Bankruptcy Hardball:

Do Bankruptcy Courts Unfairly Advantage Debtors to the Detriment of Creditors?

Speakers

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Speakers and Moderator Bios

Valerie Bantner Peo

Valerie Bantner Peo focuses her practice on creditors' rights, real estate, finance and commercial litigation with significant experience at the trial and appellate levels in bankruptcy, federal and state court. She regularly represents financial institutions, including factors and asset-based lenders, software licensors, commercial landlords and tenants, equipment lessors, and bankruptcy trustees. Ms. Bantner Peo has significant experience litigating commercial lease disputes, including eviction actions and jury trials, and in all aspects of bankruptcy reorganization and liquidation including claim disputes, lease assumptions and rejections, plan confirmation, cash collateral disputes, fraudulent transfers and preference liability.

Ms. Bantner Peo currently serves on the Board of Directors of the International Women's Insolvency and Restructuring Confederation ("IWIRC") as the Vice-Director of Regional Programming for the 2018-2019 term and served as co-chair of the Northern California IWIRC chapter from 2014 to 2018. In 2018, Ms. Bantner Peo served as co-chair of the inaugural IWIRC on the Vine conference, which drew panelists and attendees from across the country and Canada. In 2016, Ms. Bantner Peo was named an IWIRC "Rising Star" finalist and was featured in the IWIRC Connection's Member Spotlight. Ms. Bantner Peo also serves on the Executive Committee of the San Francisco Bar Association's Commercial Law and Bankruptcy section. Ms. Peo was recognized by Super Lawyer Magazine as a Northern California Super Lawyer in 2019.

Ms. Bantner Peo served as a law clerk for the Honorable Edward D. Jellen (Ret.), U.S. Bankruptcy Court for the Northern District of California.

Tobias Keller

Tobias Keller counsels clients in a variety of industries dealing with financial distress, advising on dislocations arising from excessive leverage, uncontrolled litigation, or unanticipated employee or vendor problems, and the governance questions that arise in connection with those challenges.

Mr. Keller regularly lectures for organizations on governance, distressed mergers and acquisitions, and various restructuring topics. He is a fellow in the American College of Bankruptcy and has been recognized as a leading lawyer in publications including Chambers USA.

Professor Jared Ellias

Professor Jared A. Ellias writes and teaches about corporate bankruptcy law and the governance of large firms more generally. He has served as a Teaching Fellow and Lecturer at Stanford Law School and a Visiting Associate Professor at Boston University School of Law. He joined the UC Hastings faculty in 2014 and became the founding Faculty Director of the Center for Business Law in 2018. He has received the UC Hastings Foundation Faculty Award for Faculty Scholarship, the highest research award given by UC Hastings to faculty.

His research on corporate bankruptcy topics has been published or is forthcoming in leading peer reviewed law and social science journals (such as the Journal of Legal Studies, the Journal of Legal Analysis and the Journal of Empirical Legal Studies) as well as in leading student-edited law reviews (such as the California Law Review, the Southern California Law Review and the Columbia Law Review Sidebar). He has presented papers at a large number of academic conferences (such as the Annual Meeting of the American Law and Economics Association and the Conference on Empirical Legal Studies) and faculty workshops at leading law schools (such as Yale, Columbia, Michigan, Virginia and Duke). His work has been selected for the Stanford/Yale/Harvard junior faculty forum and for presentation at the Weil, Gotshal & Manges Roundtable at Yale Law School. He has also testified on corporate bankruptcy issues before the California State Senate and presented research at a wide variety of bankruptcy lawyer conferences and events. He is widely quoted in the press, including by the New York Times, the Wall Street Journal, the Washington Post, the Financial Times, Bloomberg News and the San Francisco Chronicle, among many other media venues.

Prior to entering academia, Professor Ellias was an associate in private practice at Brown Rudnick LLP in New York, where he represented financial institutions and ad hoc and statutory creditor committees in corporate restructuring transactions, both in and out of bankruptcy court. He has trial experience in the Bankruptcy Courts of the District of Delaware, the Western District of Louisiana and the Southern District of New York.

Professor Ellias' current research focuses on the governance of large bankrupt firms and the role played by activist investors and the effect of bankruptcy filings on firms. His research interests include corporate bankruptcy, corporate governance, contract law, empirical methods in social science and law and economics.

Professor Ellias received his J.D. from Columbia Law School in 2008 and his A.B. from the University of Michigan in 2005.

Jeff Garfinkle

Jeff Garfinkle's primary practice involves the representation of secured and unsecured creditors, creditors' committees, trustees, equity receivers, debtors, and other parties in interest in a variety of bankruptcy, restructuring cases and collection matters, including out of court workouts. Jeff also specializes in matters pertaining to Articles 2 and 9 of the Uniform Commercial Code and representing purchasers of assets from bankrupt companies.

Jeff is regarded as one of the nation's leading healthcare and pharmaceutical insolvency attorneys. For more than 20 years, Mr. Garfinkle has served as primary U.S. insolvency, bankruptcy and collections counsel to the world's largest healthcare corporation. In this capacity, Jeff has handled hundreds of healthcare and pharmaceutical-related bankruptcy and restructuring matters. Beyond this work, Mr. Garfinkle has represented committees, debtors, creditors and other parties in dozens of other healthcare bankruptcy cases. The depth and extent of Mr. Garfinkle's healthcare and pharmaceutical bankruptcy representations and expertise is unparalleled.

In February 2003, Mr. Garfinkle joined Buchalter following 12 years with a large national law firm. During 1990 and 1991, Mr. Garfinkle served as law clerk to the Honorable Louise DeCarl Adler, United States Bankruptcy Judge for the Southern District of California.

Mr. Garfinkle is a frequent speaker on bankruptcy, healthcare, pharmaceutical, debt financing, and commercial law issues. He has spoken at the National Conference of Bankruptcy Judges, conferences of the American Bankruptcy Institute, and several conferences held by the American Bar Association.

For 2019 and 2020, Mr. Garfinkle again is recognized as one of the Best Lawyers in America in the area of Bankruptcy and Creditor Debtor Rights and Insolvency and Reorganization Law. Jeff is a member of the Board of Governors of the Financial Lawyers Conference and serves as Education Director for the Commercial and Regulatory Law Committee of the American Bankruptcy Institute. He has also served on the Advisory Board for the Emory Bankruptcy Developments Journal.

Mr. Garfinkle is admitted to the United States Supreme Court, First, Sixth, Eighth, and Ninth Circuit Courts of Appeals as well as all United States District Courts in California. He is a member of the American Bankruptcy Institute and Financial Lawyers Conference.

Bankruptcy Hardball

Jared A. Ellias and Robert J. Stark[1*]

On the eve of the financial crisis, a series of Delaware court decisions added up to a radical change in law: Creditors would no longer have the kind of common law protections from opportunism that helped protect their bargain for the better part of two centuries. In this Article, we argue that Delaware's shift materially altered the way large firms approach financial distress, which is now characterized by a level of chaos and rent-seeking unchecked by norms that formerly restrained managerial opportunism. We refer to the new status quo as "bankruptcy hardball." It is now routine for distressed firms to engage in tactics that harm some creditors for the benefit of other stakeholders, often in violation of contractual promises and basic principles of corporate finance. The fundamental problem is that Delaware's change in law was predicated on the faulty assumption that creditors are fully capable of protecting their bargain during periods of distress with contracts and bankruptcy law. We show through a series of case studies how the creditor's bargain is, contrary to that undergirding assumption, often an easy target for opportunistic repudiation and, in turn, dashed expectations once distress sets in. We further argue that the Delaware courts paved the way for scorched earth distressed governance, but also that judges can help fix the problem.

[1*] Associate Professor of Law, University of California, Hastings College of the Law; Partner, Brown Rudnick LLP. We thank Ken Ayotte, Douglas Baird, Michael St. Patrick Baxter, Vince Buccola, Tony Casey, John Crawford, Edith Hotchkiss, Mike Klausner, Jonathan Lipson, George Triantis, Fred Tung, David Skeel, David C. Smith, Kate Waldock, P. Sabin Willett and participants at a UC Hastings Junior Faculty Workshop for their helpful comments. Thanks to Justin Cunningham, Tyler Davis, Sarah Moran, Natalie Ryang and Lauren Watanabe for their helpful research assistance.

INTRODUCTION

In late 2017, PetSmart Inc., one of the world's leading retailers of pet supplies, found itself in deep financial distress.[2] The company's financial troubles originated with an ill-fated leveraged buy-out and acquisitions that burdened PetSmart with $6 billion in a combination of secured bank loans and unsecured bonds.[3] The leveraged buy-out and acquisition did not go well, and PetSmart's bond debt began trading at steep discounts, suggesting that traders in the bond market viewed the firm as insolvent.[4] The textbook account of corporate governance would suggest that PetSmart's board of directors would respond to this financial distress by seeking to improve the underlying business or, perhaps, by filing for Chapter 11 bankruptcy to maximize the value of the firm for the benefit of creditors. Instead, PetSmart's board recently authorized a transaction that seems shocking for a firm in its situation: It took $1.5 billion out of the reach of creditors, distributing about $900 million to its shareholders and placing $750 million in a subsidiary that was not an obligor on its $9 billion in debt.[5]

The PetSmart scenario is emblematic of a paradigm shift in the manner by which boards of directors now approach financial distress.[6] For most of American history, boards of directors were

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[2] *See* Lauren Coleman-Lochner and Eliza Ronalds-Hannon, *The Most Expensive Takeover in in Retail Is Drowning in Debt*, BLOOMBERG (Apr. 25, 2018), https://www.bloomberg.com/news/articles/2018-04-25/yielding-21-in-bond-market-the-no-1-retail-lbo-is-in-trouble.

[3] *See id*.

[4] *See id*.

[5] *See* Katherine Doherty & Eliza Ronalds-Hannon, *PetSmart Moves Part of Chewy.com Out of Creditors' Reach*, BLOOMBERG (June 4, 2018), https://www.bloomberg.com/news/articles/2018-06-04/petsmart-is-said-to-move-chewy-stake-in-j-crew-style-transfer.

[6] Reporting in the popular media has also noticed that something has changed, but this Article is the first to describe the entirety of the

counseled to manage distressed firms with an eye towards maximizing firm value for the benefit of creditors.[7] In today's world, by contrast, many firms pursue strategies intended to hurt creditors or, if possible, avoid bankruptcy for the benefit of shareholders. It is quite revealing that, after PetSmart removed $1.5 billion from the reach of creditors, the trading price of its bonds

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phenomenon. *See e.g.* Nathan Vardi, *Leon Black's Apollo Global Management Keeps Winning Battles and Outmanuevering Creditors*, FORBES (Aug. 28, 2014) (noting that a leading private equity firm is routinely winning battles with creditors, whose claims are legally senior to shareholders); Sujeet Indap, *Private equity firms' lawyers get creative*, FIN. TIMES (August 14, 2017) (quoting an analyst who declared that "Every [private equity] firm is adopting more aggressive approaches. Some sponsors will win, some will lose."); Soma Biswas, *Deal to Save J. Crew from Bankruptcy Angers High-Yield Debt Investors*, WALL. ST. J. (Sept. 21, 2017) (discussing a transaction that "pushes junior bondholders to the front of the line of creditors, ahead of term-loan holders, who were in a superior position…" and increasing fear on the part of debt investors that aggressive interpretations of credit contracts are undermining the debt markets). One prominent investment banker described 2018 as being characterized by "the brazen asset stripping [the rerouting of assets away from creditors] that [large firms] have gotten away with – mind boggling!" *See* PETITION Newsletter, 12/19/2018 (quoting J. Scott Victor).

[7] Justice Story pioneered this area of jurisprudence in the early 1800s, first as a District Court Judge, s*ee* Wood v. Dummer, 30 F. Cas. 435, 435-440 (C.C.D. Me. 1824), and then on the Supreme Court, *see* Mumma v. Potomac Company , 33 U.S. 281, 281-287 (1834). In short, his view was that managers of an insolvent firm operate the company as a "trust fund" for the benefit of creditors, and this view became known as the "trust fund doctrine." For a fuller discussion of the evolution of the trust fund doctrine into modern fiduciary duty shifting, *see generally* Henry T.C. Hu and Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1332 (2007) (summarizing the transition from trust fund doctrine to Credit Lyonnais duty shifting).

actually *increased* in value.[8] The bondholders apparently breathed a sigh of relief because they had feared far worse.[9] Although unthinkable only a few years ago, in 2018, a distressed firm's redistribution of $1.5 billion away from its creditors is seen as unexpectedly generous to those same creditors because its private equity owner did not help itself to more.

In this Article, we argue that the norms that used to restrain managers of distressed firms from declaring all-out war on creditors have been fading since the financial crisis.[10] Perhaps echoing the decline of norms of moderation in other parts of American life, managers are now playing what we are calling "bankruptcy hardball" with creditors.[11] To be sure, it is well-established that the interests of creditors, managers and

[8] *See* Doherty and Ronalds-Hannon, *supra* note 5.

[9] *See id*.

[10] In another example, the private equity owner of Caesar's, the gaming conglomerate, decided to strip the firm of its best assets to gain bargaining power over creditors if the firm filed for bankruptcy. In an internal presentation, employees of the private equity owner justified the transfer, which was later found by a court-appointed Examiner to be a fraudulent transfer, as "increasing … [our] 'war chest' [to fight creditors with] upon a potential restructuring event." *See* Final Report of Examiner Richard J. Davis at 344, *In re Caesars Entertainment Operating Company,* No. 15-01145 (Bankr. N.D. Ill. May 6, 2016).

[11] The title was inspired by the recent work of Joseph Fishkin and David E. Pozen, *Assymetric Constitional Hardball*, 118 COLUM. L. REV. 916 (2018) and Mark V. Tushnet, *Constitutional Hardball*, 37 J. MARSHALL L. REV. 523 (2004). The behavior we label "bankruptcy hardball," does not necessarily involve a bankruptcy filing, and "bankruptcy hardball" should be thought of as describing a universe of aggressive tactics in debtor-creditor relations. Many of them are not new; what is new, we believe, is the frequency and intensity of the deployment of hardball tactics, partially as a result of legal changes we describe *infra*.

shareholders diverge when a firm becomes distressed.[12] The managers of a distressed firm can use their control to select from a range of options with important distributional ramifications for the firm's stakeholders.[13] While this moral hazard – which we call *control opportunism* – is well-established, what has changed over the past ten years is the level of aggressiveness now observed of otherwise conventional firms.[14]

We argue that this change may be attributed, at least in part, to the common law's retreat from its historical role protecting creditors.[15] For most of American history, judges played an important role in policing control opportunism with various common law doctrines that provided creditors with remedies if managers went beyond the accepted boundaries of opportunistic behavior.[16] These doctrines did not function as a liability safety-net that held managers liable for any business decision that did not work out.[17] But, by explicitly focusing managerial decision-making on the interests of creditors and by exposing such decision-making

[12] *See generally* David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917, 923 (2003) (discussing corporate governance in bankruptcy); *see also* Michelle M. Harner et. al, *Activist Investors, Distressed Companies, and Value Uncertainty*, 22 AM. BANKR. INST. L. REV. 167 (2014).

