
ARTICLE

FINANCIAL DISEQUILIBRIUM

SAMIR D. PARIKH[†]

Corporate bankruptcy cases have recently undergone a shift. After decades where creditors exercised outsized control, private equity sponsors have now ascended the throne. This new group exploits contractual loopholes and employs coercive tactics to initiate creditor-on-creditor violence. The result is the ability to dictate outcomes in distress situations where equity sponsors would normally be idle passengers. The unwritten rules have been rewritten.

This new disequilibrium has the potential to fundamentally harm the financial ecosystem. Scholars have successfully chronicled the new tactics but formulating the means to mitigate market distortion has been elusive. Most scholars have appealed to the judiciary to intervene. Unfortunately, the judiciary has rejected this call, arguing that sophisticated parties should address coercion through contracts. What if that is not possible? An efficient public debt market relies on some sort of check on outright exploitation. The inability to manage bad actors renders these markets more volatile and amplifies contagion risk for national and global economies. Further, coercive measures allow a company that should have sought bankruptcy protection or some other substantive restructuring to artificially limp along. There is a significant risk that this iniquity destroys value and leaves little left to salvage by the time the company actually lands in bankruptcy.

[†] Professor of Law, Lewis & Clark Law School. For helpful comments and conversations, I am grateful to Ken Ayotte, Douglas Baird, Bruce Bennett, Vince Buccola, Elisabeth de Fontenay, Brook Gotberg, Sujeet Indap, Dan Kamensky, Ken Liang, Peter Marchetti, Doug Moll, Robert Rasmussen, Axel Sarkissian, Aaron Simowitz, Hon. Leo Strine, and Katherine Waldo. I thank my family for their unwavering support. I also want to thank the members of the *University of Pennsylvania Law Review* for their helpful comments and corrections.

This Article argues that a significant movement towards equilibrium is attainable by adjusting two aspects of this ecosystem. Primarily, Delaware courts have limited creditors to derivative breach-of-fiduciary-duty actions, even when a corporation is insolvent, and directors are actively attacking certain stakeholders. Delaware case law protects the mechanism by which equity sponsors implement coercion. I argue that when a corporation is insolvent, directors and officers who undertake hostile actions against specific creditors to whom they owe fiduciary duties should be subject to direct claims by those creditors. Unable to act with impunity, directors would be forced to properly consider all key stakeholders in formulating rehabilitation measures. Further, I advocate for the amendment of section 546(e) of the Bankruptcy Code to exclude leveraged buyouts from the fraudulent transfer safe harbor. My proposal aligns the section with its historical underpinnings and acts as a natural check on debt levels in overly aggressive acquisitions. This proposal reduces the need for coercive restructuring measures when a corporation experiences financial distress.

INTRODUCTION	1927
I. THE LEVERAGED LOAN LANDSCAPE	1932
A. <i>Leveraged Buyouts and Fraudulent Transfers</i>	1932
B. <i>The Genesis of Section 546(e)</i>	1934
C. <i>Section 546(e)'s Muddied Waters</i>	1936
D. <i>The Merit Ruling and Shifting Loopholes</i>	1938
1. <i>The Bankruptcy Problem</i>	1940
II. THE NEW ALPHA: SHIFTING FROM LENDER CONTROL TO SPONSOR CONTROL	1941
A. <i>Sponsor-Favorable Terms</i>	1943
B. <i>Incomplete Contracting by Design</i>	1944
III. CANNIBALISTIC ASSAULTS	1948
A. <i>New Weapons in the Borrower Arsenal</i>	1948
1. <i>iHeart (2015)</i>	1949
2. <i>J.Crew (2017)</i>	1951
3. <i>PetSmart/Chewy.com (2018)</i>	1954
B. <i>Sponsor Innovation Accelerates</i>	1956
1. <i>TriMark (2021)</i>	1957
2. <i>Envision Healthcare (2022)</i>	1959
IV. A MOVE TOWARDS EQUILIBRIUM	1961
A. <i>The Moment of Distress: Direct Claims Against Directors</i>	1962
1. <i>A Marked Display of Animus</i>	1963
2. <i>Incora Provides the Factual Pattern Judge Strine Hypothesized</i>	1965
3. <i>A New Standard</i>	1966

B. <i>The Moment of Acquisition: Reconceptualizing Section 546(e)'s Safe Harbor</i>	1968
1. The Judicial and Legislative Response	1969
2. Aligning Language with Objective	1972
CONCLUSION.....	1973

“Well, it’s no trick to make a lot of money . . . if all you want is to make a lot of money.”

—Herman J. Mankiewicz & Orson Welles, *Citizen Kane*

INTRODUCTION

In 2020, a group of secured lenders approached TriMark’s CFO, Chad Brooks, with a plan to save the moribund company.¹ The pandemic had eviscerated the company’s restaurant supply business and raised the specter of bankruptcy.² In these situations, distressed borrowers customarily work with secured lenders and noteholders to secure additional liquidity that can provide a bridge to more prosperous times. Brooks, however, dismissed the lenders’ overtures and reassured stakeholders that the company had “plenty of liquidity.”³ But this was not true. Without a dramatic realignment, TriMark was destined for bankruptcy. Luckily, one was already underway.

While Brooks was distracting creditors, a group of secured lenders holding a majority of TriMark’s debt (the “TriMark Majority Lenders” or the “majority lenders”) was finalizing a series of shadowed transactions to seize value from TriMark’s other lenders (the “TriMark Minority Lenders” or the “minority lenders”) and redistribute that value to themselves and the borrower.⁴ The ultimate design was an unprecedented cannibalistic assault within the growing trend of creditor-on-creditor violence. The first step involved the TriMark Majority Lenders voting to alter fundamental provisions in the original credit agreement.⁵ TriMark was then able to issue new “first out” debt of \$120 million to the TriMark Majority Lenders secured by the collateral that secured TriMark’s original first-lien debt.⁶ At the second

¹ See Plaintiffs’ Consolidated Opposition to Defendants’ Motions to Dismiss at 7, *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.*, No. 565123/2020, 2021 WL 3671541 (N.Y. Sup. Ct. Aug. 16, 2021).

² *See id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.* at 8.

⁶ *Id.*

step, TriMark issued new \$307.5 million “second out” debt to the majority lenders in a dollar-for-dollar exchange for the debt they originally held.⁷ The old debt was then retired, and the majority was no longer subject to the original loan’s terrible new terms. The plan was simple and merciless, equivalent to forcing an airplane into a death spiral before parachuting to safety. The minority lenders, who had been fully secured just months earlier, were suddenly left with little more than a promise to pay from a company that already had one foot in its financial grave.⁸

TriMark is emblematic of a dramatic shift in credit markets. Creditor-on-creditor violence was first evident at the end of the last decade⁹ but has since manifested escalating levels of aggression. The unwritten rules have been rewritten, and the precipitating factors are clear. The last twelve years have been characterized by miniscule interest rates and aggressive quantitative easing, fueling a fanatical demand for high-yield investments.¹⁰ Borrowers seized the opportunity to create debt instruments with few creditor safeguards and various trap doors and restructuring loopholes.¹¹ Private equity sponsors like Apollo and Ares have led this charge, and “provisions which are very common in agreements today can be used” to incite civil war

⁷ *Id.*

⁸ The TriMark Minority Lenders brought suit in New York state court, and TriMark sought to dismiss their claims. *See generally* Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., No. 565123/2020, 2021 WL 3671541 (N.Y. Sup. Ct. Aug. 16, 2021). Judge Cohen dismissed the plaintiffs’ fraudulent-transfer, tortious-interference, and good-faith-and-fair-dealing claims. *Id.* at *2. Judge Cohen refused to enforce the amended “no-action” clause and allowed the plaintiffs’ breach-of-contract claims to go forward, explaining that plaintiffs had plausibly argued that TriMark’s scheme had indirectly altered their “sacred rights” under the credit agreement and that those rights could only be modified with the unanimous consent of all lenders. *See id.* at *8-10.

⁹ *See* Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CAL. L. REV. 745, 748 (2020) (“[T]he norms restraining managers of distressed firms from declaring all-out war on creditors have been fading since the financial crisis.”).

¹⁰ Eliza Ronalds-Hannon & Rachel Butt, *Credit-Market Clashes Are Getting Uglier, Dirtier and More Common*, BLOOMBERG (May 10, 2022, 7:30 AM), <https://www.bloomberg.com/news/articles/2022-05-10/credit-market-clashes-are-getting-uglier-dirtier-more-common?leadSource=verify%20wall> [<https://perma.cc/6MZG-4BPE>].

¹¹ *See id.* (“To provide a company with money to work through a tough situation, you need to be rewarded The documents in some situations allow for that.”).

between creditors.¹² As interest rates rise and the economy slips into recession, greater financial distress is unavoidable.¹³

A confluence of the factors noted above is the spark necessary to ignite a financial powder keg.¹⁴ But why should policymakers and jurists intervene in these battles of titans? Conventional wisdom assumes that sophisticated parties are able to draft debt documents that compel fidelity to the essence of the bargain.¹⁵ Moreover, sophisticated parties can simply refuse to enter into deals where significant leverage asymmetries produce troublesome terms. And wronged parties can always rely on the courts to the extent contractual terms are breached.

Messages from the front lines, however, are causing a reevaluation of these assumptions.¹⁶ Debt documents attempt to establish boundaries for extremely complicated relationships. But these documents have never been able to address all material forms of gamesmanship and exploitation.¹⁷ Relational dynamics and market norms have historically policed the most egregious conduct in distress scenarios.¹⁸ In other words, the repeat-player model for

12 Lisa Lee & Sally Bakewell, *Oaktree Deal Crushed a Leveraged Loan and Exposed Market's Woes*, BLOOMBERG (Oct. 7, 2020, 6:00 AM), <https://www.bloomberg.com/news/articles/2020-10-07/oaktree-deal-crushed-a-leveraged-loan-and-exposed-market-s-woes#xj4y7vzkg> [https://perma.cc/H8CZ-43BR]; see also Jodi Xu Klein, *Pro Take: KKR Sets Off Investor Fight to Keep Envision Afloat*, WALL ST. J. (May 6, 2022, 6:30 AM), <https://www.wsj.com/articles/pro-take-kkr-sets-off-investor-fight-to-keep-envision-afloat-11651833001> [https://perma.cc/P956-KY9S] (“Many debt deals struck in recent years lack protections for investors, giving private-equity firms an avenue for more aggressive financing.”). In 2000, “covenant-lite” loans represented approximately 1% of the market; by 2021, more than 90% of loans received that label. See Abby Latour, *Covenant-Lite Deals Exceed 90% of Leveraged Loan Issuance, Setting New High*, S&P GLOB. MKT. INTEL. (Oct. 8, 2021), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/covenant-lite-deals-exceed-90-of-leveraged-loan-issuance-setting-new-high-66935148> [https://perma.cc/AM8G-MBUZ].

13 See Jonathan Levin, *The Junk Bond Reckoning Is Coming in 2023*, BLOOMBERG (Dec. 27, 2022, 10:02 AM), <https://www.bloomberg.com/opinion/articles/2022-12-27/the-junk-bond-reckoning-is-coming-in-2023#xj4y7vzkg> [https://perma.cc/6WLJ-UWCB] (“[A] Bloomberg survey of economists puts the probability of a 2023 recession at 70% . . .”).

14 See Sally Bakewell, *Apollo's Debt-Lawsuit Defeat to Reshape Wall Street Risk Models*, BLOOMBERG (July 9, 2020, 6:00 AM), <https://www.bloomberg.com/news/articles/2020-07-09/apollo-s-debt-lawsuit-defeat-to-reshape-wall-street-risk-models> [https://perma.cc/X6LZ-GQQG] (describing how yield-seeking investors have accepted weaker protections in lending agreements for years and that execution of these agreements is “merely the spark” lighting the “underlying powder keg” of flexible debt documents).

15 See Elisabeth de Fontenay, *Complete Contracts in Finance*, 2020 WIS. L. REV. 533, 546 (“[J]udges prefer contracts to be complete in the sense of ensuring that there are no gaps in coverage, [and] they tend to assume optimistically that sophisticated parties can draft them.”).

16 See, e.g., Daniel B. Kamensky, *The Rise of the Sponsor-in-Possession and Implications for Sponsor (Mis)behavior*, 171 U. PA L. REV. ONLINE (forthcoming 2023) (on file with author) (arguing that the balance of power typically assumed in bankruptcy should be reconsidered).

17 See generally de Fontenay, *supra* note 15.

18 See *id.* at 539.

these types of lending arrangements forced parties to eschew actions that would not be considered market behavior, even ones that were arguably allowed under the applicable contracts. The erosion of these relational dynamics, however, has opened up new forms of aggression.¹⁹

A typical response to the type of behavior seen in the TriMark case is that creditors should simply tighten contractual provisions to preclude this conduct, since courts would enforce such terms.²⁰ But, as we have seen, most core provisions can be amended by a mere majority. Well, the argument would proceed, the agreements should raise the voting threshold. But the new cannibalistic assaults involve companies issuing more debt in order to give the preferred group sufficient voting leverage. The final argument is that more rights should be recognized as “sacrosanct rights” that cannot be amended without unanimity. Unfortunately, this leaves borrowers with little flexibility to restructure in times of distress, a result where the cure is arguably worse than the disease.

Parties wronged by cannibalistic assaults have turned to the courts with mixed results. Courts view debt documents as sacrosanct and have indicated a tolerance for cannibalistic assaults on the premise that the conduct is not explicitly prohibited by the applicable contracts.²¹ The resulting dynamics create disequilibrium. To the extent the leveraged loan market offers retail products through mutual funds and other vehicles, public confidence is essential to the growth of these markets. A vibrant public market for debt securities relies on various measures to police exploitation.²² But public confidence is eviscerated if borrowers are allowed to target specific investors from whom to appropriate value and ostensibly pick winners and losers in

19 The Great Recession was a cataclysm that shifted financial markets and participant behaviors. New regulations, immense liquidity provided by central banks, and heightened caution throughout the lending industry coalesced to temporarily suppress leveraged lending by traditional financial institutions. The disengagement by the lending industry had limited effect. The leveraged buyout iteration seen today evolved by repopulating the lending base with non-banking financial institutions (NBFIs) immune to recent regulations. As explained by the Financial Stability Board’s December 2019 report, traditional lending institutions still play a prominent role in structuring and facilitating these acquisitions, but NBFIs have unprecedented prominence, introducing new actors, strategies, and shadowed practices. See FINANCIAL STABILITY BOARD, VULNERABILITIES ASSOCIATED WITH LEVERAGED LOANS AND COLLATERALISED LOAN OBLIGATIONS 1 (2019), <https://www.fsb.org/wp-content/uploads/P191219.pdf> [<https://perma.cc/VWY7-Y7H8>].

20 See, e.g., *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.*, No. 565123/2020, 2021 WL 3671541, at *9 (N.Y. Sup. Ct. Aug. 16, 2021) (explaining that where parties delineate their agreement in a clear, complete document, the court will enforce the terms as written).

21 See *infra* Part III. But see *ICG Glob. Loan Fund 1 DAC v. Boardriders, Inc.*, No. 655175/2020, 2022 WL 10085886, at *25 (N.Y. Sup. Ct. Oct. 17, 2022) (denying motion to dismiss despite aggressive uptiering transaction undertaken by borrower).

22 See FINANCIAL STABILITY BOARD, *supra* note 19, at 7-10 (explaining the vulnerabilities in the leveraged loans and CLO markets that can be exacerbated by the erosion of lender protections).

times of financial distress. I believe there is a public interest in minimizing cannibalistic assaults in order to bolster market integrity.

This idea of minimizing creditor-on-creditor violence may be salutary, but the means to do so have been difficult to formulate. This Article argues that a significant movement towards equilibrium is attainable by focusing on two dimensions of this ecosystem. Primarily, Delaware courts have limited creditors to derivative breach-of-fiduciary-duty actions, even when a corporation is insolvent and directors are actively attacking certain stakeholders.²³ Delaware case law protects the mechanism by which equity sponsors implement coercion. I argue that when a corporation is insolvent, directors who authorize hostile actions against specific creditors to whom they owe fiduciary duties—often in a futile attempt to avoid bankruptcy—should be subject to direct claims by those creditors. Unable to act with impunity, directors would be forced to properly consider all key stakeholders in formulating rehabilitation measures.

Further, misused legal safe harbors have allowed unchecked leveraged buyouts and stifling debt burdens.²⁴ The result is that in times of financial distress only the most audacious maneuvers can preserve value for equity holders. I advocate for amendment of section 546(e) of the Bankruptcy Code to exclude leveraged buyouts from the fraudulent transfer safe harbors. My proposal attempts to align the section with its historical underpinnings and offer a natural check on debt levels in leveraged buyouts. This proposal reduces the need for overly coercive restructuring measures when a corporation experiences financial distress.

This Article is divided into four parts. Part I describes the distressed-debt landscape and private equity's ascension. This part also unpacks leveraged buyouts and how these transactions have been insulated from fraudulent transfer law by improperly sheltering in a statutory safe harbor. The resultant environment encourages more aggressive debt layering, where target companies are often insolvent by the time the acquisition closes. Part II explains how excessive leverage forced private equity to demand "sponsor-favorable" terms in debt instruments for its portfolio companies to afford these borrowers flexibility when distress inevitably arose. Part III presents case studies capturing the rapidly escalating aggression in coercive maneuvers. Part IV provides various proposals that attempt to minimize the risk that cannibalistic assaults could destabilize credit markets.

