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On the eve of the financial crisis, a series of Delaware court decisions resulted in a radical change in law: creditors would no longer have the kind of common law protections from opportunism that helped protect their bargains 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 bargains during periods of distress with contracts and bankruptcy law. Through a series of case studies, we show how the creditor's bargain is often, contrary to that undergirding assumption, 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 corporate governance. Fortunately, judges can help fix the problem with more rigorous application of existing legal doctrines.

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INTRODUCTION

In late 2017, PetSmart Inc. (PetSmart), one of the world's leading retailers of pet supplies, found itself in deep financial distress.[1] The company's financial troubles originated with an ill-fated leveraged buyout and acquisition that burdened PetSmart with billions of debt in the form of secured bank loans and unsecured bonds.[2] The leveraged buyout and acquisition did not go well. PetSmart's bond debt began trading at steep discounts, suggesting that traders in the bond market viewed the firm as insolvent.[3] 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, who would collect before PetSmart's shareholders. Instead, PetSmart's board authorized a transaction that seems shocking for a firm in its situation: it took nearly $2 billion out of the reach of creditors, distributing about $900 million to its shareholders, and placing $750 million in a subsidiary that was not obligated to repay its $9 billion in debt.[4]

The PetSmart scenario is emblematic of a paradigm shift in how boards of directors now approach financial distress.[5] For most of American history, boards of directors were counseled to manage distressed firms with an eye towards

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1. *See* Eliza Ronalds-Hannon & Lauren Coleman-Lochner, *The Most Expensive Takeover 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/ [https://perma.cc/HA9N-ZPQ8].

2. *See id.*

3. *See id.*

4. *See* Eliza Ronalds-Hannon & Katherine Doherty, *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/ [https://perma.cc/H9UB-3YH2].

5. Reporting in the popular media has also noticed that something has changed, but this Article is the first to describe the entirety of the phenomenon. *See, e.g.*, Soma Biswas, *Deal to Save J. Crew from Bankruptcy Angers High-Yield Debt Investors*, WALL STREET J. (Sept. 21, 2017), https://www.wsj.com/articles/deal-to-save-j-crew-from-bankruptcy-angers-high-yield-debt-investors-1506011065/ [https://perma.cc/YDG6-UXXU] (discussing a transaction that pushed "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); Sujeet Indap, *Private Equity Firms' Lawyers Get Creative*, FIN. TIMES (Aug. 14, 2017), https://www.ft.com/content/3a42e50e-7e23-11e7-9108-edda0bcbc928/ [https://perma.cc/FYT3-VWS4] ("Every [private equity] firm is adopting more aggressive approaches. Some sponsors will win, some will lose."); Nathan Vardi, *Leon Black's Apollo Global Management Keeps Winning Battles and Outmaneuvering Creditors*, FORBES (Aug. 28, 2014), https://www.forbes.com/sites/nathanvardi/2014/08/28/leon-blacks-apollo-global-management-keeps-winning-battles-and-outmaneuvering-creditors/#5d7c2da2785f/ [https://perma.cc/AS2N-CKAE] (noting that a leading private equity firm is routinely winning battles with creditors, whose claims are legally senior to shareholders). 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 End of the Year Followup*, PETITION (Dec. 19, 2018) (quoting J. Scott Victor), https://petition.substack.com/p/petitions-2018-deal-of-the-year [https://perma.cc/S4CS-Y4Y3].

maximizing firm value for the benefit of creditors.[6] 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 nearly $2 billion from the reach of creditors, the trading price of its bonds actually *increased* in value.[7] The bondholders who were still harmed by the transaction likely breathed a sigh of relief because they had feared far worse.[8] Although unthinkable only a few years ago, in today's environment, a distressed firm's redistribution of nearly $2 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 restraining managers of distressed firms from declaring all-out war on creditors have been fading since the financial crisis.[9] Managers are now playing what we call "bankruptcy hardball" with creditors.[10] To be sure, it is well established that the interests of creditors, managers, and shareholders diverge when a firm becomes distressed.[11] 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.[12]

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6. Justice Story pioneered this area of jurisprudence in the early 1800s, first as a district court judge, *see* Wood v. Dummer, 30 F. Cas. 435, 435–40 (C.C.D. Me. 1824) (No 17,944), and then on the Supreme Court, *see* Mumma v. Potomac Co., 33 U.S. 281, 281–87 (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 & 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 duty shifting).

7. *See* Ronalds-Hannon & Doherty, *supra* note 4.

8. *See id.*

9. 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 should the firm ultimately file for bankruptcy. In an internal presentation, employees of the private equity owner justified the transfer, 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." *See* Final Report of Examiner Richard J. Davis at 343, *In re* Caesars Entm't Operating Co., 561 B.R. 441 (Bankr. N.D. Ill. 2016) (No. 15-01145).

10. The title was inspired by the recent works of Joseph Fishkin & David E. Pozen, *Asymmetric Constitutional Hardball*, 118 COLUM. L. REV. 915 (2018), and Mark 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* Part III.B.2–3.

11. *See* 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) (discussing Chapter 11 proceedings for alternative funds).

12. *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"). *See generally* Harner et al., *supra* note 11; Lynn M. LoPucki & William C. Whitford, *Corporate Governance in Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993) (discussing management of insolvent companies).

While this moral hazard—which we call *control opportunism*[13]—is well established, what has changed over the past ten years is the level of aggressiveness now observed of otherwise conventional firms.

This change may be attributed, at least in part, to the common law's retreat from its historical role protecting creditors.[14] For most of American history, judges played an important role in policing control opportunism with various common law doctrines providing creditors with remedies if managers went beyond the accepted boundaries of opportunistic behavior.[15] These doctrines did not function to hold managers liable to creditors for any business decision that did not work out.[16] But, by explicitly focusing managerial decision-making on the interests of creditors and by exposing such decision-making to some form—albeit hazy—of potential liability, they likely deterred a kind of swashbuckling recklessness or intentional dereliction of the creditor's bargain.[17]

However, on the eve of the financial crisis, the Delaware courts suddenly changed course.[18] In 2007, the Delaware Supreme Court's *Gheewalla* decision limited the fiduciary duties that managers previously owed to creditors in times of financial distress.[19] 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.[20] After all, such commentators reasoned, the largest creditors—generally banks and bond investors—are well situated to protect themselves.[21] 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.[22] 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

13. We believe this Article is the first to use the phrase "control opportunism" as a generic description of the perverse incentives that drive investors and managers to exploit their control over Chapter 11 debtors to extract private benefits, as further explained in Part I. But many of the agency problems and frictions on optimal governance discussed herein have been discussed in other work. *See* Levitin, *supra* note 12.

14. *See infra* Part II.

15. *See infra* notes 83–100 and accompanying text.

16. *See id.*

17. *See infra* notes 87–103 and accompanying text.

18. *See id.*

19. *See infra* notes 87–93 and accompanying text.

20. *See, e.g.*, Hu & Westbrook, *supra* note 6 (arguing that fiduciary duties for creditors are unnecessary); *infra* notes 87–89 and accompanying text.

21. *See, e.g.*, Hu & Westbrook, *supra* note 6; Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 864–68 (2008) (arguing against fiduciary duty protections for sophisticated creditors).

22. *See* Prod. Res. Grp. v. NCT Grp. (Production Resources), 863 A.2d 772, 789 (Del. Ch. 2004).

fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law, and other sources of creditor rights."[23]

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 are observable and increasingly common place.[24] We believe that this is the consequence of a fundamental misunderstanding of creditors' ability to protect themselves reliably and predictably with contracts and bankruptcy law.[25] 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.[26] 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 contract 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.[27] Indeed, as the cases we describe below make clear, debtors can often exploit their 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.[28]

Second, we contend that bankruptcy law currently provides far less protection for creditors than presumed by commentators and Delaware precedent.[29] In theory, when firms encounter severe financial trouble, they file for Chapter 11 bankruptcy, and the judge supervises a management team devoted to maximizing the firm's value to provide creditors with the best possible recovery, consistent with contractual terms negotiated pre-bankruptcy.[30] In practice, however, bankruptcy judges balance creditor interests against other policy goals, such as the need for the firm to finance itself post-petition, to

23. *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 conveyance law, implied covenants of good faith and fair dealing, [and] bankruptcy law . . . ").

24. *See infra* notes 101–103 and accompanying text.

25. *See infra* notes 105–173 and accompanying text; *see also* Haslund v. Simon Prop. Grp., 378 F.3d 653, 655 (7th Cir. 2004) (Posner, J.) (noting complete contracts are impossible, and contracts can be "shorter and simpler and cheaper" when courts fill gaps and resolve ambiguities in the case of litigation).

26. *See infra* notes 105–173 and accompanying text.

27. *See id.*

28. *See id.*

29. *See, e.g.*, Hu & Westbrook, *supra* note 6, at 1369–78 (arguing bankruptcy provides sufficient protection for creditors, and, therefore, fiduciary duty shifting to creditors should be abolished). *See contra infra* notes 175–261 and accompanying text.

30. *See generally* John A. E. Pottow, *Fiduciary Principles in Bankruptcy and Insolvency*, *in* THE OXFORD HANDBOOK OF FIDUCIARY LAW 205 (Evan J. Criddle et al. eds., 2019).

reorganize, and to protect the jobs of current and future employees.[31] 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.[32] 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.[33]

This Article proceeds as follows. In Part I, we define the problem of control opportunism. In Part II, we describe the common law's migration away from creditor protection, as well as the ideological underpinnings of that paradigm shift. In Part III, we discuss several case studies that illustrate the current state of affairs. While creditors were successful in thwarting opportunistic behavior in some of the cases we describe, we choose these cases because they illustrate different strategies that managers can use to play bankruptcy hardball, with great costs to creditors.[34]

In Part IV, we argue 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] Admittedly, *Gheewalla* is not the only force that has reshaped debtor-creditor relations. For example, 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.[36] However, we assert that, *ceteris paribus,* the status quo could be improved if today's standards were applied more rigorously.[37] Judges have the

31. *See, e.g.*, *infra* notes 175–224 and accompanying text.