[13] *See generally* Harner et. al, *supra* note 12; Lynn M. LoPucki & William C. Whitford, *Corporate Governance in Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993); *see also* Adam J. Levitin, *The Problematic Case for Incentive Compensation in Bankruptcy*, 156 U. PA. L. REV. 88, 101 (2007) (noting that the biggest corporate governance problem in Chapter 11 is navigating "the uncertainties of valuation and hence of the incentives and identity of the residual owner.").

[14] *See infra* notes through 95 and accompanying text.

[15] *See infra* Section III.

[16] *See infra* notes 79 through 94 and accompanying text.

[17] *See id*.

to a hazy form of potential liability, they likely deterred a kind of swashbuckling recklessness or intentional dereliction of the creditor's bargain.[18]

However, on the eve of the financial crisis, the Delaware courts suddenly changed course.[19] In 2007, the Delaware Supreme Court's seminal *Gheewalla* decision limited the fiduciary duties that managers previously owed to creditors in times of financial distress.[20] This shift had an ideological motivation, as influential critics argued that creditors did not need protection from judges and that fiduciary duties and other equitable remedies were unnecessary to deter control opportunism.[21] After all, many commentators reasoned, the largest creditors – generally banks and bond investors – are well-situated to protect themselves.[22] To the extent these sophisticated creditors fear opportunism, they can contract *ex ante* to prevent it and courts can simply enforce those contracts as it becomes necessary to do so.[23] Further, some judges declared that any opportunistic behavior not identified *ex ante* and banned by "contractual agreements" are ably policed by other safety-valve equitable doctrines and laws, such as "fraud and fraudulent conveyance law, implied covenants of good faith and

[18] *See infra* notes 82 through 97 and accompanying text.

[19] *See id*.

[20] *See infra* notes 82 through 88 and accompanying text.

[21] *See e.g.* Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, *supra* note 7 (arguing that fiduciary duties for creditors are unnecessary); *infra* notes 82 through 84 and accompanying text.

[22] *See e.g.* Hu & Westbrook, *supra* note 7; Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L. J. 809, 864-8 (2008) (arguing against fiduciary duty protections for sophisticated creditors).

[23] *See* Prod. Res. Grp., L.L.C. v. NCT Grp., 863 A.2d 772, 789 (Del. Ch. 2004).

fair dealing, bankruptcy law, general commercial law and other sources of creditor rights."[24]

In this Article, we argue that *Gheewalla* and its progeny relieved corporate decision-making of important guiding principles and, in the vacuous space that now exists, remarkable instances of control opportunism have become observable and, increasingly, common place.[25] We believe that this is the consequence of a fundamental misunderstanding of the ability of creditors to protect themselves with contracts and bankruptcy law.[26] First, we argue that there is no perfect contractual solution for this kind of problem because, even where creditors can foresee control opportunism, clever lawyering and the evolving circumstances of financial distress can help managers disable or evade enforcement of even the most skillfully crafted contractual covenants.[27] While the contractarian scholar might retort that creditors simply need to write better contracts, we argue that distress gives rise to a sort of cat-and-mouse game, where enforcement often hinges more on practical reality than judicial process and well-advised debtors and creditors routinely arrive at outcomes inconsistent with *ex ante* contracts.[28] Indeed, as the cases we describe below make clear, debtors can often exploit their

[24] *See* N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) (declaring that creditors do not get fiduciary duties, but are rather "afforded protection through contractual agreements, fraud and fraudulent transfer law, implied covenants of good faith and fair dealing, [and] bankruptcy law . . .").
[25] *See infra* notes 95 through 97 and accompanying text.
[26] *See infra* notes 98 through 166 and accompanying text. *See also* Haslund v. Simon Prop. Grp., Inc., 378 F.3d 653, 655 (7th Cir. 2004) (Posner, J.) (noting that complete contracts are impossible and that contracts can be "shorter and cheaper" when courts fill gaps and resolve ambiguities in the case of litigation).
[27] *See infra* notes 98 through 166 and accompanying text.
[28] *See id.*

circumstances to essentially re-write their covenants while the otherwise counteracting force -- the threat of breach of contract litigation -- has increasingly less potency as a firm's distress deepens.[29]

Second, we contend that bankruptcy law currently provides far less protection for creditors than presumed by commentators and Delaware precedent.[30] In theory, when firms encounter financial trouble, they file for Chapter 11 bankruptcy and the judge supervises a management team that devotes all of its energies to maximizing the firm's value in order to provide creditors with the best possible recovery, consistent with contractual terms negotiated pre-petition.[31] In practice, however, bankruptcy judges balance creditor interests against other important policy goals, such as the need for the firm to finance itself post-petition, to reorganize and, in an uncertain economic time, to protect the jobs of current and future employees.[32] As further explained below, clever debtors and their lawyers understand this and have developed procedural strategies that effectively disable the formal machinery of creditor protection, including related doctrines like the law governing fraudulent transfers.[33] This sort of bankruptcy hardball may help explain why PetSmart's board decided to make such an opportunistic distribution of value: With funds already in hand, the firm's private equity sponsor is now in a far better position to get

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[29] *See id.*

[30] *See generally* Hu & Westbrook, *supra* note 21 at 1369-78 (arguing that bankruptcy provides sufficient protection for creditors and therefore that fiduciary duty shifting to creditors should be abolished); *see contra infra* notes 167 through 253 and accompanying text.

[31] *See generally* John A. E. Pottow, *Fiduciary Duties in Bankruptcy and Insolvency*, OXFORD HANDBOOK OF FIDUCIARY DUTY LAW (Criddle et. al, eds. 2018).

[32] *See e.g. infra* notes 167 through 218 and accompanying text.

[33] *See infra* notes 167 through 253 and accompanying text.

more than it likely is entitled to at the conclusion of an anticipated bankruptcy process or out-of-court restructuring.[34]

This Article proceeds as follows. In Section II, we define the problem of control opportunism and in Section III we describe the common law's migration away from creditor protection, as well as the ideological underpinnings of that paradigm shift. In Section IV, we discuss several case studies that illustrate the current state of affair. While creditors were successful in thwarting opportunistic behavior in some of the cases we describe, they all illustrate different strategies that managers can use to play bankruptcy hardball, with great costs to creditors.

In Section V, we conclude by arguing that Delaware judges and bankruptcy judges could do a great deal to restore order to debtor-creditor relations by subjecting alleged control opportunism to greater scrutiny and by taking a more skeptical view of attempts by managers to disable *ex ante* contracts.[35] To be sure, *Gheewalla* is not the only force that has reshaped the status quo. For example, favorable debt market conditions have reduced the bargaining power of debt investors and emboldened managers, and the rise of hedge funds and claims trading has changed the administration of Chapter 11.[36] However, we assert that, *ceteris paribus,* the status quo

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[34] *See e.g. infra* In re Lyondell Chem. Co., 503 B.R. 348, 353 (Bankr. S.D.N.Y. 2014), *as corrected* (Jan. 16, 2014) (demonstrating the advantage of already having received money even if there is fraudulent transfer risk associated with the conveyance).

[35] *See e.g.* Henry E. Smith, *Equity as Second-Order Law: The Problem of Opportunism*, Harvard Public Law Working Paper No. 15-13 (Jan. 15, 2015) (arguing that equitable doctrines are needed to constrain opportunism).

[36] *See e.g.* Jonathan Lipson, Shadow Bankruptcy, 89 B.U. L. REV. 1686 (2009) (detailing many changes that have altered the bargaining dynamic in Chapter 11, such as the rise of claims trading, the influence of hedge

could be improved if today's standards were applied more rigorously.[37] Judges have the discretion to counteract opportunistic behavior if they choose to do so.[38] Indeed, the credit markets need predictability more than anything else, and today's frenzied world of dashed expectations and chaotic litigation is anything but.[39]

II. The Problem of Control Opportunism During Times of Financial Distress.

In this Section, we define what we believe is the major friction on optimal governance for distressed firms: control opportunism.[40] After establishing this analytical framework, we explain how management will be tempted to use their control over the firm to extract benefits -- either for itself or for its historical fiduciary constituents, the shareholders -- by favoring one group of investors over another.

A. The Classic Twin Agency Problems of Corporate Law.

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funds, investors holding credit default swaps); Douglas Baird and Robert K. Rasmussen, *Antibankruptcy*, 119 Yale L. J. 648 (2010).

[37] *See infra* Section V.

[38] *See id*.

[39] *See* Clifford J. White III, *Professional Fees, Corporate Governance, Predictability and Transparency in Chapter 11,* 35 AMER. BANKR. INS. J. 12 (May 2016) (discussing the importance of predictability in Chapter 11).

[40] For a more expansive treatment of all of the ways creditors can be opportunistic, *see* Jonathan C. Lipson, *Governance in the Breach: Controlling Creditor Opportunism*, 84 S. CAL. L. REV. 1035, 1049-59 (2011). Lipson discusses what he calls "creditor opportunism," a wider category that includes not only abuses of the power of control but also complexities created by creditors owning a wide range of claims against the firm. What we call *control opportunism* is both a more limited species of opportunism, as it only includes the temptation creditors have to be opportunistic by obtaining control of the firm and not through other ways, and more expansive in that it focuses on the behavior of managers, not creditors.

In a healthy corporation, the main agency problems of managers and shareholders are well-understood, and they are usually considered to be driven by different problematic incentives.[41] First, managers are said to be tempted by moral hazard to use their control of a healthy firm to extract value that would otherwise go to shareholders, such as by abusing the compensation-setting process to extract undeserved money[42] or by manipulating a sale process to make it easier for management's preferred new owner to buy the company instead of someone who would pay the shareholders more.[43]

There is a second agency problem at the heart of corporate governance as well: the agency conflict between shareholders and creditors.[44] Shareholders control a firm by electing the board of directors which hires the senior officers who actually run the firm.[45] Managers owe shareholders a fiduciary duty which means it is often assumed that they are operating the firm on their behalf.[46] However, the typical firm also usually funds its activities with

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[41] For the seminal article on this topic, *see* Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305-360 (1976).
[42] *See generally* Lucian Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE (Harvard Univ. Press 2006).
[43] *See e.g.* Yakov Amihud, LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES (Amihud, ed 1988) (discussing the debate over management's private interests in deciding the timing and purchaser of leveraged buy-outs).
[44] *See e.g.* Michael C. Jensen & Clifford W. Smith, *Stockholder, Manager, & Creditor Interests: Applications of Agency Theory*, VOL. 1, NO. 1 (2000).
[45] For a discussion of the history of independent directors, *see* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2006-2007).
[46] *See e.g.* General Corporation Law, 8 Del. C. § 141(a) (2016).

some amount of debt.[47] This leads to an agency conflict when the firm approaches insolvency, as managers work for shareholders, who would like to see the firm's fortunes rebound, perhaps by taking excessive risks.[48] For example, a firm may launch a new product which will either succeed massively or exhaust the firm's remaining assets.[49] To the extent these risks turn out to produce strong returns, the returns mostly inure to the benefit of shareholders.[50] To the extent the risks are unsuccessful, the downside generally falls on creditors who can find themselves holding claims against a firm with diminished value.[51] Creditors recognize this problem and routinely contract to block managers from excessively risky actions by, for example, requiring them to keep a minimum level of money in the bank or requiring creditor approval for major investments that could divert significant amounts of value.[52]

B. Updating the Debt-Equity Conflict for Modern Finance: Incentive Conflicts between Holders of Options.

The debt-equity conflict becomes even more complicated when its theoretical intuitions are imposed on modern corporate finance. Large conglomerates do not fit the classic paradigm of a single corporate borrower, single creditor and a single shareholder.[53] Instead, sizeable firms fund their activities with a combination of secured and unsecured debt and equity.[54] The investors who

[47] *See e.g.* Joshua D. Rauh & Amir Sufi, *Capital Structure and Debt Structure*, 23 REV. FIN. STUD. 4242 (2010).
[48] *See* Clifford W. Smith & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118-9 (1979).
[49] *See id.*
[50] *See id. at* 118-9.
[51] *See id.* at 118.
[52] *See id.* at 125-146 (describing bond covenants).
[53] *See* Rauh & Sufi, *supra* note 47, at 4243.
[54] *See id.*

provide all three forms of capital are contracting to receive different levels of return with different levels of risk.[55] It is clearest to think of modern investors as holding options with different levels of priority against the firm's assets.[56] Consider a hypothetical firm owned by a private equity sponsor that owes $100 to secured creditors and $50 to unsecured bondholders. In insolvency, all of these investors will be the equivalent of the holders of options.[57] The firm's secured lenders have what they probably think of *ex ante* as a deeply in the money capped call option to receive a repayment of principal plus an interest payment, as well as the right to receive the first $100 in firm value in insolvency. The firm's unsecured bondholders have the equivalent of a capped option to receive the next $50 in value from $100 until $150. The private equity sponsor has an option to receive all of the value of the firm after the $150 in debt has been paid in full.[58]

Accordingly, for the modern firm, the classic debt-equity conflict is driven by its financial circumstances and solvency at any given point in time. Imagine that this firm is considering a business plan that has a 50% chance of yielding a pay-off of a total firm value of $200 if it succeeds and a 50% chance of destroying most of the firm's value and leaving only $10 for distribution to creditors. If the firm is worth $100 today, secured creditors stand in the same position as "creditors" in the classic debt-equity narrative in that they will suffer the downside of the plan's failure, going from a

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[55] *See e.g.* C. Edward Dobbs, *Negotiating Points in Second Lien Financing Transactions*, 4 DEPAUL BUS. & COM. L.J. 190, 189-234 (2006) (discussing the interest of lenders in funding riskier, junior lien loans in exchange for higher returns).

[56] *See e.g.* Aswath Damodaran, INVESTMENT VALUATION TECHNIQUES FOR DETERMINING THE VALUE OF ANY ASSET 611-646 (John Wiley & Sons, Inc., 2d ed. 2002).

[57] *See e.g. id.*

[58] *See* Black & Scholes *supra* note **Error! Bookmark not defined.** at 654.

100% pay-off to a 10% pay-off. While the private equity shareholder remains the ultimate beneficiary of the plan, the first $50 inures to the benefit of unsecured creditors. As a result, the classic debt-equity conflict is better understood as a conflict between the holders of "deeply in-the-money" options versus "out-of-the-money" options, where the identity of the option-holders will vary based on the underlying facts.[59]

When a firm is insolvent, management will enjoy two forms of control over the ultimate pay-off that the firm's investors receive. The first is over the *substance* of any restructuring. This can involve, for example, migrating value within a conglomerate or away from the firm altogether through distributions to shareholders.[60] These types of transactions are about manipulating how and how much particular stakeholders recover vis-à-vis competitors in the capital structure.[61] Substantive control can also reflect itself in less overt ways. It might involve managerial decisions about what a firm's new business plan should look like, how much value generally exists for distribution to creditors and what the reorganized firm's capital structure should look like.[62] An aggressive business plan

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[59] This is not a new way of viewing the debt-equity conflict. Chancellor Allen reflected on a similar hypothetical in the famous footnote 55 of Credit Lyonnais. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns, Corp., No. 12150, 1991 WL 277613, at *1155, fn. 55 (Del. Ch. Dec. 30, 1991).

