TACTICAL RESTRUCTURINGS

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The traditional legal account of a corporate debtor's journey into and through bankruptcy reorganization naturally focuses on legal rights and entitlements, such as obligations arising under the debtor's existing agreements and rights articulated in the U.S. Bankruptcy Code. But the traditional legal account does little to probe why these prior agreements and transactions were entered into in the first place, and how they interact with the bankruptcy system to generate predictable outcomes. Rather, the traditional legal account applies a presumption that the debtor's financial characteristics, qualities, and features (what this Article calls "restructuring attributes") are not premeditated, at least insofar as a future bankruptcy filing is concerned. In contrast, this Article advances a theory of "tactical restructurings," which acknowledges that corporate debtors engage in deliberate prebankruptcy planning to achieve the ideal restructuring attributes and thus gain significant advantages in a future bankruptcy. By illuminating these understudied aspects of commercial restructurings, this Article contributes to a broader understanding of Chapter 11 bankruptcy as a dynamic rather than static process. Simply by manipulating key variables and inputs that are almost entirely within their control, debtors and their preferred stakeholders control the behavior of the Chapter 11 system and effectively lock in restructuring outcomes.

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INTRODUCTION

Chapter 11 of the U.S. Bankruptcy Code[1] provides a judicial process for financially distressed companies to restructure their obligations and continue in business. Given the complexity of modern corporate finance and the powerful legal rights and remedies investors possess outside of bankruptcy, the system necessarily relies on certain extraordinary features. For instance, bankruptcy law allows debtors to modify and even extinguish claims and interests over the objections of impacted parties[2] and effectuate major transactions on terms that would not be possible outside of bankruptcy.[3] Through these and other legal mechanisms, bankruptcy process overcomes dissent by forcing a recognition event modeled after a hypothetical liquidation—even though the company clearly intends to remain in business.[4]

1. 11 U.S.C. §§ 101–1532. All references to the "Bankruptcy Code" are to the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101–1532). Unless otherwise indicated, all references to chapters and sections are to the Bankruptcy Code.

2. A Chapter 11 plan may impair claims and interests, subject to various safeguards. *See, e.g.*, 11 U.S.C. §§ 1123, 1129. Once confirmed, a Chapter 11 plan discharges the debtor from all preconfirmation debts, whether or not the holder of the claim accepts the plan. *See id.* § 1141(d)(1).

3. Bankruptcy allows debtors to sell assets free and clear of other claims, liens, and encumbrances. *See id.* § 363. It also allows debtors to reject leases and other executory contracts. *See id.* § 365.

4. Although a Chapter 11 plan may impair claims and interests, the plan cannot be confirmed unless creditors or interest holders will receive at least the value that they would have received in a hypothetical Chapter 7 liquidation. *See id.* § 1129(a)(7)(A). The distribution waterfall for Chapter 7 liquidation is set forth in § 726 of the Bankruptcy Code.

There are winners and losers in this process; for some investors, the consequences can be especially harsh. In the case of an insolvent company, junior claimants and interest holders are expelled from the company's capital structure, such that they lose any rights they previously had to recoup their investments from the debtor's future earnings.[5] Senior stakeholders, meanwhile, gain more concentrated rights to the debtor's future earnings.[6]

These and other remarkable features of Chapter 11 are generally justified on the grounds that they are necessary to pull a company out of a death spiral and return it to a stable state.[7] As the prevailing narrative goes, stakeholders at all levels of the capital structure exert increasing pressure on the company in reaction to real or perceived financial and economic challenges.[8] These stakeholders exercise or threaten to exercise a range of contractual rights and legal remedies[9] to extract their increasingly insecure investments, without regard for the future of the firm or the interests of its other investors.[10] As these efforts gain steam, the company effectively loses the ability to take actions that influence the course of its existence, causing it to careen towards an almost-certain liquidation that would leave most stakeholders in a far worse position.[11]

To regain some control and obtain much-needed breathing room,[12] the debtor turns to Chapter 11 for protection.[13] Bankruptcy interventions may be extreme, but they help to ensure that the company's scarce resources are

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See id. § 726. Meanwhile, the rule of absolute priority provides that senior creditors must be paid in full before junior creditors and interest holders are entitled to receive anything. *See infra* notes 51–55 and accompanying text.

5. *See infra* notes 51–55 and accompanying text.

6. *See infra* notes 51–55 and accompanying text.

7. Professor Anthony J. Casey discusses these traditional accounts of corporate bankruptcy reorganization. *See generally* Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709 (2020).

8. The classic race to the courthouse is described in Mark J. Roe, *Three Ages of Bankruptcy*, 7 HARV. BUS. L. REV. 187, 191–92 (2017).

9. *See, e.g.*, U.C.C. § 9-601(a) (AM. L. INST. & UNIF. L. COMM'N 2023) ("After default, a secured party has the rights provided in this part and . . . those provided by agreement of the parties. A secured party . . . may reduce a claim to judgment, foreclose, or otherwise enforce the claim [or] security interest . . . by any available judicial procedure.").

10. These assumptions of value-destroying creditor collection activity are reflected in the classic creditors' bargain theoretical justification for bankruptcy. *See, e.g.*, Thomas H. Jackson, *Bankruptcy, Non-bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982) [hereinafter Jackson, *Bankruptcy*]; *see also* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Thomas H. Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, 14 J. LEGAL STUD. 73 (1985).

11. *See generally* Jackson, *Bankruptcy*, supra note 10.

12. *See, e.g.*, 11 U.S.C. § 362 (providing for an automatic stay on virtually all claims and collection activity against the debtor and the estate upon the commencement of a bankruptcy case); Soares v. Brockton Credit Union (*In re* Soares), 107 F.3d 969, 975 (1st Cir. 1997) (noting how the automatic stay provides debtors "breathing room" to restructure their affairs).

13. *See* Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 127 (1990) (The primary purpose of Chapter 11 is to "identify the cases in which the 'going concern value' of the business exceeds its 'liquidation value' and then to shield the business against efforts to force liquidation in order that the entire going concern value can be realized for the collective benefit of creditors and shareholders.").

allocated fairly and efficiently, in accordance with the company's present value and the absolute priorities of the various stakeholders. The outcome is often harsh for junior stakeholders; however, as the classic narrative goes, desperate times call for desperate measures.

But this classic narrative is based on assumptions we need to challenge. For one thing, it assumes the financially distressed company's current capital structure is the result of a complex interplay of factors that largely relate back to the predistress period, and that no part of it was premeditated to achieve any particular bankruptcy outcome. Instead, debtors are presumed to enter and proceed through bankruptcy with a cash runway and debt overhang stemming from earlier business decisions that—ruinous as they may seem in hindsight—were effectuated at a time when they were believed to be in the company's best interest. If anything, the company's subsequent distress and bankruptcy reflects the fact that the company made its capitalization decisions *without* sufficient foresight or consideration of future economic disruptions.

Recent practice developments underscore that debtors make a variety of strategic moves prior to or at the commencement of a bankruptcy case to maximize the benefits of a Chapter 11 restructuring.[14] Debtors effectuate prebankruptcy corporate reorganizations to separate assets from liabilities,[15] enter into restructuring support agreements to lock in agreements with key stakeholders,[16] and appoint special bankruptcy directors on the eve of their Chapter 11 filings.[17] It is also well documented that managers of distressed companies advocate for or align with certain dominant stakeholders,[18]

14. *See infra* Parts II.A.2.a–e.

15. *See* Michael A. Francus, *Texas Two Stepping Out of Bankruptcy*, 120 MICH. L. REV. ONLINE 38 (2022) (describing prebankruptcy planning techniques used by companies seeking to separate their operating assets from their tort liabilities and use bankruptcy to extinguish the latter); Joshua Macey & Jackson Salovaara, *Bankruptcy as Bailout: Coal Company Insolvency and the Erosion of Federal Law*, 71 STAN. L. REV. 879, 886 (2019) (describing the "strategic pre-bankruptcy conduct" that has allowed coal companies to "separate productive assets from onerous regulatory debts").

16. *See* David A. Skeel, Jr., *Distorted Choice in Corporate Bankruptcy*, 130 YALE L.J. 366 (2020) (analyzing the potentially distortive effects of restructuring support agreements).

17. *See, e.g.*, Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. 1083 (2022) (revealing troubling trends in the way that distressed companies rearrange their boards on the eve of bankruptcy).

18. The classic agency problems are discussed in George G. Triantis, *A Free-Cash-Flow Theory of Secured Debt and Creditor Priorities*, 80 VA. L. REV. 2155 (1994).

whether within[19] or outside[20] of bankruptcy, and work to advance restructurings that maximize benefits for these preferred stakeholders.

This Article builds on these prior developments and trends by advancing a theory of Chapter 11 as a dynamic process that, although designed to be flexible enough to respond to complex business, economic, and financial disruptions, also happens to respond in predictable ways to certain inputs. By identifying and manipulating these inputs through tactical decisions in the months and even years leading up to a bankruptcy filing, debtors and their preferred stakeholders effectively capture the system's inherent flexibility and remarkable investment-altering powers for private gain.[21]

Specifically, under applicable laws and customary practices, there are certain debtor financial characteristics, qualities, or features (collectively, what this Article terms "restructuring attributes") that have a significant impact on Chapter 11 outcomes. These restructuring attributes are almost entirely within the control of debtors and their dominant stakeholders, such that they can be manipulated prior to filing and during the pendency of the case in order to gain legal and strategic advantages. In other words, there are aspects of Chapter 11 that behave as toggles[22] that can be turned on and off by manipulating their corresponding restructuring attribute. Because the bankruptcy system responds in predictable ways to these inputs, debtors preparing for a bankruptcy filing—whether in the short-, medium-, or long-term—stand to gain significant tactical advantages.[23]

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19. *See* Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporate Reorganization*, 90 U. CHI. L. REV. 1, 3 (2023) (exploring the ways in which Chapter 11 debtors advance the interests of their equity sponsors); *see also* Lindsey D. Simon, *Bankruptcy Grifters*, 131 YALE L.J. 1154 (2022) (exploring the phenomenon of third-party "grifters" that benefit from other company's bankruptcy filings); Juliet M. Moringiello, *When Does Some Federal Interest Require a Different Result?: An Essay on the Use and Misuse of* Butner v. United States, 2015 U. ILL. L. REV. 657, 658–59 ("[B]y giving secured creditors excessive control over business reorganizations, Chapter 11 no longer effectively balances its two primary goals, the effective reorganization of businesses and the maximization of asset values for all creditors."); Melissa B. Jacoby, *Fast, Cheap, and Creditor-Controlled: Is Corporate Reorganization Failing?*, 54 BUFF. L. REV. 401, 429–30 (2006) (examining the historical roots of creditor control in Chapter 11).

20. For instance, debtors regularly pursue out-of-court private loan restructuring transactions that benefit some lenders at the expense of others. *See, e.g.*, Kate Waldock, *Hedge Funds Versus Private Equity in Hostile Restructurings*, THE CLS BLUE SKY BLOG (May 6, 2022), https://clsbluesky.law.columbia.edu/2022/05/06/do-hostile-restructurings-mean-a-new-identity-for-the-official-committee-in-bankruptcies [https://perma.cc/5HA8-539G]; Diane Lourdes Dick, *Hostile Restructurings*, 96 WASH. L. REV. 1333 (2021); Kenneth Ayotte & Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 YALE L.J.F. 363 (2021); Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745 (2020); Robert K. Rasmussen & Michael Simkovic, *Bounties for Errors: Market Testing Contracts*, 10 HARV. BUS. L. REV. 117 (2020); *see also* Vincent S.J. Buccola & Greg Nini, *The Loan Market Response to Dropdown and Uptier Transactions*, J. LEGAL STUD. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4143928 [https://perma.cc/4QA4-HJCC].

21. *See infra* Parts II.A.2.a–e.

22. Professor Vincent Buccola has also used the term "toggle" to describe certain functions of bankruptcy laws. *See* Vincent S.J. Buccola, *Bankruptcy's Cathedral: Property Rules, Liability Rules, and Distress*, 114 NW. U. L. REV. 705 (2019).

23. *See infra* Part II.B.

In the pages that follow, this Article identifies the most significant restructuring attributes in large and complex Chapter 11 cases. These attributes include, among other things, the debtor's "apparent insolvency," which this Article defines as a presumption of the debtor's insolvency as it is currently reflected or may reasonably be expressed in customary financial reports.[24] Other restructuring attributes focus on how various claims or interests are situated relative to the debtor's apparent reorganization and liquidation values.[25] Under prevailing bankruptcy laws and customary practices, the "secured debt hurdle"—a measure of the relationship between the estate's apparent distributable value and the economic interests of secured creditors—is the most important restructuring attribute that drives both substantive and procedural outcomes in Chapter 11 bankruptcy.[26] Then, because the typical large business debtor has multiple tiers of secured debt with different priorities and collateral pools, it is important to monitor not only a general secured debt hurdle, but also various "subhurdles" that delineate the boundaries between and among various classes of secured creditors.[27] These subhurdles interact with bankruptcy law in significant ways: to the extent they distinguish groups of creditors from one another on the priority ladder, they establish a presumption that the groups should not be treated equally under the plan.[28]

In addition to identifying the most significant restructuring attributes, this Article also describes the various ways that debtors adjust them prior to and during a bankruptcy case to enhance legal certainty, streamline litigation, and gain other advantages.[29] These insights have the potential to revolutionize our understanding of corporate bankruptcy. The traditional legal account of corporate debtors' journey through Chapter 11 naturally focuses on legal rights and entitlements, such as the obligations arising under commercial finance agreements, the equitable responsibilities of parties participating in complex debt transactions, and the legal entitlements of various stakeholders under the Bankruptcy Code.[30] But the traditional legal account does little to probe *why* underlying agreements and transactions were entered into in the first place, and how they interact with the bankruptcy system to generate predictable outcomes. Rather, absent extreme circumstances such as fraud, the traditional legal account applies a presumption that the debtor's financial characteristics, qualities, and features are not premeditated, at least insofar as a future bankruptcy filing is concerned.[31]

In contrast to the traditional legal account, this Article advances a theory of "tactical restructurings," which acknowledges that the corporate debtor's prebankruptcy planning may be premeditated to achieve certain significant

24. *See infra* Part I.A.
25. *See infra* Parts I.B–E.
26. *See infra* Part I.D.
27. *See infra* Part I.E.
28. *See infra* Part I.E.
29. *See infra* Parts I–II.
30. *See infra* Part II.A.1.
31. *See infra* notes 34–36 and accompanying text.

advantages in a future bankruptcy. By shedding light on these understudied aspects of commercial restructurings, this Article contributes to a broader understanding of Chapter 11 bankruptcy as a dynamic rather than static process. Simply by manipulating key variables and inputs that are almost entirely within their control, debtors and their preferred stakeholders control the behavior of the Chapter 11 system and effectively lock in restructuring outcomes. Debtors should therefore be understood as active participants in their own financial distress and bankruptcy, with far more agency than the conventional wisdom would suggest. Meanwhile, bankruptcy law should be understood not merely as a set of rules that provide a last-ditch, nuclear option for distressed firms, but rather as a source of broad powers that lend finality and force of law to carefully calibrated private decisions—which are often months or even years in the making.

