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HOSTILE RESTRUCTURINGS

Diane Lourdes Dick*

Abstract: The conventional wisdom holds that out-of-court loan restructurings are mostly consensual and collaborative. But this is no longer accurate. Highly aggressive, nonconsensual restructuring transactions—what I call "hostile restructurings"—are becoming a common feature of the capital markets. Relying on hypertechnical interpretations of loan agreements, one increasingly popular hostile restructuring method involves issuing new debt that enjoys higher priority than the existing debt; another involves transferring the most valuable collateral away from existing lenders to secure new borrowing.

These transactions are distinguishable from normal out-of-court restructurings by their use of coercive tactics to overcome not only the traditional minority lender holdout problem, but also the collective bargaining power of the entire lender group. In other words, in hostile restructurings, the goal of the negotiations is not simply to cram the restructuring down the throats of a self-interested or misguided minority holdout; instead, the goal is to cram the plan down on the entire lender group by pitting similarly situated lenders against one another.

Hostile restructurings not only strain normal interlender dynamics—they also challenge traditional understandings of what it means to be a senior secured creditor. The ensuing lender arms race has, in turn, carved new fault lines in chapter 11 bankruptcy proceedings. Using detailed case studies, this Article is the first to explore both how these hostile restructurings differ from the traditional interlender conflict dynamics and how they amplify the distributional concerns that have traditionally plagued bankruptcy restructurings.

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INTRODUCTION

Financially distressed and overleveraged companies generally have two options for restructuring their bank and non-bank private debt.[1] Such companies can file for chapter 11 bankruptcy[2] on either a prearranged or "free fall" basis and seek judicial confirmation of a plan of reorganization,[3] or they can convince senior lenders to amend or restate the loan agreement to give the debtor more breathing room.[4] The traditional wisdom holds that an out-of-court restructuring of this sort is almost always more efficient because it avoids the costs and uncertainties of a bankruptcy filing; however, it can be difficult to achieve because it requires collaboration and consensus. After all, senior lenders—who hold the highest priority claims against the company—must agree to voluntarily impair their own bargained-for rights;

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1. It is important to distinguish between bank and non-bank private debt, on the one hand, and public securities (such as bonds) on the other, because the latter is subject to a far more extensive legal and regulatory framework. For more on this distinction, see Jayant R. Kale & Costanza Meneghetti, *The Choice Between Public and Private Debt: A Survey*, 23 IIMB MGMT. REV. 5 (2011).

2. Article I, Section 8, Clause 4 of the U.S. Constitution gives Congress the power to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." Using this authority, Congress has passed a series of bankruptcy laws, the most recent being the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101–1532). Chapter 11 of the Bankruptcy Code provides for the reorganization of bankrupt persons. 11 U.S.C. §§ 1101–1174.

3. The chapter 11 plan of reorganization identifies, among other things, how various classes of creditors and interest holders will be treated and what specific distributions will be made from the bankruptcy estate. *See, e.g.*, 11 U.S.C. §§ 1123, 1129(a) (detailing plan confirmation requirements).

4. For a classic expression of this choice, see Stuart C. Gilson, Kose John & Larry H.P. Lang, *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315 (1990).

meanwhile, without the benefit of bankruptcy's automatic stay,[5] other stakeholders, such as junior lenders, landlords, trade creditors, and equity owners, may disrupt the restructuring by exercising their own remedies against the debtor.

Making out-of-court restructurings more difficult is the fact that the company's senior lenders—particularly when they have liens on all or substantially all of the company's assets—exercise enormous bargaining power in setting the terms of any potential restructuring. Senior lenders will naturally prefer restructuring proposals that provide them the surest and quickest recovery, even if it comes at the expense of the firm's future as a going concern.[6]

These preferences and power dynamics alone make it increasingly difficult to achieve a meaningful consensual restructuring. But complicating things further is the fact that big companies typically obtain loans from large syndicates of lenders.[7] And, even if most of the lenders agree to the terms of an out-of-court restructuring, a minority of lenders may refuse to make any concessions—either because they do not believe the restructuring makes sense, or because they believe that by holding out they can obtain a better deal.[8] Depending on the consent thresholds required for modifications to the company's loan agreements, these holdouts may derail the entire restructuring; at a minimum, they will certainly make it more expensive.

In contrast, bankruptcy offers a legal framework to shift some bargaining power to the debtor, neutralize the holdout risk, and provide a limited pathway for nonconsensual restructurings.[9] And, while bankruptcy law provides a range of protections for secured creditors, it also helps to recenter restructuring discussions around enhancing the company's long-term prospects as a going concern and maximizing the

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5. *See infra* note 56 and accompanying text.

6. "The term 'going concern value' refers to the value of assets held together and used in a business operation. This value is typically contrasted against 'liquidation value,' which is generally defined as the value of the assets, sold on a piecemeal basis, less the costs of sale." Christopher W. Frost, *Running the Asylum: Governance Problems in Bankruptcy Reorganizations*, 34 ARIZ. L. REV. 89, 92 n.8 (1992).

7. A syndicated loan is typically arranged and administered by agents who serve on behalf of the various bank and non-bank lenders. As the Second Circuit recently confirmed, syndicated loans are not considered securities. *See* Kirschner v. J.P. Morgan Chase Bank, N.A., No. 17 Civ. 6334, 2020 WL 2614765, at *10 (S.D.N.Y. May 22, 2020).

8. On the minority holdout problem in corporate restructurings, see *infra* notes 46–47 and accompanying text.

9. So-called cramdowns are authorized under 11 U.S.C. § 1129(b)(1), which provides that a plan that satisfies all other requisite provisions of 11 U.S.C. § 1129(a) may be confirmed over the objection of one or more classes.

potential recoveries of *all* stakeholders.

But despite these attractive features, bankruptcy is generally perceived as a nuclear option—it can be expensive, time-consuming, and it has profound implications for the firm's entire capital structure.[10] For these reasons, the conventional wisdom surrounding private debt modifications is that struggling companies must weigh the benefits of a limited, imperfect, consensual out-of-court restructuring against the risks and downsides that accompany a more holistic bankruptcy reorganization.

But recent developments in the U.S. capital markets—namely, the rise of what I call "hostile" out-of-court private loan restructurings[11]—have upended this conventional wisdom. Financially distressed companies increasingly use highly aggressive out-of-court restructuring transactions—referred to by finance professionals as "liability management transactions"[12] or "lender-on-lender violence"[13]—to

10. I examine these and related perceptions of bankruptcy in Diane Lourdes Dick, *Bankruptcy, Bailout, or Bust: Early Corporate Responses to the Business and Financial Challenges of Covid-19*, 40 BANKR. L. LETTER (Thompson Reuters, St. Paul, Minn.), July 2020, at 1, 7.

11. In corporate law, a "hostile takeover" occurs when a predator firm acquires control of a target company despite resistance by the target's management. For a classic discussion, see John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984).

12. The term was used in a September 2020 program hosted by the highly influential Loan Syndications and Trading Association. *See* Meyer Dworkin, Jason Kyrwood, Bridget Marsh, Brian Resnick & Ken Steinberg, *Recent Distressed Liability Management Transactions: Lessons for the Loan Market*, LSTA (Sept. 29, 2020, 4:00 PM), https://www.lsta.org/events/recent-distressed-liability-management-transactions-lessons-for-the-loan-market (last visited Nov. 6, 2021) [hereinafter LSTA Presentation].

13. Patrick D. Walling, *Navigating the Club in Private Credit Deals*, NAT'L L. REV. (Dec. 3, 2020), https://www.natlawreview.com/article/navigating-club-private-credit-deals [https://perma.cc/YD7C-E65T] (observing that others have used the phrase). Like Walling, I only mention it in passing to identify the subject of the Article. I avoid further uses of the phrase (along with its variant, "creditor-on-creditor violence") because of its similarity to—and possible derivation from—the problematic term "Black-on-[B]lack violence." *See generally* Alicia McElhaney, *'Creditor-on-Creditor Violence' Lands Big Managers in Court*, INSTITUTIONAL INV. (Nov. 20, 2020), https://www.institutionalinvestor.com/article/b1pbjxp892zp1x/Creditor-on-Creditor-Violence-Lands-Big-Managers-in-Court [https://perma.cc/J295-LDWH] (describing the trend of "creditor-on-creditor violence"); Jo Ellen Fair, *"Black-on-Black": Race, Space, and News of Africans and African Americans*, 22 ISSUE: J. OP. 35, 35–37 (1994) (examining the "meaning of a racial label, 'black-on-black,' as it is used in U.S. news stories to define and describe crime and violence in the United States and South Africa"). The latter term has been used by some observers to undermine demands for police reforms; as one commentator recently explained, "'Black-on-[B]lack crime' is a frame that presupposes [B]lack criminality—that there's something inherent to [B]lackness which makes intra-group crime more prevalent and more deadly." Jamelle Bouie, *Why "Black-on-Black Crime" Is a Dangerous Idea*, AM. PROSPECT (July 17, 2013), https://prospect.org/power/black-on-black-crime-dangerous-idea/ [https://perma.cc/5LRJ-QB8X]. In light of these associations, the use of the term to describe corporate debt restructuring dynamics is

achieve, in substance, the sort of senior loan modifications that they previously could only achieve through a bankruptcy reorganization. And in some cases, companies have been able to do things that they would not even be allowed to do in bankruptcy.

Companies generally initiate hostile restructurings by carefully reviewing their existing senior loan agreements—which are typically hundreds of pages long—in search of provisions that technically allow them to do things that arguably violate the spirit of the agreement. This approach not only exploits the plain language of the contract—it also exploits decades of statutory and judicial law directing courts to enforce contracts and otherwise stay out of commercial disputes.[14] Relying on hypertechnical interpretations of loan agreements,[15] one increasingly popular hostile restructuring method involves issuing new debt that enjoys higher priority than the existing debt; another involves transferring the most valuable collateral away from existing lenders to secure new borrowing.

A key feature of hostile restructurings is that the opportunity to participate is made available only to certain lenders—usually the precise number of lenders needed to satisfy the applicable consent thresholds in the existing agreements. The other lenders often have no idea a deal is even being negotiated; they may learn about it for the first time when they read the company's press release announcing the restructuring. And the missed opportunity carries a high cost. Lenders who are not included in the restructuring find that their rights have been economically impaired. For instance, their debt may be subordinated to hundreds of millions of dollars in new debt, or they may no longer have a meaningful interest in the company's most valuable collateral.

As one would expect, hostile restructurings have captured the attention of capital market participants,[16] their advisors,[17] and even the

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insensitive and unnecessary.

14. Diane Lourdes Dick, *Confronting the Certainty Imperative in Corporate Finance Jurisprudence*, 2011 UTAH L. REV. 1461, 1465.

15. For instance, in one of the case studies profiled in this Article, the debtor company relied on language in the loan agreement authorizing new extensions of credit under the facility in order to issue debt purely for the purpose of meeting consent thresholds for major changes. *See infra* notes 213–223 and accompanying text.

16. *See, e.g.*, 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 (last visited Nov. 1, 2021) (discussing a key case illustrating the rise of aggressive debt restructuring transactions); Matt Wirz, *Apollo Sues Serta Simmons and Owner Advent Over Debt Dispute*, WALL ST. J. (June 11, 2020, 6:03 PM), https://www.wsj.com/articles/apollo-sues-serta-simmons-and-owner-advent-over-debt-dispute-11591906294 (last visited Sept. 16, 2021) (exploring the use of "controversial maneuvers"

influential trade association for the U.S. syndicated loan market, the Loan Syndications and Trading Association (LSTA).[18] These transactions have prompted lawsuits in state court, federal district court, and federal bankruptcy court, with plaintiffs alleging the same troubling dynamics that prompted Congress—nearly a century ago—to severely restrict out-of-court restructurings of publicly traded bond debt.

These hostile restructurings have strained normal interlender dynamics while also challenging traditional understandings of what it means to be a senior secured creditor. And, while some aspects of these transactions may be thwarted by defensive drafting—such as more restrictive covenants in the underlying loan agreements—savvy debtor companies and their advisors may continue to design new hostile restructurings that exploit other hypertechnical provisions in their loan agreements. Whether it plays out ex ante or ex post, the ensuing lender arms race has, in turn, carved new fault lines in corporate bankruptcy proceedings. Indeed, recent chapter 11 cases suggest that it is becoming more difficult to reach consensus among ever more fractured lender groups, with minority lenders in some cases forming ad hoc groups to oppose the restructuring and advance alternative transactions.[19]

As market participants and their advisors struggle to adjust to this new world of hostile restructurings, the question for courts and lawmakers is whether these transactions should be accepted as innovative and competitive responses to corporate financial distress, or as normative failures in the capital markets that require corrective legal or regulatory action. Drawing insights from recent case studies,[20] this Article provides the first comprehensive academic treatment of hostile restructurings. I show how hostile restructurings have the potential to destroy value, impair the smooth functioning of the capital markets, and introduce and amplify the distributional concerns that have traditionally

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in recent debt restructurings).

17. Several major commercial law firms have hosted fascinating podcasts on the topic. *See, e.g.*, The Cramdown Podcast, *Lender on Lender Priming*, O'MELVENY & MYERS, LLP (Dec. 3, 2020), https://www.omm.com/resources/alerts-and-publications/alerts/the-cramdown-restructuring-podcast-episode-4 [https://perma.cc/QAA3-TZFT] (offering lively discourse on the growing use of aggressive debt restructuring maneuvers).

18. *See* LSTA Presentation, *supra* note 12.

19. *See, e.g.*, Statement of the First Lien Minority Group Regarding the Debtors' Sale Motion and Limited Objection to Approval of the Disclosure Statement, *In re* J.C. Penney Co., No. 20-20182 (Bankr. S.D. Tex. June 4, 2020) (setting forth a group of minority lenders' objections); *see also* Andrew Scurria, *J.C. Penney Lenders Trade Barbs Over Chapter 11 Split*, WSJ PRO BANKR. (Oct. 26, 2020, 8:48 PM), https://www.wsj.com/articles/j-c-penney-lenders-trade-barbs-over-chapter-11-split-11603759734 (last visited Nov. 1, 2021) (discussing the interlender conflicts).

20. *See infra* Part II.

plagued bankruptcy restructurings.[21]

This Article proceeds in five Parts. Part I describes the conventional wisdom of loan restructuring, focusing on out-of-court restructurings and bankruptcy reorganizations under chapter 11. Part II challenges the conventional wisdom by detailing the rise of hostile restructurings. This Part draws from rich case studies of "uptiering" and "dropdown" style hostile restructurings.[22] Part III shifts from descriptive to normative, arguing that hostile restructurings constitute a normative failure in the capital markets. This is because they violate the most fundamental norms and values underlying commercial law and practice. First, hostile restructurings threaten the important goals of legal certainty and predictability in the capital markets. Second, they violate classic and emerging theoretical justifications for nonconsensual adjustments to loan agreements. Finally, these transactions have the potential to interfere with the smooth functioning of the capital markets, causing dangerous ripple effects. Part IV explores a variety of prescriptive solutions to correct the normative failure, ultimately settling on a recommendation that courts should provide a more holistic, standards-based review of hostile restructurings. Part V concludes.

I. THE CONVENTIONAL WISDOM OF LOAN RESTRUCTURING

In commercial finance, the term "restructuring" refers to the process by which firms substantially change their debt contracts.[23] There are many reasons why firms may choose to pursue loan restructurings.[24] In many cases, the restructuring is motivated by corporate financial distress; in others, the restructuring is driven by the desire to seize some opportunity that is currently prohibited by existing loan agreements.[25]

In practice, restructuring discussions tend to arise because the company is in default of its commitments under the loan agreement. For instance, most loan agreements require ongoing compliance with strict financial covenants that test the firm's condition and performance

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21. *See infra* Part III.

22. These terms, which denote two popular methods of hostile restructuring, are used in the LSTA Presentation, *supra* note 12.

23. STUART C. GILSON, CREATING VALUE THROUGH CORPORATE RESTRUCTURING: CASE STUDIES IN BANKRUPTCIES, BUYOUTS, AND BREAKUPS 781 (2010) (building a similar definition from the seminal corporate finance scholarship of Michael Jensen and William Meckling).

24. *Id.* at 781–82.

