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Claremont McKenna College

Don't Get Screwed: What Factors Determine the Inclusion of J. Crew  
Blockers?

submitted to

Professor George Batta

by

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for

Senior Thesis

Fall 2020

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## Abstract<sup>1</sup>

A “J. Crew Maneuver” is a type of collateral-stripping event that transfers the value of a nearly insolvent company from the lender to the borrower. This concept matters to lenders because it exposes them to significant downside risk through the loss of hundreds of millions of pledged collateral. While credit analysts and debt lawyers have commented on the importance of preserving creditor value *ex ante* through lender-protective clauses embedded within debt documents, this paper breaks ground on empirically studying the determinants of these protective clauses known as “J. Crew Blockers”. I hypothesize that private equity backing, a contractionary credit environment, contractual “stickiness” and the presence of an innovative law firm all influence the likelihood of observing J. Crew Blockers in debt documents. Using a multiple regression analysis as my primary regression, I analyze 10,370 debt contracts to find that contractual stickiness is the greatest contributing factor to likelihood of J. Crew Blocker inclusion, with other factors contributing residually.

## INTRODUCTION

### Motivation

Corporate credit and indenture documents are highly technical legal documents that can be creatively manipulated to extract more value for one party at the expense of another party. Legal analysis of credit agreements is an active industry, with companies such as Covenant Review, Debtwire, S&P and Moody’s all finding their niche in protecting clients against legal actions from counterparties. One of the most recent creative manipulations of credit and indenture documents first occurred in 2016, when J. Crew transferred a significant portion of its already pledged intellectual property (“IP”) to an unrestricted subsidiary, which was then used to raise additional debt for the company. This action strips collateral, typically in the form of IP, from existing lenders. J. Crew’s collateral-stripping maneuver has sparked a broader trend that aims to protect equity investment at the lender’s expense. Instances of these collateral stripping events are becoming more common and occur at household names, such as Neiman Marcus and PetSmart.<sup>2</sup> While lenders can pursue *ex post* litigation, previous literature hypothesizes that more value can be preserved by including lender-protective clauses *ex ante*.

Due to the infamy that J. Crew’s initial transfer garnered within the investing community, subsequent collateral stripping events have been coyly referred to as “J. Crew maneuvers” (“the Maneuver”) or even as “Getting J. Screwed”. Defensive legal provisions

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<sup>1</sup> Thank you to all who have helped with the creation of this paper. To Peder Gram for introducing me to the concept of “Getting J. Screwed”. To Timothy Corprew, Ed Tolley and Anthony Ribal for their practitioner insights. Biggest thanks to Professor George Batta and Professor Janet Smith for providing substantial mentorship throughout the entire process.

<sup>2</sup> Among those listed, other examples include Cirque du Soleil, IHeartMedia, Travelport, Party City, Peabody Coal and Acosta.

within credit and indenture documents designed to prevent these Maneuvers have been coined “J. Crew blockers” (“Blockers”). All instances of the Maneuver have been initiated by private equity (“sponsor”) firms, who, in light of little to no recovery of their investment, began to enact increasingly risky strategies in order to preserve some shareholder value.<sup>3</sup>

Understanding what factors go into drafting these defensive legal provisions has implications for lenders, who can face large and unexpected losses on their investments. Hypothetically, an aggressive asset-stripping event could dig a distressed company out of insolvency, but burdening an already struggling company with additional leverage decreases the firm’s expected value for both the equity holder and lender. So far, PetSmart’s decision to designate a part of its core intellectual property as an unrestricted subsidiary is the only case of a Maneuver saving a company from insolvency. Lenders must acknowledge that there is a tangible cost associated with leaving J. Crew Blockers out of debt contracts. In 2016, J Crew’s sponsors succeeded in transferring at least \$250 million of already pledged collateral to an unrestricted subsidiary. As recently as July 2020, Neiman Marcus was forced to repay \$172 million to its unsecured claims committee (“UCC”) due to litigation related to a fraudulent J. Crew Maneuver.<sup>4</sup>

Almost no literature exists on the presence of J Crew provisions within credit documents. My paper is the first that I am aware of that evaluates empirical determinants of the adoption of such a provision. While there is much literature on contract theory, attempts to quantify such theory is limited. Difficulties with collecting data on contracts and a lack of standardization across debt documents limits the results of empirical studies. This paper contributes to existing contract theory literature and to financial economics literature on agency cost, macroeconomic impacts on negotiating leverage, and professional network theory.

### **Purpose of Paper**

The J Crew Maneuver is a recent development. While research firms such as Debtwire, Reorg and Covenant Review are actively studying the impact that this collateral stripping event has on its clients, there is still much analysis to be done. Despite current research, the market does not know how to price in Maneuvers. A debt instrument should trade lower on the secondary market if it loses a portion of its collateral. In J. Crew’s case, the price of its term loan

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<sup>3</sup> A list of companies and their sponsors: J. Crew (TPG Capital, Leonard Green & Partners), Neiman Marcus (Ares), PetSmart (BC Partners), Cirque du Soleil (TPG), IHeartMedia (Bain Capital, Thomas H. Lee Partners), Travelport (Blackstone), Party City (Thomas H. Lee), Peabody Coal (Lehman Brothers Private Equity), Acosta (Pinebridge Capital). < <https://www.capitaliq.com> > accessed 20 November 2020.

<sup>4</sup> After Neiman Marcus filed for bankruptcy, activist distressed debt investor Marble Ridge Capital filed a suit claiming fraudulent transfer. The court found irrefutable evidence showing that Neiman Marcus executives engaged in a J. Crew Maneuver after being informed that the company was insolvent. Neiman settled with Marble Ridge and the rest of the Unsecured Creditor’s Committee for \$172 million in stock.

actually rose on the news that more debt had been raised on previously pledged collateral.<sup>5</sup> PetSmart investors reacted much differently: price volatility of its term loan and unsecured bonds spiked significantly through a litigation and settlement process.<sup>6</sup>

Despite the potential loss of value that can occur due to a Maneuver, presence of J. Crew Blockers in credit and indenture documents is extremely limited. S&P Leveraged Finance found that, despite the value-destructive nature of the Maneuver, fewer than 20 percent of its clients with significant amounts of material intellectual property had sampled Blocker language in its documents.<sup>7</sup>

For a sample of 10,370 debt contracts spanning January 1, 2017 to October 10, 2020, I employ a multiple linear regression and probit model to test hypotheses related to the probability of adopting Blocker language. I hypothesize that the inclusion of Blocker language in new credit and indenture documents may be positively correlated with the presence of a private equity firm, a contracting economic environment, increased contract negotiating costs, and the presence of innovative law firms.

I construct my variables of interest in the following way: first, I include a variable that captures the presence of private equity backing. Second, I use the date that the United States declared a state of national emergency in response to the COVID-19 outbreak to identify the shift from an expansionary credit environment to the current contractionary credit environment. Third, I create a variable that determines whether a borrowing firm has sampled Blocker language in the past. Finally, I construct variables to determine whether a borrower employs law firms that are more likely to sample Blocker language.