²³ See, e.g., *N. Am. Cath. Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007) ("To date, the Court of Chancery has never recognized that a creditor has the right to assert a *direct* claim for breach of fiduciary duty against the directors of an *insolvent* corporation.").

²⁴ See generally *Deutsche Bank Tr. Co. Ams. v. Large Priv. Beneficial Owners (In re Trib. Co. Fraudulent Conv. Litig.) (Tribune II)*, 946 F.3d 66 (2d Cir. 2019) (explaining how misused safe harbors result in harmful LBOs).

Creditor-on-creditor violence is a relatively new phenomenon, but one that is proliferating rapidly as the United States moves into a recessionary period. The consequences are unclear but raise the specter that heightened aggression will render markets more volatile and potentially destabilized. This Article attempts to initiate a dialogue by proposing evolutionary approaches to improving outcomes in this brave new world.

I. THE LEVERAGED LOAN LANDSCAPE

A new order in the world of leveraged finance began to take shape in the aftermath of the Great Recession.²⁵ New regulations, immense liquidity provided by central banks, and heightened caution throughout the lending industry coalesced to temporarily suppress leveraged lending by traditional financial institutions.²⁶ The disengagement by the lending industry had limited effect. The leveraged buyout iteration seen over the last ten years evolved by repopulating the lending base with non-banking financial institutions (NBFIs)²⁷ immune to recent regulations.²⁸ As explained by the Financial Stability Board, traditional lending institutions still play a prominent role in structuring and facilitating lending, but NBFIs have unprecedented prominence—introducing new actors, strategies, and shadowed practices.²⁹

A. Leveraged Buyouts and Fraudulent Transfers

The story starts with private equity's acquisition model. A leveraged buyout is an acquisition financed with significant debt secured by the assets

²⁵ See FINANCIAL STABILITY BOARD, *supra* note 19, at 7-8 (describing vulnerabilities in the leveraged loans and CLO market following the Great Recession).

²⁶ See Himani Singh, *Evolution of Leveraged Buyouts: A New Era or Back to Square One?*, N.Y.U. J.L. & BUS. ONLINE (Jan. 18, 2020), <https://www.nyuylb.org/single-post/2020/01/18/evolving-of-leveraged-buyouts-a-new-era-or-back-to-square-one> [<https://perma.cc/68BY-MRA7>] (explaining that the traditional lending institutions “lent cautiously” after Federal banking regulators issued the Interagency Guidelines on Leveraged Lending in March 2013).

²⁷ NBFIs include investment funds, insurance companies, pension funds, and holding companies.

²⁸ See Singh, *supra* note 26 (“[T]he unregulated non-banks . . . were not covered under the Guidelines . . .”).

²⁹ See FINANCIAL STABILITY BOARD, *supra* note 19, at 1-2 (discussing the substantial exposure of non-bank investors to leveraged loan and CLO markets); see also Lisa Lee, *As Wall Street Chokes on Bad Buyout Loans, Rivals Seize Opening*, BLOOMBERG (Feb. 27, 2023, 1:00 AM), <https://www.bloomberg.com/news/articles/2023-02-27/as-wall-street-chokes-on-bad-buyout-loans-rivals-seize-opening> [<https://perma.cc/QYB6-ZH8M>] (discussing non-bank investors' novel strategies in the LBO market, including making large loans that traditionally would have required public credit options).

of the acquired company.³⁰ The private equity sponsor becomes an outright owner after infusing relatively little capital. Unfortunately, at the time of closing, the target is in a precarious position. The loans financing the acquisition have a material default risk because of the significant debt load this dynamic creates. Lenders are forced to find investors willing to participate in the loan in order to minimize exposure.³¹

Despite an inauspicious beginning, companies acquired through a leveraged buyout can thrive. Aggressive cost cutting and a modified management approach often improve cash flow. Debt service results in significant tax savings because the interest payments are deductible from the company's income. The growth of the sponsor's equity position is subsidized by the government.³²

The potential for oversized returns does not alter the fact that these debt-heavy transactions are especially susceptible to attack under fraudulent transfer laws. Even minor erosion of a target company's asset base can render it insolvent and precipitate a bankruptcy filing. From 1970 through 1984, approximately 197 leveraged buyouts occurred, but that number spiked to approximately 6,113 buyouts from 1985 through 1999.³³ This leveraged buyout boom led to an inordinate number of debt defaults and bankruptcy filings.³⁴ In many of these cases, harmed creditors attempted to unwind as a fraudulent transfer the leveraged buyout that precipitated the company's fall into

30 See Samir D. Parikh, *Saving Fraudulent Transfer Law*, 86 AM. BANKR. L.J. 305, 312-13 (2012) (“[In a leveraged buyout,] the buying group creates a shell company strictly for the purpose of the acquisition The buying group then obtains approximately 60 to 90 percent of the sale price through debt The shell uses [the borrowed] funds to purchase the shares of the target Within the senior debt tranche, there may be loans of varying terms, maturities, payment schedules, seniorities, and amortization. . . . The target often issues junk bonds to provide additional subordinated financing.”).

31 See GREGORY BROWN, DEBT AND LEVERAGE IN PRIVATE EQUITY: A SURVEY OF EXISTING RESULTS AND NEW FINDINGS 15 (2021), https://uncipc.org/wp-content/uploads/2021/01/IPC-PERC_PE-Debt-Leverage.pdf [<https://perma.cc/LFG8-NFU3>] (discussing how risk premium is a substantial factor in the overall LBO market, and how risk impacts actors in the LBO market generally).

32 See Parikh, *supra* note 30, at 313 (quoting Neil M. Garfinkel, Note, *No Way Out: Section 546(e) Is No Escape for the Public Shareholder of a Failed LBO*, 1991 COLUM. BUS. L. REV. 51, 52-53 (1991)) (“Therefore, ‘income that would ordinarily have been taxed at either the corporate or shareholder level is now used to repay the debt. So income that would otherwise have gone to pay taxes has instead, in effect, been used to subsidize the price of the [leveraged buyout].’”).

33 Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSPS. 121, 127 tbl.1 (2009); see also Per Strömberg, *The New Demography of Private Equity*, in THE GLOBAL ECONOMIC IMPACT OF PRIVATE EQUITY REPORT 2008 17 tbl.3 (2008) (showing the size and pricing of LBO deals).

34 See generally Andrade G. & Steven N. Kaplan, *How Costly Is Financial (Not Economic Distress)? Evidence from Highly Leveraged Transactions That Became Distressed*, 53 J. FIN. 1443, 1443-47 (1998) (explaining that many buyouts completed after 1985 later defaulted).

bankruptcy, and courts allowed pursuit of significant recoveries.³⁵ The possibility of a clawback sent shareholders searching for a legal response, and they found one in an obscure subsection of the Bankruptcy Code.

B. *The Genesis of Section 546(e)*

As I detailed in my article *Saving Fraudulent Transfer Law*,³⁶ section 546(e) of the Bankruptcy Code was designed to prevent the bankruptcy filing of a financial intermediary from destabilizing public securities markets. The Depository Trust & Clearing Corporation (DTCC), through its subsidiaries, which includes the Depository Trust Company (DTC) and the National Securities Clearing Corporation (NSCC), clears and settles nearly all U.S. market trades in equities and corporate and municipal bonds.³⁷ In the securities clearance process, the NSCC plays the role of guarantor, ensuring that a transaction—once initiated—will be consummated regardless of an intermediary’s failure to follow NSCC rules. In order to minimize its exposure, the NSCC requires brokers to offer three security payments.³⁸ Each broker must: (1) make regular cash or securities deposits to the NSCC’s clearing fund (“NSCC Clearing Fund”); (2) agree to make special additional deposits to the NSCC Clearing Fund based on risk fluctuations in the member’s open positions; and (3) agree to make payments based on fluctuations in the market price of a security after the trade is agreed to by the parties but before the final settlement date.³⁹

If a broker fails to deliver the subject securities or provide the necessary funds for purchase, the NSCC will intervene to ensure transfer.⁴⁰ To address

³⁵ See, e.g., *Rosener v. Majestic Mgmt., Inc. (In re OODC, LLC)*, 321 B.R. 128 (Bankr. D. Del. 2005).

³⁶ See Parikh, *supra* note 30, at 309-10 (discussing the rationale for implementing section 546(e)).

³⁷ See THE DEPOSITORY TRUST & CLEARING CORPORATION, AN INTRODUCTION TO THE DTCC 2 (2010), https://www.sechistorical.org/collection/papers/2010/2010_0701_DTCCServices.pdf [<https://perma.cc/L73D-NE5Y>] (“Today, DTCC subsidiaries clear and settle nearly all US market trades in equities, corporate and municipal bonds, US government securities and mortgage-backed securities, money market instruments and over-the-counter (OTC) derivatives.”); see also Parikh, *supra* note 30, at 326-31 (providing a detailed explanation of the securities clearing process).

³⁸ See *Bankruptcy of Commodity and Securities Brokers: Hearings Before the Subcomm. on Monopolies and Com. L. of the H. Comm. on the Judiciary*, 97th Cong. 483 (1981) (statement of Jack Nelson, President, National Securities Clearing Corporation) (discussing the four payments that brokers who wish to become members of the NSCC must make).

³⁹ See Parikh, *supra* note 30, at 330-31 (discussing the three security payments that brokers who wish to become a member of the NSCC must make).

⁴⁰ See VIRGINIA B. MORRIS & STUART Z. GOLDSTEIN, GUIDE TO CLEARANCE & SETTLEMENT 6 (2009) (“[I]f a firm goes out of business, [the NSCC] will deliver the securities or make the payments the firm owes.”); Talis J. Putnins, *Naked Short Sales and Fails-to-Deliver: An*

this obligation, the NSCC can demand a mark-to-market payment from the broker.⁴¹ Furthermore, in order to raise the necessary funds or marshal the necessary securities, the NSCC may access a member's deposited collateral.⁴² The NSCC could also take the more drastic step of ceasing to act for a member and closing out that member's open positions to offset pending cash or securities delivery obligations.⁴³ To the extent there is a shortfall and the NSCC must make purchases on the open market, it can rely on the NSCC Clearing Fund, which contains the deposits of all of the NSCC's members.⁴⁴

The Bankruptcy Code could create unanticipated obstacles where an NSCC member filed for bankruptcy and failed to fulfill its obligations pursuant to a securities trade.⁴⁵ For example, assume that a NSCC member agrees to sell 100,000 shares of XYZ at \$40 per share. After submitting the request to the NSCC, the price of XYZ rises to \$50 per share. Assume that the selling member fails to deliver the XYZ shares as scheduled. As the guarantor of the transaction, the NSCC would be obligated to obtain the necessary shares on the open market at \$50 per share and deliver them to the buyer. The NSCC could close out the breaching member's account and use its collateral to help satisfy the \$5,000,000 payment the NSCC is forced to make. However, if the breaching member filed for bankruptcy, the NSCC would be subject to federal bankruptcy law.⁴⁶ A least three provisions of the Bankruptcy Code could prevent an efficient close out: section 362's automatic stay, the preference-avoidance powers under section 547, and the fraudulent transfer avoidance powers under section 548.⁴⁷

The NSCC could have considerable exposure if it is prevented from closing out an insolvent member's account in a failure to deliver situation and using those funds to consummate a trade. Imagine if a number of members

Overview of Clearing and Settlement Procedures for Stock Trades in the U.S., 2 J. SEC. OPERATIONS & CUSTODY 340, 345-46 (2010) (describing the NSCC procedure when a participant fails to deliver stock).

⁴¹ See Putnins, *supra* note 40, at 346 (discussing how the NSCC ensures transfers from brokers).

⁴² *Id.*

⁴³ See *Bankruptcy of Commodity and Securities Brokers: Hearings Before the Subcomm. on Monopolies and Com. L. of the H. Comm. on the Judiciary*, 97th Cong. 249 (July 23, 1981) (statement of Bevis Longtreth, Commissioner, U.S. Securities and Exchange Commission) (discussing this more drastic "loss protection" mechanism).

⁴⁴ *Id.* at 251.

⁴⁵ *Id.* at 253 ("The [Bankruptcy] Code created three unanticipated problems for the securities industry, each of which casts doubt on the ability of participants in the clearance and settlement process to rely on the customary methods of protecting against the bankruptcy of another participant.").

⁴⁶ See Parikh, *supra* note 30, at 332 (citation omitted) ("In the event an NSCC member failed to fulfill its obligations pursuant to a securities trade and filed for bankruptcy, there were a number of ways that the Bankruptcy Code could create unanticipated problems for the securities industry.").

⁴⁷ 11 U.S.C. §§ 547-548.

holding significant open positions—or one extremely large institutional member⁴⁸—failed to deliver securities and filed for bankruptcy in a quickly rising market. The NSCC would be forced to enter the public market and purchase the necessary securities at a considerable premium over the initially agreed price. There is a material risk that the NSCC would have insufficient funds to consummate all necessary trades. The resulting settlement failures would destabilize the securities markets.

Based on this plausible risk to the public securities markets, Congress amended the Bankruptcy Code in 1984 to “minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries.”⁴⁹ Section 546(e) is the primary provision that seeks to effectuate this policy goal.⁵⁰

C. Section 546(e)'s Muddied Waters

Section 546(e) has a clear purpose—but the statutory language is ambiguous. However, this ambiguity presented an opportunity. In the 1990s, shareholders that benefited from an overly aggressive leveraged buyout (LBO) faced daunting fraudulent transfer actions and turned to an extremely unorthodox defense: the private stock transaction at issue was protected by the safe harbor for public securities markets. Initial rulings were unfavorable for these parties.⁵¹ Courts explained that section 546(e) was enacted to protect the securities clearing system and the public securities markets; the disposition of privately held shares had nothing to do with either.⁵²

*Lowenschuss v. Resorts International*⁵³ altered the landscape. In that case, the Third Circuit explained that 546(e)'s language fails to distinguish between publicly held and privately held shares.⁵⁴ Furthermore, the court

48 Lehman Brothers' bankruptcy demonstrated the necessity of having a provision like section 546(e). See Parikh, *supra* note 30, at 334 n.169 (citation omitted) (“When Lehman Brothers filed for bankruptcy, it had over \$500 billion worth of open trade obligations in various markets and assets classes. Due to the various exceptions to the Bankruptcy Code noted herein, the DTCC was able to act quickly to stabilize the markets.”).

49 H.R. REP. NO. 97-420, at 1 (1982).

50 See 11 U.S.C. § 546(e) (proscribing a trustee from making certain margin payments).

51 See, e.g., *Zahn v. Yucaipa Cap. Fund*, 218 B.R. 656, 680 (D.R.I. 1998) (denying the plaintiff's motion to dismiss); *Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348, 355-57 (N.D. Tex. 1996) (recommending the district court deny the defendants' motion to dismiss); *Wieboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655, 669 (N.D. Ill. 1991) (recommending the denial of a motion to dismiss).

52 See, e.g., *Zahn*, 218 B.R. at 677 (declining to apply the 564(e) exception); *Jewel Recovery*, 196 B.R. at 353; *Wieboldt Stores*, 131 B.R. at 664.

53 *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505, 515-16 (3d. Cir. 1999) (applying 546(e)), *abrogated by* *Merit Mgmt. Grp. LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 897 (2018) (rejecting application of 546(e) on the plain meaning of the statute).

54 See *id.* at 515-16 (reviewing the plain language and case law of 546(e)). *But see* *BWGS, LLC v. BMO Harris Bank, N.A. (In re BWGS, LLC)*, 644 B.R. 173, 180 (Bankr. S.D. Ind. 2022)

reiterated the widely accepted premise of statutory interpretation that when the language of a statute is clear, no further inquiry is necessary unless application of the plain language leads to an absurd result.⁵⁵ The court found that the key terms of the provision are “clear” and “broad” in scope.⁵⁶ The court also explained that “despite the fact that payments to shareholders in an LBO are not the most common securities transactions, [there is] no absurd result from the application of the statute’s plain language and [it did not] disregard it.”⁵⁷

Resorts International bound Third Circuit bankruptcy courts and influenced other circuits, most importantly the Second Circuit.⁵⁸ This shift provided private equity firms the comfort of knowing⁵⁹ that a clawback would be highly unlikely for even the most aggressive leveraged buyout.⁶⁰

A hospitable statutory construction coalesced with unprecedented low-interest rate environments in the first two decades of the century, ushering in a golden age of leveraged buyouts. From 2000 to 2007, there were approximately 3,000 LBOs.⁶¹ But from 2019 to 2020 alone there were over

(explaining that the underlying stock purchase in that case was a private transaction that did not involve the Securities Clearance and Settlement System, which § 546(e) was designed to protect).

⁵⁵ *In re Resorts Int’l*, 181 F.3d at 515 (citing *Idahoan Fresh v. Advantage Prods., Inc.*, 157 F.3d 197, 202 (3d Cir. 1998)).

⁵⁶ *See id.* at 515-16.

⁵⁷ *Id.* at 516.

⁵⁸ *See, e.g.*, *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 334 (2d Cir. 2011) (following the *Resorts International* court’s approach regarding statutory interpretation); *Contemp. Indus. Corp. v. Frost*, 564 F.3d 981, 986 (8th Cir. 2009) (approving of the *Resorts International* court’s interpretation of section 546(e)’s language and extending section 546(e)’s protection to the transfer of privately held shares); *QSI Holdings, Inc. v. Alford*, 571 F.3d 545, 551 (6th Cir. 2009) (same). *But see Halperin v. Morgan Stanley Inv. Mgmt., Inc. (In re Tops Holding II Corp.)*, 646 B.R. 617, 688 (Bankr. S.D.N.Y. 2022) (explaining that the majority interpretation of section 546(e) requires courts to analyze various convoluted questions, but the only meaningful question should be whether the transferor “was insolvent or rendered insolvent by the [distributions at issue]”); *id.* (“[A]voidance [in just about all of these cases] would have no effect on the public securities markets, the ostensible purpose for section 546(e).”).

