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Distorted Choice in Corporate Bankruptcy

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Abstract

We ordinarily assume that a central objective of every voting process is ensuring an undistorted vote. Recent developments in corporate bankruptcy, which culminates with an elaborate vote, are quite puzzling from this perspective. Two strategies now used in nearly every big case are intended to distort, and clearly do distort, the voting process. Restructuring support agreements ("RSAs") and "deathtrap" provisions remove creditors' ability to vote for or against a proposed reorganization simply on the merits.

This Article offers the first comprehensive analysis of these new distortive techniques. One possible solution is simply to ban distortive techniques, as several scholars advocate with RSAs that offer joinder bonuses. Although an antidistortion rule would be straightforward to implement, I argue this would be a mistake. The distortive techniques respond to developments that have made reorganization difficult, such as claims trading and a greater need for speed. Further, Chapter 11's baseline was never intended to be neutral: it nudges the parties toward confirming a reorganization plan. There also are independent justifications for some distortive techniques, and the alternative to using them might be even worse—possibly leading to more fire sales of debtors' assets.

How can legitimate use of the new distortive techniques be distinguished from more pernicious practices? To answer this question, I outline four rules of thumb to assist the scrutiny. Courts

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should consider whether holdouts are a serious threat, the magnitude of the coercion, the significance of any independent justifications, and whether the holdout threat is an intentional feature of the parties' contracts. I then apply the rules of thumb to a few prominent recent cases. I conclude by considering two obvious extensions of the analysis, so-called "gifting" transactions in Chapter 11 and bond-exchange offers outside of bankruptcy.

Introduction

We ordinarily assume—or at least pretend to assume—that a central objective of every voting process is ensuring an undistorted vote. Protecting the integrity of a vote is sometimes difficult, and the best way to achieve this may be contested, as reflected in the controversies over the Supreme Court's voting-rights jurisprudence and in debates over possible foreign interference in the last presidential election.[1] But nearly everyone agrees that the goal should be to remove distortions so that voters can resolve the question at hand on the merits.

Recent developments in corporate bankruptcy are quite puzzling from this perspective. Chapter 11 is organized around an elaborate vote. The debtor or other proponent of a reorganization plan divides the creditors and shareholders of the company into different classes,[2] and the creditors or shareholders in each class vote to approve or reject the proposed plan.[3] If every class of creditors and shareholders votes in favor of the proposed plan, and it satisfies a number of other requirements, the bankruptcy judge will confirm the plan.[4] Bankruptcy law gives the bankruptcy judge ample tools to police any distortions. Voting cannot begin until the court approves a disclosure statement giving the creditors and shareholders "adequate information" about the proposed plan,[5] for instance, and the judge can disqualify problematic votes.[6] The law on the books is intended to produce a simple undistorted vote.

[1] *See, e.g.*, Tim Fernholz, *No One Is Protecting the 2020 Election*, QUARTZ (Nov. 23, 2019), https://qz.com/1754314/no-one-is-protecting-the-2020-election [https://perma.cc/PVM6-9LLT]; Michael Wines, *Protection of Voting Rights for Minorities Has Fallen Sharply, a New Report Finds*, N.Y. TIMES (Sept. 12, 2018), https://www.nytimes.com/2018/09/12/us/voting-rights-minorities.html [https://perma.cc/HNY7-T3WW] (describing the controversy over the effect of the Supreme Court decision to strike down parts of the Voting Rights Act).

[2] 11 U.S.C. § 1122 (2018) (governing the classification of claims or interests).

[3] A class of creditors approves the plan if two-thirds in amount and a majority in number of the claims in the class cast a ballot vote "yes." 11 U.S.C. § 1126(c) (2018).

[4] 11 U.S.C. § 1129(a) (2018). If some but not all classes vote "yes," the plan can sometimes be approved through a "cramdown" process. 11 U.S.C. § 1129(b) (2018).

[5] 11 U.S.C. § 1125 (2018).

[6] 11 U.S.C. § 1126(e) (2018).

Yet the law as it plays out in practice looks radically different. Two of the most important developments in recent bankruptcy practice are intended to distort, and clearly do distort, the voting process. They remove creditors' ability to vote simply on the merits—that is, to vote based on the plan's proposed payout for their class.

The first is the emergence of restructuring support agreements ("RSAs").[7] In the simplest type of RSA, the debtor negotiates the terms of a potential reorganization plan with a subset of its creditors—often focusing on multiple classes of creditors but sometimes targeting a single class. The RSA commits its signatories to support a future reorganization plan that conforms to the terms of the RSA, including the proposed payout to each creditor class. A creditor that signs the RSA relinquishes its ability to decide independently whether to support a reorganization plan subsequently proposed by the debtor. It does this before—often long before—a disclosure statement is approved and the proposed reorganization is submitted to creditors for a vote.

Many recent RSAs further distort the decisionmaking process by offering to pay a "support fee" to creditors who sign the RSA. Such "signing-fee RSAs" offer compensation that may reimburse creditors for the professional fees they incurred while negotiating the RSA. A signing-fee RSA may also include a fee for supporting the reorganization plan when it is proposed and waiving the right to object, as in agreements involving Puerto Rico's electricity company and Peabody Energy.[8]

Alternatively, the RSA may provide a benefit to signatories, such as the right to provide debtor-in-possession financing during the case or to participate in a rights offering after the debtor's reorganization plan is confirmed.[9] These inducements, which are available only to those who sign

[7] RSAs are sometimes called Plan Support Agreements, or PSAs. The term RSA is typically used when the agreement is negotiated before bankruptcy, whereas PSA is usually used when the agreement is negotiated after the filing.

[8] For a detailed discussion of the Puerto Rico electricity company and Peabody Energy agreements, see *infra* Part IV.

[9] Rights offerings give creditors the right to buy equity in the reorganized company at a set price. For an overview of the use of rights offerings in bankruptcy, see Jay M. Goffman & George Howard, *Rights Offerings Prove Popular with Both Debtors, Distressed Investors: Billions Raised in Recent Offerings for Companies*, J. CORP. RENEWAL, Jan.-Feb. 2018, at 4-8.

the RSA, look like a form of vote buying, since they compensate signatories who commit to supporting an upcoming plan.

The second recent development is the use of "deathtrap" provisions in proposed reorganization plans. In a traditional deathtrap provision, the debtor proposes to give a creditor class some form of compensation if it votes "yes," but cuts it off altogether if it votes "no." The reorganization plan in the Trident Holding Company bankruptcy said, for instance, that if the First Lien Classes and the Second Lien Classes "are Accepting Classes, each Holder of an Allowed Second Lien Claim shall receive its Pro Rata share and interest in 1% of the Warrants," but if the First Lien Classes or the Second Lien Classes "are not Accepting Classes, Holders of Allowed Second Lien Claims shall not receive any distributions on account of such Allowed Second Lien Claims."[10]

A more elaborate version—the "individually targeted deathtrap"—may offer one form of compensation to individual creditors who vote "yes" and a different compensation to individual creditors who vote "no."[11] In each case, the point is to apply pressure, using both a carrot (the compensation for a "yes" vote) and a stick (worse treatment of "no" votes) to nudge the creditors or shareholders to vote in favor of the plan.[12]

RSAs and deathtraps can distort the voting process in at least three ways.[13] First, if they include supplemental payments, the additional compensation pressures creditors to vote for the reorganization plan even if creditors believe the payout is too low. These payments require a creditor to forgo

[10] Joint Plan of Reorganization of Trident Holding Company, LLC and Its Debtor Affiliates at 26, *In re* Trident Holding Company, LLC, No. 19-10384 (Bankr. S.D.N.Y. Mar. 25, 2019).

[11] Under the Arch Coal, Inc. reorganization plan, for instance, if a class of "unsecured funded debt" claims voted "yes," they would receive a specified distribution. If the class voted "no," claimants that had signed the RSA or did not opt out of the plan's third-party releases would receive the distribution, but claimants who voted "no" would not. Debtors' Third Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code at 31-32, *In re* Arch Coal, Inc., No. 16-40120-705 (Bankr. E.D. Mo. July 6, 2016).

[12] In philosophy, the combination of a threat and a benefit has been dubbed a "throffer." Hillel Steiner, *Individual Liberty*, 75 PROC. ARISTOTELIAN SOC'Y 33, 39 (1974-1975).

[13] Here and throughout the Article, I use the term "distortion" broadly, to encompass any strategy that creates incentives for a creditor to support a plan that the creditor might not support if she were voting simply on the merits.

compensation if she or the class votes "no," and thus make a "no" vote more expensive and less attractive for reasons unrelated to the creditor's views on the underlying merits of the plan. Second, distortive techniques can procedurally warp the voting process by binding creditors before the plan has been formally proposed and using exploding offers to induce creditors to commit early on. Third, RSAs and deathtraps may even distort the voting process by decreasing creditors' likelihood of success in challenging the plan in the event the class of creditors votes "no."[14] By making the alternative to voting "yes" less attractive, these techniques can coerce creditors to vote for the plan.[15]

Despite the ubiquity of the new distortive techniques, they are just beginning to attract attention in the scholarly literature. Several scholars have written about RSAs,[16] but I am not aware of any articles that devote meaningful attention to the use of deathtrap provisions or to the increase in voting distortions more generally. This Article is the first to attempt a more comprehensive analysis of the new landscape of distorted voting.

One obvious solution to bankruptcy's voting distortions might be to prohibit or sharply restrict their use. This is the usual strategy elsewhere, and in corporate law, Delaware courts have in fact banned a somewhat analogous distortion that featured in freeze-out mergers.[17] In the past, a corporate parent could use subtle forms of coercion when freezing out the minority shares of a subsidiary. If the parent made a tender offer for the minority shares, for instance, it could hint that any untendered shares would be

14 *Supra* text accompanying notes 84-85.

15 This Article is primarily concerned with distortions that are created by the RSA itself. Debtor-in-possession financing agreements that give senior lenders control of the restructuring process are sometimes accompanied by RSAs with the senior lenders. *See, e.g.*, Kenneth Ayotte & Jared A. Ellias, Bankruptcy Process for Sale 2 (May 26, 2020) (unpublished manuscript) (on file with author) (discussing the control of the lenders in the Neiman Marcus and J. Crew bankruptcies). In this context, senior lenders are taking advantage of the leverage they have asthe source of essential financing.

16 Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593 (2017); Edward J. Janger & Adam J. Levitin, *Badges of Opportunism: Principles for Policing Restructuring Support Agreements*, 13 BROOK. J. CORP., FIN. & COM. L. 169 (2018).

17 In a typical freeze-out merger, a controlling shareholder (often the parent corporation) uses a merger to force minority shareholders to take cash for their shares, leaving the controlling shareholder with 100% of the company. The key case constraining the freeze-out strategy described in the text that follows is *In re Pure Res., Inc.*, *S'holders Litig.*, 808 A.2d 421 (Del. Ch. 2002), which is discussed at the outset of Part II, *infra*.

neglected after the tender offer,[18] thus diminishing the value of untendered shares. Delaware courts have cracked down on these practices by imposing a stringent antidistortion rule.[19]

The same approach could easily be employed in Chapter 11. In its strong form, an antidistortion rule would ban the use of RSAs and deathtrap provisions altogether, since each distorts the voting process. Under a weaker antidistortion rule, courts might prohibit only the variations of RSAs and deathtraps that introduce the most significant distortions, such as signing-fee RSAs and individually targeted deathtraps.

The antidistortion approach has considerable appeal, especially for those of us who already are attracted to rule-of-law moralism. It would ensure a much more unbiased Chapter 11 vote than the vote in most current reorganization cases, while also reducing the risk of windfalls to favored creditors. It also would be relatively simple to implement. As already noted, existing bankruptcy law gives judges powerful tools to curb voting distortions. Before the debtor can solicit votes on a proposed reorganization plan during the case, for instance, the bankruptcy court must find that the disclosure statement provides "adequate information" to creditors.[20] A court could easily hold that an RSA violates this provision—and on rare occasions, courts have done precisely this.[21] RSAs and deathtrap provisions also could be struck down as inconsistent with the obligation that the plan be "proposed in good faith and not by any means forbidden by law."[22] If antidistortion is the best solution, it lies readily at hand.

18 If the controller explicitly said that it planned to delist the shares, the tender offer might have been enjoined as impermissibly coercive. *See In re Pure Res., Inc., S'holders Litig.*, 808 A.2d at 438 n.26. But the controller probably could have gotten away with a vaguer threat.

19 Lucian Bebchuk has advocated an antidistortion rule that would go even further and would attempt to remove even minor distortive effects from all tender offers. Lucian Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1747-52 (1985).

20 11 U.S.C. § 1125(b) (2018).

21 Delaware bankruptcy courts appear to have invalidated early RSAs on this ground in two 2002 decisions—*In re Stations Holding Co.*, No. 02-10882 (MFW), 2002 WL 31947022, at *3 (Bankr. D. Del. Sept, 30, 2002), and *In re NII Holdings, Inc.*, 288 B.R. 356, 362 (Bankr. D. Del. 2002)—but these cases were dismissed as having little precedential or persuasive power in a subsequent decision, *In re Indianapolis Downs, LLC.*, 486 B.R. 286, 295 (Bankr. D. Del. 2013).

22 11 U.S.C. § 1129(a)(3) (2018).

The first clue that banning the new distortive techniques may not be the optimal solution comes from the response of the bankruptcy courts. With only a few exceptions, most of them in the early 2000s, bankruptcy judges have upheld both RSAs and deathtrap provisions. To be sure, bankruptcy judges' endorsement does not necessarily mean there is no reason to worry about the distortive techniques. It is possible that judges have not yet fully recognized the distortive effects of the new techniques, or that bankruptcy judges are too quick to approve the use of provisions that make successful reorganization more likely. But courts' acquiescence to the new distortive techniques suggests these strategies may be more justified than they initially appear.

It turns out they are. The justification for permitting at least some use of these distortive techniques begins to emerge if we take a closer look at the environment in which the new distortive techniques emerged. In the early years of Chapter 11, large debtors had the option of devising reorganization plans at a leisurely pace—they had a long "runway," in current jargon.[23] This is no longer the case. Financial distress must now be resolved much more quickly, both because the value of many troubled companies is evanescent and because lenders and other creditors use debtors' need for liquidity as leverage to compress the timeline of the case.[24] Whereas the typical Chapter 11 case lasted more than two years prior to 2000,[25] the duration is now roughly one year.[26]

Achieving a speedy reorganization would be challenging even if the debtor were dealing with a stable group of creditors. But because claims

[23] The length of many early cases was seen as a major problem with Chapter 11. *See* Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 731 (1993).

[24] *Compare* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 765-66 (2002) (discussing how firms are increasingly comprised of intangible assets), *and id.* at 784 ("The control that the lender has over cash collateral makes it hard to enter into a financing arrangement without its explicit blessing."), *with* LoPucki, *supra* note 23, at 739-45 (criticizing the previous length of bankruptcy cases).

[25] *See, e.g.*, Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation Versus Chapter 11 Reorganization*, 61 J. FIN. 1253, 1270 (2006) (finding an average duration of 2.3 years for Chapter 11 cases filed between 1995 and 2001).

[26] *See* Foteini Teloni, *Chapter 11 Duration, Pre-Planned Cases, and Refiling Rates: An Empirical Analysis in the Post-BAPCPA Era*, 23 AM. BANKR. INST. L. REV. 571, 592-93 (2015) (finding that the mean duration for traditional Chapter 11 cases dropped from 634 to 430 days after 2005, and the mean for all cases (including prepackaged bankruptcies) fell from 480 to 261 days after 2005).

trading is now ubiquitous, creditors' interests are highly unstable.[27] A potential deal hammered out today may fall apart tomorrow after some claims are sold to buyers who do not believe the proposed deal is a good one.

It also is easier than ever before for a distressed-debt investor to assemble a blocking position and thereby veto the debtor's proposed reorganization plan.[28] The explosion of claims trading appears to have begun roughly a decade after the current bankruptcy laws were adopted,[29] and the market for distressed debt has grown exponentially since then.[30]

The ease with which distressed-debt traders can now acquire veto power can be both helpful and harmful. If the debtor proposes a problematic reorganization plan, a creditor's efforts to block the plan may benefit other creditors as well. But the veto facilitated by claims trading may also enable a creditor who has a conflict of interest—such as a competitor of the debtor—or other perverse incentive to thwart confirmation of a reorganization plan that serves the interests of the debtor and other creditors. Moreover, even if a creditor does not have problematic incentives, it may seek to use its leverage to obtain a disproportionate recovery for itself.[31] Given that distressed-debt traders often have a short-term focus and little reputational

[27] The first scholar to call attention to this effect of claims trading was Fred Tung. Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684 (1996). For evidence that there is less turnover than is sometimes thought, see Jared A. Ellias, *Bankruptcy Claims Trading*, 15 J. EMPIRICAL LEGAL STUD. 772, 782-83 (2018).

[28] A distressed-debt trader who acquires one-third of the value of the claims in a class can block approval, since approval requires two-thirds. 11 U.S.C. § 1126(c) (2018).

[29] The dramatic increase in claims trading began in the late 1980s and early 1990s. *See, e.g.*, Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703, 710 n.22 (2008) ("The practice of buying distressed debt . . . morphed into a more sophisticated and activist investment practice with the stock failure of 1987 and the corporate failures that followed.").

[30] Estimates of the size of the distressed-debt market vary widely, in part due to differing definitions of distressed debt. According to one, "[a]s of June 30, 2019, the total face value of distressed and defaulted debt . . . [was] $773 billion." Edward I. Altman & Robert Benhenni, *The Anatomy of Distressed Debt Markets*, 11 ANN. REV. FIN. ECON. 21, 23 (2019).