32. *See infra* notes 220–261 and accompanying text.

33. *See, e.g.*, *In re* Lyondell Chem. Co., 503 B.R. 348, 353 (Bankr. S.D.N.Y. 2014), *abrogated by In re* Tribune Co. Fraudulent Conveyance Litig., 818 F.3d 98 (2d Cir. 2016) (demonstrating the advantage of already having received money even if there is fraudulent transfer risk associated with the conveyance).

34. They also present cases involving at least some degree of arguable control opportunism. Many cases, we suspect, involve less readily observable opportunistic conduct.

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

36. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648 (2010); Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 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 funds, and investors holding credit default swaps). For a discussion of the continuing borrower-friendly credit markets, see Joe Rennison*, In Leveraged Loans*, *Sellers Are Still in Near-Total Control*, FIN. TIMES (Mar. 22, 2019), https://www.ft.com/content/68a67be6-4b58-11e9-8b7f-d49067e0f50d/ [https://perma.cc/445E-ZW76].

37. *See infra* Part IV.

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 predictable.[39] To the extent that creditor expectations are not routinely upheld *ex post*, investors will adjust *ex ante* by avoiding certain deal structures—perhaps making efficient financings unreachable in some cases, limiting the supply of capital to businesses.[40]

I.
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.[41] 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 traditional fiduciary constituents, the shareholders—by favoring one group of investors over another.

A. The Classic Twin Agency Problems of Corporate Law

In a healthy corporation, the main agency problems of managers and shareholders are well understood and usually considered to be driven by different problematic incentives.[42] 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[43] or by manipulating a sale process to make it easier for

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38. *See id.*

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

40. Investors often tailor investment contracts with an eye towards minimizing the firm's cost of capital—which can involve allocating control and monitoring rights in a range of arrangements. If creditors cannot trust that their recovery expectations will be held up *ex post*, it may limit the contracting space that investors can use to customize these bargains, reducing the supply of capital on the margin and perhaps even reducing the aggregate amount of economic activity.

41. 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 a more limited species of opportunism because it is confined to the temptation creditors have to be opportunistic through obtaining control of the firm, but "control opportunism" is also more expansive because it focuses on the behavior of managers, not creditors.

42. For the seminal article on this topic, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

43. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (discussing executives' control over their pay).

management's preferred owner to buy the company instead of a higher paying bidder.[44]

There is a second agency problem at the heart of corporate governance as well: the agency conflict between shareholders and creditors.[45] Shareholders control a firm by electing the board of directors, which hires the senior officers who actually run the firm.[46] Because managers owe shareholders a fiduciary duty, it is often assumed they are operating the firm on behalf of shareholders.[47] However, the typical firm also usually funds its activities with some amount of debt.[48] This leads to an agency conflict when the firm approaches insolvency because managers may take excessive risks to pursue shareholders' interests.[49] For example, a firm may launch a new product that will either succeed massively or exhaust the firm's remaining assets.[50] To the extent these risks turn out to produce strong returns, the returns mostly inure to the benefit of shareholders.[51] 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.[52] Creditors recognize this problem and routinely contract to block managers from pursuing excessively risky actions. For example, creditors may require firms to keep a minimum level of money in the bank or insist on creditor approval for major investments that could divert significant amounts of value.[53]

B. The Debt-Equity Conflict in Modern Finance: Control Opportunism and 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 one corporate borrower, a single creditor, and an individual shareholder.[54] Instead, sizeable firms fund their

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44. *See, e.g.*, LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES (Yakov Amihud ed., 1989) (discussing the debate over management's private interests in deciding the timing and purchaser of leveraged buyouts).

45. *See, e.g.*, Michael C. Jensen & Clifford W. Smith, Jr., *Stockholder, Manager, and Creditor Interests: Applications of Agency Theory*, *in* RECENT ADVANCES IN CORPORATE FINANCE (E. I. Altman & M. G. Subrahmanyam eds., 1985).

46. 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 (2007).

47. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2019).

48. *See, e.g.*, Joshua D. Rauh & Amir Sufi, *Capital Structure and Debt Structure*, 23 REV. FIN. STUD. 4242 (2010).

49. *See* Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118–19 (1979).

50. *See id.*

51. *See id.*

52. *See id.* at 118.

53. *See id.* at 125–46 (describing bond covenants).

54. *See* Rauh & Sufi, *supra* note 48, at 4243.

activities with a combination of secured debt, unsecured debt, and equity.[55] The investors who provide all three forms of capital are contracting to receive different levels of return with different levels of risk.[56] It is clearest to think of modern investors as holding options with different levels of priority against the firm's assets.[57]

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.[58] 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.[59]

Accordingly, for the modern firm, the debt-equity conflict is driven by the firm's financial circumstances and solvency at any given point in time. Imagine our hypothetical firm is considering a business plan that has a 50 percent chance of yielding a total firm value of $200 if it succeeds, and a 50 percent chance of destroying most of the firm's value and leaving only $10 for distribution to creditors if it fails. 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 100 percent payoff to a 10 percent payoff. And while the private equity shareholder remains the ultimate beneficiary of the plan's success, 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-

55. *See id.*

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

57. *See, e.g.*, ASWATH DAMODARAN, INVESTMENT VALUATION: TOOLS AND TECHNIQUES FOR DETERMINING THE VALUE OF ANY ASSET 611–46 (3d ed. 2012).

58. *See, e.g.*, *id.* The option-pricing framework is useful here because it provides a single framework for thinking about how pre-bankruptcy investors are treated in bankruptcy. In bankruptcy, state law and contract characteristics like security and subordination create a hierarchy between creditors who have a right to receive a pay out if their claim is "in the money." Investors are "in the money" if the firm is worth enough that the investors, with their spot in line, can expect to receive a payout. For example, if a firm is worth $500 as of the Chapter 11 petition date, a senior creditor who is entitled to the first $50 in firm value has a "deeply-in-the-money" option, meaning the firm's value would have to go down by $450—our measure of depth—for that senior creditor to sustain losses. If the firm is instead worth $100, the senior creditor would still be "in the money," but not as deeply in the money as before. A similar senior creditor owed $50 by a firm worth only $50 has an "at-the-money" call option, where the expected payout will be reduced dollar-for-dollar if the firm's value falls.

59. *See generally* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 654 (1973).

the-money" options, where the identity of the option holders will vary based on the underlying facts.[60] One cannot identify the incentives of a particular investor simply by looking at the type of investment contract they used—secured loan versus unsecured loan, for example—without contextualizing the priority created by those contracts within the capital structure as a whole and the firm's value.

When a firm is insolvent, management will enjoy two forms of control over the ultimate payoff 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.[61] These types of transactions are about manipulating how and how much particular stakeholders recover vis-à-vis competitors in the capital structure.[62] There are less overt instances of substantive control including managerial decisions about a firm's new business plan, how much value generally exists for distribution to creditors, and what the reorganized firm's capital structure should look like.[63] An aggressive business plan with optimistic projections of future earnings can support a higher valuation and more debt than a pragmatic plan with more conservative assumptions.[64] The higher the valuation, the more value that management or a bankruptcy judge can deem exists for distribution to creditors or shareholders.[65]

60. 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 *34 n.55 (Del. Ch. Dec. 30, 1991). The key intuition in this framework is to recognize the traditional model of debt-equity agency conflict—shareholders want risk, creditors want to liquidate today—is incomplete when mapped onto the complexity of modern finance. For example, unsecured creditors of one firm may have a bias towards liquidation because they are deeply in the money, while unsecured creditors of another firm may have a bias towards taking risks because they are out of the money. One cannot understand the bias of an individual investor simply by looking at the type of investment contract they have; one must look at the broader context of the value of the firm to recognize how those incentives might impact their behavior.

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

62. An example of this kind of substantive control is the PetSmart fact pattern discussed above, 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 2–5 and accompanying text.

63. *See* Jared A. Ellias, *Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?: Evidence from Junior Activist Investing*, 8 J. LEGAL ANALYSIS 493, 494–96 (2016).

64. *See id.*

65. At the end of the bankruptcy case, the judge must apportion the value of the firm based on pre-bankruptcy entitlements to value. As it is impossible to achieve a scientific measurement of the value of an operating business, the typical practice in bankruptcy is to estimate the firm's value via expert evidence or an auction process for all of the firm's assets. When the firm's value is estimated with expert evidence, an investment banker will typically draw on management's business plan to come up with an estimated range of firm value, and the judge will determine whether a plan proponent, relying on such expert evidence, has carried its burden of proof. *See id.*

Second, management controls the *timing* of any decision to restructure its debt by modifying its debt contracts and reorganizing its capital structure.[66] This can mean a consensual out-of-court exchange or a bankruptcy filing.[67] These decisions can also be enormously consequential for investors.[68] 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.[69] A slow trip through bankruptcy can extend the option of out-of-the-money creditors or shareholders, and give the firm's operations time to improve.[70]

In exercising this discretion, 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.[71] 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, 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.[72] 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 for several different reasons. One is because they traditionally think of themselves as working for the shareholders who appointed them. Another possibility is that management holds

66. *See* Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219, 221–33 (2004).