This Article is organized as follows. Part I introduces certain key restructuring attributes that have significant influence on bankruptcy outcomes. Part II explores the ways in which debtors manipulate these and other restructuring attributes before and during a Chapter 11 case. For instance, debtors engage in transactions to ensure that they enter and proceed through bankruptcy with the most beneficial secured debt profile, meaning that the secured debt hurdle and subhurdles are carefully positioned in relation to the debtor's apparent insolvency to concentrate the economic benefits of the postemergence company among preferred stakeholders.[32] Part III considers the normative implications of tactical prebankruptcy planning and recommends legal interventions to rein in the most abusive transactions.

I. KEY RESTRUCTURING ATTRIBUTES

This Article uses the term restructuring attributes[33] to refer to certain debtor financial characteristics, qualities, or features that have a significant impact on restructuring options and outcomes, making them highly susceptible to tactical prebankruptcy planning. The traditional legal account of corporate debtors' journey through Chapter 11 largely declines to probe these underlying characteristics, effectively treating them as immutable qualities that are the result of corporate decisions, actions, and inactions that predate a bankruptcy filing. To the extent these underlying conditions are disputed, the disputes are predicated upon legal rights and doctrines that have strict elements or high evidentiary burdens, such as fraudulent conveyance,[34]

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32. *See infra* Parts I.D–E.

33. The term is based on the concept of "tax attributes." Tax attributes are tax-related characteristics and qualities—such as entity type, accounting method, and prior elections and transactions—that, individually and collectively, impact the way various tax laws apply to the taxpayer's affairs. For a list of common tax attributes belonging to persons taxed as corporations, see 26 U.S.C. § 381(c).

34. Fraudulent conveyance law is designed to maximize the bankruptcy estate by unraveling prepetition transactions that were inherently unfair to creditors. There are state and federal statutes that address fraudulent transfers. *See, e.g.*, 11 U.S.C. § 544(b) (describing

recharacterization,[35] or bankruptcy preference.[36] Because disputes of this sort are highly fact intensive and rely on thorny judicial doctrines, they are expensive and time-consuming to litigate.[37] As such, courts and litigants are naturally hesitant to focus scarce resources on these battles.

For all of these reasons, the modern commercial bankruptcy restructuring process does little to probe *why* underlying agreements and transactions were entered into in the first place, and how these and other debtor financial conditions interact with the bankruptcy system to generate predictable outcomes. A theory of tactical restructuring that focuses on certain key restructuring attributes gives bankruptcy courts, litigants, and market participants new analytical tools to supplement their understanding of complex Chapter 11 cases, helping them to overcome the limitations of the traditional legal account. The following sections introduce the most significant restructuring attributes in modern Chapter 11 practice. These include the debtor's apparent insolvency—a presumption of the debtor's insolvency as it is currently reflected or may reasonably be expressed in customary financial reports.[38] Other restructuring attributes consider how various claims or interests are situated relative to the debtor's apparent reorganization and liquidation values.[39] For instance, the "administrative expense hurdle" considers whether the bankruptcy estate is at risk of becoming administratively insolvent,[40] whereas the "character of the fulcrum security" identifies the class of debt that is positioned at the point in the firm's capital structure where, under a strict application of absolute priority, all senior creditors will be paid in full, and no junior creditors are entitled to a distribution.[41] Finally, the secured debt hurdle examines the relationship between the estate's apparent distributable value and the economic interests of secured creditors.[42] Because the typical large business debtor has multiple

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the bankruptcy trustee's powers to pursue a fraudulent conveyance under the applicable state law); *id.* § 548 (setting forth the federal fraudulent conveyance statute).

35. Through the doctrine of recharacterization, bankruptcy courts treat certain debt investments in the debtor as equity investments; the decision is generally made on the basis of a nonexclusive multifactor balancing test that considers such factors as the adequacy of the debtor's capitalization, the relationship between the debtor and the supposed lender, and the corporation's ability to obtain financing from outside parties. *See In re* Autostyle Plastics, Inc., 269 F.3d 726, 749–50 (6th Cir. 2001) (setting forth the list of factors commonly considered).

36. The Bankruptcy Code provides that a trustee or debtor in possession may avoid a transfer of an interest of the debtor in property when the following elements are met and no statutory exceptions apply: (1) the transfer is to or for the benefit of a creditor, (2) the transfer is for or on account of antecedent debt, (3) the transfer is made while the debtor was insolvent, (4) the transfer is made during the preference period (on or within ninety days prior to filing for noninsiders or within one year prior to filing for insiders), and (5) the transfer has preferential effect as compared to a hypothetical liquidation without such transfer being made. *See* 11 U.S.C. § 547(b).

37. Complexities of this sort are highlighted in Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985).

38. *See infra* Part I.A.

39. *See infra* Parts I.B–II.E.

40. *See infra* Part I.B.

41. *See infra* Part I.C.

42. *See infra* Part I.D.

tiers of secured debt with different priorities and collateral pools, various secured debt subhurdles delineate the boundaries between and among various classes of secured creditors.[43] The following section considers one of the most important threshold attributes—the debtor's apparent insolvency.

A. The Debtor's Apparent Insolvency

Solvency is effectively a measure of whether and to what extent a particular firm can satisfy its liabilities.[44] *In*solvency, on the other hand, is the inability of a firm to satisfy its obligations. Insolvency may be established when a firm is unable to satisfy its debts as they become due.[45] Alternatively, it may be measured by examining the degree to which the debts of the firm exceed its assets.[46] The former is known as cash flow insolvency, whereas the latter is referred to as balance sheet insolvency.[47] Balance sheet insolvency—which is the measure typically used in bankruptcy proceedings—may take into account current and/or long-term assets and liabilities.[48]

There are certain strategic benefits for the debtor and its senior stakeholders when a debtor enters bankruptcy appearing to be insolvent. For one thing, most bankruptcy courts will decline to appoint an official equity committee[49] if the debtor is "hopelessly insolvent."[50] To understand why this is the case, it helps to review bankruptcy's distributional norms. Section 1129(b) of the Bankruptcy Code provides, in relevant part, that when an impaired class objects to the plan, the plan can be confirmed only if:

> the plan . . . is fair and equitable . . . . [T]he condition that a plan be fair and equitable . . . includes [in the case of unsecured claims] the following requirements: . . . (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or (ii) the holder of any claim or interest that is junior to the claims of such

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43. *See infra* Part I.E.

44. *See* J.B. Heaton, *Solvency Tests*, 62 BUS. LAW. 983, 988 (2007).

45. This is known as the "cash flow test" for insolvency. *See, e.g.*, Blackmore Partners, L.P. v. Link Energy L.L.C., No. Civ.A. 454-N, 2005 WL 2709639, at *3 (Del. Ch. 2005) (using both the cash flow test and the balance sheet test to analyze corporate solvency).

46. *See, e.g.*, Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 789 (Del. Ch. 1992) (applying this so-called balance sheet test of insolvency).

47. *See* Heaton, *supra* note 44, at 983.

48. See 11 U.S.C. § 101(32)(A) (defining insolvency as "the sum of such entity's debts is greater than all of such entity's property, at a fair valuation").

49. Although official unsecured creditors' committees are mandatory in most large Chapter 11 cases, the appointment of an official committee of equity security holders is discretionary. *See* 11 U.S.C. § 1102.

50. *See In re* Williams Commc'ns Grp, Inc., 281 B.R. 216, 220 (Bankr. S.D.N.Y. 2002) (articulating the prevailing standard for the appointment of an official equity committee in Chapter 11); Diane Lourdes Dick, *Grassroots Shareholder Activism in Large Commercial Bankruptcies*, 40 J. CORP. L. 1, 22–25 (2014) (examining the impact of *Williams* on shareholder representation and participation in large commercial cases). The phrase "hopelessly insolvent" was initially used in *In re* Emons Indus., Inc., 50 B.R. 692, 694 (Bankr. S.D.N.Y. 1985).

> class will not receive or retain under the plan on account of such junior claim or interest any property . . . .[51]

This language codifies the longstanding bankruptcy rule[52] of absolute priority, which stands for the seemingly simple proposition that "[i]f one creditor has priority over another, this creditor needs to be paid in full before the other is entitled to receive anything."[53] In essence, the concept of absolute priority is a rule of "vertical equity," meaning that it regulates distributions among creditors who occupy different positions in the firm's capital structure.[54] This is different from the Bankruptcy Code's parallel rule of "horizontal equity," which serves to ensure that stakeholders in the same priority position receive proportionally equal distributions.[55]

Under a system of absolute priority, the debtor's insolvency means that equity interest holders have no meaningful economic stake in the proceedings.[56] Outside of bankruptcy, they hold a lottery ticket that the debtor's fortunes will reverse before senior creditors exercise their remedies and force the company to liquidate.[57] Because bankruptcy imposes a similar "day of reckoning," with "[a]ll future possibilities . . . collapsed to the present,"[58] the process effectively forecloses whatever possibility there may be for future value to accrue to out-of-the-money junior stakeholders.[59]

Many corporate bankruptcy restructurings contemplate a debt-to-equity swap in which creditors exchange their debt claims for equity in the reorganized company.[60] Unless senior creditors agree otherwise, the insolvent firm's existing equity holders and out-of-the-money creditors must be wiped out because interest holders and junior claimants are not entitled to receive a distribution on account of their interests and claims if there is insufficient value to pay senior claims in full.[61]

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51. 11 U.S.C. § 1129(b).

52. The rule predates the Bankruptcy Code. *See* N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 508 (1913) (articulating the same principle).

53. Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 786 (2017).

54. Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 228–29, 231 (1998).

55. *See* 11 U.S.C. §§ 1122(a), 1123(a)(4), 1129(b)(1) (each addressing unfair discrimination).

56. *Id.* § 1129(b).

57. Outside of bankruptcy, there is always some value to this lottery ticket. *See* Covey v. Com. Nat'l Bank of Peoria, 960 F.2d 657, 661 (7th Cir. 1992) ("A stumble-bum would pay 1 cent for the most hopelessly insolvent firm, as the deal puts none of the bum's nonexistent assets at risk and could pay off if the debtor unexpectedly strikes it rich.").

58. Baird, *supra* note 53, at 792.

59. *See id.* at 812. For a discussion of how this artificial construct played out in recent high-profile automotive bankruptcy restructurings, see Ralph Brubaker & Charles J. Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of* Chrysler *and* GM, 2010 U. ILL. L. REV. 1375.

60. For a fascinating exploration of loan-to-own strategies, see Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians at the Gate?*, 89 WASH. U. L. REV. 155 (2011).

61. *See supra* note 51 and accompanying text.

But although much hinges on the debtor's financial condition, it can be difficult to gain an accurate picture of how that condition should be interpreted. Insolvency is often tested using information disclosed in financial statements and by engaging in price discovery; however, the concept of insolvency is, at least in theory, more meaningful as a reference to *true* or *intrinsic* value, as opposed to book value or market value.[62] This is because book value reflects historical cost and is typically used to approximate potential liquidation values,[63] whereas market value provides a measure of current investor demand for tradeable assets.[64] Both measures suffer from inherent limitations, including a tendency to discount or outright ignore assets—such as data, tax-related, and other intangible assets—that are difficult or impossible to market and monetize through sale transactions.[65] Intrinsic value, by contrast, considers both tangible and intangible assets—as well as present and future, direct and indirect monetization opportunities—to paint a fuller and more accurate picture of a firm's fundamental value as a going concern.[66]

Unfortunately, intrinsic value is also very difficult—perhaps even impossible—to measure, at least in any systematic way. And, in any event, the debtor's intrinsic value—and thus the true extent of its solvency or insolvency—is not a key restructuring attribute. After all, a solvent corporation may file for Chapter 11 bankruptcy protection.[67] Perhaps because of Chapter 11's broad eligibility rules, Chapter 11 debtors are not

62. *See, e.g.*, Zeta Consumer Prods. Corp. v. Equistar Chem. L.P. (*In re* Zeta Consumer Prods. Corp.), 291 B.R. 336, 347 (Bankr. D.N.J. 2003) ("Nevertheless, while book value may understate or fail to reflect the fair value of a debtor's assets, it provides some competent evidence as to insolvency and forms a starting point for purposes of the insolvency analysis."); Indus., Com. Elec. Inc. v. Babineau (*In re* Indus., Com. Elec., Inc.), Ch. 11 Case No. 02-45451, Adv. No. 02-4591, 2004 Bankr. LEXIS 438, at *22 (Bankr. D. Mass. Apr. 8, 2004) ("In making factual determinations of solvency, it is appropriate to adjust the asset values shown on the most contemporaneous balance sheet available to reflect 'the fair market price of the debtor's assets that could be obtained if sold in a prudent manner within a reasonable period of time to pay *the debtor's debts*.'" (quoting Lawson v. Ford Motor Co. (*In re* Roblin Indus.), 78 F.3d 30, 35 (1996))).

63. DeRosa v. Buildex Inc. (*In re* F & S Cent. Mfg. Corp.), 53 B.R. 842, 849 (Bankr. E.D.N.Y. 1985) ("Asset values carried on a balance sheet, even if derived in accordance with 'generally accepted accounting principles,' do not necessarily reflect fair value." (citation omitted)) .