25. *Id.*

against certain negotiated ratios and other metrics.[26] Violations of these covenants constitute events of default even if the company is current on all required interest and principal payments. When a company is in default, the lender has the right to exercise remedies against the borrower, such as acceleration and collection and, in the case of secured financing, repossession and foreclosure.[27]

Even in the face of severe financial or economic challenges, corporate shareholders and managers will often prefer to restructure rather than liquidate because it preserves their ongoing interest in (and control over) the firm.[28] But economically speaking, restructuring only makes sense if the firm is worth saving as a going concern;[29] otherwise, the firm should be liquidated so that any remaining assets and investment capital can be redeployed in more productive and profitable ways.[30] If the firm has greater value as a going concern, then a fair and efficient restructuring has the potential to stabilize the distressed business and preserve or even enhance the firm's going concern value; this, in turn, has the added benefit of advancing the economic interests of employees, shareholders, and the countless suppliers, vendors, and other parties that conduct business with the company.

Once controlling stakeholders decide to restructure, they may engage in formal legal proceedings, such as chapter 11 bankruptcy, or out-of-court negotiations. What drives the choice between the two?[31] Conventional wisdom holds that the main difference between out-of-court restructuring and bankruptcy restructuring is that the former

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26. For a discussion of common financial covenants, see Robert M. Lloyd, *Financial Covenants in Commercial Loan Documentation: Uses and Limitations*, 58 TENN. L. REV. 335 (1991).

27. *See, e.g.*, U.C.C. § 9-601(a) (AM. L. INST. & UNIF. L. COMM'N 2010) ("After default, a secured party has the rights provided in this part and . . . those provided by agreement of the parties. A secured party . . . may reduce a claim to judgment, foreclose, or otherwise enforce the claim [or] security interest . . . by any available judicial procedure . . . .").

28. These preferences, and the failure of modern corporate law to properly restrain them, are explored in Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745 (2020).

29. Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 789 (2017) ("When a firm has value as a going concern, the investors as a group are better off if it remains intact even when it is in financial distress and not able to pay all of its bills.").

30. Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 924 (2001).

31. A recent article explains that bankruptcy and out-of-court restructurings are not necessarily opposing choices, but can be complementary choices; for instance, an initial out-of-court restructuring can pave the way for a more efficient bankruptcy restructuring. *See* Jason Roderick Donaldson, Edward R. Morrison, Giorgia Piacentino & Xiaobo Yu, *Restructuring vs. Bankruptcy* 34–36 (Colum. L. & Econ., Working Paper No. 630, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3698161 [https://perma.cc/X3CU-6WFF].

process is largely voluntary, consensual, and collaborative, reflecting a shared vision to restructure out of court and avoid the increased risks and costs associated with bankruptcy process. In contrast, bankruptcy—while costly, risky, and often time-consuming—offers a legal framework to neutralize certain obstacles that often prevent fair and efficient out-of-court restructurings, such as extreme imbalances in bargaining power, senior lenders' collective refusal to look beyond their own self-interest, and the problem of minority holdouts. The following sections explore the conventional wisdom in more detail, beginning with the classic assumptions surrounding out-of-court restructurings.

A. The Conventional Wisdom of Out-of-Court Restructurings

Also known as a "workout,"[32] an out-of-court restructuring is a negotiated settlement between the company and some or all of its lenders outside of any formal, court-administered bankruptcy or insolvency process. Because this Article is focused on private debt, an out-of-court restructuring for these purposes means that lenders agree to voluntarily impair their own bargained-for rights and enter into new agreements with the debtor setting forth repayment and other terms.

Building on an earlier point, lenders should, in theory, agree to an out-of-court restructuring only if they believe that the firm is worth more as a going concern; if the lenders do not share this belief, they should prefer liquidation in order to avoid the risk of further losses, retrieve what remains of their investment, and deploy their capital elsewhere for potentially greater returns.[33] Senior lenders may realize their liquidation preference by enforcing—or, in many cases, simply threatening to enforce—their rights and remedies under the loan agreements, or, less commonly, by pushing the company into an involuntary bankruptcy.

Of course, much of this assumes that stakeholders are able to quickly ascertain the firm's intrinsic value and make decisions based on these dollar amounts. In reality, corporate valuation is a difficult and inexact blend of art and science, and stakeholders often have widely divergent views on the value of the company as a going concern. But assuming stakeholders sufficiently agree on a value thesis, all stakeholders should prefer the more flexible, less costly, and less invasive option of an out-of-court restructuring.[34]

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32. *See, e.g.*, Conrad B. Duberstein, *Out-of-Court Workouts*, 1 AM. BANKR. INST. L. REV. 347 (1993) (providing an overview of out-of-court restructurings).

33. *See* sources cited *supra* notes 29–30.

34. *See* Gilson et al., *supra* note 4, at 318.

Many of these benefits of out-of-court restructurings can be traced to a lack of regulatory or judicial oversight.[35] Unlike other recapitalization transactions, such as those involving public bond and equity securities, out-of-court loan restructurings are not subject to any specialized legal or regulatory regime. Instead, much like the relationship between a debtor and its creditors generally, out-of-court restructurings are properly analyzed under a patchwork of corporate, commercial, and contract laws.[36]

As exercises in contract negotiation, restructurings are subject to the terms of the existing loan agreements and to general state contract laws that govern the interpretation of those agreements and the parties' entry into new agreements. Then, pursuant to a prevailing legal paradigm in commercial law that promotes legal certainty, predictability, and uniformity above virtually all other interests, courts have tended to strictly enforce the plain language of whatever agreements may be reached. Courts tend to avoid interposing thorny equitable doctrines or judge-made law out of fear that they might interfere with the smooth functioning of the capital markets.[37]

Out-of-court restructurings typically take the form of an extension, a composition, or a debt-for-equity swap. An extension involves a restructuring of the maturity date, the interest rate, and the amount and timing of any required principal and/or interest payments.[38] It may also involve a restructuring of key nonmonetary terms, such as the debtor's obligation to comply with ongoing covenants or the presence and extent of any credit enhancements, such as collateral or guarantees.[39] A

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35. I discuss the lack of regulatory or judicial oversight in commercial finance transactions in a previous work. *See generally* Dick, *supra* note 14.

36. For a thoughtful exposition on the patchwork of laws governing debtor-creditor relations generally, see Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647 (1996). On the corporate laws setting forth the duties of corporate managers in times of distress, see Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321 (2007).

37. *See generally* Dick, *supra* note 14.

38. The term "extension" may or may not be used in reference to the restructuring transaction. For an example of a restructuring of this sort, see Great Plains Real Est. Dev., L.L.C. v. Union Cent. Life Ins. Co., No. 4:05–CV–002204, 2007 WL 6908824, at *3 (S.D. Iowa June 4, 2007), noting "[t]he Extension Agreement provided Great Plains with a lower interest rate and extended maturity date, and obligated plaintiff to tender a one-time principal payment of $391,280.96."

39. For instance, the Canadian company NFI Group Inc. recently engaged in an out-of-court restructuring of its debt facility, relaxing covenants in order to give the company some much-needed breathing room while recovering from a global pandemic. Press Release, NFI Group Inc., NFI Group Announces Amendments to Its Credit Facilities (Dec. 23, 2020), https://www.nfigroup.com/2020/12/23/nfi-group-announces-amendments-to-its-credit-facilities/ [https://perma.cc/5KGB-SRMA].

composition takes things even further, with lenders agreeing to restructure not only the foregoing items but also the principal amount of the debt.[40] By agreeing to forgive some of the outstanding obligations, lenders allow the debtor to deleverage its balance sheet.

In contrast, a debt-for-equity swap occurs when lenders agree to surrender all or part of their debt claims in exchange for equity in the firm.[41] This can help the company achieve full deleveraging; however, it also dilutes existing equity interests, forcing them to share the future upside potential with stakeholders who previously held only a fixed claim on the assets of the firm. Finally, parties to out-of-court restructurings may blend these approaches, resulting in creative hybrid solutions to corporate financial distress.[42]

Regardless of the approach used, the conventional wisdom is that out-of-court restructurings require collaboration and consensus among the company, its senior lenders, and other stakeholders that must consent to the restructuring.[43] After all, these are voluntary agreements to deviate from bargained-for rights. And this is where things begin to break down in practice.[44] Big companies typically borrow from large groups of

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40. The term "composition" is somewhat antiquated and is more likely to appear in older cases and commentary. *See, e.g.*, Hanover Nat'l Bank v. Blake, 37 N.E. 519, 519 (N.Y. 1894) (describing a classic composition agreement).

41. For a critical examination of debt-for-equity swaps, see Jongho Kim, *To Be Creditor or to Be Shareholder, That Is the Question: Is the Debt-for-Equity Swap Creditors' Financial Suicide?*, 10 J. BUS., ENTREPRENEURSHIP & L. 359 (2017).

42. Companies also increasingly use other transactions to complete out-of-court restructurings, such as assignments for the benefit of creditors and Article 9 foreclosure sales under the Uniform Commercial Code. *See* Jim Fleet, *Chapter 11 on Decline? Changes Are Here to Stay*, AM. BANKR. INST. J., Mar. 2012, at 16.

43. This conventional wisdom is reflected in decades of judicial decisions, scholarly articles, books, and treatises. *See, e.g.*, Michelle M. Harner & Jamie Marincic Griffin, *Facilitating Successful Failures*, 66 FLA. L. REV. 205, 215 (2014) ("An out-of-court restructuring typically involves a consensual agreement between the company and its major creditors to adjust the company's capital structure."); PATRICK A. GAUGHAN, MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS 461 (5th ed. 2014) (referring to out-of-court restructurings as "voluntary" and "negotiated"); *In re* Chateaugay Corp., 961 F.2d 378, 381 (2d Cir. 1992) ("A debtor in financial trouble may seek to avoid bankruptcy through a consensual out-of-court workout.").

44. Describing the somewhat analogous world of bond workouts, Professors Bratton and Levitin described these dynamics thusly:

> When a company is in financial distress, its stockholders and bondholders have every reason to negotiate a restructuring (or "workout") of its obligations to produce a sustainable capital structure and avoid the costs of a bankruptcy. The reality is different. Bondholders hold out and free ride in response to restructuring offers from distressed debtors. Debtors respond with coercive inducements and procedural maneuvers. The result is a destabilizing and potentially toxic mix of creditor opportunism and debtor coercion that can derail the workout process, forcing a bankruptcy restructuring.

William W. Bratton & Adam J. Levitin, *The New Bond Workouts*, 166 U. PA. L. REV. 1597, 1600 (2018).

syndicated lenders.[45] These groups—particularly when they enjoy a senior secured position in the company's capital structure—exercise enormous bargaining power in setting the terms of any potential restructuring. For instance, if the liquidation value is sufficient to pay the senior lenders in full, they may prefer an immediate liquidation of the firm to reduce any further risk of loss. This is true even if the firm has greater value as a going concern.

Moreover, even if most lenders believe that a consensual restructuring makes sense, some may refuse to make concessions in the hopes of using their bargaining power to obtain a better deal, either for themselves or for the entire group. If the loan agreement requires unanimous consent to any modifications, these holdouts may derail the entire restructuring; at a minimum, they will certainly make it more expensive.[46] Accordingly, even when all or most stakeholders agree in theory that the firm should be restructured, it may still wind up in bankruptcy for lack of consensus.[47]

In recent years, in order to help facilitate out-of-court restructurings, many commercial loan agreements have included collective action clauses[48] that allow restructurings with less-than-unanimous consent; this helps to prevent opportunistic holdups by lenders holding relatively small amounts of debt. For instance, loan agreements commonly allow modifications to the agreement with majority or supermajority lender consent.[49] Such provisions are presumably based on an assumption that consent rights will be exercised by lenders organized around a common desire to advance the economic interests of all similarly situated lenders. This shared economic interest is, in essence, the theoretical justification

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45. Syndicated loans are described in BLAISE GANGUIN & JOHN BILARDELLO, FUNDAMENTALS OF CORPORATE CREDIT ANALYSIS 161–63 (2005). For a classic practice-oriented treatise on syndicated loan agreements, see RICHARD WIGHT, WARREN COOKE & RICHARD GRAY, THE LSTA'S COMPLETE CREDIT AGREEMENT GUIDE (2009).

46. The holdout problem is richly explored in the context of bond debt securities in Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights*, 77 N.Y.U. L. REV. 1040 (2002). *See also* Donaldson et al., *supra* note 31.

47. *See* Gilson et al., *supra* note 4, at 20.

48. Collective action clauses in the parallel world of sovereign debt are the subject of a rich body of academic literature. *See, e.g.*, Jonathan Sedlak, Comment, *Sovereign Debt Restructuring: Statutory Reform or Contractual Solution?*, 152 U. PA. L. REV. 1483 (2004) (considering the role of collective action clauses in sovereign debt restructurings); Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317 (2002) (further examining the role of collective action clauses—as well as other contractual solutions and existing civil procedures in the U.S.—in facilitating sovereign debt restructurings).

49. For a practitioner-oriented discussion of consent thresholds in loan agreements, see Suhrud Mehta & Lauren Hanrahan, *Who's Calling the Shots?*, INT'L. FIN. L. REV., June 2013, at 23.

for giving the majority the power to force certain terms down the throats of a dissenting minority.

In this way, minority holdouts are assumed to be at best misguided; at worst, they are acting to advance their own self-interest at the expense of the majority. Either way, their continued holdout threatens the best interests of the entire group, such that forcing them to accept the majority-approved restructuring is justified. However, a handful of provisions that relate to the lenders' most important economic rights (referred to in industry parlance as "sacred rights")[50] still commonly require unanimous consent. These sacred rights include, among other things, key economic terms such as the amount of principal outstanding and the interest rate applicable to the loan.[51]

When a syndicate of senior lenders refuses to consent to an out-of-court restructuring, either because a majority of lenders declines to see the value in restructuring or because the consent thresholds in the applicable agreements are too high to overcome the holdouts, corporate stakeholders may choose to pursue chapter 11 bankruptcy.[52] Bankruptcy may also be necessary when there *is* sufficient senior lender support, but the broader restructuring plan requires other interventions that can only be obtained through a bankruptcy proceeding.[53] The following section provides a brief overview of these in-court restructurings.

B. *The Conventional Wisdom of Bankruptcy Restructurings*

Given the obstacles to achieving out-of-court restructurings, a legal solution to corporate financial distress is needed to ensure that companies can be liquidated in an orderly manner or rehabilitated to preserve going concern value. Over the years, a variety of formal and informal state and federal insolvency regimes have been developed to

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50. For a practitioner-oriented discussion of sacred rights, see Kristina L. Anderson, *The Skinny on Workouts—Dynamics in Bank Syndicates*, ABF J. (Jan. 1, 2011), https://www.abfjournal.com/articles/the-skinny-on-workouts-dynamics-in-bank-syndicates [https://perma.cc/2KJD-8QDR].

51. *Id.*

52. Most bankruptcy filings are made after weeks or months of out-of-court restructuring discussions. *See, e.g.*, Peg Brickley & Tom Corrigan, *Breitburn Energy Partners Files for Chapter 11 Bankruptcy*, WALL ST. J. (May 16, 2016, 5:32 PM), https://www.wsj.com/articles/breitburn-energy-partners-files-for-chapter-11-bankruptcy-1463400009 (last visited Nov. 2, 2021) (describing the company's monthlong negotiations with creditors prior to filing for bankruptcy protection).

53. For instance, bankruptcy allows debtors to reject leases and other executory contracts. *See* 11 U.S.C. § 365. For a discussion of the common scenarios that tend to favor bankruptcy, see Duberstein, *supra* note 32, at 351–54.

address this need.[54] It would be impossible to review all of them here; accordingly, this section focuses on modern bankruptcy reorganizations proceeding under chapter 11 of the Bankruptcy Code.

Through chapter 11, bankruptcy offers a legal framework to help shift some bargaining power to the debtor, neutralize the holdout risk, and provide a limited pathway for nonconsensual restructurings. And, while bankruptcy law provides a range of protections for secured creditors, it also helps to recenter restructuring discussions around enhancing the company's long-term prospects as a going concern, thereby theoretically maximizing the potential recoveries of *all* stakeholders rather than those in positions of control.

Upon the filing of a bankruptcy petition, two important legal events immediately take place. First, a bankruptcy estate is created, composed primarily of property in which the debtor had an interest prior to the bankruptcy filing.[55] Second, an automatic stay goes into effect, protecting the debtor and property of the estate from further collection efforts or enforcement actions by creditors (and almost everyone else, for that matter).[56] Collectively, these two mechanisms prevent the quintessential "race to the courthouse" that might occur outside of bankruptcy, as self-interested creditors rush to collect what they are owed before others seize any remaining value.[57]

In most chapter 11 cases, there is no trustee appointed to oversee the estate; instead, the debtor continues to make decisions in respect of its property—within certain legal parameters—as a "debtor in possession."[58] For instance, the debtor may use, sell, or lease property of the estate in the ordinary course of business without notice to others or a judicial hearing.[59] In order to use, sell, or lease property of the estate *outside* of the ordinary course of business, the debtor must provide notice and attend a hearing where other stakeholders may appear and voice objections.[60] In evaluating requests of this sort, bankruptcy courts

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54. The various historical and present-day regimes are richly explored elsewhere. *See, e.g.*, DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2003) (providing a thorough historical account of the evolution of U.S. bankruptcy laws, focusing on how political and economic forces helped shape the legal regime).