Getting J. Screwed is a type of agency cost. As an investment nears bankruptcy, an equity holder's incentives diverge significantly from that of the debt holders (Jensen and Meckling (1976)). If the lenders did not expect these agency costs to materialize, they may not be adequately protected from incentive misalignment. Companies backed by private equity firms are more likely to experience financial distress due to higher levels of leverage. Additionally, the concentrated ownership structure inherent of private equity portfolio companies allows these firms to execute a Maneuver quickly. These issues are observed *ex ante*, and lenders will

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<sup>5</sup> < <https://www.bloomberg.com/news/articles/2019-06-17/in-finance-j-crew-is-a-verb-it-means-to-stick-it-to-a-lender> > accessed 24 November 2020.

<sup>6</sup> Mengden (2020).

<sup>7</sup> The study sampled 120 credit agreements, representing roughly a third of the agreements executed and rated by S&P Global Ratings between early 2017 and February 2019. The study found that Blocker language was present in just 17 percent of retail agreements, 23 percent of technology, 13 percent of media, and 13 percent of consumer products. Overall, just 17 percent of all credit agreements sampled contained direct Blocker language.

< <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/leveraged-loan-news/sp-few-leveraged-loans-protect-against-j-crew-like-collateral-transfers> > accessed 20 November 2020.

want to negotiate in more downside protection into the contract, perhaps in the form of a Blocker.

The pre-COVID expansionary credit environment may have subdued the development of Blockers in debt contracts, as increased competition amongst lenders has allowed borrowers to extract greater concessions from their counterparties. If this theory holds, J. Crew Blockers will be more common in debt documents signed after COVID, as economic contractions create greater need for liquidity on whatever terms borrowers can get.

Contract completeness theory suggests that a tradeoff between linguistic accuracy and production efficiency, which keeps new language out of debt documents and incentivizes old language to stay in. In other words, a lender may think that negotiating in a Blocker is important to maintaining an adequate collateral base, but conclude that the negotiation will be cost-prohibitive. Once a Blocker is negotiated into a debt document, the opposite holds true: the borrower might want to take the language out, but believe that the cost of negotiation will be too high. I refer to this phenomenon as “contract stickiness”. If my hypothesis holds, contract stickiness will have an extremely high level of economic significance, suggesting that previous instances of Blocker language by the same borrower significantly increase the likelihood of Blocker language in future debt documents, because ink costs will strongly disincentivize negotiating parties to strike the existing Blocker clause.

Finally, professional network theory might explain the lack of Blocker language in debt documents. J. Crew Blockers are a product of legal innovation. Academics suggest that financial and legal innovations are spread through professional networks, such as law firms, investment banks and members of the Board of Directors. This theory suggests that Blockers are not yet prevalent in the market because only a subset of innovative law firms are promoting their use.

To test these hypotheses, I use Intelligize to identify debt documents containing Blocker language through a process described in Section II. I then extract the existing universe of credit and indenture documents since 2017 from Intelligize. The data is combined with Compustat and the Moody’s ratings database to add information about company financial performance. The resulting dataset is then used in regressions to evaluate variables that affect the likelihood of Blocker language appearing in a debt instrument. The final dataset consists of 10,370 observations, including 33 debt documents that sample Blocker language.

Three of four findings are consistent with the hypotheses presented. In an OLS and probit regression, all key independent variables are statistically significant. The regressions provide evidence that private equity backing, a contracting credit environment, and legal networks all contribute marginally to the probability of Blocker language

The most economically significant predictor of Blocker language is contract stickiness. While contract stickiness is the most significant indicator by an order of magnitude, the outcome seems to suggest that prior inclusion of Blocker language is more likely to increase

negotiating costs, not less. This conclusion is not overly surprising, and agrees with certain interpretations of previous literature on contract completeness.

The paper proceeds as follows. I first review existing literature on agency cost, contract completeness, macroeconomic impact on lender-protective clauses, and professional networks. Section II describes the data and variable construction used in the analysis. Section III provides empirical tests of the hypotheses. Section IV concludes and suggests areas for future research.

## I. REVIEW OF LITERATURE

### Agency Costs

The J. Crew maneuver is a form of agency cost.<sup>8</sup> Jensen and Meckling (1976) published a seminal paper on the development of agency costs called *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*. They prove why shareholders will choose a set of suboptimal investment decisions in the presence of a mixed capital structure. Jensen and Meckling begin the paper by defining an agency relationship and associated agency costs. An agency relationship is “A contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent.” An agency cost is comprised of the sum of monitoring, bonding, and residual losses.

Jensen and Meckling (1976) acknowledge that minority shareholders will realize that the manager-owner’s incentives will diverge from that of the other shareholders, and the divergence will be manifested in a decline in share price that incorporates the monitoring costs and residual difference in incentives between the parties. This assumption relies heavily on the presence of efficient markets and a set of restrictive assumptions that does not incorporate the cost of gathering information. In this way, the paper does not reflect actual market behaviors but instead gleans insight into the world of theorems and models. The findings of Jensen et al. (1976) are too theoretical to fully explain pricing volatility that occurs during a Maneuver.

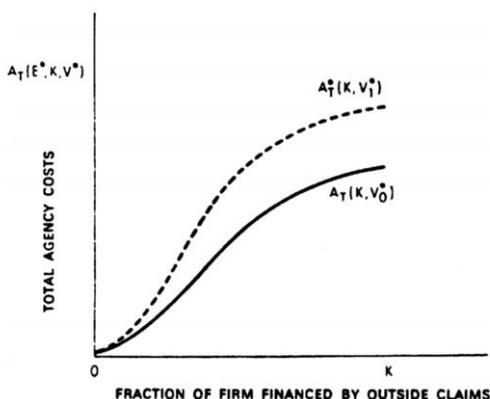
As the capital structure becomes increasingly burdened with risky debt, the actions of the agent significantly diverge from that of all stakeholders. Burdening a company with riskier debt incentivizes the manager-owner to undertake increasingly riskier investments that promise high payoffs if successful, even if the probability of payoff is low. If the investment succeeds, shareholders benefit from the residual claim. If the investment fails, creditors bear most of the loss. Engaging in higher variance investments transfers wealth from creditors to shareholders if creditors cannot prohibit the manager-owner’s actions. If creditors fully own the company, but

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<sup>8</sup> There is an extensive literature on agency cost and optimal capital structure. While this paper covers Jensen and Meckling (1976) and Myers (1976) in detail, I recognize several other authors that inform the shape of this paper. These authors include Modigliani and Miller (1958), Bradley Jarrell and Kim (1984), Harris and Raviv (1991), Leland (1994), Longstaff and Schwartz (1995) and Jensen (2009).

the manager-owner has control over the operations and assets of the company, the manager-owner has every incentive to engage in risky behaviors. Consider a company on the brink of insolvency: it will soon be owned by the creditors, yet is still run by the equity holders. If the company cannot yet be considered insolvent, a manager-owner's actions do not constitute fraudulent activities.<sup>9</sup> Figure 1 describes the incentive for rising agency costs. As the fraction of financing by outside claims grows, so does its agency cost.