64. When market value is ascertained from actual transactions, then it is the price the "relevant market placed on [the] assets given the available information at the relevant time of the transfer." Anthony J. Casey & Julia Simon-Kerr, *A Simple Theory of Complex Valuation*, 113 MICH. L. REV. 1175, 1201 (2015). Whether based on actual transactions or a sampling of market conditions, "[o]n any given date, assets are worth what people will pay for them." *Id.*

65. *See* Diane Lourdes Dick, *Bankruptcy's Corporate Tax Loophole*, 82 FORDHAM L. REV. 2273, 2306–07 (2014).

66. Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L. Q. 417, 445 n.130 (2003).

67. With the exception of municipal debtors, persons who seek federal bankruptcy protection are not required to be insolvent. *See* 11 U.S.C. § 109(d) (setting forth eligibility requirements for Chapter 11 bankruptcy without reference to the debtor's solvency). The U.S. Court of Appeals for the Ninth Circuit reiterated this principle in *Marshall v. Marshall, III* (*In re Marshall*), 721 F.3d 1032, 1069 (9th Cir. 2013), which held that Congress validly exercised constitutional power by allowing a debtor who is solvent to enter bankruptcy.

required to publicly engage in a process of discovering and proving their intrinsic solvency or insolvency before the court.[68]

Of course, debtors *do* provide detailed financial disclosures at the commencement of a bankruptcy case and for various purposes throughout the proceedings.[69] And numerous decisions—including some of the most important restructuring decisions—are made on the basis of these disclosures.[70] But under prevailing rules and customary practices, these disclosures fall far short of capturing intrinsic value. Early in the case, the debtor's financial disclosures typically rely on information contained in historical financial statements which are prepared in accordance with financial reporting rules and accounting conventions that are primarily designed to prevent *over*statement of income. These financial statements not only record assets at book value; they also reflect a pervasive conversative bias, erring on the side of discounting value and income to prevent companies from misleading investors outside of bankruptcy.[71] Finally, they fail to capture many sources of value, including some of the most important digital assets that drive firm values in the modern economy.[72]

Subsequent bankruptcy disclosures, such as valuation analyses conducted as part of the plan confirmation process, may come closer to approximating intrinsic value.[73] However, these analyses suffer from many of the same limitations. One is that they typically rely on figures obtained from the debtor's historical financial statements, notwithstanding the limitations described above. Common financial valuation techniques also rely on numerous qualitative inputs and assumptions that compound throughout the model, meaning that small adjustments to certain assumptions can generate large swings in the final valuation range. Although financial experts are trained to identify and challenge these underlying assumptions, not all stakeholders in bankruptcy have the benefit of financial advisors. And many bankruptcy judges lack formal training in business and financial analysis.[74]

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68. In contrast, Chapter 9 debtors must often engage in difficult and time-consuming eligibility battles. *See* Laura N. Coordes, *Gatekeepers Gone Wrong: Reforming the Chapter 9 Eligibility Rules*, 94 WASH. U. L. REV. 1191, 1217–18 (2017).

69. For instance, Chapter 11 debtors typically file—in order to comply with 11 U.S.C. § 1125—a disclosure statement containing adequate information regarding the debtor's assets, liabilities, and business affairs.

70. A disclosure statement of the sort described in *supra*, note 69, is intended to allow investors to make an informed judgment about a proposed plan of reorganization. *See* 11 U.S.C. § 1125.

71. *See, e.g.*, THOMAS R. ITTELSON, FINANCIAL STATEMENTS 12 (rev. & expanded ed. 2009) ("Accountants have a downward measurement bias, preferring understatement to overvaluation.").

72. *See generally* Vijay Govindarajan, Shivaram Rajgopal & Anup Srivastava, *Why Financial Statements Don't Work for Digital Companies*, HARV. BUS. REV. (Feb. 2018), https://hbr.org/2018/02/why-financial-statements-dont-work-for-digital-companies [https://perma.cc/5X4T-B95Q].

73. On the challenges inherent in valuing distressed businesses, see generally Robert J. Stark, Jack F. Williams & Anders J. Maxwell, *Market Evidence, Expert Opinion, and the Adjudicated Value of Distressed Businesses*, 68 BUS. LAW. 1039 (2013).

74. *See generally* Christopher S. Sontchi, *Valuation Methodologies: A Judge's View*, 20 AM. BANKR. INST. L. REV. 1 (2012).

In this setting, there is a danger that these seemingly sophisticated mathematical models lend an air of technical precision and scientific respectability to what essentially comes down to the debtor's own self-serving opinions and assumptions.

In light of these practical realities, what ultimately matters in Chapter 11 bankruptcy is not the debtor's *intrinsic* value,[75] but rather what is or can reasonably be reflected in customary financial reports relied on in bankruptcy proceedings. In other words, the key attribute that matters in Chapter 11 is what this Article terms the debtor's "apparent insolvency." This term reflects a presumption of the debtor's insolvency as it is currently reflected or may reasonably be expressed in customary financial reports. The important thing to understand about the debtor's apparent insolvency is that it does not necessarily need to reflect economic reality; it merely needs to serve a specific evidentiary function in the Chapter 11 proceedings.[76]

Because of the presumptive strength of the debtor's financial disclosures, a showing of apparent insolvency helps to block the formation of an official equity committee, thereby reducing litigation costs and streamlining negotiations.[77] It also creates a powerful presumption in favor of the debtor's proposed plan of reorganization. This is because bankruptcy's distributional norms—coupled with the sense of panic, scarcity, and urgency that tends to accompany corporate financial distress—make judges less sympathetic to out-of-the-money equity interest holders and creditors.[78] As parties in interest[79] they are entitled to participate in the proceedings and have their day in court. However, if they repeatedly file motions and objections and refuse reasonable settlement offers, some judges may begin to see them as disgruntled investors engaging in scorched-earth litigation tactics at the expense of the senior creditors that—if the debtor's valuation estimates are to be believed—effectively bear the true economic burden of the restructuring.[80]

Apparent insolvency is easier to show when a debtor has financial statements that express low values for many or most assets, either because

75. Intrinsic value matters to stakeholders, of course, but parties can and do conduct their own analyses using whatever information they are able to obtain via the firm's public disclosures and pursuant to whatever contractual rights they may have to receive additional information directly from the debtor.

76. Of course, through the adversarial process, other parties may challenge these valuation estimates. But bringing an effective valuation challenge takes an enormous amount of time, money, and information about the debtor and its assets.

77. *See infra* note 78 and accompanying text.

78. *See In re* Ampex Corp., No. 08-11094, 2008 WL 2051128, at *2 (Bankr. S.D.N.Y. May 14, 2008) ("Given that none of the creditors senior to equity are receiving payment in full on behalf of their claims, there simply is no value for equity holders and thus they have no meaningful interest in the outcome of the case.").

79. *See* 11 U.S.C. § 1109(b) (defining party in interest for purposes of a Chapter 11 case).

80. Frustration of this sort is evident in *In re Eastman Kodak Co.*, No. 12-10202, 2013 WL 4413300, at *5 (Bankr. S.D.N.Y. Aug. 15, 2013) ("Other than the unsupported hypothesis that Kodak, Kodak's professional advisors, the Creditors' Committee, and the Committee's professional advisors are all not to be trusted, the Shareholders provided no reason whatsoever for disregarding Kodak's publicly filed financial statements and projections.").

the assets have low historical costs or because they have been (or may soon be) impaired in accordance with financial accounting rules that give companies wide latitude to make downward adjustments.[81] It is also easier to show apparent insolvency when a company has substantial intangible assets that are not reflected on financial statements, such as many categories of intellectual property, tax assets, and data-related assets. These assets commonly slip through the cracks in bankruptcy's distributional norms because they are difficult or impossible to monetize in the hypothetical Chapter 7 liquidation used to demonstrate the fairness of a Chapter 11 plan.[82] Finally, it is easier to show apparent insolvency during periods of economic decline or when relevant commodity prices are less favorable to the company, as financial projections may reflect conservative sales and growth assumptions.

Although important strategic benefits flow from the attribute of apparent insolvency, other related restructuring attributes help to further refine the debtor's options in bankruptcy. The following section describes how and why debtors hoping to access Chapter 11 must also be mindful of the so-called administrative expenses hurdle.

B. The Administrative Expenses Hurdle

The debtor's apparent insolvency is a critically important restructuring attribute. But although profound insolvency can be a strategically useful quality in bankruptcy, there is a point at which the debtor's circumstances are simply too dire for Chapter 11.[83] Accordingly, debtors and their advisors must monitor a critical threshold that this Article calls the administrative expenses hurdle.[84] This concept helps to (1) distinguish those creditors who possess administrative expense priority claims from those who hold junior, nonpriority claims; (2) quantify the total dollar amount of such claims; and (3) compare this amount to the debtor's total apparent liquidation value at the same point in time. In essence, the administrative expenses hurdle is a measure of whether the bankruptcy estate is at risk of becoming administratively insolvent.

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81. Accounting Standards Codification 360-10 provides that long-lived assets be tested for impairment whenever events or changes in circumstances indicate that such an asset's carrying amount may not be recoverable. *See* PROP., PLANT, AND EQUIP., Statement of Fin. Acct. Standards No. 360, § 10 (FIN. ACCT. STANDARDS BD. 1993).

82. The author of this Article made this point in an earlier work with respect to valuable tax assets, such as net operating losses. *See generally* Dick, *supra* note 65.

83. *See* 11 U.S.C. § 1112(b) (providing standards for dismissing a case or converting it to Chapter 7).

84. The term is derived from references to an administrative hurdle analysis in detailed billing records submitted by an investment banking firm advising stakeholders in a recent Chapter 11 case. The analysis was likely used for internal discussion, as this is not a standard report or filing made before a bankruptcy court. *See* First Monthly Fee Application of AlixPartners, LLP, Financial Advisor to the Committee of Non Represented Retirees, for Allowance of Compensation for Professional Services Rendered and Reimbursement of Expenses Incurred for the Period From June 22, 2022 Through July 31, 2022, *In re* Armstrong Flooring, No. 22-10426 (Bankr. D. Del. Aug. 22, 2022).

Priority claims—including administrative expenses[85]—receive priority over most other debts and, unless the holder of a particular priority claim agrees otherwise, must be paid in full as a condition to confirmation of a plan of reorganization.[86] Administrative expenses include "the actual, necessary costs and expenses of preserving the estate,"[87] such as attorneys' and other professional fees, expenses incurred to operate the business postpetition, certain tax claims, and certain other obligations of the estate that have been granted administrative expense priority. Administrative claims must be paid in full, in cash, and on the effective date of the plan.[88] In light of this requirement, if it becomes apparent at any time during the proceedings that the debtor will be unable to pay its administrative expenses, the court will likely dismiss the case or convert it to a Chapter 7 liquidation.[89]

As with apparent insolvency, perceptions are key here. If other stakeholders can plausibly argue that the debtor is *at risk* of becoming administratively insolvent, they gain considerable leverage in the proceedings.[90] Instead of coming across as disgruntled investors pursuing scorched-earth litigation tactics, these stakeholders seek to position themselves as concerned and responsible constituents warning the court of an imminent financial collapse on its watch. They will likely file a flurry of motions requesting various interventions ranging from requests to appoint a trustee or examiner, on the one hand, to motions to convert or dismiss the case, on the other. These filings drive up litigation costs for all parties and introduce new risks and uncertainty. As conflicts deepen, the U.S. Trustee may become involved, leading to increased scrutiny of the debtor and the overall restructuring.

For all of these reasons, debtors must carefully monitor the administrative expenses hurdle and take steps to ensure that their apparent insolvency does not veer too close to this line. The debtor's financial disclosures and/or postpetition financing arrangements should at all times reflect a distributable value that is well above the administrative expenses hurdle or make adequate provision for the payment of these expenses. It is important to note, however,

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85. "The term 'administrative expense' is not defined in the Code, but courts agree that an administrative expense has two defining characteristics: (1) the expense and right to payment arise after the filing of bankruptcy, and (2) the consideration supporting the right to payment provides some benefit to the estate." CIT Commc'ns Fin. Corp. v. Midway Airlines Corp. (*In re* Midway Airlines Corp.), 406 F.3d 229, 237 (4th Cir. 2005).

86. *See* 11 U.S.C. § 1129(a)(9).

87. *See id.* § 503 (defining administrative expenses); *see also id.* § 507(a)(2) (granting administrative expenses second priority).

88. *See id.* § 1129(a)(9)(A).

89. *See id.* § 1112(b). Although § 1112(b)(4) does not list administrative insolvency as cause to convert or dismiss a Chapter 11 case, parties are likely to push the court to consider this factor. *See In re* AdBrite Corp., 290 B.R. 209, 217 (Bankr. S.D.N.Y. 2003) (citing C-TC 9th Ave. P'ship v. Norton Co. (*In re* C-TC 9th Ave. P'ship), 113 F.3d 1304, 1311 (2d Cir. 1997)) ("Because the list of grounds for converting or dismissing a Chapter 11 case under § 1112(b) is illustrative, not exhaustive, the court may consider other grounds and use its equitable powers to reach an appropriate result.").

90. *See, e.g.*, *In re* Bartmann, No. 03-04975, 2004 WL 1057662, at *2 (B.A.P. 10th Cir. May 10, 2004); *In re* Desmond, 331 B.R. 38, 44 (Bankr. D.N.H. 2005).

that the administrative expenses hurdle is not static. Rather, the total amount of administrative expenses can increase substantially during the pendency of the case.[91] For one thing, the total of expenses naturally expands as debtors and certain other stakeholders accrue more professional fees and expenses. But the largest increases come from the debtor-in-possession's operation of the business in the ordinary course[92] and from certain strategic choices made by the debtor during the proceedings. For instance, debtors sometimes request to grant certain prepetition claims—such as those held by critical vendors—administrative expense treatment.[93] New debtor-in-possession financing is also customarily granted administrative expense priority or superpriority claim status.[94]

Although debtors are expected to make these and other decisions in the best interests of the estate, bankruptcy courts typically give broad deference to the debtor's business judgment.[95] Debtors thus have wide latitude to adjust the administrative expenses hurdle throughout the pendency of the case. Actions that raise the administrative expenses hurdle should be thought of as "administrative expenses hurdle buildup" transactions because—regardless of the debtor's subjective intent—they have the practical effect of increasing this important restructuring attribute.

Of course, with equity security holders effectively shut out by the debtor's apparent insolvency and administrative claims ensured a full recovery, in most cases the line between in-the-money and out-of-the-money stakeholders will fall somewhere on the debt side of the firm's capital structure. As the following section explores, the character of this so-called "fulcrum security" is another key restructuring attribute.