⁵⁹ Bankruptcy’s permissive forum shopping rules allow sponsors to direct a bankruptcy filing to a court in a favorable jurisdiction. *See Lynn M. LoPucki, Chapter 11’s Descent into Lawlessness*, 96 AM. BANKR. L.J. 247, 258 (2022) (discussing pervasive forum shopping to Delaware and New York courts); Samir D. Parikh, *Modern Forum Shopping in Bankruptcy*, 46 CONN. L. REV. 159, 162 (2013) (arguing bankruptcy forum shopping increased during the Great Recession).

⁶⁰ In fact, parties have attempted to use section 546(e) to insulate various transactions from fraudulent transfer law. *See In re Tops Holding II*, 646 B.R. at 687-88 (“[A]t issue here is a transaction whereby, after encumbering a privately held company’s assets with privately issued debt, a handful of sophisticated private equity investors took massive dividends that . . . left the pension plans of thousands of workers and hundreds of creditors holding the bag.”).

⁶¹ GENERAL ACCOUNTING OFFICE, PRIVATE EQUITY: RECENT GROWTH IN LEVERAGED BUYOUTS EXPOSED RISKS THAT WARRANT CONTINUED ATTENTION 9 (2008).

6,200 LBOs.⁶² More important than the rise in frequency was the change in debt appetite. The impotency of fraudulent transfer law encouraged a significant increase in debt levels on these new deals.⁶³

D. *The Merit Ruling and Shifting Loopholes*

In 2018, *Merit Management Group, LP v. FTI Consulting, Inc.* presented a potential course correction.⁶⁴ In that dispute, Valley View and Bedford Downs were both competing for a racing license necessary to open a racetrack casino.⁶⁵ After an unsuccessful attempt to secure the license, the two companies reached an agreement: Bedford Downs would no longer seek the racing license, and Valley View agreed to purchase all of Bedford Downs' stock for a premium of \$55 million.⁶⁶ Valley View ultimately secured the racing license and purchased Bedford Downs' stock. But Valley View was unable to secure a gaming license and could not open the racetrack casino. Valley View and its parent company were, therefore, forced to file for bankruptcy.⁶⁷

In bankruptcy, the trustee for the resulting litigation trust brought suit against Bedford Downs' shareholders seeking to avoid the stock sale as constructively fraudulent. Merit argued that section 546(e) barred avoidance because the transfer was a "settlement payment" made to a covered "financial institution"—and therefore satisfied the requirements for the safe harbor.⁶⁸ The district court granted Merit's 12(c) judgment-on-the-pleadings motion, but the Seventh Circuit reversed, holding that section 546(e) did not protect transfers where the financial institution involved served as a mere conduit for the funds at issue.⁶⁹

On appeal, the Supreme Court made clear that a transaction seeking protection in section 546(e)'s safe harbor must be analyzed by focusing on the initial transferor and the final transferee.⁷⁰ Intermediaries should not be considered in determining whether the requirements of the subsection have

⁶² 2021 Year in Review: Key Investment Banking Trends, S&P GLOB. MKT. INTEL. (Dec. 20, 2022), <https://pages.marketintelligence.spglobal.com/2021-Year-in-Review-Investment-Banking-Infographic.html> [<https://perma.cc/83RW-W4A7>].

⁶³ Leveraged buyouts historically adopted a simple 6x leverage ratio, meaning that debt was no more than six times Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA). However, in recent years, private equity sponsors have been pursuing highly leveraged deals that have gone as high as 10x. See Singh, *supra* note 26.

⁶⁴ Merit Mgmt. Grp., LP v. FTI Consulting, 138 S. Ct. 883 (2018).

⁶⁵ *Id.* at 890.

⁶⁶ *Id.* at 891.

⁶⁷ *Id.*

⁶⁸ *Id.* at 891-92.

⁶⁹ *Id.* at 892.

⁷⁰ *Id.* at 892-93.

been satisfied. In *Merit*, neither the initial nor the ultimate transferee of the funds was an entity typically understood to be a financial institution; more importantly, neither the initial nor the ultimate transferee was alleged to qualify as a “financial institution” under the definition found in 11 USC § 101(22).⁷¹ Therefore, the Court ruled that the transfer did not qualify for section 546(e)’s safe harbor.

The ruling has been hailed as the end of the improper use of section 546(e) to shield constructively fraudulent transfers in LBOs.⁷² But the case does not bring about that result. The Court’s analysis proved troublesome for the ultimate transferee in that case because that party had not argued that the transferee could itself qualify as a “financial institution” as required by the subsection. However, in a footnote of the opinion, the Court left open the possibility that this argument—if it had been made—would allow the transaction to qualify under section 546(e).⁷³ The broad definition of “financial institution” includes the *customer* of a “financial institution.”⁷⁴ Therefore, even under the Supreme Court’s relatively strict reading of section 546(e), the transaction at issue could have satisfied the subsection’s requirements for protection.

Merit closed one loophole but presaged a new one, and the Second Circuit seized this opening. The Tribune Companies’ 2007 leveraged buyout and almost immediate bankruptcy led to an epic battle involving section 546(e). In 2016, the Second Circuit ruled that section 546(e) barred fraudulent transfer actions under both federal and state law in that case.⁷⁵ The *Merit* opinion, however, was issued while *Tribune I*’s cert petition was pending, and Justices Kennedy and Thomas suggested that the Second Circuit revisit its ruling in light of *Merit*.⁷⁶

⁷¹ *Id.* at 897.

⁷² See *Supreme Court Closes Safe Harbor Loophole in Fraudulent Conveyance Litigation*, KASOWITZ BENSON TORRES, https://www.kasowitz.com/media/3490/client-alert_supreme-court-closes-safe-harbor-loophole-in-fraudulent-conveyance-litigation.pdf [<https://perma.cc/H6CA-RH4C>] (last visited May 20, 2023) (“The Supreme Court has now foreclosed this expansive interpretation of Section 546(e)”). To be clear, *Merit* left many issues unresolved, including whether section 546(e) barred causes of action based on a state fraudulent transfer law. The Second Circuit ruled that the section did in fact bar actions based on state fraudulent transfer law. See *Deutsche Bank Tr. Co. Ams. v. Large Priv. Beneficial Owners (In re Trib. Co. Fraudulent Conv. Litig.) (Tribune I)*, 818 F.3d 98, 105 (2d Cir. 2016). But see *PAH Litig. Tr. v. Water St. Healthcare Partners L.P. (In re Physiotherapy Holdings, Inc.)*, No. 13-12965, 2016 WL 311831, at *10 (Bankr. D. Del. June 20, 2016) (noting that a presumption against preemption is appropriate because states have traditionally controlled fraudulent transfer law).

⁷³ *Merit*, 138 S. Ct. at 890 n.2.

⁷⁴ 11 U.S.C. § 101(22)(A).

⁷⁵ *Tribune I*, 818 F.3d 98 (2d Cir. 2016), *vacated*, *Tribune II*, 946 F.3d 66 (2d Cir. 2019).

⁷⁶ *Deutsche Bank Tr. Co. Ams. v. Robert R. McCormick Found.*, 138 S. Ct. 1162 (2018).

The Second Circuit did in fact recall its mandate in *Tribune II*, but it found a new basis to reach the same conclusion.⁷⁷ As noted above, the *Merit* court left open the issue of whether a customer of a financial institution could itself qualify as a financial institution for purposes of satisfying section 546(e)'s requirements. The Second Circuit concluded that Computershare—the financial institution in that case—qualified as Tribune's agent in the leveraged buyout simply by agreeing to act as an intermediary between Tribune and its shareholders.⁷⁸ By occupying this position, the court recharacterized Tribune as a financial institution under section 101(22)(A)'s definition.⁷⁹ The court, however, disregarded the fact that Computershare was merely performing services for Tribune pursuant to a service contract and the relationship could not be described as satisfying any prevailing definition of an agency relationship.⁸⁰

1. The Bankruptcy Problem

Section 546(e) was never intended to protect the transactions at the core of almost every leveraged buyout. Recipients of fraudulently transferred funds have been able to shelter in section 546(e)'s safe harbor because of poor statutory drafting and compliant jurists. This was not a policy decision. Courts have created a windfall for shareholders well aware of the risks inherent in an over-leveraged acquisition.

This jurisprudential shift also benefitted private equity sponsors, who have displaced lenders as the apex predators in the corporate restructuring ecosystem. With the ability to freely access section 546(e)'s safe harbor, redeeming shareholders are immune from fraudulent transfer law and sponsors are able to engage in historically aggressive debt layering for their

⁷⁷ See *Tribune II*, 946 F.3d at 72. The Second Circuit appeared to be motivated by its belief that an alternative, less rigid interpretation of section 546(e) would lead to chaos in capital markets because of investor uncertainty regarding a potential clawback. *Id.* at 92-93.

⁷⁸ *Id.* at 78-80.

⁷⁹ *Id.*

⁸⁰ The recent *Nine West* bankruptcy pushed this faulty syllogism further. See *In re Nine W. LBO Sec. Litig.*, 482 F. Supp. 3d 187, 191 (S.D.N.Y. 2020) (ruling that even though the financial institution involved in that transfer was an intermediary as to only .4% of the overall transferred funds, it was an "agent" of the transferees for all connected transfers and shareholders would be able to shelter in section 546(e)'s safe harbor even though ostensibly none of the transfers at issue involved a "financial institution"); see also Peter Marchetti, *Section 546(e) Redux—The Proper Framework for the Construction of the Terms Financial Institution and Financial Participant Contained in the Bankruptcy Code After the U.S. Supreme Court's Holding in Merit*, 43 CARDOZO L. REV. 1107, 1136 (2022) ("The district court [in *Nine West*] . . . [held] that once [the financial institution] was found to be an agent with respect to *any* transfer connected to the LBO . . . , it qualified as an agent of [Nine West] so that Section 546(e) would insulate *all* transfers made in connection with the LBO from avoidance . . .").

acquisitions.⁸¹ Of course, crushing debt loads afford portfolio companies very little margin for error. These targets are invariably balancing on the edge of bankruptcy for many years after the LBO, and bankruptcy presents its own problems for shareholders. But, as explored in the following section, there was a contractual solution to this problem.

II. THE NEW ALPHA: SHIFTING FROM LENDER CONTROL TO SPONSOR CONTROL

In the years before the Great Recession, secured lenders dictated outcomes in distress situations.⁸² Sophisticated companies had invariably relied on a lender or syndicate of lenders for a term loan and a revolver. The debt instruments capturing this arrangement kept the borrower on a short leash.⁸³ The lenders held senior liens on all of the borrower's assets. Liquidity issues could not be addressed without lender consent because assets could not be sold, nor could they be used for additional secured financing. Further, standard loan contracts contained robust maintenance and incurrence covenants that allowed lenders to actively monitor and police borrowers.⁸⁴ Tripping any one of the debt covenants entitles the lender to impose penalties

⁸¹ See BROWN, *supra* note 31, at 53 fig.6 (capturing the increasing debt ratios in LBOs since the Great Recession); see also Abby Latour, *As LBOs Surged in Q4'20, US Purchase Price Multiples Hit New Heights*, S&P GLOB. MKT. INTEL. (Dec. 20, 2022, 2:11 PM), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/as-lbos-surged-in-q4-20-us-purchase-price-multiples-hit-new-heights-62227223> [https://perma.cc/QEG8-9PSK] (noting the increasing debt multiples in large corporate LBOs since the Great Recession). I acknowledge that prevailing interest rates play a significant role in debt levels in LBOs, but opportunity meets will because of section 546(e)'s involvement.

⁸² See Douglas Baird & Robert Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 752 (2002) (“[W]hen a large firm uses Chapter 11 . . . , its principal lenders are usually already in control and Chapter 11 merely puts in place a preexisting deal.”). For scholarly articles describing the power that secured lenders enjoyed in corporate bankruptcy cases prior to the Great Recession, see Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115 (2009); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917 (2003).

⁸³ See Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporate Reorganization*, 90 U. CHI. L. REV. 1, 11 (2023) (“[T]ight covenants and blanket liens . . . gave lenders a pronounced influence over the way a borrower's prospective distress would be resolved.”).

⁸⁴ These covenants oblige a borrower to maintain minimum leverage ratios (e.g., leverage ratio, secured debt-to-EBITDA ratio) and other staples of financial stability. See Frederick Tung, *Do Lenders Still Monitor? Leveraged Lending and the Search for Covenants*, 47 J. CORP. L. 153, 170 (2021) (“These tighter covenants, by putting borrowers on a tighter leash, helped address both presale moral hazard and adverse selection.”). Financial maintenance covenants and incurrence covenants measure borrower health and ideally impose discipline. Maintenance covenants require a borrower to meet certain financial tests (e.g., debt-to-cash-flow ratio) at set intervals, often times at quarter end. Incurrence covenants restrict borrower action, including attempts to incur more debt, pay dividends, or make an acquisition. *Id.* at 179.

and, in some cases, “even call the existing loan and begin enforcement proceedings.”⁸⁵

Borrower constraints were exacerbated when the borrower was in distress because it had invariably tripped covenants that further tightened the financial leash. And by the turn of the century, lenders were not intimidated by the threat of a bankruptcy filing. Lenders were quite comfortable participating in a bankruptcy case and continuing to receive the fruits of their unique position.⁸⁶

This boring narrative recently received a jolt. After decades where creditors exercised control, private equity sponsors have ascended the throne. The rise of private equity has introduced new actors and dynamics.⁸⁷ Highly levered entities often approach the bankruptcy precipice after a leveraged buyout.⁸⁸ The risk of this compromised position is that equity stakes would be wiped out in bankruptcy, and creditors would become the new owners. But private equity sponsors decided they prefer to not be subject to the general rules of capitalism. This preference fostered an unprecedented willingness to engage in battle to preserve value.⁸⁹

The goal in typical distress situations is simple: push out debt maturities and secure cash infusions to find a bridge to more prosperous times.⁹⁰ But private equity’s directives have become far more ambitious; nothing short of redistributing value seized from creditors will do.⁹¹ But how can the King’s orders be fulfilled? The solution begins with contract architecture.

85 Vincent S.J. Buccola & Greg Nini, *The Loan Market Response to Dropdown and Uptier Transactions* 8 (June 22, 2022) (unpublished manuscript), <https://ssrn.com/abstract=4143928> [<https://perma.cc/GR93-KTWE>].

86 For example, prepetition lenders often became the postpetition financier of the debtor’s case, demanding and receiving extremely favorable terms through the debtor-in-possession (DIP) loan. See, e.g., *Revlon Chapter 11 Filing and \$575 Million Term DIP Financing*, DAVIS POLK (Aug. 3, 2022), <https://www.davispolk.com/experience/revlon-chapter-11-filing-and-575-million-term-loan-dip-financing> [<https://perma.cc/7EXD-4UVX>] (describing prepetition lenders becoming postpetition lenders).

87 See Buccola, *supra* note 83, at 21 (citations omitted) (“Since the global financial crisis, the share of companies on Moody’s B3 Negative and Lower List owned by a private equity sponsor has increased by 25%. Approximately 70% of such companies were sponsor owned Between 2000 and 2017, the number of companies controlled by a private equity sponsor increased nearly fivefold, while the number of listed companies dropped by a third.”).

88 Alicia McElhaney, *LBOs Make (More) Companies Go Bankrupt, Research Shows*, INSTITUTIONAL INV. (July 26, 2019), <https://www.institutionalinvestor.com/article/bigfygl4r8661f/LBOs-Make-More-Companies-Go-Bankrupt-Research-Shows> [<https://perma.cc/74AZ-U526>].

89 MAX FRUMES & SUJEET INDAP, *THE CAESARS PALACE COUP* 120 (2021) (“[The fear was] that Apollo had a systematic plan to siphon value away from creditors.”).

90 *Id.*

91 Kamensky, *supra* note 16.

A. *Sponsor-Favorable Terms*

In the 2000s, transactional agreements—including debt instruments—became more voluminous and complex.⁹² Agreements moved away from employing standards of conduct and adopted specific restrictions with the idea of bolstering predictability.⁹³ Intricate contracts create front-end costs but offer the hope of reducing backend costs and opportunistic behavior. But that did not materialize in the distressed debt world. In fact, detailed debt instruments calling for strict interpretations have actually created more avenues to coercion.⁹⁴

Oversized debt burdens mean that private equity sponsors can preserve value in times of distress only if borrower optionality is preserved *ex ante*.⁹⁵ The easiest solution for a private equity sponsor managing a distressed portfolio company is to simply take value from lenders and noteholders. But, as noted above, voluminous debt instruments supposedly made that appropriation impossible. This fact caused sponsors to begin modifying certain provisions and adopting unique interpretations of others.

The dirty secret in distressed debt markets is that most contracts are actually terrible jumbles with conflicting and ambiguous provisions. Unwritten rules guide behavior in these settings. Business norms and the threat of reputational harm work together to deter coercive measures that may arguably be countenanced by the applicable contracts but ultimately anathema to market expectations.⁹⁶ But private equity sponsors are quite willing to disregard business norms and the risk of reputational harm.⁹⁷ Large private equity sponsors face little reprisal risk because of their unique

⁹² See de Fontenay, *supra* note 15, at 537 (“A merger that required only a twenty page agreement in 1990 might well require over one-hundred pages today.”).