[60] For example, the debtor can move value outside of a collateral basket under a secured loan agreement or from one corporate entity to another.

[61] An example of this kind of substantive control is the PetSmart fact pattern discussed *supra*, where the board authorized a large dividend to shareholders and otherwise migrated value within the conglomerate away from creditors before restructuring discussions even began. *See supra* notes 2 through 5 and accompanying text.

[62] *See* Jared A. Ellias, *Do Activist Investors Constrain Managerial Moral Hazard?: Evidence from Junior Activist Investing*, 8 J. LEG. ANAL. 493, 494-6 (2016).

with optimistic projections of future earnings can support a higher valuation and more debt than a pessimistic plan with more conservative assumptions.[63] The higher the valuation, the more value that management or a bankruptcy judge can deem exists for distribution to creditors or shareholders.[64]

Second, management controls the *timing* of any decision to restructure its debt by modifying its debt contracts and reorganizing its capital structure.[65] This can mean a consensual out-of-court exchange or a bankruptcy filing.[66] These are decisions that can also be enormously consequential for investors.[67] A quick bankruptcy filing can benefit senior option-holders, who may prefer to exchange their debt for the firm's equity today rather than risk further degradation of firm value.[68] A slow trip through bankruptcy can extend the option of out-of-the-money creditor or shareholders and give the firm's operations time to improve.[69]

In exercising this control, management will be tempted by what we refer to as *control opportunism:* corporate decision-making that favors one group of stakeholders over another and can benefit management financially or in other ways.[70] Managers have

[63] *See id.*

[64] *See id.*

[65] *See* Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219, 221-233 (2004).

[66] *See generally* Adam Levitin & William Bratton, *The New Bond Workouts*, 167 U. PA. L. REV. 1 (2018) (discussing out-of-court debt exchanges exchanges).

[67] *See generally* LoPucki & Whitford, *supra* note 13, at 691-719.

[68] *See id.*

[69] *See id.*

[70] Here too, Chancellor Allen's footnote 55 is reflective of what is observed in the real world. *See Credit Lyonnais* at *34, fn. 55 (Del. Ch. Dec. 30, 1991) ("The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and

personal and financial interests to act strategically. For example, imagine that there are plausible reasons to think that a troubled firm should delay bankruptcy because its fortunes will improve, and also imagine that, at the same time, there are equally plausible reasons to think a firm should immediately file for bankruptcy because its fortunes will not improve. Neither option is a clear value maximizing strategy, and neither appears better than the other. So, the board looks for reasons other than value maximization to select one strategy over the other. Management can align with the senior option-holder and file for bankruptcy immediately with a conservative business plan and strategy to exit bankruptcy quickly. In exchange, the senior option-holder can reward managers with lucrative post-bankruptcy employment. Alternatively, management can align with junior option-holders and delay filing for bankruptcy as long as possible or file for bankruptcy with an aggressive business plan that keeps junior option-holders in the money. Management may choose this path because they traditionally think of themselves as working for the shareholders who appointed them, because they hold a potential lucrative block of the firm's stock or perhaps because they have little affinity for the firm's lenders.[71]

Moreover, even an unbiased manager has incentives to make strategic decisions. Managers generally want to avoid the scrutiny and expense associated with bankruptcy.[72] If bankruptcy is

creating complexities for directors."); *see also* Jared A. Ellias, *supra* note 62, at 494-6.

[71] Social psychology has long recognized that people tend to be biased in favor of other people and things they are more familiar with. *See e.g.* Robet B. Zajonc, *Attitudinal Effects of Mere Exposure*, 9 J. PERSONALITY & SOC. PSY. 1 (1968) (showing evidence of the the 'mere exposure effect').

[72] *See generally* Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEG. STUDIES 277 (1991).

unavoidable, then they naturally want the company to exit as soon as possible to minimize the delay, inconvenience, and business dislocation that comes with running a firm under bankruptcy court administration.[73] They also generally prefer to have as little debt as possible upon emergence from bankruptcy, in an effort to free-up future financing capacity, make a return trip to bankruptcy less likely, and perhaps to enrich themselves via executive stock options.[74] Further, management is unlikely to benefit at all from a prolonged bankruptcy process that exhausts restructuring options and fairly adjudicates and estimates all of the claims of creditors.

Importantly, control opportunism can have significant real-world consequences. Fear that managers will favor one creditor group over another can upset incentives to invest *ex ante*.[75] In general, many observers believe that the current state of Chapter 11 practice favors senior option-holders at the expense of junior creditor and shareholders.[76]

III. The Modern Approach of the Common Law to Control Opportunism.

While modern finance has complicated the story of control opportunism, the law has long recognized that managers have

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[73] *See id.*

[74] *See* Paul M. Goldschmid, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 191 COLUM. BUS. L. REV. 192, 266-7 (2005).

[75] *See generally* Barry Adler, *Game Theoretic Bankruptcy Valuation*, 41 J. LEG. STUDIES 209-238 (2012).

[76] *See generally* Skeel, *supra* note 12 at 923; *see also* Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 KY. L.J. 839 (2005); *see also* George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19-46 (2004); Douglas A. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003).

distorted incentives when a firm nears insolvency. Historically, the law often responded by extending equitable protections that created liability for managers if they grossly abused their discretion. In early American history this equitable protection took the form of the so-called "trust fund doctrine," and in modern times judges began to use fiduciary duty law to protect creditors.[77] In this Section, we briefly summarize the rise and fall of modern fiduciary duties to creditors.

A. The Emergence of Fiduciary Duties for Creditors in Delaware.

In the early 1980s, corporate debt became more central to corporate finance, as banking deregulation and the rise of junk bonds changed the traditional profile of a typical corporate creditor, and the classic agency problem between debt and equity began to loom larger and larger. The problem of debt grew in importance as junk bonds opened up a new source of junior priority

[77] As this Article focuses on developments since the financial crisis, space constraints prevent us from providing a full discussion of the trust fund doctrine. For good introductions, *see* Hu & Westbrook, *supra* note 7 and Norwood P. Beveridge, *Fiduciary Duties to Creditors*, 25 ST. MARY'S L.J. 589 (1994). Justice Story's "trust fund doctrine" also aligned with seminal receivership and bankruptcy precedent, including Supreme Court opinions: (i) establishing the absolute priority rule, *see* Northern Pacific Railway Co. v. Boyd, 228 U.S. 482 (1913); (ii) imposing strict evidentiary standards before creditors must cede value to shareholders, *see* National Surety Co. v. Coriell, 289 U.S. 426 (1933); and (iii) condemning control opportunism intended to shift estate value from creditors to shareholders, *see* Pepper v. Litton, 308 U.S. 295 (1939). Many of these principles were incorporated into the Bankruptcy Code, *see, e.g.*, 11 U.S.C. 1129(b)(2), and continue to establish lender expectations. But, as discussed herein, they are increasingly ignored and/or rendered ineffectual in the day-to-day administration of insolvency scenarios and bankruptcy cases.

financing, and firms began to finance riskier ventures with debt that might have previously been funded with equity. Junk bonds also financed the wave of leveraged buy-outs. As a percentage of firm value, debt increased from 20% of firm value in the 1920s to 65% in the early 1990s.[78] Eventually, corporate America began to labor under this historically unprecedented debt load.

Perhaps in reaction to the rise of debt as well as the need to adjudicate claims arising out of leveraged buy-outs, the Delaware Chancery Court expanded the range of scenarios when boards of directors would need to consider creditors in their decision making.[79] In *Credit Lyonnais,* the court held that the board of a firm "operating in the vicinity of insolvency" owed its fiduciary duty not just to shareholders but to the "corporate enterprise" as a whole.[80] This shift was necessary given directors' incentives to put

[78] *See* John R. Graham, et. al, *A Century of Capital Structure: The Leveraging of Corporate America,* 118 J. FIN. ECON. 658 (2015) (tracing the history of corporate debt).

[79] *See* Credit Lyonnais, 1991 WL 277613 at *34; *see also* Dianna F. Coffino & Charles H. Jeanfraeu, *Delaware Hits the Brakes: The Effect of Gheewalla and Trenwick on Creditor Claims*, 17 J. BANKR. L & PRAC. 1. Art. 3 (2008) (describing the shift). Even prior to *Credit Lyonnais*, many courts outside of Delaware held that the fiduciary duties of directors shifted from the corporation's stockholders to its creditors when the corporation was in fact insolvent. *See, e.g.*, Clarkson Co. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981); *see also* FDIC v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982). Note that even before *Credit Lyonnais* and *Gheewalla*, some Delaware courts had already begun to articulate a view of the world that deprived creditors of equitable protections. *See e.g. Katz v. Oak Indus.*, 508 A.2d 873, 879 (Del. Ch. 1986) (arguing that "the terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.")

[80] *See* Credit Lyonnais, 1991 WL 277613 at *34. Twenty five years before *Credit Lyonnais*, in 1974, a Delaware court suggested in dicta that a creditor

creditors' money at risk while looking out for shareholder interests.[81] The change in the law had the effect of changing the liability calculus of boards of directors in the event that the firm was "in the vicinity of insolvency," as directors could conceivably now be held liable to creditors as well as shareholders.

B. The Academic and Judicial Movement Away from Equitable Protections for Creditors.

The law's modern evolution towards protecting creditors was not well-received by many academic commentators and Delaware jurists. Academic commentators grew to dispute the fundamental logic of *Credit Lyonnaise*.[82] While courts thought they were reducing the costs of contracting by not requiring creditors to attempt to anticipate all potential scenarios where their interests could diverge from shareholders, academic contract theorists became increasingly convinced that equitable doctrines aimed to achieve fairness – like contract law doctrines that would void otherwise enforceable contracts – were largely unnecessary and

might be able to recover against directors or officers of a corporation even without a contractual right to do so in the event of "fraud, insolvency or a violation of a statute…" *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974), *aff'd in part, rev'd in part*, 347 A.2d 133 (Del. 1975).

[81] *See id.*; *see also* Myron M. Sheinfeld & Judy Harris Pippitt, *Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and After Initiation of A Bankruptcy Case*, 60 BUS. LAW. 79, 88 (2004).

[82] *See, e.g.,* Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1348 (2007) (stating that "duty shifting doctrines are flatly inconsistent with the long-held aspirations of the field of corporate governance and they preclude the use of analytical techniques made possible by modern finance"); *see also* Frederick Tung, *Gap Filling in the Zone of Insolvency*, 1 J. Bus. & Tech. L. 1201, 1204 (2007) (suggest[ing] "that at least for commercial creditors, fiduciary duties that include such creditors are unnecessary.").

that courts should enforce agreements strictly as written.[83] As Douglas Baird and Robert K. Rasmussen wrote in an influential Article in 2006, after first describing the ability of lenders to create and enforce contractual covenants:

> In today's environment, we see little need for judicial doctrines designed to promote investor welfare. For example, courts in recent years have taken more seriously the notion that the board's allegiance should shift to the creditors when the business finds itself in the "zone of insolvency." In the absence of such a shift of priorities, the argument goes, the board may incline too much toward imprudent gambles designed to get them back into the money. Such a shift of fiduciary duties may be unnecessary, however. Lenders, as we have seen, are quite capable of taking care of themselves. Rather than adding ill defined fiduciary duties to the contracts that they write, a better course may be to ensure that such duties do not impede the exercise of contractual rights for which creditors have bargained.[84]

[83] *See* Alan Schwatz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003) (arguing that commercial parties "want the state to enforce the contracts that they write, not the contracts that a decisionmaker with a concern for fairness would prefer them to have written."); Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 1189 UCLA L. REV. 1189, 1193 (2003) (arguing that the ability of banks and bondholders to protect themselves and exit bad investments mean that they should be limited to the contractual rights they have negotiated).

[84] *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 1209 U. PA. L. REV. 1210, 1248 (2006); *see also* Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary? Duties in the Vicinity of Insolvency,* J. BUS. & TECH. L. 335 (2007).

At the same time that commentators increasingly argued against fiduciary duty shifting on theoretical grounds, Delaware courts grew less comfortable that the system they created in *Credit Lyonnaise* was administrable or had a coherent internal logic.[85] Thus, in *Gheewalla*, the Delaware Supreme Court essentially reversed *Credit Lyonnais,* eliminating the idea that fiduciary duties shift in the "zone of insolvency."[86] The court noted that creditors have many ways to protect themselves, such as through contractual covenants, fraudulent transfer law and the implied covenant of good faith, which "render the imposition of an additional, unique layer of protection through direct claims for breach of fiduciary duty unnecessary."[87] *Gheewalla* merely left open the possibility that creditors could bring derivative claims against the board when the firm became insolvent.[88]

In *Quadrant Structured Products Co. v. Vertin*, the Delaware Chancery Court went even further, arguably placing creditors in a worse position in fiduciary duty analysis than they were before

[85] *See* Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 170-174 (Del. Ch. 2006) (echoing the reasoning of the Chancery Court that deepening insolvency was only a "catchy term" and not a legitimate cause of action); *see also* Hugh M. McDonald et al., *Lafferty's Orphan: The Abandonment of Deepening Insolvency,* 26 AM. BANKR. INST. J. 56 (2007).
[86] *See* Quadrant Structured Prod. Co. v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014) (stating that "in *Gheewalla,* the Delaware Supreme Court discarded the zone" [of insolvency]); *see also* Charles H. Jeanfraeu, 2012 ANN. SURV. OF BANKR. LAW. 13 (2012) (stating that "After *Gheewalla,* the ability of creditors of solvent corporations to use the threat of a breach of fiduciary duty lawsuit against directors to increase their leverage in restructuring negotiations was sharply curtailed.").
[87] *See Quadrant*, 102 A.3d at 160 n.4.
[88] *See generally* Dianna F. Coffino & Charles H. Jeanfraeu, *Delaware Hits the Brakes: The Effect of Gheewalla and Trenwick on Creditor Claim*s, 17 J. Bankr. L & Prac 1. Art. 3 (2008).

Credit Lyonnaise.[89] In *Quadrant*, the court found that, post-*Gheewalla*, the directors and officers of insolvent firms do not owe a fiduciary duty to creditors.[90] Instead, the directors of an insolvent firm may consider the interests of creditors when assessing their fiduciary duty to the corporation, which in some cases might justify taking a "less risky" course of action such as an efficient liquidation.[91] But, if the directors, in their business judgment, decide to take "extreme risk," that too will be protected by the business judgment rule.[92]

In sum, *Quadrant* confirmed that *Gheewalla* marked a radical shift in the law. Prior to *Gheewalla*, it was largely uncontested that directors needed to focus their efforts on creditor returns during times of insolvency, or face liability.[93] That is no longer the case. While creditors may still bring derivative claims in limited scenarios, this remaining right represents scant consolation for the protections previously enjoyed under traditional equity jurisprudence.[94]

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[89] *See Quadrant,* 102 A.3d at 174.