**Figure 1: Total Agency Costs as a Function of the Fraction of the Firm Financed by Outside Claims**



Myers (1976) expanded on the notion of agency costs as it relates to corporate borrowing later the same year. His suggestions rely heavily on the creation of defensive contractual provisions within credit documents that prohibit certain agency costs. These provisions are a form of monitoring costs. While the previous literature failed to explain why a shareholder would be willing to take on risky debt that would necessarily reduce the value of the overall firm, he posited that a rational manager-owner may assume the additional debt as long as the value destruction of the financing was less than or equal to the government-subsidized tax-deductible interest on the financial instrument. This is one of the tenets of modern private equity investment: juice equity returns by reaping the benefit of tax-shielded interest payments. However, he goes on to argue that too much risky debt “creates situations *ex post* which management can serve shareholders’ interests by making sub-optimal decisions.” A Maneuver is one such example of *ex post* sub-optimal decision making, since the incentives of the manager-

<sup>9</sup> As stated, this is only true if it can be argued that the company is still solvent. If the company is not solvent, then a transfer of wealth to shareholders is a fraudulent transfer. This occurred during the Neiman Marcus Maneuver, when the court found evidence that company executives had disregarded three independent valuations that all suggested that Neiman Marcus had a negative equity value.

owner of a nearly insolvent company is significantly misaligned with the incentives of its lenders. Such is the case of companies who attempt a J. Crew Maneuver.

Myers (1976) presents a set of basic contractual provisions that prevent agency costs in the absence of monitoring costs. Myer's first recommendation for a complete contract is to prohibit the manager-owner from investing in any NPV-negative projects. *Ex ante*, this provision is impractical because an investment's payoff can only be known with certainty *ex post*. Creditors cannot rely on management's expectations because management and creditor incentives have diverged. His second recommendation is to renegotiate the debt contract such that the contract re-aligns both party's interests if an investment payoff differs from its expected payoff. He dismisses this recommendation due to the high cost of continual renegotiation between parties. Myer's next recommendation is to shorten the maturity of debt such that creditors can renegotiate its terms before every major investment decision made by the firm. He similarly dismisses this idea based on monitoring costs. Myers's final recommendation is to issue restrictive covenants, such as banning dividend payments in certain scenarios so the firm cannot sell certain assets and dividend out the return immediately before it goes bankrupt. He acknowledges that a company that cannot allow for dividends may necessarily be investing in NPV negative projects if no positive projects exist.

J. Crew Maneuvers can help equity holders circumvent restrictive covenants. Although not described in Myers (1976), J. Crew Maneuvers also allow equity holders to legally engage in claim dilution. Claim dilution is described in Smith and Warner (1979), and constitutes a situation where a bondholder's claim on the assets is reduced by issuing additional debt with the same or higher priority. Dividend restrictions and anti-dilution clauses are both common practice in the modern-day lending market. Under normal circumstances, the outright sale of core intellectual property followed by an immediate dividend of the proceeds ahead of a bankruptcy would be strictly prohibited by a company's debt documents. So would re-pledging already secured collateral. Both acts represent ethically murky decisions made by management that would not normally occur outside a situation of near solvency (Jensen (2009)). The Maneuver exploits a loophole present within incomplete contracts that allows for equity holders to increase its investment at the expense of the creditors.

### **Contract Completeness**

Contract completeness is defined as, "One which specifies the rights and duties of each party in every state of the world" (Ganglmair and Wardlaw (2017)). In an ideal world, a J. Crew maneuver would either not be able to happen because the debt contract would prohibit it, or the Maneuver would already be priced in. Contract completeness is hard to quantify because contracts are a complex nexus of unstandardized clauses. A lack of standardization across

contracts makes formal empirical analyses difficult, which explains why the area is generally under-researched.<sup>10</sup>

Ganglmair and Wardlaw (2017) analyze the level of contract similarity, finding that more complex contracts are correlated with greater default risk, uncertainty, capital structure complexity, and likelihood of renegotiation. They find that larger contracts have greater levels of standardization and that borrowers, not lenders, are the greatest indicator of similarity within credit agreements. As a result of this finding, Ganglmair et al. strongly rejects the concept the existence of boilerplate language, which is a hotly contested conclusion. Their method for measuring complexity is rudimentary. Ganglmair et al. (2017) uses a simple word and sentence count of the credit agreement, arguing that a credit provision's complexity is a function of its length. While they recognize that this estimate is noisy, they accept this tradeoff since their metrics are easy to understand and appear to be a reasonable proxy for complexity. Ganglmair et al. concludes by positing that a lack of contract completeness may be more favorable than that of a complete contract in the presence of monitoring costs, including ink costs, which is defined as the "time and lost value inherent in specifying [contractual] contingencies" (Ganglmair et al. (2017)). Contract incompleteness leaves both explicit and implied contract terms, which the latter's interpretation can reasonably be disagreed upon (Goetz and Scott (1985)).

Choi, Gulati and Scott (2020) further expand on ink costs through a term they call encrustation, which is a concept used to describe cut-and-paste "boilerplate" language that may once have had a meaning in a previous contract, but no longer serves a practical purpose and may in fact hurt parties in *ex post* litigation. Encrustation is consistent with the Ganglmair et al. (2017) observation that incomplete contracts may add more value to both parties than complete contracts. By using language previously used in old credit documents verbatim, the firm is cutting down on the amount of ink costs associated with drafting the contract. A tradeoff exists between linguistic accuracy and production efficiency. Choi et al. (2020) hypothesizes that greater encrustation exists in credit documents where more agency costs are present. They present a spectrum of legal documents, from mergers and acquisitions ("M&A") contracts to sovereign bond contracts, showing that a higher level of agency costs correlates to greater amounts of boilerplate language. M&A contracts, they argue, should have the least amount of encrustation since one manager-owner is negotiating with another manager-owner. Conversely, sovereign bonds have the greatest level of encrustation since they are issued by the state (an agent of its people) to many lenders. The number of lenders is also associated with greater encrustation because the ink costs of negotiating fine details with many lenders is significantly higher than the cost of negotiating with just one lender. Choi et al. (2020) summarizes their point through a metaphor: "one might think of the attorneys who draft M&A contracts as

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<sup>10</sup> While empirical research on contract completeness is under-studied, theory is not. Much theory exists on the topic of contract completeness. Prominent academics include Oliver Hart, Edward Green, Stephen Spear and Sanjay Srivastava.

artisans and the bond lawyers who issue standard boilerplate as workers on an assembly line". Private equity-backed debt documents bear less agency cost than sovereign bonds, but more than M&A contracts. A debt document's increased ink costs relative to M&A contracts may explain why Blocker language is included in so few documents. Blocker language may also be more susceptible to encrustation, as renegotiation of the clause becomes cost-prohibitive.