⁹³ See *id.* at 537-38.

⁹⁴ See Elisabeth de Fontenay, *Windstream and Contract Opportunism 7* (May 12, 2020) (unpublished manuscript), <https://ssrn.com/abstract=3603752> [<https://perma.cc/UT4N-5PUP>] (“The lesson to be drawn from all this . . . is that highly formalistic drafting and interpretation of contracts opens the door for significant opportunism *ex post*, whether by the initial parties or by third parties (such as a hedge fund buying bonds well after an alleged default occurred).”); see also Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RESERVE L. REV. 187, 197-98 (2005) (detailing the economic theory of incomplete contracts and how interpretation impacts compliance).

⁹⁵ See FRUMES & INDAP, *supra* note 89, at 34 (noting that “covenant-lite” agreements afforded Caesars Casinos the ability “to operate through downturns with much less risk of needing bank amendments, further administrative burden, or risk of default . . .”).

⁹⁶ See de Fontenay, *supra* note 15, at 539 (“[N]ow that finance itself has become more transactional (rather than relational), arm’s-length, and disintermediated, the parties are perhaps wise to . . . [avoid] relying on standards and the other party’s good faith.”).

⁹⁷ *Id.* This breakdown can be attributed in part to the entry of NBFIs and other nontraditional actors in the distressed debt investment community.

position in the marketplace coupled with their ability to “blacklist” investors by excluding them from lucrative future deals.⁹⁸

An extended period of ultra-low interest rates over the last decade coupled with quantitative easing caused money managers and investors to desperately chase yield.⁹⁹ Blurry-eyed investing allowed sponsors to undertake unprecedented contractual planning.¹⁰⁰ Borrowers—in most cases, at the direction of private equity sponsors—were able to demand debt instruments that left investors with few legal protections.¹⁰¹ In other cases, the “sponsor-designated counsel” process allowed borrowers to enjoy undue influence over negotiations.¹⁰² Loose covenants replaced stringent ones and many covenants disappeared entirely. For example, as part of the leveraged buyout of the entity that would ultimately be known as Caesars Casinos, the only covenants imposed on the debtor were a payment covenant and a flimsy senior-secured debt-to-EBITDA ratio.¹⁰³ Covenant permissiveness coupled with section 546(e)’s generous safe harbor emboldened sponsors to increase debt levels on the presumption that more options would exist if significant financial distress subsequently materialized.

B. *Incomplete Contracting by Design*

Modern restructuring cases highlight gaps in the theory of incomplete contracting. From a legal perspective, a “complete” contract is one that

⁹⁸ See FRUMES & INDAP, *supra* note 89, at 122 (“[Executives at Apollo, the equity sponsor of the debtors in the Caesars bankruptcy case,] made calls to [key executives at] Oaktree [a creditor in the case who was standing in the way of a settlement Apollo sought] . . . Apollo ominously reminded them that Oaktree and [the other key creditors in the case] depended on deal flow from Apollo that they could be excluded from in the future.”); *see id.* at 71 (“Apollo was a big, powerful institution . . . And while investment banks had a job to do, they were aware that crossing powerful private equity firms could be expensive in the long run.”).

⁹⁹ FRUMES & INDAP, *supra* note 89, at 34 (“Debt investors were hungry for high-yielding loans and bonds in the mid-2000s. [It was a] seller’s market.”).

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 34.

¹⁰² “Sponsor-designated counsel” describes the process by which a private equity sponsor is allowed “to appoint and pay for the law firms that represent the lenders funding their deals.” *See* Silas Brown, Will Louch & Laura Benitez, *The Powerful City Lawyer at the Center of Private Equity Storm*, BLOOMBERG L. (Feb. 16, 2023), <https://www.bloomberglaw.com/bloomberglawnews/bankruptcy-law/X2ANOGOOooooo> [<https://perma.cc/KG38-FMHS>]. Lender counsel in these cases are in a difficult position because “[b]eing on the wrong side of [the borrower] can result in law firms being frozen out of future deals.” *See id.* (“It is very difficult to feel you have independence when the other firm sitting across the table may have played a role in getting you your job . . .”).

¹⁰³ See FRUMES & INDAP, *supra* note 89, at 34 (“Debt investors were hungry for high-yielding loans and bonds in the mid-2000s. This seller’s market meant that the contracts under which [Caesars’] debt was going to be sold would contain few restrictions . . . [Caesars’] LBO debt [had] just a single covenant: the senior secured debt-to-EBITDA ratio test.”).

specifies precisely what conduct is required by contractual parties in substantially all scenarios.¹⁰⁴ Incomplete contract theory explains that parties to a voluntary agreement cannot address substantially all contractual contingencies.¹⁰⁵ The theory focuses primarily on drafter limitations and attributes incomplete contracting to information costs, transaction costs, and agency costs.¹⁰⁶ But scholars have overlooked the fact that incomplete contracting in debt markets is often by design.¹⁰⁷

A savvy borrower can benefit from an incomplete contract for myriad reasons. An incomplete contract coupled with few financial covenants affords borrowers a first-mover advantage. Creditors lack the means to effectively monitor the borrower.¹⁰⁸ The opportunity for creditor intervention is limited without a covenant breach or meaningful oversight. I argue that bankruptcy is the only viable option by the time distress has been identified.¹⁰⁹ Further, as more NBFIs invade lender groups, monitoring responsibilities fall on parties with less experience handling them. Without oversight, the borrower can mobilize to protect or redistribute value in ways that are initially undetectable. In other words, borrowers can make preemptive strikes.

Preemptive strikes are premised on the incomplete contract at issue allowing a borrower to interpret ambiguous provisions in a way that provides optionality in distress situations.¹¹⁰ Borrowers are not deterred by the fact that their interpretation does not align with market expectations and is unlikely to be supported by a court of law. As noted above, there are various ways a borrower and its equity sponsor can compel creditors to accept a questionable interpretation. Primarily, incomplete contracts in this context

¹⁰⁴ See Scott & Triantis, *supra* note 94, at 190 (“A contract is incomplete if it fails to provide for the efficient set of obligations in each possible state of the world.”).

¹⁰⁵ *Id.*

¹⁰⁶ de Fontenay, *supra* note 15, at 541; see also Buccola & Nini, *supra* note 85, at 25 (“Contracts are incomplete because it is impossible, or prohibitively costly, to anticipate every contingency and negotiate the proper outcomes in advance.”).

¹⁰⁷ In these situations, the debt instrument is not incomplete because it fails to address a particular dispute or situation. Rather, the contract is incomplete because it contains woefully ambiguous concepts in a restriction that is intended to be extremely specific and detailed. For example, indentures and term loan agreements invariably contain detailed provisions that restrict borrowers from entering into various types of transactions—including asset transfers—with affiliated companies. However, “permitted investments” or “restricted payments” are excluded from these restrictions by provisions with woefully ambiguous language that allow the borrower to circumvent a core restriction. See *infra* Part III.

¹⁰⁸ See Tung, *supra* note 84, at 182 (describing concerns that the growing absence of covenant protections leaves lenders without sufficient monitoring authority).

¹⁰⁹ See *id.* Sponsor tactics in bankruptcy have also evolved. For example, sponsors customarily use restructuring support agreements to secure the support of select creditor groups and ultimately bind dissident groups through class voting. See generally David A. Skeel, Jr., *Distorted Choice in Corporate Bankruptcy*, 130 YALE L.J. 366 (2020).

¹¹⁰ See *infra* Part III.

benefit parties that have the most relational leverage.¹¹¹ A borrower may be able to impose compliance on certain creditors who enjoy extensive business relationships with the borrower's sponsor and may not be willing to risk a billion-dollar relationship over a million-dollar dispute.¹¹²

With this game plan, sponsors have effectively taken contractual provisions that seek to limit borrower conduct and imbued them with ambiguity and vagaries that create loopholes and trapdoors, allowing a borrower to easily circumvent the crux of the restriction at issue.¹¹³ These provisions are collectively referred to as "sponsor-favorable terms" and current attempts to prospectively eliminate these provisions from debt contracts has limited benefit for parties subject to the thousands of contracts already in the marketplace. For example, these "loose" contracts allow borrowers to transfer assets out of a collateral package, surreptitiously eroding creditor positions.¹¹⁴ Further, private equity sponsors have become increasingly skilled at circumventing the few protections that remain. This has serious repercussions for stakeholders and the distressed-debt market, as well as for employees and pension funds.

Courts, however, have offered creditors little sympathy.¹¹⁵ As noted above, the customary response to creditor exploitation is that creditors should

¹¹¹ See FRUMES & INDAP, *supra* note 89, at 34-35 (describing power structures in the Caesars bankruptcy case). Though outside the scope of this Article, it is worthwhile to note that many of the ideas in Part II connect to relational contracting. For example, the idea of relational leverage can be juxtaposed with the overall crux of relational contracting. The latter is premised on the idea that exchange based on contract "can only be understood in light of the parties' relationships"—ones either involving or lacking trust. Paul MacMahon, *Reviews*, 78 MODERN L. REV. 708 (2015) (reviewing JEAN BRAUCHER, JOHN KIDWELL & WILLIAM C. WHITFORD, *REVISITING THE CONTRACTS SCHOLARSHIP OF STEWART MACAULAY* (2013)). Relational contract theory can be interpreted to assert that the ills of incomplete contracting can be remedied by parties working to align their respective interests and developing a framework agreement that allows each party to choose the means to achieve agreed-upon goals; reputational risk and the terms of the formal contract merely serve as backstops to encourage compliance. My idea of relational leverage overlaps but ultimately diverges from this premise by asserting that in the distressed debt marketplace many relationships are severely imbalanced, and the party that enjoys the ability to threaten material harm in future business transactions can exploit that position when faced with contractual ambiguity.

¹¹² See Samir D. Parikh, *Scarlet-Lettered Bankruptcy: A Public Benefit Proposal for Mass Tort Villains*, 117 NW. U. L. REV. 425, 442-46 (2022) (describing leverage exercised by "bullying creditors" in bankruptcy auctions).

¹¹³ See FRUMES & INDAP, *supra* note 89, at 69 ("Apollo treasured finance lawyers who were experts at drafting bond indentures and loan agreements that were wired with all the flexibility Apollo liked.").

¹¹⁴ See *infra* Section III.A.

¹¹⁵ See *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.*, No. 565123/2020, 2021 WL 3671541, at *7 (N.Y. Sup. Ct. Aug. 16, 2021) ("[T]he amended no-action provisions are unenforceable and inapplicable to the claims asserted in this action."); see also *iHeart Commc'ns, Inc. v. Benefit St. Partners LLC*, No. SA-17-CV-00009-XR, 2017 WL 1032510, at *18 (W.D. Tex. Mar. 16, 2017) (finding no jurisdiction over declaratory judgment claims under the Edge Act). Counterparties can argue a lack of good faith and fair dealing, but the conduct in question in

simply tighten up contractual provisions to preclude this conduct.¹¹⁶ But, as detailed in Part III, most core contractual provisions can be amended by a mere majority. This allows borrowers to pit creditors against each other, with the winning group altering provisions in order to receive a premium. Well, the argument proceeds, the agreements should merely raise the voting threshold. But the new cannibalistic assaults involve coercive debt issuances—where a company issues more debt in order to give the preferred group sufficient voting leverage. The final argument is that more rights should be recognized as “sacrosanct rights” that cannot be amended without unanimity. Unfortunately, this creates a situation where borrowers have no flexibility to restructure in times of distress, an outcome where the cure is arguably worse than the disease. Further, restructuring risk is invariably low in these cases. Creditors must be careful to avoid allowing remote possibilities to dictate contract architecture.

The judiciary’s position coupled with equity sponsors’ new aggression has provided enough carrots and sticks to encourage creditor groups to turn on one another.¹¹⁷ The idea is simple enough: the borrower identifies a subset of disfavored creditors from whom value can be seized, offers a portion of that value to a favored group, keeps the balance for the company, and allows the private equity sponsor to improve its position while avoiding the borrower’s bankruptcy. Creditors are ensnared in a prisoners’ dilemma: some can opt to take a relatively small haircut but receive more than they otherwise would in a bankruptcy; those that fail to defect may be forced to take a large haircut and potentially lose their right to bring litigation to address borrower malfeasance.¹¹⁸ Overcoming transaction costs and properly coordinating is notoriously difficult for creditors.¹¹⁹ Therefore, each creditor is ostensibly sitting in its cell pondering the consequences if it does not accept the borrower’s offer—assuming it has even been offered the right to participate.

coercive exchanges invariably complies with the strict language of the contract. Therefore, these arguments rarely survive. The duty of good faith cannot “impose obligations . . . beyond the express terms of the parties’ agreement.” *Audax Credit Opportunities Offshore Ltd.*, 2021 WL 3671541, at *10 (citation omitted).

¹¹⁶ See, e.g., *Audax Credit Opportunities Offshore Ltd.*, 2021 WL 3671541, at *9 (explaining that where parties delineate their agreement in a clear, complete document, the court will enforce the terms as written).

¹¹⁷ See, e.g., *id.* at *2 (“Generally speaking, the spirit of such transactions among lenders is all for one, one for all. But not always.”).

¹¹⁸ See Samir D. Parikh, *Creditors Strike Back: The Return of the Cooperation Agreement*, 72 DUKE L.J. ONLINE (forthcoming 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4410235 [<https://perma.cc/M5PZ-R447>] (situating coercive exchange dynamics within the prisoners’ dilemma model).

¹¹⁹ See *id.*

No creditor group is immune from the new tactics. As detailed in Part III, both lenders and noteholders are fair game. The prize for the borrower is new funding, extended maturities, and immunity from litigation involving maneuvers that oftentimes resemble fraudulent transfers, breaches of contract, and violations of fiduciary duties. The private equity sponsor usually improves its position in the capital structure or receives some sort of dividend; at the very least, the borrower is able to avoid bankruptcy and preserve the sponsor's equity stake.

Debt-heavy LBOs allow private equity to avoid capital-intensive commitments. But the choice creates significant risk of default for acquired firms. The best way to manage this risk is to draft debt documents that eliminate key covenants and enhance borrower optionality in times of distress—a path that private equity sponsors began mapping out years ago.¹²⁰ In fact, sponsor-favorable terms may encourage sponsors to pursue debt accumulation as a means to shift risk to creditors. Distress is now proliferating, and corporate restructuring is becoming prevalent. Debt instruments and contract design cannot prevent opportunism in distressed debt investing.¹²¹ Sponsors have the means and the inclination to engage in coercion to preserve value, forcing creditors to participate in cannibalistic assaults. Market participants anticipated that these loopholes would be exploited, but as explored below, the level of aggression has proven surprising.

III. CANNIBALISTIC ASSAULTS

The previous sections detailed the unique ways that leveraged buyouts are insulated from fraudulent transfer law and how this exalted status has encouraged excessively aggressive acquisitions. To balance out the obvious risks that come with over-leveraged companies, private equity sponsors have been subtly modifying debt documents to eliminate restrictive covenants and open loopholes that would allow for new and creative ways to rehabilitate distressed companies. The new arsenal that resulted from this contractual evolution produced cannibalistic assaults manifesting in two stages, captured by a few representative cases explored below.

A. New Weapons in the Borrower Arsenal

Since the Great Recession, sponsor-favorable terms have found their way into debt documents and given creative and brazen borrowers a panoply of

¹²⁰ See *supra* Section II.A.

¹²¹ See de Fontenay, *supra* note 15, at 535 (“[C]omplex, detailed contracts . . . [can] still leave the parties vulnerable to opportunistic enforcement . . .”).

restructuring options.¹²² But exploitation of these terms did not begin in earnest until 2015. As detailed below, initial maneuvers involved one or two creative tactics designed to accomplish a specific objective. For example, indentures and term loan agreements invariably contain detailed provisions that restrict borrowers from entering into various types of transactions—including asset transfers—with affiliated companies. However, “permitted investments” or “restricted payments” are excluded from these restrictions by provisions with woefully ambiguous language.¹²³ These exceptions became the trapdoors that allowed borrowers to move assets away from creditors and then compel exchanges or pursue new borrowing.

1. iHeart (2015)

Not surprisingly, one of the initial cases exploiting a contractual loophole affected noteholders. In 2015, iHeart Media was facing a serious revenue shortfall and other complications related to an aggressive leveraged buyout in 2008.¹²⁴ The company had issued several priority guarantee notes (the “iHeart Notes”) due in 2019 or later but had little prospect of satisfying that obligation. iHeart’s equity sponsors wanted to push out the maturity date, but noteholders were uninterested in an exchange.¹²⁵ A plan emerged for a subsidiary to purchase iHeart’s debt at a discount and—in the event of iHeart’s inevitable breach—not declare a default.¹²⁶ Naturally, the applicable indenture included a covenant that prevented the borrowers from making such a purchase, but the restrictions excluded “Permitted Investments.”¹²⁷

¹²² See *supra* Section II.A.

¹²³ See *infra* subsection III.A.1.

¹²⁴ See Tom Hals, *Largest U.S. Radio Company iHeartMedia Files for Bankruptcy*, REUTERS (Mar. 15, 2018, 1:19 AM), <https://www.reuters.com/article/us-iheartmedia-bankruptcy/largest-u-s-radio-company-iheartmedia-files-for-bankruptcy-idUSKCN1GRoGB> [<https://perma.cc/CH87-KSHF>].

¹²⁵ See *iHeart Commc’ns, Inc. v. Benefit St. Partners LLC*, No. SA-17-CV-00009-XR, 2017 WL 1032510, at *3 (W.D. Tex. Mar. 16, 2017) (detailing how noteholders “conspired together to threaten iHeart” instead of engaging in an exchange).