67. *See generally* William W. Bratton & Adam J. Levitin, *The New Bond Workouts*, 166 U. PA. L. REV. 1597 (2018) (discussing out-of-court debt exchanges exchanges).

68. *See generally* LoPucki & Whitford, *supra* note 12, at 691–719.

69. *See id.*

70. *See id.*

71. Here too, Chancellor Allen's footnote 55 is reflective of what is observed in the real world. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) ("The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors."); *see also* Ellias, *supra* note 63 (describing the moral hazards and perverse incentives managers face).

72. *See, e.g.*, Jared A. Ellias, *Regulating Bankruptcy Bonuses*, 92 S. CAL. L. REV. 653, 682 (2019) (discussing the post-bankruptcy employment contract awarded by senior option holders to Citadel Broadcasting's CEO).

a potentially lucrative block of the firm's stock. Lastly, management may simply have little affinity for the firm's lenders.[73]

Moreover, even a manager free of any bias towards any stakeholder has private incentives to run a bankruptcy process geared towards a quick exit and lower creditor recoveries. For example, managers generally want to avoid the scrutiny and expense associated with bankruptcy.[74] If bankruptcy is 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.[75] Managers also generally prefer to have as little debt as possible upon emergence from bankruptcy in order to free up future financing capacity and make a return trip to bankruptcy less likely.[76] Further, management is unlikely to benefit from a prolonged bankruptcy process that exhausts restructuring options and fairly adjudicates all creditor claims.

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*.[77] Further, the incentives managers have to be strategic and run a speedy bankruptcy process lead many observers to conclude Chapter 11 practice currently favors senior option holders at the expense of junior creditors and shareholders, even without any attempt by management to favor one group over another.[78]

II.
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 distorted incentives when a firm nears insolvency. Historically, courts extended equitable protections that created liability for managers who grossly abused their discretion. In early American history, this equitable protection took the form of the so-called "trust fund doctrine." In modern times, judges used fiduciary duty law to protect creditors.[79]

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73. 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.*, Robert B. Zajonc, *Attitudinal Effects of Mere Exposure*, 9 J. PERSONALITY & SOC. PSYCHOL. 1 (1968) (showing evidence of the mere exposure effect).

74. *See generally* Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991) (suggesting that managers prioritize avoiding financial trouble, especially bankruptcy).

75. *See id.*

76. *See* Paul M. Goldschmid, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 191 COLUM. BUS. L. REV. 191, 266–67 (2005).

77. *See generally* Barry E. Adler, *Game-Theoretic Bankruptcy Valuation*, 41 J. LEGAL STUD. 209 (2012).

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

79. As this Article focuses on developments since the financial crisis, space constraints prevent us from fully discussing the trust fund doctrine. For good introductions, see Hu & Westbrook, *supra*

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. Thus, 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 financing, and firms began to finance riskier ventures with debt that might have previously been funded with equity.[80] Junk bonds also financed a wave of leveraged buyouts. Debt as a percentage of firm value increased from about 25 percent of firm value in the 1930s to 65 percent in the early 1990s.[81] Eventually, corporate America began to labor under this unprecedented debt load.

Perhaps in reaction to the rise of debt as well as the need to adjudicate claims arising out of leveraged buyouts, the Delaware Chancery Court expanded the range of scenarios in which boards of directors would need to consider creditor interests.[82] 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 also to the "corporate enterprise" as a whole.[83] This shift was

note 6, at 1331–36, and Norwood P. Beveridge, Jr., *Does a Corporation's Board of Directors Owe a Fiduciary Duty to its 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 *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482, 502 (1913); (ii) imposing strict evidentiary standards before creditors must cede value to shareholders, see *Nat'l Sur. Co. v. Coriell*, 289 U.S. 426, 436–37 (1933); and (iii) condemning control opportunism intended to shift estate value from creditors to shareholders, see *Pepper v. Litton*, 308 U.S. 295, 311–13 (1939). Many of these principles were incorporated into the Bankruptcy Code, see for example 11 U.S.C. § 1129(b)(2) (2018), and continue to shape lender expectations. But, as discussed herein, these principles are increasingly ignored and/or rendered ineffectual in the day-to-day administration of insolvency scenarios and bankruptcy cases.

80. *See* Jeremy I. Bulow et al., *Distinguishing Debt from Equity in the Junk Bond Era*, *in* DEBT, TAXES, AND CORPORATE RESTRUCTURING 135, 144–45 (John B. Shoven & Joel Waldfogel eds., 1990).

81. *See* John R. Graham et al., *A Century of Capital Structure: The Leveraging of Corporate America,* 118 J. FIN. ECON. 658, 659 (2015) (tracing the history of corporate debt).

82. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991); *see also* Dianne F. Coffino & Charles H. Jeanfreau, *Delaware Hits the Brakes: The Effect of* Gheewalla *and* Trenwick *on Creditor Claims*, 17 J. BANKR. L & PRAC. 1 (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) ("However, when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors."). Note that, even before *Credit Lyonnais* and *Gheewalla*, some Delaware courts had already begun to articulate a view that deprived creditors of equitable protections. *See, e.g.*, Katz v. Oak Indus., 508 A.2d 873, 879 (Del. Ch. 1986) ("The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.").

83. 1991 WL 277613, at *34. Twenty-five years before *Credit Lyonnais*, in 1974, a Delaware court suggested in dicta that a creditor might be able to recover against directors or officers of a

necessary given directors' incentives to put creditors' money at risk while looking out for shareholder interests.[84] The *Credit Lyonnais* opinion, while unpublished, was widely influential in changing the liability calculus of boards of directors. After *Credit Lyonnais*, if the firm was "in the vicinity of insolvency," directors could be held liable to creditors as well as shareholders.[85]

B. Academic Critique of Equitable Protections and Judicial Movement Away from Fiduciary Duties for Creditors

The law's evolution toward protecting creditors was not well-received by many academic commentators and Delaware jurists. Academics disputed the fundamental logic of *Credit Lyonnais*.[86] Courts thought they were reducing the costs of contracting by not requiring creditors to anticipate all scenarios where creditor interests could diverge from shareholders. Academic contract theorists, in particular, became increasingly convinced that equitable doctrines aimed to achieve fairness—like those voiding otherwise enforceable contracts—were largely unnecessary and that courts should enforce agreements strictly as written.[87] 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

corporation even without a contractual right 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).

84. *See Credit Lyonnais*, 1991 WL 277613, at *34; *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).

85. *See, e.g.*, Bo Becker & Per Strömberg, *Fiduciary Duties and Equity-Debtholder Conflicts*, 25 REV. FIN. STUD. 1931, 1933, 1937 (2012) (noting that *Credit Lyonnais* was "immediately recognized as an important precedent" and finding empirical evidence that firms altered their capital structure and investment policy in light of the new legal regime).

86. *See, e.g.*, Hu & Westbrook, *supra* note 6, at 1348 ("[D]uty 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) ("[A]t least for commercial creditors, fiduciary duties that include such creditors are unnecessary . . . .").

87. *See* Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 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); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 618 (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").

> 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.[88]

As academic commentators increasingly argued against fiduciary duty shifting on theoretical grounds, Delaware courts grew less confident that the system they created in *Credit Lyonnais* was administrable or logically coherent.[89] Thus, in *Gheewalla*, the Delaware Supreme Court essentially reversed *Credit Lyonnais* and eliminated the idea that fiduciary duties shift in the "zone of insolvency."[90] The court noted that creditors have many ways to protect themselves, such as contractual covenants, fraudulent transfer law, and the implied covenant of good faith. The court concluded that these protections "render the imposition of an additional, unique layer of protection through direct claims for breach of fiduciary duty unnecessary."[91] *Gheewalla* merely left open the possibility that creditors could bring derivative claims against the board when the firm became insolvent.[92]

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 prior to *Credit Lyonnais*.[93] In *Quadrant*, the court found that the directors and officers of insolvent firms do not owe a fiduciary duty to creditors.[94] Instead, the directors of an insolvent firm may consider the interests of creditors when assessing their fiduciary duty to the corporation,

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88. Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1248 (2006); *see also* Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency,* 1 J. BUS. & TECH. L. 335 (2007) (arguing that firms in the zone of insolvency owe creditors only those rights contracted for and those implied by the covenant of good faith).

89. *See* Trenwick Am. Litig. Tr. v. Ernst & Young, 906 A.2d 168, 170–74 (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, 56 (2007) ("[D]eepening insolvency—whether articulated as a cause of action or theory of damages—is based on a brittle legal foundation that is quickly eroding away.").

90. *See* Quadrant Structured Prod. Co. v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014) ("In *Gheewalla,* the Delaware Supreme Court discarded the zone [of insolvency]."); *see also* Adam B. Badawi, *Debt Contract Terms and Creditor Control*, 4 J. L. FIN. ACC. 1 (2019) (examining the impact of the *Gheewalla* decision); Charles H. Jeanfreau, *Unexpected Setbacks for Creditors in Chapter 11 Cases*, 2012 ANN. SURVS. BANKR. L. 365, 369 (2012) ("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.").

91. N. Am. Catholic Educ. Programming Found. v. Gheewalla*,* 930 A.2d 92, 100 (Del. 2007).

92. *See generally* Coffino & Jeanfreau, *supra* note 82.

93. *See* 102 A.3d at 174 (Del. Ch. 2014).