As previously discussed, credit contracts are highly complex and unique to each borrower and situation. The borrower and lender are at liberty to define any concept as they wish. This presents an issue in empirical literature. Badawi and de Fontenay (2019) recognize these unique contractual definitions and argue that the existing academic literature does not properly accommodate for changes across certain definitions, leading to an oversimplification of analysis within the academic community. Their primary concern is with the definition of EBITDA, which has diverged materially from actual Earnings Before Interest, Taxes, Depreciation and Amortization. Definitions of EBITDA have expanded significantly, particularly since the Federal Reserve periodically capped the leverage a bank can loan to a company at 6:1.<sup>11</sup> To circumvent these regulatory restrictions, borrowers and lenders have simply allowed for more permissive EBITDA definitions that may or may not actually represent the company's cash flow. These overblown definitions of EBITDA have been primarily driven by private equity-backed firms, however non-private equity backed companies are also benefitting from the relaxation of traditional measures of EBITDA.<sup>12</sup> A negative relationship exists between permissiveness of EBITDA and covenants, however, in the case of sponsor-backed companies, these covenants have many carve-outs that create an environment in which J. Crew Blockers may exist.

### **Macroeconomic Impact on Lender-Protective Clauses**

The loosening of sponsor-backed covenants is also a function of a pre-COVID expansionary credit environment that heavily favored borrowers over lenders. Roberts and Sufi (2009) suggest that debt covenant permissiveness is tied to major structural changes in the debt markets, implying that an exogenous negative economic shock (such as a pandemic) may tighten the status quo of loose covenants and creative EBITDA definitions. Other research similarly finds that a negative credit cycle is correlated with lenders receiving greater collateral packages and stricter contractual terms (Jimenez, Salas and Saurina (2006).

Mengen (2020) finds evidence that the post-COVID contractionary credit environment increases the likelihood of Blocker language within new debt documents, citing that lenders of multiple large retail, travel and entertainment companies have successfully negotiated J. Crew

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<sup>11</sup> According to Badawi et al. (2019), the Federal Reserve decided to drop the guidance in 2018, as it was discovered that while leveraged lending by banks had decreased, leveraged lending by non-bank institutions increased substantially, creating an uncertain level of overall risk for the financial sector.

<sup>12</sup> Mengden (2020).

Blockers into their credit agreements after liquidity in the debt markets dried up during March 2020. Mengden argues that the pre-COVID credit cycle created the catalyst for J. Crew Maneuvers by allowing for expansive EBITDA definitions, historically loose covenants, and questionable asset valuations. He claims that loose EBITDA definitions are particularly dangerous and suggests that instead, credit documents should renegotiate tighter covenants and EBITDA definitions with looser ratios. Mengden does not acknowledge that this thesis, while hypothetically beneficial to the lender, was impractical for the majority of the last decade due to the 2013 Interagency Guidance on Leveraged Lending. While *ex post* litigation will always be a possibility, Mengden (2020) suggests that it is less efficient than *ex ante* renegotiation of credit agreements.

A J. Crew Maneuver is just one of many aggressive tactics that equity investors employ to stay in control of their investment. Borrowers have been observed to bend accounting rules when they find themselves close to breaching a covenant, and companies adopt more flexible accounting practices and engage in aggressive manipulation of accruals to keep a technical default at bay (Sweeny (1994); DeFond and Jiambalvo (1994)). Borrowers have a reason to be afraid of breaching a financial covenant: a violation is strongly correlated with a sharp reduction in company investment, especially in the presence of agency and information problems (Chava and Roberts (2008)).

Coates, Palia and Wu (2019) examine contract completeness within M&A contracts by assessing how bidder and target protective clauses affects abnormal returns and likelihood of deal completion. They found that bidder protective clauses empirically lead to higher abnormal returns for the bidder, however with a lower completion rate. A target will have a lower incentive to accept a bid if it gives more power to the bidder. The Coates et al. finding can likely be extended to the credit market. A lender demanding prohibitive covenants or tight Earnings Before Interest, Taxes and Depreciation (“EBITDA”) definitions will possibly be disregarded in favor of a lender willing to provide a covenant-lite loan.

### **Professional Networks**

Research suggests that financial and legal innovations spread through professional networks such as law firms, financial firms and Board of Director positions. Dechow and Tan (2020) suggest that professional networks are linked with innovation of accounting practices. Armstrong and Larcker (2009) suggest that board members spread certain accounting practices, and Bizjak, Lemmon and Whitby (2009) suggest that accounting practices spread through geographic link. Other academics have focused on the way that lawyers influence earnings quality and other corporate practices. Kwak, Ro and Suk (2012) suggest that corporate disclosures are materially influenced when one of the top management team members includes a lawyer. Since Blockers are a form of legal innovation, their presence may be spread exclusively through a network of innovative law firms.

## Application of Literature

I draw my hypotheses from the authors stated above. Jensen and Meckling (1976), Myers (1976) and Jensen (2009) all inform my hypothesis on private equity involvement. Jensen and Meckling (1976) indicates that increasing levels of risky debt increases agency cost. Myers (1976) recommends contractual provisions that allow for the presence of beneficial risky debt while also mitigating agency costs through monitoring and bonding. Jensen (2009) suggests that an increasingly insolvent company will take highly risky and unorthodox maneuvers to shift value from the lender to the borrower. My hypothesis on Blocker inclusion and the credit cycle stems from other observed instances of macroeconomic conditions and their impact on lender-protective clauses (Roberts and Sufi (2009); Jimenez et al. (2006)). Choi et al. (2020) informs my hypothesis that ink costs for debt documents will incentivize Blocker language to be sticky, as debt documents are more “assembly line” than their “artisan” M&A counterparts. The Ganglmair and Wardlaw (2017) paper suggests that as ink costs go up, likelihood of successful negotiation goes down, leaving greater amounts of implied, rather than explicit terms (Goetz and Scott (1985)).

## II. DATA AND SAMPLE

### The Data

I use several databases to construct my sample. Intelligize provides information on SEC-registered debt documents. Using this information, I extract the entire universe of relevant debt documents and identify which contracts contain Blocker language. Compustat adds financial metrics for companies in the sample. Moody’s Default and Recovery Database is used to extract ratings information for companies included in the sample.

Language found in debt documents is highly variable across contracts. As a result, hand extraction of documents containing Blocker language is an imperfect, time intensive process that generally requires legal training. Due to the limited time and lack of legal knowledge, I used several supporting resources to identify the entire universe of documents containing Blocker language as accurately as I could. I first tried requesting existing data from Covenant Review and S&P but was informed that the information was proprietary. With the easiest option ruled out, whitepapers and other publicly available information became the best avenue for identifying specific language. Justin Smith, Debtwire Managing Director, provides some clarity on commonalities between Blocker-inclusive documents in his whitepaper, *J Crew Blocker: Don’t Believe the Hype*. He delineates six examples of Blocker language included in debt documents.<sup>13</sup> In Reorg Research’s *Covenant Conversations*, Peter Washkowitz, Head of Reorg

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<sup>13</sup> < <https://www.debtwire.com/info/j-crew-blocker-don%E2%80%99t-believe-hype> > accessed 20 November 2020.