[31] For a similar typology of holdout behavior, see William W. Bratton & Adam J. Levitin, *The New Bond Workouts*, 166 U. PA. L. REV. 1597, 1607 (2018). In addition to holdout creditors who vote strategically because they have a conflict of interest or seek to obtain an extra payoff for themselves, Bratton and Levitin include creditors who vote sincerely, but misjudge the benefits of the proposed transaction.

stake in the consequences of their intervention, the potential for problematic holdouts is significant.

Of course, the emergence of new obstacles to a successful reorganization does not justify voting distortions by itself. All else equal, the appropriate response might be something along the lines of "tough luck." But all else is not equal in bankruptcy. Perhaps surprisingly for those who assume votes should be undistorted, the Chapter 11 vote is not intended to be neutral and uncoerced. The voting rules already include features that are designed to nudge the parties toward confirmation of a reorganization plan. If one or more classes vote against a proposed reorganization plan, for instance, the plan can nevertheless be "crammed down" if, among other things, the proposed plan "does not discriminate unfairly, and is fair and equitable."[32] There also is an implicit threat that, if the parties fail to devise a confirmable reorganization plan, the case will be converted to Chapter 7, and the debtor's assets will be sold off in pieces by a court-appointed trustee.[33]

If the goal is to tilt the playing field slightly toward reorganization, and recent developments have made reorganization more difficult, distortive techniques that soften the effects of these developments might not be inherently bad. Distortive techniques may sometimes be appropriate to counteract destructive holdout activity.[34]

There also are independent justifications for some distortive techniques. The signing-fee RSA, for instance—which some commentators treat as per se disqualifying[35]—may compensate the signatories for the cost of negotiating a plan that benefits all creditors and for committing themselves and any successors to support the proposed reorganization plan even if a

[32] 11 U.S.C. § 1129(b)(1) (2018).

[33] 11 U.S.C. § 1112 (2018) (governing conversion or dismissal).

[34] Janger and Levitin have similar concerns and advocate that claims traders' voting rights be limited to the amount they paid for the claim. Edward J. Janger & Adam J. Levitin, *One Dollar, One Vote: Mark-to-Market Governance in Bankruptcy*, 104 IOWA L. REV. 1857, 1858 (2019). Although I am not persuaded that distressed-debt investors should automatically be disenfranchised in this way, I do favor giving debtors some ability to discipline holdouts.

[35] Janger & Levitin, *supra* note 16, at 186 (characterizing payments to signatories as "badges of opportunism"). Douglas Baird also appears to be skeptical of RSA fees, citing complaints that the proposed fees in *In re Caesars Entertainment Operating Co.*, 533 B.R. 714 (Bankr. N.D. Ill. 2015) were "coercive" and "improper," but concludes "they are somewhat rare." *See* Baird, *supra* note 16, at 610. This is no longer true.

better alternative emerges. A deathtrap provision may resolve—or at least postpone until after confirmation—a high-stakes dispute that could otherwise derail the reorganization process by consuming the debtor in time-consuming litigation.[36] To be sure, the purported benefits of a distortive technique may be exaggerated or outweighed by the potentially pernicious effects of the technique. But there often are legitimate justifications for using a technique even if it incidentally distorts the voting process. In this sense, the new distortive techniques are quite similar to lockups in corporate merger-and-acquisition transactions, where they also can be both problematic and beneficial.[37]

Finally, we need to consider how the parties might respond to a partial or complete ban of distortive techniques. One obvious possibility is that some distressed debtors that might otherwise reorganize under Chapter 11 would now be unable to do so and would be forced to resolve their distress through a sale of assets instead. To be sure, asset sales can be an effective solution to the debtor's financial distress.[38] But no one has a vote in an asset sale,[39] and an antidistortion rule could misdirect debtors away from the traditional Chapter 11 process when Chapter 11 would be the best solution to the debtor's financial distress.

These complicating factors suggest it would be a mistake to ban distortive techniques altogether. This doesn't mean that distortive techniques should always be permitted, however. RSAs and deathtrap provisions sometimes do distort the voting process in indefensible ways. RSA fees sometimes appear to be little more than vote buying, for instance, and the structure of some deathtrap provisions is highly coercive.

Thus far, courts seem to have taken a "know it when they see it" approach to the new distortive techniques. When a debtor agreed to exchange 100% of the company's post-reorganization stock for a secured creditor's $238

36 This appears to have been true in the *Momentive* case, where the deathtrap's terms reflected a dispute over a make-whole provision. *See infra* Section I.B.
37 The analogy to corporate lockups (or "breakup fees") is discussed *infra* Section III.C.
38 *See* Jean-Marie Meier & Henri Servaes, *The Bright Side of Fire Sales*, 32 REV. FIN. STUD. 4228, 4230 (2019). For a more skeptical view, see Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH L. REV. 1, 8-11 (2007).
39 11 U.S.C. § 363(b) (2018) (allowing the sale of assets if approved by a court after notice and hearing).

million claim—without doing a market test of the transaction or negotiating with any other creditors (including nearly $1.2 billion of other secured claims)—the court balked, finding that the agreement "breeds contempt rather than fostering negotiations," and refused to approve it.[40] In most (though not all) other cases, courts have approved the distortive techniques.

My goal in this Article is to offer additional guidance for the determinations courts are now making. I start with the standard assumption that the general objective of the bankruptcy process is value maximization. Chapter 11 does not seek to achieve this objective directly, however. Instead, it provides a framework for renegotiating the parties' entitlements that culminates with the Chapter 11 voting process. An assessment of the new distortive techniques therefore needs to consider carefully both the parties' entitlements and the procedural integrity of the Chapter 11 process.

My analysis suggests that some distortive techniques should nearly always be permitted and others usually barred. Traditional deathtraps are an example of the former; exploding RSAs that give potential signatories only a brief period of time to decide are in the latter category. For distortive techniques that fall in the middle, I offer a handful of rules of thumb. I then apply the rules of thumb to four important recent cases. My analysis suggests that if bankruptcy judges clearly signal a willingness to strike down egregious uses of distortive techniques, the parties will adjust accordingly, eventually rendering court intervention unnecessary in most cases.[41]

Part I of the Article describes the new distortive techniques in more detail, using the RSA in the *ResCap* case[42] and the deathtrap provision in the *Momentive* case[43] as my principal illustrations. In Part II, I ask why bankruptcy courts have been so willing to condone their use, particularly given courts' hostility to distortion in other contexts. I argue that the answer lies in the dramatic recent changes that have made corporate reorganization much

[40] *In re* Innkeepers USA Trust, 442 B.R. 227, 234 (Bankr. S.D.N.Y. 2010). The court also questioned the need to enter into the agreement so early in the case. *Id.* at 233.
[41] *Cf.* Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 950-51 (1997) (describing how divorce law provides a framework for parties to negotiate their rights and responsibilities and how often parties "resolve distributional questions . . . without bringing any contested issue to court for adjudication").
[42] *In re* Residential Capital, LLC, 501 B.R. 549 (Bankr. S.D.N.Y. 2013).
[43] *In re* MPM Silicones, LLC, 518 B.R. 740 (Bankr. S.D.N.Y. 2014).

more difficult than in the past, coupled with the surprisingly unneutral baseline of the Chapter 11 voting process.

Parts III and IV develop and apply a framework for scrutinizing the new distortive techniques. Part III offers four rules of thumb. The first and second focus on the threat of holdout behavior and the magnitude of procedural or entitlement coercion. The third and fourth consider any independent justifications for a distortive technique that might warrant marginally more coercion and (much less common) any special contractual terms that might call for less. I conclude the Part by considering whether and when a creditor should be permitted to change its vote on a plan. In Part IV, I apply the rules of thumb to some complex recent cases: the elaborate RSA for PREPA, Puerto Rico's electricity company; the convoluted deathtrap provision in the *Momentive* case; and the use of both RSAs and deathtraps in two prominent coal-company reorganizations.

Although my focus is on strategies that distort the Chapter 11 vote, the analysis has implications for a variety of related issues. In Part V, I consider two of the most obvious extensions: so-called gifting transactions in Chapter 11 and coercive bond exchanges outside of bankruptcy. Gifting transactions are especially interesting, because they are quite similar to RSAs and deathtrap provisions in some respects, yet bankruptcy courts have viewed them with considerably more suspicion. I consider in Part V why this might be so.

I. The New Distortive Techniques

When the drafters crafted current Chapter 11, they imagined the vote as the capstone of a three-step process. First, the debtor would negotiate over the terms of a potential restructuring with the senior creditor (usually a bank), the creditors' committee (representing the widely scattered unsecured creditors) and the shareholders. The debtor would then ask the court to approve a disclosure statement outlining the terms of the proposed plan, and to authorize the debtor to send ballots to each creditor or shareholder. Only then would a creditor or shareholder accept or reject the plan, based on a simple assessment of the payout the plan promised to the claims or interests in the creditor's or shareholder's class.

In current cases, the voting process looks very different than the drafters envisioned. In nearly every large case, the debtor uses one or both of the new distortive techniques to shape the Chapter 11 vote: RSAs to lock in the votes of many or most creditors before a disclosure statement is ever approved; and deathtrap provisions to entice creditors to vote "yes."

In this Part, I use two brief case studies to show how the new distortive techniques work. I begin with *ResCap*, which featured a pre-bankruptcy RSA followed by a more comprehensive post-petition RSA. I then turn to *Momentive*, which included a clever deathtrap provision. In each context, I also describe variations on the distortive techniques that have been used in other cases.

A) RSAs (and PSAs): The *ResCap* Case

Debtors use RSAs (and PSAs) to lock in creditor support for an anticipated reorganization plan. Sometimes arranged before bankruptcy and sometimes during the case, an RSA or PSA commits the creditors who sign the agreement to support any future reorganization plan that reflects the terms of the agreement.

Perhaps the best-known case with an extensive RSA/PSA is *ResCap*. ResCap, which was spun off from General Motors in the early 2000s, was the parent corporation of Residential Funding Company ("RFC"), one of the largest securitizers of home mortgages in the early 2000s.[44] RFC purchased mortgage loans from the lenders who made the original loans (sometimes called "correspondent lenders") and resold them into residential mortgage-backed securities ("RMBS") trusts. Cash from investors in the trusts financed the trusts' purchase of the mortgage loans; the investors were then compensated from the payments that homeowners made on the underlying mortgage loans.

When the housing market began to wobble in 2007 on the eve of the Great Recession, many of the underlying mortgages in the trusts started defaulting. This eventually prompted an onslaught of litigation against ResCap and RFC by investors in the trusts and monoline insurers who had

[44] ResCap's business is summarized in a massive examiner's report filed in the case. *See* Report of Arthur J. Gonzalez, as Examiner at III-1 to -6, *In re* Residential Capital, LLC, 501 B.R. 549 (Bankr. S.D.N.Y. 2013) (No. 12-12020 (MG)).

insured the investment interests in many of the trusts. These plaintiffs alleged that RFC had misrepresented the quality of the mortgage loans it included in the trusts.

As ResCap teetered on the edge of bankruptcy in early 2012, it reached a settlement with the plaintiffs in the two largest groups of RMBS class action claims and memorialized the settlement in a Plan Support Agreement that was intended to serve as the basis for a reorganization plan. Under the PSA, the RMBS investors would be given an $8.7 billion allowed claim in the bankruptcy;[45] under a companion agreement, Ally Financial, a former affiliate of ResCap and RFC that did not file for bankruptcy, would contribute $750 million, as well as provide $220 million in debtor-in-possession financing to facilitate a sale of ResCap and its affiliates' mortgage-servicing assets.[46] The parties planned to sell the servicing assets almost immediately and to move the case quickly through Chapter 11.[47]

Although the asset sale succeeded, garnering $2.1 billion, the original PSA met fierce resistance from other parties in the case. The Unsecured Creditors Committee insisted that the $8.7 billion claim was far too high,[48] and a major monoline insurer condemned the agreement as "more about getting a release for Ally than achieving a fair and equitable deal."[49] After the debtor abandoned the agreement under an onslaught of opposition a few months

[45] Affidavit of James Whitlinger, Chief Financial Officer of Residential Capital, LLC, in Support of Chapter 11 Petitions and First Day Pleadings, ex. 10, at 9, *In re* Residential Capital, LLC, 501 B.R. 549 (Bankr. S.D.N.Y. 2013) (No. 12-12020 (MG)), ECF No. 6. Exhibits 8 through 10 show the three Plan Support Agreements.

[46] *Id.* ex. 8, at 6, 7. Exhibit 8 shows the Plan Support Agreement with AFI.

[47] In an affidavit accompanying the filing, which came five days after the PSA was signed, ResCap's chief financial officer predicted that ResCap would propose a reorganization plan within thirty days. *Id.* at 4.

[48] Objection of the Official Committee of Unsecured Creditors to the Debtors' Motion Pursuant to Fed. R. Bankr. P. 9019 for Approval of the RMBS Trust Settlement Agreements at 22, *In re* Residential Capital, LLC, 501 B.R. 549 (Bankr. S.D.N.Y. 2013) (No. 12-12020 (MG)), ECF No. 2825.

[49] Objection of Assured Guaranty Municipal Corp. and Certain Affiliates to Debtors' Motion Pursuant to Bankruptcy Rule 9019 for Order Approving RMBS Trust Settlement Agreements at 7, *In re* Residential Capital, LLC, 501 B.R. 549 (Bankr. S.D.N.Y. 2013) (No. 12-12020 (MG)), ECF No. 2791; *see also id.* at 2 ("The settlement . . . is an integral part of the Debtors' efforts to obtain a third party release for parent Ally Financial, Inc. ("AFI") and its nondebtor subsidiaries . . . .").

later, a mediator was appointed (then-sitting Bankruptcy Judge James Peck), and the parties began negotiating a new PSA.

Four months later, the parties agreed to a new PSA.[50] The new PSA ultimately encompassed more than twenty constituencies, including the debtors, Ally, the Unsecured Creditors Committee, the major RMBS claimants and the monoline insurers.[51] The PSA included a term sheet detailing how each class would be treated under the reorganization plan contemplated by the PSA,[52] as well as the structure of a trust that would be set up to pursue avoidance claims and other actions after confirmation of the plan.[53] As is typical with these agreements, the PSA included milestones establishing a strict timeline for the plan-confirmation process: a definitive PSA agreement by May 23, 2013; the filing of a reorganization plan and disclosure statement, as well as court approval of the PSA, by July 3, 2013; and confirmation of the reorganization of a reorganization plan by December 15, 2013.[54] To lock in the parties' commitment, signatories were forbidden from objecting to the reorganization plan, directly or indirectly supporting any alternative plan,[55] and transferring any portion of their claims unless the purchaser of their claim also agreed to be bound by the PSA.[56]

The initial and final ResCap PSA illustrate the two approaches commonly taken with RSAs and PSAs. The first version focused on the dominant class of creditors in the case, the billions of dollars of RMBS claims; whereas the final PSA was far more comprehensive. From the plan proponents' perspective, there are obvious tradeoffs between the two. While it is easier to reach agreement with a single key constituency than with numerous constituencies, a narrower PSA is more likely to face serious pushback from other creditors.

[50] Debtor's Motion for an Order Under Bankruptcy Code Sections 105(a) and 363(b) Authorizing the Debtors to Enter into and Perform Under a Plan Support Agreement with Ally Financial Inc., the Creditors' Committee, and Certain Consenting Claimants, ex. 3, *In re* Residential Capital, LLC, 501 B.R. 549 (Bankr. S.D.N.Y. 2013) (No. 12-12020 (MG)), ECF No. 3814 [hereinafter *ResCap* PSA].

[51] *See* Findings of Fact at 33, *In re* Residential Capital, 501 B.R. 549 (Bankr. S.D.N.Y. 2013) (No. 12-12020 (MG)), ECF No. 6066.

[52] *ResCap* PSA, *supra* note 50, ex. B, at 2-16.

[53] *Id.* ex. B, annex II.

[54] *Id.* ex. A, at 4.

[55] *Id.* at 10.

[56] *Id.* at 12.

Neither PSA included a signing fee for parties that joined the agreement.[57] Recent agreements often do have such fees. The agreement in the PREPA reorganization, for instance, promised signatories a "waiver and support" payment equivalent to 1.62% of their claims.[58] Also, rather than an explicit fee, RSAs sometimes compensate their signatories in other ways, such as inviting them to participate in a rights offering.[59] Even without these fees, the simplest PSA or RSA distorts the voting process by committing the signatories to vote in favor of a future plan; distortion is especially obvious when signatories receive a fee that is not available to those who do not sign the agreement.

B) Deathtrap Plan Provisions: The *Momentive* Case

The second distortive strategy is including a "deathtrap" provision in a proposed reorganization plan. In a traditional deathtrap, one class of creditors (or sometimes multiple classes) is told that it will receive a specified payout if the class votes in favor of the proposed reorganization and a worse payout if the class votes "no." In many cases, the deathtrap promises a payment to the class if it votes in favor of a proposed plan but denies it anything if it votes against.[60]

The leading recent case, *In re MPM Silicones, LLC* (often referred to as *Momentive*, the debtor's trade name), included a more creative deathtrap.[61] Momentive was a silicone and quartz manufacturer that had been acquired in 2006 by Apollo, the well-known private-equity fund.[62] After a highly contested set of negotiations, Momentive proposed a reorganization plan that employed a deathtrap provision to try to pin down its senior creditors (First and 1.5 Lien Noteholders). The deathtrap gave the senior creditors a choice. They could accept the plan, which promised full payment in cash but

57 The PSAs did compensate the plaintiffs' attorneys by giving them substantial claims in the case. *Id.* ex. B, at 5.
58 The PREPA RSA is discussed in detail *infra* Section IV.A.
59 This was the approach in *In re Peabody Energy Corp.*, 933 F.3d 918 (8th Cir. 2019), discussed *infra* Section IV.C.2.
60 *E.g.*, *In re* Zenith Elecs. Corp., 241 B.R. 92, 105 (Bankr. D. Del. 1999).
61 518 B.R. 740 (Bankr. S.D.N.Y. 2014).
62 Emily Glazer, *Momentive Performance Preparing for Mid-April Bankruptcy Filing*, WALL ST. J. (Apr. 1, 2014, 6:43 PM ET), https://www.wsj.com/articles/momentive-performance-preparing-for-mid-april-bankruptcy-filing-1396388146 [https://perma.cc/SH53-XWDP].

required the creditors to waive a $200 million make-whole claim,[63] or they could reject the plan, assert their make-whole claim, and receive replacement notes plus the cramdown rate of interest. Because the cramdown rate of interest often undercompensates creditors and the senior creditors' success on their make-whole claim was highly uncertain, the deathtrap structure put pressure on the senior creditors to accept the cash payout.