[90] *See id.* at 176 (citing Stearn & Kandestin, *Delaware's Solvency Test: What Is It and Does It Make Sense? A Comparison of Solvency Tests Under the Bankruptcy Code and Delaware Law*, 36 DEL. J. CORP. L. 165, 171 (2011)).

[91] *See id.* at 175 (citing *Production Resources* as standing for the proposition that the "zone of insolvency" line of cases should be understood as providing directors a defense if they choose a more conservative course of action instead of "undertak[ing] extreme risk.").

[92] *See id.* (stating that the creditor plaintiff cannot rebut the business judgment rule merely by arguing that the directors took an excessively risky course of action, so long as it was designed to benefit the corporation as a whole, including creditors).

[93] As P. Sabin Willett notes, the change created by *Gheewalla* was so significant that it likely took lawyers a period of adjustment before they began to advise boards that fiduciary duties no longer ran to creditors. *See Gheewalla and the Director's Dilemma,* 64 BUS. LAW. 1087, 1088 (2009).

[94] *See* Prod. Res. Group, LLC v. NCT Group Inc., 863 A.2d 772, 798 (Del. Ch. 2004) (the court suggested that such a scenario could be a situation in

C. How the Paradigm Shift has Altered the Legal Advice Given to the Boards During Periods of Financial Distress.

Important evidence of the paradigm shift can be found in juxtaposing the advice lawyers give to distressed debtors, before and after *Gheewalla* and *Quadrant*. For example, in an article written for clients in 2001, lawyers at a leading law firm wrote that: "[w]hen a corporation becomes insolvent, … [r]ather than pursuing high-risk strategies for the benefit of shareholders, directors must seek to protect creditors' claims to corporate assets and earnings.[95] After *Quadrant,* a leading law firm wrote in a client alert that directors can now favor some creditors over others without having to worry about liability.[96] Similarly, another leading law firm wrote that

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which "directors display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor."); *see also* Bryan Anderson, *Gheewalla and Insolvency: Greater Certainty for Directors of Distressed Companies*, 11 U. PA. J. BUS. L. 1031, 1037 (2009).

[95] *See* J. Douglas Bacon & Jennifer A. Love, *When Good Things Happen to Bad People: Practical Aspects of Holding Directors and Managers of Insolvent Corporations Accountable*, 10 J. BANKR. L. & PRAC. 185, 186 (2001).

[96] *See* John L. Reed & Henry duPont Ridgley, *Delaware Court of Chancery Issues Significant Ruling on the Ability of Creditors to Assert Fiduciary Duty Claims Against Directors: Key Takeaways*, DLA PIPER (May 14, 2015), https://www.dlapiper.com/en/us/insights/publications/2015/05/delaware-court--chancery-issues-significant-ruling/ (noting that after Gheewalla, directors can favor certain creditors over others without breaching their fiduciary duty and have no obligation to run the business for the protection of creditors); *see also More Clarity to Delaware Directors When Considering Restructuring Transactions*, SULLIVAN & CROMWELL LLP (May 14, 2015), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Restructuring.pdf (noting that directors are now protected by the business judgment rule even in insolvency); *see also* Marshall S. Huebner & Darren S. Klein, *The Fiduciary Duties of Directors of Troubled Companies*, 34 AM. BANKR. INST. J. 18, 81 (2005).

Quadrant will protect directors "adopting a high-risk business strategy that might benefit controlling shareholders when a corporation is insolvent…"[97]

In other words, pre-*Gheewalla,* the advice was stern and directional, and protective of the creditors' bargain. Post-*Quadrant*, the advice is vacuous, provides little directional guidance to the board, and focuses instead on the freedom from liability the board now enjoys so long as it can plausibly justify any course of action.

IV. *Gheewalla's* Shaky Foundations.

Without fiduciary duty, creditor protection rests on the idea that creditors are sufficiently protected through contract law, with fraudulent transfer law and bankruptcy law hovering in the background. We consider each of these arguments in turn, using case studies to suggest that each area of law provides far less protection for creditors than the Delaware courts assumed.

A. The Limits of Contractual Solutions to Control Opportunism.

The classic argument against equitable protections for creditors is that they are well positioned to protect themselves with contract law. The problem with this argument is that creditors cannot design perfect contractual language *ex ante* to cover all conceivable forms of opportunism. In this section, we use three case studies to show how management can play bankruptcy hardball to thwart the contractual expectations of creditors, or to impose costs on

[97] *See* Mark S. Chehi, *Delaware Court of Chancery Decision Clarifies Fiduciary Issues in Insolvent Company Context*, SKADDEN (Jan. 2015), https://www.skadden.com/insights/publications/2015/01/delaware-court-of-chancery-decision-clarifies-fidu.

investors that they could not have contracted to block *ex ante*. In our first case study, Forest Oil, we show how managers can get around contractual covenants by designing transactions to exploit contractual ambiguities, and how judges are willing to privilege form over substance in *ex post* litigation. The lesson of this case study is that even creditors who can anticipate opportunism can struggle to craft a covenant that good lawyers cannot evade *ex post.* In our second case study, Cumulus Media, we show that creative managers can reinterpret contractual language to come up with uses and transactions that were probably never anticipated by the lenders that originally extended credit. In the third case study, Colt Holdings, we should how control of a corporation can give managers the opportunity to stall a bankruptcy filing and, after filing for bankruptcy, to stall an inevitable restructuring, destroying millions of dollars in value to prolong the private equity owner's option value. This is a problem that is very hard to solve with a contract.

The important lesson of this Section is that, even when creditors expressly recognize a risk, designing a contractual solution that addresses it is hard – and may, in fact, be impossible given the skill of the lawyers that represent insolvent companies and given that the threat of breach of contract litigation has decreasing potency as the company's fortunes deteriorate.

1. Forest Oil: Thwarting the Intent of a Contract with Form-Over-Substance Transaction Engineering.

For an example of how control opportunism can thwart the bargained-for protections of creditors, consider Forest Oil Corporation. In early 2014, Forest was a deeply troubled company.[98] The oil and natural gas firm was buffeted by declining

[98] *See* Declaration of Michael Magilton at 66, In re Sabine Oil & Gas Corp., No. 15-11835 (Bankr. S.D.N.Y. 2015).

revenue and overwhelming debt, which included about comprised of borrowings under a reserve-based loan facility and $800 million in unsecured bonds.[99] In May of 2014, Forest entered a deal that promised to solve its financial trouble: a sale of the firm to Sabine Oil & Gas Company.[100] The combined entity would repay all outstanding debt and Forest's public stockholders would receive a healthy equity interest in the new enterprise.[101] The transaction was scheduled to close towards the end of 2014.[102]

Importantly, Forest's bondholders had anticipated the risk of something important changing if the firm was sold or underwent a similar fundamental transformation and they had protected themselves with a "change in control" covenant.[103] The bond indentures defined a "change of control" broadly to include several possibilities, including: (1) when a person or group comes to own more than 50% of the total voting power of the company; (2) upon the sale of all or substantially all of the assets of the company; and (3) upon a merger or consolidation with another entity resulting in Forest Oil stockholders no longer holding at least 50% voting power.[104] The "change of control" covenant thus required the bond debt to be paid off in full if someone bought Forest Oil.[105] Accordingly, Sabine arranged for the combined firm to borrow

[99] *See id.* at 50-52.
[100] *See* Declaration of Michael Magilton, *supra* note 98, at 34.
[101] *See* In re Sabine Oil & Gas Corp., 547 B.R. 503, 521 (Bankr. S.D.N.Y.), *aff'd*, 562 B.R. 211 (S.D.N.Y. 2016).
[102] *See id.*
[103] *See id.*
[104] Complaint at ¶¶ 24-32, *Wilmington Sav. Fund Soc'y v. Forest Oil Corp.*, No. 650584/2015 (N.Y. Sup. Ct. 2015) [hereinafter *Wilmington Savings Complaint*]
[105] *See In re Sabine Oil & Gas Corp.*, 547 B.R 503 at 521.

$800 million in new bank debt to refinance the outstanding bonds.[106]

However, prior to the closing, crude oil prices collapsed, throwing the assumptions undergirding the deal into chaos.[107] Sabine quickly found itself with a deal it no longer wanted on the terms it had negotiated.[108] While Sabine had the financial wherewithal to close the deal, the fall in oil prices meant that the combined company would struggle to service the debt that the deal would require.[109] Sabine wanted out of the deal.[110] The Forest board initially refused, and for good reason: Forest would not survive on its own and, regardless, falling commodity prices was a contractual risk assumed by Sabine and its private equity sponsor.[111] Indeed, by this point, Forest was clearly insolvent, with assets estimated to cover only approximately 70% of its bond debt.[112] If Forest wanted

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106 *See id.*
107 Crude oil fell from $103 per barrel in July to $55 per barrel by mid-December of 2014. *See In re Sabine Oil & Gas Corp.*, 547 B.R 503 at 523; *see also* Sabine Oil Complaint at 51-53, Sabine Oil & Gas Corp. v. Wilmington Trust N.A., Case No. 15-11835 (Bankr. S.D.N.Y. 2015).
108 *See In re Sabine Oil & Gas Corp.*, 547 B.R. at 525.
109 *See* Debtors' Objection to the Motions of the Official Committee of Unsecured Creditors, Forest Notes Indenture Trustees, and Bank of New York Mellon Trust Company N.A. For (i) Leave, Standing, and Authority to Commence and Prosecute Certain Claims and Causes of Action on Behalf of The Debtors' Estates And (ii) Non-Exclusive Settlement Authority at 4, In re Sabine Oil & Gas Corp, No. 15-11835 (Bankr. S.D.N.Y. 2015) [hereinafter *Sabine Oil Debtors' Objection*].
110 *See id.*
111 *See* Sabine Oil Complaint, *supra* note 107, at 75-81.
112 *See id*. at 120-122.

to avoid bankruptcy, it needed the deal to somehow close – but on terms Sabine could accept.[113]

To bridge the gap with Sabine, a Forest director suggested an alternative approach.[114] The merger would close as originally planned, but the Forest bonds would not be refinanced.[115] Rather, they would remain outstanding post-closing, but now subordinated to $1.65 billion in legacy Sabine secured debt "merged into" the combined company.[116] To achieve this outcome, the transaction was re-engineered to supposedly avoid triggering a "change of control" under the Forest bond indentures.[117] The work-around was simple: instead of buying all of Forest's stock, Sabine's equity sponsor would receive stock with limited control rights.[118]

More specifically, the revised transaction would allow Forest stockholders to continue to retain majority voting power in the company, but would be left with only a 26.5% economic interest.[119] First, a Certificate of Amendment authorized Forest Oil to increase the number of its common shares, and to create new "Series A Non-Voting Equity-Equivalent Preferred Shares."[120] Sabine then contributed to Forest all of its equity interests in Sabine Oil & Gas Holdings LLC.[121] In exchange for those equity contributions, Forest Oil granted Sabine shares of Forest Oil stock, representing, in all, approximately a 73.5% economic interest in the

[113] *See id*. at 81.
[114] *See id*. at 526.
[115] *See id*. at 525-527.
[116] *See id*.
[117] *See id*.
[118] *See id*. at 525.
[119] *See id*.
[120] *See id*. at 97.
[121] *See id*. at 98.

new company and 40% of the total voting power.[122] Because Forest stockholders still retained a 60% majority of the voting stock of the company, a "change of control" theoretically did not occur.[123]

The theoretical did not reflect the actual, however. The Forest and Sabine boards approved "technical changes" to the post-closing corporate charter and bylaws that gave Sabine's private equity owner virtual control of the new board of directors and that control was guaranteed far into the future.[124] By any practical measure, a "change of control" certainly had occurred.

The modified transaction closed mid-December 2014, without any advance notice to stakeholders.[125] The bond market gasped at the betrayal, and the market value of outstanding Forest bonds dropped from more than $500 million to less than $280 million as bondholders found themselves suddenly sitting behind more than $1.6 billion in legacy Sabine secured debt in the combined corporate structure.[126] The Forest bondholders promptly brought suit, but it did not go far.[127] A few short months after the deal closed, the combined company filed for Chapter 11 relief.[128] The bondholders' lawsuit was stayed before the state court could even consider a motion to dismiss. In the end, Forest bondholders recovered less than $16 million, or about 97% less than they could have received had their bargained-for covenants been honored.

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[122] *See* Declaration of Michael Magilton at 62, In re Sabine Oil & Gas Corp., No. 15-11835 (Bankr. S.D.N.Y. 2015).
[123] *See In re Sabine Oil & Gas Corp.*, 547 B.R. 503 at 526.
[124] *See* Wilmington Savings Complaint, *supra* note 104, at 44.
[125] *See id*. at 41.
[126] *See* Sabine Oil Complaint, *supra* note 107, at 122.
[127] *See id*. at 122.
[128] *See id*. at 134-142.

2. Cumulus Media: Thwarting the Intent of a Contract with an Implausible Debt Exchange.

For another example of a debtor devising a restructuring transaction that simultaneously appeared to satisfy the technical language of a debt contract while standing the spirit of the language on its head, consider Cumulus Media Inc., one of the country's largest owners of radio stations.[129] Prior to financial distress, Cumulus borrowed $2.4 billion, consisting of a $1.8 billion senior secured term loan, and $610 million in unsecured notes.[130] By 2015, Cumulus began struggling, and started exploring options to restructure its balance sheet.[131] By the end of 2016, the implied market value of Cumulus was below the amount of the secured debt, suggesting that the unsecured noteholders were completely out of the money.[132]

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[129] *See* Declaration of John F. Abbot in Support of Chapter 11 Petitions and First Day Motions at 3, In re Cumulus Media Inc., et al., No. 17-13381 (Bankr. S.D.N.Y. Nov. 30, 2017) [hereinafter *Declaration of John F. Abbot].*

[130] The term loan was secured by a first priority lien on substantially all of Cumulus' assets. *See* Cumulus Complaint Seeking Declaratory Judgment at 2, Cumulus Media Holdings Inc. et al. v. JPMorgan Chase Bank, N.A., No. 16-9591 (S.D.N.Y. Dec. 12, 2016) [hereinafter *Cumulus Complaint*].

[131] *See* Declaration of John F. Abbot, *supra* note 129, at 18-19 (most notably, Cumulus acquired Citadel Broadcasting in 2011 and then Westwood One in 2013).