94. *See id.* at 176 (citing Robert J. Stearn, Jr. & Cory D. 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)).

which in some cases might justify taking a "less risky" course of action such as an efficient liquidation.[95] But, if the directors, in their business judgment, decide to take "extreme risk," that decision too will be protected by the business judgment rule.[96]

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.[97] After *Gheewalla*, that is no longer the case. While creditors may still bring derivative claims in limited scenarios such as disloyal wealth transfers,[98] this remaining right represents scant consolation for the loss of the broader protections previously enjoyed under traditional equity jurisprudence.[99]

Juxtaposing the advice lawyers gave to distressed debtors before and after *Gheewalla* and *Quadrant* provides important evidence of the paradigm shift in the approach boards are counseled to take when a firm approaches insolvency. 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."[100] After *Quadrant,* a leading law firm wrote in a client alert that directors can now favor some

95. *See id.* at 175 (citing *Production Resources*, 863 A.2d 772 (Del. Ch. 2004), 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"). In the language of financial economics, an efficient liquidation is a liquidation where the assets are efficiently put to their highest-valued use, typically through sale to its highest valued user. For example, a failed retailer might efficiently liquidate its land to a housing developer that builds apartment buildings. For a deeper discussion of how bankruptcy law reallocates assets toward productive uses, see Shai Bernstein et al., *Asset Allocation in Bankruptcy*, 74 J. FIN. 5 (2019).

96. *See* Quadrant Structured Prod. Co. v. Vertin, 102 A.3d 155, 192 (Del. Ch. 2014) (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).

97. As 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* Sabin Willet, Gheewalla *and the Director's Dilemma*, 64 BUS. LAW. 1087, 1088 (2009).

98. *See* Quadrant Structured Prod. Liability Co. v. Vertin, 115 A.2d 535, 544 (Del. Ch. 2015) (noting that the chief function of the creditor derivative suit is to protect a corporation from self-dealing payments and other disloyal wealth transfers).

99. *See* Prod. Res. Grp. v. NCT Grp., 863 A.2d 772, 798 (Del. Ch. 2004) (suggesting that such a scenario could be a situation in 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) (explaining that dicta in *Production Resources* and *Big Lots* left open the possibility of direct claims by creditors).

100. 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).

creditors over others without having to worry about liability.[101] Another leading law firm wrote that *Quadrant* protects directors "adopting a high-risk business strategy that might benefit controlling shareholders when a corporation is insolvent . . . ."[102]

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

III.
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 creditors can protect themselves with contract law.[103] 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 contractual expectations or impose costs that creditors could not have prevented *ex ante*. In our first case study, *Forest Oil*, we show how managers can design transactions to exploit contractual ambiguities. The lesson of this case study is that even creditors who anticipate opportunism can struggle to craft a covenant that good lawyers cannot evade *ex post.* In our second case study, *Cumulus*

101. *See* John L. Reed, *Delaware Court of Chancery Issues Significant Ruling on the Ability of Creditors to Assert Fiduciary Duty Claims Against Directors: Key Takeaways*, DLA PIPER LLP (May 14, 2015), https://www.dlapiper.com/en/us/insights/publications/2015/05/delaware-court--chancery-issues-significant-ruling/ [https://perma.cc/7KN2-MN33] (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* SULLIVAN & CROMWELL LLP, MORE CLARITY FOR DELAWARE DIRECTORS WHEN CONSIDERING RESTRUCTURING TRANSACTIONS (2015), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Restructuring.pdf/ [https://perma.cc/Y9PR-D6S6] (noting that directors are now protected by the business judgment rule even in insolvency); Marshall S. Huebner & Darren S. Klein, *The Fiduciary Duties of Directors of Troubled Companies*, 34 AM. BANKR. INST. J. 18 (2015).

102. Mark S. Chehi et al., *Delaware Court of Chancery Decision Clarifies Fiduciary Issues in Insolvent Company Context*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (2015), https://www.skadden.com/insights/publications/2015/01/delaware-court-of-chancery-decision-clarifies-fidu/ [https://perma.cc/LK5Q-4HW5].

103. *See supra* notes 83–89 and accompanying text.

Media, we show that managers can reinterpret contractual language for uses and transactions that were probably never anticipated by the lenders that originally extended credit. In the third case study, *Colt Holdings*, we show 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 problem 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 is hard—and may, in fact, be impossible given the skill of the lawyers that represent insolvent companies and that the threat of contract-based 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 creditors' bargained-for protections, consider Forest Oil Corporation (Forest Oil). In early 2014, Forest Oil was a deeply troubled company.[104] The oil and natural gas firm was buffeted by declining revenue and overwhelming debt, which included borrowings under a reserve-based loan facility and about $800 million in unsecured bonds.[105] In May of 2014, Forest Oil entered a deal that promised to solve its financial trouble: a sale of the firm to Sabine Oil & Gas Company (Sabine).[106] Under the terms of the deal, the combined entity would repay all outstanding debt, and Forest Oil's public stockholders would receive a healthy equity interest in the new enterprise.[107] The transaction was scheduled to close towards the end of 2014.[108]

Importantly, Forest Oil's bondholders had protected themselves with a "change-of-control" covenant in case the firm was sold or underwent a similar fundamental transformation.[109] The bond indentures defined "change-of-control" broadly to include several possibilities, including: (1) when a person or group comes to own more than 50 percent 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 percent voting power.[110] The "change-of-control" covenant thus required the bond debt to be paid off in full if someone

104. *See* Declaration of Michael Magilton at 7, *In re* Sabine Oil & Gas Corp., 547 B.R. 503 (Bankr. S.D.N.Y. 2016) (No. 15-11835).

105. *See id.* at 19–20, 50–52.

106. *Id.* at 13.

107. *See In re Sabine Oil & Gas Corp.,* 547 B.R. at 521.

108. *See id.*

109. *See id.*

110. Complaint ¶¶ 24–57, Wilmington Sav. Fund Soc'y v. Forest Oil Corp., No. 650584/2015 (N.Y. Sup. Ct. Feb. 25, 2015) [hereinafter Wilmington Savings Complaint].

bought Forest Oil.[111] Accordingly, Sabine arranged for the combined firm to borrow $800 million in new bank debt to refinance the outstanding bonds.[112]

However, prior to the closing of the transaction between Forest Oil and Sabine, crude oil prices collapsed and threw the assumptions undergirding the deal into chaos.[113] Sabine found itself with a deal it no longer wanted on the terms it had negotiated.[114] 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.[115] Sabine wanted out.[116] The Forest Oil board initially refused, and for good reason: Forest Oil would not survive on its own, and falling commodity prices were a contractual risk assumed by Sabine and its private equity sponsor.[117] Indeed, by this point, Forest Oil was clearly insolvent, with assets estimated to cover approximately 70 percent of its bond debt.[118] To avoid bankruptcy, Forest Oil needed the deal to somehow close—but on terms Sabine could accept.[119]

To bridge the gap with Sabine, a Forest Oil director suggested an alternative approach.[120] The merger would close as originally planned, but the Forest Oil bonds would not be refinanced.[121] Rather, the bonds would remain outstanding post-closing, but subordinated to $1.65 billion in preexisting Sabine secured debt that would be merged into the combined company.[122] To achieve this outcome, the transaction was re-engineered to avoid triggering a "change-of-control" under the Forest Oil bond indentures.[123] The work-around was simple: instead of buying all of Forest Oil's stock, Sabine's equity sponsor would receive stock with limited control rights.[124]

The re-engineered transaction circumvented the intent of the "change-of-control" covenant. More specifically, the revised transaction would allow Forest Oil stockholders to retain majority voting power in the company, but it would

111. *See In re Sabine Oil & Gas Corp.,* 547 B.R. at 521.

112. *See id.*

113. Crude oil fell from $103 per barrel in July to $55 per barrel by mid-December of 2014. Complaint ¶¶ 51–53, *In re* Sabine Oil & Gas Corp., 547 B.R. 503 (2016) (No. 15-11835) [hereinafter Sabine Oil Complaint].

114. *See In re Sabine Oil & Gas Corp.*, 547 B.R. at 525.

115. *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., 547 B.R. 503 (2016) (No. 15-11835) [hereinafter Sabine Oil Debtors' Objection].

116. *See id.*

117. *See* Sabine Oil Complaint, *supra* note 113, ¶¶ 75–81.

118. *See id.* ¶¶ 120–22.

119. *See id.* ¶¶ 81.

120. *See In re Sabine Oil & Gas Corp.*, 547 B.R. at 526.

121. *See id.* at 525–27.

122. *See id.*

123. *See id.*

124. *See id.* at 525.

leave them with only a 26.5 percent economic interest.[125] 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."[126] Sabine then contributed its equity interests in Sabine Oil & Gas Holdings LLC to Forest Oil.[127] In exchange for those equity contributions, Forest Oil granted Sabine shares of Forest Oil stock, representing, in all, approximately a 73.5 percent economic interest in the new company and 40 percent of the total voting power.[128] Because Forest Oil stockholders still retained a 60 percent majority of the voting stock of the company, a "change-of-control" did not occur as dictated by the bond indenture.[129]

By any practical measure, however, a "change-of-control" certainly had occurred. The Forest Oil and Sabine boards approved "technical changes" to the post-closing corporate charter and bylaws. These changes gave Sabine's private equity owner virtual control of the new board of directors that was guaranteed far into the future.[130]

The Forest Oil and Sabine boards reached a solution—but one that came at the expense of bondholders. The modified transaction closed mid-December 2014, without any advance notice to stakeholders.[131] The bond market gasped at the betrayal, and the market value of outstanding Forest Oil bonds dropped from more than $800 million when the merger was announced to less than $370 million. Bondholders found themselves suddenly sitting behind more than $1.6 billion in legacy Sabine secured debt in the combined corporate structure.[132] The Forest Oil bondholders promptly brought suit.[133] Unfortunately, the lawsuit did not go far. A few months after the deal closed, the combined company filed for Chapter 11 relief.[134] The bondholders' lawsuit was stayed by the Chapter 11 filing before the state court could even consider a motion to dismiss. In the end, Forest Oil bondholders recovered less than $16 million, or about 97 percent less than they could have received had their bargained-for covenants been honored.