The senior creditors nevertheless rejected the plan and chose to litigate the make-whole claim.[64] This proved to be a mistake, as the district court held that they were not entitled to the make-whole payment, a decision that was subsequently affirmed by the Second Circuit.[65] Having lost on the make-whole provision, the senior creditors sought to rescind their "no" vote on the reorganization plan and to take the originally offered cash payout. The district court told the senior creditors that it was too late—their "no" vote could not be reversed.[66] In effect, the court validated the coercive structure of the deathtrap treatment by refusing to undo it after the fact.

In one sense, the deathtrap provision failed from the debtor's perspective: it did not induce the senior creditors to abandon their make-whole claim and to vote in favor of the proposed reorganization plan. But it did enable Momentive to postpone the make-whole litigation until after the reorganization plan was confirmed.

Some recent deathtrap provisions are tailored to individual creditors rather than to the class as a whole. The Arch Coal reorganization plan

[63] *In re* MPM Silicones, L.L.C., 874 F.3d 787, 805 (2d Cir. 2017). A "make-whole" provision requires a breaching promisor to pay a fee designed to compensate the promisee for profits lost as a result of the breach. In a loan contract, the lost profits often consist largely of unaccrued interest payments. Some courts have enforced make-whole payments. *See, e.g.*, *In re* Energy Future Holdings Corp., 842 F.3d 247, 261 (3d Cir. 2016) (holding that the make-whole provision must be honored); *In re* Sch. Specialty, Inc., No. 13-10125 (KJC), 2013 WL 1838513, at *5 (Bankr. D. Del. Apr. 22, 2013) (concluding that a make-whole provision was a legitimate liquidated-damages provision, not unmatured interest, which would be precluded by section 502(b)(2)). Other courts have rejected them. *See, e.g.*, *In re* MPM Silicones, LLC, 531 B.R. 321, 336 (S.D.N.Y. 2015), *aff'd in part*, *rev'd in part*, 874 F.3d 787, 794 (2d Cir. 2017) (holding that a make-whole provision was unenforceable because it did not "clearly and unambiguously call for the payment of the make-whole premium in the event of an acceleration of debt").

[64] *In re MPM Silicones, LLC*, 518 B.R. 740, 749-51 (Bankr. S.D.N.Y. 2014).

[65] *In re MPM Silicones, LLC*, 531 B.R. at 336, *aff'd in part*, *rev'd in part*, 874 F.3d at 801-04.

[66] *See id.* at 326.

featured a deathtrap that promised a payout to individual creditors who voted in favor of the plan, even if the class as a whole rejected the plan.[67] Creditors who voted against the plan would not receive any compensation if the class voted "no."

As with RSAs, bankruptcy courts regularly seem to approve the use of deathtraps in proposed reorganization plans. Other than a court rejecting the technique in one of the earliest cases featuring a deathtrap, they are nearly always permitted despite the distorting effect they have on creditors' voting decisions.[68]

C) A Brief History of the New Distortive Techniques

Having described how the new distortive techniques work, I briefly recount their emergence and evolution in the discussion that follows.

1. The Rise of Restructuring and Plan Support Agreements

After occasional use in the 1980s and 90s,[69] RSAs and PSAs began to proliferate in the early 2000s. The Delaware courts encountered these agreements for the first time in 2002.[70] Since 2010, RSAs have become increasingly prevalent. They are now found in most large cases, sometimes negotiated prior to the case and sometimes negotiated in bankruptcy. If the RSA is finalized before the case, the debtor generally asks to be permitted to assume the contract under bankruptcy's executory-contract provision;[71] if it is finalized during the case, the parties treat it as a settlement.[72]

67 The Arch Coal deathtrap is discussed *infra* Section IV.C.1.
68 *See infra* Section II.B.
69 Agreements in *In re Texaco Inc.*, 81 B.R. 813, 814-15 (Bankr. S.D.N.Y. 1988), and *In re Kellogg Square P'ship*, 160 B.R. 336, 338 (Bankr. D. Minn. 1993), are early examples, although the terms "lock-up agreement," "plan support agreement," and "restructuring agreement" originated later.
70 *See In re* Indianapolis Downs, LLC., 486 B.R. 286, 295 (Bankr. D. Del. 2013) (discussing *In re* NII Holdings, Inc., 288 B.R. 356 (Bankr. D. Del. 2002) and *In re* Stations Holding Co., No. 02-10882 (MFW), 2002 WL 31947022 (Bankr. D. Del. 2002)).
71 11 U.S.C. § 365 (2018).
72 FED. R. BANKR. P. 9019.

Why the rise of RSAs? One obvious reason is the much more compressed timeline of current bankruptcy cases than during the early years of the Bankruptcy Code. The going-concern value of a troubled firm evaporates more quickly than in the past, and creditors routinely use their leverage to hasten the restructuring process.[73] The early Chapter 11 cases often took years to complete, and critics complained that courts' willingness to repeatedly extend the debtor's exclusive right to file a reorganization plan exacerbated this tendency.[74] As creditors began using the terms of debtor-in-possession financing agreements and other contracts to speed up the case, and as fewer companies fit the old "bricks and mortar" pattern, debtors' ability to chart a leisurely course in bankruptcy disappeared.[75] Under pressure to emerge from bankruptcy quickly, many debtors now put the contours of a potential reorganization in place before filing for bankruptcy, as part of a "pre-arranged" plan.[76] An RSA helps lock in these commitments.

Second, and closely related, is the disruptive effect of the emergence of pervasive claims trading. It wouldn't be quite as essential to lock in creditors' commitments if a debtor knew it would be dealing with the same body of creditors throughout its Chapter 11 case. But the creditor base is constantly shifting in many current cases.[77] Starting in the late 1980s, the market for distressed debt mushroomed,[78] and now stands at roughly $773 billion,

[73] *See* David A. Skeel, Jr., *Creditors' Ball: The 'New' New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 921-22 (2003); *supra* note 24 and accompanying text.

[74] Under 11 U.S.C. § 1121(b) (2018), the debtor has the exclusive right to file a reorganization plan for the first 120 days of the case. Prior to 2005, there was no limit on the number of times the bankruptcy judge could extend the exclusivity period (the limit is now eighteen months). 11 U.S.C. § 1121(d)(2)(A) (2018). The classic critique of the length of early Chapter 11 cases is LoPucki, *supra* note 23, at 729-31.

[75] "[M]any contemporary businesses depend on knowledge and ideas rather than on hard assets. Because these companies' most important assets can walk out the door at any moment, they cannot afford to negotiate for months or years toward an eventual restructuring." Skeel, *supra* note 73, at 922 (discussing post-petition financing and incentive compensation for managers as well); *see, e.g.*, Baird & Rasmussen, *supra* note 24, at 766, 784-85.

[76] Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 678-79 (2003).

[77] *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 652 (2010). For evidence that the instability is not quite as great as many think, see Ellias, *supra* note 27, at 774.

[78] *See, e.g.*, Harner, *supra* note 29, at 710 n.22 (suggesting the expansion began after the 1987 stock-market crash).

according to one measure.[79] An investor can buy or sell a major stake in a corporate debtor almost instantaneously. Absent an RSA, the debtor could not be sure that the deal it struck with one set of creditors would be honored by subsequent purchasers of these claims. RSAs solve this problem by contractually obligating any subsequent purchaser of claims to honor an RSA joined by the predecessor.[80]

These features of RSAs can be seen as mildly distorting Chapter 11 voting, since the signatories pre-commit to a future reorganization plan and will not be able to make a fresh decision whether to approve the plan when it is formally proposed. But the distortion is relatively limited, and Chapter 11 explicitly contemplates that the debtor may secure votes on a potential reorganization prior to bankruptcy.[81]

Some of the additional tools used by debtors to persuade investors to join an RSA in more recent cases are substantially more distortive.[82] One standard inducement is a fee paid to creditors who sign the RSA. Often called a support or commitment fee, the fee is characterized as compensation to the creditor for waiving her right to object to a proposed reorganization plan based on the RSA. The fee may also compensate creditors' lawyers and other professionals for their efforts in negotiating the RSA. Because these fees ensure a greater payout for creditors who sign the RSA than those who do not, they introduce a distortion into Chapter 11 voting. The higher payout offered to signatories than nonsignatories creates pressure for creditors to join the RSA.

Some RSAs add a further nudge by making their benefits "exploding," offering the fee only to creditors who sign up within a specified time period—say, within thirty days—or by giving larger benefits to those who sign on earlier. The proposed PREPA RSA, for instance, provides immediate interest payments for early signatories but a later commencement for

79 Altman & Benhenni, *supra* note 30, at 23 (estimating the total face value of distressed and defaulted debt).

80 Other factors may also contribute to RSAs' popularity. A top bankruptcy lawyer recently told me that he thinks herd behavior among bankruptcy lawyers and financial advisors' preference for a contractual arrangement have contributed to the spread of RSAs. Interview with James Sprayregen, Restructuring Partner, Kirkland & Ellis LLP (Jan. 7, 2020).

81 11 U.S.C. § 1125(g) (2018).

82 Note that RSAs may raise other concerns, such as silencing of potential objections. But my concern here is voting distortions.

creditors who joined after the initial signing period. These features can put additional pressure on creditors to agree to the RSA, and to do so quickly.[83]

2. The Expanding Role of Deathtrap Provisions

The early deathtrap plans could be described as "cramdowns on the cheap." If a reorganization plan is consensual—that is, every class of creditors and shareholders votes to approve it—the bankruptcy judge does not need to determine the precise value of the company and whether the priority of each class has been fully honored.[84] By approving the plan, a class waives these objections.

If one or more classes vote "no," it is still possible for the plan to be confirmed through the "cramdown" alternative.[85] But cramdown requires the court to determine the value of the company, because the court is required to ascertain whether the priority of the objecting class is being respected under the plan.[86] For the first decade after the Bankruptcy Code was enacted in 1978, there was a strong bias toward consensual reorganization, and debtors were reticent to use the cramdown option.[87]

The early deathtraps took advantage of the cramdown option without directly invoking it by proposing to cut off a class that voted "no." This

83 Where the time pressure is severe, the effect is somewhat similar to the coercive Saturday Night Special tender offers sometimes made by takeover bidders in the 1960s. For a more detailed discussion of the analogy, see *infra* note 135 and accompanying text.

84 The requirements for confirming a plan consensually are set forth in 11 U.S.C. § 1129(a) (2018), which includes the requirement that every class approve the plan, 11 U.S.C. § 1129(a)(8) (2018).

85 11 U.S.C. § 1129(b) (2018).

86 A cramdown cannot be approved unless a court determines that classes higher in priority than the objecting class are not being overcompensated, and that the objecting class is either being fully compensated or no lower-priority class is receiving anything. *E.g.*, Case v. L.A. Lumber Co., 308 U.S. 106, 116-19 (1939) (linking the absolute-priority rule to the "fair and equitable" requirement). Determining whether absolute priority is satisfied requires a valuation of the firm and of any securities being provided as compensation.

87 LoPucki and Whitford noted and criticized this bias in their massive study of large reorganization cases. *See* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 682 (1993); *see also* Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625 (1991) (arguing that equity could be preemptively crammed down if the debtor is clearly insolvent).

strategy offered two important benefits over a traditional cramdown. First, the deathtrap provision included a carrot—the prospect of a recovery that the target of the deathtrap (nearly always shareholders) would not otherwise receive—to encourage the target to vote for the plan. If the equity holders voted "yes," there would be no need to actually attempt a cramdown. Second, the offer of compensation could shape the bankruptcy judge's perception of the cramdown proposal if the class did vote "no." If the class had the option of accepting a payout, a judge might be more willing to approve a plan that cut them off entirely. The deathtrap added a "you had your chance" feature to the plan-confirmation process.

Most of the early deathtraps seem to have been designed to take advantage of these benefits and to cram down classes of equity—the lowest-priority classes in the priority waterfall—at a time when cramdowns were generally disfavored.[88] Although the aversion to cramming down equity has largely disappeared, deathtraps still are quite commonly used with classes of equity,[89] as well as with junior creditors.[90] But deathtraps have increasingly migrated up the priority hierarchy. In *Momentive*, the deathtrap provision was used with the senior class of creditors.[91]

Like RSAs, deathtraps also have evolved beyond their traditional form. As *Momentive* shows, deathtraps now may involve a choice between two compensation alternatives. In addition, individually targeted deathtraps seek to influence individual creditors by offering them benefits for voting "yes" even when their class votes "no."[92]

All of these deathtraps are designed to counteract potential obstacles to confirmation. With shareholders (and in some cases, junior creditors), the concern is that a reorganization plan cannot be confirmed consensually if the equity-holders vote "no," even if the equity appears to be deeply

88 As discussed in Section III.C below, courts were somewhat skeptical at first, striking deathtraps down in two early cases. *See In re* MCORP Fin., Inc., 137 B.R. 219, 236 (Bankr. S.D. Tex. 1992); *In re* Allegheny Int'l, Inc., 118 B.R. 282, 304 n.15 (Bankr. W.D. Pa. 1990).
89 *See, e.g.*, Plan of Reorganization at 19, *In re* Parker Drilling, No. 18-36958 (MI) (Bankr. S.D. Tex. Mar. 7, 2019) (offering equity 1.65% of the new stock, subscription rights, and warrants if the class voted "yes," and no distribution if they voted "no").
90 *See, e.g.*, *In re* Samson Res. Corp., 590 B.R. 643, 646, 653 (Bankr. D. Del. 2017).
91 *See supra* Section I.B.
92 *See supra* notes 11-12 and accompanying text; *infra* notes 199-202 and accompanying text (describing the individually targeted deathtrap in *Arch Coal*).

underwater. Given courts' willingness to confirm cramdown plans that cut off equity, this is less troubling for plan proponents now than in the early years of the Bankruptcy Code. But the concern has not disappeared altogether. Plan proponents still would rather pursue a consensual plan than a cramdown given the expense and uncertainty of the process.[93]

With more senior creditors, the principal concern is holdouts, and the most salient development the dramatic rise of the distressed-debt market. In the world envisioned by the drafters of the 1978 Code, the creditors with whom the debtor was negotiating were creditors the debtor had dealt with prior to bankruptcy and in many cases had an ongoing relationship. Today's bankruptcy cases look very different. By the time a substantial debtor files for bankruptcy, much of its debt is often held by hedge funds and other distressed-debt traders who have acquired stakes with the intention of using the tools available in the restructuring process to maximize the return on their investment. One key tool is bankruptcy's voting rules. Because a class's approval requires the support of two-thirds of the debt in the class, a distressed-debt trader that holds one-third of a class's debt has veto power over the vote of the class.[94] A deathtrap can sometimes counteract that holdout threat.

I should emphasize the concerns I have highlighted do not necessarily justify the use of deathtraps. They simply explain why deathtraps have emerged. I turn to whether the new distortive techniques should be permitted in the next Part.

II. Why is Distortion Tolerated?

Before beginning this inquiry, I should pause to underscore just how puzzling bankruptcy courts' tolerance of the new distortive techniques is. Elsewhere in the law, attempts to distort a vote or other decisionmaking process are routinely condemned, especially if it is obvious how the distortion can be removed. Indeed, we need only look to corporate law—which lies just across the insolvency line from bankruptcy—to find a starkly

93 *See In re* Zenith Elecs. Corp., 241 B.R. 92, 105 (Bankr. D. Del. 1999).
94 *See* 11 U.S.C. § 1126(c) (2018) (providing that a class has accepted the plan if two-thirds in amount and a majority in number of the creditors in the class vote in favor of the plan).

different response to the use of distortive techniques. The distortion at issue there involved freeze-out mergers, and it arose during precisely the same period as RSAs and deathtrap provisions began to proliferate in bankruptcy.

The simplest way for a parent corporation to freeze out the non-parent shareholders of a subsidiary is to merge the subsidiary into the parent corporation (or into a newly created sub of the parent) through a traditional merger. But if the controller holds 90% of the controlled subsidiary's stock, it can use Delaware's short-form merger statute,[95] which does not require a vote and for a while was subject to much less scrutiny than a traditional merger.[96] To reach the 90% threshold, a controller may launch a tender offer for the shares of the subsidiary that the controller does not own. This is where distortion can slip in. The controller could significantly increase its prospects of success by hinting that shares that are not tendered into the offer will face an unappealing future—a nudge somewhat similar to the strategy used with deathtrap provisions.[97] Rather than permitting this strategy, as bankruptcy courts have done with RSAs and deathtraps, the Delaware courts decisively acted to end the practice. They sharply expanded the definition of impermissible "coercion" and made clear they would enjoin any tender offer that distorted minority shareholders' decision whether to tender.[98]

[95] DEL. CODE ANN. tit. 8, § 253 (2019).
[96] In *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 246 (Del. 2001), the Delaware Supreme Court made clear that short-form mergers would be upheld in the absence of egregious misbehavior. For criticism of the divergent treatment (at that time) of the two approaches to freeze-outs, see Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 20-21 (2005).
[97] Threatening to subsequently freeze out, at a lower price, any shareholder who did not tender, or to delist any stock that was not tendered, would be especially effective but probably deemed coercive even under a narrower definition of coercion. But simply remaining mum about what would happen to nontendering shares would not be coercive under the traditional definition and would still create pressure to tender because shareholders might fear adverse consequences, such as eventual delisting.
[98] *In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421 (Del. Ch. 2002). In the *Pure Resources* case, then-Vice Chancellor Leo Strine announced that a controlling shareholder's tender offer would be enjoined as coercive unless it satisfied three requirements. The controlling shareholder must (1) include a nonwaivable condition promising not to go through with the tender offer unless a majority of the minority shareholders tender their shares; (2) commit to a prompt short-form merger at the same price as the tender offer if it obtains more than 90% of the shares; and (3) refrain from any threats to shareholders who do not tender. *Id.* at 445.