[132] Cumulus' market value was only about $1.45 billion or, in other words, about $360 million less than the amount due to the secured lenders, rendering the unsecured noteholders completely out of the money. *See* Term Loan Parties' Memorandum of Law in Opposition to Plaintiffs' Motion for Summary Judgment and in Support of Their Cross-Motion for Summary Judgment at 5-6, Cumulus Media Holdings Inc. et

Cumulus' term loan credit agreement included standard terms that allowed the company to borrow additional secured debt, under a "working capital" revolving line of credit. In general, a revolving line of credit is the corporate equivalent of a personal credit card. It allows a company to borrow money, and then repay it, which most firms use to pay their daily operational needs, including raw material costs, payroll, rent, and utilities. Importantly, the revolving line of credit would be senior in terms of payment priority to Cumulus' term lender. While it may seem strange for term lenders to commit in advance to allow other lenders have a claim senior to theirs, doing so actually protected the term lenders by providing the company the ability to manage its business.[133] Revolving loans are generally a very safe form of lending for banks, with very low interest payments and a very low likelihood of not being repaid in full if the firm falls into financial distress.

As is increasingly common among distressed firms, Cumulus reacted to its financial distress by devising an incredibly aggressive scheme to "refinance" its debt. In reality, there was no refinancing: Cumulus had devised a scheme to transform its bondholders into revolving lenders through a sham transaction by creating a fake revolving line of credit. The plan proceeded in three steps. First, Cumulus would "borrow" the full amount they were

al. v. JPMorgan Chase Bank, N.A., et al, No. 16-cv-9591 (S.D.N.Y. Feb. 27, 2017) [hereinafter *Cumulus Term Loan Parties' Memo*] (between the third quarter of 2013, when the Term Loans were made, and 3Q 2016, the company's earnings fell by 50%, from $416 million annually to $212 million).

133 The credit agreement allowed Cumulus to borrow in this way up to $200 million on a senior basis, but that amount could be increased with "incremental" facilities at the discretion of the borrower. By early 2017, Cumulus seemingly had the ability to borrow up to an additional $305 million ahead of the term lenders.

allowed to under their revolving line of credit.[134] Second, management would dramatically increase the interest rate (from about 4.25% to 14.25%) and extend out the maturity date of the new debt without needing the permission of anyone other than the revolving lenders.[135] Third, management would give the high-interest, senior secured debt to the bondholders in a debt exchange that replaced $610 million in out-of-the-money unsecured debt with $305 million "borrowed" under the revolving line of credit.[136] In short, the firm would magically transform the unsecured creditors into secured creditors, using the right to obtain a credit line for working capital in a way that had nothing to do with working capital. The firm's shareholders would benefit from this exchange, as it would decrease the firm's overall debt. But, the firm's term lenders would see their rights against their collateral diluted by $305 million.[137] The firm's term lenders reacted with fury, suing to block the exchange and, after extensive litigation, succeeding in convincing a judge to enjoin it.[138]

[134] *See id*. at 3.
[135] *See id*.
[136] *See id*.
[137] *See id*. at 7-8.
[138] *See* Cumulus Term Loan Parties' Memo, *supra* note 132, at 9. Most importantly, a provision in the credit agreement blocked Cumulus from taking actions that "materially and adversely" affected the interest of the term lenders. *See* Cumulus Complaint, *supra* note 130, at Exhibit A § 4.25 ("Cumulus Term Loan Agreement") (The amendment to the credit agreement was the removal of the financial ratio that allowed the firm to incur incremental secured debt as part of the debt exchange. The Term Lenders also argued that the credit agreement allowed the refinancing of the senior notes through the transaction Cumulus sought to effectuate (§8.8(j)), *see also* Transcript of Proceedings at 90, Cumulus Media Holdings Inc., et al. v. JPMorgan Chase Bank, N.A., et al, No. 16-9591 (S.D.N.Y. Mar. 08, 2017) [hereinafter *Cumulus Transcript with Ruling*].

The failed Cumulus proposal was brazen. When the credit agreement was signed, Cumulus had bargained for certain rights that were meant to provide the firm with working capital in the event of financial distress. Presumably, *ex ante,* the lenders who extended the term loan did not anticipate, let assume the risk, that Cumulus would use such availability to refinance junior, unsecured bond debt and bootstrap such debt to a senior priority position. But, there was also no reason that Cumulus could not have decided instead to pursue a fully-consensual restructuring with the support of the term loan lenders. Cumulus instead decided to go for broke, pursuing a strategy that was not only based on an implausible reading of the credit agreement but also remarkably inconsistent with the underlying principles of secured lending. The result of Cumulus' desperate attempt to avoid Chapter 11 is that the firm wasted years pursuing dead-end restructuring strategies, incurring unnecessary litigation expense and suffering unknown opportunity costs.

3. Colt Holdings: Helpless Creditors in the Face of a Management Team Determined to Extract a Ransom for their Private Equity Sponsor.

In some cases, managers do not need to stand behind an implausible reading of a contract to harm creditors. Instead, they only need to delay a restructuring, in effect by holding the firm hostage in an effort to preserve shareholder option-value, consider Colt Holdings Company, the manufacturer of iconic "Colt" firearms. As we explain below, Colt endured a prolonged period of financial distress in large part because its private equity sponsor starved it for cash and left it unable to invest in improving its business. Management then tried to use Chapter 11 to protect the private equity firm's investment while denying creditors their rightful recovery, in violation of foundational legal principles. This strategy did not work, and the case ended in predictable fashion but only after the legal and other administrative expenses consumed the money that the company might have otherwise used to modernize its operations.

We include this case study because it further illustrates the limits of contract law as a serviceable protection for creditors. The sort of opportunistic conduct employed here – stalling, ignoring creditors in negotiations, pursuing deals that were in the best interests of a deeply out-of-the-money shareholder while the firm deteriorated – seems virtually impossible to protect against via contractual covenants.[139] Even though creditors were able to eventually prevail in litigation, there is no remedy at law to make them whole for the losses they suffered.

As with Cumulus Media, much of Colt's debt originated from a leveraged buy-out, here led by private equity firm Sciens Capital Management.[140] For years, Sciens exploited its ownership position to drain Colt of cash, meaning that little of the company's cash flow was reinvested in the business. Between 2002 and 2014,

[139] It is possible to try to wrest control of a firm with an involuntary bankruptcy filing. *See e.g.* In re Caesars Entm't Operating Co., Inc., 2015 WL 495259, at *1 (Bankr. D. Del. Feb. 2, 2015) (discussing the Caesar's involuntary bankruptcy filing). But, in general, involuntary bankruptcies are very rare because lenders fear being held liable for damaging the business. *See e.g.* David S. Kennedy et. al., *The Involuntary Bankruptcy Process: A Study of the Relevant Statutory and Procedural Provisions and Related Matters*, 31 U. MEM. L. REV. 1, 51 (2000) (discussing the potential liability of petitioning creditors for damages if an involuntary petition is found to be in bad faith).

[140] *See* Disclosure Statement for Debtors' Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code at 14, In re Colt Holding Company LLC, et al., Case No. 15-11296 (Bankr. D. Del. Nov. 10, 2015) [hereinafter *Colt's Disclosure Statement*].

the business distributed $241.3 million to Sciens.[141] These transfers left Colt without the ability to keep up with its peers when it came to automating manufacturing and other investments in research and development.

In the fall of 2014, Colt's capital structure included three forms of funded debt: (1) a secured revolving loan; (2) a secured term loan in the principal amount of $48 million; and (3) unsecured senior notes in the principal amount of $246 million.[142] The unsecured notes were then trading at substantial discounts to par, given a general market perception that Colt would have difficulty satisfying, among other obligations, an interest payment due November 15th.[143] Anticipating a restructuring, the company's noteholders organized and reached out to the company, offering "fresh capital on better terms than presently available" in the marketplace.[144] The company did not immediately respond to the

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[141] *See* Colt Defense Inc., Registration Statement (Form S-1) (21, 84) (June 3, 2005); Colt Defense LLC, Amendment No. 2 (Form S-4) (79, F-25) (Mar. 21, 2011); Colt Defense LLC, Annual Report (Form 10-K) (63, 82) (Feb. 24, 2012); Colt Defense LLC, Annual Report (Form 10-K/A) (90) (Mar. 26, 2013); Colt Defense LLC, Annual Report (Form 10-K/A) (39, 86-87) (Sept. 15, 2014). Additionally, the company passed on all of its tax attributes to its owner. *See* Keith A. Maib's Declaration in Support of the Debtors' Chapter 11 Petitions and First Day Pleadings, In re Colt Holding Company LLC, et al., Case No. 15-11296 (Bankr. D. Del. June 15, 2015) [hereinafter *Maib Declaration.*].

[142] *See* Colt Defense LLC, Quarterly Report (Form 10-Q/A) (Sept. 28, 2014) (23-45) (Dec. 3, 2014).

[143] *See Colt Defense Bondholder Group Advised by Brown Rudnick, GLC, Awaits Numbers*, Reorg-Research (Nov. 19, 2014, 3:39 PM), https://platform.beta.reorg-research.com/v3/#/items/intel/1934?item_id=7545.

[144] *See* Declaration of Abraham T. Han in Support of the Objection and Supplemental Objection of the Ad Hoc Consortium of Holders of 8.75% Colt Defense LLC and Colt Finance Corp LLC Senior Notes Due 2017 to

invitation; instead, it refinanced its existing secured debt in a transaction that only gave it enough additional capital to make the November interest payment.[145]

Two months later, Colt replaced its senior secured revolving line of credit with a $33 million term loan.[146] The new term loan did not add incremental liquidity and, by comparison to its prior borrowing arrangement, imposed higher capital costs and tightened covenants.[147] The noteholders again wrote to Colt, "respectfully urg[ing] the Board to change course, and start working towards a more consensual and value-accretive resolution."[148] Colt's written reply was terse and, again, dismissive.[149]

On April 1, 2015, Colt filed a notice with the SEC indicating that it would not be making its required securities filings on time.[150] The filing said that Colt "is unable to provide an expected date" for resuming SEC compliance.[151] And on April 14, 2015, Colt made

the Debtors Motion for Interim DIP Loan Approval at Exhibit H, In re Colt Holding Company LLC, et al., Case No. 15-11296 (Bankr. D. Del. June 19, 2015) [hereinafter *Han Declaration*].

[145] *See* Supplemental Objection of Ad Hoc Consortium of Holders of Senior Notes to Debtors' DIP Motion at ¶ 20, In re Colt Holding Co. LLC, et al., Case No. 15-11296 (Bankr. D. Del. June 19, 2015) [hereinafter *Supplemental Objection to Colt's Debtors' DIP Motion*]; Colt Defense LLC, (Form 8-K) (Nov. 18, 2014).

[146] *See* Colt Defense LLC, (Form 8-K) (Feb. 10, 2015).

[147] *See id.*; Supplemental Objection to Colt's Debtors' DIP Motion at ¶ 23.

[148] *See* Han Declaration, *supra* note 144, at Exhibit P.

[149] *See* Supplemental Objection to Colt's Debtors' DIP Motion at ¶ 25.

[150] In particular, Colt announced that it would not be timely filing its 2014 10-K statement and that no one should rely on its 2013 audited financial statements. *See* Colt Defense LLC, (Form 12b-25) (Apr. 1, 2015).

[151] *See id.*

a wildly implausible offer to its noteholders, offering to give them junior secured claims if they would reduce the amount they were owed by 70%.[152] Notably, the firm's private equity owner, Sciens, was not offering to take any losses of its own under the proposal. [153] The offer also contained a threat to the noteholders: Sciens owned the building that housed Colt's only manufacturing facility; Sciens leased that facility to Colt; and the lease was about to expire.[154] The disclosure went on to say that Sciens had the power to deny lease renewal and cause great harm to the business, with the implication being that the private equity owner could evict Colt if the exchange offer that would allow them to maintain their investment failed.[155] Notwithstanding the eviction threat, the exchange offer was almost unanimously rejected by the noteholders.[156]

Colt then agreed to receive a counter-proposal from the noteholders committee.[157] The noteholders made an offer that offered the firm new cash, but at a price: Sciens would have to give

[152] The offer contained other problematic terms. Under the exchange offer: Old notes would be exchanged for new "third-lien" secured notes reflecting a 70% principal reduction; the new indenture would be stripped of "substantially all" protective covenants contained in the existing indenture; and, all default enforcement rights would be vested in the term loan lenders, via an onerous intercreditor agreement that rendered the noteholders "silenced" third-lien lenders. *See* Supplemental Objection to Colt's Debtors' DIP Motion at ¶ 28; Colt Defense LLC, (Form 12b-25) (Exhibit T3E.1) (Apr. 15, 2015).
[153] *See* Colt Defense LLC, (Form 12b-25) (Exhibit T3E.1) (Apr. 15, 2015).
[154] *See id.* at 45.
[155] *Id.* at 45-46.
[156] *See* Maib Declaration, *supra* note 141, at ¶ 22.
[157] *See* Han Declaration, *supra* note 144, at ¶ 32, 36.

up its ownership of the company.[158] The proposal was rejected out of hand.[159] When asked if the company would support *any* plan that transferred ownership from Sciens to noteholders, one company representative allegedly responded: "Hell no!"[160] The only alternative to the debt exchange was, as allegedly stated by the same representative, "litigation."[161]

On June 14, 2015, Colt filed for Chapter 11 relief in Delaware.[162] The bankruptcy filing kicked off intense litigation, as noteholders successfully fought Sciens' attempt to remain in control of the firm.[163] In the end, noteholders were forced to cede

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[158] In particular, the noteholders offered to: (1) refinance the first-lien term loan on a junior-lien basis with attractive terms; (2) elevate the second-lien term loan to a first-lien position; (3) provide an incremental $20 million in availability, also on a junior-lien basis, to help Colt with, among other things, modernizing operations; and (4) convert the notes to equity, reducing the firm's debt load. *See id.* at Exhibit R.

[159] *See* Han Declaration, *supra* note 144, at ¶ 41.

[160] *See id.* at ¶ 43.

[161] *See id.* at ¶ 41.

[162] *See* Chapter 11 Voluntary Petition, In re Colt Holding Co. LLC, et al., Case No. 15-11296 (Bankr. D. Del. June 14, 2015).

[163] Sciens' scheme proceeded in two parts. With its bankruptcy petition, Colt filed two connected motions. First, Colt filed a motion for approval of an accelerated Section 363 sale process, with Sciens as the proposed "stalking horse" bidder. *See* Debtors' Motion, Pursuant to 11 U.S.C. Sections 105, 363, and 365, and Fed. R. Bankr. P. 2002, 6004, 6006, 9008 and 9014, for Entry of (A) an Order (I) Approving Bid Procedures in Connection with the Sale of Substantially All of the Debtors' Assets Free and Clear of Liens, Claims, Encumbrances, and Other Interests, (II) Approving Procedures Related to the Assumption and Assignment of Executory Contracts and Unexpired Leases in Connection with Such Sale, (III) Approving the Form and Manner of Notice Thereof, (IV) Scheduling the Hearing to Consider Approval of Such Sale, and (V) Granting Certain Related Relief; and (B) an Order Approving the Sale of

about 20% of the firm's post-bankruptcy equity to Sciens, given their status as the owner of Colt's factory, but they otherwise became the owners of the firm.[164]

In certain respects, the restructuring outcome is consistent with what one might have expected. But it came at a tremendous cost: the firm's financial condition deteriorated significantly due to management's insistence on delaying to provide Sciens with more bargaining power. In fact, the money that Colt borrowed in the bankruptcy – which could have been spent modernizing its business – was instead spent on the costs of bankruptcy and continuing operating *status quo*. Indeed, the post-petition professional costs of the debtor's lawyers alone amounted to more than $14.5 million.[165] Colt never received the financing needed for

Substantially All of the Debtors' Assets, In re Colt Holding Co. LLC, et al., Case No. 15-11296 (Bankr. D. Del. June 15, 2015).