Covenants, gives the names of multiple companies with Blockers in place.<sup>14</sup> Cross-referencing the language used in the Debtwire article with the companies discussed in the Reorg podcast, I was able to identify specific Blocker language used in each credit document. I inputted the specific Blocker phrases in the Intelligize search function to yield 79 unique contracts containing Blocker language. To assure that the information was fairly accurate, I contacted a senior member of S&P's Leveraged Finance team, who confirmed the validity of my search. Once I could no longer identify more contracts with Blocker language, I extracted the entire universe of credit and indenture agreements from January 1, 2017 to October 15, 2020. The initial sample contains 31,308 debt documents. After filtering for relevant industries using SIC codes, the sample is reduced to 20,994 documents. Removing documents without dates yields 18,395 credit and indenture agreements.

### **Issues with the Collection Process**

Imperfections exist within the dataset. It is likely that I have not identified the entire universe of publicly filed debt documents that contain Blocker language due to the issues stated in the previous section. Additionally, I could not reduce my sample size based on industry. Intelligize uses Standard Industrial Classification (“SIC”) codes to identify a company’s industry, which did not prove to be an accurate way to filter for Blocker-heavy industries. Borrowers with a large concentration of intellectual property are most likely to engage in stripping collateral from its lenders, although my sample did not reflect this fact.<sup>15</sup> It might be reasonably assumed that IP-heavy industries should be mostly included under Life Sciences or Technology, but just as many documents with Blockers are associated with Manufacturing and Trade and Services. See table 1 for the distribution of blockers amongst SIC codes. Given the distribution of industries containing Blockers, the final sample includes debt documents from Manufacturing, Trade & Services, Technology, Real Estate & Construction, and Life Sciences.

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<sup>14</sup> < <https://podcasts.apple.com/us/podcast/covenants-primer-on-j-crew-blockers-how-issuers-can/id1326289731?i=1000493786054> > accessed 20 November 2020.

<sup>15</sup> Public documentation of J. Crew Maneuvers indicates that IP-heavy industries are more susceptible to an asset stripping event, however I could not find a good explanation of why. In my conversation with the senior member of S&P, he mentioned that restrictions typically exist for “hard assets”, but not necessarily for IP. Legal permissiveness “gets a little bit squishy,” which allows for the possibility of a Maneuver.

**Table 1: Distribution of Both Blocker-Specific Contracts and All Contracts by Industry**

This table presents the number and frequency of contracts by industry, broken up by Blocker identification.

Industry	Blockers		Contracts (All)		▲ Frequency
	Number	Frequency	Number	Frequency	
Manufacturing	16	21.1%	3688	20.0%	1.0%
Trade & Services	20	26.3%	4181	22.7%	3.6%
Technology	20	26.3%	3006	16.3%	10.0%
Real Estate & Construction	7	9.2%	3222	17.5%	-8.3%
Life Sciences	13	17.1%	4298	23.4%	-6.3%
<b>Total</b>	<b>76</b>	<b>100.0%</b>	<b>18395</b>	<b>100.0%</b>	<b>0.0%</b>

As expected, the Office of Technology has a much higher frequency of Blocker contracts than the general contract pool. But counter-intuitively, the Office of Life Sciences shows a lower than average frequency of Blocker contracts. Also, the Office of Manufacturing contains a higher frequency of Blocker contracts than the general population. One would think that manufacturing, an asset-intensive industry, would be underweighted to Blocker contracts relative to other, higher-IP industries. It seems reasonable to include the Offices of Manufacturing, Trade & Services, and Real Estate & Construction in the analysis.

### Key Independent Variables

The goal of this study is to understand how private equity involvement, credit cycles, contract stickiness, and professional networks influence the presence of Blocker language. Presence of a private equity firm indicates the marriage of excessive leverage and a highly concentrated ownership that can carry out its intentions quickly, causing a divergence between manager-owner actions and lender desires. The US's declaration of a national emergency indicates whether the debt document was initiated in an expansionary or contractionary credit environment, since the COVID-19 pandemic was immediately followed by a sharp economic decline. Contract stickiness is determined by whether a given firm has employed Blocker language in a previous debt document. Professional networks are determined by identifying whether companies that have included at least one instance of Blocker language in their debt documents are connected by a similar law firm. I include the variable "PE Backed" to indicate whether a company benefits from a private equity investment. The variable takes a value of one if information on an acquiring law or financial firm is present, and a zero if absent. To assess whether the contract was negotiated in a contractionary credit environment, I include a dummy variable called "COVID". COVID takes the value of one if the contract was initiated on or after March 13, 2020, the day that President Donald Trump declared a state of national emergency due to the COVID-19 pandemic, and gives a value of zero if the contract was initiated before the declaration. "Sticky" identifies debt documents employed by a given company that are preceded by at least one prior document containing Blocker language. Intelligize provides

information on a company's choice of law firm. "Top Law" refers to one of the top ten law firms that are associated with companies that sample Blocker language in at least one of their documents. Top Law takes a value of one in the presence of one of these ten law firms and a zero otherwise.

I anticipate that all key independent variables will have a positive contribution to the likelihood that a given debt document samples Blocker language. Private equity backing increases agency cost and firm-level decision-making ability *ex ante*, which in turn increases the likelihood that lenders will include more clauses protecting them from downside scenarios. Since a contractionary environment shifts bargaining power to lenders, contracts initiated after COVID will likely have greater lender-protective clauses, including a Blocker clause. Contract stickiness will increase the likelihood of Blocker language, as the ink cost of negotiating a Blocker out of the contract may be too high for the borrower. Finally, the presence of a law firm linked to multiple companies with Blocker contracts should indicate a higher likelihood of Blocker language in other borrowers using the same law firms.

### **Control Variables**

I use the Compustat database to introduce additional control variables. Controls derived from Compustat include the natural log of revenue, net income scaled to total assets ("ROA"), and industry-weighted leverage. I define leverage as total debt to EBITDA. Industry-weighted leverage is intended to be a control for default probability, as it is assumed that companies within the same industry will have roughly the same level of cash flow stability, and healthy companies will therefore choose an average level of industry leverage. "Industry Weighted Leverage" is defined as the leverage of the individual company, minus the average leverage per SIC code of the Intelligize database. "Ln(Revenue)" is used as a control for size, and "ROA" is used as a control for operating performance. Moody's ratings are then added into the dataset as an additional control for default probability. I use "Speculative" to indicate whether Moody's has issued the company a speculative rating, assigning a value of one if present and a zero if otherwise. "Doc Type" is also included, which takes a value of one if the document is an indenture, to control for the possible differences between indenture and credit documents. Dummy variables for industries are included.

Information on both professional relationships and credit ratings are spotty, and reducing the sample to observations where either set of information is always present would produce inconclusive results. As such, both Top Law and Speculative have been transformed into interaction terms, where the a one indicates the presence of a rating or relationship, but a zero does not necessarily indicate its absence, since it may simply mean that the information does not exist within this dataset. I include dummy variables "Law Info" and "Moody's" that indicate whether the information exists, where a one indicates the presence of information, and a zero otherwise. The final dataset is the inner join of the Intelligize and Compustat databases.