55. 11 U.S.C. § 541(a).

56. *Id.* § 362.

57. This fundamental goal of bankruptcy law is concisely explained in Mark J. Roe, *Three Ages of Bankruptcy*, 7 HARV. BUS. L. REV. 187, 191–92 (2017).

58. 11 U.S.C. §§ 1107(a), 1108. Unless the context suggests otherwise, I use the term "debtor" to refer to the debtor-in-possession.

59. *Id.* § 363(c)(1).

60. *Id.* § 363(b)(1).

typically grant considerable deference to the debtor's business judgment.

Meanwhile, the debtor is expected to work towards a confirmable plan of reorganization. The Bankruptcy Code gives the debtor the exclusive right to propose a plan for the first 120 days of the case, with extensions commonly requested and granted.[61] Increasingly, debtors enter chapter 11 with some or even all of the critical pieces of a plan already in place—either in the form of a prepackaged or prenegotiated plan, or in the form of a support agreement in which major stakeholders commit in advance to support a plan that meets certain general or specific parameters.[62] A bankruptcy plan may contemplate using the same restructuring techniques that are used out of court; and, much like out-of-court restructurings, bankruptcy plans may blend together multiple techniques into sophisticated hybrid plans. Meanwhile, the debtor is also expected to review its executory contracts and unexpired leases and determine, generally, whether to assume, reject, or attempt to renegotiate these agreements for better terms.[63]

Collectively, these rules afford the bankrupt company some breathing room to reflect on the business and determine next steps. And, to the extent they place the debtor in the driver's seat for the most important restructuring decisions, they also shift some of the bargaining power back to the debtor. Of course, modern commercial realities undercut these dynamics somewhat. For instance, business debtors typically enter bankruptcy in dire need of cash to finance operations and pay for goods and services. If—as is very often the case—all of the company's cash is subject to security interests, it constitutes "cash collateral" and cannot be used without the consent of the secured party or express permission of the court.[64]

If the debtor cannot obtain permission to use cash collateral, or if the amount of available cash is insufficient, the debtor may need to obtain financing on a post-petition basis.[65] These so-called "DIP loans"—which are often extended by the debtor's most powerful stakeholders—tend to include highly restrictive covenants that bind the company to certain

61. *Id.* § 1121.

62. For more on agreements of this sort, see David A. Skeel, Jr., *Distorted Choice in Corporate Bankruptcy*, 130 YALE L.J. 366 (2020); Edward J. Janger & Adam J. Levitin, *Badges of Opportunism: Principles for Policing Restructuring Support Agreements*, 13 BROOK. J. CORP. FIN. & COM. L. 169 (2018); and Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593 (2017).

63. 11 U.S.C. § 365(a).

64. *Id.* § 363(c).

65. *Id.* § 364.

restructuring decisions and timelines.[66] DIP loans are also typically extended on a super-priority basis, meaning that they have the right to be repaid before most other claims.[67] In light of these and other aspects of modern chapter 11 practice, many argue that senior lenders[68]—including, in particular, DIP lenders[69]—have far too much power over bankruptcy restructurings.

But while chapter 11's modern-day impacts on bargaining power may be debated, the Bankruptcy Code's ability to neutralize the holdout risk is much clearer. Because bankruptcy restructuring is typically an exercise in scarcity, most plans contemplate impairment of some claims and interests. In accordance with bankruptcy's default distributional rule of absolute priority,[70] value flows downward, with senior classes entitled to be paid in full before junior classes receive anything.[71] To this end, the plan organizes creditors and interest holders into classes based on the nature of the claim or interest,[72] ranked in terms of priority.[73]

Parties are given detailed information about the plan and the debtor's overall financial condition. Then they are asked to vote on the plan on a class-by-class basis. A class is considered to accept the plan if it is accepted by creditors holding a majority in number and at least two-thirds in amount of allowed claims in the class.[74] In this way, bankruptcy

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66. *See generally* Frederick Tung, *Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis*, 37 YALE J. ON REG. 651 (2020).

67. *See* 11 U.S.C. § 364(c) (allowing debtors to incur debts with priority over any or all administrative expenses).

68. *See, e.g.*, Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 KY. L.J. 839 (2005) (exploring the role of creditor control in modern business bankruptcies); George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEVS. J. 19 (2004) (considering how secured creditors, in particular, exploit certain agency problems that are inherent in chapter 11 bankruptcy); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003) (emphasizing that creditor control is a pervasive feature of chapter 11).

69. I explore the effects of DIP loans on power dynamics in Diane Lourdes Dick, *The Bearish Bankruptcy*, 52 GA. L. REV. 437 (2018).

70. Although absolute priority remains the default distributional norm in bankruptcy, Professor Baird has made a strong case for replacing it with a norm of "relative priority." *See* Baird, *supra* note 29.

71. *See* 11 U.S.C. § 1129(b) (providing that a plan may be confirmed over the objections of impaired parties if it is "fair and equitable," meaning that holders of claims and interests are either paid in full or that no junior stakeholders receive a distribution).

72. *Id.* § 1122.

73. To the extent lenders have entered into intercreditor agreements that restrict the extent to which they can participate in the debtor's eventual bankruptcy, courts have struggled with the question of whether such agreements are enforceable in bankruptcy. For a rich discussion, see Edward R. Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015 U. ILL. L. REV. 721.

74. 11 U.S.C. § 1126(c). A similar rule applies to classes of equity interests. *Id.* § 1126(d).

law is able to override the higher consent thresholds—including requirements of unanimous consent—that would have applied to an out-of-court restructuring.

This power to bind holdouts within each class of claims or interests is a significant feature of bankruptcy law. There are, however, important safeguards in place for dissenting parties. For instance, the plan must provide the same treatment for all claims or interests within a class, unless the holder agrees to be treated differently.[75] This means that creditors are generally entitled to be paid on a pro rata basis with other similarly-situated creditors.

Following the vote, the plan proponent must obtain judicial confirmation of the plan by making a showing that it complies with a long list of requirements laid out in the Bankruptcy Code.[76] These requirements include, among other things, that the plan has been proposed in good faith[77] and that the plan is feasible.[78] Many plans are confirmed on a consensual basis, meaning that each class of claims or interests that is impaired has accepted the plan.[79] But the Bankruptcy Code also provides a mechanism to cram down a plan over the objections of one or more dissenting classes.[80] As an added check on the plan proponent's power, there must be at least one impaired class of claims that has accepted the plan.[81] Plan proponents are not permitted to engage in class gerrymandering in order to manufacture the required consenting class.

Assuming at least one impaired class has accepted the plan, the proponent must show that the plan does not "discriminate unfairly"[82] and that the plan is "fair and equitable"[83] with respect to each dissenting class. Most of the objections to a cramdown plan focus on the latter

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75. *Id.* § 1123(a)(4).

76. *Id.* § 1129 (which also folds in other requirements, such as those in 11 U.S.C. § 1122 and § 1123).

77. *Id.* § 1129(a)(3). The good faith standard is "generally interpreted to mean that there exists 'a reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code.'" *In re* Madison Hotel Assocs., 749 F.2d 410, 425 (7th Cir. 1984) (citation omitted).

78. 11 U.S.C. § 1129(a)(11).

79. *Id.* § 1129(a)(8).

80. *Id.* § 1129(b).

81. *Id.* § 1129(a)(10).

82. *Id.* § 1129(b)(1). Unfair discrimination is a murky concept that generally means that the debtor has treated a class differently than another class without any reasonable basis. *See, e.g.*, *id.* § 1322 (laying out a similar standard for a chapter 13 plan).

83. *Id.* § 1129(b)(1).

requirement, which is considered by many to be the most essential creditor safeguard in the Bankruptcy Code.[84] Generally speaking, a plan is fair and equitable with respect to a dissenting class if it provides at least as much as the class would have been entitled to receive in a hypothetical chapter 7 liquidation, and no junior holder receives anything on account of their claim or interest.[85] With respect to secured creditors, who hold property interests that even federal bankruptcy law cannot undermine, the standard is generally construed to mean that they retain their lien and receive deferred cash payments with a present value equal to or greater than the value of their collateral.[86]

Proving that the fair and equitable standard has been met can be difficult; it requires expert testimony establishing the likely liquidation value of the firm as well as the present value of the firm as a going concern.[87] Because bankruptcy law is concerned with the income-generating potential of the reorganized firm, going concern value is primarily measured using the discounted cash flow method.[88] Like all exercises in corporate valuations, these reports are expensive and time-consuming, and they rely on qualitative inputs from the company.[89] For this reason, the threat of cramdown is often enough to bring parties back to the negotiation table to reach a consensual plan.

By restoring some bargaining power to the debtor, neutralizing the holdout risk, and providing a pathway for a nonconsensual restructuring, bankruptcy is traditionally viewed as a legal process that helps parties achieve restructurings that they would not have been able to achieve on an out-of-court basis. And, in so doing, it recenters all parties' focus on the company's long-term prospects as a going concern. This arguably helps to maximize the recoveries of *all* stakeholders.

Of course, as this summary of chapter 11 has revealed, there are

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84. In a dissenting Third Circuit opinion, Judge Ambro highlighted the importance of the "fair and equitable" standard: "Instead of the court-determined standard of the prior Bankruptcy Act, the Bankruptcy Code created stronger creditor safeguards and protections in § 1129(b)(2)(A)." *In re* Phila. Newspapers, LLC, 599 F.3d 298, 335 (3d Cir. 2010) (Ambro, J., dissenting); *see also* Anthony L. Miscioscia, Jr., *The Bankruptcy Code and the New Value Doctrine: An Examination into History, Illusions, and the Need for Competitive Bidding*, 79 VA. L. REV. 917, 919 (1993) ("If applied rigorously [the cramdown rules] provide[] creditors with a strong leverage device for use in negotiating reorganization plans.").

85. 11 U.S.C. § 1129(b)(2).

86. *Id.* § 1129(b)(2)(A).

87. These valuation reports are the subject of IAN RATNER, GRANT T. STEIN & JOHN C. WEITNAUER, BUSINESS VALUATION AND BANKRUPTCY (2009).

88. *Id.* at 39–58.

89. I explore these and related issues in Diane Lourdes Dick, *Valuation in Chapter 11 Bankruptcy: The Dangers of an Implicit Market Test*, 2017 ILL. L. REV. 1487.

numerous statutory requirements that must be satisfied, and bankruptcy involves many trips to the courthouse. Other parties—including the smallest stakeholders—may intervene, introducing high levels of uncertainty. Even where there appears to be consensus among the parties, the judge[90] or the U.S. Trustee[91] may object to the debtor's proposals. Accordingly, it should be no surprise that bankruptcy comes with significant costs.[92] These costs can be further divided into direct and indirect costs, with the former category including professional fees and other expenses and the latter category including various opportunity costs, such as reputational damage.[93]

For these reasons, bankruptcy is often viewed as the nuclear option, to be avoided at all costs.[94] Under the conventional wisdom, these realities ought to encourage parties to work harder to collaborate and reach consensual out-of-court restructurings. As the following section reveals, this is not the case anymore. Instead, debtor companies increasingly pursue hostile restructurings, allowing them to achieve many of the benefits of a bankruptcy restructuring without all of the risks, costs, or creditor safeguards.

II. THE RISE OF HOSTILE OUT-OF-COURT RESTRUCTURINGS

This Part examines a series of illustrative examples of hostile restructurings. The analysis is divided into two sections, each focusing on a commonly utilized transaction structure. The first section explores "uptiering"[95] transactions involving the extension of new, senior tranches of debt. Drawing from restructuring transactions recently pursued by Serta, Inc., and NYDJ Apparel, LLC, this section shows how

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90. Bankruptcy judges possess broad equitable and discretionary powers; they are also expected to manage cases in ways that produce quick and efficient outcomes. These complex and, at times, conflicting responsibilities are richly explored in Melissa B. Jacoby, *What Should Judges Do in Chapter 11?*, 2015 U. ILL. L. REV. 572; Melissa B. Jacoby, *Fast, Cheap, and Creditor-Controlled: Is Corporate Reorganization Failing?*, 54 BUFF. L. REV. 401, 427–33 (2006).

91. The role of the U.S. Trustee is thoughtfully explored in Lindsey D. Simon, *The Guardian Trustee in Bankruptcy Courts and Beyond*, 98 N.C. L. REV. 1297 (2020).

92. For a comprehensive discussion of bankruptcy costs, see EDWARD I. ALTMAN & EDITH HOTCHKISS, CORPORATE FINANCIAL DISTRESS AND BANKRUPTCY: PREDICT AND AVOID BANKRUPTCY, ANALYZE AND INVEST IN DISTRESSED DEBT 71–81 (4th ed. 2019).

93. *Id.* at 93.

94. *See, e.g.*, Richard Danielson, *The Nuclear Option: Clearwater Condo Owners Push Back Against Bond Debt*, TAMPA BAY TIMES (June 28, 2019), https://www.tampabay.com/business/the-nuclear-option-clearwater-condo-owners-push-back-against-bond-debt-20190628/ [https://perma.cc/SMV4-ZBZW] (referring to a bankruptcy filing as a "nuclear option").

95. The term is used in LSTA Presentation, *supra* note 12.

these new priming debt issuances are often the product of secretive and divisive negotiations orchestrated by the company. The second section explores the "dropdown"[96] maneuver to transfer the most valuable collateral out of the reach of lenders so that it may be used to secure new debt issuances. Drawing from such prominent examples as J. Crew Group, Inc. and Revlon, Inc., this section reveals just how contentious hostile restructurings can be.

A. *Uptiering Restructuring Transactions*

In hostile restructurings that use the uptiering transaction structure, the company issues new super-priority debt. These new extensions of credit typically roll up the loans of some of the existing lenders, essentially resulting in an intra-class subordination of some of the senior debt. For instance, the privately-owned U.S. bedding manufacturer Serta, Inc. (collectively, with its subsidiaries that are party to the company's senior loan agreements, "Serta")[97] recently engaged in a transaction of this sort, leading to the subordination of the debts of some of its senior secured lenders.

The story began in 2016, when Serta and its senior lenders entered into a syndicated first lien loan agreement.[98] This senior secured financing arrangement provided the company with $1.95 billion in loans (the "First Lien Loans").[99] At the same time, the company and another group of lenders established a second lien loan facility providing for $450 million in loans.[100] As is typically the case in secured financing deals structured with first and second lien facilities, each group of lenders was separately granted liens on the same collateral—here, Serta's intellectual property and related royalty streams.[101] Then, pursuant to an intercreditor agreement, the two groups of lenders agreed that in the event Serta defaults on its obligations and the lenders must exercise their remedies under the agreements (for instance, by

96. The term is also used in LSTA Presentation, *supra* note 12.

97. *About Serta*, SERTA, https://www.serta.com/about [https://perma.cc/H2VB-MZCT].

98. Complaint at 11, North Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC, No. 652243/2020, 2020 N.Y. Misc. LEXIS 4222 (N.Y. Sup. Ct. Aug. 4, 2020).

99. *Id.*

100. *Id.*

101. Such a lien is enforceable if it is created and attached under U.C.C. § 9-203 (AM. L. INST. & UNIF. L. COMM'N 2010). Assuming the secured party is the first to perfect a security interest in the collateral, it will be entitled, after the borrower's default, to collect against the value of the collateral before competing lienholders' claims are satisfied. *See* U.C.C. § 9-322(a) (AM. L. INST. & UNIF. L. COMM'N 2010).

foreclosing on collateral), the obligations arising under the First Lien Loans must be satisfied in full before lenders holding second lien loans are entitled to recover.

To ensure that the proceeds of any such disposition of collateral are distributed fairly to lenders *within* each tranche, the loan agreement also contained a fairly standard payment waterfall provision[102] entitling each lender (after certain expenses and entitled reimbursements are paid) to a pro rata share of any proceeds of the collateral, based on the face amount of loans that each lender owns.[103] This means that, within each tranche, no lender would have a superior right to the value of the collateral over any other lender. As further evidence of the lenders' commitment to proportional sharing of proceeds, the loan agreement provided that to the extent any lender receives payment on account of its loans that is of a greater proportion than that received by others, the surplus must be shared ratably among the lenders within that tranche.[104]

Serta's loan agreement generally provided that it may be amended with the consent of the "Required Lenders," a term defined to mean lenders holding more than 50% of the face value of the loans.[105] Meanwhile, sacred rights could only be amended with "the consent of each Lender directly and adversely affected thereby."[106] This unanimous consent requirement applied to, among other things, the amendment of critical economic terms, such as the outstanding principal amount, the interest rate, and the maturity date.[107] It also applied to amendments to the waterfall provision requiring pro rata sharing of any proceeds of collateral.[108] But not every transaction in which a lender receives value

102. The Third Circuit recently explained how provisions of this sort function. *See In re* Energy Future Holdings Corp., 773 F. App'x 89, 91 (3d Cir. 2019) ("A waterfall provision sets the order in which parties will receive benefits from an asset pool.").