Why have bankruptcy judges responded so differently? To answer this question, I begin by considering the structure of bankruptcy law itself, which leads to a surprising discovery: the Chapter 11 vote was never intended to be truly neutral. This structural feature of Chapter 11, along with several other features of the new distortive techniques, suggests that the techniques are not always pernicious, or so I argue in Section II.B.

A) The Baseline is Not Neutral

If the Chapter 11 vote were an ordinary vote, the new distortive techniques would be deeply problematic. Deathtraps and RSAs are designed to distort the vote by nudging, and in some cases, coercing the parties to support the plan. This is precisely what we try to prevent in ordinary voting processes.

But if we take a closer look at the structure of Chapter 11, it turns out the Chapter 11 vote is not designed to be an ordinary vote. The baseline is not neutral. To the contrary, Chapter 11 is subtly biased toward confirmation of a reorganization plan at each stage of the case. This does not mean that most cases will result in confirmed reorganization plans, of course. But the baseline is tilted toward confirmation, which puts the new distortive techniques in a very different light.

Start with the beginning of a case. When a debtor files for bankruptcy, it is nearly impossible for creditors to reverse the filing and restore the status quo. Although creditors sometimes do challenge the filing, arguing that the debtor has entered bankruptcy in bad faith, these objections usually fail.[99] Absent an admission by the debtor's managers that the company really does not need to be in bankruptcy, the debtor is permitted to remain in bankruptcy, even if it appears to be solvent when the bankruptcy petition is

[99] For a discussion of the early case law, see Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 924-27, 933-37 (1991).

filed.[100] Unlike with mergers or other fundamental corporate transactions, which can be stopped if shareholders vote "no," neither shareholders nor creditors have an opportunity to thwart a bankruptcy filing.

Once the debtor has entered bankruptcy, the process moves toward a vote that is implicitly coercive. Even if the debtor proposes a traditional reorganization plan, the proposed payout to a particular class may be backed by an implicit threat to cram down the class involuntarily if it votes "no." This threat is particularly potent with lower-priority creditors and shareholders, since they risk receiving nothing in a cramdown if the debtor is deeply insolvent. So if the plan offers to give shareholders warrants to purchase stock in the newly reorganized company, for instance, shareholders know that the debtor may simply ask the court to approve a cramdown plan that cuts them off altogether if they vote "no."

A traditional plan also carries the implicit threat that if creditors vote "no" the debtor will convert the case to Chapter 7, and the company will be liquidated.[101] In a piecemeal liquidation, creditors may receive considerably less than if the company is reorganized or sold through a going-concern sale.

To be sure, creditors—especially creditors on whom the debtor depends—are not helpless against these features of Chapter 11. The debtor-in-possession financer may insist that the debtor sell its assets in a bankruptcy sale rather than going through a full-blown Chapter 11 reorganization.[102] Creditors also may give the debtor's managers performance-based compensation to incentivize a prompt, effective reorganization.[103] But the Chapter 11 process itself is coercive.

Thus far, I have focused on Chapter 11's bias toward confirming a reorganization plan, without attempting to explain *why* Chapter 11 has this

100 SGL Carbon was the rare exception. The company issued a press release proclaiming that it was "financially healthy" and had filed for bankruptcy solely to resolve "excessive . . . demands" by the plaintiffs in antitrust litigation. *In re* SGL Carbon Corp., 200 F.3d 154, 157 (3d Cir. 1999). The Third Circuit held that "filing . . . merely to obtain tactical litigation advantages" did not constitute good faith. *Id.* at 165.
101 *See* 11 U.S.C. § 1112(a) (2018) (giving the debtor broad discretion to convert a Chapter 11 case to Chapter 7).
102 *See, e.g.*, Skeel, *supra* note 73, at 926 n.34 (describing the FAO Schwartz and United Airlines bankruptcies).
103 *Id.* at 926-28.

bias. Historically, lawmakers (prodded by restructuring professionals) were concerned about holdout creditors interfering with a beneficial restructuring;[104] this was the rationale for including a vote that would bind objecting creditors. Further, the legislative history of the current Bankruptcy Code indicates that Congress believed reorganization is often preferable to liquidation, because it better preserves value for creditors and jobs for employees.[105] In my view, the nudge toward confirmation is defensible on normative grounds,[106] in addition to being consistent both with the structure of Chapter 11 and with lawmakers' intent.

B) <u>The Case for Permitting (Some) Distortion</u>

Bankruptcy's non-neutral baseline seems to be a key reason for bankruptcy judges' willingness to allow the distortive techniques. At the outset, however, some were skeptical. In *Allegheny International*, for instance, the court declined to enforce a provision in the reorganization plan providing that if any class of shareholders voted "no," it and any lower-priority class of shareholders would not receive any recovery.[107] "[T]here is no authority in the Bankruptcy Code," the court concluded, "for discriminating against classes who vote against a plan of reorganization."[108] Two years later, another bankruptcy court—in what seems to be the first case to use the term "deathtrap"—rejected a somewhat similar provision that would have denied any recovery to three classes of shareholders if the first

104 *See, e.g.*, Lloyd K. Garrison, *Corporate Reorganization Under the Federal Bankruptcy Power*, 19 VA. L. REV. 317, 317-18 (1933) (advocating for codification of large-scale corporate reorganization).

105 *See, e.g.*, H.R. REP. NO. 95-595, at 220 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 ("The purpose of a business reorganization case . . . is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.").

106 One caveat: I would define the objective as achieving an efficient resolution of financial distress, rather than treating reorganization as inherently good in itself, as some of the legislative history does. The bias toward confirmation seems fully compatible with efficient resolution, in part because it counteracts strategic behavior.

107 *In re* Allegheny Int'l, Inc., 118 B.R. 282, 304 n.15 (Bankr. W.D. Pa. 1990).

108 *Id.*

shareholder class voted against the plan.[109] The court concluded that this provision "results in the plan[] not being fair and equitable."[110]

By the end of the decade, a Delaware bankruptcy judge found nothing problematic about a provision promising new debentures to a class of bondholders if they voted in favor of the plan, but no recovery if they rejected it. Using almost identical language as the earlier cases, but inserting the word "no," the court said:

> There is *no* prohibition in the Code against a Plan proponent offering different treatment to a class depending on whether it votes to accept or reject the Plan. One justification for such disparate treatment is that, if the class accepts, the Plan proponent is saved the expense and uncertainty of a cramdown fight.[111]

Put another way: since the deathtrap plan was simply incorporating the effect of a possible cramdown into a consensual plan, it was no more coercive than a Chapter 11 cramdown already is and should not be seen as problematic.

Although this logic may justify a traditional deathtrap provision, it does not explain courts' willingness to permit other distortive techniques, such as signing-fee RSAs or individually targeted deathtraps. Several leading bankruptcy scholars have in fact essentially proposed that signing-fee RSAs be banned.[112] But the nature of current bankruptcy practice and of the distortive techniques themselves suggests the need for a more nuanced approach even to these techniques.

First, given the dramatic change in bankruptcy practice discussed earlier, the new distortive techniques can be seen as restoring the balance—with its tilt toward confirmation—contemplated in the structure of the Bankruptcy Code. RSAs make a speedy reorganization more feasible and counteract the

[109] *In re* MCorp Fin., Inc., 137 B.R. 219, 236 (Bankr. S.D. Tex. 1992).
[110] *Id.* In the Drexel Burnham bankruptcy, by contrast, the court upheld a plan provision that offered warrants to classes that accepted the plan but nothing if they rejected. *In re* Drexel Burnham Lambert Grp., Inc., 140 B.R. 347, 350 (Bankr. S.D.N.Y. 1992).
[111] *In re* Zenith Elecs. Corp., 241 B.R. 92, 105 (Bankr. D. Del. 1999) (emphasis added) (citation omitted).
[112] According to these scholars, payments to signatories should be viewed as a "badge of opportunism." Janger & Levitin, *supra* note 16, at 169.

destabilizing effect of claims trading on the creditor base. If RSA fees are often used to co-opt problematic holdouts,[113] they may at least sometimes be defensible, even if mildly offensive, for much the same reason as vote buying is sometimes permitted in corporate law.[114] The same logic also applies to deathtrap provisions.[115]

Second, Chapter 11 is not designed to pick a single, most-favored result, as votes in many other contexts are. The vote in a large case consists of numerous different votes, one for each class of creditors or shareholders. Rather than selecting a single optimal outcome, the votes are designed as a check on the larger renegotiation process.[116]

Third, creditors in a Chapter 11 case are not as vulnerable to prisoners' dilemma concerns as shareholders deciding how to respond to a tender offer outside of bankruptcy. The creditors are much less widely scattered. The bond debt of a publicly held company tends to be much more concentrated than stock, and first and second liens generally are concentrated as well.[117] Even if creditors were widely scattered, unsecured creditors are represented by a creditors' committee after the Chapter 11 case is filed.[118] As a result, creditors can more easily coordinate than shareholders confronted with a coercive tender offer—or the prisoners in a prisoners' dilemma game.

Fourth, the creditors who negotiate an RSA may incur very real costs that are not borne by creditors who are not involved in the negotiations. The principal costs are the fees of a signatory's bankruptcy lawyers and financial advisors. There may also be other costs, such as the cost of forgoing trading while the parties are negotiating the terms of the RSA and being subject to

113 Ironically, the same voting rules that were originally put in place to discipline holdouts now invite holdouts, due to how high they are set.

114 *See* Schreiber v. Carney, 447 A.2d 17, 22-26 (Del. Ch. 1982) (approving vote buying when the transaction was approved by shareholders).

115 Notice also that, unlike with a tender offer, investors who decline the proposed treatment in the context of a deathtrap with differential consideration will not retain their existing interest in the company. Their interest, like the interest of investors who vote "yes," will be transformed.

116 Consider, by way of contrast, the vote on a merger or other fundamental transaction in corporate law. These votes often have an up-or-down quality similar to that of votes in other contexts.

117 *See generally* Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 Nw. U. L. REV. 565, 584 (1994) (noting the high concentration of bond holdings).

118 *See* 11 U.S.C. § 1102(a) (2018) (requiring the United States Trustee to appoint a committee of creditors holding unsecured claims).

nondisclosure obligations. An RSA fee may compensate these creditors for some of their costs, and in doing so reduces the extent to which other creditors can free ride on the negotiations of signatories to the agreement.

Finally, we also need to consider how the parties would respond if all voting distortions were banned. One obvious possibility is that some distressed debtors that might otherwise reorganize under Chapter 11 would now be unable to do so, and would be forced to resolve their distress through a sale of assets instead.[119] To be sure, asset sales are sometimes an effective solution to a debtor's financial distress.[120] But there is less democracy in an asset sale, not more, since debtors' creditors and shareholders do not have any vote at all in an asset sale.[121] And a ban on distortive techniques could lead to more sales in cases where sales are inefficient, and the traditional Chapter 11 process would produce a superior result.[122]

It might be possible to achieve some of the benefits of the new distortive techniques while limiting their distortion of the voting process. Under existing law, bankruptcy courts can award compensation to a creditor that makes a "substantial contribution in a case."[123] Courts could use this provision to reward creditors who perform the public good of negotiating a reorganization plan, while banning RSA fees. The problem with this approach is that it replicates only some of the benefits of the distortive technique. Perhaps most importantly, it would remove the debtor's ability to use RSA fees to counteract the threat of holdouts.

I do not mean to suggest there is no reason for concern about the new distortive techniques. There is. But the potential benefits of counteracting

[119] Sales of assets have been a common alternative to the traditional Chapter 11 process in the past several decades. *See* Baird & Rasmussen, *supra* note 2476, at 675 & n.6 (discussing the rise of sales).

[120] *See, e.g.*, Meier & Servaes, *supra* note 38, at 4231 (finding that the welfare loss of sales is lower than is often thought).

[121] The provision governing asset sales is 11 U.S.C. § 363(b) (2018), which requires only that the court authorize the sale after notice and a hearing. For discussion of the additional safeguards courts tend to apply, see Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 739-41 (2010).

[122] The classic context in which traditional Chapter 11 may be superior to a sale is where the highest-valuing potential purchasers are themselves financially distressed. *See* Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343, 1344 (1992).

[123] 11 U.S.C. § 503(b)(3)(D) (2018).

holdout problems and reducing free-riding, as well as creditors' ability to coordinate, suggest that distortive techniques should be scrutinized in a more nuanced fashion, not simply disallowed.

An analogy to corporate law may once again be helpful. Courts were initially quite skeptical of corporate voting agreements, often striking them down for interfering with directorial functions or on other grounds.[124] As courts recognized the potential benefits of voting arrangements, which are loosely analogous to those of RSAs, the hostility to these arrangements began to dissipate. Courts adopted a more nuanced approach, enforcing most voting agreements in close corporations but striking down agreements that appear to be pernicious.[125]

III. Rules of Thumb for the New Distortive Techniques

I have argued thus far that the distortions in current bankruptcy practice can be problematic but sometimes serve a valuable function. It would therefore be a mistake to simply outlaw the distortions altogether.

How should bankruptcy judges determine which distortive techniques to permit? The current approach has a "know it when I see it" quality: the courts have approved most deathtraps and RSAs but occasionally strike one down if it seems excessive. In this Part, I outline four rules of thumb that might provide additional structure to courts' analysis. I conclude by considering whether creditors should be permitted to change their votes when their vote was shaped by distortive techniques.

A) <u>Are Holdouts Present (or Likely)?</u>

[124] *See, e.g.*, McQuade v. Stoneham, 189 N.E. 234, 237 (N.Y. 1934) (striking down the voting agreement because it would interfere with directors' oversight role).
[125] *See, e.g.*, Galler v. Galler, 203 N.E.2d 577, 587 (Ill. 1964) (upholding shareholder agreement); Zion v. Kurtz, 405 N.E.2d 681, 684 (N.Y. 1980) (same). *But see* Puro v. Puro, 393 N.Y.S.2d 633, 637 (N.Y. Sup. Court 1976) (specifically declining to enforce provision requiring appointment of a particular person as director where the person had committed misconduct). For an extensive survey of cases, see 1 AM. BAR ASS'N, MODEL BUSINESS CORPORATION ACT ANNOTATED 7-254 to -261 (4th ed. 2008).

We tend to assume that coercion is pernicious and should always be rooted out. But coercion can sometimes be beneficial.[126] The prisoner's dilemma itself is perhaps the best illustration. Few would argue that the threat of a higher prison sentence if a criminal defendant declines to confess, as in the prisoner's dilemma, should be prohibited.[127] The Bankruptcy Code veers into somewhat similar terrain by including liquidation and cramdown options, each of which nudges the parties toward approval of a proposed reorganization plan.

Each of bankruptcy's new distortive techniques can sometimes be justified in these terms. As we have seen, an RSA streamlines the reorganization process and reduces the risk that initial support for a plan will dissolve as potentially supportive creditors sell their claims to buyers who may view the claims differently. An RSA also may discourage problematic holdout behavior, especially if it gives a support fee to signatories. Deathtraps can also serve beneficial functions by helping counteract holdout behavior. Traditional deathtraps are essentially a simplified form of cramdown.

The potential for distortive techniques to counteract potential problems suggests an initial rule of thumb: courts should ask whether the distortion is in fact playing this role—whether it counteracts a potential threat to the reorganization process.[128] To be sure, bankruptcy judges already have the option of disqualifying votes cast in bad faith. If a creditor's behavior is clearly designed to obstruct the reorganization process, a judge can invalidate its vote.[129] But this is a blunt tool. Holdout creditors often do not telegraph their intention to torpedo the process, and the line between aggressive bargaining and destructively holding out is fuzzy. A distortive technique is a less draconian response to holdout behavior.

126 For a classic analysis of the complexities of coercion and the importance of the baseline from which it is assessed, see Peter Westen, *"Freedom" and "Coercion"—Virtue Words and Vice Words*, 1985 DUKE L.J. 541 (1985).
127 I borrow this example from an excellent article by Susan Kuo and Benjamin Means. Susan S. Kuo & Benjamin Means, *Collective Coercion*, 57 B.C. L. REV. 1599, 1603-04, 1604 n.18 (2016).
128 My use of the term "threat" is not altogether coincidental. It echoes a key feature of Delaware's takeover jurisprudence. *See* Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946 (Del. 1985).
129 *See* 11 U.S.C. § 1126(e) (2018) (authorizing courts to "designate" votes not cast in good faith).

In some cases, there may be an identifiable, strategically minded holdout creditor. The *Momentive* senior lenders, whom the bankruptcy judge described as using their intercreditor agreement as "a sword to enable the [lenders] to work around the Bankruptcy Code," may be an example.[130] An RSA or a deathtrap provision can be justified as a means of diminishing such creditors' incentive to hold out.

Suppose no identifiable holdout creditor has emerged. How might a court gauge the likelihood of a threat to the reorganization process? One obvious proxy for the threat of holdout behavior is a liquid claims-trading market for the company's debt. If claims are actively traded, distressed-debt traders can easily take a blocking position in any given class of debt. Courts should be open to distortive techniques in this context.

If there is no identifiable holdout creditor and claims are not actively traded, by contrast, distortive techniques are less justified. This will often be the case with small or mid-sized debtors, for instance, or with large debtors if the bankruptcy judge has imposed a freeze on claims trading. If a particular class of claims is not actively traded, this also may weigh against permitting distortive techniques, even if there is a vibrant market for claims of other classes.