10,370 observations remain, including 33 observations that sample Blocker language. Summary statistics for all variables are included in table 2.

The estimate for Top Law is noisy. Many companies with law firm information had multiple law firms listed, and it is unclear as to which of these law firms represented the company in a debt contract negotiation. It is entirely possible that the top law firms identified in this paper had no say in what was drafted into the borrower's debt documents. Further, the law firm truly of interest is not the borrower's law firm, but rather the lender's law firm, since it assumed that the lender is pushing for the inclusion of Blocker language, not the other way around. It may be reasonable to assume that a borrower's law firm may have a significant say in the inclusion of Blocker language, as they are responsible for arguing these provisions out, although this changes variable's interpretation. Instead of being the top ten most innovative law firms, the output seems to suggest that these law firms are the most likely to be permissive of Blocker language. I keep this variable because I believe it may still have some explanatory power in the regression despite its noise.

### **Descriptive Statistics**

Descriptive statistics for continuous and non-continuous variables are provided in table 2. The dataset is broken up into Blocker and non-Blocker observations to show how each population is represented in the dataset. All variables of interest – PE Backed, COVID, Sticky and Top Law – are observed more frequently in Blockers documents than they are when no Blocker is present.

## Table 2: Descriptive Statistics

This table reports descriptive statistics for non-continuous and continuous variables, broken up by Blocker identification. (Blockers = 33, Non-Blockers = 10,337)

Panel A: Descriptive statistics for non-continuous variables		
Variable	<i>Percentage of Sample</i>	
	Blocker Language	No Blocker Language
COVID	0.182	0.036
Doc Type	0.182	0.262
Law Info	0.818	0.350
Life Sciences	0.061	0.206
Moodys	0.091	0.067
PE Backed	0.212	0.051
Real Estate	0.091	0.102
Speculative	0.091	0.047
Sticky	0.242	0.002
Technology	0.212	0.182
Top Law	0.601	0.105
Trade Services	0.333	0.166

Panel B: Descriptive statistics for continuous variables.					
	Min	Max	Mean	Median	Std. Dev
A. Blocker Observations					
ROA	-0.41	0.15	-0.08	-0.04	0.15
Weighted Leverage	-20.90	28.86	3.62	-2.76	10.47
Ln(Revenue)	4.65	9.53	7.47	7.41	1.48
B. Non-Blocker Observations					
ROA	-46.87	0.46	-0.11	0.01	1.14
Weighted Leverage	-30.32	36.11	-0.02	-0.05	6.10
Ln(Revenue)	-6.22	13.12	6.85	7.20	2.41

### III. REGRESSION ANALYSIS

I begin by using an OLS regression to establish a correlation between the model's explanatory variables and the presence of a Blocker. I then include a probit model to assess how a non-linear predictive model changes the interpretation of my findings.

#### OLS Regression

Model (1) uses OLS regression analysis to determine whether being a borrower backed by a private equity firm increases the probability that the company will include Blocker language. Models (2), (3), and (4) examine the effects that COVID, contract stickiness and law firm links have on the inclusion of Blocker language, respectively. Finally, in model (5), I examine all effects simultaneously. Each firm  $i$  that initiates any number of contracts  $c$  on date  $t$  is included in the following regressions. Results are presented in table 4.

$$Blocker_{i,t,c} = \alpha + \beta PE\ Backed_i + \gamma Controls_{i,t} + \varepsilon \quad (1)$$

$$Blocker_{i,t,c} = \alpha + \beta COVID + \gamma Controls_{i,t} + \varepsilon \quad (2)$$

$$Blocker_{i,t,c} = \alpha + \beta Sticky_{i,t,c} + \gamma Controls_{i,t} + \varepsilon \quad (3)$$

$$Blocker_{i,t,c} = \alpha + \beta Law\ Firm_i + \gamma Controls_{i,t} + \varepsilon \quad (4)$$

$$Blocker_{i,t,c} = \alpha + \beta PE\ Backed_i + \gamma COVID + \delta Sticky_{i,t,c} + \zeta Law\ Firm_i + \eta Controls_{i,t} + \varepsilon \quad (5)$$

**Table 3: Linear Regressions of Blocker Inclusion Rates and Key Independent Variables**

This table reports the OLS regression results for a sample of credit and indenture documents from January 2017 to October 2020. The dependent variable is the presence of Blocker language within a given document. All independent variables are defined in Section II. \*\*\*, \*\*, \* indicate that the parameter estimate is significantly different from zero at the 1 percent, 5 percent, and 10 percent level, respectively.

	Dependent Variable: Inclusion of Blocker				
	(1)	(2)	(3)	(4)	(5)
Intercept	0.00162 (0.00210)	0.00207 (0.00209)	0.00231 (0.00190)	0.00262 (0.00209)	0.00165 (0.00204)
<b>Key independent</b>					
PE Backed	0.00842*** (0.00227)				0.00813*** (0.00221)
COVID		0.01263*** (0.00294)			0.01149*** (0.00285)
Sticky			0.2402*** (0.00923)		0.2367*** (0.00938)
Professional Relationships					
Law Info				0.00174 (0.00129)	0.00143 (0.00126)
Top Law				0.001533*** (0.00199)	0.01379*** (0.00193)
<b>Control Variables</b>					
ROA	-0.00026 (0.00050)	-0.00019 (0.00051)	-0.00007 (0.00045)	-0.00017 (0.00050)	-0.00005 (0.00049)
Doc Type	0.00163 (0.00133)	-0.00229 (0.00132)	-0.00345 (0.00120)	0.00019 (0.00137)	0.00024 (0.00133)
Speculative	0.00645 (0.00429)	0.00561 (0.00428)	0.00394 (0.00682)	0.00272 (0.00429)	0.00231 (0.00416)
Weighted Leverage	0.00029*** (0.00009)	0.00028** (0.00009)	0.00035*** (0.00008)	0.00027*** (0.00008)	0.00032*** (0.00008)
ln(Revenue)	0.00033 (0.00026)	0.00027 (0.00026)	0.00013 (0.00024)	-0.00011 (0.00027)	-0.00029 (0.00026)
Moody's	-0.00476 (0.00363)	-0.00326 (0.00362)	-0.00199 (0.00324)	-0.00244 (0.00361)	-0.00162 (0.00351)
Industry					
(Manufacturing)					
Trade & Services	-0.00024 (0.00152)	-0.00056 (0.00152)	-0.00053 (0.00139)	-0.00047 (0.00152)	0.00047 (0.00147)
Technology	-0.00024 (0.00168)	-0.00008 (0.00168)	0.00016 (0.00153)	-0.00063 (0.00168)	0.00010 (0.00163)
Real Estate & Construction	-0.00186 (0.00197)	-0.00047 (0.00196)	0.00004 (0.00176)	-0.00124 (0.00196)	-0.00061 (0.00192)
Life Sciences	-0.00274 (0.00167)	-0.00245 (0.00167)	-0.00144 (0.00151)	-0.00295 (0.00166)	-0.00129 (0.00162)
Number of Observations	10,370	10,370	10,370	10,370	10,370
Adjusted R <sup>2</sup>	0.00936	0.00469	0.09241	0.00776	0.1003