[164] The global settlement had many moving pieces: (1) the DIP loan was "rolled" into a new first lien term loan; (2) the second lien debt was rolled into a new second lien term loan; (3) incremental liquidity ($50 million) was raised by rights offering to noteholders (supplying $45 million) and Sciens (supplying $5 million); (4) the lease on the manufacturing facility was extended; and (5) equity was divided between noteholders (83.25%) and Sciens (16.75%)*See generally* Debtors' Motion for Entry of an Order Authorizing the Debtors to Enter into and Perform Under the Restructuring Support Agreement, In re Colt Holding Co. LLC, et al., Case No. 15-11296 (Bankr. D. Del. October 9, 2015).

[165] *See* Order [Omnibus] Awarding Final Allowance of Compensation for Services Rendered and for Reimbursement of Expenses at Exhibit A, In re Colt Holding Co. LLC, et al., Case No. 15-11296 (Bankr. D. Del. June 29, 2016).

long overdue R&D and automation and left bankruptcy without improving its competitive position.[166]

B. The Limits of Relying on Bankruptcy Law to Protect Investors.

Bankruptcy law is often cited as a body of law that protects creditors, and there can be no doubt that this is true. But bankruptcy law has multiple policy goals and some of them – especially protecting corporations and their employees – can loom larger for judges than the need to give pre-bankruptcy creditors the benefit of their bargain. The need to protect the firm loomed particularly large after the financial crisis shook the economy to the core, creating a body of precedent that has further eroded creditor rights. The cases below all involve extreme facts, but they also involve managers playing bankruptcy hardball in defiance of the bargained-for protections of creditors and equitable principles.

In the first case study, *General Growth Properties*, we show how *ex ante* contractual arrangements often yield to other bankruptcy policy goals, such as protecting jobs and promoting reorganization. In the second case study, *American Safety Razor*, we show how these other policy priorities can create space for opportunism. In *American Safety Razor,* management appears to have tried to redistribute value away to favored senior creditors at

[166] One of the peculiar aspects of this story is that Colt's board was not dominated by self-interested Sciens employees and close affiliates. In fact, the board majority was actually comprised of two military generals, two union representatives, and a retired restructuring lawyer *See* Maib Declaration, *supra* note 141, at ¶ 48. It is entirely possible that this otherwise disinterested board hewed closely to *Gheewalla* and its progeny, using the maturing lease to justify taking actions like proposing restructuring transactions that would leave control in the hands of Sciens while denying the noteholders the benefit of their bargain.

the expense of junior creditors by manipulating the rules of an auction process – a transaction that would have also allowed them to keep their jobs instead of being immediately swallowed by a strategic acquirer. In *Lyondell,* management was able to successfully sabotage the prosecution of valuable fraudulent conveyance claims by junior creditors, for the benefit of senior creditors. The *Lyondell* example shows how a well-advised management team's deft understanding of bankruptcy policy priorities and procedural rules can rob creditors of rights they would have had outside of bankruptcy.

1. General Growth Properties: How the Creditor Bargain May Yield to Other Bankruptcy Policy Goals.

In late 2008, General Growth Properties ("GGP"), one of the largest owners and operators of shopping centers in the country began to experience financial distress.[167] GGP historically financed its commercial real estate at the project level, borrowing for each venture against the particular assets being developed.[168] Such loans generally had terms of three to seven years and, so, the company's "business plan was based on the premise it would be able to refinance the debt" whenever circumstances required.[169] This business plan collapsed in the wake of the financial crisis, when even firms with the highest quality collateral like GGP found themselves unable to access capital to refinance their debt.[170]

[167] *See* In re Gen. Growth Props., 409 B.R. 43, 53 (Bankr. S.D.N.Y. 2009). At the time of its bankruptcy filing, the accounting value of GGP's assets was nearly $30 billion supporting more than $27 billion in liabilities. *Id*. at 48.

[168] *See generally id*.

[169] *See id*. at 53.

[170] *See id*. at 50.

Historically, GGP and its lenders set up a very specific lending structure, with the goal of achieving "asset isolation" – the separation of a high quality real estate asset from the rest of conglomerate.[171] Simplifying things, the typical "bankruptcy-remote" structure was as follows. A wholly owned GGP subsidiary entity owned specific real estate assets, financed with loans due to a lender. A representative example was Stonestown Shopping Center L.P., which owned a mall in San Francisco.[172] In order to protect their collateral interests, the lenders required GGP to separate the San Francisco mall from the rest of the conglomerate, which GGP agreed to do in exchange for lower interest rates.[173] Importantly, each subsidiary board had to consist of a majority of "independent managers" who essentially represented the lender's interests.[174] As the law requires the board of each subsidiary to separately approve its bankruptcy filing, this structure was designed to ensure that the conglomerate could not drag the isolated asset into a larger GGP bankruptcy and thereby help fund the reorganization of other parts of the conglomerate.[175] The lender

[171] *See* Motion of ING Clarion Capital Loan Services LLC Pursuant to 11 U.S.C. § 1112(b) to Dismiss the Cases of Bakersfield Mall LP; GGP-Tucson Mall LLC; Lancaster Trust' Ho Retail Properties II LP' RS Properties Inc.; Stonestown Shopping Center LP; and Fashion Place LLC at 9, In Re Gen. Growth Props., No. 09-11977 (Bankr. S.D.N.Y. May 4, 2009) [hereinafter *ING Clarion Motion*].

[172] *See id*.

[173] *See id*. at 1.

[174] *See* Motion of FRM Funding Company, Inc. Pursuant to 11 U.S.C. § 1112(b), to Dismiss the Chapter 11 Case of Fox River Shopping Center, LLC at 67, In re General Growth Properties Inc., No. 09-11977 (Bankr. S.D.N.Y June 17, 2009) [hereinafter *FRM Motion*] (noting the "independent managers" were generally required to be appointed by a "nationally recognized company that provides professional independent directors, managers and trustees").

[175] *See id*. at 7. (noting a typical operating agreement (the equivalent to the corporate charter) had a provision requiring the independent

sought this protection to avoid being delayed for repayment or having its rights prejudiced as assets were diverted to fund affiliate bankruptcies.[176]

As GGP's financial distress worsened, the conglomerate's management team took unprecedented steps to unwind the "asset isolation" structure, force each subsidiary to file for bankruptcy, and thereby keep the conglomerate together.[177] The steps taken were dramatic. At approximately 2:00 a.m., GGP's managers fired the independent directors at each subsidiary via email and, once control was fully established, initiated the collective bankruptcy proceedings.[178] The bankruptcy filings and the violation of the "asset isolation" structure immediately roiled the credit markets.[179]

GGP's various project lenders now found themselves in exactly the situation they had contractually sought to avoid.[180] They asked the bankruptcy court to dismiss the subsidiary bankruptcy petitions as bad faith filings.[181] They also alleged that management's actions had violated their particular obligor firm's

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directors to consider the interests of the subsidiary and its creditors in deciding whether to file for bankruptcy. This structure was designed to get around the fact that a contract that directly restricts a corporation's ability to file for bankruptcy is not enforceable).

[176] *See id*. at 15.

[177] *See id*. at 2-3.

[178] *See id*.

[179] *General Growth Properties, Inc. Decision Notes Weaknesses of Securitization Special Purpose Entities*, O'MELVENY AND MYERS LLP (Aug. 13, 2009), https://www.omm.com/resources/alerts-and-publications/publications/general-growth-properties-inc-decision-notes-weaknesses-of-securitization-special-purpose-entities/.

[180] *Id.*

[181] In re Gen. Growth Props, *supra* note 167, at 47.

fiduciary duties.[182] The bankruptcy judge recognized that the "asset isolation" structure had been set up to "create impediments to a bankruptcy filing."[183] However, given that the subsidiaries were solvent – hence the need for their assets to fund the bankruptcy – the court found that the only fiduciary duty that the subsidiary boards owed was to their shareholders, and the shareholder was in each case the parent corporation that needed their assets to reorganize.[184] Similarly, the court found that the dead-of-night dismissal of the independent directors did not constitute bad faith, given that the subsidiaries' organizational documents allowed GGP to do so.[185]

This scenario illustrates how, in bankruptcy, larger business goals and practical necessity can overwhelm the creditor bargain. The GGP structure reflected clear risk allocation: The project lenders agreed to provide capital, and at more attractive rates than was otherwise available in the market, in exchange for particular "asset isolation" protections. That bargain was not honored, the lenders pleaded with the bankruptcy court to enforce their deal, and the bankruptcy court was unmoved. Unlike the other case studies discussed in this Article, GGP's case did not involve a salacious form of control opportunism, and its facts were highly unusual. But, the case outcome reflects a lesson of far greater reach: The bankruptcy court is, by nature, an hospitable forum for debtors, and the process intends to follow management's lead, at least at case inception. Generally speaking, in this tug of war, the individual creditor bargain does not have equal footing with the debtor's larger restructuring goals.

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[182] *See id.* at 63.
[183] *Id.* at 63-64.
[184] *Id*. at 64.
[185] *Id*. at 68.

2. American Safety Razor: How Management's Control Over the Case Narrative Further Enables Opportunism.

The bankruptcy of American Safety Razor LLC also provides lessons on how the bankruptcy process can be exploited to thwart the creditor bargain. As we describe below, management's guiding interest as the firm fell into insolvency may have been preserving their own jobs. The firm's managers appear to have silently advanced an opportunistic agenda, which they almost succeeded in doing. While the stealthy maneuvering was exposed and disabled, it took an unusual and unlikely constellation of circumstances for that to happen. The story provides a useful example of how a management team can spin a narrative – the need to exit bankruptcy immediately to avoid the firm's value melting away, financing that requires an immediate auction, manipulation of said auction – to profit at the expense of creditors.

ASR was in the business of manufacturing disposable wet-shave razors for personal consumption.[186] ASR was a major player in the "private label" razor business, manufacturing store branded razors such as "Walgreen's" razors.[187] All things being equal, in late 2009, ASR appeared to be more than able to weather the financial crisis and pay the interest and principal on approximately $240 million in first lien secured debt and $175 million in second lien secured debt.[188] However, in late 2009, ASR learned that its largest

[186] *See* Affidavit of J. Andrew Bolt, Executive Vice President and Chief Financial Officer of American Safety Razor Company, LLC and Blade Acquisition Company, and Vice President and Authorized Officer of the Other Debtors, in Support of First Day Motions at 4,6, In Re Am. Safety Razor Co., LLC, No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter *First Day Affidavit*].
[187] *See id*. at 6.
[188] *See id*. at 9.

customer, Walmart, would be discontinuing the business relationship, throwing the firm into turmoil and triggering defaults under the firm's first and second lien debt contracts.[189]

The firm soon entered pre-bankruptcy negotiations with ad hoc committees of first and second lien lenders.[190] As the "junior" option-holder, the ad hoc committee of second lien lenders had strong incentives to make sure that management did not collude with senior lenders to disadvantage their claims. The second lien lenders soon engaged Goldman Sachs to try to refinance the first lien debt.[191] Shortly thereafter, Goldman Sachs issued a letter stating that it was "highly confident" that it could arrange and syndicate "$300.0 million" in new debt capital for the company, more than enough to repay the first lien lenders and provide the second lien lenders all of the firm's residual value, through equitization of their debt.[192] Nevertheless, the letter warned that, in order to realize on this expectation, Goldman Sachs would require "reasonable time to market the Financing with the assistance of management of the Company."[193] Instead, a few weeks later -- while the refinancing process was still underway -- ASR filed for Chapter 11 relief in Delaware.[194]

It quickly became clear why ASR had filed for Chapter 11 so suddenly: It had another plan in mind, one that offered particular

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[189] *See id*. at 11.
[190] *See id*. at 14-15.
[191] *See id*. at 4.
[192] Energizer Holdings, Inc.'s Objection to Second Lien Lenders' Application for Allowance of an Administrative Claim at Exhibit A ¶ 8, In re Old Razor Co. LLC *(*f/k/a Am. Safety Razor Co., LLC*)* et al., No. 10-12351 (Bankr. D. Del. June 23, 2011) [hereinafter *Energizer's Objection*].
[193] *Id.*
[194] *See* GSO DIP Objection, *supra* note 141, at 4.

benefits for the company's management team. With the Chapter 11 petition, ASR immediately sought permission to sell all of its assets to the first lien lenders through a Section 363 credit bid, subject to higher or better offers.[195] The sale was structured as a "credit bid," where the first lien lenders would not pay any money at all. Instead, they would simply waive their claim against the debtor. This meant that any superior bid would need to be made in cash, and would need to be higher than the $240 million in first lien debt. As part of their credit bid, the first lien lenders promised to assume the employment agreements of management, guaranteeing them continued employment or lucrative severance.[196]

In considering the motion, the bankruptcy judge confronted a decision environment that the debtor had decisively tilted in their favor.[197] She found herself confronted by a management team that

[195] *See* Debtors' Motion Pursuant to § 105(a), 363 and 365 of the Bankruptcy Code and Bankruptcy Rules 2002, 6004, 6006, for Entry of an Order (A) Approving the Sale of Substantially All of the Debtors' Assets Free and Clear of Encumbrances and (B) Authorizing the Assumption and Assignment of Certain Executory Contracts and Unexpired Leases at 19-20, In Re Am. Safety Razor *Co.*, LLC, No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter *ASR Debtors' Sale Motion*].

[196] *See id.* at 10-11; *id.*, Exhibit B at § 7.16 (providing twelve month employment guarantees to existing employees along with "substantially comparable bonuses"). *See also* Transcript of Proceedings at 139:5-141:4, In re Am. Safety Razor Company, LLC, et al., No. 10-12351 (Bankr. D. Del. Oct. 1, 2010) (noting Energizer marked up the first lien lenders' purchase agreement to reserve right to terminate employees).