103. For the relevant excerpts from the loan agreement, see Plaintiffs' Memorandum of Law in Support of Their Application for a Temporary Restraining Order, a Preliminary Injunction, and Expedited Discovery, Exhibit B, *Serta*, No. 652243/2020, 2020 N.Y. Misc. LEXIS 4222 [hereinafter Plaintiffs' Memorandum Exhibit B]. Section 2.18(b) contains the payment waterfall. That section provides that after certain expenses are paid, the proceeds of collateral are to be divided pro rata among the first lien lenders, based on the face amount of their ownership of loans. This means that all first lien lenders would share the proceeds based on the percentage of the loans that they own. *See* Complaint, *supra* note 98, at 15.

104. *See* Plaintiffs' Memorandum Exhibit B, *supra* note 103, at 76–77 (reprinting section 2.18(c)).

105. Lender Defendants' Memorandum of Law in Opposition to Plaintiffs' Application for a Temporary Restraining Order, a Preliminary Injunction, and Expedited Discovery at 7, *Serta*, No. 652243/2020, 2020 N.Y. Misc. LEXIS 4222 [hereinafter Defendants' Memorandum].

106. Plaintiffs' Memorandum Exhibit B, *supra* note 103, at 137 (reprinting section 9.02(b)(A)).

107. *Id.* at 137–38 (reprinting sections 9.02(b)(A)(1)–(6)).

108. *Id.* at 138 (reprinting section 9.02(b)(A)(6)).

on account of its debt position would be subject to the pro rata sharing requirement. In carveout language, the agreement provided that consent was *not* required for debt-to-debt exchanges on a non-pro rata basis that take place pursuant to an open market transaction,[109] even if Serta is the one purchasing the debt.[110]

In the years following Serta's entry into the loan agreement, the company's financial condition worsened. The company faced increased competition from new direct-to-consumer mattress brands.[111] It also faced mounting pressure as one of its largest retail partners filed for bankruptcy protection.[112] By early 2020, with the global COVID-19 pandemic threatening another recession, Serta found it increasingly difficult to manage the risks and consequences of a highly leveraged balance sheet. Although management continued to offer assurances that the company was on solid footing, rating agencies slashed Serta's ratings to junk.[113] By June, the First Lien Loans were trading at less than fifty cents on the dollar, while the second lien loans were trading at less than twenty cents on the dollar.[114]

To enhance the firm's balance sheet and improve liquidity, Serta commenced negotiations with various groups of existing lenders to restructure the senior secured debt. This was no small undertaking; at the time, there was over $2 billion in debt still outstanding under the senior secured facility. The company's board of directors formed a special finance committee of independent directors to consider and evaluate proposals.[115] Serta entered into confidentiality agreements with several lender groups, binding them to "no-talk"[116] provisions that would prevent them from disclosing the terms of a potential deal to other lenders and potentially coordinating with each other to the detriment of

109. *Id.* at 149 (reprinting section 9.05(g)). The term "affiliated lender" is defined elsewhere in the agreement to include Serta. *See* Defendants' Memorandum, *supra* note 105, at 12.

110. *See* Plaintiffs' Memorandum Exhibit B, *supra* note 103, at 77 (reprinting section 2.18(c)(ii)(B), which carves out the proceeds of an assignment or sale of loans pursuant to section 9.05 from the pro rata sharing provision).

111. Affidavit of Allen Barry Canipe at 2, *Serta*, No. 652243/2020, 2020 N.Y. Misc. LEXIS 4222 [hereinafter Canipe Affidavit].

112. *See* Voluntary Petition for Non-Individuals Filing for Bankruptcy, *In re* Mattress Firm, Inc., No. 18-12241-CSS (Bankr. D. Del. Mar. 24, 2020).

113. Complaint, *supra* note 98, at 16.

114. Affirmation of Jennifer L. Conn in Support of Lender Defendants' Opposition to Plaintiffs' Application for a Temporary Restraining Order, a Preliminary Injunction, and Expedited Discovery, Exhibit 2, *Serta*, No. 652243/2020, 2020 N.Y. Misc. LEXIS 4222.

115. These efforts are described more fully in the Canipe Affidavit, *supra* note 111.

116. Such provisions, and the closely related "no-shop" provisions, are the subject of Karl F. Balz, *No-Shop Clauses*, 28 DEL. J. CORP. L. 513 (2003).

Serta.[117]

Serta would later characterize these negotiations as a "competitive process between competing lender groups" conducted in good faith.[118] Through this process, two lead proposals emerged: the first, advanced by lenders holding a slim majority of the First Lien Loans, contemplated a new super-priority debt facility consisting of the participating lenders' loans, which would prime all of the existing tranches under the senior secured facility.[119] The other, proposed by a group of lenders holding approximately 30% of the First Lien Loans, contemplated the transfer of the most valuable collateral away from the lenders under the senior secured facility so that it could be used to secure the participating lenders' loans.[120] Each proposal provided much-needed access to new credit; each was also an exclusive deal, meaning that lender participation would be limited to those lenders involved in the negotiations.

Serta—acting through its special finance committee—chose the former proposal over the latter, and in June 2020 the company announced that it had reached a deal that would reduce the company's overall debt burden by approximately $400 million.[121] The restructuring would unfold as follows. First, lenders holding 50.1% of the First Lien Loans[122] would fund $200 million in new First Lien Loan debt.[123] Then, the company would conduct a debt-to-debt exchange on a non-pro rata basis with these participating lenders, pursuant to which the lenders would swap, at a discount,[124] their First Lien Loans (including the

117. Serta Simmons Bedding, LLC's Memorandum of Law in Opposition to Plaintiffs' Application for a Temporary Restraining Order, a Preliminary Injunction, and Expedited Discovery at 5, *Serta*, No. 652243/2020, 2020 N.Y. Misc. LEXIS 4222 [hereinafter Serta's Memorandum].

118. *Id.* at 1.

119. This structure had been used by other companies in recent years. *See, e.g.*, CPI Card Group Inc., Quarterly Report (Form 10-Q), at 15 (Apr. 23, 2020) (describing an uptiering transaction effectuated in March 2020); Fusion Connect, Inc., Current Report (Form 8-K) (May 10, 2019) (describing an uptiering transaction effectuated in May 2019); McDermott International, Inc., Current Report (Form 8-K) (Oct. 17, 2019) (describing an uptiering transaction effectuated in October 2019).

120. This structure is described in more detail *infra* section II.B.

121. Press Release, Serta, Inc., Serta Simmons Bedding Enters into Agreement with Majority of Lenders on Deleveraging and Liquidity Enhancing Transaction (June 8, 2020), https://sertasimmons.com/news/serta-simmons-bedding-enters-into-agreement-with-majority-of-lenders-on-deleveraging-and-liquidity-enhancing-transaction/ [https://perma.cc/C6TM-C5AM] [hereinafter Serta Press Release].

122. Serta's Memorandum, *supra* note 117, at 6.

123. *See* Serta Press Release, *supra* note 121. Loan agreements typically allow the company to issue to debt under certain circumstances.

124. The company would provide seventy-four cents of new loans in exchange for each dollar of existing first lien loans. Defendants' Memorandum, *supra* note 105, at 12.

$200 million in new loans) for loans issued under a new credit facility.[125] Next, the participating lenders would use their majority power to execute a series of amendments to the 2016 loan agreement that would give the new loan facility senior payment priority. Finally, the parties would execute an intercreditor agreement establishing the payment priorities for the new facility.[126]

Once these steps were completed, the proposed credit facility would include the $200 million in new loans, which would prime all of the other debt (called a super-priority "first out" in industry parlance).[127] Next, there would be a $875 million debt facility (known as a "second out" tranche) consisting of the debt exchanged by the participating lenders.[128] Last, the agreement contemplated an unspecified amount of "third out" debt that would potentially arise in the future.[129] And, pursuant to the amendments to the 2016 loan agreement, *all* tranches of the new facility would rank ahead of the First Lien Loans. In other words, following the consummation of these transactions, there would be more than $1 billion in debt that would have priority over the $814 million remaining First Lien Loans owned by the lenders who were not invited to participate in the restructuring.

Unwilling to accept this fate, the lenders who advanced the losing proposal filed suit in a New York state court against Serta, its private equity owner, and the lenders participating in the restructuring.[130] The plaintiffs alleged, among other things, that the restructuring amounted to a breach of contract and breach of the implied covenant of good faith and fair dealing.[131] Given that time was of the essence, the aggrieved lenders asked the court to impose a preliminary injunction[132] and

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125. Plaintiffs' Memorandum Exhibit B, *supra* note 103, at 149 (reprinting section 9.05(g)). The language does not expressly prohibit exclusive deals.

126. Defendants' Memorandum, *supra* note 105, at 18.

127. *See* Serta Press Release, *supra* note 121.

128. *Id.*

129. *Id.*

130. *See generally* Complaint, *supra* note 98 (initiating the lawsuit).

131. There is a covenant of good faith and fair dealing implied in every contract. *See, e.g.*, RESTATEMENT (SECOND) OF CONTS. § 205 (AM. L. INST. 1981) (providing a concise restatement of the prevailing U.S. common law concerning the duty of good faith and fair dealing); U.C.C. § 1-304 (AM. L. INST. & UNIF. L. COMM'N 2010) (setting forth the duty of good faith applicable to contracts and duties arising under the Uniform Commercial Code).

132. A preliminary injunction is granted where a plaintiff can demonstrate (1) a likelihood of ultimate success on the merits; (2) the prospect of irreparable injury if the provisional relief is withheld; and (3) a balance of equities tipping in the moving party's favor. *See* Gramercy Co. v. Benenson, 223 A.D.2d 497, 498 (N.Y. App. Div. 1996); N.Y. C.P.L.R. §§ 6301, 6313 (CONSOL. 2021).

temporary restraining order[133] to enjoin the already-announced transactions until a decision could be reached on the merits.

In their breach of contract claim, the plaintiffs had to overcome Serta's insistence that each individual step of the proposed restructuring was permitted under the loan agreement. For instance, the proposed debt exchange arguably constituted a permissible open market transaction, such that it may take place on a non-pro rata basis.[134] Similarly, the priming amendment arguably only required majority lender consent.[135] Further bolstering Serta's case, the loan agreement did not include a common provision prohibiting subordination of claims or liens without unanimous consent.[136]

The plaintiffs, for their part, argued that the overall economic effect of the restructuring violated the plain language of the loan agreement because such profound changes to the rights of senior secured lenders must require unanimous consent.[137] For instance, the plaintiffs argued that the defendants effectively amended the pro rata sharing clause without the consent of all of the lenders.[138] In a similar way, the plaintiffs insisted that the proposed transaction would have the economic effect of releasing substantially all of their collateral, and that any such release also requires unanimous consent.[139] In essence, they argued that the proposed transaction would effectively relegate the plaintiffs to unsecured status in clear violation of their sacred rights in the loan agreement.[140]

The plaintiffs also complained that the company went about the restructuring process in a way that violated the lenders' procedural

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133. A temporary restraining order is a remedy that requires the proponent demonstrate (1) a likelihood of success on the merits, (2) irreparable injury absent a restraining order, and (3) a balance of equities tipping in its favor. *See* Silvestre v. De Loaiza, 820 N.Y.S.2d 440, 441 (N.Y. Sup. Ct. 2006). In *Serta*, the plaintiffs argued that such relief was necessary because, absent intervention by the court, the plaintiffs would suffer "immediate and irreparable injury" from the transaction moving forward. *See* Plaintiffs' Memorandum of Law in Support of Their Application for a Temporary Restraining Order, a Preliminary Injunction, and Expedited Discovery at 14–20, North Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC, No. 652243/2020, 2020 N.Y. Misc. LEXIS 4222 (N.Y. Sup. Ct. Aug. 4, 2020) [hereinafter Plaintiffs' Memorandum].

134. This interpretation is based on the provisions in the loan agreement, discussed *supra* notes 109 and 110 and accompanying text.

135. *See supra* note 105 and accompanying text (describing how amendments to the loan agreement generally only require the consent of a majority of the lenders).

136. Defendants' Memorandum, *supra* note 105, at 8.

137. Complaint, *supra* note 98, at 3–5.

138. *Id.* at 5.

139. *Id.* at 4.

140. On sacred rights, see Anderson, *supra* note 50 and accompanying text.

rights. Namely, they argued that the exclusive nature of the proposed restructuring essentially amounted to an "unlawful scheme to rob certain of Serta's lenders, including Plaintiffs, of their bargained-for rights. . .while protecting and providing special benefits to a group of favored lenders who agreed to participate in the scheme."[141] Serta, for its part, acknowledged the exclusive nature of the deal. But the company argued that this was a feature rather than a bug:

> Plaintiffs suggest that they should be permitted to participate in the Proposed Transaction, but Plaintiffs' participation would not accomplish the goal of deleveraging the Company. If every First Lien Loan lender was permitted to exchange their debt into the new facility, there would be no reduction in debt because the participating lenders would not be incentivized to sell their debt at a discount, whereas now, with the Defendant Lenders, the net reduction is nearly $400 million.[142]

Then, the company reminded the court that one of the plaintiffs had spearheaded a losing restructuring proposal, which would have had similar effects on excluded lenders. Serta remarked that this lender must know full well that "this is the way restructuring transactions are commonly done."[143]

The company also challenged the plaintiffs' argument that the proposed transaction amounted to lien stripping, reminding the court that all existing liens would remain in place.[144] And, in response to the plaintiffs' request for injunctive relief, Serta insisted that there can be no irreparable harm because the purported damages have a determinable value and each plaintiff can be made whole through an award of money damages.[145] Thus, even if the court were to accept the plaintiffs' argument that their liens had been effectively stripped, "the liens only protect Plaintiffs' right to be paid *money*, just as the allegedly depreciating value of the loans is measured in dollars and cents. All that would be required to make Plaintiffs whole is a simple calculation of the value of their debt."[146] Finally, Serta shrugged off concerns about the

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141. Complaint, *supra* note 98, at 3.

142. Serta's Memorandum, *supra* note 117, at 9; *see also* Affidavit of Roopesh K. Shah at 9, North Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC, No. 652243/2020, 2020 N.Y. Misc. LEXIS 4222 (N.Y. Sup. Ct. Aug. 4, 2020) [hereinafter Shah Affidavit] ("[T]he fewer holders that are offered the opportunity to participate in the debt-for-debt exchange, the more incentivized they will be to exchange the debt at a greater discount.").

143. Serta's Memorandum, *supra* note 117, at 10.

144. *Id.* at 12 ("First, no one is stripping Plaintiffs of their liens in the collateral.")

145. *Id.* at 11.

146. *Id.* at 12 (emphasis in original).

company's solvency and the minority lenders' eventual position in any future bankruptcy reorganization. These hypothetical concerns were, in its view, insufficient grounds for a finding of irreparable harm: "Plaintiffs are left claiming a vague harm to their bargaining 'leverage.'"[147]

Moreover, the company's advisors maintained that Serta would suffer significant and irreparable harm if the proposed transactions were enjoined. A financial advisor explained that if the transaction did not go forward:

> [Serta's] lenders will have no incentive to negotiate with [Serta] as separate groups, and instead would be incentivized to unite so as to obtain the best terms for the lenders, to the detriment of [Serta]. As [Serta's] lenders now know their respective positions on a potential refinancing, the lenders have no incentive to compete with one another to grant [Serta] favorable terms, but rather are incentivized to act as one group.[148]

In the financial advisor's view, the company's carefully constructed "competitive process" offered the only "meaningful opportunity for the company to deleverage."[149]

Given the tendency for courts to strictly construe commercial finance agreements,[150] the weight of the authority was against the plaintiffs. But the plaintiffs also alleged that the restructuring breached the implied covenant of good faith and fair dealing.[151] Under basic principles of state contract law, every agreement contains an implied duty of good faith and fair dealing.[152] This is generally understood to mean that parties to contracts should behave honestly and work to uphold the spirit of the agreement.