I find that all regressions show a positive and statistically significant relationship with the inclusion of Blocker language. Model (1) suggests that the presence of private equity backing increases the likelihood of Blocker language by 0.84 percent ( $p < 0.01$ ). Model (2) suggests that contracts drafted during the COVID contractionary credit environment increases the likelihood of Blocker language by 1.26 percent ( $p < 0.01$ ). Model (3) proposes that the presence of Blocker language in former contracts increases the likelihood of Blocker language by 24.02 percent ( $p < 0.01$ ). Model (4) proposes that using a law firm that has other clients who have instituted Blockers increases the likelihood of Blocker language by 0.15 percent ( $p < 0.01$ ). Model (5) suggests that neither statistical nor economic significance erodes when all determinants of interest are included simultaneously. Weighted leverage remains statistically significant across all models, suggesting that a one-point increase in leverage is associated with a 0.03 percent increase in likelihood that Blocker language is included within a debt document ( $p < 0.01$ ).

### Probit Regression

I also include a probit marginal effects model of the regressions above as a robustness check on my results. Each firm  $i$  that initiates any number of contracts  $c$  on date  $t$  is included in the following regressions. I use the term “mfx” to describe the marginal effect within a given regression. Results are presented in table 4.

$$mfx(\text{probit}(\text{Blocker}_{i,t,c})) = \alpha + \beta \text{ PE Backed}_i + \gamma \text{ Controls}_{i,t} + \varepsilon \quad (6)$$

$$mfx(\text{probit}(\text{Blocker}_{i,t,c})) = \alpha + \beta \text{ COVID} + \gamma \text{ Controls}_{i,t} + \varepsilon \quad (7)$$

$$mfx(\text{probit}(\text{Blocker}_{i,t,c})) = \alpha + \beta \text{ Sticky}_{i,t,c} + \gamma \text{ Controls}_{i,t} + \varepsilon \quad (8)$$

$$mfx(\text{probit}(\text{Blocker}_{i,t,c})) = \alpha + \beta \text{ Law Firm}_i + \gamma \text{ Controls}_{i,t} + \varepsilon \quad (9)$$

$$mfx(\text{probit}(\text{Blocker}_{i,t,c})) = \alpha + \beta \text{ PE Backed}_i + \gamma \text{ COVID} + \delta \text{ Sticky}_{i,t,c} + \zeta \text{ Law Firm}_i + \eta \text{ Controls}_{i,t} + \varepsilon \quad (10)$$

**Table 4. Probit Marginal Effects Regressions of Blocker Inclusion Rates and Key Independent Variables**

This table reports the probit marginal effects regression results for a sample of credit and indenture documents from January 2017 to October 2020. The dependent variable is the presence of Blocker language within a given document. All independent variables are defined in the Section II. \*\*\*, \*\*, \* indicate that the parameter estimate is significantly different from zero at the 1 percent, 5 percent, and 10 percent level, respectively.

Dependent Variable: Inclusion of Blocker					
	(1)	(2)	(3)	(4)	(5)
Intercept	NA (NA)	NA (NA)	NA (NA)	NA (NA)	NA (NA)
<b>Key Independent Variables</b>					
PE Backed	0.0050*** (0.00170)				0.0041*** (0.00160)
COVID		0.0055*** (0.00180)			0.0058*** (0.00170)
Sticky			0.0177*** (0.00330)		0.015*** (0.00280)
Professional Relationships					
Law Info				0.003* (0.00160)	0.0035** (0.00160)
Top Law				0.0059*** (0.00160)	0.0048*** (0.00140)
<b>Control Variables</b>					
ROA	-0.00020 (0.00040)	-0.00020 (0.00040)	-0.00010 (0.00050)	-0.00020 (0.00040)	-0.00010 (0.00060)
Doc Type	-0.00190 (0.00150)	-0.0028* (0.00150)	-0.00220 (0.00140)	0.00050 (0.00140)	0.00090 (0.00140)
Speculative	0.03260 (0.92930)	0.03070 (0.96430)	0.02760 (1.38190)	0.02880 (1.36180)	0.02320 (1.13880)
Weighted Leverage	0.0002*** (0.00010)	0.0002*** (0.00010)	0.0002*** (0.00010)	0.0002*** (0.00010)	0.0002*** (0.00010)
ln(Revenue)	0.00050 (0.00030)	0.00040 (0.00030)	0.00030 (0.00030)	0.00000 (0.00030)	-0.00020 (0.00030)
Moody's	-0.03130 (0.92920)	-0.02870 (0.96430)	-0.02670 (1.38190)	-0.02850 (1.36180)	-0.02230 (1.13880)
Industry					
(Manufacturing)					
Trade & Services	0.00010 (0.00140)	-0.00040 (0.00140)	0.00090 (0.00140)	0.00020 (0.00140)	0.00030 (0.00130)
Technology	0.00020 (0.00160)	0.00010 (0.00160)	0.00100 (0.00150)	-0.00060 (0.00160)	0.00030 (0.00150)
Real Estate & Construction	-0.00160 (0.00220)	-0.00080 (0.00210)	-0.00170 (0.00240)	-0.00160 (0.00220)	-0.00190 (0.00230)
Life Sciences	-0.0039* (0.00230)	-0.00370 (0.00230)	-0.00220 (0.00210)	-0.0043* (0.00240)	-0.00240 (0.00210)
Number of Observations	10,370	10,370	10,370	10,370	10,370
Adjusted R <sup>2</sup>	0.00936	0.00469	0.09241	0.00776	0.1003

All key independent variables are deemed to be statistically significant, however the level of economic significance is unclear. The issue may stem from a scarcity of Blocker observations leading to a lack of explanatory power in both models.<sup>16</sup> The probit model confirmed the results of the OLS model, although with less economic significance. Model (6) suggests that the presence of private equity backing increases the likelihood of Blocker language by 0.50 percent ( $p < 0.01$ ). Model (7) suggests that contracts drafted during the COVID contractionary credit environment increases the likelihood of Blocker language by 0.55 percent ( $p < 0.01$ ). Model (8) proposes that the presence of Blocker language in former contracts increases the likelihood of Blocker language by 1.77 percent ( $p < 0.01$ ). Model (9) proposes that using a law firm that has other clients who have instituted Blockers increases the likelihood of Blocker language by 0.59 percent ( $p < 0.01$ ). Model (10) suggests that neither statistical nor economic significance erodes when all determinants of interest are included simultaneously. Weighted leverage remains statistically significant across all models, suggesting that a one-point increase in leverage is associated with a 0.02 percent increase in likelihood that Blocker language is included within a debt document ( $p < 0.01$ ). Law Info becomes statistically significant, suggesting that the inclusion of law information increases the probability of Blocker inclusion by 0.35 percent ( $p < 0.05$ ).