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 satisfies the technical language of a debt contract while standing

125. *See id.*
126. Sabine Oil Complaint, *supra* note 113, ¶ 97.
127. *See id.* ¶ 98.
128. Declaration of Michael Magilton, *supra* note 104, at 62.
129. *See In re Sabine Oil & Gas Corp.*, 547 B.R. at 526.
130. *See* Wilmington Savings Complaint, *supra* note 110, at 44–46.
131. *See id.* at 41.
132. *See* Christine Idzelis & Laura J. Keller, *Forest Oil Seen Punishing Bondholders with Rarely Used Loophole*, BLOOMBERG (Dec. 17, 2014), https://www.bloomberg.com/news/articles/2014-12-17/forest-oil-seen-punishing-bondholders-with-rarely-used-loophole/ [https://perma.cc/KW82-LQG5].
133. *See* Declaration of Michael Magilton, *supra* note 104, at 26.
134. *See id.* at 1–2.

the spirit of the language on its head, consider Cumulus Media Inc. (Cumulus), one of the country's largest owners of radio stations.[135] 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.[136] By 2015, Cumulus began struggling and started exploring options to restructure its balance sheet.[137] 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."[138]

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. A revolving line of credit allows a company to borrow money and then repay it later. Most firms use revolving lines of credit to pay their daily operational needs, including raw material costs, payroll, rent, and utilities. Importantly, the revolving line of credit would be senior in payment priority to Cumulus' term loan. While it may seem strange for term lenders to allow other lenders to have a senior claim, doing so actually protects the term lenders by providing the company the means to manage its business.[139] Revolving loans are generally a safe form of lending for banks, with low interest payments and a 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 aggressive strategy to "refinance" its debt. In reality, there was no refinancing: Cumulus planned to transform its bondholders into revolving lenders through a sham transaction that created a dubious revolving line of credit. The plan proceeded in three steps. First, Cumulus would

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

136. 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. v. JPMorgan Chase Bank, No. 16-cv-9591 (S.D.N.Y. Mar. 3, 2017), 2017 WL 1367233 [hereinafter Cumulus Complaint].

137. *See* Declaration of John F. Abbot, *supra* note 135, at 18–19 (noting that Cumulus made several large acquisitions, including Citadel Broadcasting in 2011 and then Westwood One in 2013).

138. 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 Plaintiffs' Motion for Summary Judgment at 5–6, *Cumulus Media Holdings Inc.*, No. 16-cv-9591, 2017 WL 1367233 [hereinafter Cumulus Term Loan Parties' Memo] (reporting that between the third quarter of 2013, when the Term Loans were made, and the third quarter of 2016, Cumulus' earnings fell by nearly 50 percent, from $416 million annually to $212 million).

139. 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. *See* Cumulus Term Loan Parties' Memo, *supra* note 138, at 7.

"borrow" the full amount allowed under their revolving line of credit.[140] Second, management would dramatically increase the interest rate (from about 4.25 percent to 14.25 percent) and extend the maturity date of the new debt without needing the permission of anyone other than the revolving lenders.[141] 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.[142]

In short, the firm would magically transform the bondholders, Cumulus' unsecured creditors, into secured creditors through exploiting the right to obtain a senior credit line for working capital. The firm's shareholders would benefit from this exchange, as it would decrease the firm's overall debt. The firm's term lenders, however, would see their rights against their collateral diluted by $209 million.[143] The term lenders reacted with fury and sued to block the exchange. After extensive litigation, the term lenders convinced a judge to enjoin the plan.[144]

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 alone consciously decide to assume the risk, that Cumulus would use these rights to refinance junior, unsecured bond debt and bootstrap such debt to a senior priority position. Cumulus' strategy was not only based on an implausible reading of the credit agreement but also remarkably inconsistent with the underlying principles of secured lending. While the court eventually blocked Cumulus, the firm still 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 improper reading of a contract to harm creditors. Instead, they can simply delay a restructuring, effectively holding the firm hostage to preserve shareholder option-value. Consider the conduct of Colt Holdings Company (Colt), the manufacturer of

140. *See id.* at 13.

141. *See id.*

142. *See id.*

143. *See id.* at 7–8.

144. *See id.* 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 136, 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. *Id.* § 8.8(j); *see* Transcript of Proceedings at 90, *Cumulus Media Holdings Inc.*, No. 16-cv-9591, 2017 WL 1367233 [hereinafter Cumulus Transcript with Ruling].

iconic "Colt" firearms. Colt endured a prolonged period of financial distress primarily 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.[145] 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, and 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.[146] Even though creditors were able to eventually prevail in litigation, there is no remedy at law to make them whole.

Much of Colt's debt originated from a leveraged buyout led by a private equity firm.[147] For years, Colt's equity sponsor exploited its ownership position to drain Colt of cash, and, as a result, little of the company's cash flow was reinvested in the business. Between 2002 and 2014, the business distributed $241.3 million to the private equity sponsor.[148] These transfers left Colt without

145. *See* Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1459 (1990) (discussing the priority that creditors have over shareholders).

146. 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., No. 15-10047 (KG), 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).

147. *See* Disclosure Statement for Debtors' Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code at 14, *In re* Colt Holding Co., No. 15-11296-LSS (Bankr. D. Del. Nov. 10, 2015) [hereinafter Colt's Disclosure Statement] (describing the 2013 merger with New Colt Holding Corp., a privately-held manufacturing affiliate of Colt Holdings Company).

148. *See* Colt Def. Inc., Registration Statement (Form S-1), at 21, 84 (June 3, 2005) (reporting that Colt Defense paid $36.4 million in distributions between 2002 and 2004 and reporting fees paid to its equity sponsor pursuant to a management agreement); Colt Defense LLC (Form S-4, Amendment No. 2), at 79, F-25 (Mar. 21, 2011) (reporting that Colt Defense paid $166 million in distributions between 2007 and 2010 and describing a "financial advisory agreement" with its equity sponsor); Colt Defense LLC, Annual Report (Form 10-K), at 63, 82 (Feb. 22, 2012); Colt Defense LLC, Annual Report (Form 10-K), at 90 (Mar. 25, 2013) (reporting that Colt Defense paid $21.2 million in distributions between 2010 and 2012); Colt Defense LLC, Annual Report (Form 10-K/A), at 39, 86-87 (Sept. 12, 2014) (noting a decrease in cash distribution to members from $12.9 million in 2011 to $3.3 million in 2012 and describing a "consulting agreement" with its equity sponsor). 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 Co., No. 15-11296-LSS (Bankr. D. Del. June 15, 2015) [hereinafter Maib Declaration].

the ability to keep up with its peers when it came to manufacturing automation and other research and development investments.

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.[149] The unsecured notes were then trading at a low price because of the market perception that Colt would have difficulty satisfying, among other obligations, an interest payment due on November 15.[150] 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.[151] The company did not immediately respond to the offer; instead, it refinanced its existing secured debt in a transaction that only gave it enough additional capital to make the November interest payment.[152]

Two months later, Colt exchanged its senior secured revolving line of credit with a $33 million term loan.[153] The new term loan did not increase Colt's liquidity and, by comparison to its prior borrowing arrangement, imposed higher capital costs and tightened covenants.[154] 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."[155] Colt's written reply was terse and, again, dismissive.[156]

On April 1, 2015, Colt filed a notice with the U.S. Securities and Exchange Commission (SEC) indicating that it would not be making its required securities filings on time. [157] The filing said that Colt is "unable to provide an expected date" for resuming SEC compliance.[158] And on April 14, 2015, Colt made an aggressive offer to its noteholders, offering to give them junior secured claims if

149. *See* Colt Defense LLC, Quarterly Report for Sept. 28, 2014 (Form 10-Q/A), at 23–45 (Dec. 2, 2014).

150. *See Colt Defense Bondholder Group Advised by Brown Rudnick, GLC, Awaits Numbers*, REORG-RESEARCH (Nov. 19, 2014), https://platform.beta.reorg-research.com/v3/#/items/intel/1934?item_id=7545/.

151. *See* Declaration of Abraham T. Han in Support of the Objection and Supplemental Objection of the Ad Hoc Consortium of Holders of 8.75 percent Colt Defense LLC and Colt Finance Corp LLC Senior Notes Due 2017 to the Debtors Motion for Interim DIP Loan Approval at Exhibit H, *In re* Colt Holding Co., No. 15-11296-LSS (Bankr. D. Del. June 19, 2015) [hereinafter Han Declaration].

152. *See* Supplemental Objection of Ad Hoc Consortium of Holders of Senior Notes to Debtors' DIP Motion ¶ 20, *In re* Colt Holding Co., No. 15-11296-LSS (Bankr. D. Del. June 19, 2015) [hereinafter Supplemental Objection to Colt's Debtors' DIP Motion]; Colt Defense LLC, Current Report (Form 8-K) (Nov. 17, 2014) (disclosing Colt Defense's entry into new $70 million senior secured term loan facility on November 17, 2014, days after receiving the letter from the noteholders).

153. *See* Colt Defense LLC, Current Report (Form 8-K) (Feb. 9, 2015) (describing Colt Defense's entry into a credit agreement with Cortland Capital Market Services).

154. *See id.*; Supplemental Objection to Colt's Debtors' DIP Motion, *supra* note 152, ¶ 23.

155. *See* Han Declaration, *supra* note 151, at Exhibit P.

156. *See* Supplemental Objection to Colt's Debtors' DIP Motion, *supra* note 152, ¶ 25.