To bolster the latter claim, the plaintiffs reminded the court of a 2018 decision to deny a motion to dismiss a complaint alleging similar conduct.[153] The debtor in that case, clothing manufacturer NYDJ Apparel, LLC (collectively, with its subsidiaries that are party to the company's senior loan agreements, "NYDJ"), had engaged in an uptiering transaction in May 2017 with 53% of lenders from the

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147. *Id.* at 13.

148. Shah Affidavit, *supra* note 142, at 8.

149. *Id.*

150. *See generally* Dick, *supra* note 14 (discussing courts' modern reliance on strict interpretation of commercial financing agreements).

151. Complaint, *supra* note 98, at 23.

152. *See* sources cited *supra* note 131.

153. Plaintiffs' Memorandum, *supra* note 133, at 17.

company's senior secured credit facility.[154]

The NYDJ plaintiffs—composed of dissenting minority lenders—argued that the restructuring negotiations were conducted "with no notice, under cover of darkness,"[155] and that some lenders only learned of the proposed transaction when it was publicly announced. One plaintiff lender alleged that it had been invited to participate in the scheme months earlier but declined to do so because it believed that the plan was proposed in bad faith.[156] According to this plaintiff, the plan proponent had boasted "that the number of lenders benefitting from [the scheme] would be kept to the bare minimum necessary to form a majority so that the spoils of the scheme could be shared among the smallest possible pool of lenders."[157]

At a hearing to address the conflicts surrounding NYDJ's restructuring, the judge seemed to take issue with the secretive nature of the negotiations. After parsing through language in the agreement establishing consent thresholds for various types of amendments, the judge took a moment to reflect on the broader meaning of the words in the original agreement. "Doesn't the phrase written consent imply that you're going to ask everyone to consent?"[158] More broadly, he asked, "Isn't there an implied covenant of good faith anymore?"[159] When the company's attorneys attempted to redirect the court's attention to language requiring a simple majority, the judge expounded further on customary practice and reasonable commercial expectations of good faith and fair dealing in this context:

> No, no. I'm not saying they required the written consent of every lender. But how do you determine if you have the consent of lender A, if you don't ask lender A would you consent. Instead, you have a quote majority, 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. It really seems unethical.[160]

154. *NYDJ, or Can You Really Prime 47% of Lenders Without Their Consent?*, KING & SPALDING, https://www.kslaw.com/attachments/000/008/524/original/How_did_they_do_it_NYDJ.pdf?1611586634 [https://perma.cc/726C-4NPG].

155. Complaint at 5, Octagon Credit Invs., LLC v. NYDJ Apparel, LLC, No. 656677/2017 (N.Y. Sup. Ct. Nov. 1, 2017).

156. *Id.* at 12–13.

157. *Id.* at 12.

158. Transcript of Proceedings at 22, *Octagon Credit Invs.*, No. 656677/2017 (N.Y. Sup. Ct. Mar. 27, 2018).

159. *Id.* at 26.

160. *Id.* at 23.

The aggrieved lenders had advanced a similar interpretation, explaining that "the reason you have the class vote is so the majority of the class can bind the holdouts that don't go along with class vote. The purpose of the provision isn't to allow the majority to [improve its own position at the expense of] the minority."[161] From that vantage point, it was not hard to see that the company's restructuring proposal violated both the language and the spirit of the original loan agreement, as well as the most basic conceptions of good faith and fair dealing. For these reasons, the court denied the motion to dismiss, opining that the plaintiffs had stated a claim for, among other things, breach of the implied covenant of good faith and fair dealing.[162] The parties later reached a settlement pursuant to which NYDJ invited all of the lenders to exchange their debt at a discounted rate and participate in a new facility.[163]

Although the dispute surrounding the NYDJ restructuring was similar in some respects to the dispute surrounding Serta's restructuring, there were important differences. For one, the plaintiffs opposing Serta's restructuring were far less sympathetic, particularly in their quest for equitable relief—in fact, they arguably came to the court with unclean hands.[164] This is because they had tried to advance their own exclusive restructuring plan that, in the words of the defendants, "would have done the very thing [the plaintiffs] now accuse[] the Defendant Lenders of doing—stripping hundreds of millions of dollars of existing collateral away from the other lenders, and placing them . . . in an exclusive 'super-priority' position in the event of default."[165]

Additionally, although NYDJ, like Serta, had insisted that the transactions were permitted under the plain language of the loan agreement, there was at least some circumstantial evidence in the NYDJ restructuring to suggest otherwise. Notably, the company's law firm, in a third-party legal opinion addressing the restructuring agreement's enforceability, expressly declined to opine as to whether the company had complied with the consent provisions in the loan agreement.[166]

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161. *Id.* at 37.

162. *Id.* at 43.

163. *See* Affirmation, Exhibit B at 13, *Octagon Credit Invs.*, No. 656677/2017.

164. Defendants' Memorandum, *supra* note 105, at 1; *see also* United for Peace & Just. v. Bloomberg, 783 N.Y.S.2d 255, 259 (N.Y. Sup. Ct. 2004) (denying a request for an injunction where "plaintiff does not come to court with 'clean hands'").

165. Serta's Memorandum, *supra* note 117, at 2.

166. Exhibit G at 7, *Octagon Credit Invs.*, No. 656677/2017 (providing a copy of the legal opinion; the relevant qualification is set forth in paragraph (u)).

Finally, although the record in the NYDJ dispute was thin with respect to the company's process for vetting proposals, Serta provided ample evidence of management's efforts to comply with their fiduciary obligations in evaluating a major transaction. For instance, the company had spent nearly a year evaluating multiple strategic alternatives, and even retained a law firm and financial advisor to assist with the process.[167] And, as Serta narrowed down its options to several competing proposals, it vested decision-making authority in a committee of independent directors.[168] These internal processes helped to frame the restructuring as a sound exercise of business judgment, and possibly the company's only option to survive a severe economic downturn.

After initially entering a temporary restraining order to prevent Serta from moving forward with the proposed restructuring,[169] the court declined to grant the plaintiffs' request for a preliminary injunction.[170] This is because, in the court's view, the plaintiffs had failed to establish a likelihood of success on the merits.[171] Adopting the company's hypertechnical interpretation, the court explained that it "seems to permit[] the debt-to-debt exchange on a non-pro rata basis as part of an open market transaction."[172] And, since the amendments did not, in the court's view, impact sacred rights under the loan agreement, unanimous consent was not required.[173] Serta completed the restructuring in June 2020.[174]

B. Drop-Down Restructuring Transactions

In hostile restructurings that use the drop-down transaction

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167. *See generally* Affidavit, *supra* note 142.

168. *Id.* at 3.

169. Defendants' Memorandum, *supra* note 105, at 13.

170. Order at 11, North Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC, No. 652243/2020, 2020 N.Y. Misc. LEXIS 4222 (N.Y. Sup. Ct. Aug. 4, 2020).

171. *Id.* at 9–10.

172. *Id.* at 8.

173. *Id.*

174. Press Release, Serta, Inc., Serta Simmons Bedding Closes Previously Announced Deleveraging and Liquidity Enhancing Transaction (June 22, 2020), https://sertasimmons.com/news/serta-simmons-bedding-closes-previously-announced-deleveraging-and-liquidity-enhancing-transaction/ [https://perma.cc/NAX6-YUGJ]. The plaintiffs continued to pursue the matter in federal court, but their claims were dismissed in March 2021. Transcript of Hearing at 7, *Serta*, No. 652243/2020, 2020 N.Y. Misc. LEXIS 4222; *see also* Opinion, LCM XXII Ltd. v. Serta Simmons Bedding, LLC, No. 20-cv-5090, at 1–2 (S.D.N.Y Mar. 9, 2021); Complaint, *LCM XXII Ltd.*, No. 20-cv-5090.

structure,[175] companies transfer valuable collateral out of the reach of existing lenders in order to secure new debt issuances. This structure was infamously used by U.S. apparel retailer J. Crew Group, Inc. (collectively, with its subsidiaries that are party to the company's senior loan agreements, "J. Crew"), when, in 2016, certain senior secured lenders under a $1.57 billion credit facility claimed to have been "shocked and dismayed" to find themselves on the losing end of a drop-down restructuring.[176]

Specifically, the company had transferred certain portions of the lenders' most valuable intellectual property collateral—including the "J. Crew" branding—to new, wholly-owned subsidiaries that would not be considered debtors or guarantors under the loan agreement.[177] At the time of the transfer, the intellectual property assets were estimated by J. Crew to be worth approximately $250 million,[178] while the aggrieved lenders would later assert that these assets were worth upwards of $1 billion.[179] Following the transfer, the company promised to redirect $59 million per year to the new subsidiary to compensate it for the use of the intellectual property for branding and merchandising purposes.[180]

When they learned of the transfer, the senior secured lenders collectively demanded the resignation of the administrative agent[181] and appointed a new one.[182] The company, sensing opposition on the horizon, sued the newly-appointed administrative agent for a declaratory judgment ratifying the transfers and declaring them permissible under the agreement.[183] The agent asserted counterclaims, arguing that the asset transfer violated the loan agreement and also constituted a fraudulent transfer.[184]

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175. "Drop-down transaction" is an industry term for a restructuring in which the company transfers assets to a subsidiary, typically in order to effectuate a sale transaction or to secure debt issued by that subsidiary. *See generally* Scott W. Dolson, *Rollover Equity Transactions 2021*, FROST BROWN TODD LLC (Jan. 28, 2021), https://frostbrowntodd.com/rollover-equity-transactions/ [https://perma.cc/4D5G-3JAN].

176. Complaint at 3, Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y, No. 654397/2017, 2018 WL 1947405 (N.Y. Sup. Ct. Apr. 25, 2018).

177. *Id.*

178. *Id.* at 19.

179. Affidavit at 13, *Eaton Vance Mgmt.*, No. 654397/2017, 2018 WL 1947405.

180. Complaint, *supra* note 176, at 4.

181. Complaint for Declaratory Judgment at 19, J. Crew Grp., Inc. v. Wilmington Sav. Fund Soc'y, No. 650574/2017 (N.Y. Sup. Ct. Feb. 1, 2017).

182. Complaint, *supra* note 176, at 37.

183. Complaint, *supra* note 181, at 19.

184. Defendant's Answer, Affirmative Defenses, and Counterclaims at 21–22, J. Crew Grp., Inc. v. Wilmington Sav. Fund Soc'y, No. 650574/2017 (N.Y. Sup. Ct. March 24, 2017).

Specifically, the agent argued that the transfer was part of a "multistep process to divert the value of [a] 'critical' and 'integral' asset away from J. Crew Company and its creditors" for the benefit of equity owners,[185] and that each individual step—much like the transaction as a whole—was in violation of the loan agreement. For instance, one of the earliest steps in the transaction was the designation of "unrestricted subsidiaries."[186] While the agreement contained common language allowing the company to make designations of this sort, the company could only do so upon a showing that the company was then in compliance with certain financial covenants.[187] But according to the agent, the company's calculations, as well as certain inputs used to make those calculations, were incorrect.[188] As a result, the company's designation of the subsidiaries as unrestricted constituted a default under the loan agreement.[189] The agent also claimed that J. Crew was actually insolvent at the time of the transfers, and that the transfers were primarily motivated by a desire to drive down the value of the senior secured debt so that the company could buy back the loans at a discount.[190]

J. Crew, for its part, argued that the transactions *were* permitted under the plain language of the loan agreement.[191] This is because the agreement contained several common carveouts that allowed investments by the company in both restricted *and* unrestricted subsidiaries.[192] For instance, the agreement allowed investments in unrestricted subsidiaries up to certain predetermined thresholds, plus an additional amount based on earnings if the company was not in default.[193]

In June 2017, while the agent's suit was still pending, the company announced the next steps in the drop-down transaction: J. Crew would

185. *Id.* at 19.

186. *Id.* at 20. In typical loan agreements, so-called restricted subsidiaries are subject to covenants while unrestricted subsidiaries are not.

187. *Id.* at 30–31.

188. *Id.* at 31–32.

189. *Id.* at 32.

190. *See id.* at 51–52.

191. J. Crew's Memorandum of Law in Opposition to Plaintiffs' Order to Show Cause for Entry of a Temporary Restraining Order and for a Preliminary Injunction at 21–22, Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y, No. 654397/2017, 2018 WL 1947405 (N.Y. Sup. Ct. Apr. 25, 2018) [hereinafter J. Crew's Memorandum of Law].

192. Complaint, *supra* note 181, at 17–18. The company describes how each step of the transaction technically complies with the loan agreement in its Complaint. *Id.* at 12–14.

193. *Id*. at 13.

use the new, asset-rich, unrestricted subsidiaries to entice certain junior, unsecured bondholders to exchange their debt for new secured bonds of lesser principal amount and longer maturities.[194] Meanwhile, the company solicited senior secured lenders to consent to the transactions, direct the agent to drop the lawsuit, and agree to certain amendments to the loan agreement.[195] To sweeten the proverbial pot, the company offered to purchase up to $150 million of the senior secured debt at par even though the loans were then trading at seventy cents on the dollar.[196] The lenders were given three days to decide.[197]

Lenders who collectively held approximately 88% of the outstanding loans voted to accept the restructuring terms.[198] Accordingly, the agent received a written direction instructing the agent to acknowledge the amendments to the loan agreement and dismiss the pending litigation once the amendments became effective.[199] In a last-ditch effort to stop the transaction, minority lenders filed suit in New York state court against the company and the agent to enjoin the transactions.[200] The minority lenders raised, among other things, breach of contract and fraudulent conveyance claims.[201]

The court denied the minority lenders' request for a temporary restraining order and preliminary injunction.[202] In so ruling, the court seemed to be most persuaded by the fact that such a large majority of lenders consented to the transaction.[203] The company and the agent later moved to dismiss most of the lenders' claims on the grounds that the Plaintiffs' requests for declaratory judgment and injunctive relief were moot.[204] Although the minority lenders argued that they should be permitted to bring claims when compliance with a no-action clause in

194. Memorandum of Law in Support of Motion for Leave to Amend/Supplement Counterclaims at 2, *J. Crew Grp., Inc.*, No. 650574/2017.

195. *See* Complaint, *supra* note 176, at 5.

196. *Id.* at 25.

197. *Id.*

198. J. Crew's Memorandum of Law, *supra* note 191, at 1.

199. Stipulation and [Proposed] Order at 2, *J. Crew Grp., Inc.*, No. 650574/2017.

200. Complaint, *supra* note 176, at 50–53.

201. *Id.*

202. Transcript at 46–49, Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y, No. 654397/2017, 2018 WL 1947405 (N.Y. Sup. Ct. Apr. 25, 2018).

203. *See id.*

204. *See, e.g.*, Defendant's Memorandum of Law in Support of Motion to Dismiss, *Eaton Vance Mgmt.*, No. 654397/2017, 2018 WL 1947405 (providing further support for the movant's arguments).

the agreement would be futile,[205] the court declined to embrace this argument and granted the motions to dismiss in April 2018.[206] The minority lenders appealed, but the appellate court upheld the trial court's decision.[207] With only one narrow breach of contract claim remaining (based on an argument that the transaction required unanimous consent), the parties engaged in discovery for over a year before the minority lenders finally dropped the suit.[208]

Following the company's legal victories, the drop-down structure has come to be known as the "J. Crew" transaction; the term is also used as a verb—to be "J. Crewed."[209] But while J. Crew has the dubious distinction of setting the deal precedent,[210] more recent transactions have only upped the ante. Consider the recent restructuring of a $2 billion senior secured credit facility by U.S.-based global beauty company Revlon, Inc. (collectively, with its subsidiaries that are party to the company's senior loan agreements, "Revlon").[211] The credit facility, established in 2016 to finance the acquisition of the Elizabeth Arden brand portfolio, was secured by, among other things, Revlon's most valuable intellectual property, including trademarks and other rights associated with some of the world's most well-known beauty brands.

In August 2019, Revlon commenced a drop-down transaction to transfer intellectual property assets to a new subsidiary, beyond the reach of the senior secured lenders' security interests. As in J. Crew, these assets were then leased back to the operating subsidiaries so that they could continue to use the intellectual property in their business activities. Finally, the company used the newly transferred assets to secure $200 million in new debt.[212]

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205. Plaintiffs' Memorandum of Law in Opposition to Motion to Dismiss at 14, *Eaton Vance Mgmt.*, No. 654397/2017, 2018 WL 1947405.

206. *See, e.g.*, Decision and Order, *Eaton Vance Mgmt.*, No. 654397/2017, 2018 WL 1947405 (granting the motions to dismiss).