¹²⁶ See *id.*

¹²⁷ See *id.* Section 4.10 of the applicable indentures (the “iHeart Indentures”) stated that “[t]he Issuer shall not, and shall not permit any of its Restricted Subsidiaries to, consummate an Asset Sale, unless’ one of a series of exceptions applies. ‘Asset Sale’ is defined in the Indentures as meaning ‘the sale, conveyance transfer or other disposition . . . of property or assets . . . of the Issuer or any of its Restricted Subsidiaries,’ or ‘the issuance or sale of Equity Interests of any Restricted Subsidiary.’” See First Amended Petition for a Temporary Restraining Order, Temporary Injunction, Permanent Injunction and Declaratory Relief at 10-11, *iHeart Commc’ns, Inc. v. Benefit St. Partners LLC*, No. 2016-04006, 2016 WL 902088 (Tex. Dist. Mar. 8, 2016) (citing iHeart Indentures §§ 4.10, 1.01). The indentures also restricted iHeart’s ability to enter into various types of transactions with affiliated companies. See *id.* at 11 (citing iHeart Indentures § 4.11(a)).

The term “Permitted Investment” captured capital contributions of less than \$600 million made to an affiliate of the borrower.¹²⁸ As written, this exception produced an unexpected result: iHeart could orchestrate a transfer of significant corporate assets—an action that would ordinarily be forbidden—as long as the actions arguably benefited the company. By the end of 2015, iHeart’s private equity sponsors had few options left and decided to pursue an aggressive “drop down” transaction.¹²⁹

On December 3, 2015, Clear Channel Holdings, a wholly owned subsidiary of iHeart that was restricted under the applicable indenture, contributed 100 million Class B shares of Clear Channel Outdoor Holdings (CCOH) to Broader Media, a newly formed, wholly owned unrestricted subsidiary of iHeart.¹³⁰ The shares were valued at \$516 million.¹³¹ The plan was for CCOH to declare a significant dividend. With the new funds, Broader Media would purchase approximately \$383 million of the iHeart Notes.¹³² The final step was unspoken but obvious: iHeart would not pay Broader Media upon maturity of the iHeart Notes but iHeart would be insulated because Broader Media would not declare a default.

Noteholders objected to this clever maneuver and sent default notices arguing that the transfer of shares could not be a “Permitted Investment” because the transaction was—quite simply—not an investment.¹³³ iHeart responded by filing a complaint in Texas state court seeking (1) an order prohibiting the noteholders from issuing a default notice, and (2) a declaratory judgment that the company was not in default.¹³⁴

In upholding the transaction, Judge Stryker highlighted the discrepancy between market expectations and contractual provisions in sponsor-favorable documents.¹³⁵ Judge Stryker explained that though the iHeart Noteholders may have believed that the covenant restricting transfers to unrestricted subsidiaries was robust, the “Permitted Investment” exception to that covenant was large enough to ostensibly swallow the rule.¹³⁶ There were no restrictions on iHeart (1) creating an unrestricted subsidiary, (2) subjectively valuing CCOH shares so as to remain below the \$600 million transfer cap, or

128 *iHeart*, 2017 WL 1032510, at *3.

129 See Buccola & Nini, *supra* note 85, at 10.

130 See First Amended Petition, *supra* note 127, at 14; see also *iHeart*, 2017 WL 1032510, at *3.

131 See *iHeart*, 2017 WL 1032510, at *3 n.4.

132 See *id.* at *4.

133 *Id.* at *4.

134 See First Amended Petition, *supra* note 127, at 4.

135 See Brief for Appellee at 30-33, *Franklin Advisers, Inc. v. iHeart Commc'ns, Inc.*, No. 04-16-00532-CV, 2017 WL 4518297 (Tex. App. Oct. 11, 2017) (detailing Judge Stryker’s ruling).

136 See *id.* at 32.

(3) then transferring the shares to the unrestricted subsidiary, which could then freely purchase iHeart's debt.¹³⁷

A distressed corporate entity attempting to exploit noteholders was not necessarily novel, but the terms at issue and the court's willingness to enforce these terms in a way that arguably contravened market expectations highlighted new possibilities for future distressed borrowers.¹³⁸

2. J.Crew (2017)

Just two years later, iHeart's restructuring model was taken into uncharted waters. J.Crew struck at the king—secured lenders—and hit. In 2013, J.Crew funded a “dividend recap”¹³⁹ by selling approximately \$500 million in new payment-in-kind notes with a 2019 maturity (the “2019 PIK Notes”).¹⁴⁰ By 2016, the company was experiencing significant distress and was certain to default on the notes.¹⁴¹ The company's term loan agreement permitted a convoluted, multi-stage process by which assets could be moved out of the term lenders' collateral package.¹⁴² Section 7.02 of the agreement allowed a restricted loan party to make up to a \$150 million investment¹⁴³ in a restricted subsidiary as long as the subsidiary was not a party to the term loan.¹⁴⁴

¹³⁷ After Judge Stryker's ruling, iHeart went forward with its plan and purchased the iHeart Notes. But the \$222 million price tag was “approximately \$100 million higher” than the company would have paid if the Noteholders had not intervened. *See iHeart*, 2017 WL 1032510, at *4.

¹³⁸ The *iHeart* ruling made it clear that there are a number of restructuring options if a court adopts a strict reading of applicable indentures and accompanying term loan provisions. Primarily, an issuer could rely on an unrestricted subsidiary to compel an attractive debt-for-debt exchange offer. The new debt would be secured by the assets transferred to the unrestricted subsidiary and could be senior to old debt, especially if that old debt is unsecured. This possibility would create a powerful incentive to participate in an exchange even under terms unfavorable to the investor. Further, assets transferred to an unrestricted subsidiary initially valued at an amount permitted by the indenture could then be sold at a much higher price and the funds used in a variety of ways without recourse.

¹³⁹ A dividend recap, or dividend recapitalization, involves taking on new debt in order to pay a special dividend to investors. Here, that dividend went to the company's private equity sponsors. Amended Complaint at 18, *Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y*, 171 A.D.3d 626 (N.Y. Sup. Ct. 2019) [hereinafter “J.Crew Complaint”].

¹⁴⁰ *Id.* at 21; *see also* Kenneth Ayotte & Christina Scully, *J.Crew, Nine West, and the Complexities of Financial Distress*, 131 YALE L.J. FORUM 363, 368 n.19 (2021) (“Payment-in-kind notes are debt securities that allow for interest to be paid ‘in kind’ in the form of additional notes or by increasing the outstanding principal instead of in cash.”).

¹⁴¹ Ayotte & Scully, *supra* note 140, at 368.

¹⁴² *Id.* at 368-69.

¹⁴³ Lenders may have assumed that “investments” could be only cash distributions, but the language of the governing documents appeared to allow transfers of any type of asset. *See* David W. Morse, *Where Did My Collateral Go?*, SECURED LENDER (July 15, 2017), https://www.martindale.com/matter/asr-2500841.Otterbourg_TSL.pdf [<https://perma.cc/2XPR-ZEC9>].

¹⁴⁴ *See* Ayotte & Scully, *supra* note 140, at 369 n. 28.

Further, the loan agreement allowed a restricted subsidiary to make up to a \$100 million investment in another corporate entity.¹⁴⁵ Finally, the loan agreement permitted a restricted subsidiary not subject to the agreement to make investments in an unrestricted subsidiary¹⁴⁶ as long as the investments were financed with proceeds received by the restricted subsidiary from an investment in such entity.¹⁴⁷ After the transfer, there were no contractual limits on the use of the transferred investment. Collectively, these provisions created the trap door that allowed for a “drop-down” transaction.¹⁴⁸

In December 2016, J.Crew engaged a third party that valued core company trademarks at \$347 million.¹⁴⁹ Relying on the loan agreement’s two investment provisions, the company transferred a subset of these trademarks that it independently valued at \$250 million (72.04%) to a restricted subsidiary that was a Non-Loan Party.¹⁵⁰ The trademarks were then transferred to J.Crew Brand Holdings, a newly formed, unrestricted subsidiary that was not subject to the covenants or restrictions found in the loan agreement.¹⁵¹ If the transfers were upheld, the trademarks would become unencumbered and J.Crew could use them without creditor restrictions.

Outraged term lenders argued that J.Crew had defaulted under the loan agreement.¹⁵² On February 1, 2017, J.Crew commenced an action against the administrative agent for the term lenders seeking a declaratory ruling that no event of default had occurred.¹⁵³

While litigation was pending, J.Crew continued executing its plan in which exploiting the contractual loophole was just the first step. J.Crew’s innovation was layering multiple coercive measures onto the deal. On June 12, 2017, J.Crew offered holders of the 2019 PIK Notes the opportunity to exchange the original notes for new notes maturing in 2021, secured primarily by the transferred trademarks.¹⁵⁴ This offer was similar to one the noteholders

¹⁴⁵ See *id.*

¹⁴⁶ An unrestricted subsidiary is an affiliate of the borrower whose assets do not represent lenders’ collateral and who is not otherwise subject to the covenants or other terms of the credit facility. See David W. Morse, *Surprise! Where Did My Collateral Go (Again)? The Chewy.com Story*, SECURED FIN. NETWORK (Apr. 1, 2019), [https://www.sfnet.com/home/industry-data-publications/the-secured-lender/magazine/tsl-article-detail/surprise!-where-did-my-collateral-go-\(again\)-the-chewy.com-story](https://www.sfnet.com/home/industry-data-publications/the-secured-lender/magazine/tsl-article-detail/surprise!-where-did-my-collateral-go-(again)-the-chewy.com-story) [<https://perma.cc/AC94-7GAE>].

¹⁴⁷ See Ayotte & Scully, *supra* note 140, at 368.

¹⁴⁸ See *id.* at 368-69.

¹⁴⁹ J.Crew Complaint, *supra* note 139, at 21.

¹⁵⁰ *Id.* at 19.

¹⁵¹ *Id.* at 14-15.

¹⁵² *Id.* at 2-5.

¹⁵³ *Id.* at 26.

¹⁵⁴ *Id.* at 29. J.Crew’s first proposed exchange offer, which was rejected outright, would have allowed certain noteholders to exchange the 2019 PIK Notes for \$200 million of new notes due in 2021. *Id.* at 28-29.

had rejected just months before, but this time J.Crew offered a threat: as part of the exchange, consenting noteholders would agree to strip various covenants from the 2019 PIK Notes.¹⁵⁵ In other words, if enough noteholders consented to the exchange, this group would eviscerate the non-consenting noteholder's position on the way out the door. Sensing a viable threat, a super-majority of the noteholder group agreed to participate.¹⁵⁶ But J.Crew was still not done. The next step was to squeeze a deal out of the term lenders.

J. Crew made a similarly coercive offer to all term lenders. The company offered to purchase \$150 million of the term loans funded by the issuance of new debt.¹⁵⁷ Those that consented received partial repayment at par, and J. Crew agreed to close the trap-door loophole.¹⁵⁸ In exchange, a majority of the consenting lenders would, before officially accepting J.Crew's offer, vote to (1) release the remaining 28% of the trademark as collateral under the J.Crew term-loan agreement, (2) pay a \$59 million license fee to one of the newly formed unrestricted subsidiaries, and (3) modify the "no-action clause"¹⁵⁹ in the J.Crew Term Loan Agreement, which would prevent any claims or counterclaims the administrative agent had made or could make regarding the drop-down transaction.¹⁶⁰ For the term lenders, the offer was a poor one at best, but those that did not consent faced the risk of their value being transferred to the consenting lenders while losing the ability to appeal to the courts. Term lenders had only three days to decide.¹⁶¹ With limited time to coordinate and otherwise dissuade defectors, 88% of lenders agreed to the exchange.¹⁶²

¹⁵⁵ *Id.* at 30-31.

¹⁵⁶ *Id.* at 32.

¹⁵⁷ *Id.* at 30-31.

¹⁵⁸ *Id.*

¹⁵⁹ When companies issue notes or bonds, an "indenture" is invariably created to govern the terms of the debt instrument. A "no-action" clause is a common provision in an indenture that establishes when and how creditors can take legal action against the issuer. *See, e.g., Eleventh Circuit Rules "No-Action" Clause Bars Noteholders' Fraudulent-Transfer Claims*, JONES DAY: INSIGHTS (July/Aug. 2012), <https://www.jonesday.com/en/insights/2012/08/eleventh-circuit-rules-no-action-clause-bars-noteholders-fraudulent-transfer-claims> [<https://perma.cc/AVY2-KN6A>] (providing a standard example of a "no-action" clause).

¹⁶⁰ J.Crew Complaint, *supra* note 139, at 30.

¹⁶¹ *Id.* at 32.

¹⁶² *See* Diane Lourdes Dick, *Hostile Restructurings*, 96 U. WASH. L. REV. 1333, 1365 (2021) ("Lenders who collectively held approximately 88% of the outstanding loans voted to accept the restructuring terms."). Once J.Crew had the consent of 88% of lenders, this group was able to instruct the administrative agent on the Term Loan Agreement to cease any litigation related to the drop-down transaction. *Id.*

Unfortunately for J.Crew, the deal was oversubscribed and failed to secure the necessary level of financial flexibility. Despite its herculean efforts, J.Crew filed for bankruptcy on May 4, 2020.¹⁶³

3. PetSmart/Chewy.com (2018)

Sponsor victories with iHeart and J.Crew spurred further innovation and aggression. By 2018, PetSmart was drowning in debt from a \$8.5 billion leveraged buyout in 2015 coordinated by its private equity sponsor, BC Partners, and a \$3 billion acquisition of Chewy.com.¹⁶⁴ The acquisition of Chewy.com had been especially troubling because it appeared to accelerate the company's financial decline and had required a \$1 billion infusion of capital by BC Partners.¹⁶⁵ The sponsor wanted its money back and had the means to get it.¹⁶⁶

The first step was to rely on the “restricted payment” exception to the restriction on asset transfers. The term-loan agreement contained the customary negative covenant prohibiting various payments and distributions

¹⁶³ Mike Spector, *J. Crew Files for Bankruptcy as Preppy Retailer Succumbs to COVID-19 Fallout*, REUTERS (May 4, 2020, 3:52 AM), <https://www.reuters.com/article/us-j-crew-group-bankruptcy/j-crew-files-for-bankruptcy-as-preppy-retailer-succumbs-to-covid-19-fallout-idUSKBN22GoO4> [<https://perma.cc/J782-T4P8>]. The possibility of being “J.Screwed” is very real in the current environment. See Reshmi Basu & Rachel Butt, *Instant Pot Maker Lays Foundation for Controversial Debt Move*, BLOOMBERG (Jan. 25, 2023, 5:41 PM), <https://www.bloomberg.com/news/articles/2023-01-25/instant-pot-maker-lays-foundation-for-controversial-debt-move#xj4y7vzkg> [<https://perma.cc/CL6A-CV6P>] (describing the use of a similar maneuver by housewares maker Instant Brands Holdings); see also Shannon D. Harrington, *The Fear of Being J. Crewed Is Once Again Roiling Leveraged Loans*, BLOOMBERG (Jan. 28, 2023, 2:58 PM), <https://www.bloomberg.com/news/articles/2023-01-28/the-fear-of-being-j-crewed-is-once-again-roiling-leveraged-loans#xj4y7vzkg> [<https://perma.cc/345Y-ZB33>] (describing the use of similar maneuvers in recent years by major companies).

¹⁶⁴ See Michael J. De La Merced, *PetSmart Accepts 8.7 Billion Buyout*, N.Y. TIMES (Dec. 14, 2014, 4:33 PM), <https://archive.nytimes.com/dealbook.nytimes.com/2014/12/14/petsmart-to-sell-itself-to-investor-group-for-8-7-billion/> [<https://perma.cc/4728-K5BK>]; Jason Del Ray, *PetSmart Is Acquiring Chewy.com for \$3.35 Billion in Largest E-Commerce Acquisition*, CNBC (Apr. 18, 2017, 3:46 PM), <https://www.cnbc.com/2017/04/18/petsmart-buys-chewy.html> [<https://perma.cc/CCE9-QBSZ>] (describing the deal as “the biggest e-commerce acquisition in history”).

¹⁶⁵ See Joe Rennison & Sujeet Indap, *PetSmart Scraps Debt Deal After Investor Push Back*, FIN. TIMES (Oct. 30, 2020), <https://www.ft.com/content/bb212e94-3048-45c8-9fac-d01b592c6898> [<https://perma.cc/K4K9-J4UX>] (describing PetSmart as “struggling under debt it took on to fund the acquisition” of Chewy.com).