157. In particular, Colt announced that it would not be timely filing its 2014 10-K statement. *See* Colt Defense LLC, Notification of Late Filing (Form 12b-25) (Apr. 1, 2015).

158. *See id.*

they would reduce the amount they were owed by 70 percent.[159] Notably, the firm's private equity owner was not offering to take any losses of its own under the proposal.[160] The offer also contained a disclosure intended to threaten the noteholders: the private equity sponsor also owned the building that housed Colt's only manufacturing facility; the private equity sponsor leased that facility to Colt; and the lease was about to expire.[161] The disclosure went on to say that Colt's equity sponsor had the power to deny lease renewal and cause great harm to the business, implying that the private equity owner could evict Colt if the exchange offer that would allow them to maintain their investment failed.[162] Notwithstanding the eviction threat, the exchange offer was soundly rejected by the noteholders.[163]

The noteholders then made a counteroffer that would give Colt new cash, but at a price: the equity sponsor would have to give up its ownership of the company.[164] The proposal was rejected out of hand.[165] When asked if the company would support *any* plan that transferred ownership from the equity sponsor to noteholders, one company representative allegedly responded: "Hell no!"[166] The only alternative to the debt exchange was, as allegedly stated by the same representative, "litigat[ion]."[167]

On June 14, 2015, Colt filed for Chapter 11 relief in Delaware.[168] The bankruptcy filing kicked off intense litigation, as noteholders successfully fought the equity sponsor's attempt to remain in control of the firm.[169] In the end,

159. The offer contained other problematic terms. Under the exchange offer, old notes would be exchanged for new "third-lien" secured notes reflecting a 70 percent 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, *supra* note 152, ¶ 28; Colt Defense LLC, *supra* note 158, at Exhibit T3E.1.

160. *See* Colt Defense LLC, *supra* note 157, at Exhibit T3E.1.

161. *See* Supplemental Objection to Colt's Debtors' DIP Motion, *supra* note 152, at 45.

162. *Id.* at 45–46.

163. *See* Maib Declaration, *supra* note 148, ¶ 22 (stating that the noteholders informed the Company that "there was absolutely no interest in the Company's Prepackaged Plan").

164. 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* Han Declaration, *supra* note 151, Exhibit R.

165. *See id.* ¶ 41.

166. *See id.* ¶ 43.

167. *See id.* ¶ 41.

168. *See* Chapter 11 Voluntary Petition, *In re* Colt Holding Co., No. 15-11296-LSS (Bankr. D. Del. June 14, 2015).

169. The equity sponsor's scheme proceeded in two parts. With its bankruptcy petition, Colt filed a motion for approval of an accelerated Section 363 sale process, with the equity sponsor as the proposed "Stalking Horse" bidder. *See* Debtors' Motion, Pursuant to 11 U.S.C. §§ 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,

noteholders were forced to cede about 20 percent of the firm's post-bankruptcy equity to the pre-bankruptcy equity sponsor, given its ownership of Colt's factory, but they otherwise became the owners of the firm.[170]

In certain respects, the restructuring outcome was consistent with what one might have expected. The firm entered Chapter 11 and exited with less debt and owned by its pre-bankruptcy creditors. But management's attempts to save the equity sponsor's investment meant that the outcome came at a tremendous cost: the firm's financial condition deteriorated significantly because management insisted on delaying the restructuring to provide the equity sponsor 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 covering 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.[171] Colt never received the financing needed for long overdue R&D and automation, and left bankruptcy without improving its competitive position.[172] While contract law can do many things for creditors, it cannot protect against a management team determined to stall and delay bankruptcy and a bona fide restructuring to the point that the firm itself is damaged.

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

Bankruptcy law is often cited as a body of law that protects creditors.[173] But bankruptcy law has multiple policy goals, some of which, especially

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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 Substantially All of the Debtors' Assets ¶ 13, *In re Colt Holding Co.*, No. 15-11296-LSS. Second, Colt filed a motion seeking to approve a debtor-in-possession financing from its pre-petition first lien lender, which required the firm to close on the Section 363 sale within 60 days. *See* Motion to Approve Debtor In Possession Financing, *In re Colt Holding Co.*, No. 15-11296-LSS.

170. 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 the equity sponsor (supplying $5 million); (4) the lease on the manufacturing facility was extended; and (5) equity was divided between noteholders (83.25 percent) and the equity sponsor (16.75 percent). *See* 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.*, No. 15-11296-LSS.

171. *See* Omnibus Order Awarding Final Allowance of Compensation for Services Rendered and for Reimbursement of Expenses at Exhibit A, *In re Colt Holding Co.*, No. 15-11296-LSS.

172. One of the peculiar aspects of this story is that Colt's board was not dominated by self-interested employees of the equity sponsor and close affiliates. In fact, the board majority was comprised of two military generals, two union representatives, and a retired restructuring lawyer *See* Maib Declaration, *supra* note 148, ¶ 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 the equity sponsor while denying the noteholders the benefit of their bargain.

173. *See generally In re* Schwartz-Tallard, 803 F.3d 1095, 1100 (9th Cir. 2015) (noting that bankruptcy law protects the interests of creditors as a whole).

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 such as, in that case, a potentially rigged auction process. 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*

General Growth Properties (GGP), one of the largest owners and operators of shopping centers in the country, historically financed its commercial real estate at the project level, borrowing for each venture against the particular assets being developed.[174] Such loans generally had terms of three to seven years, thus the company's "business plan was based on the premise it would be able to refinance the debt" whenever circumstances required.[175]

To this end, 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 the conglomerate.[176] To simplify things, the typical "bankruptcy-remote" structure was as follows. A wholly-owned GGP subsidiary entity owned specific real estate assets, financed with loans. A representative example was Stonestown Shopping Center L.P., which owned a mall in San Francisco, CA.[177] 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.[178] Importantly, each subsidiary board had to consist of a majority of "independent managers" who

174. *See In re* Gen. Growth Props., 409 B.R. 43, 53–54 (Bankr. S.D.N.Y. 2009).

175. *See id.* at 53.

176. *See* Motion of ING Clarion Capital Loan Services LLC, Pursuant to 11 U.S.C. § 1112(b) to Dismiss the Cases of Bakersfield Mall LLC; Rasccap Realty, Ltd.; Visalia Mall, L.P.; GGP-Tucson Mall L.L.C; Lancaster Trust; Ho Retail Properties II Limited Partnership; RS Properties Inc.; Stonestown Shopping Center L.P.; and Fashion Place, LLC at 2, 9, *In re* Gen. Growth Props., 409 B.R. 43 (No. 09-11977-alg) [hereinafter ING Clarion Motion].

177. *See id.* at 9.

178. *See id.* at 1.

essentially represented the lender's interests.[179] 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.[180] The lender sought this protection to avoid being delayed for repayment or having its rights prejudiced as assets were diverted to fund affiliate bankruptcies.[181]

In the wake of the financial crisis, GGP was unable to refinance its debt and the firm's financial distress worsened.[182] The management team's reaction was unprecedented. They took steps to unwind the "asset isolation" structure, force each subsidiary to file for bankruptcy, and thereby keep the conglomerate together—and the company's senior managers in their jobs.[183] The steps taken were dramatic. At approximately 2:00 a.m. on April 16, 2009, GGP's managers fired the independent directors at each subsidiary via email and, once control was fully established, initiated the collective bankruptcy proceedings.[184] The bankruptcy filings and the violation of the "asset isolation" structure immediately roiled the credit markets.[185]

GGP's various project lenders now found themselves in exactly the situation they had contractually sought to avoid.[186] They asked the bankruptcy court to dismiss the subsidiary bankruptcy petitions as bad faith filings.[187] They also alleged that management's actions had violated their particular obligor

179. *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 6–7, *In re Gen. Growth Props.*, 409 B.R. 43 (No. 09-11977-alg) [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).

180. *See id.* at 7 (noting a typical operating agreement (the equivalent to the corporate charter) had a provision requiring the independent 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 unenforceability of a contract that directly restricts a corporation's ability to file for bankruptcy).

181. *See id.* at 15.

182. *See In re Gen. Growth Props.*, 409 B.R. at 53 (describing how the 2008 crisis in commercial mortgage-backed securities markets impaired the company's ability to refinance its debt). 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.

183. *See* ING Clarion Motion, *supra* note 176, at 2–3.

184. *See id.*

185. General Growth Properties, Inc. *Decision Notes Weaknesses of Securitization Special Purpose Entities*, O'MELVENY & 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/ [https://perma.cc/YY4X-WWFK] ("This decision should serve as a cautionary tale for those involved in structuring SPE and CMBS transactions.").

186. *Id.* (explaining that "the debtors subject to the motions to dismiss were structured to be SPEs so that project-level entities would be bankruptcy-remote," but "[t]he SPE structures failed to keep the project-level entities out of bankruptcy").

187. *In re Gen. Growth Props.*, 409 B.R. at 47 ("The primary ground on which dismissal is sought is that the Subject Debtors' cases were filed in bad faith.").

firm's fiduciary duties.[188] The bankruptcy judge recognized that the "asset isolation" structure had been set up to "create impediments to a bankruptcy filing."[189] 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.[190] 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.[191]

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 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, a hospitable forum for debtors, and the process intends to follow management's lead, at least at inception. Generally speaking, in this tug of war, the individual creditor bargain does not have equal footing with the debtor's larger restructuring goals.

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

The bankruptcy of American Safety Razor LLC (ASR) 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 to profit at the expense of creditors: the need to exit bankruptcy

188. *See id.* at 63 (noting that the Operating Agreements of the project lenders provide that Independent Managers owe a "fiduciary duty of loyalty and care" when performing their duties under the agreement).