Beyond looking for identifiable holdout creditors and actively traded claims markets, courts should also consider a creditor's holdings in other classes. In many large cases, some creditors hold claims in multiple classes, and these crossholdings can increase a creditor's incentive to hold out. A creditor that has a substantial claim against one subsidiary might implicitly threaten to thwart the reorganization of the parent unless the subsidiary claim is given disproportionately favorable treatment. The debtor might also be justified in using a deathtrap or RSA to counter this holdout threat.

In most large corporate bankruptcies, the risk of problematic holdout behavior will be significant. But if holdouts are unlikely to be a major concern, the court should police distortive techniques much more aggressively.

B) <u>How Coercive Is the Distortive Technique?</u>

[130] *In re* MPM Silicones, L.L.C., 596 B.R. 416, 449 (S.D.N.Y. 2019).

The extent of the holdout risk needs to be considered jointly with a second factor, the coerciveness of the distortive technique.[131] If the holdout risk is severe, a more coercive technique may be justified; if not, it is not.[132]

The simplest RSAs and traditional deathtraps are at the weak end of the coercion spectrum. An RSA that does not include a signing bonus or other inducement, as with the ResCap PSA discussed earlier, commits signatories to supporting a reorganization plan that accords with the terms of the RSA. To be sure, this commitment is mildly coercive, but it is justified by the need to ensure that subsequent claims trading does not undermine the deal that has been put in place.[133]

Traditional deathtraps are analogous to a simple RSA. In a traditional deathtrap, all of the creditors (or shareholders) in the class receive a payout if the class votes "yes," and all of them receive nothing if they vote "no." A traditional deathtrap is coercive, but only weakly so. From the perspective of the creditors in the class, it is an assurance game rather than a prisoner's dilemma.[134] If the payout is too low, the class can reject it. To be sure, the class does run the risk of receiving nothing if it votes "no," but this simply reflects the structure of Chapter 11—the baseline is not neutral, as we have seen. The coerciveness of a simple RSA or traditional deathtrap is limited. Each should be permitted unless there is little or no risk of holdouts.

A signing-fee RSA is more coercive. Because joiners receive different—and higher—overall consideration than those who do not join, there is greater pressure for creditors to join, akin to a structurally coercive tender

131 Oscar Couwenberg and Stephen Lubben also have noted the possibility of coercion with RSAs. Oscar Couwenberg & Stephen J. Lubben, *Private Benefits Without Control? Modern Chapter 11 and the Market for Corporate Control*, 13 BROOK. J. CORP. FIN. & COM. L. 145, 166 (2018).

132 The first two rules of thumb are somewhat similar to the two prongs of the *Unocal* test in corporate law, which applies when the directors of a target corporation use defensive measures. *Unocal*, 493 A.2d at 953.

133 Moreover, it is not clear that most RSAs are truly binding. At least one top bankruptcy lawyer almost never seeks court approval of the RSA in his cases, based on his view that the parties generally honor RSAs but would not be legally bound if they withdrew from the RSA based on changed circumstances. Interview with James Sprayregen, *supra* note 80.

134 Kuo & Means, *supra* note 127127, at 1614-15. In an assurance game, "all players can win by cooperating" and assuring each other that they will play the riskier and mutually preferred strategy. *Id.* at 1615; *see also* Richard H. McAdams, *Beyond the Prisoners' Dilemma: Coordination, Game Theory, and Law*, 82 S. CAL. L. REV. 209, 220-22 (2009) (providing an illustration of an assurance game).

offer in corporate law.[135] The inclusion of a fee alters creditors' entitlements, since it means they will get one payout if they sign the RSA (their pro-rata recovery plus the fee) and another if they do not (just their pro-rata recovery). As a result, even a creditor who believes the payout proposed by the RSA is too low may feel pressured to join, lest she be left with the worst possible outcome—enough of her fellow creditors join the RSA to provide a vote in favor of the proposed reorganization plan, and she doesn't get the RSA fee.[136]

Some RSAs add procedural coercion to the entitlement coercion created by a fee. These exploding RSAs may require creditors to join quickly, for instance—say, within two weeks—or encourage creditors to join early by promising interim payments that begin as soon as the creditor joins.[137] An RSA that couples a fee with a short joinder period calls to mind the old Saturday Night Special tender offers that gave shareholders very little time to decide whether to tender their shares and were made available on a first-come, first-served basis.[138] Saturday Night Specials were banned a few years after they emerged.[139]

135 In a structurally coercive tender offer, the bidder tenders for some or all of the shares of a target corporation and signals that shareholders who do not tender will be subject to a freeze-out at a lower price or will find their shares devalued in other ways. This can give shareholders an incentive to tender even if they believe the offer is inadequate, since they fear the even worse treatment they will receive if enough of their fellow shareholders tender into the offer and the bidder ends up with control. Delaware signaled its disapproval of structurally coercive tender offers in *Unocal*, 493 A.2d at 956, and blatant two-tier tender offers largely disappeared thereafter. *See also In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 445-47 (Del. Ch. 2002) (making clear that more subtle variations on the strategy—such as manipulating the majority of the minority requirement—also will be treated as improperly coercive).

136 Fees that are available only to a limited subgroup of creditors also may give a windfall to these creditors. *See infra* Section IV(C)(2)(discussing the *Peabody Energy* case).

137 The Peabody Energy RSA is an example of the former and the PREPA RSA of the latter. They are discussed *infra* Sections IV.C.2 and IV.A, respectively.

138 A bidder might make a tender offer for 50% of the shares, for instance, and end the offer as soon as 50% of shares had been tendered, excluding shareholders who tendered later.

139 The Williams Act of 1968 outlawed Saturday Night Specials by requiring that tender offers treat late joiners the same as early joiners. Williams Act, Pub. L. No. 90-439, § 3(d)(7), 82 Stat. 454, 457 (1968) (codified as amended in scattered sections of 15 U.S.C.).

RSAs can create another form of procedural coercion as well—they can cut off other parties and the court's access to information. If the RSA forbids signatories from criticizing the reorganization plan, it could silence a potentially important source of information—especially if the signatories are sophisticated parties and nonsignatories less so.[140] The court should consider the informational impact when assessing the coerciveness of an RSA.

As with RSAs, deathtrap provisions can take more coercive forms. Under the plan of adjustment initially proposed for Puerto Rico, for instance, bondholders whose debt had been challenged as unconstitutional were given a choice either to accept a 35% payout or reject the payout and litigate the constitutionality of their debt, with the prospect of receiving a higher payout if they succeeded and nothing if they lost.[141] Rather than all receiving the same consideration, the creditors who accepted the payout would receive different consideration than those who rejected it.[142]

The larger the fee or differential compensation is in relation to the amount of a creditor's claim, the more coercive it will be. Suppose a creditor has a $100 claim, the total amount of claims in the creditor's class is $1000, and the creditor believes that $600 for the class (thus, $60 for her claim) would be an appropriate recovery: she would vote "yes" if the reorganization plan offered her class at least $600, "no" if it offered less. If the debtor were negotiating an RSA that offered $400 to the class and a 2.5% fee to each creditor who signed the RSA, the 2.5% fee would not be especially coercive. The creditor would receive less than other creditors in her class if she declined to sign and the plan eventually was approved, but the difference

The SEC promulgated regulations under the Williams Act that required tender offers be held open for at least 20 days. 17 C.F.R. § 240.14e-1 (2019). For an overview of the Williams Act changes, see, for example, Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1254-60 (1973).

140 For discussion of this concern with RSAs, see Baird, *supra* note 16, at 617-19, which concludes that the silencing was not problematic in the cases under discussion.

141 *See* Title III Joint Plan of Adjustment of the Commonwealth of Puerto Rico, et al. at 3-4, *In re* Fin. Oversight Mgmt. Bd., No. 17-BK-3283-LTS (D.P.R. Sept. 27, 2019) (defining "2014 CW Bond Settlement" and "2014 Settling CW Bond Distribution").

142 Although individually targeted deathtraps may seem to directly violate Chapter 11, they actually do not. Chapter 11 requires that every member of a class of creditors be given the same consideration. 11 U.S.C. § 1123(a)(4) (2018). But the stricture is waived if a creditor agrees to the divergent consideration. *Id.* If the individually targeted deathtrap gives creditors a choice, it technically satisfies this requirement.

would not be substantial.[143] If the RSA offered $400 and a 15% fee, by contrast, the RSA would be much more coercive. Although the creditor's potential recovery ($55) would less than she considers fair, if she voted "no" and a sufficiently high majority of her fellow creditors voted "yes," she would be stuck with a far inferior recovery ($40). Faced with this prospect, she might sign the RSA, despite believing that the offer is inadequate. Notice that the fee would be even more coercive if the debtor structured it as a fixed total amount ($150) rather than a percentage, since signatories would receive amounts not claimed by other creditors in the class.[144]

Deathtraps can create the same issues of entitlement coercion as RSA fees.[145] The larger the difference in compensation is in comparison to the size of a creditor's claim, the more coercive the deathtrap will be. And if compensation is structured as a pool of compensation, rather than a fixed amount for each creditor that votes "yes," the coercion increases.

In each context, the fee will be more coercive if the signing protocol also includes procedural coercion. An exploding RSA will be more coercive than an RSA that does not favor early joiners or provides only a brief opportunity to join.

C) The Presence of Independent Justifications

The third factor that sometimes comes into play is the presence of independent justifications for the distortive technique. If the RSA or deathtrap responds to the risk of problematic holdouts and is not coercive, the court may not need to consider the third rule of thumb. But in borderline

143 Assuming the plan was approved, the creditor would receive $42.50 ($40 plus a $2.50 fee) if she voted "yes" and $40 if she voted "no."

144 Suppose, for instance, that if the creditor joins the RSA, the RSA will have 80% ($800) of support in the class. These $800 of creditors would share the $150 pool, which means that the creditor would receive an $18.50 fee ($100/$800 x $150) on account of her $100 claim, rather than the $15 she would receive if the fee were 15%. In this case, creditor would receive $58.50 if she joined the RSA, and $40 if she did not, if the plan were ultimately approved.

145 Procedural coercion is less often an issue with deathtraps because bankruptcy law regulates the voting process. Bankruptcy procedure rules require that creditors be given at least twenty-eight days' notice of the disclosure statement hearing, FED. R. BANKR. P. 3017(a), and bankruptcy courts generally give them several weeks to vote after the disclosure statement and ballots have been distributed.

cases, the presence or absence of independent justifications can be quite important.

The creditors who negotiate the terms of an RSA—and thus the terms of a potential reorganization plan—provide a public good, since reorganization may be valuable for everyone, and they also forgo the opportunity to trade during the negotiations. The drafters of the Bankruptcy Code assumed the creditors' committee would play this role, rather than individual creditors.[146] But in current cases, the creditors' committee often is not the principal locus of negotiations, because, among other reasons, distressed-debt funds may prefer to form their own ad hoc committees, or the "fulcrum" class—the class that will be converted into equity post-reorganization—is a class of lien creditors rather than the general creditors represented by the creditors' committee.[147] If the RSA fee is available to all creditors, even those that did not contribute to the negotiations, the public-good justification is weaker for the later-joining creditors, even though they too bear some costs, such as the obligation to bind any transfers of their claim to the RSA. Moreover, a more inclusive RSA fee reduces the risk that the fee will be used to reward creditors that are in a position to extract private benefits.

Courts' treatment of breakup fees outside of bankruptcy provides useful insight into how these benefits and costs can be incorporated into the analysis. Breakup fees are typically promised by a target corporation as compensation to the bidder if a proposed acquisition fails to go through, either because another bidder emerges or the shareholders of the target reject the acquisition.[148] Outside of bankruptcy, courts generally allow breakup fees in merger transactions if the fee is no more than three to four percent of the

146 *See, e.g.*, David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 525-28 (1992).

147 Indeed, the dynamics of large-scale corporate reorganization have changed so much that a lively debate has emerged as to whether creditors' committees should even be appointed in every case. *See, e.g.*, Christopher S. Sontchi & Bruce Grohsgal, *Should the Appointment of a Committee of Unsecured Creditors' Committee Be Made Optional in Chapter 11?*, 38 AM. BANKR. INST. J. 12 (2019).

148 There is a robust scholarly literature on breakups and other forms of "lockups." For lockups in corporate law, see, for example, John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307 (2000). For lockups in bankruptcy, see, for example, Bruce A. Markell, *The Case Against Breakup Fees in Bankruptcy*, 66 AM. BANKR. L.J. 349 (1992).

overall value of the deal.[149] Courts have not established a single set of guidelines for breakup fees in bankruptcy,[150] but they generally have limited breakup fees to one to three percent of the proposed purchase price.[151] The best justification for permitting breakup fees, rather than disallowing them altogether, is that they compensate the bidder for its costs in the event the transaction collapses. At the same time, breakup fees provide modest protection for the deal favored by the target's directors, who have agreed to permit a change-in-control transaction.[152]

RSA fees loosely resemble breakup fees, but there are several important differences between the two: although RSAs sometimes include breakup fees (structured as a payment in the event the proposed reorganization plan is not confirmed), standard RSA fees are not compensation in the event the deal

149 *E.g.*, *In re* Answers Corp. S'holder Litig., No. 6170-VCN, 2012 WL 1253072, at *8 & n.50 (Del. Ch. Apr. 11, 2012); *In re* Topps Co. S'holder Litig., 926 A.2d 58, 86-87 (Del. Ch. 2007)("[T]here is a significant amount of statistical data to back up a general proposition that fees 'usually' fall in the 3% to 4% range."); *cf.* Brazen v. Bell Atl. Corp., 695 A.2d 43, 49 n.17 (Del. 1997) (presenting Delaware case law on breakup fees).

150 Three different standards for scrutinizing breakup fees have emerged in the bankruptcy courts. Under the most lenient test, the court assesses a debtor's request to agree to a breakup fee under a business-judgment-rule standard. *In re* Integrated Res., Inc. 147 B.R. 650, 657-58 (S.D.N.Y. 1992). A second group of courts considers the "best interest of the estate." *In re* Am. W. Airlines, Inc. 166 B.R. 908, 912-13 (Bankr. D. Ariz. 1994) (endorsing the perspective of Markell, *supra* note 148). Under the strictest approach, followed by courts in the Third Circuit, courts consider whether the breakup fee qualifies as an administrative expense, *In re* O'Brien Envtl. Energy, Inc., 181 F.3d 527, 532-33 (3d Cir. 1999)—that is, whether the fee was "necessary to preserve the value of the estate," *id.* at 535. For further discussion, see generally Monica E. White, Note, *Give Me a Break-Up Fee:* In re Reliant Energy Channelview LP *and the Third Circuit's Improper Rejection of a Bankruptcy Bid Protection Provision*, 48 HOUS. L. REV. 659 (2011), which argues for the business-judgment-rule approach.

151 *See, e.g.*, AgriProcessors, Inc. v. Fokkena (*In re* Tama Beef Packing, Inc.), 321 B.R. 496, 498 (B.A.P. 8th Cir. 2005) (noting that breakup fees are "usually limited to one to four percent of the purchase price"); *In re* Dura Auto. Sys., Inc., No. 06-11202 (KJC), 2007 WL 7728109, at *91 (Bankr. D. Del. Aug. 15, 2007) (noting that past breakup fees approved by the court have generally been between 2% and 3%); 3 COLLIER ON BANKRUPTCY ¶ 363.02[7] (Matthew Bender & Co.16th ed. 2019) (concluding that courts typically limit breakup fees to 3% of the deal value, although they "have approved higher amounts, up to about 5 percent of the consideration, in unusual circumstances").

152 *See, e.g.*, David A. Skeel, Jr., *A Reliance Damages Approach to Corporate Lockups*, 90 NW. U. L. REV. 564 (1996). For an argument that breakup fees should be more tightly constrained, see Coates & Subramanian, *supra* note 148, at 376-77.

fails. The signatories of an RSA receive the fee when the RSA becomes the basis for a successful reorganization. RSA fees also directly affect the vote on a proposed reorganization plan, whereas the effect of a lockup on voting is indirect. Further, RSA fees are designed to address different concerns than breakup fees, such as the risk of holdouts.

Despite these distinctions, the cost to the signatories is nevertheless an appropriate initial yardstick for assessing RSA fees, as with lockups. As noted earlier, the parties who negotiate an RSA are in a sense providing a public good for other creditors.[153] The signatories may incur two other kinds of costs as well. They will be precluded from buying or selling claims during periods of active negotiation, and any purchasers of their existing claims will be constrained by the terms of the RSA. The signatories also waive their right to subsequently object to a reorganization plan that conforms with the requirements of the RSA. It may be possible to quantify some of the costs of committing to the RSA—by tracking changes in the value of claims during the period of the negotiations, for instance. But even if the less tangible costs cannot be quantified, they should be taken into account when a court determines whether and to what extent to approve an RSA fee.

Other independent justifications can be analyzed in somewhat analogous terms. If a proposed reorganization plan includes a differential deathtrap that requires creditors who vote "yes" to agree to waive potential causes of action against third parties, for instance, the court should assess the value of the third-party release. If the parties to an RSA agree to participate in a rights offering and commit to backstopping that offering (i.e., purchase any unsold shares), the court should consider the value of this backstopping benefit.

A similar logic applies with independent justifications that do not directly benefit the debtor. The signatories to the PREPA RSA, for instance, were promised interest payments that effectively functioned as a settlement of the signatory bondholders' claim to post-petition interest. The threshold question here, as with waivers or a rights offering, is the reasonableness of the payments.