207. Eaton Vance Mgmt. v. Wilmington Sav. Fund Soc'y, 99 N.Y.S.3d 28, 28 (App. Div. 2019).

208. Stipulation of Discontinuance, *Eaton Vance Mgmt.*, No. 654397/2017, 2018 WL 1947405.

209. Peter Coy, *In Finance, 'J. Crew' Is a Verb. It Means to Stick It to a Lender*, BLOOMBERG BUSINESSWEEK (June 17, 2019, 2:00 AM), https://www.bloomberg.com/news/articles/2019-06-17/in-finance-j-crew-is-a-verb-it-means-to-stick-it-to-a-lender [https://perma.cc/AA6R-R3JS].

210. Soon after the transaction was completed, one rather prescient observer predicted that "[r]ivals who once mimicked the fashionable items on its racks will soon be copying its debt restructuring." Lauren Silva Laughlin, *J. Crew Debt Maneuver Can Be a Model for Other Troubled Retailers*, N.Y. TIMES: DEALBOOK (June 14, 2017), https://www.nytimes.com/2017/06/14/business/dealbook/jcrew-retailers-debt.html [https://perma.cc/4CHS-ZKEK].

211. *Our Company*, REVLON, https://www.revloninc.com/our-company [https://perma.cc/J9DK-KB2H].

212. Jasmine Wu, *Revlon Stock Jumps on Report that the Cosmetics Company Is Considering a*

In the spring of 2020, Revlon proposed repeating the maneuver in a transaction that some senior lenders would later argue "siphoned off nearly all of the remaining intellectual property" securing the obligations owed to them.[213] This time around, Revlon proposed issuing nearly $900 million in new debt, secured by a first-priority lien on the intellectual property.[214] $200 million of the new debt would be used to pay off the debt issued in the smaller J. Crew maneuver that the company had previously completed.[215] Additionally, the new facility would roll up approximately $950 million of debt under the 2016 facility, granting these participating lenders second and third priority liens.[216] Excluded lenders would have no liens at all in the intellectual property. And, while they would continue to have liens on the company's remaining assets, their interest would be diluted by a *pari passu* lien securing the new tranches.[217]

Under the loan agreement, the transfer of the intellectual property collateral, the release of the senior lenders' liens on such property, and the grant of the *pari passu* lien on the balance of the senior lenders' collateral would all require consent by a majority of the senior secured lenders. In an effort to resist the sort of tyranny by a self-interested majority that occurred in the Serta restructuring, a group of more than 50% of the senior lenders "assembled in an effort to protect themselves against further theft of their collateral."[218] Specifically, they entered into a joint cooperation agreement promising to resist the proposed transaction.[219]

To overcome this opposition, Revlon exercised its right under the loan agreement to issue new, unfunded revolver commitments (later described by senior lenders as "not real loans, just empty promises to loan")[220]:

> [Revlon] took the position that these new "lenders" would then be afforded the right to vote (even though they had no economic

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Sale, CNBC (Aug. 15, 2019, 4:43 PM), https://www.cnbc.com/2019/08/15/revlon-stock-jumps-on-report-it-is-considering-a-sale.html [https://perma.cc/MYQ6-ZGLD].

213. Complaint at 4, UMB Bank, Nat'l Assoc. v. Revlon, Inc., No. 1:20-cv-06352 (S.D.N.Y. Aug. 12, 2020).

214. *Id.* at 5.

215. *Id.*

216. *Id.* at 49, 58.

217. *Id.* at 5.

218. *Id.*

219. *Id.*

220. *Id.* at 6.

> stake or standing to do so), thereby conjuring up a false majority consent for the 2020 Transaction. These fake commitments rigged the math: [Revlon] would issue the exact amount of commitments necessary to inch over the 50.0% consent threshold. The new revolver commitments served no legitimate business purpose; rather, they were created solely to manipulate and gerrymander voting on the Proposed Amendment so that [Revlon] could consummate its scheme to siphon away substantially all of the collateral from the 2016 Term Lenders.[221]

When the senior secured lenders decried the sham nature of the plan, Revlon issued actual debt; of course, within days of its issuance, it would be replaced by new loans. In other words, "[t]he revolving loans were designed to vote against their own fake interest and to vanish only days after being issued."[222] The plan worked, and the new debt issuances allowed the amendments to pass "by less than half a percent."[223]

The excluded lenders filed suit in August 2020, raising the same types of claims made by lenders in the other case studies: namely, that the transactions breached the express provisions of the loan agreement as well as the implied covenant of good faith and fair dealing, and that the asset transfers constituted fraudulent transfers.[224] But in a curious twist of fate, the lenders' claims were rendered moot when the administrative agent accidentally paid all of the senior secured lenders in full.[225] Upon discovering the error, the agent issued notices to the lenders, informing them that the payments were erroneously made and demanding return of the funds. A majority of the lenders refused to return the funds, arguing that the amounts paid constituted a valid discharge for value of the debt.[226] The agent then filed suit against them.[227] The case went to trial in December 2020[228] and the court ruled in February 2021 that the

221. *Id*.

222. *Id*. at 7 (emphasis omitted).

223. *Id.* (emphasis omitted).

224. *Id*.

225. For thoughtful commentary on the accidental payoff and the legal battle it inspired, see Jonathan Macey, *Schoolyard Justice in Federal Court*, WALL ST. J. (June 8, 2021, 12:54 PM), https://www.wsj.com/articles/schoolyard-justice-in-federal-court-11623171249 [https://perma.cc/C7SE-RVCM].

226. See *id.*

227. *In re* Citibank Aug. 11, 2020 Wire Transfers, 520 F. Supp. 3d 390, 409 (S.D.N.Y. 2021).

228. Jonathan Stempel, *Citigroup Urges Return of Mistaken Revlon Payment as Trial Ends*, REUTERS (Dec. 16, 2020, 10:04 AM), https://www.reuters.com/business/legal/citigroup-urges-return-mistaken-revlon-payment-trial-ends-2020-12-16/ (last visited Nov. 1, 2021).

lenders were entitled to keep the sums they received.[229] With the debt extinguished, the excluded lenders' lawsuit became irrelevant.

C. *Summary of Case Studies*

The case studies show that the prevailing assumption that out-of-court restructurings of senior loans are mostly collaborative and consensual is no longer accurate. Nonconsensual restructuring transactions are becoming a common feature of the capital markets. These transactions—which I call "hostile restructurings"—are distinguishable from normal out-of-court restructurings by their use of aggressive tactics to overcome not only the traditional minority lender holdout problem, but also the collective bargaining power of the entire lender group. In other words, in hostile restructurings, the goal is not simply to cram a restructuring down the throats of a self-interested or misguided minority holdout; instead, the goal is to cram a plan down on the *entire* lender group, pitting lenders against one another to achieve restructuring goals that benefit the company's other stakeholders.

For instance, companies negotiate with multiple lender groups in tandem and in secret, even requiring them to promise *not* to speak to their co-lenders about prospective deals. In essence, companies utilize a "divide and conquer" strategy[230] to dilute the traditional bargaining power enjoyed by large senior lender groups.[231] These tactics incentivize individual lenders or factions to offer enough concessions to the debtor to ensure their continued position at the top of the priority ladder. Where syndicated lender groups have attempted to reclaim their collective bargaining power and band together to defend against hostile restructurings, at least one company has subverted the attempt by issuing new debt to artificially manufacture the necessary majority.[232]

The benefits of hostile restructurings to companies, their other stakeholders, and the markets more broadly are clear. Like all debt restructurings, hostile restructurings help companies manage fast-approaching maturities, reduce interest expenses, and relax covenants.

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229. *In re Citibank*, 520 F. Supp. 3d at 451.

230. For a fascinating discussion of "divide and conquer" as a negotiation strategy, see Larry Crump, *For the Sake of the Team: Unity and Disunity in a Multiparty Major League Baseball Negotiation*, 21 NEGOT. J. 317 (2005).

231. In a classic article exploring bond restructurings, Professor Brudney contrasted the negotiation disadvantages faced by dispersed bondholders against the superior bargaining position enjoyed by a hypothetical sole lender. *See* Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1831 (1992).

232. *See supra* notes 218–227 and accompanying text.

Because they generally feature a debt-for-debt exchange in which participating lenders agree to exchange their existing debt for new debt at a discount, they help to deleverage troubled companies, in some cases helping to preserve solvency and stave off bankruptcy.

These transactions also offer cash-strapped companies relatively quick access to much-needed liquidity on an out-of-court basis. And, to the extent they include additional borrowing capacity that may be used for future debt buy-backs, transactions of this sort allow companies to take advantage of lower market prices of their own debt as they continue to deleverage. Finally, like all successful restructurings, hostile restructurings have the potential to stabilize and preserve valuable and productive business enterprises, advancing the interests of employees, shareholders, and the countless suppliers, vendors, and other parties that conduct business with the company.

Hostile restructurings may also enhance the overall efficiency of the market for corporate debt restructuring. For instance, in a play on the classic prisoner's dilemma,[233] if lenders are aware that companies regularly pursue hostile restructurings that only benefit some lenders at the expense of others, they may be more inclined to agree to a debtor's initial restructuring proposal in order to ensure that they are not on the losing end of a hostile restructuring.[234] In other words, the threat of hostile restructurings may help to counterbalance the economic incentives for lenders to collectively refuse to make concessions or engage in strategic holdout behavior. A more competitive market for out-of-court restructurings may, in turn, enhance firm value by allowing firms to reconfigure their capital structure more quickly and efficiently in distressed situations.

But hostile restructurings also introduce considerable uncertainty and, accordingly, carry substantial litigation costs. Although the companies promoting these transactions often claim that they do not technically violate existing agreements, hostile restructurings tend to proceed under strained interpretations of highly technical language, at the same time

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233. Judge Easterbrook described the classic prisoners' dilemma:

> Two prisoners, unable to confer with one another, must decide whether to take the prosecutor's offer: confess, inculpate the other, and serve a year in jail, or keep silent and serve five years. If the prisoners could make a (binding) bargain with each other, they would keep silent and both would go free. But they can't communicate, and each fears that the other will talk. So both confess.

Page v. United States, 884 F.2d 300, 301 (7th Cir. 1989).

234. This is a spin on the classic argument that hostile takeovers enhance market efficiency through a disciplinary effect. *See generally* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

implicating thorny and fact-intensive legal and equitable doctrines, such as the implied covenant of good faith and fair dealing and fraudulent transfer laws. Despite these costs and uncertainties, aggrieved and dissenting lenders have every incentive to engage in extensive litigation. After all, hostile restructurings delve a harsh blow to excluded lenders, who lose valuable collateral and/or their priority status on future repayment.

And while these are the most obvious direct costs, there are also a number of indirect costs. Hostile restructurings have the potential to destroy value, impair the smooth functioning of the capital markets, and introduce and amplify the distributional concerns that have traditionally plagued bankruptcy restructurings. The following Part considers these indirect costs, arguing that hostile restructurings constitute a normative failure in the capital markets.

III. HOSTILE OUT-OF-COURT LOAN RESTRUCTURINGS AS A NORMATIVE FAILURE

The previous Part highlighted some of the more immediate risks and benefits of hostile restructurings. This Part takes a closer look, concluding that the rise of hostile restructurings should be understood as a normative failure in the U.S. capital markets.[235] This is because these transactions violate the most fundamental norms and values underlying commercial law and practice. First, hostile restructurings threaten the important goals of legal certainty and predictability in the capital markets. Second, they violate classic and emerging theoretical justifications for nonconsensual adjustments to loan agreements. Finally, these transactions have the potential to interfere with the smooth functioning of the capital markets, causing counterproductive outcomes and other dangerous ripple effects. Moreover, these problems are unlikely to self-correct; in fact, they are likely to become worse over time.

A. *Hostile Restructurings Threaten Legal Certainty and Predictability in the Capital Markets*

Hostile restructurings threaten the important goals of legal certainty and predictability in the capital markets by undermining investor confidence in payment priority and lien rights.[236] Priority—whether in

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235. Robert Cooter, *Normative Failure Theory of Law*, 82 CORNELL L. REV. 947 (1997).

236. The unique role of the lien—as opposed to other property rights and entitlements—in

respect of payment or lien rights—is always a concern to lenders. But in times of economic uncertainty and corporate financial distress, it is a far more pressing concern. This is because in the event of a future bankruptcy filing, distribution rights are typically determined in accordance with absolute priority.[237]

Through private ordering, the grant of consensual liens, and the grant of lien and payment priority, debtors exercise their rights "to prefer some creditors over others."[238] Under the common law, these sorts of preferences were viewed as a fraud on other creditors.[239] As a classic work explained, "When a debtor grants a security interest to one of his creditors, he increases the riskiness of other creditors' claims by reducing their expected value in bankruptcy."[240] But modern commercial law accepts these risks on the grounds that they are counterbalanced by the voluntary nature of most commercial transactions: after all, subsequent creditors have an opportunity to conduct due diligence and identify prior liens. As Professors Jackson and Kronman explained: "[T]hese other creditors will be aware of this risk and will insist on a premium for lending on an unsecured basis, will demand collateral (or some other protection) to secure their own claims, or will search for another borrower whose enterprise is less risky."[241]

Another classic work defended consensual liens based on a "normative theory of security interests [that] is grounded upon the normative theories that justify the institution of property. The right to own private property is the essential bedrock of capitalism and an essential component of a market economy."[242] In other words, a lien is one of the many sticks in the proverbial bundle that represent rights in private property, and owners are free to distribute those sticks as they see fit. "[I]nsofar as any . . . adverse effects on existing and future unsecured creditors are concerned, the transfer of a security interest does

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modern corporate finance is richly explored in Ofer Eldar & Andrew Verstein, *The Enduring Distinction Between Business Entities and Security Interests*, 92 S. CAL. L. REV. 213 (2019).

237. *See supra* notes 70–71.

238. Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1147–48 (1979).

239. *See, e.g.*, Clow v. Woods, 5 Serg. & Rawle 275, 284 (Pa. 1819) ("The mortgage of a chattel is a pledge; that to such pledge a delivery of the chattel is necessary, and that every such mortgage, where the parties stand in the relation of debtor and creditor, unaccompanied with such possession as the subject-matter is capable of, is fraudulent and void against all other creditors . . . .").

240. *See* Jackson & Kronman, *supra* note 238, at 1147.

241. *Id.* at 1148.

242. Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2047–48 (1994).

not differ fundamentally from other transfers of a property interest in exchange for equivalent value."[243]

Subsequent works have challenged these and other traditional justifications for consensual liens, but almost entirely from the perspective of unsecured creditors[244] and involuntary creditors, such as tort claimants and other lien creditors.[245] But hostile restructurings do not implicate these familiar concerns over the ability for unsecured creditors to eventually collect from debtors that have granted consensual liens to their other creditors. Instead, hostile restructurings raise a different question: whether a company can prefer some of its *existing senior secured creditors* over others. In other words, hostile restructurings implicate questions of intra-class subordination among creditors that were previously given the same stick to share.

Here, the law, customary practice, and economic realities all suggest that this conduct should not be allowed. While debtor companies may argue that hostile restructurings do not, as a technical matter, impair the rights of the excluded lenders, they clearly change the economic substance of the arrangement. And this may be all it takes to undermine investor confidence in payment priority and lien rights. Changes to payment priority impact a creditor's relative position in the bankruptcy distribution scheme, while new *pari passu* debt issuances dilute each lender's pro rata distribution. Moreover, claims in bankruptcy are treated as secured only to the value of the collateral properly securing those obligations.[246] If the most valuable property has been transferred out of the collateral pool, or if all of the collateral value is consumed by new, higher-priority debt issuances, then the lenders' claims will be effectively relegated to unsecured status.[247]

Of course, some market participants would argue that these are

243. *Id.* at 2052.

244. Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994).

245. *See id.*; *see also* Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373 (1997).

246. Under the Bankruptcy Code, a claim is treated as secured only "to the extent of the value of such creditor's interest" in the collateral, with the remainder of the creditor's claim treated as unsecured. 11 U.S.C. § 506(a)(1). Alternatively, an undersecured creditor holding a valid lien on the debtor's property may elect to have its claim treated as fully secured by making an election under 11 U.S.C. § 1111(b).

247. The precarious position of junior, undersecured creditors was recently highlighted in *In re* Consol. Bedding, Inc., No. 09-11875, 2021 WL 2638594 (Bankr. D. Del. June 25, 2021), which reaffirmed a first lien creditor's rights with respect to collateral shared with a subordinated second lien creditor. Although the opinion focuses on provisions of an intercreditor agreement, the outcome of the case—that the second lien creditor was not entitled to a distribution—drives home the importance of priority, dilution, and collateral value. *Id.* at *5.

acceptable risks for competitive transactions negotiated among sophisticated parties.[248] But as the following section explores, it is difficult to imagine that lenders would, collectively, agree to hostile restructurings as an effective solution to the traditional obstacles that impede fair and efficient out-of-court restructurings.