C. The Character of the Fulcrum Security

In bankruptcy, the term fulcrum security refers to the class of debt that is positioned at the point in the firm's capital structure where, under a strict application of absolute priority, all senior creditors will be paid in full and no

91. *See infra* notes 92–94 and accompanying text.

92. *See* 11 U.S.C. § 503(b)(1)(A) (referring to the "actual, necessary costs and expenses of preserving the estate").

93. *See In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004).

94. *See* 11 U.S.C. § 364.

95. The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company." Off. Comm. of Subordinated Bondholders v. Integrated Res., Inc. (*In re* Integrated Res., Inc.), 147 B.R. 650, 656 (S.D.N.Y. 1992) (quoting Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)); *see also* Comm. of Asbestos-Related Litigants and/or Creditors v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 60 B.R. 612, 615–16 (Bankr. S.D.N.Y. 1986) ("[T]he Code favors the continued operation of a business by a debtor and a presumption of reasonableness attaches to a debtor's management decisions."); *In re* Simasko Prod. Co., 47 B.R. 444, 449 (D. Colo. 1985) ("Business judgments should be left to the board room and not to this Court. Only in circumstances where there are allegations of, and a real potential for, abuse by corporate insiders should the Court scrutinize the actions of the corporation." (citation omitted)).

junior creditors will be entitled to a distribution.[96] The term "fulcrum" refers to the fact that these creditors occupy a pivotal role in the restructuring.

Traditionally, the fulcrum security was the class of debt that would be converted to equity in the reorganized company.[97] The equity interests in the reorganized company constitute "property" under the Bankruptcy Code's distributional rules.[98] But junior creditors and interest holders are not entitled to receive or retain any property on account of[99] their claims or interests unless senior creditors have been paid in full, typically with cash or through a new or reinstated debt facility.[100] In effect, the firm's inability to satisfy the fulcrum security holders' claims in cash or other property gives them a right to the residual value of the reorganized company, which is reflected in its common equity shares.[101]

During the Great Recession, so-called "loan-to-own" investment strategies were commonplace, as distressed investors attempted to predict the fulcrum security in a bankrupt company and acquire such claims in the hopes that they would be converted to equity and then reap future economic rewards if and when the postemergence company rebounds.[102] Because equity enjoys the full upside potential of the firm, the investment strategy has the potential to enable returns far beyond what debt instruments can provide. But it is a risky gamble: if the investor aims too high in the capital structure, it holds a debt that can be reinstated as a debt investment rather than converted to equity, and if it aims too low in the capital structure, it holds a worthless claim.[103]

Today's corporate restructurings no longer follow this classic playbook. It has become customary for senior creditors to advance to the equity position based on a valuation analysis that assigns a cash-equivalent present value to the shares of the reorganized company as of the effective date of the plan.[104] To the extent junior creditors are the fulcrum security, the debtor may offer them cash or other property.

But the character of the fulcrum security remains a crucial restructuring attribute because it identifies the stakeholder with the greatest economic incentive to contest valuation estimates and challenge the debtor's proposed plan of reorganization. And because the debtor's valuation estimates already establish that the fulcrum security holders have an economic stake in the case,

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96. *See* Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians at the Gate?*, 89 WASH. U. L. REV. 155, 161 (2011).

97. *See id.*

98. *See* 11 U.S.C. § 541.

99. There is, however, a limited "new value" exception. *See* Bank of Am. Nat'l. Tr. & Sav. Ass'n. v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999).

100. *See supra* notes 52–53 and accompanying text.

101. Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673, 689 (2018).

102. *See* Harner, *supra* note 97, at 161–68.

103. *See* Harner, *supra* note 97, at 168.

104. For an overview of the issues that arise in respect of this common plan structure, see generally Michael T. Roberts, *The Bankruptcy Discount: Profiting at the Expense of Others in Chapter 11*, 21 AM. BANKR. INST. L. REV. 157 (2013).

the court is likely to take their motions and objections more seriously. Thus, a debtor proposing to pay its fulcrum security holders a lump sum distribution on the effective date of the plan should expect these junior claimants to push for a higher valuation of the company as a going concern—if they succeed, then they have also proven that senior creditors are receiving a windfall at their expense, and that this excess value should flow to them.

At the same time, to the extent that even the fulcrum security holders agree that the value of the reorganized company is not enough to make them whole, there are some incentives to reach a rapid settlement. Bankruptcy litigation imposes significant costs on the estate; the debtor must pay its own advisors and experts as well as those of the official creditors' committee.[105] Meanwhile, each additional conflict adds further delay and injects additional uncertainty. Bankruptcy judges tend to emphasize these points and push the parties to reach an agreement.

As a result, debtors are often able to reach a settlement with their fulcrum security holders. This settlement, in turn, is useful for dealing with other plan dissenters: it allows the debtor to satisfy the cramdown requirement that at least one impaired class of claims has accepted the plan[106] while also lending more support to the view that dissenting junior classes are merely engaging in value-destroying nuisance litigation. But although a higher cash distribution may be enough to gain plan support in many cases, fulcrum security holders are increasingly demanding a portion of the equity in the reorganized company or some other contingent distribution with a higher future payoff potential.[107] The following section describes another restructuring attribute—the secured debt hurdle—which can be used to gain even more control over the debtor's relationship with fulcrum security holders.

D. The Secured Debt Hurdle

In corporate restructurings, the term secured debt hurdle is occasionally used[108] to describe the debtor's capital structure at any given point in time.

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105. *See* 11 U.S.C. § 503.

106. *See id.* § 1129(a)(10).

107. The author of this Article discusses the evolution of contingent bankruptcy distributions in Diane Lourdes Dick, *Contingent Distributions in Bankruptcy Restructurings*, BANKR. L. LETTER (Thomson Reuters), Jan. 2023.

108. The term is occasionally used in motions, briefs, and objections to describe the relationship between the debtor's outstanding secured debts and its going-concern value. *See, e.g.*, Debtors' Post-Trial Brief in Support of Debtors' Amended Joint Prearranged Chapter 11 Plan Dated September 4, 2015 (Enterprise Valuation and Confirmation Issues) at 2–4, *In re* Boomerang Tube, LLC, 548 B.R. 69 (Bankr. D. Del. 2016) (No. 15-11247) (describing the secured debt hurdle in that case). Most recently, the term appeared in detailed billing records submitted by an investment banking firm advising stakeholders in a large Chapter 11 case. The so-called secured debt hurdle analysis was likely used for internal discussion, as this is not a standard report or filing made before a bankruptcy court. *See* First Monthly Fee Application of AlixPartners, LLP, Financial Advisor to the Committee of Non Represented Retirees, for Allowance of Compensation for Professional Services Rendered and Reimbursement of Expenses Incurred for the Period From June 22, 2022 Through July 31, 2022, *In re* Armstrong Flooring, Inc., No. 22-10426 (Bankr. D. Del. Aug. 22, 2022).

In essence, the concept works to (1) distinguish those creditors who possess liens on the debtor's property from those who hold unsecured claims, (2) quantify the total dollar amount of all or certain (typically the most senior) classes of secured debt, and (3) compare this amount to the debtor's total enterprise value at the same point in time. It is important to note that under the Bankruptcy Code, claims are only treated as secured to the extent of the value of the collateral property.[109] To the extent that the obligations exceed the value of the collateral, the claim should be bifurcated into a secured and unsecured portion.[110]

The secured debt hurdle is not to be confused with the "loan-to-value ratio." In commercial loan agreements, a loan-to-value ratio financial covenant establishes a minimum collateral value that the borrower must maintain at all times while the loan is outstanding. The ratio is typically expressed as a percentage, derived from comparing the outstanding loan amount with the value of the collateral.

Although the origin of the phrase secured debt hurdle is unclear, the expression evokes several other important concepts in law and finance that relate to investment viability. For instance, the word "hurdle" is commonly used by investment advisors to analyze internal rates of return; when used this way, the "hurdle" is a threshold that must be met for a particular investment to become profitable. "Hurdle" is also occasionally used in reference to credit risk; a particular debtor is deemed to be creditworthy if it can generate profits or raise equity to maintain the requisite debt-to-equity ratio.

The use of the word hurdle in the phrase secured debt hurdle also likely refers to functional thresholds set by modern bankruptcy law's adherence to a system of absolute priority. Secured creditors occupy the highest tiers of the firm's capital structure. Under a system of strict absolute priority, then, unsecured creditors and equity holders are not entitled to a distribution unless secured claims have been satisfied in full.[111] Moreover, because secured creditors have property interests in assets earmarked as collateral, they have a host of other significant rights and entitlements in bankruptcy. For instance, a creditor holding a secured claim has the right to receive postpetition interest, fees, costs, and charges to the extent of the equity cushion in their collateral.[112] They are also entitled to receive adequate protection for any decrease in the value of their interest in the collateral resulting from the debtor's use, sale, lease, or granting of a lien.[113] Finally, they are permitted to credit bid their claims in a sale of the collateral.[114]

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109. *See* 11 U.S.C. § 506(a).
110. *See id.* § 506(c).
111. *See supra* notes 51–55 and accompanying text; *see also* 11 U.S.C. § 725.
112. *See* 11 U.S.C. § 506(b).
113. *See id.* § 363(e).
114. *See id.* § 363(k).

Secured creditors also have important rights in a cramdown scenario.[115] When a class of secured claims objects to the plan, the plan can be confirmed only if:

> the plan . . . is fair and equitable . . . . [T]he condition that a plan be fair and equitable . . . includes [in the case of secured claims] the following requirements: . . . (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property.[116]

In essence, although the debtor can shed many unsecured claims and junior interests in bankruptcy, it cannot shed secured claims without distributing value equal to the allowed amount of their claims.

Of course, the debtor has some room to push back on secured creditor demands. It may argue that the collateral is lower in value than the amount of debt it secures, such that the creditor's claim must be bifurcated into a secured and unsecured portion.[117] If successful, this argument has the practical effect of lowering the secured debt hurdle. But because secured creditor rights and entitlements often arise early in bankruptcy cases, in the form of motions to lift the automatic stay and/or obtain adequate protection, the debtor's attempt to bifurcate secured claims has the potential to introduce an expensive and time-consuming valuation battle in the earliest days of the case. It also potentially changes the character of—or at least significantly impacts—the fulcrum securityholder, thereby stirring new waves of conflict and instability.

In light of these practical realities, the secured creditor cramdown rules have several important implications for corporate reorganizations. First, the total amount of secured debt is also the amount that the debtor's enterprise value must exceed before unsecured creditors and equity security holders would be entitled to a distribution.[118] But senior creditors are not entitled to a windfall. Thus, if the present value of the reorganized company *exceeds* the amount of the outstanding secured debt, then this excess value must flow to junior classes.[119]

The secured debt hurdle is therefore a measure of the relationship between the estate's apparent distributable value and the economic interests of secured creditors. This makes it an incredibly important restructuring attribute with profound substantive and procedural implications. When going-concern

115. *See generally* Diane Lourdes Dick, Brian D. Hulse & Kevin D. Badgley, *Reevaluating Risk and Return in Chapter 11 Secured Creditor Cramdowns: Interest Rates and Beyond*, 93 AM. BANKR. L.J. 175 (2019).
116. 11 U.S.C. § 1129(b).
117. *See supra* note 110 and accompanying text.
118. 11 U.S.C. § 1129(b).
119. *See id.*

value is equal to or greater than the amount of the secured debt and administrative expenses (but still insufficient to make all creditors whole), the unsecured creditors are the fulcrum security holders and thus have a significant economic stake in the restructuring. The committee can be expected to zealously advocate for a larger distribution to unsecured creditors by arguing, among other things, that the valuation analysis commissioned by the debtor is too low. There will likely be threats to file competing plans,[120] calls for the debtor to essentially market test the plan by soliciting bids from outside acquirors, and potentially a lengthy and expensive battle of the experts during the confirmation trial. The committee will also likely demand to share in the upside by receiving equity in the reorganized company or some other form of contingent distribution.

In contrast, when the present value of the reorganized company is greater than the administrative expenses hurdle but less than the amount of the secured debt, secured creditors are the fulcrum security holders and the unsecured creditors are totally out of the money. There is essentially a strong economic presumption in favor of confirming the debtor's proposed plan. Because secured creditors are already taking a proverbial "haircut," the court will be less sympathetic toward the unsecured creditors' committee and may view their motions and objections as nuisance litigation that only serves to impose additional economic burdens on secured creditors. Although the committee may believe that other restructuring plans would infuse more value, there are strong presumptions in favor of a debt-to-equity plan: in light of bankruptcy's secured creditor entitlements, the secured debt hurdle sets a price floor for competing plans and auction sales.[121]

In this way, the secured debt hurdle is a measure of how streamlined the plan confirmation process will be. A debt-to-equity swap will be the most efficient, effective, and advantageous if it occurs at a time when the secured debt hurdle is above the company's valuation range as derived from common valuation methodologies. This is the ideal secured debt hurdle because it effectively confirms the debtor's apparent insolvency and ensures that secured creditors are the fulcrum security holders. Perhaps somewhat counterintuitively, the current system incentivizes senior secured creditors to care more about the *relationship* between the secured debt hurdle and the debtor's apparent insolvency than about the actual valuation figures advanced by the debtor. So long as the secured debt hurdle is in the ideal position relative to the debtor's apparent insolvency, then senior secured creditors may quietly rely on their own assessments of intrinsic value and have no reason to contest a valuation estimate that seems too high or too low. This suggests that bankruptcy courts may place too much emphasis on senior stakeholder support as a signal that the plan assigns a reasonable value to the company as a going concern.

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120. Although the debtor initially has exclusive rights to file a plan, the exclusivity period is subject to expiration or termination for cause. *See id.* § 1121.

121. *See supra* notes 111–14 and accompanying text.

Much like the administrative expenses hurdle, the secured debt hurdle is not a fixed, preexisting amount of secured indebtedness. Rather, the amount of secured debt can and often does increase substantially during the pendency of the case. For one thing, it naturally expands as secured creditors accrue more fees and interest charges on over-secured debts.[122] The largest increases, however, come from the debtor's postpetition borrowing.[123] And, although there are statutory and judicial standards governing major postpetition transactions of this sort, debtors are given wide latitude to make these and other business decisions. These so-called debtor-in-possession (DIP) financing arrangements are typically given superpriority over other administrative expenses of the estate, along with a security interest in any unencumbered assets or a junior or even priming lien on already encumbered assets.[124] DIP financing arrangements are often established in the earliest days of the case and may consist of large credit facilities that the debtor may or may not fully extend during the pendency of the case.