¹⁶⁶ The equity sponsor elected disinterested directors to PetSmart's board—PetSmart would subsequently argue that these directors conceived of and supported the maneuvers. But the impartiality of these directors is rightfully disputed as they were hand selected by PetSmart's equity sponsor and took actions that predominately benefitted the sponsor. Counterclaims, Answer, and Affirmative Defenses at 16, *Argos Holdings, Inc. v. Wilmington Tr. Nat'l Ass'n*, No. 18cv5773(DLC), 2019 WL 1397150 (S.D.N.Y. Mar. 28, 2019) [hereinafter “PetSmart Answer”].

but also provided a number of exceptions for “Restricted Payments.”¹⁶⁷ The loan agreement allowed PetSmart to make payments up to the sum of \$200 million plus any funds that could be categorized as “Available Equity Amount”—a term that captured capital contributions received by PetSmart after the closing of the PetSmart Term Loan Agreement.¹⁶⁸ PetSmart argued that since it received \$1 billion in capital contributions in connection with its acquisition of Chewy.com, it could distribute up to \$1.2 billion.¹⁶⁹ Consequently, PetSmart’s board voted to issue a dividend to its equity sponsor in the form of 20% of Chewy stock,¹⁷⁰ valued at \$908.5 million.¹⁷¹ This distribution ostensibly made BC Partners whole after its capital infusion and significantly eroded the secured lenders’ position. The dividend sent value up the corporate chain. Further, Chewy.com was no longer a wholly owned subsidiary of PetSmart, which—pursuant to PetSmart’s interpretation of Section 9.15 of the term loan agreement—arguably released Chewy.com’s guarantee on the term loan and the lenders’ lien on Chewy.com’s assets.¹⁷²

The ordeal for lenders was not over yet. PetSmart next relied on the “investment” exception that is common in various credit agreements. PetSmart formed a new, wholly owned unrestricted subsidiary and then adopted the position that section 6.04 of the term loan agreement permitted it to transfer Chewy.com stock to the unrestricted subsidiary in the amount of approximately \$1.2 billion.¹⁷³ Based on this tactic, PetSmart transferred 16.5% of Chewy.com stock—estimated to be less than \$750 million—to an unrestricted subsidiary controlled by BC Partners.¹⁷⁴

A flurry of litigation ensued, but as those battles unfolded, Chewy.com’s financial performance improved significantly.¹⁷⁵ As a result, BC Partners decided to bring an end to the dispute, adopting J.Crew’s framework. BC

¹⁶⁷ Complaint at 15, *Argos Holdings, Inc. v. Wilmington Tr. Nat’l Ass’n*, No. 18cv5773(DLC), 2019 WL 1397150 (S.D.N.Y. Mar. 28, 2019) [hereinafter “PetSmart Complaint”].

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 16.

¹⁷⁰ *Id.* at 2. It is unclear if the term loan agreement contemplated a “restricted payment” being in a form other than cash. Once again, ambiguity in the agreement—which I argue was by design—benefited the equity sponsor.

¹⁷¹ *Id.* at 16. PetSmart sent Chewy stock to Argos Holdings—its parent entity. Argos Holdings sent the stock to its parent, Argos Intermediate Holdco III, Inc., which in turn sent the stock to its new, wholly owned subsidiary, Buddy Holdings Corp. All entities were controlled by BC Partners. See PetSmart Answer, *supra* note 166, at 15.

¹⁷² PetSmart Complaint, *supra* note 7, at 10. This tactic was also used by Apollo in advance of Caesar’s bankruptcy case. See FRUMES & INDAP, *supra* note 89, at 96.

¹⁷³ \$200 million plus 50% of the company’s consolidated net income since the effective date of the term loan. PetSmart Complaint, *supra* note 167, at 16.

¹⁷⁴ *Id.* at 2, 17.

¹⁷⁵ See *id.* at 9 (explaining that Chewy’s valuation increased by nearly \$1.5 billion in the year following the start of litigation).

Partners made a general offer to all loan holders: as part of the exchange offer, consenting holders would receive a small fee, an increased interest rate on the debt, and a commitment from the company to aggressively reduce the outstanding balance.¹⁷⁶ The coercive term was that those in the consenting group would vote to alter the terms of the loan agreement to withdraw all litigation related to the transfer of Chewy.com stock.¹⁷⁷ The offer was open for twenty-four hours or until a majority of loan holders consented.¹⁷⁸ The creditor response to this offer was unlike the one seen with iHeart, however, as loan holders were able to coordinate and indicated that the collective would not accept the offer.¹⁷⁹ Without a majority, PetSmart would not be able to alter the terms of the loan agreement or cease the pending litigation. However, as is often the case in a prisoner's dilemma scenario, a defection occurred. A few hours before the termination of the twenty-four hour deadline, Apollo accepted the borrower's offer, causing a rush to enter Valhalla before the doors closed.¹⁸⁰ PetSmart secured the majority it needed. This group ultimately voted to dismiss the litigation in April 2019, leaving the other loan holders without recourse.¹⁸¹

B. Sponsor Innovation Accelerates

Private equity sponsors created a contractual arsenal to provide distressed entities optionality. In recent years, this arsenal was deployed and borrowers began layering coercive measures. The result was the power to dictate outcomes and select winners and losers in distress situations. Two representative cases appear below.

¹⁷⁶ Sujeet Indap, *Pet Supplies IPO Follows Dog-Eat-Dog Battle for Debtholders*, FIN. TIMES (May 6, 2019), <https://www.ft.com/content/e8afa8bc-6f98-11e9-bf5c-6eeb837566c5> [https://perma.cc/YT5M-VTR4].

¹⁷⁷ *See id.*

¹⁷⁸ *Id.*

¹⁷⁹ The loan holders did not have sufficient time to prepare a joint cooperation agreement or similar document that—if signed—could have served to bind the group. Joint cooperation agreements represent a creditor countermeasure to coercive borrower tactics. *See* Parikh, *supra* note 118. The tactic was first seen in the Caesars' bankruptcy case with the junior lienholders. *See* FRUMES & INDAP, *supra* note 89, at 253 ("The plan was to form a so-called 'cooperation agreement,' where a group of holders would commit to refuse to [settle with the borrower]."). These types of agreement may not be enforceable but are becoming more prevalent. *See* Davide Scigliuzzo & Eliza Ronalds-Hannon, *Apollo, Pimco in Pact to Prevent Creditor Brawl Over Carvana*, BLOOMBERG L. (Dec. 6, 2022), <https://www.bloomberg.com/news/articles/2022-12-07/apollo-pimco-sign-pact-to-prevent-creditor-brawl-over-carvana> [https://perma.cc/X5QG-5JY8]; Kristin Mugford & Sarah Gulick, *Revlon: Surviving COVID-19*, HARV. BUS. SCH. 10 (Mar. 3, 2021).

¹⁸⁰ *See* Indap, *supra* note 176.

¹⁸¹ *Id.*

1. TriMark (2021)

TriMark may be the first coercive exchange that can be attributed to the Covid-19 pandemic. The pandemic eliminated most indoor dining options, and TriMark's restaurant supply business was one of many casualties.¹⁸² Even while TriMark's CFO, Chad Brooks, was dismissing creditor inquiries about the need for an out-of-court restructuring,¹⁸³ the company had already selected a group of secured lenders holding a majority of TriMark's debt to help effectuate an up-tier exchange¹⁸⁴ coupled with "exit consents"—the promise that lenders would vote to alter covenants on existing agreements.

TriMark's plan was a departure from the coercive exchanges of the previous few years. The first step involved the TriMark Majority Lenders voting to alter fundamental provisions in the original credit agreement. The modifications (1) pushed out the repayment schedule for the original loan, (2) subordinated the collateral position of the other lenders (the "TriMark Minority Lenders") to that of the majority, (3) stripped ostensibly all protective covenants out of the original credit agreement, and (4) broadened the scope of the applicable "no-action" clause to prevent the TriMark minority lenders from attempting to stop the scheme.¹⁸⁵ TriMark was then able to issue new "First-Out" debt of \$120 million to the TriMark Majority Lenders secured by the collateral that had secured TriMark's original first-lien debt.¹⁸⁶ TriMark also issued new \$307.5 million "Second-Out" debt to the

¹⁸² See Plaintiffs' Consolidated Opposition to Defendants' Motions to Dismiss at 7, *Audax Credit Opportunities Offshore Ltd v. TMK Hawk Parent, Corp.*, No. 565123/2020, 2021 WL 3671541 (N.Y. Sup. Aug. 16, 2021).

¹⁸³ See *id.* (alleging that Brooks said to concerned creditors that TriMark's "liquidity remain[s] strong," and "TriMark does have plenty of liquidity").

¹⁸⁴ An "up-tier" transaction is one in which a group of creditors provide additional financing in exchange for a super-priority position achieved by altering the original term loan. The two big pieces of the maneuver involve (1) securing a majority of lenders who can then amend the applicable credit agreement to subordinate the liens and/or claims of existing lenders, often described as "exit consents"; and (2) the borrower conducting non-pro rata buy-backs or exchanges of existing debt for new debt as "open market" purchases. See, e.g., Decision + Order on Motion at 4, *N. Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC*, No. 652243/2020 (N.Y. Sup. Ct. June 19, 2020). The maneuver can also be effectuated in a bankruptcy case through creative provisions in a DIP loan. See Kenneth Ayotte & Alex Zhicheng Huang, Standardizing and Unbundling the Sub Rosa DIP Loan (Dec. 27, 2022) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4313279 [<https://perma.cc/UQ8V-MNX9>].

¹⁸⁵ *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.*, No. 565123/2020, 2021 WL 3671541, at *4-5, 8, 11 (N.Y. Sup. Ct. Aug. 16, 2021.) The revised "no-action" clause prevented the TriMark Minority Lenders from filing "any actions or proceedings, judicial or otherwise, for any right or remedy or assert[ing] any other Cause of Action" against TriMark or the TriMark Majority Lenders. *Id.* at *5. The extension of protection to the majority lenders was a "notable departure from industry norms . . ." *Id.* The clause was ultimately found to be unenforceable. *Id.* at *7.

¹⁸⁶ *Id.* at *5.

majority lenders in a dollar-for-dollar exchange for the debt they originally held.¹⁸⁷ The old debt was then retired, and the majority was no longer subject to the original loan's terrible news terms.¹⁸⁸

TriMark found support for its actions in the credit documents. Section 9.02 of the first-lien lenders term loan (First Lien Credit Agreement) provided that lenders having more than 50% of the outstanding term loans and unused commitments could waive, amend, or modify any of the agreement's provisions, except for certain "sacred rights."¹⁸⁹ Section 6 contained covenants that restricted incurrence of new debt or new liens on the subject collateral senior to the lenders' interests.¹⁹⁰ And Section 4.02 established the waterfall among the three constituents in the credit agreement, subject to the intercreditor agreement.¹⁹¹ The company's cannibalistic assault relied on Section 9.02 to eliminate Section 6 and then modify the definition of "Intercreditor Agreements" to include the new super senior credit agreement, thereby giving the TriMark majority lenders priority over the TriMark minority lenders.¹⁹² Other changes were made to the original loan which allowed for the subordination of the Losing Lenders' collateral position through alteration of the waterfall provision.¹⁹³

Particularly noteworthy was the fact that the no-action clause modifications were unprecedented.¹⁹⁴ The new amended terms precluded any lender from "tak[ing] or institut[ing] any actions or proceedings, judicial or otherwise, for any right or remedy or assert[ing] any other Cause of Action" against TriMark and the Lender Defendants.¹⁹⁵ This was "a notable departure from industry norms."¹⁹⁶ All claims had to be directed to the administrative agent. The ability to "direct," however, "had a new and significant catch."¹⁹⁷ Under Section 9.03[f] of the Amended Agreement, the Administrative Agent could proceed only if the Lenders posted a cash indemnity

¹⁸⁷ See *id.*

¹⁸⁸ At this time, the first lien debt was trading at 78 cents with a total market value of \$239.85 million. The exchange would land the winning lenders approximately \$67.65 million in increased value. *Id.* at *5.

¹⁸⁹ *Id.* at *3-4.

¹⁹⁰ *Id.* at *5.

¹⁹¹ *Id.*

¹⁹² *Id.* at *3-5.

¹⁹³ *Id.* at *5.

¹⁹⁴ See TriMark: *Are 'Sacred Rights' Still Sacrosanct?*, ALSTON & BIRD: NEWS & INSIGHTS (Sept. 10, 2021) ("Before [TriMark] . . . it was often assumed . . . that typical sacred rights provisions in credit agreements protected nonparticipating lenders from these transactions.").

¹⁹⁵ *Audax Credit Opportunities Offshore Ltd.*, 2021 WL 3671541, at *5.

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

of not less than the sum of (x) all fees, costs and expenses of the Administrative Agent determines, in its sole discretion, could foreseeably be incurred in connection with such action and (y) the amount of any claims, obligations or liability, via counter-claims or otherwise, that the Administrative Agent determines, in its sole discretion, could foreseeably be awarded to the defendants in connection with such action. For good measure, the Amended Agreement purportedly indemnifies the Administrative Agent “for acts taken in bad faith.”¹⁹⁸

Finally, the new agreement removed the requirement that TriMark had to indemnify the Lenders for “any and all losses, claims, damages and liabilities” and related “legal fees and expenses.”¹⁹⁹

Significant litigation ensued but was promptly settled in January 2022. The non-participating lenders were allowed to swap their loans on a dollar-for-dollar basis for the tranche B paper. But the participating lenders still emerged victorious, retaining their senior position in the capital structure.²⁰⁰

2. Envision Healthcare (2022)

In 2022, Envision Healthcare proactively engaged with a select group of existing creditors and new third-party lenders to solicit proposals to reduce the company’s overall indebtedness.²⁰¹ This process resembled a sealed-bid auction and a group led by Centerbridge Partners was the winning bidder.²⁰²

The deal that emerged was not offered to all lenders. Rather, only a select group were allowed to participate.²⁰³ The heart of the offer involved a dreaded drop-down transaction. Envision moved 80% of its ambulatory services business, AmSurg Corp., to an unrestricted subsidiary and out of lenders’ collateral package.²⁰⁴ After the transfer, AmSurg was used as collateral to borrow up to \$2.6 billion in first-lien and second-lien loans from a group led

¹⁹⁸ *Id.* (emphasis and citations omitted). Barclays Bank resigned as administrative agent because of these changes. *Id.*

¹⁹⁹ *Id.* Note that this did not work in TriMark. The court refused to enforce the no-action clause as modified because the new language was targeted at the Losing Lenders specifically. *Id.* at *5-7.

²⁰⁰ See *Lender on Lender Violence is Back! And On Steroids*, PETITION (Apr. 6, 2022), [hereinafter *Lender on Lender Violence is Back!*], <https://petition.substack.com/p/incoradeal> [https://perma.cc/APG9-MVVX].

²⁰¹ See Alexander Saeedy & Jodi Xu Klein, *KKR’s Envision Sparks Lender Dispute with Centerbridge, Angelo Gordon Deal*, WALL ST. J. (May 2, 2022, 6:55 PM), <https://www.wsj.com/articles/kkrs-envision-sparks-lender-dispute-with-centerbridge-angelo-deal-11651524188> [https://perma.cc/XX8D-56DM].

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.*

by Centerbridge.²⁰⁵ The funds helped repurchase the company's existing debt and reduce total indebtedness by approximately \$600 million.²⁰⁶ Existing secured lenders' liens on AmSurg were released through the maneuver.²⁰⁷ The trading value of the original loan immediately reflected the diminished position, falling to 53 cents on the dollar from a high of 82 cents earlier in the year.²⁰⁸

The disadvantaged lenders—including Blackstone Credit and SVP Global—objected, but they could not be described as innocent bystanders. These lenders had proposed an even more aggressive “up-tiering” plan to Envision that would have primed other lenders.²⁰⁹ Envision had rejected this offer, not because it was unethical but because the competing offer provided the company with additional flexibility to effectuate another drop-down transaction in the future if necessary to secure additional financing.²¹⁰

There were many innovations in Envision's restructuring. The most surprising of which may be the fact that the company was not facing an immediate default or liquidity crisis, which are customarily prerequisites to coercive measures.²¹¹ The company saw an opportunity and proactively sought it out. Further, the company did not confine itself to working exclusively with existing lenders. Rather, it engaged with a group of third-party financial institutions that had little existing credit exposure to Envision. This allowed the company to force creditors to invest the time and resources into formulating competing offers.²¹² Finally, regardless of which proposal was selected, the advantageous terms in both were available only to a small subset of parties. There was no scenario where the borrower was going to

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ See Eliza Ronalds-Hannon & Rachel Butt, *Credit-Market Clashes are Getting Uglier, Dirtier and More Common*, BLOOMBERG L. (May 10, 2022, 7:30 AM), <https://www.bloomberg.com/news/articles/2022-05-10/credit-market-clashes-are-getting-uglier-dirtier-more-common?leadSource=verify%20wall> [<https://perma.cc/5J8V-5K22>].

²⁰⁹ See Jodi Xu Klein, *KKR Sets Off Investor Fight to Keep Envision Afloat*, WALL ST. J. (May 6, 2022), <https://www.wsj.com/articles/pro-take-kr-sets-off-investor-fight-to-keep-envision-afloat-11651833001> [<https://perma.cc/P956-KY9S>].

²¹⁰ *Id.*

²¹¹ See *id.*

²¹² See Matt Levine, *Terra Flops*, BLOOMBERG OP.: MONEY STUFF (May 11, 2022, 1:44 PM), <https://www.bloomberg.com/opinion/articles/2022-05-11/terra-flops> [<https://perma.cc/DQ2T-X8DJ>] (“Some of Envision's creditors were like ‘pay us off and hose the other guys, we’ll make it worth your while.’ Envision turned them down and instead took money from a different set of lenders, hosing the first guys. That’s how it works!”).

make an exchange offer to the lender collective and accept all willing participants—a course that had proven ill-fated for J.Crew.²¹³

IV. A MOVE TOWARDS EQUILIBRIUM

Directors and officers are the architects of the new coercive exchanges creating disequilibrium. To the extent the leveraged loan market offers retail products through mutual funds and other vehicles, public confidence is essential to the growth of these markets. A vibrant public market for debt securities relies on various measures to police exploitation. But public confidence is eviscerated if borrowers are allowed to target specific investors from whom to appropriate value and ostensibly pick winners and losers in times of financial distress.²¹⁴ I believe there is a public interest in minimizing cannibalistic assaults in order to bolster market integrity. Further, these maneuvers are designed to avoid bankruptcy—a formal proceeding that preserves value by offering a quick asset sale or the means by which a debtor can rehabilitate faltering operations. Bankruptcy is tough, but oftentimes necessary, medicine. Many of the companies that implemented coercive exchanges failed to improve their financial situation. Envision, Incora, iHeart, J.Crew, and Serta Simmons all filed for bankruptcy.²¹⁵ These cases

²¹³ See Vince Sullivan, *J.Crew Just First In Expected Flood of Retail Bankruptcies*, LAW360 (May 4, 2020, 9:24 PM), <https://www.law360.com/articles/1270220/j-crew-just-first-in-expected-flood-of-retail-bankruptcies> [<https://perma.cc/SUR5-HD7Y>].