B. Hostile Restructurings Violate Theoretical Justifications for Nonconsensual Restructurings

Hostile restructurings afford companies the power to unilaterally impair lender rights and interests—in economic substance if not in legal form—in ways that, if permissible at all, would only be permitted in bankruptcy. In essence, these are mini cramdown plans. This may be why proponents of hostile restructurings often justify their actions by citing the broad policy goals of bankruptcy law.[249]

It may be helpful, then, to consider whether hostile restructurings comply with classical and emergent theoretical justifications for nonconsensual interventions in bankruptcy. Consider, for instance, the traditional "Creditors' Bargain" theoretical paradigm.[250] Under this model, bankruptcy laws—which naturally interfere with creditors' state law rights—are explained as satisfying a hypothetical ex ante negotiation among all of a firm's creditors. Although each would fare better outside of bankruptcy if it could ensure its success in the proverbial race to the courthouse, bankruptcy provides the next-best alternative by promising a fair and efficient collective regime that promises to treat similarly-situated creditors the same way.

More recently, Professor Casey has advanced a more nuanced theoretical justification for bankruptcy laws: they "solve the incomplete contracting problem that accompanies financial distress."[251] This "New Bargaining Theory," as Professor Casey refers to it,[252] shifts attention away from a purely hypothetical ex ante negotiation, focusing instead on

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248. *See supra* note 143 and accompanying text.

249. For instance, Serta defended its hostile restructuring on the grounds that it was the only way to overcome the senior lenders' superior bargaining position and restructure its financial obligations. *See supra* notes 148–149 and accompanying text.

250. For a classic presentation of the creditors' bargain theory, see Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 862 (1982), which explains that bankruptcy processes help to offset the "strategic costs that would otherwise be associated with a race to the courthouse".

251. Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709, 1711 (2020).

252. *Id.* at 1716.

the actual "renegotiation framework" that chapter 11 provides. Viewed in this light, chapter 11's rules and structures are best understood as an attempt to help parties overcome the impasses that naturally arise when certain types of scarcity—such as highly complex and uncertain situations of corporate financial distress—are governed by incomplete contracts.

Hostile restructurings violate the norms and principles reflected in both of these theoretical frameworks.[253] It is difficult to imagine that lenders would collectively agree, ex ante, to tactics of this sort as a way to overcome their coordination problems and restructure their obligations out of court. This is because, from the lenders' collective perspective, hostile restructurings are neither fair nor efficient. For one thing, hostile restructurings allocate economic burdens to excluded lenders with few, if any, legal safeguards. And, for reasons I describe below, hostile restructurings are likely to cause the lender group to incur additional monitoring and transaction costs—all for the privilege of leaving value on the proverbial negotiation table.

And, while there is no clear evidence that senior lenders prefer the off-the-rack renegotiation framework offered under chapter 11, there is at least some evidence of the restructuring process syndicated lenders *would* prefer. Such evidence can be found in the voluntary norms and standards that have been adopted in the industry. For instance, the nonbinding LSTA Procedures for Credit Agreement Modifications (the "LSTA Procedures"),[254] developed by a working group consisting of representatives from the largest agent banks, provide voluntary standards for out-of-court syndicated loan restructurings.[255] The LSTA Procedures detail a process in which restructuring proposals are channeled through the administrative agent, who then disseminates the information to *all* lenders—both in written form and by coordinating conference calls with the company—so that each lender may decide whether to consent.[256]

253. While the law and economics paradigm continues to prevail in modern bankruptcy law, other theoretical paradigms ultimately identify similar principles of bankruptcy. For instance, legal philosophy suggests that a system of corporate insolvency law should promote justice, fairness, liberty, equality, and reasonableness. *See* RIZWAAN JAMEEL MOKAL, CORPORATE INSOLVENCY LAW: THEORY AND APPLICATION 2–10 (2005); *see also* SARAH PATERSON, CORPORATE REORGANISATION LAW AND FORCES OF CHANGE (2020); JANIS PEARL SARRA, CREDITOR RIGHTS AND THE PUBLIC INTEREST: RESTRUCTURING INSOLVENT CORPORATIONS (2003).

254. Exhibit H, Octagon Credit Invs., LLC v. NYDJ Apparel, LLC, No. 656677/2017 (N.Y. Sup. Ct. Nov. 1, 2017) (providing a copy of the LSTA Procedures for Credit Agreement Modifications).

255. On the history and purpose of the working group, see generally *Working Out Syndication Ground Rules*, AM. BANKER (Nov. 8, 2001, 2:00 AM), https://www.americanbanker.com/news/working-out-syndication-ground-rules (last visited Oct. 18, 2021).

256. *See* Exhibit H, *supra* note 254.

Similar nonbinding, norms-based debt restructuring principles have been advanced by other market participants and industry associations around the world; these principles similarly emphasize the sharing of information with all creditors and the existence of an intracreditor governance structure that advances the interests of the creditors collectively.[257]

Instead of following procedures of this sort, hostile restructurings exploit existing agency problems among syndicated lenders, leading to further breakdowns in governance and increased economic burdens. As discussed above, most modern syndicated loan agreements are designed to overcome the holdout problem by allowing restructurings to take place with less-than-unanimous consent. Implicit in this design is an assumption that the majority will exercise consent rights in the best interests of all lenders—and not simply to enhance its own self-interests at the expense of the minority. Unfortunately, there is often no clear legal or contractual obligation to act in the best interests of the entire group and, as the case studies reveal, companies use these agency problems to their own advantage.

While hostile restructurings may admittedly delay or even prevent liquidations, they also impose increased monitoring costs on lender groups, as each lender must do its own redundant monitoring to ensure that it does not find itself on the losing end of a hostile restructuring. The ensuing lender arms race manifests ex ante as more contentious loan negotiations and defensive draftsmanship, and ex post as further fractionalization and self-protective posturing in restructuring negotiations. These dynamics, in turn, threaten the overall fairness and efficiency of all restructuring processes—whether within or outside of court—that have come to rely on collaboration and consensus. For instance, recent chapter 11 cases have featured minority lender ad hoc groups formed by minority lenders to oppose restructuring decisions that they believe advance the interests of other stakeholders—including their co-lenders—at their expense.[258] And, as the following section explains, the costs do not end with the parties directly impacted by these transactions.

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257. *See* JOSE M. GARRIDO, WORLD BANK, OUT-OF-COURT DEBT RESTRUCTURING 39–47 (2012) (discussing the so-called "London Approach" and the INSOL Principles—two prominent examples of nonbinding, norms-based debt restructuring principles).

258. *See* sources cited *supra* note 19.

C. *Hostile Restructurings May Cause Dangerous Ripple Effects in the Capital Markets*

Hostile restructurings also have the potential to cause counterproductive outcomes and other inefficiencies in the capital markets. Because corporate shareholders and managers often prefer to restructure rather than liquidate, powerful lender groups have traditionally served as a check on the impulse to engage in economically irrational restructurings.[259] But hostile restructurings override this protective mechanism by interjecting new incentives for lenders to engage in restructurings simply to defend themselves. This makes them more likely to agree to restructurings that are not otherwise economically justified.

Hostile restructurings are also likely to cause a "race for the bottom"[260] in the market for debt restructurings. With lenders highly incentivized to do whatever it takes to ensure that they receive the concentrated economic benefits offered only to participating lenders, they are forced to essentially negotiate against themselves. There is little incentive to evaluate the entire consideration paid to all of the senior lenders collectively. This can lead to a situation where the lenders, collectively, leave value on the proverbial negotiation table, allowing it to flow down to junior stakeholders in a way that would violate absolute priority in a bankruptcy setting. Indeed, this is likely a primary motivation for engaging in hostile restructurings.

And the ripple effects extend far beyond the debt markets. Elsewhere in the financial markets, hostile restructurings can have a dangerous signaling effect.[261] Loan restructurings—like all major corporate

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259. Corporate decision-making in times of corporate financial distress has been the subject of considerable attention by the Delaware Court of Chancery. *See, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991) (establishing that directors and officers of a Delaware corporation that is insolvent or in the "zone" of insolvency owe their fiduciary duties to stockholders and creditors).

260. The phrase has been used to describe a variety of phenomena in commercial and corporate law. *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974) (using the phrase to explain the prominence of Delaware corporate law).

261. The role of monitoring and signaling in commercial law has been explored extensively in the literature. See Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982), for a classic discussion exploring the role of secured creditors in monitoring the firm), and Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 9–14 (1981), which questions the then-prevailing view that junior creditors monitor. More recently, Professors Jacoby and Janger question the applicability of this monitoring theory to modern corporate restructurings, where senior secured creditors purport to have liens in all of the debtor's assets. Melissa B. Jacoby & Edward Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673, 717–19 (2018).

recapitalizations—are often publicized in a positive light, with reference to newly invested capital and the establishment of new debt facilities. A press release of this sort may be construed by other market participants as a sign that the senior lenders—who arguably enjoy an information advantage relative to other stakeholders—believe that the company is worth restructuring because it has greater value as a going concern.[262] This signaling effect is most likely to influence new or existing junior stakeholders, such as shareholders and trade creditors.

In reality, the very transactions that junior stakeholders may interpret as restructurings to preserve going concern value may actually be disguised *liquidations* by the most senior and well-informed stakeholders, who trade their existing senior position in the firm for an equally[263] senior position in which the economic benefits are concentrated among fewer lenders. The senior lenders do this because they fear—or perhaps even know—that in a hypothetical liquidation there would not be enough value to allow all of the lenders to enjoy the economic benefits of the senior position. When viewed in this light, the entire hostile restructuring transaction—including any new capital invested into the firm—is properly understood as an attempt to shore up the participating lenders' liquidation preference in exchange for allowing other stakeholders to siphon value away from their unwitting co-lenders.[264] While hostile restructurings may help the firm to avoid liquidation and enhance its value as a going concern, this benefit may be incidental to the true, self-interested motives of controlling stakeholders and participating lenders.

For all of these reasons, the rise of hostile restructurings should be understood as a normative failure in the U.S. capital markets that will likely continue and grow worse over time. The following Part considers the various legal or regulatory interventions that may be used to address the problem.

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262. Signaling of this sort is studied in Christophe J. Godlewski, *The Certification Value of Private Debt Renegotiation and the Design of Financial Contracts: Empirical Evidence from Europe*, 53 J. BANKING & FIN. 1–17 (2015).

263. Here, I mean that participating lenders were previously in a senior secured, first-priority position. After a hostile restructuring, they are also in a senior secured, first-priority position. Thus, while their position has changed relative to the excluded lenders, they continue to enjoy the most senior position in the firm's capital structure.

264. These dynamics are explored in Ellias & Stark, *supra* note 28.

IV. POTENTIAL LEGAL AND REGULATORY INTERVENTIONS TO CORRECT THE NORMATIVE FAILURE

How can the legal or regulatory system respond to and help correct the normative failure of hostile restructurings? This Part considers various possible solutions, ranging from a purely private ordering response to more top-down statutory or regulatory interventions. Ultimately, I settle on a recommendation that courts should provide a more holistic, standards-based review of hostile restructurings. Although this solution is likely to impose substantial economic burdens in the short-run, in the form of increased litigation costs and greater legal uncertainty, it will eventually provide a roadmap that parties may voluntarily apply to their out-of-court restructuring transactions in order to avoid judicial scrutiny. But before describing the ideal form of judicial intervention, it is important to consider other alternative legal responses. The following section explores the most direct solution: enhanced private ordering.

A. Private Ordering

Hostile restructurings may be entirely prevented—or at least dramatically curtailed—by private ordering. In fact, some have argued that lax private ordering—specifically, the recent trend towards so-called "cov-lite" loan agreements—is to blame for hostile restructurings in the first place.[265] If this is true, then parties to syndicated loan agreements may be able to restrict companies from engaging in hostile restructurings simply by including strict covenants and other provisions that explicitly forbid conduct of this sort.

For instance, syndicated lender groups can insist, ex ante, on provisions that would prevent debtors from engaging in uptiering and drop-down transactions. Helpful provisions would include covenants that prohibit lien and payment subordination and non-pro-rata open market purchases,[266] language imposing tighter restrictions on transactions involving the collateral and/or any unrestricted subsidiaries,[267] limitations on new debt issuances,[268] and provisions

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265. *See, e.g.*, Victoria Ivashina & Boris Vallee, *Weak Credit Covenants* 3 (Nat'l Bureau of Econ. Rsch., Working Paper No. 27316, 2020) (analyzing a large sample of modern credit agreements, focusing on provisions that weaken important covenants).

266. These are examples of so-called negative covenants, which are richly explored in Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection*, 84 CORNELL L. REV. 305 (1999).

267. The need for enhanced clarity around transactions of this sort is explored in Brad Cheek,

requiring that all lenders have an opportunity to participate in any priming facilities.

To some extent, this sort of defensive drafting is already taking place in the industry.[269] The problem, however, is that savvy debtor companies and their advisors may continue to design new hostile restructurings that exploit other hypertechnical provisions in their loan agreements. And, given the high stakes involved, all parties to these transactions have incentives to advance novel interpretations of even the most standard contract terms. Indeed, one need only to look to the sovereign bond market for a cautionary tale: conflicting interpretations of *pari passu* clauses have generated extensive litigation, grinding restructurings to a halt while courts struggle to understand each side's rights and obligations under the agreement.[270] Acknowledging these and other practical realities, several commentators have recently expressed skepticism regarding lenders' ability to close all of the loopholes that may be lurking in their agreements.[271]

Another option would be for parties to include more sweeping provisions, such as unanimous or near-unanimous consent requirements or prohibitions against debtor companies negotiating directly with individual lenders or lender factions. In a similar way, syndicated lender groups could enter into side agreements, ex post, affirming their commitment to pro rata sharing of economic benefits and collective action that benefits all similarly situated lenders.

Tearin' Up iHeart: The Recent Trend with Troubled Companies and the Unrestricted Subsidiary Transfer Tactic, 23 N.C. BANKING INST. 271 (2019).

268. For an example of this type of negative covenant, see Committee on Trust Indentures and Indenture Trustees, *Model Negotiated Covenants and Related Definitions*, 61 BUS. LAW. 1439, 1500–01 (2006).

269. *See, e.g.*, Yoruk Bahceli, *The Devil's in The Detail for Junk Debt Investors Facing Coronavirus Defaults*, REUTERS (Apr. 29, 2020, 10:41 PM), https://www.reuters.com/article/idUSKBN22C0OK [https://perma.cc/L5KH-E9G9] (describing the "J Crew blocker" provisions).

270. For a thorough discussion, see Natalie A. Turchi, Note, *Restructuring A Sovereign Bond Pari Passu Work-Around: Can Holdout Creditors Ever Have Equal Treatment?*, 83 FORDHAM L. REV. 2171 (2015).

271. *See* Ellias & Stark, *supra* note 28, at 787 ("The lawyers who represent large firms are simply too skilled in the perpetual cat-and-mouse game not to find loopholes and ways around even the best contractual language."); *see also COVID-19: Prime Time for Priming*, O'MELVENY & MYERS LLP (July 15, 2020), https://www.omm.com/resources/alerts-and-publications/alerts/covid-19-prime-time-for-priming/ [https://perma.cc/W6TQ-Z346] (opining that lenders may never be able to close up all of the loopholes); Stephen J. Choi, Mitu Gulati & Robert E. Scott, *The Black Hole Problem in Commercial Boilerplate*, 67 DUKE L.J. 1, 72 (2017) (exploring, with respect to bond indenture agreements, the broader tendency for stakeholders to scrutinize agreements for terms that others may have overlooked or mispriced).

But both types of agreements would be difficult to monitor and enforce and would likely make out-of-court restructurings far more difficult. Relatedly, there is a real danger that loan agreements could become "hyperrigid," driving more companies into bankruptcy and leading to spillover effects in the capital markets.[272] The following section swings to the other end of the proverbial pendulum, considering a top-down solution in the form of regulatory or statutory intervention.

B. Regulatory or Statutory Interventions

The problem of hostile restructurings is not a new phenomenon in the U.S. capital markets. In fact, many aspects of these transactions are reminiscent of problems that have plagued out-of-court restructurings in the public bond markets. In the first half of last century, the U.S. Securities and Exchange Commission ("SEC") focused its attention on corporate reorganizations conducted pursuant to collective action clauses in bond indentures. After surveying high-profile cases, the SEC found that these restructurings featured numerous "abuses and problems."[273]

Notably, the SEC was concerned that controlling stakeholders were initiating bond restructurings in order to allocate the firm's economic burdens to the bondholders.[274] The concern may have also stemmed from stories of abusive restructurings under the equity receivership model used to restructure railroads prior to the enactment of a corporate bankruptcy reorganization statute.[275]

In order to prevent abusive out-of-court bond restructurings, the SEC proposed, and Congress enacted, section 316(b) of the Trust Indenture Act ("TIA").[276] This section prohibits amendments to bond indentures that purport to bind nonconsenting bondholders to a reduction in their right to receive payment.[277] The language effectively forecloses out-of-court bond restructurings that reduce the amount of principal outstanding

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272. For an in-depth look at the problem of hyperrigid securitization agreements, see Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1076 (2009).

273. SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PART VI at 150 (1936).

274. *See* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 250–52 (1987).

275. Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420 (2004).

276. Pub. L. No 76-253, 53 Stat. 1149, 1173 (1939) (codified as amended at 15 U.S.C. § 77ppp).

277. *See id.*

or the interest rate applicable to the debt.[278]

The existence of section 316(b), and the history that led to its enactment, provides important precedent for a similar type of top-down regulatory or statutory response to hostile *loan* restructurings. But drafting a statute or regulation of this sort would be difficult. A rule modeled after section 316(b) would fail to capture many types of hostile restructurings, as these transactions do not always technically impair payment rights; instead, these transactions tend to impact the *economic substance* of payment priority and lien rights. It would be difficult to develop a standard that would fully capture all potential forms of hostile restructurings without going too far and essentially foreclosing the possibility of out-of-court loan restructurings.

And, even if such a rule could be designed to be comprehensive without being overbroad, syndicated loan notes are not traditionally viewed as securities, and so there is not currently a regulatory infrastructure in place to monitor and enforce compliance with such a provision in the syndicated loan market. Finally, the benefits of section 316(b) in the parallel world of bond restructurings are hotly disputed in the academic literature.[279] Such thorough and well-reasoned critiques not only call into question the wisdom of adopting a similar rule for loan restructurings; they would also make it practically impossible to pass such a measure.

But while syndicated loans are not traditionally subject to any specialized legal or regulatory regime, they are subject to the laws generally, including state contract law. And disputes arising under these agreements are subject to the jurisdiction of state and federal courts. Accordingly, the following section considers the possibility of a judicial solution to the problem of hostile restructurings.

C. Judicial Intervention

Given the challenges and limitations associated with a pure private ordering solution, on the one hand, and a top-down statutory or regulatory response, on the other, the best solution is for courts to provide a more holistic, standards-based review of hostile restructurings.

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278. For a thorough discussion of the mechanics of section 316(b), see Bratton & Levitin, *supra* note 44, at 1615–18.

279. *See, e.g.*, Bratton & Levitin, *supra* note 44, at 1602 (arguing for repeal); Harold B. Groendyke, Note, *A Renewed Need for Collective Action: The Trust Indenture Act of 1939 and Out-of-Court Restructurings*, 94 TEX. L. REV. 1239, 1241 (2016) (arguing for "a new Securities and Exchange Commission (SEC) rule that requires all out-of-court restructurings with bondholders to be negotiated by an uncoerced majority vote").

In this regard, I join a chorus of corporate and commercial law scholars who have made recent calls for greater judicial involvement in commercial finance disputes. For instance, scholars have called for greater judicial scrutiny of corporate decision-making in times of financial distress in order to counterbalance the moral hazards that lead managers to favor some stakeholders at the expense of others.[280] Others have argued that, in the case of out-of-court bond debt restructurings, section 316(b) should be repealed in favor of the renewed application of a "long forgotten, but still valid, equity doctrine of intercreditor good faith duties."[281]

Judicial intervention in hostile restructurings can take many forms. It can be as simple as a renewed emphasis on existing legal and equitable principles, such as the implied covenant of good faith and fair dealing. Or it can be as complex as courts superimposing a formal restructuring regime based on the Bankruptcy Code—or any other modern or historical insolvency regime, for that matter.

As one example of the latter type of intervention, courts could subject hostile restructurings to something like the chapter 11 plan confirmation standards. In lawsuits brought by excluded lenders alleging that a restructuring is an unlawful hostile restructuring, debtor companies could be required to defend the restructuring and establish its lawfulness by making a showing that it did not unfairly discriminate against the excluded lenders and that it treated them fairly and equitably. In developing suitable standards, it would be assumed that courts would borrow heavily from bankruptcy law; corporate law's entire fairness standard would also provide a useful corollary.[282] Then, depending on the nature of the allegations raised by the excluded lenders, the court may import other, finer rules and principles of bankruptcy and corporate law. For instance, in cases involving allegations of consent gerrymandering, courts could draw from bankruptcy jurisprudence on so-called class gerrymandering used by some debtors to manufacture an accepting impaired class in chapter 11.[283]

But this type of judicial intervention suffers from some obvious

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280. *See* Ellias & Stark, *supra* note 28.

281. Bratton & Levitin, *supra* note 44, at 1602.

282. There is some Delaware precedent for applying the entire fairness standard to corporate finance transactions. *See* IRA Trust FBO Bobbie Ahmed v. Crane, No. 12742, 2017 WL 7053964, at *9 (Del. Ch. Dec. 11, 2017) (finding that a recapitalization was a "conflicted controller transaction" that invoked entire fairness review).

283. Class gerrymandering in bankruptcy is explored in *In re* Greystone III Joint Venture, 995 F.2d 1274, 1279–80 (5th Cir. 1991).

drawbacks. For one thing, this process would undermine the very notion of an "out-of-court" restructuring, as debtor companies must be prepared to make a showing that their allegedly hostile restructuring satisfies the requisite judicial standard. In practice, this means that all out-of-court restructurings that feature some interlender conflict would essentially be subject to the same legal hurdles as prepackaged bankruptcies—albeit with expanded opportunities for corporate stakeholders to forum shop across both federal *and* state courts.[284] This would increase costs and legal uncertainty considerably.

As one potential solution, Congress could amend the Bankruptcy Code to provide a streamlined process for reviewing and approving hostile restructurings, much like the recent chapter 16 proposals for bond restructurings.[285] But without some sort of clear statutory prohibition on hostile restructurings (such that all parties understand that they must submit to the streamlined bankruptcy proceeding in order to move forward), any such proceeding would likely be marred by disputes grounded in state contract law. For instance, disputes would likely center on the question of whether a proposed restructuring is in fact a hostile restructuring that ought to be conducted through the streamlined bankruptcy proceeding, or whether it is simply a garden-variety exercise of rights clearly set forth in the underlying loan agreement. Similar to the eligibility battles that often accompany chapter 9 bankruptcy filings, these disputes have the potential to spill across several forums, driving up costs and introducing new forms of legal uncertainty.

The better solution, then, is for all courts to approach disputes arising out of loan restructurings with a renewed emphasis on existing legal and equitable principles, such as the implied covenant of good faith and fair dealing. As discussed above, under basic principles of state contract law, the implied covenant is generally understood to mean that parties to contracts should behave honestly and work to uphold the spirit of the agreement.[286] Parties to contracts should not, for instance, undermine the

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284. Much ink has been spilled on the current problem of forum shopping in bankruptcy. *See generally, e.g.*, Laura Napoli Coordes, *The Geography of Bankruptcy*, 68 VAND. L. REV. 381 (2015) (critiquing the practice of forum shopping and proposing procedural solutions); LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (2005) (asserting that forum shopping has caused bankruptcy judges to compete with one another for large cases, to the detriment of the bankruptcy system and most stakeholders).

285. Chapter 16 proposals are described in Mark J. Roe, *The Trust Indenture Act of 1939 in Congress and the Courts in 2016: Bringing the SEC to the Table*, 129 HARV. L. REV. F. 360, 374 (2016).

286. *See, e.g.*, 511 W. 232nd Owners Corp. v. Jennifer Realty Co., 773 N.E.2d 496, 500 (N.Y. 2002) (explaining that the "covenant embraces a pledge that 'neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the

rights of their counterparties to receive the benefits of the bargain.

Under New York law—which governs most large syndicated bank loan agreements—the implied covenant is breached "when a party acts in a manner that would deprive the other party of the right to receive the benefits of their agreement."[287] The implied covenant encompasses those "promises which a reasonable promisee would be justified in understanding were included."[288] Moreover, "[a] party may be in breach of its implied duty of good faith and fair dealing even if it is not in breach of its express contractual obligations" to the extent such party's actions "destroy or injure the right of another party to receive the benefits of the contract."[289]

Of course, the courts hearing disputes arising out of hostile restructurings have always had the covenant of good faith and fair dealing at their disposal. Indeed, it was raised by plaintiffs in cases profiled in this Article, and it inspired one court to deny a motion to dismiss.[290] The problem is that in order to reach a decision on the merits, the implied covenant demands a deeply contextual review, taking into account all of the facts and circumstances of the case.[291] But the courts hearing commercial finance disputes do so in the shadow of decades of precedent establishing that courts should not interfere with the smooth functioning of the capital markets by applying thorny judicial doctrines or, worse yet, interposing new judge-made law.[292] Instead, in the name of preserving legal certainty, predictability, and uniformity and ensuring the smooth functioning of the credit markets, courts should simply enforce the plain language of the agreement and otherwise stay out of the dispute.[293]

For courts already so inclined to abstain in the name of certainty, predictability, and uniformity, the implied covenant provides a ready doctrinal out: case law establishes that the implied covenant should not

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contract'" (quoting Dalton v. Educ. Testing Serv., 663 N.E.2d 289, 291 (N.Y. 1995))).

287. 1357 Tarrytown Rd. Auto, LLC v. Granite Properties, LLC, 37 N.Y.S.3d 341, 343 (App. Div. 2016).

288. *Id.*

289. Chase Manhattan Bank v. Keystone Distribs., Inc., 873 F. Supp. 808, 815 (S.D.N.Y. 1994).

290. *See supra* section II.A; Transcript of Proceedings, *supra* note 158.

291. "[A]s Delaware judges, lawyers, and scholars alike have all acknowledged, the implied contractual covenant of good faith and fair dealing is an inherently contextual, standards-based, and, therefore, indeterminate doctrine." Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 246 (2011).

292. *See generally* Dick, *supra* note 14.

293. *See id.*

be used to contradict the express provisions of the agreement.[294] For instance, courts have found that there is no violation of the implied covenant where the agreement unambiguously affords a party the right to take some action or exercise some discretion.[295]

With respect to hostile restructurings, then, the first challenge is overcoming courts' own reluctance to engage in a deep contextual review. Then, the second challenge is overcoming the argument that each and every step taken in the restructuring was technically in compliance with the plain language of the loan agreement. With respect to the first challenge, although it is true that heightened judicial scrutiny would introduce new forms of legal uncertainty into the capital markets, this risk is outweighed by the benefits of correcting the normative failure of hostile restructurings. For all of the reasons provided in Part III, hostile restructurings themselves have the potential to cause dangerous ripple effects. Accordingly, legal intervention is in fact needed to preserve and protect legal certainty and the smooth functioning of the capital markets.

Regarding the second challenge, there are two ways courts can move beyond arguments that the transactions are protected from scrutiny because they technically comply with the express provisions of the agreement. First, courts can take a page from tax and corporate law and apply a "step-transaction approach" that treats multiple transactions that occur contemporaneously as one transaction.[296] This would allow for a more expansive inquiry that focuses judicial attention on the overall economic effect of a string of transactions rather than the technical permissibility of each individual step.[297] In a similar way, courts can

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294. 767 Third Ave. LLC v. Greble & Finger, LLP, 778 N.Y.S.2d 157, 158 (App. Div. 2004).

295. *See, e.g.*, ELBT Realty, LLC v. Mineola Garden City Co., 42 N.Y.S.3d 304, 304 (App. Div. 2016) (explaining that the implied covenant should not be used to override an express provision in a contract stating "that the purchaser could terminate the contract in 'its sole discretion' and for 'any reason whatsoever'"); Moran v. Erk, 901 N.E.2d 187, 192 (N.Y. 2008) (interpreting an attorney approval contingency clause according to its plain meaning); Nat'l Westminster Bank, U.S.A. v. Ross, 130 B.R. 656, 680 (S.D.N.Y. 1991) (declining "to imply an obligation of good faith inconsistent with other express terms of the parties contractual relationship").

296. The doctrine can be traced to the classic tax case, Gregory v. Helvering, 293 U.S. 465 (1935). In *Gregory*, the Court criticized the practice of "exalt[ing] artifice above reality," instead urging courts to "fix[] the character of the proceeding by what actually occurred." *Id.* at 469–70. This focus on the bigger picture revealed the transactions at issue to be "an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else." *Id.* at 470; *see also* Am. Potash & Chem. Corp. v. United States, 399 F.2d 194, 202–05 (Cl. Ct. 1968) (further describing the step-transaction doctrine in modern tax law).

297. There is some modern precedent for applying the step-transaction doctrine to commercial finance agreements. *See* Sharon Steel Corp. v. Chase Manhattan Bank, 691 F.2d 1039, 1050–52 (2d Cir. 1982) (suggesting, in the way it analyzed whether an issuer had sold "substantially all" of its

engage in more holistic reviews that consider whether the hostile restructuring, as a whole, violates the plain language and spirit of the original loan agreement. Indeed, hostile restructurings are likely to violate the plain language and spirit of senior secured loan agreements that reflect both a collective design[298] and an intent to share ratably the economic risks and benefits.

Here, the focus should be on whether, taking into account the overall effect of the restructuring, existing creditors have been treated fairly and equitably—not simply whether they are ultimately afforded equal treatment.[299] Courts may develop a list of factors to evaluate the fairness of a particular restructuring proposal. For instance, courts should closely examine the exclusive nature of the restructuring proposal: a proposal that is offered to all or substantially all of the existing lenders is less likely to constitute a hostile restructuring; in contrast, courts should be more suspicious of proposals that are only offered to the number of lenders necessary to overcome applicable consent thresholds. Similarly, courts should consider the level of participation by existing lenders: a proposal—particularly one that was offered to all or substantially all of the lenders—is unlikely to constitute a hostile restructuring if it has garnered the support of an overwhelming majority of the existing lenders.

Secrecy, as well as efforts by the proposal sponsor to "divide and conquer" the lender group, are also important factors to consider. A proposal is more likely to constitute a hostile restructuring when it is the product of negotiations with lenders who promise to keep information concerning the proposal away from other lenders. In contrast, proposals that are directed to the administrative agent for simultaneous distribution to all lenders are unlikely to constitute hostile restructurings, even if they contain aggressive terms. Finally, attempts by the debtor company to manufacture or "gerrymander" consent—such as by issuing new debt or debt commitments on the eve of solicitation—are highly indicative of a hostile restructuring.

Of course, it is important to acknowledge that any form of heightened judicial scrutiny will naturally impose substantial economic burdens in the short run, in the form of increased litigation costs and greater legal

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assets, that a series of transactions can be considered as a collective whole).

298. For a classic case finding that corporate debt agreements evidence a collective design, see Beal Sav. Bank v. Sommer, 865 N.E.2d 318 (N.Y. 2007).

299. Equality among creditors, as Professor Skeel argues, is a rather meaningless virtue in modern bankruptcy law. *See* David A. Skeel, Jr., *The Empty Idea of "Equality of Creditors"*, 166 U. PA. L. REV. 699 (2018).

uncertainty. But after several high-profile cases, companies, their stakeholders, and their advisors would have a template to follow in designing fair and efficient out-of-court restructuring transactions that avoid judicial scrutiny altogether.[300] And over time, voluntary practices—such as the solicitation of fairness opinions to assess hostile restructuring transactions—may evolve to help parties focus on the economic substance of the transaction and potentially even iron out their disputes at an earlier stage in the process. In this way, judicial intervention has the potential to provide a uniquely fair, efficient, and targeted solution to the new and burgeoning problem of hostile restructurings.

CONCLUSION

The U.S. capital markets increasingly feature what I call "hostile restructurings": out-of-court syndicated loan restructuring transactions that rely on aggressive negotiation tactics to overcome not only the traditional lender holdout problem, but also the collective bargaining power of the entire lender group. These transactions require corrective intervention, ideally by the courts. But to answer this call to service, courts must overcome decades of precedent establishing that judges should not interfere with the smooth functioning of the capital markets by applying thorny judicial doctrines to commercial finance disputes or, worse yet, by interposing new judge-made law. By showcasing the many ways in which hostile restructurings constitute a normative failure in the capital markets, this Article provides both the call to action and the theoretical justification for a fair, efficient, and effective form of judicial intervention that can help to restore the smooth functioning of the capital markets.

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300. Professor Skeel similarly argues that a few high-profile cases have the potential to help clarify legal standards, reducing the need for future litigation. Skeel, *supra* note 62, at 377.