This means that the secured debt hurdle can be adjusted—effectively in real time—by making additional draws against a DIP facility. These and other actions taken by debtors that have the effect of raising the secured debt hurdle—regardless of subjective intent—should be thought of as "secured debt hurdle buildup" transactions because they have the practical effect of increasing this important restructuring attribute.

E. Secured Debt Subhurdles

The secured debt hurdle speaks to the relationship between the debtor's going-concern value and the overall amount of secured indebtedness. But the typical large business debtor has multiple tiers of secured debt with different priorities and collateral pools.[125] These major secured debts are typically classified separately in a bankruptcy plan.[126] For this reason, it is important to monitor not only a general secured debt hurdle, but also various "subhurdles" that delineate the boundaries between and among various classes of secured creditors. Much like the general secured debt hurdle, these subhurdles may naturally be adjusted during the pendency of the case through the imposition of fees and interest and by arranging new postpetition indebtedness.

Secured debt subhurdles may also be adjusted through prebankruptcy transactions. The debtor's ability to proactively adjust its secured debt subhurdles is complicated by the fact that corporate borrowers typically obtain their senior secured debt from large syndicates of lenders. Because lenders occupying the same tranche of a syndicate are normally on equal

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122. *See supra* note 110 and accompanying text.

123. *See generally* David A. Skeel, *Jr.*, *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905 (2004).

124. *See* 11 U.S.C. § 364.

125. The nuances and complexities of corporate capital structures are discussed in Joshua D. Rauh & Amir Sufi, *Capital Structure and Debt Structure*, 23 REV. FIN. STUD. 4242 (2010).

126. *See* 11 U.S.C. § 1122.

footing with one another,[127] each tranche of secured debt effectively operates as a secured debt subhurdle. As the outstanding obligations increase, the entire subhurdle is raised; as the debts are paid off, the entire subhurdle is lowered.

Of course, debtors may be able to successfully rearrange their secured debt subhurdles through consensual out-of-court restructurings. But it can be difficult to achieve lender consensus, and senior secured creditors have traditionally held all the power in these negotiations. In recent years, however, corporate debtors have increasingly pursued highly aggressive out-of-court restructurings of their senior secured syndicated loan facilities.[128] These transactions—which have been referred to in the literature as "hostile restructurings"[129] or as debtor companies playing "bankruptcy hardball"[130]—are distinguishable from normal debt restructurings by their use of divide and conquer tactics to push through a restructuring that benefits some lenders in the syndicate at the expense of others.[131] One popular hostile restructuring method involves issuing new debt that enjoys higher priority than the existing debt.[132] Another method involves transferring the most valuable collateral away from existing lenders to secure new borrowing.[133]

Through prebankruptcy transactions of this sort, debtors can more effectively rearrange their existing secured debt subhurdles and introduce new ones.[134] For instance, a hostile restructuring often divides a single senior secured debt facility into two or more smaller facilities with different levels of priority.[135]

There are important strategic benefits to be gained from these moves. To the extent the secured debt hurdle is higher than the debtor's going-concern value, the debtor will be able to effectuate a debt-to-equity plan in what will likely be a relatively streamlined Chapter 11 proceeding.[136] But because lenders within each tranche are on equal footing with one another, the debtor cannot discriminate within the tranche and must allow all to share in the equity.[137] By completing a prebankruptcy hostile restructuring to set up new secured debt subhurdles that are closer to the debtor's going-concern value, the debtor can designate a more consolidated class of senior creditors who will advance to the equity position. Moreover, because these transactions

127. This is because pari passu clauses are standard in syndicated loan agreements.
128. *See supra* note 20 and accompanying text.
129. Dick, *supra* note 20.
130. Ellias & Stark, *supra* note 20.
131. The alliance politics and divide and conquer techniques used in hostile restructurings are explored in Diane Lourdes Dick, *Alliance Politics in Corporate Debt Restructurings*, 39 EMORY BANKR. DEVS. J. 285 (2023); Baird, *supra* note 53.
132. *See* Dick, *supra* note 20, at 1352.
133. *See* Dick, *supra* note 20, at 1363–64.
134. *See infra* Parts II.A.2.d–e.
135. *See* Dick, *supra* note 20, at 1352.
136. *See supra* Part I.D.
137. *See* 11 U.S.C. § 1122(a) (providing that only substantially similar claims can occupy a class); *id.* § 1123(a)(4) (mandating equal treatment for all members within the same class).

essentially invite participating lenders—or any other stakeholders, for that matter—to leap over hurdles that they would not have been able to leap over under the terms of the original loan agreement, they basically allow debtors to hand select their future owners. Thus, these transactions not only rearrange subhurdles; they also have the potential to advance internal or external investors to the highest position on the absolute priority ladder.

For participating lenders, the benefits of engaging in a hostile restructuring transaction are obvious: by concentrating the secured debt into smaller classes for bankruptcy purposes, the debtor is able to assign the equity in the reorganized company to a smaller group of future owners.[138] At the same time, these transactions are not without risk: most hostile restructurings involve the extension of new financing to the company.[139] In addition to the normal risks of making loans to distressed companies, these transactions carry the risk that the debtor is or will become so profoundly insolvent that it will be unable to ever repay even its most senior creditors.

With an analytical framework now in place, the following part uses a recent high profile Chapter 11 bankruptcy case to explore how debtors and their dominant stakeholders arrange their restructuring attributes in order to mitigate some of the risks that naturally arise in the prebankruptcy and bankruptcy settings. The case study reveals the limitations of the traditional legal account and the importance of focusing on tactical prebankruptcy moves to gain the ideal restructuring attributes.

II. RESTRUCTURING ATTRIBUTES IN ACTION: A CASE STUDY

The strategic importance of restructuring attributes gives debtors strong incentives to proactively engage in transactions designed to achieve the most beneficial attributes. This strategic importance also makes restructuring attributes a useful analytical framework for discussing complex Chapter 11 cases and predicting restructuring outcomes. Focusing on these debtor characteristics helps to illuminate the most important variables and articulate them in ways that capture their legal and strategic significance. This Article now surgically demonstrates the utility of this framework by analyzing a recent high profile Chapter 11 case—*In re Serta Simmons Bedding, LLC*.[140]—with a special focus on how and to what extent debtors and their senior stakeholders managed restructuring attributes.

A. In re Serta Simmons Bedding, LLC

U.S. bedding manufacturer Serta Simmons Bedding, LLC, filed for Chapter 11 bankruptcy on January 23, 2023, in the U.S. Bankruptcy Court

138. *See* Dick, *supra* note 20, at 1358.

139. *See id.* at 1354 (relating the story of Serta's recent hostile restructuring and discussing how the transaction raised new debt capital for the company).

140. Ch.11 Case No. 23-90020, Adv. No. 23-9001, 2023 WL 3855820, at *5 (Bankr. S.D. Tex. June 6, 2023).

for the Southern District of Texas.[141] At first blush, it seemed to be a relatively straightforward restructuring: the debtor entered bankruptcy with a restructuring support agreement reflecting consensus among lenders holding approximately 81 percent of the aggregate outstanding principal amount of its highest priority secured debt and 77 percent of its second highest priority secured debt.[142] The agreed upon plan of reorganization contemplated that the senior secured debts would be converted to equity.[143]

Despite this impressive showing of stakeholder support, the case would be anything but consensual. Serta's journey through Chapter 11 would be mired by extensive litigation concerning a 2020 out-of-court debt restructuring transaction that amended the terms of a 2016 senior syndicated financing agreement providing for 1.95 billion dollars in first lien loans and 450 million dollars in second lien loans.[144] These outstanding claims left a substantial litigation overhang, meaning that the company's future remained clouded by the possibility that all or some of the lender plaintiffs would eventually succeed in prosecuting their breach of contract and related claims in state or federal court.[145]

The 2020 restructuring was so controversial because it reconfigured Serta's capital structure at a time when the highest priority secured debt had been trading at less than fifty cents on the dollar and the second highest priority secured debt was trading at less than twenty cents on the dollar.[146] With more than two billion dollars in senior secured debt still outstanding under the 2016 facility,[147] the company struck a deal with lenders holding a little more than half of the first lien debt.[148] The participating lenders would fund 200 million dollars in new first lien loan debt.[149] Then, Serta would conduct a debt-to-debt exchange on a non–pro rata basis with these participating lenders, pursuant to which the lenders would swap their existing 992 million dollars of first lien loans for approximately 734 million dollars of new superpriority loans, and 299 million dollars of second lien debt for 116 million dollars of new superpriority debt.[150]

Because the 2016 agreement only required the consent of lenders holding more than 50 percent of the face value of the existing debt, the 50.1 percent of lenders participating in the 2020 restructuring were able to use their majority power to execute a series of amendments to the 2016 loan agreement

141. *See* Chapter 11 Voluntary Petition Non-Individual, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. Jan. 23, 2023).

142. *See* Adversary Complaint at 12, *In re* Serta Simmons Bedding, LLC, No. 23-09001 (Bankr. S.D. Tex. Jan. 24, 2023).

143. *See id.*

144. The author of this Article describes the 2020 restructuring transaction in Dick, *supra* note 20, at 1352–62.

145. *See* Adversary Complaint, *supra* note 142, at 25.

146. Dick, *supra* note 20, at 1354.

147. *See id.*

148. *See id.* at 1355.

149. *See id.*

150. *See id.* For additional discussion of the mechanics, see Adversary Complaint, *supra* note 142, at 15–19.

to ensure that the new loan facility would prime all of the existing tranches under the 2016 facility.[151] Participating lenders then executed a new intercreditor agreement establishing payment priorities for the new facility.[152] Specifically, they agreed that the 200 million dollars in new loans would enjoy the highest priority, followed by 875 million dollars of exchanged debt and an unspecified amount of "third-out" debt that may be issued in the future.[153] Most importantly, all of these new tranches would enjoy priority over the 814 million dollars remaining first lien debt held by lenders who were excluded from the 2020 restructuring.[154]

Reflecting on the 2020 restructuring, Serta characterized the transaction as a net positive for the company and its stakeholders:

> Ultimately, the [2020] Transaction reduced Serta Simmons Bedding's debt by approximately $400 million, lowered Serta Simmons Bedding's all-in interest expense, created new collateral for the benefit of all Lenders . . . and increased Serta Simmons Bedding's cash position to $300 million. Absent the [2020] Transaction, which allowed Serta Simmons Bedding to deleverage its balance sheet, Serta Simmons Bedding would likely have been put on the path to restructuring far sooner.[155]

Not everyone shared such a rosy view of the transaction. Shortly after the 2020 restructuring was completed, Moody's Investors Service downgraded the remaining first lien debt held by the excluded lenders to the agency's second lowest rating, reflecting an assessment that the debt was "highly speculative and with likelihood of being near or in default."[156] At that time, the agency predicted that the excluded lenders would "potentially be left with little or no remaining collateral coverage in Serta Simmons," and would be in "a position that is subordinated to new, higher priority debt."[157]

Because of the significant legal and economic ramifications of the 2020 restructuring, the excluded lenders filed suit in a New York state court against Serta, its private equity owner, and participating lenders, alleging that the 2020 restructuring transaction breached the 2016 loan agreement's consent provisions and violated the implied covenant of good faith and fair dealing.[158] The lenders asked for and received a temporary restraining order to prevent Serta from moving forward with the proposed restructuring.[159] The court declined to grant their request for a preliminary injunction on the grounds that the lenders' claims were unlikely to succeed, allowing Serta to

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151. *See* Dick, *supra* note 20, at 1355.
152. *See id.*
153. *Id.*
154. *See id.* at 1356.
155. Adversary Complaint, *supra* note 142, at 13.
156. Complaint at 4, AG Centre St. P'ship L.P. v. Serta Simmons Bedding, LLC, No. 654181/2022 (N.Y. Sup. Ct. Nov. 3, 2022).
157. *Id.*
158. *See* Complaint, N. Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC, No. 652243/2020 (N.Y. Sup. Ct. Aug. 4, 2020).
159. *See* Decision and Order on Motion at 6, N. Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC, No. 652243/2020 (N.Y. Sup. Ct. June 19, 2020).

effectuate the hostile restructuring in June 2020.[160] But the 2020 restructuring would not be the final word for Serta, as the company would ultimately file for bankruptcy several years later.[161]

The following subsection provides a traditional legal account of Serta's journey into and through the federal bankruptcy process, focusing on the legal rights and obligations of the parties under the governing agreements, relevant state laws, and federal bankruptcy law.

1. The Traditional Legal Account of Serta's Path Through Chapter 11

The traditional legal framework provides a useful starting point for analyzing Serta's bankruptcy case, helping to unpack the rights and obligations of the parties. In November 2022, with a possible Serta bankruptcy on the horizon, the excluded lenders filed a new suit against Serta and the lenders who participated in the 2020 restructuring.[162] Inspired by an apparent shift in sentiment by state and federal courts reviewing hostile restructurings,[163] the Supreme Court of the State of New York action held that the 2020 restructuring wrongfully subordinated the excluded lenders' debt without their consent in breach of the 2016 loan documents, and that it also breached the implied covenant of good faith and fair dealing by stripping away the excluded lenders' bargained-for economic rights and entitlements.[164] "The consequence," the lender-plaintiffs alleged, "has been to transform Plaintiffs from secured first lien lenders to effectively unsecured creditors in a highly distressed company,"[165] while "allowing other lenders—including Second Lien Lenders—improperly to leapfrog into a new, purportedly 'superpriority' position."[166]

Serta moved to dismiss the lenders' claims in early January 2023 on the grounds that the 2020 restructuring was expressly permitted by the 2016 loan documents.[167] In the alternative, Serta asked the Supreme Court of the State of New York to stay the action until a similar suit filed by another excluded lender in the U.S. District Court for the Southern District of New York could

160. *See id.* at 11.

161. *See* Petition, *supra* note 141.

162. *See* Adversary Complaint, *supra* note 142.