²¹⁴ See Kevin Eckhardt, *Court Opinion Review: The Third Circuit's LTL Decision and the Serta/Revlon Liability Management Cases*, REORG: AMS. CORE CREDIT (Feb. 7, 2023, 1:27 PM) (“[T]hese kinds of disputes could be very, very bad for distressed debt business. Funds that invest in investment-grade assets . . . are not accustomed to being involuntarily subordinated . . . by groups of fellow investors in league with the borrower. They certainly do not want to get involved in yearslong, expensive litigation . . . Turning our coverage universe into a bar fight . . . doesn’t help bring new investors into the space.”).

²¹⁵ See Rachel Butt, *KKR's Envision Files for Bankruptcy to Cut \$5.6 Billion Debt*, BLOOMBERG NEWS (May 15, 2023, 5:51 AM), <https://news.bloomberglaw.com/bankruptcy-law/kkrs-envision-files-bankruptcy-after-creditor-talks-fail> [<https://perma.cc/W2JC-NK57>]; Simon Lee, *Incora Files for Chapter 11 With Over \$300m in DIP Financing*, BLOOMBERG (May 31, 2023, 1:58 AM), <https://news.bloomberglaw.com/bankruptcy-law/incora-files-for-chapter-11-with-over-300m-in-dip-financing> [<https://perma.cc/94MZ-XD9M>]; Tom Hals, *Largest U.S. Radio Company iHeartMedia Files for Bankruptcy*, REUTERS (Mar. 15, 2018, 1:19 AM), <https://www.reuters.com/article/us-iheartmedia-bankruptcy/largest-u-s-radio-company-iheartmedia-files-for-bankruptcy-idUSKCNiGRoGB> [<https://perma.cc/CH87-KSHF>] (describing the circumstances surrounding iHeartMedia’s bankruptcy filing); Sullivan, *supra* note 213 (describing the circumstances surrounding J.Crew’s bankruptcy filing); Amelia Pollard & Luca Casiraghi, *Serta Simmons Files for Bankruptcy Amid Financing Controversy*, BLOOMBERG (Jan. 23, 2023, 11:47 PM), <https://www.bloomberglaw.com/bloomberglawnews/bankruptcy-law/XAMFoUNK000000> [<https://perma.cc/FS3A-2T2V>] (explaining that Serta was forced to file for bankruptcy after disagreements with creditors eliminated any other means of reducing the company’s debt load); see also Erin Hudson, Rachel Butt & Eliza Ronalds Hannon, *KKR's Envision Lenders Tap Advisers as Business Concerns Mount*, BLOOMBERG L. (Mar. 30, 2023, 4:38 PM),

demonstrate that evasion can destroy value by allowing a “zombie” company to limp along until there is very little left to salvage.²¹⁶

A move towards financial equilibrium in distressed debt markets is possible by adjusting the two bookends of the process: the moment of distress and the moment of acquisition.

A. *The Moment of Distress: Direct Claims Against Directors*

Directors are tasked with pursuing economic activities that maximize a firm’s value for the benefit of a firm’s residual beneficiaries, its equity capital owners.²¹⁷ Naturally, shareholders and the firm are owed fiduciary duties, and a director’s breach of such duties can entitle shareholders to bring either direct or derivative claims.²¹⁸ Directors of a solvent firm, however, do not owe fiduciary duties to creditors, who are ostensibly able to protect themselves through contractual provisions, implied covenants, and various specific legal doctrines, including fraudulent transfer law.²¹⁹

As is often the case, insolvency²²⁰ overturns these staid dynamics. Financial distress does “curious things to incentives, exposing creditors to risks of opportunistic behavior.”²²¹ Therefore, in all key jurisdictions, fiduciary duties for directors of an insolvent firm extend to include creditors.²²² In these situations, directors can be analogized to trustees

<https://www.bloomberglaw.com/bloomberglawnews/bankruptcy-law/XEUTK25C000000>

[<https://perma.cc/2GP2-8FK2>] (describing KKR’s actions ahead of potential bankruptcy filing).

²¹⁶ See Vince Sullivan, “Zombie” Retailers Like Bed Bath & Beyond Face a Reckoning, LAW360 (Jan. 26, 2023, 2:50 PM), <https://www.law360.com/articles/1569855> [<https://perma.cc/A4W9-N4TF>] (“Retailers like Bed Bath & Beyond . . . have now become ‘zombie companies’ that can only make enough revenue to service their debt.”).

²¹⁷ See, e.g., Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001) (outlining the status quo as it relates to shareholder wealth maximization). Senior officers of a firm have many of the same obligations and duties faced by the firm’s directors. See *Gantler v. Stephens*, 965 A.2d 695, 708-09 (Del. 2009) (“[C]orporate officers owe fiduciary duties that are identical to those owed by corporate directors.”).

²¹⁸ See *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004) (“We set forth in this Opinion the law to be applied henceforth in determining whether a stockholder’s claim is derivative or direct. That issue must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?” (emphasis in original)). *Tooley* requires a showing of some individualized harm for a direct claim to be asserted.

²¹⁹ See, e.g., *Prods. Res. Grp., LLC v. NCT Grp., Inc.*, 863 A.2d 772, 790 (Del. Ch. 2004) (enumerating various protections ostensibly available to creditors).

²²⁰ The context for this discussion is insolvency; the impact of a firm being in a wider “zone of insolvency” is outside this Article’s scope.

²²¹ See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

²²² Delaware case law provides that “insolvency” in this context means insolvency in fact as opposed to insolvency implied or conceded through a federal bankruptcy filing or other similar

obligated to preserve capital for the benefit of creditors who enjoy a newfound interest in the firm's assets.²²³

The fact that fiduciary duties extend to creditors in times of firm insolvency should not imply that creditors enjoy the same substantive rights as shareholders. The firm's insolvency does not alter management's primary objective: growing the firm and maximizing its value. But in executing that obligation, breaches of fiduciary duties may occur. In cases where a director's breach injures the firm itself, creditors may bring a derivative claim against the director. But what rights do creditors enjoy in cases where a director of an insolvent firm breaches a fiduciary duty and an individual creditor—rather than the firm—is the injured party?

1. A Marked Display of Animus

In *Production Resources Group, L.L.C. v. NCT Group, Inc.*,²²⁴ then-Vice Chancellor Leo Strine acknowledged the need to clarify this complex question and presaged the creditor-on-creditor violence that has permeated the industry today. Vice Chancellor Strine wondered what rights a disadvantaged creditor would enjoy where directors of an insolvent firm targeted that particular creditor and diminished its potential recovery to the benefit of the firm, a subset of the firm's creditors, and other stakeholders. At that time, Delaware case law held that creditors of an insolvent firm could bring direct claims if the directors were motivated by pure self-interest.²²⁵ But what if self-dealing was not involved? This was an open issue.²²⁶ In dicta, Vice Chancellor Strine stated that creditors may still be entitled to protection in some cases.²²⁷ He envisioned “circumstances in which . . . directors display such a marked display of animus towards a particular creditor with a proven

statutory proceeding. See *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787-88 (Del. Ch. 1992) (concluding that insolvency in this context means insolvency in fact). A creditor required to establish insolvency would need to demonstrate insolvency at the time suit is filed, see *Quadrant Structured Prods. Co. v. Vertin*, 115 A.3d 535, 548 (Del. Ch. 2015), and could do so under the “balance sheet” test or “cash flow” test. See *id.* at 556-57.

²²³ See *Royce de R. Barondes, Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45, 64 (1998) (describing the “trust fund doctrine” and the basis for fiduciary duty extension).

²²⁴ 863 A.2d 772, 790 (Del. Ch. 2004).

²²⁵ See, e.g., *Asmussen v. Quaker City Corp.*, 156 A. 180, 181 (Del. Ch. 1931).

²²⁶ See *Prod. Res. Grp., LLC v. NCT Grp., Inc.*, 863 A.2d 772, 797 (Del. Ch. 2004) (“[Plaintiff] assumes that all [creditor] fiduciary duty claims become direct when a firm is insolvent. . . . The [defendants assert] that all [creditor] fiduciary duty claims must be derivative. To my mind, the question has no stark answer.”).

²²⁷ *Id.* at 798.

entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor.”²²⁸

Many commentators and jurists believed that Vice Chancellor Strine had hypothesized a fact pattern that could not exist.²²⁹ Conventional wisdom was that directors of an insolvent firm could breach fiduciary duties owed to creditors, but one of two elements would be unavoidable: either the directors would be involved in self-dealing or the corporation would be harmed. And creditors already enjoyed causes of action in these situations.²³⁰

This skepticism in part prompted the Delaware Supreme Court to subsequently reject Vice Chancellor Strine’s guidance. In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, the plaintiff was a creditor and contractual counterparty to Clearwire, an allegedly insolvent Delaware corporation.²³¹ The plaintiff argued that three directors had breached their fiduciary duties by instructing Clearwire to exercise its contractual right to retain certain spectrum licenses—an act that arguably benefited the corporation but significantly harmed the plaintiff by depriving it of the ability to acquire the licenses for itself. The plaintiff asserted various direct claims, relying on the direct-claim carveout intimated in *Production Resources*.

The *Gheewalla* court unequivocally rejected the possibility of a direct claim.²³² But the decisiveness of the court’s position was inconsistent with the sparse rationale supporting the action. In just a few sentences, the court reasoned that recognizing direct fiduciary duty obligations owed to creditors “would create a conflict between those directors’ duty to maximize the value of the insolvent corporation Directors of insolvent corporations [needed to] retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.”²³³ The court did not explain why it believed this right was threatened.

The *Gheewalla* court undertook a wholesale repudiation of the direct-claim carveout in *Production Resources* even though the facts of *Gheewalla* failed to raise the issues that concerned Vice Chancellor Strine.²³⁴ In

²²⁸ *Id.* at 798.

²²⁹ See, e.g., Roger A. Lane, *Direct Creditor Claims for Breach of Fiduciary Duty: Is They Is, or Is They Ain’t? A Practitioner’s Notes from the Field*, 1 J. BUS. & TECH. L. 483, 490 (2007) (implying that the category of claims envisioned by Vice Chancellor Strine did not exist).

²³⁰ See, e.g., Pa. Co. for Ins. on Lives & Granting Annuities v. S. Broad St. Theatre Co., 174 A. 112, 116 (Del. Ch. 1934); *Asmussen*, 156 A. at 181.

²³¹ 930 A.2d 92, 93 (Del. 2007).

²³² See *id.* at 103.

²³³ *Id.*

²³⁴ Other jurisdictions do allow creditors of insolvent firms to bring direct claims against directors and officers in unique situations. See, e.g., *Arabi Gin Co., v Plexus Cotton, Ltd. (In re Joseph Walker & Co.)*, 522 B.R. 165, 199-200 (Bankr. D.S.C. 2014); see also Alessandra Zanardo,

Gheewalla, the plaintiff–creditor argued that the directors exercised contractual rights that indirectly harmed its interests but ignored the fact that the board’s actions arguably benefited the corporation. This is not the type of fact pattern Vice Chancellor Strine had envisioned. *Production Resources* recognizes that directors of an insolvent firm enjoy the same value-maximization directive imposed on those of solvent firms, and directors can make decisions that they believe benefit the firm but could indirectly harm creditors.²³⁵ Further, the direct-claim carveout envisioned by Judge Strine does not prevent a director of an insolvent firm from engaging in vigorous, good faith negotiation with creditors. None of these issues is in dispute. The question missed by *Gheewalla* is what recourse should be available when directors of an insolvent firm act directly against a creditor but are not involved in self-dealing and the harm realized affects only that creditor. Further, despite *Gheewalla*’s pronouncement, the need for fiduciary duties persists even when creditors enjoy contractual rights and access to common law and statutory forms of relief. Fiduciary duties fill obvious gaps in these structures. The true importance of *Production Resources* was not captured by the facts of *Gheewalla* and its progeny.²³⁶ The recent cannibalistic assault cases, however, highlight the potential myopia.

2. Incora Provides the Factual Pattern Judge Strine Hypothesized

Incora is one of the more recent hostile restructurings and provides the most aggressive tactics seen to date. Private equity sponsor Platinum Equity acquired Wesco Aircraft in 2020 just months before the Covid-19 pandemic eviscerated all financial projections. The company had \$650 million secured notes maturing in 2024, but a \$100 million coupon payment was due in 2022. Perhaps more troubling, the notes required the borrower to repurchase some of the debt at the end of each fiscal year.²³⁷

Against this backdrop, Silver Point Capital and PIMCO were slowly building their ownership position with Incora’s 2024 and 2026 notes. The

Fiduciary Duties of Directors of Insolvent Corporations: A Comparative Perspective, 93 CHI.-KENT L. REV. 867, 880 & n.51 (2018) (explaining that in France, in an insolvency setting, a creditor has standing to bring claims for breach of fiduciary duties if the creditor can show he has suffered an injury distinct from that suffered by the other creditors).

²³⁵ Just as a director could vote to pay a reduced dividend to shareholders, which could in turn, cause a shareholder to default on a debt obligation. The indirect harm caused by this decision is not actionable.

²³⁶ *Gheewalla*’s progeny includes *Quadrant Structured Products Co. v. Vertin*, 115 A.3d 535, 548 (Del Ch. 2015), which offers a fact pattern similarly at odds with what Judge Strine contemplated. In *Quadrant*, directors of an insolvent firm adopted an investment strategy that involved greater prospective returns alongside increased financial risk. Creditors objected, arguing that the firm should liquidate to preserve value. The Delaware Chancery Court rejected this argument. *See id.*

²³⁷ *See Lender on Lender Violence is Back*, *supra* note 200.

notes had a provision that allowed holders of two-thirds of the issued debt to amend the indenture to release liens on collateral. The buying spree indicated that a cannibalistic assault was contemplated. In response, various noteholders formed a coalition and signed a “cooperation agreement”²³⁸ agreeing not to join in any exchange that provided for recoveries on a non-pro rata basis. Further, threatened noteholders started buying up Incora bond debt in an effort to keep Silver Point Capital and PIMCO from achieving a super-majority position.²³⁹ When the dust settled, the minority noteholders had secured a blocking position.

This is the point where the borrower arguably crossed the Rubicon and broke various written and unwritten rules. The indenture allowed Incora to issue more debt with few restrictions. Normally, there would not be a market for debt from a distressed company, but Incora was not selling to the market at large. Incora issued just enough new debt to give Silver Point and PIMCO the super-majority position they needed to alter the applicable indentures and release the existing liens. The arrangement provided Incora \$250 million in new capital. Before exchanging their notes into new superpriority secured notes maturing in 2026, Silver Point Capital and PIMCO voted to strip liens that were protecting existing noteholders.²⁴⁰

In the final insult, Incora executed a “roll-up” that benefited its private equity sponsors. Platinum and Carlyle Group held some unsecured, junior debt. In the event of a bankruptcy, this position would most likely be wiped out. A complete loss just two years after the acquisition would have been a disastrous result. But Incora—with little justification or explanation—allowed Platinum and Carlyle to exchange their debt, which had obviously ranked below the old secured notes, into new secured notes maturing in 2022 and 2023. Ownership was allowed to move up the capital structure and ostensibly subordinate secured noteholders against their will.

3. A New Standard

Imagine if a board of directors of a solvent corporation determined that it would be financially destabilizing to pay its customary \$100 million in dividends to all shareholders in the same class. Instead, the board decides to pay the three largest shareholders in that class their pro rata portion of \$75 million and retain \$25 million. These actions could be described as benefitting

²³⁸ See Scigliuzzo & Ronalds-Hannon, *supra* note 179.

²³⁹ In fact, demand was so strong that Incora’s 2026 notes briefly traded above par in March 2022. See Lender on Lender Violence is Back, *supra* note 200.

²⁴⁰ In anticipation of future litigation, Incora followed TriMark’s lead and left some incremental lien capacity that they could ultimately offer to non-participating noteholders in the event the group-initiated litigation challenging Incora’s actions.

the corporation. Nevertheless, the board's fiduciary duties would undoubtedly preclude this economically desirable differential treatment.²⁴¹ This basic principle similarly applies to creditors of insolvent firms.

During a time when Incora was arguably insolvent, the corporation's directors and senior officers formulated a plan to seize value from a subset of disfavored creditors that could be distributed to a preferred group of creditors, with benefits flowing to the corporation as well as to its private equity owner. When the plan was temporarily thwarted by the disfavored creditors, the corporation issued more debt to only the favored creditors, allowing for the plan to resume. And without explanation, the corporation allowed its private equity owner to exchange debt to occupy a higher position in the priority scheme.