[197] To support the sale motion and the credit bid, the debtor also sought permission to borrow $25 million in post-petition financing from the first lien lenders. *See* ASR Debtors' Motion Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364, and 507 (I) Authorizing Debtors (A) To Obtain Postpetition Financing and (B) To Utilize Cash Collateral; (II) Granting Liens and Providing Super-Priority Administrative Expense Status; (III) Granting Adequate Protection to Prepetition Secured Parties; and (IV) Scheduling

claimed that the sale was needed to preserve the company's approximately 1700 employees.[198] Time is of the essence, management said, because the firm's major selling season ended in October – meaning the firm, which filed for bankruptcy at the very end of July, needed to emerge in a matter of weeks in order to have a viable business.[199] In effect, management claimed to have waited so long to file for bankruptcy that the judge had no alternative but to approve the financing and sale motions.[200] If the judge forced management to explore alternatives, she might put 1700 people[201] out of jobs in the midst of the most difficult job market in decades.[202] The second lien lenders would likely be of little help, as they were bound by an intercreditor agreement that prohibited them from objecting to any asset sale supported by the first lien lenders.[203]

Management then set about rigging the auction process. Every bidder was required to sign a confidentiality agreement in order to bid, which gave the company the ability to hide the

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a Final Hearing at 1, In re Am. Safety Razor Co., LLC, et al., No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter *ASR DIP Motion*].

198 *See generally* ASR First Day Affidavit, *supra* note 186.

199 *See id.* at 18.

200 *See generally id.*

201 *See id.* at 8.

202 *See* ASR Debtors' Motion Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364, and 507 (I) Authorizing Debtors (A) To Obtain Postpetition Financing and (B) To Utilize Cash Collateral; (II) Granting Liens and Providing Super-Priority Administrative Expense Status; (III) Granting Adequate Protection to Prepetition Secured Parties; and (IV) Scheduling a Final Hearing, In re Am. Safety Razor Co., LLC, et al., No. 10-12351 (Bankr. D. Del. July 28, 2010)

203 Transcript of Proceedings from 9/30/2010 at 94-95, In re Am. Safety Razor Co., LLC, et al., No. 10-12351 (Bankr. D. Del. Oct. 5, 2010) [hereinafter *ASR 9/30 Transcript*].

identity of bidders as well as terms offered.[204] A month after bidding had begun, a news service suddenly reported that Energizer Holdings, Inc. had extended a $300 to $325 million cash bid for the company.[205] This was news to the second lien lenders: Their committee did not receive notice from ASR that Energizer had submitted a bid, and Energizer was contractually prohibited by ASR to relay that information to the second lien committee.[206] But, to ASR, this was not news at all: ASR had rejected Energizer's bid out of hand.[207] ASR would later argue in court that its decision was justified because Energizer's bid was fraught with antitrust risk, thus preferring the first lien lender's remarkably lower credit bid.[208] They would also deny the second lien lenders' allegations that ASR's stated antitrust concern was mere façade, that the real motivation behind rejecting the bid was that Energizer, which intended to merge ASR into its Schick subsidiary, simply would not want ASR's historical management team.[209]

The second lien lenders promptly filed an aggressive objection to the sale motion, ignoring any restraints under the intercreditor agreement and commencing fierce litigation.[210] Management screamed bad faith and tried to stop both the second lien lenders and Energizer from appearing in court, threatening to seek damages from the second lien lenders for breach of their

[204] *See* Transcript of Proceedings from 9/29/2010 at 77-86, In re Am. Safety Razor Co., LLC, et al., No. 10-12351 (Bankr. D. Del. Oct. 5, 2010) [hereinafter *ASR 9/29 Transcript*].
[205] *See* Energizer's Objection at Exhibit A ¶ 19.
[206] *See Id*.
[207] *See* Energizer's Objection at Exhibit A ¶ 20.
[208] *See* ASR 9/29 Transcript, *supra* note 204, at 18-20.
[209] *See* ASR 9/30 Transcript, *supra* note 203, at 18.
[210] *See* Objection of the Second-Lien Lenders to the Debtor's Sales Motion at 1, In re Am. Safety Razor Co., LLC, et al., No. 10-12351 (Bankr. D. Del. Jul 28, 2010) [hereinafter *Objection to ASR's Sales Motion*]

intercreditor agreement and Energizer for breach of the non-disclosure agreement.[211] Nevertheless, during the court proceeding, the second lien lenders introduced evidence and presented expert witness testimony to support its contention that Energizer's bid was much higher than the first lien lenders' bid, there was no meaningful antitrust risk and, more to the point, that management was abusing its position of control.[212] The court found that ASR had, in fact, acted inappropriately ejecting Energizer from the bidding process and, as a remedy, continued the sale hearing for eight days to afford Energizer the opportunity to finalize its offer for the company.[213]

At the subsequent hearing, Energizer presented a final bid that offered to repay the first lien debt in full, assume all administrative and unsecured claims, and provide $57 million -- about a 31% cash distribution -- for the second lien lenders.[214] Remarkably, ASR and the first lien lenders continued its strenuous opposition to the Energizer bid, contending that the Energizer bid still imposed too much antitrust risk.[215] The bankruptcy court overruled the objections.[216] Energizer's "hostile" bid closed a few weeks later, no antitrust problems materialized, and members of management were terminated soon thereafter. [217]

[211] *See* ASR 9/30 Transcript, *supra* note 203, at 25, 50.
[212] *See* 9/29 Transcript, *supra* note 204, at 74-92.
[213] *See* 9/30 Transcript, *supra* note 203, at 37-41.
[214] *See generally* Exhibit(s) Notice of Filing of Energizer Holdings, Inc's Reverse Bid Filed by Energizer Holdings, Inc., In re Am. Safety Razor Co., LLC, et al., No. 10-12351 (Bankr. D. Del. July 28, 2010)
[215] Hilary Russ, *Energizer Wins American Safety Razor With $301M Bids*, LAW360 (Oct. 8, 2010), https://www.law360.com/articles/200242/energizer-wins-american-safety-razor-with-301m-bid.
[216] *See id.*
[217] *See id*.

ASR's case story seemingly has a happy ending: Control opportunism was thwarted and value did ultimately flow in a manner seemingly consistent with the pre-petition bargain. But, that was as much dumb luck as anything else. It took a news service reporting a bid that was otherwise hidden by confidentiality agreement, as well as a group of sufficiently angry second lien lenders who not only had the courage of their convictions but also the patience and willingness to fund a fight on such hostile terrain. When the news of Energizer's bid leaked, ASR immediately threatened a fierce battle in all directions. Many potential bidders and creditors would have simply moved on, deterred by the rhetoric and a seemingly-rigged process. As such, the lesson of the case is not so much found in the ultimate case outcome; it is, rather, found in observing how management can employ Machiavellian strategies behind the scenes that, with any luck, will forever remain hidden. Moreover, there can be no assurance that the second lien lenders did, in fact, receive the true inherent value of their bargain. There was, after all, no real auction process, Energizer or potential other bidders spurned by the process might have been willing to pay more,[218] and the significant fees charged by ASR's lawyers were ultimately borne by the second lien lenders.

3. Lyondell: How Debtors and Lenders Can Collude to Hurt Junior Creditors.

In addition to contract and bankruptcy law, the *Gheewalla* court also cited fraudulent transfer law as rendering equitable

[218] Energizer had signaled it was to continue to participate in bidding, but they never had any reason to raise their bid. *See generally* Notice of Energizer Holdings, Inc.'s Continued Interest to Participate in Sale Process and to Consummate Transaction, In re Old Razor Co. LLC (f/k/a Am. Safety Razor Co., LLC) et al., No. 10-12351 (Bankr. D. Del. September 27, 2010).

protections for creditors unnecessary. Fraudulent transfer law provides creditors a cause of action when firms intentionally or constructively strip the firm of assets to the detriment of existing creditors. As an initial matter, the case law consistently shows weaknesses in fraudulent transfer theory as a creditor remedy, as the *Forest Oil* case story exemplifies.[219] But, more to the point, bankruptcy law provides managers with a toolkit to neuter fraudulent transfer claims. In addition to the now standard method of using bankruptcy financing to handcuff management's discretion, management also has the ability to settle fraudulent transfer claims without the permission of the creditor who suffered the loss as a result of the conveyance. This is due to an anomaly in corporate law. While creditors can bring fraudulent transfer claims on their own outside of bankruptcy, inside Chapter 11 the debtor-in-possession can control all property of the estate, including fraudulent transfer claims. Courts have held that this control includes the right to settle those claims, even if the true plaintiff-creditor who was harmed by the conveyance opposes the settlement on the grounds that it is far too low.

In other words, managers can use bankruptcy law to strip creditors of rights they would have had outside of bankruptcy. The basic problem with the prosecution of fraudulent transfer claims in

[219] Consider the Tribune LBO fraudulent transfer litigation. The LBO took place in 2007 and the Chapter 11 filing occurred in 2008. Fraudulent transfer litigation was initiated in 2011. In a recent Wall Street Journal article, which referred to the LBO litigation as a "classic of the genre," Judge Kevin Carey was quoted as saying "it doesn't sound like we are very close [to the end of the litigation]." This hearing took place on July 10, 2018. *See* Peg Brickley, *Judge Pushes Settlement Talks in Tribune LBO Court Fight*, WALL ST. J. (Jul. 10, 2018), https://www.wsj.com/articles/judge-pushes-settlement-talks-in-tribune-lbo-court. -fight-1531257092. If a "classic of the genre" is alive seven-years (and counting) and still nowhere near the end, it hardly can be seen as a reliable buttress for the creditor's bargain.

bankruptcy is that a debtor in bankruptcy is controlled by a management team that seeks to ensure the quickest bankruptcy and the brightest future for the debtor – goals that often conflict with a fulsome prosecution of fraudulent transfer remedies. In many asset-stripping transactions, the defendants in a fraudulent transfer are also the party providing post-bankruptcy financing to the debtor. This means leverage over management and, in certain situations, the ability to choke the procedural rights of unsecured creditors. While the debtor's actions are subject to court review, the legal standards invariably require the judge to consider the best interest of the debtor's other constituencies, such as current and future employees and managers. This particular fragility opens the door for control opportunism, as reflected in the Chapter 11 case of *Lyondell Bassell*.

In December 2007, chemical giant Bassell A.F. S.C.A. acquired Lyondell AF S.C.A. in a textbook leveraged buyout funded with $21 billion in new secured borrowings heaped on top of the firm's already extant $3.1 billion in unsecured debt.[220] The combined firm competed in a cyclical, investment-heavy petrochemical industry and the heavy debt burden left the firm unable to withstand any weakening of its core business.[221] Merely 12 weeks after the closing the transaction, Lyondell began to run out of cash.[222] As the Great Recession ravaged the economy, Lyondell collapsed into bankruptcy in January 2009. This put Lyondell's $3.1 billion in prior unsecured bonds in a desperate position, sitting behind $21

[220] *See In re Lyondell Chem. Co.,* 503 B.R. 348, 353.
[221] *See* Lyondell Complaint at 3, In re Lyondell Chem. Co., 503 B.R. 348, No. 09-10023 (Bankr. S.D.N.Y. 2014).
[222] *See* Objection of the Official Committee of Unsecured Creditors to Debtors' Motion to Approve Settlement Agreement with Financing Party Defendants in Committee Litigation at 90, In re Lyondell Chem. Co., No. 09-1375 (Bankr. S.D.N.Y. Jan 4, 2016) [hereinafter *Lyondell UCC Settlement Objection*].

billion in LBO secured debt.[223] Given that the LBO cash went to the historical shareholders but the debtors remained liable on transaction-related secured debt the LBO transaction had the effect of stripping Lyondell of substantial value.[224]

These facts would seem to lend themselves to a textbook fraudulent transfer claim, with pre-LBO unsecured creditors hoping to avoid liens transferred to the secured lenders and the $12.5 billion paid to old Lyondell shareholders.[225] The lenders would, however, be able to exploit bargaining power to secure from management a release of their fraudulent transfer exposure for a relatively small amount – all with the blessing of the bankruptcy judge.

Like most large firms, Lyondell's management team began bankruptcy by seeking a DIP loan to fund the bankruptcy case.[226] Lyondell, as with most firms in the modern era of secured credit,[227] arrived in bankruptcy with liens fully encumbering all of its assets – in this case, the liens of the lenders that funded the LBO. In

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[223] *See* Lyondell Complaint, *supra* note 220, at 353 (describe pre-LBO debt).
[224] *See* Weisfelner v. Blavatnik, 543 B.R. 428, 433 (Bankr. S.D.N.Y. 2016).
[225] *See* Lyondell Complaint, *supra* note 220 at 355 (describe pre-LBO debt).
[226] *See* Motion for an Order (I) Authorizing Debtors (A) To Obtain Post-Petition Financing Pursuant to 11 U.S.C. §§ 105, 361, 362, 364(c)(1), 364(c)(2), 364(c)(3), 364(d)(1), and 364(e), (B) To Utilize Cash Collateral Pursuant to 11 U.S.C. § 363 and (C) To Purchase Certain Assets Pursuant to 11 U.S.C. § 363, (II) Granting Adequate Protection to Pre-Petition Secured Parties Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364 and (III) Scheduling Final Hearing Pursuant to Bankruptcy Rules 4001(b) and (c) at 2, In Re Lyondell Chem. Co., No. 09-1375 (Bankr. S.D.N.Y. Jan 4, 2016) [hereinafter *Lyondell DIP Motion*].
[227] *See* Barry E. Adler, *Value Destruction in the New Era of Chapter 11*, 29 J.L. ECON. & ORG. 461 (2013).

practice, lenders seldom agree to fund reorganizations without obtaining a priming lien, which generally requires the consent of the existing lienholder. This effective veto right means that the existing senior secured lender is the only plausible DIP lender because they can veto any other loan.

In this case, the senior secured lenders exploited their right to provide DIP financing to defend preemptively their liens against fraudulent transfer claims and acquire what the pre-LBO unsecured creditors would later condemn as "near total influence over the management of the bankruptcy cases."[228] The lender's influence grew from seven conditions attached to the DIP financing. First, they limited the official committee of Unsecured Creditors' lien investigation budget to $250,000, a paltry sum in comparison to the more than $20 million that would ultimately be spent. Second, they allotted the official committee about four months to investigate the facts surrounding the LBO.[229] Third, they required Lyondell to exit bankruptcy within ten months – a herculean task for one of the largest corporate failures in history in the midst of a historic financial dislocation.[230] Fourth, they sought – and obtained – new collateral for $3.25 billion of the existing secured debt: the proceeds of avoidance actions. Fifth, they demanded a variety of additional contractual covenants which had the effect of giving them control over management, especially including the right to recommend a change in management.[231] Sixth, the debtors agreed to pay the litigation costs of the bank defendants in any fraudulent transfer action.[232] Seventh, the debtor agreed to waive their right to prosecute the fraudulent transfer

[228] *See* Lyondell UCC Settlement Objection to 9019, *supra* note 222, at 7.
[229] *See id*.
[230] *See id*.
[231] *See id*. at 3.
[232] *See id*.

actions on behalf of the estate, leaving the official committee to do so with a very limited budget.[233]

Combined, these provisions of the DIP order had the effect of dramatically weakening the ability of pre-LBO unsecured creditors to prosecute their fraudulent transfer claims. The bankruptcy code expects the official committee to prosecute these actions on their behalf, but the committee would have almost no time to marshal evidence to put forward the most persuasive complaint and their professionals would not get paid for their work associated with doing so once the $250,000 budget was exhausted. Moreover, the fraudulent transfer claims would need to be resolved for the firm to exit bankruptcy and the lenders provided a very short runway for that to happen.

