in conduct that obviously does not fit with the parties' original intent. (The "trap-door" in the J. Crew credit documentation that allowed for collateral stripping comes to mind here, as but one among many recent examples.)

As discussed above, if lenders are harmed in one transaction in a manner that they did not expect, they will find no sympathy from judges in subsequent transactions if they fail to include language addressing that specific problem. But that is far from a straightforward solution. The more new language is added to address a single bad outcome, the more chances there are for new and different unexpected problems to arise, the more complexity increases, and the more potentially undesirable interactions arise among the various contract provisions. Returning to the Citibank/Revlon case, one need only observe the current fights over proposed new "mistaken payment" provisions to recognize how intractable it can be to try to resolve each new problem with more new language.

Furthermore, because the language is so complex, there is always a chance that a judge will get it wrong when interpreting the contract if a dispute arises—that is, that the judge will interpret the contract in a manner that the market overall would not expect. Given that, there is every incentive for opportunistic parties to sue to try to enforce unexpected interpretations that serve their interests, at the expense of all other parties. (C.f. the endless fights over the *pari passu* clause in Argentina's bond indentures, or the dispute over the make-whole premium in *Cash America*.[3])] In turn, this emboldens other parties to engage in precisely this type of "contract arbitrage," which disrupts the market by making outcomes less predictable and effectively imposes a tax on all debt deals.

## IV. CONCLUSION

There is a growing sense in the loan market that credit expectations and actual outcomes are diverging, and that the behavior of borrowers and lenders has become increasingly aggressive. How did we arrive here? The combination of persistently low interest rates, the explosion in the number and types of lenders and borrowers, the influence of highly sophisticated and incentivized actors such as private equity funds and distressed debt hedge funds, and the surge in complexity of documentation, has led to the devolution of norms and the decline in legal and contractual protections in the loan market.

Is there a way to reverse course, while retaining the considerable benefits of a vast and diverse loan market? While higher interest rates would help to some extent, the deeper problems relating to the negotiation and interpretation of debt contracts do not offer any ready solutions. It is conceivable that the market would achieve more predictable outcomes by shifting dispute resolution away from generalist judges, and toward experts such as arbitration panels or the Delaware Chancery Court. Complexity in loan documentation is here to stay, however, creating endless new opportunities for aggressive parties to exploit.

[3] See NML Capital, Ltd. v. Republic of Argentina (S.D.N.Y. Dec. 7, 2011); Wilmington Savings Fund Society, FSB v. Cash America International, Inc. (S.D.N.Y. 2016).