163. For instance, in a federal suit brought by another of Serta's excluded lenders, the U.S. District Court for the Southern District of New York denied Serta's motion to dismiss the claims. *See* LCM XXII Ltd. v. Serta Simmons Bedding, LLC, 21 Civ. 3987, 2022 WL 953109 (S.D.N.Y. Mar. 29, 2022). Similarly, in another case involving a similar hostile restructuring of another company, a New York state court denied the defendants' motions to dismiss. *See* ICG Glob. Loan Fund 1 DAC v. Boardriders Inc., No. 655175/2020, 2022 WL 10085886 (N.Y. Sup. Ct. Oct. 17, 2022).

164. *See* Adversary Complaint, *supra* note 142.

165. *Id.* at 2.

166. *Id.* at 18.

167. *See* Serta Simmons Bedding, LLC's Memorandum of Law in Support of its Motion to Dismiss or Stay in the Alternative, AG Centre St. P'ship L.P. v. Serta Simmons Bedding, LLC, No. 654181/2022 (N.Y. Sup. Ct. Jan. 9, 2023).

be resolved.[168] Both matters, however, were still pending as of the company's bankruptcy filing on January 23, 2023.[169]

Although the claims against Serta were clearly subject to the Bankruptcy Code's automatic stay,[170] there was some question as to whether the claims against the lender-defendants were automatically stayed by the bankruptcy filing.[171] And so, within the first twenty-four hours of the bankruptcy case, the excluded lenders sought to remove their prepetition claims against the nondebtor parties from the Supreme Court of the State of New York to the Southern District of New York, where the other excluded lender suit was still pending.[172]

The removal action kicked off a series of conflicts over venue and the scope of the automatic stay. Serta argued that the removal action was intended to "avoid having [the bankruptcy court] decide, or otherwise have any preclusive effect upon," the issues in dispute, even though resolution of these claims was necessary for a successful reorganization.[173] The company also argued that the stay ought to apply to the claims brought against the participating lenders, given the "identity of interest" between Serta and these nondebtor entities.[174] In a separate adversary proceeding, Serta asked the bankruptcy court to stay the district court litigation and to issue a declaratory judgment, arguing (1) that the 2020 hostile restructuring was permissible under the 2016 Credit Agreement, and (2) that the plaintiffs did not violate the covenant of good faith and fair dealing by entering into the 2020 transaction.[175] According to Serta, the 2020 transaction was the product of an "extensive and competitive process to restructure its debt," and should be construed and enforced in accordance with its terms.[176]

In essence, the company sought a final declaration as to the priority of creditors pursuant to the prepetition credit agreements. Until the conflicts with the excluded lenders could be resolved, the outstanding claims would "directly impact priority and distributions under the Debtors' proposed Plan" and would make it difficult or even impossible to obtain stakeholder support because the debtor would remain subject to indemnity obligations under its

168. *See id.* at 21–22 (citing Complaint, LCM XXII Ltd. v. Serta Simmons Bedding, LLC, 21 Civ. 3987, 2022 WL 953109 (S.D.N.Y. 2022)).

169. *See* Adversary Complaint, *supra* note 142, at 8.

170. *See* 11 U.S.C. §§ 362(a)(1), (3) ("[A] petition filed under [the Bankruptcy Code] . . . operates as a stay, applicable to all entities, of [] the commencement or continuation . . . of a judicial . . . action or proceeding against the debtor . . . [or] any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.").

171. *See* Notice of Filing of Notice of Removal at 7, AG Centre St. P'ship L.P. v. Serta Simmons Bedding, LLC, No. 654181/2022 (N.Y. Sup. Ct. Jan. 24, 2023).

172. *See generally id.*

173. *See* Adversary Complaint, *supra* note 142, at 3.

174. *See* Debtors' Emergency Motion for an Order (I) Declaring that the Automatic Stay Applies to Certain Non-Debtor Parties or Alternatively Extending the Automatic Stay to Certain Non-Debtor Parties and (II) Preliminarily Enjoining the Prepetition Action, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. Jan. 24, 2023).

175. *See* Adversary Complaint, *supra* note 142.

176. *See* Debtors' Emergency Motion, *supra* note 174, at 2.

prepetition financing agreements.[177] Although the debtor acknowledged that the conflicts could be resolved by allowing the federal court litigation to proceed, proceeding in this manner would, in the debtor's opinion, deprive Serta of the protections afforded by the automatic stay and subject the bankruptcy estate to the "administrative burdens and costs associated with defending the Prepetition Action during the pendency of the Chapter 11 Cases."[178]

The Bankruptcy Court for the Southern District of Texas agreed with Serta, entering an initial order temporarily staying the claims against the participating lenders.[179] After a hearing on the matter, the bankruptcy court extended the order for the duration of the bankruptcy proceedings.[180] At the hearing, counsel for the debtor argued that the claims against the participating lenders "challenge[] the validity of the debtors' prepetition agreements," and "[t]hose agreements are property of the estate."[181] This is because they "provide the debtors with valuable rights" relating to the bankruptcy, such as the right to "enforce the priorities" set forth in the agreements.[182] In light of the indemnification provisions contained in the agreements, any actions against the participating lenders would ultimately impact the bankruptcy estate.[183]

The bankruptcy court grilled Serta's counsel with respect to the former argument, questioning how what appeared to be mere "claims adjudication" could necessarily rise to the level of "exercising control over property of the estate."[184] Debtor's counsel backed away from this argument, ultimately resting the case on much broader "identity of interest" grounds.[185] Meanwhile, counsel for the lender-defendants emphasized that the claims were squarely within the bankruptcy court's exclusive jurisdiction because they were core proceedings concerning "the capital structure of the reorganized entity, as well as the priority of claims."[186]

The court embraced this latter view, explaining that the questions at stake in the litigation went not only to the claims adjudication process, but also to plan confirmation, given that the court would have to find that the plan—and the transactions underlying the plan—complied with all applicable law.[187] Whether the claims were litigated in state or federal district court, the

177. *See id.* at 4.
178. *Id.* at 7.
179. *See* Order Temporarily Staying or Enjoining Certain Prepetition Actions, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. Feb. 2, 2023).
180. *See* Order (I) Extending the Automatic Stay to Certain Non-Debtor Parties and (II) Enjoining the Prepetition Actions, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. Mar. 21, 2023).
181. Exhibit B at 8, AG Centre St. P'ship L.P. v. Serta Simmons Bedding, LLC, No. 654181/2022 (N.Y. Sup. Ct. Mar. 21, 2023) (providing the transcript of the status conference before Judge David R. Jones in the Bankruptcy Court for the Southern District of Texas).
182. *Id.*
183. *See id.* at 9.
184. *Id.* at 15–16.
185. *Id.* at 16–17.
186. *Id.* at 19.
187. *See id.* at 30–32.

bankruptcy court would essentially have to wait for resolution before it could confirm a plan.[188] Reiterating that these determinations "run[] directly to the core function" of the bankruptcy court, Judge David R. Jones concluded that "[t]here is not a path that I am willing to accept that allows another court to make those determinations for me."[189]

With the litigation enjoined for the remainder of the case, the disputes concerning the validity of the 2020 restructuring would have to be resolved through the adversarial proceeding in the bankruptcy court.[190] At a combined trial addressing both the adversary proceeding and the confirmation of the debtor's proposed plan of reorganization,[191] arguments returned to the underlying question of whether the 2020 restructuring violated the express terms of the 2020 Credit Agreement and/or the implied covenant of good faith and fair dealing.[192]

In closing arguments, debtor's counsel explained the genesis of the 2020 restructuring: "The company was facing an existential threat due to COVID, and was about to run out of money. It was also significantly over-leveraged, so it did what any reasonable company would do. It engaged its current lenders, as well as multiple third-party lenders, as part of a competitive process to try to find the best deal that it could in the market."[193] Without that deal, debtor's counsel explained, "the company would likely have had to file for bankruptcy back in 2020."[194] "Engaging the market and picking the best deal available after a competitive process to save the company," counsel argued, "is the epitome of good faith and certainly not a breach of the implied covenant of good faith and fair dealing."[195]

Just as they had previously, the company and the participating lenders defended the 2020 restructuring on the grounds that each step of the transaction was permitted by the express terms of the 2016 credit documents—which did not codify antisubordination of the existing debt as a sacred right—and that there was no harm to the excluded lenders because their existing credit documents and liens would remain in place.[196] In other words, the company did not rescind its promise to repay every dollar of the debt, or extinguish the lien rights securing these obligations. Closing arguments focused on the implied covenant of good faith and fair dealing,

188. *See id.* at 40–42.
189. *Id.* at 60–61.
190. The plaintiffs in the other action already pending in the Southern District of New York were granted permission to intervene in the adversarial proceeding. *See* Order Granting LCM Lenders' Unopposed Emergency Motion to Intervene, *In re* Serta Simmons Bedding, LLC, No. 23-09000 (Bankr. S.D. Tex. Feb. 1, 2023).
191. *See* Debtors' and PTL Lenders' Emergency Motion to Certify Pending Appeals to the Fifth Circuit at 3, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. July 5, 2023).
192. *See* Transcript of Confirmation Closing Arguments at 7–8, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. May 30, 2023).
193. *Id.*
194. *Id.*
195. *Id.* at 8.
196. *See* Dick, *supra* note 20, at 1356–58; *see also* Exhibit B, *supra* note 181, at 57–62.

with the debtor frequently reminding the court that the excluded lenders would have engaged in an equally hostile restructuring if given the opportunity.[197] Meanwhile, counsel for the participating lenders argued that the 2020 restructuring "was supported by the words of the 2016 credit agreement," and that the lenders engaged in the hostile restructuring "as an act of self-defense, to protect their investors against the dropdown transaction that had disastrous downside consequences for the investment in Serta debt."[198]

On June 6, 2023, the bankruptcy court entered a memorandum opinion confirming the debtors' proposed plan of reorganization and adjudicating the claims that were the subject of the adversary proceeding.[199] Although Judge Jones acknowledged that the 2020 restructuring was a "position enhancing transaction" in that it benefited some lenders at the expense of others, he concluded that judicial intervention is unnecessary and inappropriate, as lenders are well positioned to protect themselves:

> Lender exposure to these types of transactions can be easily minimized with careful drafting of lending documents. While the result may seem harsh, there is no equity to achieve in this case. Sophisticated financial titans engaged in a winner-take-all battle. There was a winner and a loser. Such an outcome was not only foreseeable, it is the only correct result. The risk of loss is a check on unrestrained behavior.[200]

Following this decision, the court entered a ruling in the adversary proceeding in favor of Serta and the other plaintiffs, approving the 2020 hostile restructuring and denying the excluded lenders' counterclaims.[201] Meanwhile, after their motions for a stay of confirmation were denied,[202] the excluded lenders appealed the bankruptcy court's decision to the U.S. Court of Appeals for the Fifth Circuit.[203] Those appeals are still pending as of this writing.

The traditional legal account of Serta's journey through Chapter 11 naturally focuses on legal rights and entitlements, such as rights and obligations arising under commercial finance agreements, the legal and equitable responsibilities of parties participating in complex debt

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197. *See* Exhibit B, *supra* note 181, at 7–23.

198. *Id.* at 57–58.

199. *See In re* Serta Simmons Bedding, LLC, Ch. 11 Case No. 23-90020, Adv. No. 23-9001, 2023 WL 3855820 (Bankr. S.D. Tex. 2023). The opinion was followed by a confirmation order. Findings of Fact, Conclusions of Law, and Order Confirming Second Amended Joint Chapter 11 Plan of Serta Simmons Bedding, LLC and Its Affiliated Debtors, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. June 14, 2023).

200. *In re Serta Simmons Bedding, LLC.*, 2023 WL 3855820, at *14 .

201. *See* Final Judgment, *In re* Serta Simmons Bedding, LLC, Ch. 11 Case No. 23-09001, Adv. No. 23-09001, 2023 Bankr. LEXIS 1479 (Bankr. S.D. Tex. June 6, 2023).

202. *See* Order Denying (A) Objectors Stay Motions, (B) LCM Lenders Joinder in (I) Excluded Lenders Emergency Motion to Stay the Confirmation Order and (II) Citadel Equity Fund Ltd.'s Motion to Extend Stay of Effective Date of Confirmation Order, and Joinders Thereto, Denying Motion to Extend Time, Denying Emergency Motion, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. June 21, 2023).

203. *See* Order on Motion for Certification of Direct Appeal to the Fifth Circuit, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. Jul. 7, 2023).

transactions, and the bankruptcy entitlements of various stakeholders in a complex Chapter 11 case. However, it does not probe the underlying transactions that created the firm's extant capital structure. Instead, it gives substantial deference to these underlying conditions, effectively taking them as a given unless there are indications of breach of contract, fraud, or other wrongdoing. But these sorts of claims tend to have strict elements and high evidentiary burdens, such that they can be extremely expensive and time consuming to prosecute and adjudicate. In essence, because it is hyper focused on legal rights and obligations, the traditional legal account does not consider *why* these agreements and transactions were entered into in the first place, and how earlier moves might interact with the bankruptcy system to generate predictable outcomes. To understand these underlying motivations, this Article turns now to the tactical account of Serta's conduct.

2. The Tactical Account of Serta's Path Through Chapter 11

To help shed additional light on the ways in which corporate debtors interact with a dynamic bankruptcy system to achieve specific restructuring outcomes, the following subsections use the restructuring attributes as an alternative analytical framework to discuss Serta's bankruptcy and the 2020 restructuring transaction. By focusing on restructuring attributes in addition to legal rights and entitlements, the debtor's overall restructuring strategy—spanning the 2020 restructuring and the eventual Chapter 11 case—becomes much clearer. The story of tactical restructuring that emerges, in turn, helps to sharpen the legal analysis and open new pathways for reforming bankruptcy and commercial laws.

a. Serta's Apparent Insolvency

Serta's bankruptcy and plan-related disclosures portrayed the company as deeply insolvent. The debtor's preliminary financial disclosures reported real and personal property assets with a total current book value of approximately seventy-eight million dollars and debts in excess of 1.9 billion dollars.[204] Later in the case, a valuation analysis prepared in conjunction with the debtor's proposed plan of reorganization estimated the going-concern value of the reorganized company to be between approximately 700 million dollars and one billion dollars,[205] an amount that

204. *See* Global Notes, Statements of Limitations, and Methodologies, Disclaimers, and Specific Disclosure Regarding the Debtor's Schedules of Assets and Liabilities and Statements of Financial Affairs at 29, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. Mar. 9, 2023).

