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Bankruptcy: Bankruptcy Hardball

Jared Ellias

Bankruptcy

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By many accounts, we have entered an era of unprecedented contentiousness in debtor-creditor relations. For an example of the new status quo, consider the recent actions of PetSmart, a perfectly normal American corporation struggling with debt from a leveraged buyout gone sour. 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 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.

This type of scorched-earth maneuvering is a form of "bankruptcy hardball." To be sure, distressed companies and their major financial creditors have always had their share of combative negotiations, conflict, and litigation. But the current level of chaos and rent-seeking is unprecedented. 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. It is quite revealing that, after PetSmart removed nearly $2 billion from the reach of creditors, the trading price of its bonds actually *increased* in value. The bondholders who were still harmed by the transaction likely breathed a sigh of relief because they had feared far worse. Although unthinkable only a few years ago, a distressed firm's redistribution of nearly $2 billion away from its creditors is seen, in today's environment, as unexpectedly generous to those same creditors because its private-equity owner did not help itself to more.

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[1] Excerpted and adapted from Jared A. Ellias & Robert A. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745 (2020).

The new environment is rooted, in part, in a series of recent Delaware court decisions that 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 these decisions—most importantly *Gheewalla* followed by *Quadrant Structured Products*[2]—the Delaware courts dramatically reduced the ability of creditors of insolvent firms to prosecute claims for breach of fiduciary duty. To be sure, other factors have contributed to the status quo, such as debt-market conditions, a loosening of the basket of traditional covenants, and broader economic factors. But the common law's retreat from protecting creditors has qualitatively changed the liability calculus for boards of directors of troubled firms.

To illustrate the change, consider the advice that law firms provide to the boards of troubled companies. In an article for clients written in 2001, prior to *Gheewalla*, 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."[3] 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.[4] Similarly, another leading law firm wrote that *Quadrant* will protect directors "adopting a high-risk business strategy that might benefit controlling shareholders when a corporation is insolvent."[5]

This revolution in the common law was premised on the faulty assumption that creditors are fully capable of protecting their

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[2] Quadrant Structured Prod. Co. v. Vertin, 102 A.3d 155 (Del. Ch. 2014); N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92 (Del. 2007).

[3] *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).

[4] *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).

[5] *See* Mark S. Chehi, *Delaware Court of Chancery Decision Clarifies Fiduciary Issues in Insolvent Company Context*, SKADDEN (Jan. 2015).

bargain during periods of distress with contracts and bankruptcy law. The reality is contrary to that undergirding assumption, for several reasons.

First, the creditor's bargain often is an easy target for opportunistic repudiation and, in turn, dashed expectations once distress sets in. Even the most sophisticated creditors cannot protect themselves with contract law alone. They cannot foresee every contingency ex ante, and skilled debtor's lawyers can often find ways to get around even carefully written contracts. For example, the bondholders of Forest Oil contracted *ex ante* for redemption in the event of a change in control—only to see the debtor claim it "contracted around" that covenant even though the firm had, in fact, been sold to a new controller.

Second, while bankruptcy law does protect creditors, it also answers to other policy goals, such as reorganizing distressed firms and protecting jobs. And well-advised debtors and creditors can run strategic and smart bankruptcy processes that use procedural tools to pressure the judge into making decisions that further the policy goal of say, promoting reorganization, even at the expense of vindicating creditor rights. Bankrupt LyondellBassell's managers, for example, exploited an odd quirk of bankruptcy law to settle valuable fraudulent-transfer claims worth potentially billions, without, initially, the input of the unsecured creditors who were the real plaintiffs. Bankruptcy law can protect the rights of creditors, but it can also be used to take rights away from creditors that they would have had outside of bankruptcy. 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 became better positioned to get more than it might be entitled to at the conclusion of a bankruptcy process or out-of-court restructuring.

Although the Delaware courts have paved the way for bankruptcy hardball to become the de facto mode of distressed governance, judges can help fix the problem by pushing back against overreach. *Gheewalla* is not the only force that has reshaped debtor-creditor relations. Perpetually favorable debt-market conditions in the years after the financial crisis 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. The status quo could be improved if today's standards were applied more rigorously.

State 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. To illustrate, consider lawsuits filed by creditors against a firm's board for violating covenants. While courts often consider these to be contracts cases, it is easy to imagine how a fiduciary-duty analysis could, consistent with *Gheewalla* and *Quadrant*, be grafted on top. Courts can consider the board's level of analysis in connection with the disputed action and whether it was really taken in good faith. Similarly, courts can view more skeptically the technical arguments that a company complied with the letter of a debt contract in a way that clearly violates the intended spirit of the contractual covenant. In this way, management would be restrained by having to justify conduct under more searching judiciary scrutiny. While a more aggressive application of the business-judgment rule would not eliminate bankruptcy hardball, it would likely deter the most egregious cases.

Additionally, fraudulent-transfer litigation has been devalued as an insolvency remedy. This kind of action currently takes a very long time to litigate, and courts should be mindful of litigation duration in scheduling hearings and ruling on fraudulent-transfer motions. The slow-moving trains of justice embolden the entire private-equity industry to extract excessive dividends from portfolio firms, knowing that any fraudulent-transfer action might take more than a decade to litigate, by which time most employees currently at the private-equity firm will be gone. Bankruptcy judges also should also consider whether fraudulent-transfer law needs to operate more aggressively, mindful of *Gheewalla* and the spate of opportunism since the financial crisis.

Finally, bankruptcy judges need to be more assertive in the face of demands from management that certain liquidation is the only alternative to a course of action that benefits one stakeholder over another. There is no reason to think that debtor-in-possession financing would really dry up if bankruptcy judges announced they would not allow such financings to limit the investigative rights of unsecured creditors over purported fraudulent transactions.

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