189. *See id.* at 63–64.

190. *Id.* at 64 (finding that Delaware law "provides that the directors of a solvent corporation are authorized—indeed, required—to consider the interests of the shareholders in exercising their fiduciary duties" and finding that the managers did not breach their fiduciary duties by "voting to file based on the interests of the Group").

191. *Id.* at 68.

immediately to avoid the firm's value melting away, an immediate auction required for financing, and manipulation of said auction.

ASR was in the business of manufacturing disposable wet-shave razors for personal consumption.[192] ASR was a major player in the "private label" razor business, manufacturing razors that stores would sell under their own brand.[193] 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.[194] However, in late 2009, ASR learned that its largest customer would be discontinuing the business relationship, thereby throwing the firm into turmoil and triggering defaults under the firm's first and second lien debt contracts.[195]

The firm soon entered pre-bankruptcy negotiations with ad hoc committees of first and second lien lenders.[196] 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.[197] Shortly thereafter, Goldman Sachs issued a letter stating that it was "highly confident" that it could arrange and syndicate "$300 million" in new debt capital for the company, which would be more than enough to repay the first lien lenders, leaving the second lien lenders as the firm's new owners.[198] Nevertheless, the letter warned that, in order to realize this expectation, Goldman Sachs would require "reasonable time to market the Financing with the assistance of management of the Company."[199] Instead, a few weeks later—while the refinancing process was still underway—ASR filed for Chapter 11 relief in Delaware.[200]

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

192. *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., No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter First Day Affidavit].

193. *See id*. at 6 (noting that ASR products are "primarily sold under a retailer's store brand").

194. *See id.* at 9.

195. *See id.* at 11.

196. *See id.* at 14–15.

197. *See id.* at 16–17.

198. Energizer Holdings, Inc.'s Objection to Second Lien Lenders' Application for Allowance of an Administrative Claim at Exhibit A ¶ 8, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. June 23, 2011) [hereinafter Energizer's Objection].

199. *Id.*

200. *See* Objection of Blackrock Kelso Capital Corp. and GSO/Blackstone Debt Funds Management LLC, as Collateral Manager, to Debtors' Motions for Orders Approving: (1) Proposed Post-Petition Financing, and (2) Terms of the Debtors' Retention of Lazard Middle Market LLC at 4, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. June 23, 2011).

process.[201] The auction used a framework in which the first lien lenders were the stalking horse bidders with 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 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.[202]

In considering the motion, the bankruptcy judge confronted a decision environment where the debtor had decisively tilted in their favor.[203] She found herself confronted by a management team that claimed that the sale was needed to preserve the company's approximately 1,700 employees.[204] Time was 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.[205] 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.[206] If the judge forced management to explore alternatives, she might put 1,700 people[207] out of jobs in the midst of the most difficult job market in decades.[208] 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.[209]

201. *See* Debtors' Motion Pursuant to Sections 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.*, No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter ASR Debtors' Sale Motion].

202. *See id.* at 10–11; *id.* at Exhibit B, Part 2 § 7.16 (providing twelve-month employment guarantees to existing employees along with "substantially comparable bonuses"); *see also* Transcript of Proceedings from September 28, 2010 at 139:5–14:4, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. Oct. 1, 2010) (noting Energizer bid expressly carves out similar employment protections and Energizer marked up the first lien lenders' purchase agreement to reserve right to terminate employees).

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

204. *See generally* ASR First Day Affidavit, *supra* note 192 (emphasizing the need to leave bankruptcy quickly to keep the firm from collapsing during its key selling seasons).

205. *See id.* at 18.

206. *See generally id.* (emphasizing that time is of essence).

207. *See id.* at 8.

208. *See* ASR DIP Motion, *supra* note 203.

209. Transcript of Proceedings from 9/30/2010 at 94–95, *In re* Am. Safety Razor Co., No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter ASR 9/30 Transcript].

Management then set about designing an auction process that gave them full control over the process. Every bidder was required to sign a confidentiality agreement in order to bid, which gave the company the ability to hide the identity of bidders as well as terms offered.[210] A month after bidding had begun, a news service suddenly reported that Energizer Holdings, Inc. (Energizer) had extended a $300 to $325 million cash bid for the company as part of the bankruptcy auction process.[211] 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.[212] But, to ASR, this was not news at all: ASR had rejected Energizer's bid out of hand.[213] ASR would later argue in court that its decision was justified because Energizer's bid was fraught with antitrust risk, an important reason to prefer the first lien lenders' otherwise lower credit bid.[214] 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 ASR's understanding that Energizer, which intended to merge ASR into its Schick subsidiary, simply would not want ASR's historical management team.[215]

The second lien lenders promptly filed an aggressive objection to the sale motion, ignoring any restraints under the intercreditor agreement and commencing fierce litigation.[216] Management responded with charges of bad faith and tried to stop both the second lien lenders and Energizer from appearing in bankruptcy court, threatening to seek damages from the second lien lenders for breach of their intercreditor agreement and Energizer for breach of the non-disclosure agreement.[217] 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, that there was no meaningful antitrust risk, and, more to the point, that management was abusing its position of control.[218] The court found that ASR had, in fact, acted inappropriately by ejecting Energizer from the bidding

210. *See* Transcript of Proceedings from 9/29/2010 at 77–86, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. Oct. 5, 2010) [hereinafter ASR 9/29 Transcript].

211. *See* Energizer's Objection, *supra* note 198, at Exhibit A ¶ 19.

212. *See id.*

213. *See id.* at Exhibit A ¶ 20.

214. *See* ASR 9/29 Transcript, *supra* note 210, at 18–20.

215. *See* ASR 9/30 Transcript, *supra* note 209, at 18.

216. *See* Objection of the Second-Lien Lenders to the Debtors' Sale Motion, and Emergency Cross-Motion Requesting: (I) Authority to Commence an Investigation of the Debtors' Auction Process Pursuant to Bankruptcy Rule 2004; (II) Appointment of an Examiner; and/or (III) Appointment of a Chapter II Trustee at 1, *In re* Am. Safety Razor Co., No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter Objection to ASR's Sales Motion].

217. *See* ASR 9/30 Transcript, *supra* note 209, at 25, 50.

218. *See* 9/29 Transcript, *supra* note 210, at 74–92.

process and, as a remedy, continued the sale hearing for eight days to afford Energizer the opportunity to finalize its offer for the company.[219]

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 percent cash distribution—for the second lien lenders.[220] Remarkably, ASR and the first lien lenders continued their strenuous opposition to the Energizer bid, which the bankruptcy court overruled.[221] Energizer's "hostile" bid closed a few weeks later, no antitrust problems materialized, and members of management were terminated soon thereafter.[222]

This 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; rather, it is 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 other potential bidders spurned by the process might have been willing to pay more,[223] and the significant fees charged by ASR's lawyers were ultimately borne by the second lien lenders.

3. *Lyondell: How Debtors and Lenders Can Take Advantage of Rules of Bankruptcy Law to Neuter Fraudulent Transfer Claims*

In addition to contract and bankruptcy law, the *Gheewalla* court also cited fraudulent transfer law as rendering equitable protections for creditors unnecessary. Fraudulent transfer law provides creditors a cause of action when

219. *See* 9/30 Transcript, *supra* note 209, at 37–41.

220. *See generally* Notice of Filing of Energizer Holdings, Inc's Revised Bid at Exhibit A, B, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. July 28, 2010).

221. 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/ [https://perma.cc/2E3P-MRPQ].

222. *See id.*

223. 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 Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. July 28, 2010).

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.[224] 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 (DIP) can control all property of the estate, including fraudulent transfer claims.[225] 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.[226]

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 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 some 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 AF S.C.A. acquired Lyondell AF S.C.A. (Lyondell) in a textbook leveraged buyout (LBO) funded with $21 billion in new secured borrowings from a group of investors (the LBO Lenders)

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224. 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 July 2018 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]." *See* Peg Brickley, *Judge Pushes Settlement Talks in Tribune LBO Court Fight*, WALL STREET J. (Jul. 10, 2018), https://www.wsj.com/articles/judge-pushes-settlement-talks-in-tribune-lbo-court-fight-1531257092/ [https://perma.cc/JZ5A-HCTY]. If a "classic of the genre" is alive eight and a half years (and counting) and still nowhere near the end, it hardly can be seen as a reliable buttress for the creditor's bargain.

225. *See* Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 572 (3d Cir. 2003) (discussing the need to allow creditors to bring the fraudulent transfer claims that otherwise are controlled by the Chapter 11 debtor as derivative actions).

226. *See In re* Adelphia Commc'ns Corp., 368 B.R. 140, 271–72 (Bankr. S.D.N.Y. 2007).

heaped on top of the firm's already extant $3.1 billion in unsecured debt.[227] The combined firm competed in a cyclical, investment-heavy petrochemical industry, and the heavy debt burden left the firm vulnerable to weakening in its core business.[228] Merely twelve weeks after closing the transaction, Lyondell began to run out of cash.[229] 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 billion in secured debt owed to LBO Lenders.[230] Given that the LBO cash went to the historical shareholders, but the debtors remained liable on transaction-related secured debt, the LBO transaction thus had the effect of stripping Lyondell of substantial value.[231]

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.[232] LBO 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.[233] Lyondell, like most firms in the modern era of secured credit,[234] arrived in bankruptcy with liens fully encumbering all of its assets—in this case, the liens of the lenders that funded the LBO. In practice, lenders seldom agree to fund reorganizations without obtaining a priming lien,[235] which generally requires the consent of the existing

227. *See In re* Lyondell Chem. Co., 503 B.R. 348, 353 (Bankr. S.D.N.Y. 2014), *as corrected* (Jan. 16, 2014), *abrogated by In re* Tribune Co. Fraudulent Conveyance Litig., 818 F.3d 98 (2d Cir. 2016).