Thus, the lenders could exploit the debtors' need to obtain financing to fortify their ability to defend against fraudulent transfer liability. In evaluating requests to finance the case, the judge must make a finding, among other things, that: (1) the proposed financing is an exercise of sound business judgment; (2) in the best interests of the estate and its creditors; (3) the financing is necessary to preserve the estate's assets; and (4) that the loan's terms were fair; and (5) the financing was negotiated in good faith.[234] Of these factors, only the second considers the interests of unsecured creditors directly and the judge was allowed to, as he did, find that the restrictions on the official committee's ability to prosecute the fraudulent transfer actions were reasonable products of management's business judgment and desire to secure debtor-in-possession financing.[235] After all, management represented to

[233] *See id*.

[234] *See* In re Roeben, 294 B.R. 844, 845 (Bankr. W.D. Mo. 2003).

[235] *See* Transcript of the Motion for Entry of an Order Authorizing the Debtors to Enter into the Eighth Amendment to their Debtor-in-

the court that the failure to approve the financing "would likely result in liquidation, severe employee dislocation and crippling losses for vendors and customers."[236] It is not surprising that avoiding that liquidation was more important to the judge than protecting pre-LBO unsecured creditors.

To be sure, the bankruptcy judge did provide the official committee with some bargaining power. The court granted the official committee permission to prosecute the claims, which was granted on an accelerated schedule that Lyondell's management demanded to ensure the firm could exit Chapter 11 expeditiously.[237] The parties agreed to conclude discovery and conduct a bench trial in a few months on the extremely complicated, fact intensive, fraudulent transfer issues.

However, bankruptcy law created a wrinkle that hung over the head of the unsecured creditors like a sword of Damocles: the debtor's management team retained the power to settle the claim on their own without the input of the official committee.[238] That power would ultimately undermine the official committee's ability to litigate.

Lyondell's management team took several steps that had the effect of reducing the ability of the official committee to procure a favorable settlement. First, prior to the hearing on the official committee's motion to prosecute the fraudulent transfer claims, the

possession Loan Agreement to (A) Increase the Amount of the Commitment Thereunder Until the Funding Date of the Proposed Sale Transaction and (B) Extend the Maturity Date at 743, In re Terrestar Networks Inc., et al., No. 10-15446 (Bankr. S.D.N.Y. Aug 19, 2011).

236 *See* Lyondell DIP Motion, *supra* note 226, at 6.

237 *See* Lyondell UCC Settlement Objection, *supra* note 222, at 24.

238 *See* In re Adelphia Commc'ns Corp., 544 F.3d 420, 424 (2d Cir. 2008).

debtors asserted that even though the official committee had the right to prosecute the claims, they believed they had the power to settle them since the causes of action ultimately belonged to the bankruptcy estate.[239] In other words, the official committee, representing the class of aggrieved pre-bankruptcy creditors, could see the claims settled by a party whose major motivation was to exit bankruptcy. In a private e-mail, the lead lawyer for the debtors assured a major secured lender that he would deploy the right to settle the claim when "[our] leverage [is] greatest."[240] The unspoken implication in that email was that management had aligned with the lenders and would use its power to settle to their benefit.

Management also effectively granted the LBO banks the ability to "hold-up" a $22 billion restructuring by making them the provider of exit financing. Obviously, the LBO defendants refused to allow the fraudulent transfer claims to be prosecuted by any plan of reorganization they were funding, which meant they had to be settled for the firm to leave bankruptcy.[241] As the committee's lawyers built their case for trial, management's lawyers monitored all depositions but refused to meet with the committee's lawyers to understand their view of the strength of the claims.[242]

The debtors then shocked the official committee by announcing that they had settled the fraudulent transfer claims for $300 million, which the official committee saw as a "lowball settlement" that paid them a fraction of the $3.2 billion they were owed.[243] Notably, the debtors never claimed they settled the claims for "as much as

[239] *See* Lyondell UCC Settlement Objection to 9019, *supra* note 222, at 25.
[240] *See id*.
[241] *See id*. at 27.
[242] *See id*. at 29.
[243] *See id*. at 70-71.

possible,"[244] but rather that the settlement would "permit the reorganization to proceed" while "ensuring the unsecured creditors a very fair recovery."[245] They accused the unsecured creditors, who strenuously opposed the settlement of "gambling with the future of LyondellBassell and nearly 16,000 jobs as well."[246] Perhaps telegraphing how he would rule, at the hearing when the settlement was initially announced, the bankruptcy judge reaffirmed that "[the bankruptcy court's] highest responsibility is to ensure that our patient doesn't die on the operating table."[247]

The settlement motion put enormous pressure on the official committee because of the permissive common law tests that govern the debtor's powers to settle claims in bankruptcy. When the debtor proposes to settle a claim, the settlement "need not be the best a debtor could have obtained" and must only "fall within a range of reasonableness."[248] In the Second Circuit:

> [T]here is a range of reasonableness with respect to a settlement—a range which recognizes the uncertainties of law and fact in any particular case and the concomitant risks and costs necessarily inherent in taking any litigation to completion—and the [bankruptcy] judge will not be reversed if

[244] *See id*. at 61.
[245] Debtors' Memorandum of Law in Support of Motion to Approve Settlement with Financing Party Defendants in Committee Litigation at 3, In re Lyondell Chemical Co., et al., No. 09-01375 (Bankr. S.D.N.Y. Feb. 11, 2010) [hereinafter *Lyondell Debtors' Memo*].
[246] *See id*. at 21.
[247] *See* Lyondell UCC Settlement Objection, *supra* note 222, at 63.
[248] In re Adelphia Commc'ns Corp., 327 B.R. 143, 159 (Bankr. S.D.N.Y.), adhered to on reconsideration, 327 B.R. 175 (Bankr. S.D.N.Y. 2005).

> the appellate court concludes that the settlement lies within that range.[249]

Thus, the debtors could obtain judicial approval merely by showing it was reasonable given the various risks and uncertainties associated with the litigation. Further, the caselaw expressly allowed management to "consider the good of the entire enterprise" in proposing a settlement, not just the unsecured creditors.[250] As part of the judge's reasonableness analysis, he was required to consider "the complexity, expense and likely duration of the litigation" as well as the balance to the firm itself in being able to exit bankruptcy in a prompt manner.[251] In support of the settlement, management asserted that "only the [prosecution of fraudulent transfer claims] stand[] between the company and [leaving bankruptcy]; only the [prosecution of fraudulent transfer claims] poses the threat of liquidation."[252] Under the pressure of the debtors' settlement motion, the committee settled the claims for an additional $150 million, agreeing to release the LBO lenders from any additional liability.[253]

In conclusion, the story of Lyondell shows how procedural machinations and a determined management team can cripple the prosecution of a potentially valuable fraudulent transfer claim.

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[249] Newman v. Stein, 464 F.2d 689, 693 (2d Cir.), *cert. denied*, 409 U.S. 1039, 93 S.Ct. 521, 34 L.Ed.2d 488 (1972) (construing TMT in context of settlement of derivative suit).
[250] *In re Adelphia Communications Corp.*, 327 B.R. at 165.
[251] *See* Lyondell Debtors' Memo, *supra* note 245, at 53.
[252] *See id.* at 60-61.
[253] *See* Joint Amended and Revised Motion of the Debtors and the Official Committee of Unsecured Creditors to Approve Revised Settlement Agreement with Financing Party Defendants in Committee Litigation, In re Lyondell Chemical Co., et al., No. 09-01375 (Bankr. S.D.N.Y. Mar. 11, 2010).

Lyondell engaged in a risky leveraged buy-out that stripped the firm of assets, leaving its pre-bankruptcy unsecured creditors buried under $20 billion in debt that put it into bankruptcy barely a year later. When the official committee attempted to prosecute those claims on behalf of unsecured creditors, they found themselves given mere months to build a case that would normally take years because of the bargaining power the lenders had over management through the DIP motion. When they prepared to try the claims to the judge, they found the claims settled out from under them by management, who did not pretend they had sought "the highest possible settlement," but rather a settlement that would protect the company and its employees – a factor that mattered to the Judge. Under the pressure of that standard, the official committee was forced to settle the claim for about 15% of what they might have obtained had they won in Court.

V. Adjudicating Control Opportunism in the New Era of Governance of Distressed Firms.

As the case studies above suggest, debtor-creditor relations have declined in the ten years following *Gheewalla.* Well-established norms and patterns of behavior have been upset and broken, and basic standards of comity have devolved. This is to the overall detriment of the credit markets. Lenders need to have predictable recovery expectations in order to provide *ex ante* credit.

However, we believe that judges can do better without returning to a world of fiduciary duty shifting. We believe that non-bankruptcy judges, including state court judges and federal judges, and bankruptcy judges each have a role to play in restoring predictability and order to distressed governance. Importantly, the changes we describe below are entirely under the control of judges and would require no significant legislation. They also would not require major shifts in the law. They would simply need judges to view managers of distressed firms with a practiced skepticism, recognizing that control opportunism might influence whatever it is management is trying to do.

First, state court and federal judges adjudicating contract disputes should consider whether management's proposed course of action is a reasonable, good-faith display of business judgment that promises to maximize the value of the firm. Even in the absence of an explicit duty that shifts to creditors, many commentators and courts believe that managers continue to owe their fiduciary duty in the first instance to the firm, not to shareholders directly.[254] For an example of how this could work, consider the lawsuit filed by Cumulus Media's Term Lenders. They sued asserting contract claims to block what they saw as a misuse of the revolving loan provision of the loan contract. While the court considered this as a contract case, it is easy to imagine how a fiduciary duty analysis could be grafted on top of it in a way that is consistent with *Gheewalla* and *Quadrant*.

For example, the court could have considered the level of analysis that management undertook in connection with the exchange offer, as courts often do in investigating fiduciary duty

[254] *See Quadrant*, 115 A.3d at 547. Note that a substantial number of courts and commentators believe that fiduciary duties run directly to shareholders, not to the corporation in the first instance. *See generally* Andrew S. Gold, *Dynamic Fiduciary Duties*, 34 Cardozo L. Rev. 491 (2012) (discussing how it is unclear whether fiduciary duties are owed to the corporation or the shareholders in the first instance.) As Gold points out, the standard formulation is to say "duties are owed to the corporation and its shareholders," which incorrectly suggests that the interests of the corporation and the shareholders never conflict. *Id.* at 493.

claims and the applicability of the business judgment rule.[255] For example, did Forest Oil's board really think that the merger with Sabine would maximize the value of the firm and benefit the corporation as a whole? In performing this analysis, courts should attach highly limited value to the notion that avoiding bankruptcy is a benefit to the corporation. Did PetSmart's board really think that a dividend to its private equity sponsor would help a distressed firm already struggling under the weight of billions of dollars of debt?

For an example of how this might work, consider the bankruptcy court's fiduciary duty analysis in Forest Oil.[256] The court summarily dismissed the fiduciary claims as being inconsistent with the law after *Gheewalla* and *Quadrant*. But what if the court had instead viewed the transaction through the prism of management re-engineering the deal to purportedly evade the change of control covenant? Surely, this kind of conduct should, and could, raise judicial eyebrows. The judicial tendency, especially since *Gheewalla*, has been to encouraging debtors to try to evade contractual covenants to do things they had previously promised not to do. Maybe those *ex ante* promises should be taken more seriously in subsequent litigation.

Importantly, we believe that management would be restrained if they knew they would one day be forced to justify their conduct under a business judgment rule with more teeth. While a more aggressive application of the business judgment rule would not eliminate control opportunism, it might deter some of the most egregious cases.

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[255] The seminal case in this area is Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)

[256] *See In re Sabine Oil & Gas Corp.*, 547 B.R. at 503.

Additionally, fraudulent transfer lawsuits currently take far too long to litigate. While some of this reflects the state of affairs in the judiciary more generally, courts should be mindful of this in scheduling hearings and ruling on motions. The Tribune and Lyondell litigations are still pending, ten years after the transaction that gave rise to them. The slow moving trains of justice here have broader consequences than denying justice to one particular plaintiff or another. It emboldens the entire private equity industry to extract excessive dividends from portfolio firms, knowing that it might take more than a decade to litigate the fraudulent transfer action, by which time every employee currently at the private equity firm will be gone.

Similarly, we believe that bankruptcy judges need to simply be more assertive in the face of demands from management that the alternative to a course of action that benefits one stakeholder over another is certain liquidation.[257] There is no reason to think that debtor-in-possession financing would really dry up if bankruptcy judges announced they would not allow debtor-in-possession financings to limit the investigative rights of unsecured creditors over purported fraudulent transactions. Similarly, there is limited empirical evidence supporting the view that firms need to emerge from Chapter 11 so quickly that there is not enough time to fully investigate an important fraudulent transfer claim.

Bankruptcy judges should also be wary of procedural mechanisms like sale motions and motions to settle claims that strip unsecured creditors of due process rights. Information should be widely shared and managers should never have the right to conceal the existence of "higher and better" bids. If the official committee of unsecured creditors receives permission to bring a cause of

[257] Others have expressed this sentiment as well. *See e.g.* Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014).

action, for example, management should not be allowed to settle it over the official committee's objection.

Bankruptcy judges should also consider whether fraudulent transfer law needs to operate more aggressively, mindful of *Gheewalla* and the spate of opportunism since the financial crisis. For example, courts could consider whether the collapsing doctrine should be applied in a way that is more plaintiff-friendly that is currently the case. Courts should also be skeptical of efforts to inoculate leveraged buy-outs from challenges, such as round-trip transactions, that lack economic substance. To be sure, nothing we have described are major reforms, but they could combine to a significantly different boardroom decision-making environment for distressed firms.

VI. Conclusion.

We are currently living in an new historical moment. The common law has largely vacated its historic role as protector of creditors, and the marketplace has never been as chaotic and unpredictable as it is today.

In this Article, we argued that the changes in law were driven by misunderstandings about the ability of creditors to protect themselves using contract law and bankruptcy law. As the case studies above showed, opportunistic managers are difficult to restrain with contracts even when the risk of opportunism is identified and contracted for *ex ante.* The lawyers who represent large firms are simply too skilled in the perpetual cat-and-mouse game not to find loopholes and ways around even the best drafted contractual language. Moreover, bankruptcy law turns out to answer to many policy goals, not just creditor protection, and judges may consider those goals - like preserving firm value and maximizing employment - to win when they compete with a creditor's argument that management committed some pre-bankruptcy harm to creditors.

However, as we outlined in Section V, judges can do much more than they are doing to help. A more aggressive application of the business judgment standard will force boards to think harder about their actions and to do more to justify them. An adverse decision constraining control opportunism would likely go quite a way to chill this type of aggressive conduct. Just as judges created the current system of distressed governance, so too can they recreate it.