If independent justifications are present, a signing fee or differential compensation may be justified even if it makes the RSA or deathtrap

153 *See supra* text accompanying note 146. Note that this role is somewhat analogous to serving on a creditors' committee. There, attorneys' fees are paid but the creditors' opportunity costs are not compensated.

marginally more coercive than the risk of holdout behavior appears to warrant. If a fee or compensation is greater than the benefit provided, however, or if its effect is highly coercive, it should not be permitted.

D) Is the Hold-Out Risk Created by Contract?

The discussion thus far has assumed that the parties' contract does not purport to impose limitations on restructuring that are intended to apply in bankruptcy; these limitations may be in the form of provisions such as a supermajority voting rule or unanimity requirement. If the contract does impose such restrictions, a fourth rule of thumb comes into play: unless there is a good reason not to honor efforts to contract around the bankruptcy's voting rules, courts should view distortive techniques more skeptically, even if the prospect of holdouts is high.[154]

The logic for this rule of thumb, which may initially seem counterintuitive, comes from an important literature on contract renegotiation. In structuring an initial contract, the parties face a choice whether to make renegotiation easy or difficult. Renegotiation is more likely to succeed, for instance, if the contract requires only a simple majority vote than if every creditor must agree.[155] Each approach has key costs and benefits. While easily renegotiated contracts can be beneficial ex post, as they facilitate a restructuring if the debtor's fortunes deteriorate, they may create suboptimal incentives ex ante. Renegotiation-proof contracts, by contrast, can interfere with a restructuring that makes sense ex post but may create better incentives ex ante.

Although the voting rules in the Bankruptcy Code are mandatory, the debtor or its creditors occasionally attempt to alter them by contract,.[156] Loan syndicates are a good illustration how parties might attempt to contract around the voting rules. The terms of loan syndicates usually preclude

154 For an argument that bankruptcy judges tend to be too hostile to ex ante contracts, see David A. Skeel, Jr. & George Triantis, *Bankruptcy's Uneasy Shift to a Contract Paradigm*, 166 U. PA. L. REV. 1777, 1806, 1808-11 (2018). For a discussion of externalities as a legitimate concern, see *id.* at 1811-12.
155 *See, e.g.*, Patrick Bolton & David S. Scharfstein, *Optimal Debt Structure and the Number of Creditors*, 104 J. POL. ECON. 1, 3 (1996) (arguing that borrowing from multiple creditors discourages the borrower from defaulting and renegotiating).
156 *See, e.g.*, Bank of Am., Nat'l Ass'n v. N. LaSalle St. Ltd. P'ship (In re 203 N. LaSalle St. P'ship), 246 B.R. 325, 331-32 (Bankr. N.D. Ill. 2000) (refusing to enforce assignment of voting rights from junior to senior creditors).

renegotiation of the loan unless every lender agrees, or provide for other, carefully tailored internal voting arrangements.[157] Because each participant has its own claim, syndicates are subject to the ordinary Chapter 11 voting rules if the debtor files for bankruptcy.[158] But a syndicate can also be structured as a single claim representing the entire syndicate, which would be voted in Chapter 11 pursuant to the syndicate's voting rules. In my view, courts should honor such arrangements absent clear evidence they impose externalities on other parties. At the very least, courts should be more skeptical of distortive techniques if the parties' contract reflects a decision to make renegotiation difficult.[159]

Because efforts to contract around the bankruptcy voting rules are uncommon, the fourth rule of thumb usually will not come into play in bankruptcy. But this may change. Further, this rule of thumb has important implications outside of bankruptcy, as discussed later.[160]

E) Should Creditors be Permitted to Change their Votes?

A final consideration is whether courts should permit creditors to change their votes on a reorganization plan if confirmation has been facilitated by the new distortive techniques. The bankruptcy rules explicitly contemplate vote changes if a creditor can demonstrate "cause."[161]

Courts have interpreted the "cause" standard quite liberally where a creditor wishes to change a vote that was cast by mistake, or where the

[157] *See, e.g.,* Amir Sufi, *Information Asymmetry and Financing Arrangements: Evidence from Syndicated Loans*, 62 J. FIN. 629, 633 (2007)(finding that "unanimity of all syndicate members is always required to change terms related to principal, interest, maturity, or collateral," whereas other terms are subject to different voting rules). .

[158] *See* 11 U.S.C. § 1126(c) (2018) (defining acceptance by a class as two-thirds in amount and a majority in number voting yes).

[159] Another, more complicated, example is bond indentures. Most corporate bond indentures prohibit the restructuring of a bondholder's principal without her consent. This restriction, which is imposed by the Trust Indenture Act of 1939, Pub. L. No. 76-253, § 316, 53 Stat. 1149, 1172 (1939), was intended to apply outside of bankruptcy but not in bankruptcy. This provision is discussed in Section IV.A and Section V.B, *infra*.

[160] *See* Section V.B, *infra*.

[161] FED. R. BANKR. P. 3018(a) ("For cause shown, the court after notice and hearing may permit a creditor or equity security holder to change or withdraw an acceptance or rejection.").

reorganization plan was modified after the vote.[162] They also have allowed creditors to change a rejection to an acceptance after the debtor negotiated with the creditor to secure acceptance.[163] But courts have refused to permit vote changes by creditors seeking strategic advantage or where there appeared to be an improper motive.[164]

The logic of these cases could easily be extended to the new distortive techniques. If courts routinely permitted creditors to change votes that were subject to distortion, it could undermine the voting process. But in at least two contexts, vote changes may occasionally be appropriate. First, if the creditor would have been entitled to compensation had she signed an RSA or voted "yes," and the RSA or deathtrap is significantly distortive, the court could allow the creditor to change her vote and receive the extra compensation if the class votes to accept the plan.[165] The possibility that a creditor who opposed the plan could later change her vote would at least slightly reduce the consequences of voting "no."

A second context where a vote change may be appropriate is when a creditor has voted "yes," and her class has approved the plan, but the plan can only be approved by cramdown, because at least one other class has

162 *See, e.g.*, *In re* Am. Solar King Corp., 90 B.R. 808, 826-27 (Bankr. W.D. Tex. 1988) (approving a vote change because the plan was modified after the debtor had reached a settlement agreement with the creditor, and no one objected to the change at the relevant hearing). For a succinct overview of the case law, see Charles M. Oellermann & Mark G. Douglas, *Voter's Remorse: Taking Back an Acceptance or Rejection of a Chapter 11 Plan*, JONES DAY PUBL'N (Nov.-Dec. 2014), https://www.jonesday.com/en/insights/2014/12/voters-remorse-taking-back-an-acceptance-or-rejection-of-a-chapter-11-plan [https://perma.cc/22FK-N5BA].

163 *In re* Bourbon Saloon, Inc., No. 11-11518, 2012 WL 899282, at *2 (Bankr. E.D. La. Mar. 14, 2012) (allowing a creditor to change its vote from rejection to acceptance after the debtor negotiated with the creditor in an effort to avoid cramdown).

164 *See, e.g.*, *In re* Mcorp Fin., Inc., 137 B.R. 237, 239 (Bankr. S.D. Tex. 1992) (denying a motion to change a creditor's vote because "the timing of the change [was] highly suspect"—the creditor sought to change his vote on the same day he reached a side agreement with the debtor, which was one day after the debtor realized changing the creditor's vote would turn a rejecting class into an accepting class); *cf. In re* Epic Assocs. V, 62 B.R. 918, 924 (Bankr. E.D. Va. 1986) (ruling that "cause" for vote changing was established by "the brevity of the voting period, and the intricacy of the Second Amended Joint Plan of Reorganization and its supplements").

165 If the benefit would not have been available to the creditor—as, for instance, with an RSA fee that was offered only to creditors that negotiated a plan that the creditor had no involvement in—the vote change should not be permitted.

voted "no."[166] The vote change would only benefit a creditor if enough claims in her class also elected to change their vote to shift the vote of the class from "yes" to "no." But where their vote would make a difference, a vote change would provide creditors the protections given to objecting classes.[167]

Vote changes should only be allowed sparingly. But they are a potentially useful escape valve in cases where the court did not invalidate a significantly distortive RSA or deathtrap.

IV. Applying the Framework: Four Case Studies

In this Part, I turn to the practical task of showing how the rules of thumb might be applied in a particular case. I focus on four widely discussed recent cases. Each involves a distinctive and creative, but not patently pernicious, use of the distortive techniques. The rules-of-thumb analysis reveals that distortive techniques were permissible in *PREPA* and *Momentive*, borderline in *Arch Coal*, and should have been prohibited in *Peabody*.

A) <u>PREPA: A Complex RSA</u>[168]

The restructuring of Puerto Rico's electricity company, PREPA, has featured two different RSAs, one negotiated (but not finalized) before and the other after the enactment of legislation giving Puerto Rico and its public corporations access to a Chapter 11-like restructuring option.[169] Each RSA

166 *See* 11 U.S.C. § 1129(a)(8) (2018) (providing that a reorganization plan can be confirmed consensually only if every class votes "yes").
167 Two key cramdown protections for an objecting class are the prohibition against "unfair discrimination" and the requirement that the absolute-priority rule be satisfied with respect to the class. 11 U.S.C. § 1129(b) (2018). These protections are not available for a class that approves the plan.
168 As disclosed at the outset of this Article, I am on the Puerto Rico oversight board that negotiated and signed the PREPA RSA on behalf of PREPA, and I am actively involved in the case.
169 PROMESA, the 2016 Puerto Rico legislation, includes a set of restructuring provisions drawn from Chapter 11 and from Chapter 9, which governs municipal bankruptcy. *See* Puerto Rico Oversight, Management, and Economic Stability Act, Pub. L. No. 114-187, §§ 301-17, 130 Stat. 549, 577-85 (2016). The restructuring provisions are generally referred to as "Title III," which is where they appear in PROMESA.

centered on PREPA's largest group of creditors—bondholders who hold more than $8 billion of the company's $11 billion debt. The earlier RSA would have paid the bondholders 85% of their claims, but it was eventually rejected by the Oversight Board by a closely divided vote.[170]

Over the next year—starting after the destruction inflicted by Hurricane Maria—the Oversight Board and an ad hoc group of PREPA bondholders re-opened negotiations. The negotiations culminated with a preliminary RSA on July 30, 2018 and a definitive RSA on May 3, 2019.[171] Assured Guaranty, a major insurer of PREPA bonds, joined the RSA during the months between the preliminary and final agreements,[172] and two other bond insurers (Syncora and National) joined after the definitive agreement was signed.[173]

Although the proposed PREPA RSA is quite intricate, its basic terms can be easily stated. Bondholders who joined the RSA would receive new bonds worth a maximum of 77.5% of their claims,[174] as well as three additional benefits. First, the bondholders would be given a waiver and support fee of

170 *See* Andrew G. Biggs, Arthur J. Gonzalez, Ana J. Matosantos & David Skeel, *Privatize Puerto Rico's Power*, WALL ST. J. (June 29, 2017, 6:55 PM ET), https://www.wsj.com/articles/privatize-puerto-ricos-power-1498776904 [https://perma.cc/D8DD-JQJW].

171 Definitive Restructuring Support Agreement, *In re* Fin. Oversight & Mgmt. Bd., No. 17-BK-04780-LTS (D.P.R. Sept. 9, 2019); Preliminary Restructuring Support Agreement, *In re* Fin. Oversight & Mgmt. Bd., No. 17-BK-04780-LTS (D.P.R. Sept. 9, 2019).

172 Definitive Restructuring Support Agreement, *supra* note 171, at 1.

173 Amendment No. 3 to Definitive Restructuring Agreement at 1, *In re* Fin. Oversight & Mgmt. Bd., No. 17-BK-04780-LTS (D.P.R. Sept. 9, 2019). Collectively the bond insurers held roughly $2.3 billion of PREPA's bonds as of September 9, 2019. *See* Conformed Definitive Restructuring Support Agreement Incorporating Amendments Through September 9, 2019 at 2, *In re* Fin. Oversight & Mgmt. Bd., No. 17-BK-04780-LTS (D.P.R. Sept. 9, 2019) (listing amounts held by Assured, Syncora and National) [hereinafter Conformed Definitive RSA].

174 Bondholders would receive two kinds of bonds, an "A bond" that pays 67.5% of their claims, and a "B bond" whose payout ranges from 0 to 10%, depending on the demand for electricity in the next 47 years. Declaration of David Brownstein in Support of Joint Motion of Puerto Rico Electric Power Authority and AAFAF Pursuant to Bankruptcy Code Sections 362, 502, 922, and 928, and Bankruptcy Rules 3012(A)(1) and 9019 for Order Approving Settlements Embodied in the Restructuring Support Agreement at 13, *In re* Fin. Oversight & Mgmt. Bd., No. 17-BK-04780-LTS (D.P.R. Sept. 9, 2019) [hereinafter Declaration of David Brownstein].

1.62% of their claims, as accrued through May 1, 2019.[175] Second, they would receive interest payments at a rate of 5.25%, and these payments varied based on when the bondholder joined the RSA. A bondholder who joined the RSA by May 31, 2019 would receive interest payments starting as of May 1, 2019. For bondholders who joined after May 31, 2019 but by December 1, 2019, the commencement date would be September 1, 2019. Those that joined after December 1, 2019 would not receive interest payments prior to confirmation of a restructuring plan.[176] As a final inducement, signatories also would be reimbursed for the professional fees they incurred in negotiating the RSA, up to a maximum of $25 million.[177]

To assess whether an RSA with these terms should be permitted, start with the first factor, holdouts. Holdouts appear to have been a major concern in the restructuring in two respects. The first is a familiar feature of many current cases, the effect of a vibrant market for distressed debt. The PREPA bonds were actively traded,[178] which created the possibility that strategically minded traders would act as holdouts, perhaps threatening to block any deal that had been tentatively approved by the existing bondholders. The second holdout issue was distinctive to PREPA's creditors. At least one of the bond insurers appeared to be in precarious financial condition. If true, the bond insurer had an incentive to resist any significant write-down of its debt, even if a write-down were economically warranted.[179]

Given the significant holdout concerns, at least some coercion—the second rule of thumb—could be justified. The principal question is whether

[175] *Id.* at 12.
[176] *See* Definitive Restructuring Support Agreement, *supra* note 171, at 3 (defining "Administrative Claim Commencement").
[177] *Id.* at 44.
[178] Andrew Scurria, *Puerto Rico Utility Deal Stumbles, Shaking Muni Investors*, WALL ST. J. (Mar. 2, 2020, 7:10 PM ET), https://www.wsj.com/articles/puerto-rico-utility-deal-stumbles-shaking-muni-investors-11583194215 [https://perma.cc/YN8K-JAJ9] (describing "turnover among Prepa's investors").
[179] *See, e.g,* Moody's Investors Service, *Rating Action: Moody's downgrades MBIA Inc. and National Public Finance Guarantee Corp. (IFS to Baa2); MBIA Insurance Corp. affirmed at Caa1* (Jan. 17, 2018)(attributing downgrade to, among other things, "an increase probability of more severe losses resulting from National's Puerto Rico exposures"), https://www.moodys.com/research/Moodys-downgrades-MBIA-Inc-and-National-Public-Finance-Guarantee-Corp--PR_377693. It is worth noting that all of the bond insurers would have been paid in full under the original RSA.

the entitlement or procedural coercion in the RSA was excessive.[180] By itself, the magnitude of the waiver and support fee—1.62%—seems generous but within the acceptable range. The interest payments raise issues both of process and entitlement. The payments would be quite substantial—more than double the amount of the waiver and support fee—and coercively structured, since first adopters begin receiving the payments earlier. The procedural coercion is significantly mitigated by the fact that the preliminary RSA was signed nine months before the definitive RSA, giving bondholders ample time to decide whether to join. Given the amount of the overall fees, the entitlement coercion is a closer call.

Turning to the third rule of thumb, there were at least three independent justifications for the terms of the RSA. First, the ad hoc group of bondholders provided a public good by negotiating the RSA and forgoing trading for extended periods of time, beginning from even before the Title III petition was filed on behalf of PREPA.[181] These contributions suggest that a generous compensation for costs would be appropriate.

Second, in return for signing the RSA, bondholders relinquished the right to ask for the appointment of a receiver, which bondholders were entitled to request if 25% of the bondholders join the motion. The receiver's task would be to collect what the bondholders were owed, which could easily derail the reorganization effort. The bond insurers had pursued litigation, asking the court to permit the receiver to be appointed. If several of the bond insurers joined the RSA and withdrew from the receiver action, fewer than 25% of the bondholders needed would support the motion, and the receivership threat would be averted.

180 The creditors' committee fiercely opposed approval of the RSA, contending that the RSA "is deeply flawed, and the Government Parties have provided no credible justification for the windfall it will provide to the Supporting Holders." Official Committee of Unsecured Creditors' Objection to Joint Motion of Puerto Rico Electric Power Authority and AAFAF Pursuant to Bankruptcy Code Sections 362, 502, 922 and 928 and Bankruptcy Rules 3012(a)(1) and 9019 for Order Approving Settlements Embodied in Restructuring Support Agreement at 10, *In re* Fin. Oversight & Mgmt. Bd., 361 F. Supp. 3d 203 (D.P.R. 2019) (No. 17-BK-3283).

181 Because $25 million of their attorneys' fees were compensated separately, the incremental value of the public good provided is somewhat less than would otherwise be the case.

Third, the interest payments settled the bondholders' contested claim that they were secured creditors, who were entitled to interest payments on the full amount of their claims for the duration of the restructuring case. Under the RSA, the bondholders would receive interest, but the payments would begin more than a year after the petition was filed, and the payments would be based on the amount of their restructured claim, not their full claim. Given that the RSA fees were on the borderline of being permissible even apart from independent justifications, and there were substantial independent justifications, the RSA seems clearly permissible.