228. *See* Complaint at 3, *In re Lyondell Chem. Co.*, 503 B.R. 348 (No. 09-10023).

229. *See* Corrected 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.*, 503 B.R. 348 (No. 09-10023) [hereinafter *Lyondell* UCC Settlement Objection].

230. *See In re Lyondell Chem. Co.*, 503 B.R. at 353 (describing pre-LBO debt).

231. *See* Weisfelner v. Blavatnik, 543 B.R. 428, 433 (Bankr. S.D.N.Y. 2016).

232. *See In re Lyondell Chem. Co.*, 503 B.R. at 355 (describing pre-LBO debt).

233. *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.*, 503 B.R. 348 (No. 09-10023) [hereinafter *Lyondell* DIP Motion].

234. *See* Barry E. Adler et al., *Value Destruction in the New Era of Chapter 11*, 29 J. L. ECON. & ORG. 461, 462 (2012).

235. A priming lien is a lien that is senior to all existing liens. In practice, the lenders who make DIP Loans want to protect their investment with a priming lien and in practice that often requires the consent of the existing lienholder (typically, a bank) as the existing lienholder can litigate to block the loan, which can scare off other lenders. For a general discussion of DIP lending that elaborates on this framework, see George G. Triantis, *Debtor-in-Possession Financing*, *in* RESEARCH HANDBOOK ON CORPORATE BANKRUPTCY LAW (Barry E. Adler ed., forthcoming June 2020).

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.[236]

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."[237] The lenders grew their influence through attaching seven conditions to the DIP financing. First, they limited the Official Committee of Unsecured Creditors' (the "Official Committee") 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 that committee about four months to investigate the facts surrounding the LBO.[238] 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 historic financial dislocation.[239] 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.[240] Sixth, the debtors agreed to pay the litigation costs of the bank defendants in any fraudulent transfer action.[241] Seventh, the debtor agreed to waive their right to prosecute the fraudulent transfer actions on behalf of the estate, leaving the official committee to do so with a very limited budget.[242]

Combined, these provisions of the DIP order dramatically weakened the ability of pre-LBO unsecured creditors to prosecute fraudulent transfer claims. The bankruptcy code expects the Official Committee to prosecute these actions on their behalf, but the Official Committee would have almost no time to marshal evidence for 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 LBO 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 find, among other things, that: (1) the proposed financing is an exercise of sound business judgment; (2) the

236. *See, e.g.*, B. Espen Eckbo et al., *Rent Extraction by Super-Priority Lenders* at Table 3 (Tuck Sch. of Bus., Working Paper No. 3384389, 2019) (showing that 70 percent of DIP loans are from pre-petition lenders in a sample of Chapter 11 debtors that filed for bankruptcy between 2002 and 2014).

237. *See Lyondell* UCC Settlement Objection, *supra* note 229, at 7.

238. *See id.* at 10–11.

239. *See id.* at 7.

240. *See id.* at 7–8.

241. *See id.* at 8.

242. *See id.*

financing is in the best interests of the estate and its creditors; (3) the financing is necessary to preserve the estate's assets; (4) the loan's terms were fair; and (5) the financing was negotiated in good faith.[243] 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 DIP financing.[244] After all, management represented to the court that the failure to approve the financing "would likely result in liquidation, severe employee dislocation and crippling losses for vendors and customers."[245] 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.[246] 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 gave the debtor's management team the power to settle the claim without the input of the Official Committee.[247] 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 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.[248] 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 email, 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."[249]

243. *See In re* Roeben, 294 B.R. 840, 845 (Bankr. E.D. Ark. 2003).

244. *See* Transcript of the Motion for Entry of an Order Authorizing the Debtors to Enter into the 8th Amendment to their Debtor-in-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., 457 B.R. 254 (Bankr. S.D.N.Y. 2011) (No. 10-15446).

245. *See Lyondell* DIP Motion, *supra* note 233, at 6.

246. *See Lyondell* UCC Settlement Objection, *supra* note 229, at 24.

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

248. *See Lyondell* UCC Settlement Objection, *supra* note 229, at 25.

249. *See id.*

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 prosecute any fraudulent transfer claims by any plan of reorganization they were funding, which meant the claims had to be settled for the firm to leave bankruptcy.[250] As the Official Committee's lawyers built their case for trial, management's lawyers monitored all depositions but refused to meet with the Official Committee's lawyers to understand their view of the strength of the claims.[251]

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 unsecured creditors a fraction of the $3.2 billion they were owed.[252] Notably, the debtors never asserted that they settled the claims for "as much as possible,"[253] but rather that the settlement would "permit the reorganization to proceed" while "ensuring the unsecured creditors a very fair recovery."[254] They accused the unsecured creditors, who strenuously opposed the settlement, of "gambling with the future of LyondellBassell and nearly 16,000 jobs as well."[255] 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."[256]

Because of the permissive common law tests whose key is "reasonableness" of the debtor's proposal to settle claims in bankruptcy, 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.[257] 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.[258] 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."[259] Under the pressure of the debtors' settlement motion, the

250. *See id.* at 27.
251. *See id.* at 29.
252. *See id.* at 26, 70–71.
253. *See id.* at 61.
254. 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., 503 B.R. 348 (Bankr. S.D.N.Y. 2014) (No. 09-10023) [hereinafter *Lyondell* Debtors' Memo].
255. *See id.* at 2.
256. *See Lyondell* UCC Settlement Objection, *supra* note 229, at 63.
257. *In re* Adelphia Commc'ns Corp., 327 B.R. 143, 165 (Bankr. S.D.N.Y. 2005).
258. *See Lyondell* Debtors' Memo, *supra* note 254, at 53.
259. *See id.* at 60–61.

committee settled the claims for an additional $150 million, agreeing to release the LBO lenders from any additional liability.[260]

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. Lyondell engaged in a risky leveraged buyout 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, the committee members 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 percent of what they might have obtained had they won in court.

IV.
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 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 because 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. 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 not require significant legislation or major shifts in the law. They would simply have judges view managers of distressed firms with a practiced skepticism, recognizing that control opportunism might influence whatever it is management is trying to do.

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

260. *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 at 8, *In re* Lyondell Chemical Co., 503 B.R. 348 (Bankr. S.D.N.Y. 2014) (No. 09-10023).

duty in the first instance to the firm, not to shareholders directly.[261] For an example of how this could work, consider the lawsuit filed by Cumulus' Term Lenders. They sued asserting contract claims to block what they saw as a misuse of the revolving loan provision in 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 claims and the applicability of the business judgment rule.[262] Did Forest Oil's board really think that the reconstituted merger with Sabine, heaping on all that legacy Sabine secured debt, 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 benefits 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 fiduciary duty analysis in bankruptcy courts, Forest Oil offers an illustrative example.[263] The court summarily dismissed the fiduciary claims as being inconsistent with the law after *Gheewalla* and *Quadrant*. But what if the court had instead believed that the management re-engineered the deal to purportedly evade the change of control covenant? Surely, this kind of conduct should, and could, raise judicial eyebrows. The judicial tendency, since *Gheewalla*, has been encouraging to debtors intending 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 be forced to justify their conduct under a judiciary inquiry with more bite. While a more aggressive application of the business judgment rule would not eliminate control opportunism, 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. While some of this reflects the state of affairs in the judiciary generally, courts should be mindful of litigation duration in scheduling hearings and ruling on fraudulent transfer motions. The slow-moving trains of justice have broader consequences than denying justice to a particular plaintiff. It emboldens the

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261. *See* Quadrant Structured Prods. v. Vertin, 115 A.3d 535, 547 (Del. Ch. 2015). 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 both shareholders and the corporation," which incorrectly suggests that the interests of the corporation and the shareholders never conflict. *Id.* at 493.

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

263. *See In re* Sabine Oil & Gas Corp., 547 B.R. 503 (Bankr. S.D.N.Y. 2016).

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 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.[264] There is no reason to think that DIP financing would really dry up if bankruptcy judges announced they would not allow DIP 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 action, for example, the court should be loath to allow management the right 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 technical aspects of fraudulent transfer law—such as the "collapsing doctrine"—should be applied in a more plaintiff-friendly way.[265] Courts should also be skeptical of efforts to inoculate leveraged buyouts from challenges, such as round-trip transactions, that lack economic substance. To be sure, nothing we have described are major reforms, but they could create a significantly different boardroom decision-making environment for distressed firms.

CONCLUSION

In this Article, we argued that the common law's journey away from creditor protection was driven by the mistaken belief that creditors could protect themselves using contract and bankruptcy law. As the case studies above show, opportunistic managers are difficult to restrain with contracts even when the risk

264. 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) (pointing out the problems with expedited sales of assets in bankruptcy proceedings).

265. The collapsing doctrine is a common law analysis that allows a court to view several transactions as an integrated whole, which can expand the range of avoidable transactions in the common situation where a leveraged transaction has several steps and the firm only become insolvent by some measures at the last step. By "collapsing" the several steps into one, the entire transaction can be avoided as a fraudulent transfer. *See In re* Route 70 & Massachusetts, L.L.C., No. 09-14771(RG), 2011 WL 1883856, at *1 (Bankr. D.N.J. May 17, 2011).

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 contractual language. Moreover, bankruptcy judges consider many policy goals, outside of creditor protection—like preserving firm value and maximizing employment—and these other goals often win when they compete with a creditor's argument that management committed some pre-bankruptcy harm to creditors.

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