These actions arguably represent the "marked degree of animus" that Vice Chancellor Strine envisioned.²⁴² Directors and officers took affirmative action against certain bondholders to whom they owed fiduciary duties. The disfavored bondholders suffered harm that other bondholders did not; in fact, favored bondholders received significant benefits. The corporation was not harmed so a derivative suit would not exist. But the idea that fiduciaries could directly target those to whom they owe fiduciary duties is anathema to the fundamental nature of these relationships.

If Incora's disfavored bondholders sought to bring litigation, they would be able to satisfy *Tooley* and could arguably assert direct claims but for *Gheewalla's* prohibition. From one perspective, the corporation was not harmed,²⁴³ and there did not appear to be any self-dealing. Incora's bondholders could bring suit, but their claims would be limited to breach of contract, which—as detailed in Part III—has proven to be of limited value.

²⁴¹ See *Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 797 (Del. Ch. 2004) ("Assume . . . that the board controlled 80% of the stock and consistently shorted the remaining stockholders on dividend distributions [I]t seems likely that the injured minority stockholders could assert direct duty of loyalty claims"); Matt Levine, *Distressed-Debt Deal Makes People Mad*, BLOOMBERG OP.: MONEY STUFF (Apr. 7, 2022, 1:35 PM), <https://www.bloomberg.com/opinion/articles/2022-04-07/distressed-debt-deal-makes-people-mad> [<https://perma.cc/F3ZH-YL5Y>] ("Broadly speaking, companies have fiduciary duties to their shareholders [Y]ou can't get 51% of shareholders to vote themselves a big dividend at the expense of the other 49%.")

²⁴² *Prod. Res. Grp.*, 863 A.2d at 798. Naturally, there are many other cases like Incora, including *TriMark*, see *supra* Part III, and *NYDJ Apparel*, see *Dick*, *supra* note 162, at 1360 (considering the facts of *NYDJ*, Judge Ramos remarked, when you have "a slight majority[] going off into a side room and saying we're going to consent amongst ourselves and to hell with the rest of these guys[,] [i]t really seems unethical").

²⁴³ One could argue that the coercive exchange merely allowed the company to limp along, destroying value, as opposed to filing for bankruptcy and actually addressing systemic issues. This has borne out as companies that initiated creditor-on-creditor violence have begun filing for bankruptcy, including *J.Crew* and *Serta Simmons*.

Ultimately, in cases like this, I argue that an attacked creditor should be able to bring a direct breach-of-fiduciary-duty cause of action.²⁴⁴ The plaintiff-creditor would bear the burden of establishing that (1) the firm was insolvent at the time the action or series of actions²⁴⁵ at issue were taken, (2) the plaintiff-creditor was owed fiduciary duties,²⁴⁶ and (3) directors²⁴⁷ intended to directly seize economic or financial interests from the disfavored plaintiff-creditor and redistribute these interests to favored creditors, the firm itself, or both. A plaintiff-creditor would then have to satisfy *Tooley* and establish the egregious nature of the wrong, that any recovery would go to the plaintiff-creditor, and that it can prevail without showing injury to the firm.

Creditors who can establish these elements would shift the burden to the firm, which would then have to establish that the board was pursuing legitimate business ambitions—including increasing enterprise value—and had acted in good faith to avoid the differential treatment.²⁴⁸ This would be hard to establish in cases where a board's first—and potentially only—plan was a cannibalistic assault culminating in a debt exchange that was available to only a small subset of favored creditors.

This subtle shift would address a significant flaw in the judiciary's fiduciary duty jurisprudence. Creditors would have recourse in extreme cases, which would provide a meaningful check on the most aggressive forms of cannibalistic assaults.

B. *The Moment of Acquisition: Reconceptualizing Section 546(e)'s Safe Harbor*

The new coercive exchanges involve distinct debtors, with distinct financial issues, in distinct industries. Naturally, one unifying factor is the involvement of a private equity sponsor dictating outcomes, and many commentators have noted this. But what has been overlooked is that private equity's presence is half of the story.

The truly unifying element in these cases is that all the borrowers at issue were acquired through a leveraged buyout that had occurred a few years before the coercive measures were undertaken. One could argue that this is

²⁴⁴ Under Delaware law, a creditor may not bring a direct or derivative claim against a limited liability company. *See* CML V, LLC v. Bax, 28 A.3d 1037, 1041 (Del. 2011) (holding that Delaware Limited Liability Company Act limits standing exclusively to members or assignees of the LLC).

²⁴⁵ In considering a direct claim, the court will need to determine if a series of actions should be considered collectively because they were part of the same general design or scheme.

²⁴⁶ The duty of loyalty would most likely be implicated in these cases. Naturally, the business judgment rule would not be a defense to this type of claim.

²⁴⁷ Once again, this would include senior officers.

²⁴⁸ Just as with the shareholder dividend example noted in subsection IV.A.3, *supra*, the mere fact that a firm benefitted financially from the coercive maneuver would not justify all forms of differential treatment.

just a feature of private equity ownership and not a precipitating factor. But the leveraged buyouts create staggering debt obligations, leaving borrowers with limited restructuring options in times of distress.²⁴⁹ Various federal and state laws could work to limit aggressive debt accumulation that renders a company insolvent, but—as explained in Section I.C.—section 546(e)’s permissive language allows these acquisitions to avoid scrutiny. The safe harbors arguably encourage reckless dealmaking²⁵⁰ and shield improper dividend payments to private equity sponsors.²⁵¹

There is no policy justification for shielding LBOs and other transactions that present no threat to public securities markets. Fraudulent transfer law represents a foundational tenet of the bankruptcy system, policing transfers for less than reasonably equivalent value that cause the transferor’s insolvency or occur at a time when the transferor is already insolvent. An exception to this tenet was made to preserve the efficient functioning of the public securities market.²⁵² But poor statutory drafting has allowed too many interlopers to shelter in section 546(e)’s safe harbor. Shielding all transactions that happen to involve securities does nothing to protect the integrity of the public securities markets and represents an unreasonable windfall for a small group of individuals and entities willing to exploit section 546(e).

1. The Judicial and Legislative Response

In the sphere relevant to this Article, recipients of fraudulent conveyances have been able to shelter in section 546(e)’s safe harbor by making one of two arguments: (1) a leveraged buyout initiated a settlement payment that was made to a financial institution or (2) a transfer of funds is protected from

²⁴⁹ See Levine, *supra* note 212 (“[T]his basic pattern comes up a lot, but often in companies owned by private equity sponsors. There are reasons for this. One is that private equity tends to buy companies in leveraged buyouts, which means that many private equity companies have a lot of debt, which means that they are more likely to run into distress and have to [engage in coercive exchanges].”).

²⁵⁰ See *id.* I acknowledge that some cases where creditors are seeking to unwind a disastrous LBO involve claims that the secured creditors’ liens should be voided. Attacking liens, however, is often more difficult than pursuing clawback actions against redeeming shareholders and this course has not been a prominent issue in many recent cases, including Merit Mgmt. Grp., LP v. FTI Consulting, Inc., 138 S. Ct. 883 (2018), *Tribune II*, 946 F.3d 66 (2d Cir. 2019), and *In re Nine W.*, 482 F. Supp. 3d 187, 196 (S.D.N.Y. 2020).

²⁵¹ See Halperin v. Morgan Stanley Inv. Mgmt., Inc. (*In re Tops Holding II Corp.*), 646 B.R. 617, 688 (Bankr. S.D.N.Y. 2022) (“[A]fter encumbering a privately held company’s assets with privately issued debt, a handful of sophisticated private equity investors took massive dividends. . . . The avoidance of these dividends . . . would have no effect on the public securities markets, the ostensible purpose of section 546(e).” (emphasis added)).

²⁵² See Peterson v. Somers Dublin Ltd., 729 F.3d 741, 748 (7th Cir. 2013) (“The Trustee concludes that § 546(e) is designed ‘to protect this country’s legitimate market transactions that promote the stability of and confidence in the financial markets.’”).

avoidance because it was made to a financial institution in connection with a securities contract.

The involvement of a “financial institution” is the key element of both arguments. The definition of the term includes traditional financial institutions such as commercial and savings banks but goes further to also include a “customer” of such institutions if the bank involved in a subject transaction is acting as an agent for that customer–transferee.²⁵³ As noted in Section I.D., the *Merit* ruling noted this aspect of the “financial institution” definition and declined to consider its impact on the 546(e) safe harbor analysis.²⁵⁴ The Second Circuit seized this opening in *Tribune II* and ruled that the financial institution involved in the leveraged buyout in that case was in fact the agent of the customer–transferees, which allowed the customer–transferee to shelter in section 546(e)’s safe harbor.²⁵⁵ But the basis for the Second Circuit’s conclusion is unclear.

For a customer–transferee that is not a traditional financial institution to qualify as a “financial institution” for purposes of section 546(e), the Code requires that the bank or similar entity involved in the subject transaction must be “acting as an agent or custodian” for that customer.²⁵⁶ “Agent” is not defined in the Code so the common law legal definition should govern.²⁵⁷ The Second Circuit in *Tribune II* adopted an extremely streamlined interpretation of the necessary criteria to establish an agency relationship. The court concluded that if a party manifested intent to grant authority to a third party and maintained control over key aspects of the undertaking, mere assent by that third party would create an agency relationship.²⁵⁸

The Second Circuit’s conclusion, however, is flawed. The comments to the influential Restatement (Third) of Agency § 101 explain that an agency relationship requires the agent to “owe[] a fiduciary obligation to the principal.”²⁵⁹ Many actors perform intermediary roles between parties engaged in complex transactions without becoming agents. “For example, an employee of a courier service who shuttles documents among parties who are

²⁵³ 11 U.S.C. § 101(22). A transfer involving a traditional financial institution acting as a “custodian” for a customer could also qualify for the safe harbor but is rarely applicable in the cases at issue in this Article.

²⁵⁴ *Merit Mgmt. Grp.*, 138 S. Ct. at 890 n.2.

²⁵⁵ *Tribune II*, 946 F.3d at 78-79.

²⁵⁶ 11 U.S.C. § 101(22)(A). The term “customer” is defined narrowly in 11 U.S.C. § 741, but the definition of “financial institution” makes clear that the term “customer” has a more expansive meaning than what § 741 delineates. *Compare id.*, with 11 U.S.C. § 741(2).

²⁵⁷ Though reaching significantly different conclusions, both the Second Circuit in *Tribune II*, 946 F.3d at 79, and Judge Oxholm in *Buchwald Cap. Advisors, LLC v. Papas (In re Greektown Holdings)*, 621 B.R. 797, 825 (Bankr. E.D. Mich. 2020) agreed on this initial premise.

²⁵⁸ See *Tribune II*, 946 F.3d at 79.

²⁵⁹ RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. e (AM. L. INST. 2005).

closing a transaction . . . is not the parties' agent simply because an intermediary function is provided."²⁶⁰ However, the Second Circuit did not attempt to distinguish between mere intermediaries and agents. By grouping all service providers in the same category, the court disregarded the functional value of agency in this context. Indeed, a true agent is a business representative tasked to "bring about, modify, affect, accept performance of, or terminate contractual obligations between his principal and third persons."²⁶¹ This alignment of interest and ability to modify transactions is why a customer of a "financial institution" could herself be recognized as a "financial institution" under section 546(e).²⁶²

The Second Circuit identified the correct test to assess an agency relationship but then misapplied it. As to the question of whether the service provider in a transaction has manifested the necessary consent to be recognized as an agent for the customer–transferee, the final inquiry is whether the service provider served as a true business representative authorized by the principal to act on its behalf.²⁶³ Without this analysis, any service provider could qualify as an agent.²⁶⁴

In terms of remedying this incongruence, courts could follow the *Greektown Holdings* ruling to properly assess agency relationships. This would require a substantive review of governing contracts between customer–transferees and relevant intermediaries. I suspect the conclusion in most cases would be that an agency relationship did not exist between the key parties.²⁶⁵

A legislative response would involve Congress clarifying who qualifies as an "agent" for purposes of section 546(e) by adding a definition for the term to the Code that follows the federal common law as guided by the Restatement. This latter course is optimal as to avoid disparate outcomes across jurisdictions, a reality that takes on additional weight in bankruptcy's permissive forum-shopping scheme.²⁶⁶

²⁶⁰ RESTATEMENT (THIRD) OF AGENCY §1.01 cmt. h (AM. L. INST. 2005).

²⁶¹ *Kitchen v. Boyd* (*In re Newpower*), 233 F.3d 922, 933 (6th Cir. 2000) (quoting *Saint Clair Intermediate Sch. Dist. v. Intermediate Educ. Ass'n*, 581 N.W.2d 707, 716 (1998) (internal citation omitted)).

²⁶² See Marchetti, *supra* note 80, at 1158. ("Congress intended to protect narrowly defined systemically important financial market participants that engage in specialized financial transactions . . . when it included the [unique "customer" protection] in Section 101(22)(A). It did not intend to protect garden-variety [shareholders] from constructive fraudulent transfer or preference liability . . .").

²⁶³ See Buchwald Cap. Advisors, LLC v. Papas (*In re Greektown Holdings*), 621 B.R. 797, 827 (Bankr. E.D. Mich. 2020) ("To establish common law agency, there must be a finding that a principal authorized the agent to act on its behalf.").

²⁶⁴ See *id.*

²⁶⁵ See Marchetti, *supra* note 80, at 1130–31 (reaching this same conclusion).

²⁶⁶ See generally Parikh, *supra* note 59.

Ultimately, a simple clarification that a customer will rarely be recognized as a “financial institution” for purposes of section 546(e) may limit perverse uses of the safe harbor.²⁶⁷ It increases the possibility of a clawback and, in turn, forces directors to properly assess the risks of approving improper dividends and evaluate the financial position of the entity that will emerge from a leveraged buyout. But is it enough?

2. Aligning Language with Objective

The idea of thoughtlessly handing out immunity to parties that have engaged in actual and constructive fraud is puzzling and undermines a central tenet of the U.S. bankruptcy system. There are a number of incremental steps that can be taken to attempt to minimize the harm caused by section 546(e)’s unfortunate language and bizarre amendments over the years. But the truth is that even if all these measures are implemented, they are merely half-measures. Section 546(e)’s overly inclusive language provides many options for creative parties to shelter in its safe harbor. Therefore, the ideal path forward involves Congress comprehensively redrafting section 546(e) to properly align the section’s language with its clear objectives.

A prevalent argument voiced by the Second Circuit in *Tribune II* is that the section is serving a vital purpose in its current iteration; indeed, the argument goes, all the interlopers deserve sheltering because the distorted safe harbor provides comfort to parties who benefit from overly aggressive dealmaking.²⁶⁸ But it’s unclear why these actors are entitled to protection at creditor expense.

Further, the Second Circuit in *Tribune II* argued that revisions to section 546(e) would lead to chaos in capital markets because investors who receive dividends and sell shares could face uncertainty regarding a potential clawback action being asserted years down the road.²⁶⁹ Though somewhat implausible, let us assume this is an issue that could have a material effect on capital markets. The answer to the Second Circuit’s concern is to provide a more limited statute of limitations, not bless entirely wrongful conduct.

In fact, this argument highlights how some jurists have misunderstood the dynamics in these safe harbor cases and assumed market actors will remain static even as business and legal environments shift. Changes to section

²⁶⁷ I acknowledge that there are still other loopholes, including a transferee qualifying as a “financial institution” because they are registered under the 1940 Act and therefore independently qualify as a “financial institution.” The main effect of the change I recommend is to create potential exposure for a significant subset of the transferee group, which should force directors to more aggressively assess the solvency of the target at the time of the acquisition.

²⁶⁸ See *Tribune II*, 946 F.3d 66, 92-93 (2d Cir. 2019).

²⁶⁹ See *id.*

546(e) would remove ill-gotten immunity. Directors and officers in these circumstances would have to adjust, forced to better assess the subject firm's financial position before issuing dividends or approving an overly aggressive LBO. These actors would demand that solvency opinions actually mean something. As things currently stand, the safe harbors allow directors to eschew their fiduciary obligations, comfortable in the knowledge that the safe harbor will shield their dereliction. Aggressive change to section 546(e) would place these parties in the same position as the vast majority of market actors who cannot act with impunity when transferring assets.

Ultimately, the safe harbors are not intended to allow parties to disregard their duties or engage in fraudulent behavior. The safe harbors are designed to prevent the bankruptcy of a financial intermediary from causing real-time chaos and destabilizing public securities markets. The Second Circuit's justification in *Tribune II* is misguided, and section 546(e)'s simple purpose—protecting public securities markets—has been distorted. A comprehensive redrafting of section 546(e) is long overdue.

CONCLUSION

With astounding precision, private equity firms have reconstituted bargaining dynamics in distress situations. Increased leverage in acquisitions coupled with diminished lender oversight and debt-instrument ambiguity have created an advantageous formula and allowed sponsors to choose winners and losers when addressing a subsidiary's potential bankruptcy. The consequences of the resulting volatility are unclear but could—with the rise in retail products offered through mutual funds and other vehicles—ultimately undermine public confidence in debt securities markets.

This Article argues that modifications to the bookends of this process can help restore balance. On one end, directors of an insolvent firm who initiate action designed to undermine the financial interests of creditors to whom fiduciary duties are owed should be subject to direct breach-of-fiduciary-duty claims. This recourse would create a meaningful check on coercive maneuvers that merely shift value from one stakeholder group to another but fail to actually improve a failing business. On the other side, I advocate for a reconceptualization of section 546(e) that would exclude most leveraged buyouts from the fraudulent transfer safe harbor. Without immunity for redeeming shareholders, directors would be forced to better assess debt levels for acquisition targets. As a result, these firms would not be limited to coercive exchanges in times of distress.

* * * * *