The fourth rule of thumb—the parties' contracts—adds an important wrinkle but does not alter this conclusion. The PREPA bond contracts include a so-called unanimity clause—a provision stating that the principal or interest of a bond cannot be altered unless the individual bondholder consents.[182] Outside of bankruptcy, no bondholder could be bound by a vote of other bondholders to restructure the bonds. If this provision reflected a conscious decision by the parties to make the bonds difficult to restructure in bankruptcy, it would call for much more stringent scrutiny of efforts to discipline holdouts. There is good reason to believe it did not, however. The Trust Indenture Act of 1939 requires that this provision be included in corporate bonds but intends for bond restructurings to take place in bankruptcy, under bankruptcy's majority voting rules.[183] With ordinary corporate bonds, the unanimity requirement is dictated by law and is intended to be overridden in bankruptcy.[184]

There is one final twist. Unlike private entities, public issuers such as PREPA are not subject to the Trust Indenture Act.[185] If the inclusion of the unanimity requirement reflected a conscious decision to discourage renegotiation, a court would need to take this into consideration. But the inclusion of a unanimity requirement may simply reflect a mimicking of the

[182] Section 1102 of the Trust Agreement, under which PREPA issued bonds, permits most amendments if 60% of the bonds agree, but excludes any "extension of the maturity of the principal of or the in[t]erest on any bond" or "a reduction in the principal amount of any bond." *Trust Agreement, Puerto Rico Water Resources Authority to First National City Bank, Trustee*, § 1102, at 88-89 (Jan. 1, 1974).
[183] *See, e.g.*, Bratton & Levitin, *supra* note 31, at 1600.
[184] *See infra* notes 242-243 and accompanying text.
[185] *See, e.g.*, Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1329-30 (2002).

handling of corporate debt.[186] Even if it were more intentional, the same logic would have applied with PREPA debt as with ordinary corporate debt: the debt would be subject to the unanimity requirement outside of bankruptcy, but it could be restructured under the bankruptcy voting provisions if PREPA filed for (municipal) bankruptcy.[187]

The unanimity provision does not alter the earlier conclusion that the PREPA RSA fees are substantial but justifiable. Although the entitlement coercion is significant, the high risk of holdout behavior and the presence of substantial independent justifications suggest that the fees should be permitted.

B) Momentive: A Complex Deathtrap

As discussed earlier, Momentive's deathtrap gave its senior (First and 1.5 Lien Noteholder) creditors a choice. They could either accept the plan, which promised payment in cash in full but required the creditors to waive a $200 million make-whole claim. Or they could reject the plan, assert their make-whole claim, and receive replacement notes plus the cramdown rate of interest.[188] To the extent this provision was intended to nudge the senior creditors into accepting the plan, it didn't work. The senior creditors rejected the plan, choosing to litigate their case for the make-whole claim.

Although it is not clear how actively Momentive's debt was traded, the case was hotly contested throughout, and the principal creditors were

[186] *See, e.g.*, *id.* (noting this possibility).
[187] Puerto Rico had access to municipal bankruptcy when the PREPA indenture was put in place, and thus could have permitted PREPA to file for bankruptcy if needed, but it lost access to municipal bankruptcy when Congress adopted a new definition of "state" in 1984. For the history, see Stephen J. Lubben, *Puerto Rico and the Bankruptcy Clause*, 88 AM. BANKR. L.J. 553, 573-78 (2014). PROMESA created a new bankruptcy-like option in 2016. Puerto Rico Oversight, Management, and Economic Stability Act, Pub. L. No. 114-187, § 301-17 130 Stat. 549, 577-85.
[188] *See supra* Section I.B.

distressed-debt investors who posed a significant risk of holdout.[189] The senior and junior creditors had an elaborate contract—which became a major source of litigation in the case—but the contract did not alter the voting rights each class of creditor had within its class.[190] The first rule of thumb thus suggests that the use of distortive techniques was warranted, and the fourth—the parties' contracts—does not alter this conclusion.

Turning to the second rule of thumb, coercion, there does not appear to have been procedural coercion. The distortion occurred in the Chapter 11 vote itself, and the vote was not rushed or otherwise irregular. Although the potential silencing of the junior creditors was hotly contested,[191] the court ultimately concluded that the deathtrap did not silence any constituency.

The key question is whether the entitlement coercion was excessive. The first point to note is that the senior creditors' rejection of the plan does not negate the possibility the deathtrap was too coercive. The deathtrap left the senior creditors with a difficult decision of choosing between accepting a full payout on a smaller claim, and continuing to insist on receiving an additional make-whole claim but facing the risk of receiving a below-market interest rate on their claim. Indeed, if the senior creditors were clairvoyant, they would have known they should not reject the plan, since their make-whole claim would ultimately be disallowed.[192]

To assess the deathtrap's coerciveness, we need to consider two uncertainties in the rejection payout. A deathtrap based on the first uncertainty—the validity of the make-whole claim—does not seem problematic. Suppose that the plan offered the senior creditors $100 in cash—the amount of their claim—but no make-whole claim if they

189 *Cf.* Nick Brown, *Momentive's $570 Mln Bankruptcy Loan Package Approved by Judge*, REUTERS (May 23, 2014, 1:05 PM), https://www.reuters.com/article/momentive-bankruptcy/momentives-570-mln-bankruptcy-loan-package-approved-by-judge-idUSL1N0O913C20140523 [https://perma.cc/XCE7-E6BA] (mentioning the involvement of Aurelius Capital Management and Apollo Global Management). For discussion of the principal disputes in the case, see Kenneth Ayotte, Anthony J. Casey & David A. Skeel, Jr., *Bankruptcy on the Side*, 112 NW. U.L. REV. 255, 268-69 (2017).

190 *Id.* at 295-97 (describing voting in the case).

191 *Id.* at 269 (describing the court's conclusion the intercreditor agreement did not preclude the junior creditors from objecting).

192 Absent clairvoyance, whether the provision was coercive would depend in part on the senior creditors' ex ante probability of success on their make-whole claim.

accepted, and $75 in cash and the right to litigate a $50 make-whole claim if they rejected the plan. This deathtrap postpones potentially time-consuming make-whole litigation until after confirmation of a plan, thus enabling an earlier confirmation, and it may reflect the debtor's legitimately lower assessment of the likelihood that the senior creditors will succeed. Any coercive effect seems limited, and justified by the risk of holdouts.

In *Momentive* itself, there was a second uncertainty—the possibility the senior creditors would be given a below-market interest rate on their claim. To illustrate the effects of this uncertainty, suppose the debtor proposes to give the senior creditors $75 not in cash but in a promissory note bearing a below-market interest rate; this depressed rate makes the note worth less than $75. The threat of a below-market interest rate increases the debtor's leverage in the restructuring process. But it is not a tool of the debtor's own devising. The possibility of a below-market interest rate is the legacy of a problematic Supreme Court decision.[193] Even without considering the third rule of thumb, independent justifications,[194] the deathtrap was therefore defensible. On the fourth rule of thumb, the parties' intercreditor agreement did not include voting rules purporting to alter the bankruptcy voting rules.[195]

Although the bankruptcy judge felt compelled to confirm a below-market interest rate, the Second Circuit reversed on this one point, instructing the bankruptcy court to take the market rate into account.[196] If this ruling is generally followed, it will remove debtor's ability to wield the prospect of a below-market interest rate over creditors. That was the dominant source of coercion in *Momentive*, not the deathtrap provision, which was simply an elaborate version of the generally permissible traditional deathtrap.

[193] Till v. SCS Credit Corp., 541 U.S. 465 (2004). Criticism of *Till* is widespread. *See, e.g.*, Anthony J. Casey, *Bankruptcy's Endowment Effect*, 33 EMORY BANKR. DEVS. J. 141, 143-45 (2016).

[194] The principal independent justification was postponing the make-whole litigation until after confirmation. Its significance was limited, given that the debtor could have attained this benefit without using a deathtrap.

[195] Second Lien Intercreditor Agreement, *In re* MPM Silicones, L.L.C., No. 14-22503-rdd (Bankr. S.D.N.Y. Sept. 9, 2014), 2014 WL 4436335.

[196] In the Matter of MPM Silicones, L.L.C, 874 F.3d 787, 799-801 (2d Cir. 2017). The Second Circuit held that *Till* did not preclude consideration of market interest where there is a clear market for the type of loan in question.

C) Coal Company RSAs and Deathtraps

Since 2010, most of the largest coal mining companies in the United States, including Peabody, Arch Coal, and Patriot, have gone through Chapter 11 at least once. The reorganizations have been controversial because the companies have shed both environmental and pension obligations in their bankruptcy cases.[197] Perhaps not surprisingly, the coal companies have been quite aggressive in their use of the new distortive techniques. The discussion that follows considers both Arch Coal and Peabody.

1. Arch Coal

Arch Coal, which filed for bankruptcy in early 2016, initially proposed a reorganization plan with a deathtrap. The deathtrap would reinstate adequate protection claims that the senior creditors had waived if the unsecured creditors committee ("Committee") obtained standing to pursue litigation, if the Committee objected to the plan, or if the unsecured creditors voted against the plan.[198] The Committee strenuously objected to this treatment.

By its structure, the deathtrap thus appeared to effect both procedural and substantive coercion. It sought to silence the principal representative of general creditors—the Committee—and threatened to deplete the assets that would otherwise be available to unsecured creditors if they voted against the plan.

The final version of Arch's plan included a different deathtrap provision. If the class of Unsecured Funded Debt Claims voted "yes,"[199] the Allowed

[197] *See* Joshua Macey & Jackson Salovaara, *Bankruptcy as Bailout: Coal Company Insolvency and the Erosion of Federal Law*, 71 STAN. L. REV. 879, 882-85 (2019).
[198] Secured creditors can seek adequate protection to ensure that the collateral securing their debt is sufficient for the value of their claims. 11 U.S.C. § 362(d)(1); § 361 (2018).
[199] The class of Unsecured Funded Debt Claims included both the Allowed Notes Claims and the First Lien Deficiency Claim. *See* Debtors' Third Amended Plan of Reorganization at 46-47, *In re* Arch Coal, Inc., No. 16-40120-705 (Bankr. E.D. Mo. Jan. 11, 2016), ECF No. 1091.

Notes Claims would receive a pro-rata share of an eventual distribution.[200] If the class of Unsecured Funded Debt Claims voted "no," a holder of an Allowed Notes Claim would receive a pro-rata share of the eventual distribution[201] only if it either voted "yes" or did not vote *and* agreed to a release of third-party claims.[202]

The effect of the deathtrap was to treat holders of Allowed Notes Claims who voted "yes" and agreed to release the third-party claims differently from those who did not, in the event the class of Unsecured Funded Debt Claims as a whole voted "no." A holder of an Allowed Notes Claim who voted "no" would receive a lower payout than others in its class if the plan was confirmed.

Here, the potential threat of holdouts appears to have been significant, since the Allowed Notes Claims were actively traded. The first rule of thumb therefore suggests the use of a distortive technique may be appropriate. Although procedural coercion was not present—the voting process was not rushed or irregular—the deathtrap imposed entitlement coercion that was analogous to a structurally coercive tender offer in corporate law.[203]

The holders of Allowed Notes Claims were not as vulnerable as shareholders faced with a coercive two-tier tender offer in corporate law, given their greater ability to coordinate. And holders who agreed to the third-party releases were providing an independent benefit by waiving their right to pursue third-party claims. The deathtrap may therefore have been justifiable, but it appears to have been right on the margin between legitimate and problematic.[204] Given this close call, it would have been appropriate for a bankruptcy court to allow a creditor that voted "no" to change its vote

200 The First Lien Deficiency Claim was excluded from the distribution described in the text. *Id.* at 30-31.
201 *Id.*
202 Allowed Notes Claim holders could agree to release third-party claims either by signing the RSA, which committed signatories to the release, or by not opting out of the releases.
203 For discussion of structurally coercive tender offers, see *supra* note 135 and accompanying text.
204 The value of the differential compensation, and thus the magnitude of the coercion, cannot be determined from the record in the case. In its liquidation analysis for the case, the debtor estimated the total recovery for "unsecured debt instrument claims" to be very low, 1.2% to 2.9%. Debtors' Third Amended Plan of Reorganization, app'x B, at B-5, *In re* Arch Coal, Inc., No. 16-40120-705 (Bankr. E.D. Mo. Jan. 11, 2016), ECF No. 1091.

after the fact and to receive the higher recovery. But the deathtrap was not coercive enough to warrant striking it down.

2. Peabody Energy

When Peabody Energy filed for bankruptcy in 2016, it had several major groups of secured creditors and one major unsecured class: $2.85 billion of first liens; $1 billion of second lien secured notes; and $4.5 billion of unsecured senior notes and subordinated debentures.[205] Even before bankruptcy, the unsecured-note and debenture holders had challenged the scope of the secured creditors' liens. After filing for bankruptcy, Peabody sided with the unsecured creditors and objected to the scope of the liens. The bankruptcy court sent the contending parties into mediation. Creditors that wished to participate would be required to refrain from trading during the mediation. A creditor that did not participate initially could subsequently petition to be included, subject to the same no-trading condition.

The mediation participants used the process not just to resolve the lien dispute, but to create a framework for the overall reorganization. The centerpiece of the framework was a two-part financing arrangement that would raise $1.5 billion of exit financing for Peabody,[206] while also providing attractive benefits for the creditors involved. The first part would raise $750 million through a rights offering of new common stock. Select creditors could participate and purchase new common stock at a 45% discount to the expected value of the stock.[207]

The second part, a private placement of $750 million of new preferred stock at a 35% discount, created far more controversy.[208] The private placement had three tranches:

1) 22.5% of the placement was made available only to seven second-lien holders and noteholders that had been principal architects of the proposed plan;

[205] [*In re* Peabody Energy Corp., 582 B.R. 771 (Bankr. E.D. Mo. 2017) (No. 16-42529)].
[206] Exit financing is funding that a reorganized debtor can use after it emerges from bankruptcy.
[207] *In re* Peabody Energy Corp., 933 F.3d 918, 922 (8th Cir. 2019).
[208] In a private placement, shares are sold only to preselected investors.

2) 5% was available to any creditor, but creditors were given fewer than three days to provide the required documentation;
3) 72% was available to any creditor, subject to supplying the required documentation in roughly 30 days.[209]

The core documentation obligation was joining the parties' PSA.[210] Under the PSA, the second lien holders would receive 52% of their claims and the unsecured creditors 22%.[211] Signatories were required to vote in favor of the plan, forgo any objections to the plan, agree to a sizeable breakup fee if the PSA was not honored, and agree to backstop the rights offering and private placement in return for a fee.[212] Backstopping the rights offering would require creditors to purchase all unclaimed shares, guaranteeing that the debtor would raise $750 million.

An ad hoc group of second liens and noteholders who had not joined the mediation challenged the private placement.[213] "That a heist of the sort planned here has not been attempted in recent memory should not be surprising," they complained.[214] The ad hoc objectors insisted that the private placement's fees violated the requirement that all the members of a class of creditors be treated the same. The ad hoc group also offered to sponsor a $1.75 billion rights offering without any discount to the expected value of the stock, and to serve as backstop for the offering. The bankruptcy court, district court, and Eighth Circuit all rejected these arguments and upheld the reorganization plan. The Eighth Circuit signaled discomfort with the aggressiveness of the debtor's arrangement, however. The court was right to express uneasiness, as we shall see.

209 933 F.3d at 922-23.
210 *Id.*
211 *Id.* at 923.
212 *Id.* at 922-923.
213 The creditors' committee initially opposed the proposed plan and rights offering but dropped its objection when the proponents agreed to set aside $60 million for general unsecured claims. Brief for Appellee Official Committee of Unsecured Creditors of Peabody Energy Corp. at 3, 6, *In re* Peabody Energy Corp., 933 F.3d 918 (8th Cir. 2019) (No. 18-1302). After the objectors offered an alternative financing transaction, the creditors' committee negotiated for an additional $15 million in return for a commitment not to withdraw its support. *Id.* at 7.
214 Objection of Ad Hoc Committee of Non-Consenting Creditors to Confirmation of Debtors' Chapter 11 Plan at 3, *In re* Peabody Energy Corp., 582 B.R. 771 (Bankr. E.D. Mo. 2017) (No. 16-42529).

The first thing to note is that rights offerings and private placements sponsored by creditors are both controversial and increasingly common. One possible response would simply be to prohibit them, given the difficulty of determining whether they are fair. Banning these offerings would be defensible if it forced debtors to use alternative methods to nudge creditors to support a plan and compensate those who negotiated a plan. The principal cost would be losing a potentially valuable source of financing for companies emerging from Chapter 11.

If rights offerings and their ilk are not banned, how should the Peabody private placement be assessed? The first rule of thumb, holdout risk, strongly favors permitting at least some distortive techniques. The case was heavily litigated, there was significant trading of Peabody claims,[215] and the risk of holdout behavior was significant throughout the case.[216]

Turning to the rights offering—the parties' response to the holdout risk—each tranche raises concerns. The issue with the first tranche was not coercion, but rather that the payout possibly promised more to the seven creditors than their involvement in negotiations could justify—potentially amounting to a windfall. The inside creditors may have used their control of the process to obtain private benefits. The second and third tranches created both procedural and entitlement coercion. Because the parties had only three days to decide whether to participate in the second tranche,[217] they faced significant procedural coercion. And because the compensation for participating in the second and third tranches—including the steep discount for the stock and the backstop fees—seems to have been above market, these tranches were quite coercive from an entitlement perspective.

The procedural coercion seems to have been the one feature of the private placement that concerned the Eighth Circuit. "It is troubling," the court

215 *See, e.g.*, Taylor Kuykendall, *Peabody's Bankruptcy Exit Painful Lesson in Distressed Firms for Some Investors*, S&P GLOBAL MKT. INTELLIGENCE (May 3, 2017, 8:07 AM) https://www.spglobal.com/marketintelligence/en/news-insights/trending/n1yauikkar-jet7a3hy7ja2 [https://perma.cc/SUN9-J4TU].