205. *See* Disclosure Statement for Joint Chapter 11 Plan of Serta Simmons Bedding, LLC and Its Affiliated Debtors at Exh. F, Valuation Analysis, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. Mar. 23, 2023).

is clearly insufficient to pay secured claims in excess of 1.9 billion dollars, let alone the company's millions of dollars in unsecured claims.[206]

Of course, these financial disclosures and reports do not purport to capture the intrinsic value of the company. Nor do they purport to reflect market value. A plan-related valuation analysis contains a disclaimer that the analysis "does not necessarily reflect values that could be attainable in the public or private markets" and that the value estimate assigned to the equity interests in the reorganized company "does not purport to be an estimate of the post-reorganization market value of the reorganized debtors."[207]

Serta's financial disclosures and reports suffer from many of the limitations that tend to plague bankruptcy-related analyses of this sort.[208] The company's preliminary disclosures include a disclaimer that they are based on "financial data derived from [the debtor's] books and records and historical financial statements that were available at the time of such preparation."[209] The low values reflected for Serta's assets most likely reflect low historical costs. It is important to note, however, that these preliminary disclosures rely on historical financial statements and do not purport to provide current appraisal values.[210] As a result, they do not fully reflect the value of the debtor's goodwill, intellectual property, tax assets, and data-related assets.[211]

In a similar way, the company's plan-related valuation analysis includes a disclaimer that the preparers relied on the debtor's financial projections and financial statements and "did not conduct an independent verification of the Financial Projections . . . [or] conduct an independent evaluation or appraisal of the Debtors' assets in connection with this valuation."[212] Because financial projections are such a significant part of the discounted cash flow valuation analysis, the analysis warns that "[t]he Reorganized Debtors' actual future results may differ materially (positively or negatively) from the Financial Projections and, as a result, the actual total enterprise value of the Reorganized Debtors may be significantly higher or lower than the estimated range herein."[213] Serta's ability to show apparent insolvency was naturally influenced by assumptions made in various underlying reports; these assumptions likely address such important variables as the relevant commodity prices and future sales and growth assumptions.

In sum, Serta and its advisors never attempted to prove the company's true or intrinsic value. Rather, the debtor provided the customary financial reports

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206. *See* Debtors' Schedules of Assets and Liabilities and Statements of Financial Affairs at 29, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. Mar. 9, 2023).

207. Disclosure Statement, *supra* note 205, at 231–235.

208. On the limitations of bankruptcy valuation analyses, see Diane Lourdes Dick, *Valuation in Chapter 11 Bankruptcy: The Dangers of an Implicit Market Test*, 2017 U. ILL. L. REV. 1487.

209. Debtors' Schedules of Assets and Liabilities, *supra* note 206, at 2.

210. *See id.*

211. *See id.*

212. Disclosure Statement, *supra* note 205, at 231–235.

213. *Id.*

that are typically relied on in bankruptcy proceedings. These documents support a presumption of Serta's insolvency as it is currently reflected or may reasonably be expressed in customary financial reports, thereby serving their intended evidentiary function in the Chapter 11 proceedings. As a restructuring attribute, Serta's apparent insolvency would create a powerful presumption in favor of the debtor's proposed plan of reorganization, positioning discontented junior stakeholders as disgruntled investors engaging in scorched-earth litigation tactics at the expense of senior creditors who effectively bear the true economic burden of the restructuring.

Of course, given the dire financial picture that Serta's earliest financial disclosures painted, stakeholders may have questioned the company's administrative solvency and pushed for a liquidation. To understand how these arguments may have fared, the following subsection takes a closer look at Serta's administrative expense hurdle.

b. Serta's Administrative Expense Hurdle

Notwithstanding the low asset values listed on Serta's preliminary financial disclosures, the company is worth considerably more as a going concern to the extent it intends to use said assets to generate future income. But even when debtors enter Chapter 11 with the best intentions, bankruptcy reorganization is an expensive process; if the case is not carefully monitored, the costs can cause the estate to become administratively insolvent. If the debtor cannot pay the expenses associated with the restructuring, then it will be converted to a Chapter 7, leading to rapid erosion of value at all levels of the capital structure, or dismissed, meaning that the debtor would no longer receive the protections of bankruptcy.

Given the importance of the administrative expense hurdle to the case and, more broadly, to the integrity of the bankruptcy system, interested parties should expect significant attention to the issue throughout the proceedings. Behind the scenes, the debtor, its senior secured creditors, and their respective financial advisors would naturally monitor the debtor's administrative expenses and conduct analyses to ensure that the estate always has a distributable value well above the administrative expenses hurdle.

Additionally, a corporate debtor must take steps to assure the *court* that it will not become administratively insolvent on its watch, though the requisite showing need not come in the form of additional financial disclosures, declarations of administrative solvency, or mini-valuation trials. In today's corporate Chapter 11 cases, these assurances often come in the form of contractual innovations.[214] Reflecting the modern trend, Serta financed its bankruptcy restructuring—and publicly managed its administrative expense hurdle—by borrowing 125 million dollars on a postpetition basis, promising to adhere to an approved budget that made adequate provisions for administrative expenses, and negotiating a carve out from the superpriority

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214. On contractual innovations generally, see Matthew Jennejohn, Julian Nyarko & Eric L. Talley, *Contractual Evolution*, 89 U. CHI. L. REV. 901 (2022).

status and first priority priming lien otherwise granted to the postpetition debt.[215] In its request for court approval of the proposed postpetition financing arrangement, Serta aptly declared that "the Carve Out protects against administrative insolvency during the pendency of these chapter 11 cases by ensuring that assets are available to pay U.S. Trustee's fees and professional fees of the Debtors and any statutory committee."[216]

The carve out protected (1) all fees required to be paid to the bankruptcy court and to the U.S. Trustee; (2) all "reasonable and documented fees and expenses" (subject to a fifty thousand dollar cap) incurred by a trustee in the event that the case is converted to a Chapter 7 liquidation;[217] and (3) all allowed debtor and committee professional fees, costs, and expenses incurred prior to delivery of a carve out notice (and, after such delivery, all fees, costs, and expenses subject to a five million dollar cap on debtor fees, costs, and expenses and a 150 thousand dollar cap on committee fees, costs, and expenses).[218] To provide further assurances, the debtor and the postpetition lenders also agreed to establish a segregated deposit account and fund it "in an amount equal to all obligations benefiting from the Carve Out,"[219] as well as maintain a financial reserve in an amount equal to the sum of the additional amounts subject to the carve out.[220]

To be sure, Serta and its postpetition lenders are not the first to use mechanisms of this sort to publicly manage the administrative expense hurdle. Many courts insist on carve outs to pay attorneys and other professionals because "[a]bsent such protection, the collective rights and expectations of all parties-in-interest are sorely prejudiced."[221] By using these familiar techniques, Serta was able to put to rest any concerns over administrative insolvency and sidestep the need to engage in additional disclosures, declarations, or valuation battles. Nonetheless, Serta's financial disclosures painted a dire picture; with the company apparently insolvent, stakeholders would no doubt wonder how far on the priority ladder the company's distributable value would reach. The following subsection considers the character of Serta's fulcrum security.

215. *See* Final Order (I) Authorizing Debtors to (A) Obtain Post-petition Financing and (B) Use Cash Collateral, (II) Granting (A) Liens and Providing Claims with Superpriority Administrative Expense Status and (B) Adequate Protection to Certain Prepetition Lenders, (III) Modifying Automatic Stay, and (IV) Granting Related Relief at 2–4, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. Jan. 24, 2023).

216. Emergency Motion of Debtors for Interim and Final Orders (I) Authorizing Debtors to (A) Obtain Post-petition Financing and (B) Use Cash Collateral, (II) Granting (A) Liens and Providing Claims with Superpriority Administrative Expense Status and (B) Adequate Protection to Certain Prepetition Lenders, (III) Modifying Automatic Stay, (IV) Scheduling a Final Hearing, and (V) Granting Related Relief at 40, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. Jan. 24, 2023).

217. *See id.*; 11 U.S.C. § 726(b).

218. *See* Emergency Motion, *supra* note 216, at 14.

219. *Id.* at 52–53.

220. *Id.* at 56.

221. *In re* Ames Dept. Stores Inc., 115 B.R. 34, 38 (Bankr. S.D.N.Y. 1990).

c. The Character of Serta's Fulcrum Security

Under bankruptcy's distributional norms, the value of the reorganized company must be allocated based on priorities determined under relevant state laws and as set forth in the Bankruptcy Code.[222] Reflecting these norms, Serta's plan of reorganization contemplated that certain secured claims and certain priority claims would be unimpaired, meaning that they would be paid in full because the legal, equitable, and contractual rights of the holders would be unaltered by the plan.[223]

As to the senior secured debts arising out of the 2020 restructuring, the plan contemplated that the lenders would fund 200 million dollars in new-money, term loans with superpriority status.[224] Regarding the 875 million dollars of debt exchanged in the 2020 restructuring, the debtor's valuation analysis suggests there is insufficient value to pay these claims in full.[225] Accordingly, the plan contemplated a debt-to-equity swap estimated to yield a 73.7 to 75.6 percent recovery.[226] Although the valuation analysis estimated the value of the reorganized debtor to be somewhere between 700 million dollars and one billion dollars, the debtor would emerge with funded debt and some cash on hand, such that the estimated value of the common equity would be "approximately $365 million and $665 million with a midpoint of $515 million."[227]

In other words, Serta identified debts owed to the lenders who participated in the 2020 debt exchange as the fulcrum security.[228] This is the class of debt that is positioned at the point in the firm's capital structure where, under a strict application of absolute priority, all senior creditors would be paid in full and no junior creditors would be entitled to a distribution.[229] The next-in-line class consisted of lenders under the 2016 loan agreement who were excluded from the 2020 restructuring and were technically out of the money.[230] Assuming the bankruptcy court respected both the 2020 restructuring (which subordinated their claims) and the debtor's valuation analysis (which portrayed the company as woefully insolvent), these creditors would not be entitled to any distribution.[231] However, given the importance of reaching a settlement with this constituency, the plan offered 4 percent of the common equity to share pro rata in accordance with their

222. *See* 11 U.S.C. § 1129.

223. *See* Second Amended Joint Chapter 11 Plan of Serta Simmons Bedding, LLC and its Affiliated Debtors at 27, *In re* Serta Simmons Bedding, LLC, No. 23-90020 (Bankr. S.D. Tex. May 23, 2023).

224. *See* Second Amended Joint Chapter 11 Plan, *supra* note 223, at 10 (identifying the new "first lien first out" term loan).

225. *See* Disclosure Statement, *supra* note 205, at 231–235.

226. *See id.* at 14.

227. *Id.* at 231–235.

228. *See id.* at 14. (identifying the "FLSO Claims" as the first class slated to receive less than 100 percent recovery).

229. *See supra* Part I.C.

230. *See* Disclosure Statement, *supra* note 205, at 15 (identifying "Non-PTL Term Loan Claims").

231. *See supra* notes 56–59 and accompanying text.

interests if they voted in favor of the plan; if the class voted to reject the plan, they would receive only 1 percent of the common equity.[232]

Finally, most general unsecured creditors were slated to receive the proverbial pennies on the dollar under the proposed plan; however, to facilitate the company's current and future commercial activities, the plan offered a full recovery to certain critical trade partners who provide ongoing products and services to Serta.[233]

As the fulcrum security, the lenders who participated in the 2020 restructuring were positioned throughout the case as the stakeholders with the greatest economic incentive to contest valuation estimates and challenge the debtor's proposed plan of reorganization. Since the plan suggested that the fulcrum security holders would receive a distribution presently valued at less than the face amount of their claims, the court would have been more likely to take their motions and objections seriously. This is because such lenders were already taking a proverbial haircut and were at risk of taking an even bigger haircut if the confirmation battle had been permitted to drag on indefinitely.

At the same time, because the plan contemplated a debt-to-equity swap, the lenders who participated in the 2020 restructuring would also receive virtually all the upside potential in the reorganized company. Moreover, to the extent the valuation analysis was too conservative (or an outright lowball) the lenders who participated in the 2020 restructuring would enjoy whatever excess intrinsic value exists. In essence, although the court may have gained some comfort from the fulcrum security holder's tacit approval of the plan, the uncomfortable truth is that the participating lenders may not have had any economic incentive to challenge the plan or its underlying financial assumptions.

Because the fulcrum security was a secured debt class, the more important attribute for these claimants to monitor was the secured debt hurdle and subhurdles, which speak to the level of consolidation in the debt-to-equity conversion. The following subsections consider these attributes, with special attention to how Serta adjusted its secured debt hurdle and subhurdles prior to bankruptcy.

d. Serta's Secured Debt Hurdle

Prior to the 2020 restructuring, Serta's secured debt hurdle was primarily set by a senior secured financing arrangement initiated in 2016.[234] The arrangement gave the company access to 1.95 billion dollars in first lien loans and 450 million dollars in second lien loans.[235] Both facilities were syndicated, meaning that the funds were made available by a large group of

232. *See* Disclosure Statement, *supra* note 205, at 15.
233. *See id.* at 15–16.
234. *See* Complaint at 11, N. Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC, No. 652243/2020 (N.Y. Sup. Ct. Aug. 4, 2020).
235. *See id.*

lenders.[236] Each group of lenders holds liens on the same collateral; however, the two groups agreed that in the event of a default, the obligations arising under the first lien facility must be satisfied in full before the second lien lenders are entitled to be paid.

Of course, a large company like Serta typically has numerous other secured debts, whether arising from contractual arrangements or by operation of statutory law or judicial intervention. But the vast majority of the company's secured debts pertain to its senior secured credit facility.[237] Thus, prior to the 2020 restructuring, Serta's secured debt hurdle would have been at least the total amount outstanding under the 2016 senior secured credit facility: a fluctuating amount in excess of two billion dollars.[238]

Based on the debtor's bankruptcy disclosures, which make the classic showing of apparent insolvency, the secured debt hurdle was potentially well above the debtor's enterprise value and may have been for quite some time.[239] To rightsize the firm's capital structure, the debtor would need to reduce the secured debt hurdle to an amount equal to or (ideally) significantly below the enterprise value of the firm. The debtor could do this by extinguishing debt and/or swapping debt for equity, within or outside of bankruptcy.