### **Analysis of Results**

Private equity backing leads to a higher probability of observing Blocker language within a debt document, which is consistent with agency cost theory, especially within scenarios of an overvalued equity stake (Jensen (2009)). My findings support the thesis provided by Jensen and Meckling (1976) and Myers (1976), since a higher observed level of agency cost within private equity portfolio companies seems to lead to stronger lender protective covenants. A lender can protect against a downside scenario by spending additional upfront inking costs to assure that different forms of agency costs, such as a J. Crew Maneuver, does not occur. The directionality and statistical significance of Industry Weighted Leverage also supports the agency cost thesis, implying that an increase in industry-weighted leverage increases the likelihood of the inclusion of Blocker language. Both effects remain statistically significant for the probit model, however its economic significance is dampened.

The link between credit environment and Blocker language holds as hypothesized for both OLS and probit. This finding supports that of the Roberts and Sufi (2009), Jimenez et al. (2006) and Hackbarth et al. (2006) conclusions, pointing toward tighter covenant definitions,

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<sup>16</sup> While no model should “fit the noise”, a linear model is likely too rigid to be used with a small number of Blocker observations. Similarly, probit marginal effects will likely yield little result by construction. Marginal effects holds all independent variables constant at the mean. Since Blockers are found in the rightmost tail of the distribution, the likelihood that any meaningful change will be observed at the mean is small.

ratios, and collateral requirements during times of credit contraction. Assuming the Coates et al. (2019) finding holds for credit contracts, a lender who used the contracting credit environment to extract favorable concessions from the borrower may realize an outsized return over the course of its investment.

Contract stickiness is by far the most economically and statistically significant indicator of Blocker language, however its relative lack of predictive power is surprising. The OLS regression suggests that contract stickiness increases the probability of Blocker language by 24 percent while the probit model differed significantly, suggesting that contract stickiness adds to the probability of inclusion by only 1.7 percent, all other variables fixed at the mean. While significant, this finding does not support my thesis. I hypothesized that the presence of a prior Blocker would induce borrowers to keep the language in future contracts, as the ink cost of negotiating the lender protective clause out may be prohibitive. My findings suggest that the presence of stickiness only increases the probability of Blocker language by 24 percent, which indicates that Blockers are negotiated out of 76 percent of contracts that previously included the language. This finding suggests perhaps another interpretation: that Blocker language is an important negotiating point, and that the benefit borrowers accrue from excluding this provision is perceived *ex ante* to be higher than the cost they incur in doing so. This finding seems to be in line with Ganglmair and Wardlaw (2017), who strongly reject the existence of boilerplate language. It also may suggest that Choi et al. (2020) present an overstated opinion on the level of encrustation present within bond contracts, indicating that bond lawyers are less of an assembly worker and more of an artisan when it comes to drafting debt documents.<sup>17</sup> Another explanation may be that encrustation within debt documents is still significant as Choi et al. (2020) suggest, however the encrustation is found in another part of the contract.<sup>18</sup> The increased rate of negotiation may also align with the Coates et al. (2019) finding, which suggests that greater lender protective clauses lead to a higher rate of incompleteness. In other words, lenders may not have as much negotiating power as previously hypothesized, despite half the sample occurring during one of the greatest economic contractions in history. This interpretation seems to contradict my finding that a contracting credit environment is correlated with greater lender negotiating power. Perhaps a weaker credit environment is still tied to greater lender negotiating power, but less than I previously hypothesized.

The link between law firm relationship and inclusion of Blocker language is statistically significant, although I hesitate to place emphasis on this variable due to the noisiness of the search and the lack of observations. Just 35 percent of firms within the dataset had law firm observations, meaning that 65 percent did not. Additionally, law firm information is observed

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<sup>17</sup> I acknowledge that bonds and loans are not the same type of debt instrument, but it may be reasonably assumed that the Choi et al. (2020) finding applies to loans as it does to bonds.

<sup>18</sup> I draw this hypothesis from a conversation with a retired bond lawyer, who told me that, "A credit agreement has 120 pages in it. The real meat is in the covenants... 50-60 pages are what makes a contract a good contract. The other stuff is what is boilerplate." Interview on 28 September 2020.

2.3 times more frequently in debt documents that sample Blocker language than in documents not containing the language. The association is likely nothing more than random chance. Due to this anomaly, the probit model found Law Info to be mildly significant ( $p < 0.10$ ). Law Info's significance seriously undermines the validity of Top Law's significance. I do not place much explanatory power on this variable due to its construction and minimal economic significance.

#### IV. CONCLUSION

In this study, I seek to understand what factors influence the inclusion of Blocker language in debt documents. I take motivation from capital structure and agency cost theory, contract completeness and complexity theory, credit cycle theory, and professional network theory, hypothesizing that private equity backing, a contractual credit environment, contract stickiness and professional legal networks all contribute to the likelihood of Blocker inclusion. I find that all key independent variables are associated with a higher chance of including Blocker language in a debt document.

While all variables are statistically significant and positively correlated with the inclusion of Blocker language, I find that both an OLS and probit regression of the variables yields little true economic significance. In my OLS regression, private equity backing increases the likelihood of Blocker inclusion by just 0.84 percent. A contractual credit environment increased Blocker likelihood by 1.26 percent. Stickiness, the variable serving as a proxy for ink cost and encrustation, had the highest economic and statistical significance, although an OLS interpretation of the results still provides unclear real-world implications. Presence of sticky language increased Blocker likelihood by 24.02 percent. Finally, inclusion of an innovative legal network increased inclusion probability by 0.15 percent. The results from my private equity backing, contractual credit environment and legal network variables are all in line with my hypothesis. Contract stickiness, while significant, is not consistent with my hypothesis. The lack of explanatory power associated with all key independent variables may be explained in part by downward bias from the low number of Blocker observations relative to the number of non-Blocker observations.

While this paper broke ground on academic research related to J. Crew Maneuvers, much more work is yet to be done. I recommend that a professional with legal training conduct a more in-depth count of the number of Blockers outstanding. If it is confirmed that only roughly 80 such Blockers exists, perhaps it is better to leave future Blocker analysis for a time when more observations are available. The model can be improved by incorporating more indicators of financial distress, credit cycles, stickiness, and professional networks. For example, a future researcher may take the advice of Ganglmair and Wardlaw (2017), who suggest that contract length is an accurate proxy for default risk and complexity. Future studies may also focus on refining the Top Law variable to have more complete information on law firm, especially for lender law firms, rather than borrower law firms. It may also be hypothesized that

the decision to negotiate in Blocker language comes from the lender itself, not the lender law firm. In this case, future research could study the lender relationship with Blocker inclusion. Creating a model to understand the determinants of Blocker language is interesting, but of more importance is understanding how Maneuvers should be priced by the market. Due to the low number of companies that have engaged in J. Crew Maneuvers, more time will need to pass to establish conclusive findings of debt pricing models for J. Crew Maneuvers.

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