216 The same factors that created significant holdout concerns also reduced the likelihood that the PSA would undermine the voting process by silencing potential objections to the reorganization plan. For discussion of the risk that creditor agreements may silence potentially important objections, see Ayotte, Casey & Skeel, *supra* note 189, at 285-86; and Baird, *supra* note 16, at 617.

217 *In re* Peabody Energy Corp., 933 F.3d at 923.

wrote, "that creditors wishing to take part in the Private Placement had to elect to do so before approval of all the agreements and the disclosure statement."[218] The court nevertheless found independent justifications, concluding that the arrangement was acceptable because "time was of the essence given the volatile nature of the coal market," and "delay was likely to cost the Debtors around $30 million per month in addition to other litigation costs."[219]

The Eighth Circuit showed little concern with the first tranche giving exclusive rights to seven creditors and with the magnitude of its recoveries for creditors that joined one or more of the three tranches; nor did the court consider the entitlement coercion this created. According to the court, the exclusivity of the first tranche was justified because "that sub-group took on more [backstopping] obligations" than other creditors in the same class.[220] Further, the supra-competitive cost of the private placement was acceptable because "the Debtors might not have convinced the parties to the security-interest dispute to settle or commit to any number of the other agreements if the Debtors had not offered the preferred stock at a discount."[221] In effect, the court concluded that the rights offering was coercive and potentially problematic, but there were independent justifications for the distortive technique.[222]

But if we focus more directly on the coercive features of the private placement than the Eight Circuit did, the court's conclusions seem deeply problematic. Procedural coercion lends itself to relatively clear rules. Absent truly extraordinary circumstances (i.e., a highly compelling independent justification), a three-day joinder period is simply too rushed, particularly because the creditors that did not participate in the mediation had only recently learned about the private placement. In this regard, it is worth comparing how the law treats tender-offer deadlines. Tender offers must be held open for at least twenty days, under securities law reforms and SEC

218 *Id.* at 928.
219 *Id.*
220 *Id.*
221 *Id.*
222 *Id.* Although the Eighth Circuit did not emphasize this, the subgroup also bore the cost of forgoing the opportunity to trade while the mediation was ongoing. *In re* Peabody Energy Corp., 582 B.R. 771, 782 (E.D. Mo. 2017).

regulations promulgated in response to the structurally similar Saturday Night Specials of the 1960s.[223]

The entitlement coercion is less straightforward. A significant problem with rights offerings is that they are hard to value, making it difficult to tell just how much they are compensating the parties for joining the PSA. The ad hoc objectors claimed the compensation to signatories was $1.4 billion,[224] but this and any other number is speculative. For a bankruptcy judge to presumptively prohibit rights offerings would seem quite justifiable and in keeping with courts' treatment of potentially problematic provisions in the debtor-in-possession financing realm.[225] Alternatively, given the potential benefits of rights offerings,[226] courts could police rights offerings much more carefully, for instance by requiring that they be made available to all creditors and subject to a market test.[227]

Absent a presumption against rights offerings as part of a PSA, a court needs to determine whether the entitlement coercion is excessive, as well as the related question of whether plan proponents are receiving excessive compensation for the public good they have supplied. In this case, the answer to both questions appears to be yes. The rights offering was expected to be quite lucrative, given the large discount from expected market values.[228] The favored creditors' exclusive access to the first tranche gave them an extremely high potential recovery, and the discounted shares available in the

[223] *See supra* notes 138-139 and accompanying text.

[224] The ad hoc objectors alleged that the initial 22.5% tranche alone would assure its seven recipients a $103.5 million profit and that the overall profit on the private placement would be $1.4 billion. Objection of Ad Hoc Committee of Non-Consenting Creditors to Confirmation of Debtors' Chapter 11 Plan, *supra* note 214, at 2-3.

[225] The bankruptcy judges in the Southern District of New York have guidelines requiring proponents of debtor-in-possession loans to explicitly flag, among other things, any provision using new collateral to collateralize prepetition obligations. *See* LOCAL BANKR. R. FOR THE S.D.N.Y 4001-2(a)(6).

[226] In a volatile industry such as oil and gas, for instance, there may be a significant benefit to lining up exit financing in advance. *See* email correspondence from James Sprayregen to David Skeel (Aug. 3, 2020).

[227] For a nice analysis of the *Peabody* case and a proposal for "reasonableness" scrutiny of rights offerings along these lines, see Shelby V. Saxon, *Rights Offerings and Private Placements in Chapter 11: How Creditors Can Strike a Windfall Within the Boundaries of the Bankruptcy Code*, AM. BANKR. L.J. (forthcoming 2020).

[228] Though rights offerings are typically difficult to value, the parties to the mediation in *Peabody* agreed on a value for the equity. *In re* Peabody Energy Corp., 582 B.R. 771, 776 n.5 (E.D. Mo. 2017).

other tranches created significant pressure for nonparticipants in the mediation to sign the PSA.

The presence of independent justifications, such as the need for a prompt reorganization and for exit financing, might warrant a somewhat more coercive PSA than would otherwise be the case. But they were not so extraordinary as to justify the enormous benefits enjoyed by the plan proponents and other participating creditors.[229]

One response to the coercion might be to permit the objecting creditors to change their vote against the plan and to require that they be allowed to participate in the rights offering. The procedural and entitlement coercion could be construed as "cause" for giving the objecting creditors an opportunity to revisit their earlier decision.[230]

But this would not address the excessive compensation in the first tranche of the rights offering, which was available only to plan proponents, and the distortive techniques in *Peabody* were so egregious that they deserved a more aggressive rebuke. *Peabody* would have been a prime case for the court to refuse to approve the rights offering and signal that acutely coercive PSA terms will not be permitted, much as Delaware courts have done with extreme corporate lockups.[231] By policing egregious uses of distortive techniques, bankruptcy courts could curb the parties' temptation to overreach and thereby simplify their own task of discerning improperly coercive tactics.

V. Extensions

[229] Given the conclusion under the first three rules of thumb that the PSA with a rights offering should not have been permitted, it is unnecessary to consider whether the parties' contracts purported to limit restructuring. But there was no claim that the parties intended to limit restructuring through contract.

[230] *See supra* Section III.E.

[231] In *Revlon*, the Delaware Supreme Court struck down an asset lockup that purported to commit to selling Revlon's "crown jewels" to the favored bidder. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184-85 (Del. 1986). In *QVC*, the Court struck down a lockup of 20% of the target's stock. Paramount Commc'ns Inc. v. QVC Network, Inc., 637 A.2d 34, 39 (Del. 1994).

Although the rules of thumb outlined in Part III were developed with bankruptcy's new distortive techniques in mind, the same logic can be applied in analogous contexts. In this Part, I extend the analysis to two issues that bear a strong familial relationship to the new distortive techniques: gifting in Chapter 11 and coercive bond-exchange offers outside of bankruptcy.

A) Gifting Transactions

In a gifting transaction, one class of claims relinquishes a portion of its recovery and "donates" this portion to a class of equal or lower priority.[232] In *In re DBSD North America*, for instance, the Second Lien creditors purported to gift a portion of their recovery to DBSD's shareholder, which would receive stock and warrants in the reorganized debtor—despite Sprint holding unsecured claims in a higher-priority class, objecting to the plan, and not being paid in full.[233] Although DBSD receiving stock and warrants seemed to violate the absolute-priority rule, the debtor argued that the shareholder's recovery should not count for absolute-priority-rule purposes because it was a gift, not a distribution from the estate.[234]

Gifting differs from the other distortive techniques we have considered in two respects. First, although it can distort the voting process by circumventing the vote of an objecting class and by helping to secure a favorable vote from the class receiving the gift, gifting is not directly linked to the vote. Second, gifting purports to be an intercreditor transfer, rather than a transfer from the debtor or the estate. But the effect of gifting is quite similar to those of the other distortive techniques, and securing a favorable

232 *See* Michael Carnevale, Comment, *Is Gifting Dead in Chapter 11 Reorganizations? Examining Absolute Priority in the Wake of the Second Circuit's No-Gift Rule in In re* DBSD, 15 U. PA. J. BUS. L. 225, 230-31 (2012).
233 Dish Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 93-94 (2d Cir. 2011).
234 The Second Circuit ultimately rejected this argument. *Id.* at 98-101.

vote is usually one of the objectives of a gifting transaction. Gifting also is sometimes used in combination with an RSA or deathtrap.[235]

Courts have been far more hostile to gifting than to the other distortive techniques. Although gifting is sometimes permitted,[236] the Second and Third Circuits have largely banned the practice. In *In re DBSD North America*, for instance, the Second Circuit held that the purported gift violated the absolute-priority rule and refused to confirm the proposed plan.[237]

The analysis of this Article helps explain why courts have been so skeptical of gifting transactions. In effect, the gifting arrangement is like infinite coercion of the intervening class—the class is forced to agree to the transaction, even if the members of the class vote to reject the plan. Moreover, unlike with RSA fees, the beneficiary of the gift generally does not provide any additional benefit to the estate that justifies the compensation it receives.[238]

This does not mean that gifting should never be permitted. In the face of a severe holdout problem, gifting may sometimes be appropriate. This is the most plausible defense of a gifting transaction in Detroit's municipal bankruptcy, for instance, where a class of unlimited tax bonds purported to gift a portion of their recovery to Detroit's pension beneficiaries.[239] The gift weakened the potential unfair-discrimination objections of two monoline

[235] *See, e.g.*, Kevin J. Walsh, *Uncertain Times: Recent Bankruptcy Case Law Leaves Parties Unsure and Possibly Searching for Alternatives*, ASPATORE, 2011 WL 6471012, at *4 (suggesting that deathtraps can be used to encourage acceptance of a plan that includes a gift). Interestingly, after the bankruptcy court rejected a deathtrap in the early case *In re MCorp Financial, Inc.*, 137 B.R. 219, 236 (Bankr. S.D. Tex. 1992), the district court later confirmed a plan that included a gift, *In re* MCorp Fin., Inc., 160 B.R. 941, 960 (S.D. Tex. 1993).
[236] *E.g.*, Official Unsecured Creditors' Comm. v. Stern (*In re* SPM Mfg. Corp.), 984 F.2d 1305, 1311-15 (1st Cir. 1993).
[237] *E.g.*, 634 F.3d at 98-101; *see also In re* Armstrong World Indus., Inc., 432 F.3d 507, 514 (3d Cir. 2005) (providing another example of a court finding that a gifting scheme violated the absolute-priority rule). *In re DBSD*, the Second Circuit distinguished the case from *In re SPM Manufacturing Corp.* in two respects—first pointing out that it was a Chapter 7 case, so the absolute-priority rule did not explicitly apply, and second that the property in question belonged to the secured creditor because the stay had been lifted. *In re* DBSD, 634 F.3d at 98.
[238] "The 'gift' . . . may not be made to obtain valuable services going forward, but rather to ensure that the reorganization takes the shape that the senior creditor wants." BARRY E. ADLER, ANTHONY J. CASEY, EDWARD R. MORRISON, BAIRD & JACKSON'S BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS 881 (5th ed. 2020).
[239] *In re* City of Detroit, 524 B.R. 147, 187-90 (Bankr. E.D. Mich. 2014).

insurers that had held out for much of the case.[240] Even here, the gift was somewhat questionable, because the insurers' holdout does not appear to have been simply strategic.[241] But a court might plausibly conclude the gift was defensible. Absent a very serious holdout issue, gifts should not be permitted. Courts' tendency to view them much more skeptically than RSAs or deathtrap provisions is thus entirely justified.

B) <u>Coercive Bond Exchanges</u>

Under section 316(b) the Trust Indenture Act of 1939, a corporate bond cannot include a provision that facilitates a vote to restructure the bonds outside of bankruptcy if the company falls into financial distress.[242] Each bondholder must be permitted to decide for herself whether to accept any proposal to "impair" the payment terms of the bonds. According to William Douglas, the leading New Deal proponent of section 316(b), the objective was to ensure that troubled companies with significant bond debt would restructure in bankruptcy rather than outside of bankruptcy.[243] In bankruptcy, the restructuring would take place under the watchful eye of a bankruptcy judge.

Faced with this stricture, companies that wish to restructure their bonds outside of bankruptcy make exchange offers, where the company asks bondholders to accept a restructured bond in place of their current bond. The strategy works only if a high percentage of bondholders—often 90%—agree to the exchange, since nonconsenting bondholders need to be paid in full.[244] To nudge bondholders to accept, the exchanges often include an element of coercion. The company may ask consenting bondholders to vote to alter the terms of the old bonds in an undesirable way, for instance, without expressly impairing the bonds' payment terms.[245]

240 *See id.* at 257-58.
241 It is also unclear whether all of the unlimited tax bondholders were even aware that giving a portion of their recovery to the pensioners could be treated as a gift.
242 15 U.S.C. § 77ppp(b) (2018).
243 The legislative history of section 316(b) is discussed in DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 121-22 (2001).
244 *See* John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1214-15 (1991).
245 *See* Bratton & Levitin, *supra* note 31, at 1608-11.

In *Marblegate Asset Management*, *LLC v. Education Management Finance Corp.*,[246] the debtor took this strategy to the extreme. Under the terms of the exchange, the assets of Education Management Corporation ("EDMC") would be sold in a foreclosure to a newly created subsidiary of EDMC. Consenting bondholders would receive restructured bonds with claims against the new subsidiary. The payment rights of nonconsenting bondholders would not be explicitly altered, but they would be left with a claim against a company that no longer had any assets—an empty shell.[247] A divided panel of the Second Circuit upheld the transaction. According to the majority, section 316(b) was intended only to prohibit amendments to payment terms, not to forbid restructurings done through foreclosure.[248] So long as the payment terms are not altered, the court concluded, the exchange should be permitted.[249]

The first thing to note is that the fourth rule of thumb—the nature of the parties' contracts—is especially important for assessing bond-exchange offers. Unlike Chapter 11, which nudges the parties toward a restructuring, section 316(b) was intended to discourage out-of-court restructuring and channel the debtor into bankruptcy. Courts' willingness to permit coercive bond exchanges appears to be colored by their doubts about the wisdom of this baseline—reservations that are widely shared by commentators.[250]

The "impairment" language in section 316(b) can be seen a proxy for this Article's second rule of thumb—the degree of coercion, especially entitlement coercion. If construed broadly, the language would suggest that the debtor cannot pressure a bondholder to accept a restructuring in any way—completely forbidding entitlement coercion. It would not be difficult to strictly enforce section 316(b)'s no-impairment rule, and the results would not be as dire as sometimes feared. Given the ease of effecting a prepackaged

[246] 846 F.3d 1 (2d Cir. 2017).
[247] *Id.* at 4.
[248] *Id.* at 10.
[249] *Id.* at 17.
[250] The classic early article is Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 277-79 (1987).

bankruptcy, many of the firms that conduct bond exchanges could achieve the same benefits nearly as quickly in bankruptcy.[251]

If a more flexible interpretation of "impairment" is inevitable, the first rule of thumb, holdouts, becomes far more important. *Marblegate* responded to the holdout problem in that case, but it did so with a reading of section 316(b) that could eviscerate any limits on coercion unless reined in by subsequent courts. A better solution would be to define "impairment" strictly, but to exclude cases where there is a severe holdout problem.[252] *Marblegate* was just such a case. If EDMC failed to restructure and was forced to file for bankruptcy, it would lose the federal funding that was essential to its business. A single large holdout creditor—Marblegate—refused to agree to the restructuring, implicitly threatening to destroy the company unless it received a special payout. Under these highly unusual circumstances, extreme entitlement coercion was justified.[253]

Notice that the same rules of thumb we used to analyze bankruptcy's new distortive techniques also can be used with gifting and bond-exchange offers. Granted, the analysis develops quite differently, given the different contexts. With both gifting and bond-exchange offers, a strong presumption against permitting the strategies is warranted.

[251] Bratton and Levitin suggest that secured-creditor control makes bankruptcy an unpromising alternative. Bratton & Levitin, *supra* note 31, at 1642-45. This does not seem likely to be a serious obstacle where secured creditors will be fully protected, as they are in most prepackaged bankruptcies. It is more of an issue with companies that are not readily amenable to a prepackaged bankruptcy.

[252] A similar result could be achieved by coupling *Marblegate*'s lax reading of impairment with a good-faith obligation, as some scholars have advocated. *See id.* at 1673; *see also* DAVID CHRISTOPH EHMKE, BOND DEBT GOVERNANCE: A COMPARATIVE ANALYSIS OF DIFFERENT SOLUTIONS TO FINANCIAL DISTRESS OF CORPORATE BOND DEBTORS 238 (2018) ("[O]ne can reasonabl[y] read sec 316(b) TIA in a way that . . . does not protect holdouts from being exposed to a higher risk level once the exit consent is completed.").

[253] In doctrinal terms, a court might conclude Marblegate's payment rights were not truly impaired because the company would fail absent the exchange, and bondholders would receive little or nothing in bankruptcy. This is similar to the approach used by the Supreme Court in the Contracts Clause context. *See* Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 513-16 (1942) (holding that restructuring of municipal bonds did not violate the Contracts Clause because it made bondholders better off in the context of a financial crisis).

Conclusion

The new distortive techniques appear unseemly, often moving the Chapter 11 voting process far away from the ideal of voting only on the merits. The simplest and initially most appealing response would be to ban them.

Yet a strong antidistortion rule turns out to be undesirable once the structure of Chapter 11 and the nature of current Chapter 11 practice are taken into account. Some distortive techniques, such as a traditional deathtrap, are fully consistent with Chapter 11. Others are needed to counteract the instability of creditors in current cases and the significantly heightened risk of holdouts. Even seemingly problematic features of the new distortive techniques often prove justifiable in context.

These factors suggest that the new distortive techniques should be policed rather than banned. In this Article, I have attempted to provide insights into how this might be done. I have offered both general rules of thumb to guide the analysis and specific recommendations, such as appropriate limits on the size of RSA fees.