Complicating matters is the fact that, pursuant to the 2016 syndicated loan agreement, the lenders within each tranche of debt sat on equal footing with one another.[240] Each lender would therefore be entitled to receive its pro rata share of any payments made by the debtor or any proceeds from the disposition of collateral, and each lender would, in theory, have equal rights to participate in exchange offers or other restructurings.[241]

To shift the secured debt hurdle, then, Serta would need to negotiate an out-of-court restructuring with the entire loan syndicate or file for Chapter 11 bankruptcy and forcibly move the secured debt hurdle by showing that the collateral is worth less than the amount of the outstanding obligations, such that the excess debt should be treated as unsecured debt for bankruptcy purposes.[242] In either case, each lender within a tranche would suffer the same impairment—pro rata in accordance with its interest. In other words,

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236. On syndicated loan agreements, see RICHARD WIGHT, WARREN COOKE & RICHARD GRAY, THE LSTA'S COMPLETE CREDIT AGREEMENT GUIDE (2009).

237. *See* Disclosure Statement, *supra* note 205, at 14.

238. *See* Global Notes, Statements of Limitations, and Methodologies, Disclaimers, and Specific Disclosure Regarding the Debtor's Schedule of Assets and Liabilities, *supra* note 204, at 29.

239. *See supra* Part II.A.2.a.

240. *See* Complaint, *supra* note 156, at 22.

241. For the relevant excerpts from the loan agreement, see Plaintiffs' Memorandum of Law in Support of Their Application for a Temporary Restraining Order, a Preliminary Injunction, and Expedited Discovery, N. Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC, No. 652243/2020, 2020 N.Y. Misc. LEXIS 4222 (N.Y. Sup. Ct. Aug. 4. 2020).

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

if the restructuring contemplated the exchange of debt at a discount, each lender would experience the same discount. If the restructuring contemplated a debt-to-equity swap, each lender would receive the same fractional share of the outstanding equity offered to that creditor class. By reducing the company's overall amount of senior secured debt, the 2020 restructuring had the effect of shifting Serta's secured debt hurdle.

Of course, Serta—like most companies—had multiple tranches of secured debt, such that any future bankruptcy restructuring would be dictated by the position of the subhurdles that form the various classes for plan treatment and voting purposes.[243] The following subsection takes a closer look at Serta's secured debt subhurdles, both before and after the 2020 restructuring.

e. Serta's Secured Debt Subhurdles

The greatest impact of the 2020 restructuring is that it adjusted the company's secured debt subhurdles prior to the debtor's bankruptcy filing. Instead of having the first secured debt subhurdle at approximately two billion dollars (the amount of debt outstanding under the first lien credit facility), the first secured debt subhurdle would now be at 200 million dollars, followed by another secured debt subhurdle to capture the next 875 million dollars of debt, and so on. In this way, the restructuring divided the existing senior secured facility into multiple new facilities with different levels of priority.

Of course, shifting or introducing new secured debt subhurdles would have a major impact on legal rights and entitlements.[244] Lenders who were previously within the highest secured debt subhurdle would now be relegated down to the fourth secured debt subhurdle. Meanwhile, the act of concentrating the secured debt into smaller tranches would interact in powerful ways with bankruptcy process, as each tranche would be treated separately for priority (and eventually plan treatment) purposes.

B. What the Restructuring Attributes Tell Us About Serta's Path Through Chapter 11

By assessing Serta's restructuring attributes—and considering how they interact with legal rights and obligations—we gain a clearer picture of Serta's bankruptcy strategy. At the time of the 2020 restructuring, when the company was financially distressed and likely insolvent, Serta worked with certain senior lenders to redesign its capital structure. The hostile restructuring may have helped to stave off bankruptcy in the short term; however, it also had the effect of maximizing and consolidating the benefits of a future Chapter 11 bankruptcy filing. Specifically, it rearranged the company's secured debt subhurdles, bringing the fulcrum security holders closer to the firm's apparent going-concern value. This subhurdle adjustment would have the effect of making a future bankruptcy debt-to-equity swap—

243. *See* Disclosure Statement, *supra* note 205, at 14.
244. *See supra* Part I.E.

as well as future debt or equity capital investments—more attractive to participating lenders, thereby increasing the company's access to (and reducing the cost of) capital at a time when the company would normally have little to no restructuring options. Although the traditional legal account takes the placement of Serta's secured debt subhurdles as a preexisting financial reality, an alternative framework focusing on Serta's restructuring attributes appreciates the tactical prebankruptcy planning implications of these prior transactions.

The 2020 restructuring also advanced certain investors to the highest position on the absolute priority ladder while relegating others to what is essentially an unsecured status in bankruptcy's forced day of reckoning. In this way, the 2020 restructuring allowed the company to not only allocate the economic benefits and burdens of financial distress, but to hand select its future owners.

Finally, the 2020 restructuring set the terms of a future bankruptcy plan of reorganization without having to comply with important creditor safeguards provided under bankruptcy law. By aligning its restructuring attributes in an ideal manner, the company and the participating lenders were able to streamline the bankruptcy process and reduce legal risks by gaining the benefit of certain presumptions set forth in substantive bankruptcy law or under customary bankruptcy practices and procedures. For instance, the fact that the secured debt hurdle was well in excess of the debtor's apparent going-concern value made it difficult for out-of-the-money stakeholders to gain much sympathy from the court. In effect, the company's 2020 restructuring and related moves should be understood as calculated, tactical prebankruptcy planning intended to align the company's capital structure and financial profile perfectly with bankruptcy law and other relevant sources of substantive and procedural rights to generate the desired restructuring outcomes. Although it is impossible to know the subjective intent that motivated any particular prebankruptcy move, the fact remains that the company's conduct had the effect of adjusting the company's restructuring attributes, enabling the company to achieve certain strategic financial objectives.

Part III of this Article takes up the normative question of whether and to what extent bankruptcy law should restrain or otherwise regulate this subtle yet effective form of corporate prebankruptcy planning.

III. IMPLICATIONS FOR BANKRUPTCY REFORM

Although restructuring attributes have not received systematic attention from bankruptcy courts and scholars, they are quietly relied upon as the analytical foundation of virtually all Chapter 11 strategies. And, because they can be adjusted through prebankruptcy planning, restructuring attributes are the centerpiece of sophisticated tactical restructuring strategies that can span months or even years.

Restructuring attributes set floors and ceilings that serve to foreclose the legal rights and remedies of other stakeholders and maximize investment

returns, helping to determine the practical ease and viability of a Chapter 11 restructuring effort and the technical feasibility of particular plans of reorganization. For instance, the administrative expenses hurdle establishes the baseline right of the debtor to engage in a Chapter 11 restructuring and minimize the risk of conversion to a Chapter 7 liquidation.[245] The debtor's apparent insolvency makes it extremely difficult for out-of-the-money stakeholders to challenge the debtor's restructuring plan, as the debtor need only remind the court that its most senior creditors are already taking a proverbial haircut and that additional litigation will further impair their claims.[246] The secured debt hurdle, for its part, sets a valuation threshold that must be overcome for value to flow to junior claimants (typically unsecured creditors and equity holders); it also sets a practical hurdle in that any valuation *below* the secured debt hurdle will reinforce the debtor's apparent insolvency.[247]

Because of their profound impact on substantive and procedural bankruptcy rights, restructuring attributes are key to understanding the relationship between Chapter 11 and the broader financial markets. By focusing on these understudied inputs, courts and commentators can more fully appreciate Chapter 11 bankruptcy as a dynamic process that responds in predictable ways, allowing debtors and their preferred stakeholders to effectively capture the system's inherent flexibility and remarkable investment-altering powers for private gain.

A focus on restructuring attributes—and the tactical restructuring strategies they inspire—also reveals major shortcomings of the traditional legal framework. First, the traditional legal account does not do enough to probe the debtor's underlying financial characteristics. Absent allegations of fraud, breach of contract, or other clear wrongdoing or a showing that a transaction must be treated some other way by operation of bankruptcy or other applicable law (for instance, because a prebankruptcy transfer amounts to a preference), Chapter 11 effectively treats the debtor's financial attributes as immutable qualities that are the result of corporate decisions, actions, and inactions that predate—and are separate and distinct from—a subsequent bankruptcy filing. This treatment likely stems from a broader commercial law commitment to important principles of legal certainty, uniformity, and predictability.[248] The judiciary has long acknowledged that the subsequent unraveling of a commercial transaction has the potential to wreak havoc on the financial markets and cause dangerous ripple effects.[249]

This is not to say that legal certainty and predictability are unimportant; parties to corporate bankruptcy reorganizations—and the various transactions that precede those reorganizations—rely on the legal system to

245. *See supra* Part I.B.
246. *See supra* Part I.A.
247. *See supra* Part I.D.
248. The author of this Article explores these foundations of commercial law in Diane Lourdes Dick, *Confronting the Certainty Imperative in Corporate Finance Jurisprudence*, 2011 UTAH L. REV. 1461.
249. *See id.*

defend their commercial expectations.[250] The most effective reforms, then, lie in between the two extremes of ignoring restructuring attributes, on the one hand, and unraveling prior transactions, on the other. Simply by acknowledging the potential for tactical prebankruptcy planning and analyzing the debtor's restructuring attributes (along with any recent adjustments to them), bankruptcy courts gain a more nuanced view of the litigation dynamics unfolding in their courtroom. For example, a court may be less inclined to sympathize with a class of fulcrum security holders that is comprised of lenders who participated in a recent transaction to lower their secured debt subhurdle such that they would advance to a more concentrated equity position in the reorganized company.

In more egregious cases of tactical restructuring, such as Serta's, bankruptcy law serves as a source of broad powers to lend finality and force of law to carefully calibrated private decisions.[251] In other words, the primary benefit to be gained from the bankruptcy filing is not the classic bankruptcy breathing room or even the opportunity to engage in an orderly restructuring process. Rather, the primary benefit is the potential to solidify an earlier hostile restructuring by locking in priorities and forcing the recognition event that only bankruptcy can provide, short of an actual liquidation that would forever extinguish the firm's upside potential.

The implications of this statement become even clearer when considered in the shadow of tax and corporate law's "step-transaction" doctrine, which treats multiple transactions that occur contemporaneously as one transaction.[252] The doctrine takes a more expansive view of multistep transactions such as those that comprise a tactical restructuring; rather than analyzing each separate step in a vacuum, it focuses on the overall economic effect of multiple transactions.[253] Where debtors engage in tactical prebankruptcy transactions to adjust important restructuring attributes in ways that generate significant advantages in a future bankruptcy, bankruptcy courts can use the step-transaction doctrine to consolidate the prebankruptcy transactions and the eventual bankruptcy plan of reorganization. In effect, these separate transactions would be understood as integrated steps of a unitary plan to achieve a certain in-court restructuring outcome and would be recharacterized as a single restructuring transaction for bankruptcy purposes.

Examined in this light, Serta's 2020 restructuring reveals itself as the first step in an integrated transaction finalized pursuant to the bankruptcy court's confirmation order. By shifting its secured debt subhurdles prior to the bankruptcy filing, Serta gained the ability to discriminate within the senior tranche, as opposed to allowing all to share in the eventual equity

250. *See id.*

251. *See supra* Part II.A.2.

252. *See* Gregory v. Helvering, 293 U.S. 465 (1935); *see also* Am. Potash & Chem. Corp. v. United States, 399 F.2d 194, 202–05 (Cl. Ct. 1968) (highlighting the step transaction doctrine in modern tax law).

253. For a general discussion, see Oliver C. Murray, Jr., *Step Transactions*, 24 U. MIA. L. REV. 60 (1969).

conversion.[254] Additionally, by introducing new secured debt subhurdles closer to the debtor's going-concern value (at least as it would be expressed in the customary financial disclosures and analyses typically relied on in bankruptcy proceedings), the 2020 restructuring allowed Serta to designate a more consolidated class of senior creditors who would eventually advance to the equity position.[255]

Stepping together the debtor's tactical prebankruptcy planning and ultimate Chapter 11 plan implicates another important commercial law doctrine. Bankruptcy's sub rosa plan doctrine[256] reminds practitioners that debtors must not use transactions—such as assets sales or postpetition financing arrangements—to achieve the overall effect of a Chapter 11 reorganization without going through the process of drafting and negotiating a plan, soliciting votes, and satisfying a long list of statutory plan confirmation requirements.[257] The doctrine applies even where a court finds that the underlying transaction was necessary, the terms were fair, and the parties acted in good faith.[258] For instance, the U.S. Bankruptcy Court for the Southern District of New York has found that a postpetition financing arrangement represents a prohibited sub rosa Chapter 11 plan when an equity subscription provision locks into place opportunities to acquire stock in the reorganized company at a significant discount.[259] To the extent the equity subscription terms are not market tested, there is no way for the court to determine "whether that discount is appropriate . . . [and whether] the Debtors' decision to make that election, [or] the 20% discount, will be subject to creditor comment or Court review."[260]

Transactions of this sort that are entered into before plan confirmation may amount to a de facto Chapter 11 plan that fails to comply with critical safeguards set forth in the Bankruptcy Code.[261] Much like § 363 sales and structured dismissals, postpetition financing transactions have the potential to make "concessions to creditors or parties in interest that are unauthorized under, or in conflict with, provisions under the Bankruptcy Code."[262] Bankruptcy courts are especially concerned with postpetition financing

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254. *See supra* Part II.A.2.e.

255. *See supra* Part II.A.2.e.

256. *See generally* Craig A. Sloane, *The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 BANKR. DEVS. J. 37 (1999).

257. Such requirements are set forth in § 1129(a) of the Bankruptcy Code. *See* 11 U.S.C. § 1129(a).

258. *See In re* LATAM Airlines Grp. S.A., 620 B.R. 722 (Bankr. S.D.N.Y. 2020) (making findings of this sort before proceeding to hold that a postpetition financing agreement was a sub rosa plan).

259. *See id*. at 820.

260. *Id.* at 819.

261. *See id.* at 812 (citing Motorola, Inc. v. Off. Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, 466 (2d Cir. 2007); Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (*In re* Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir. 1983)).

262. *Id.* at 816 (citing Resolution Tr. Corp. v. Off. Unsecured Creditors Comm. (*In re* Def. Drug Stores, Inc.), 145 B.R. 312, 317 (B.A.P. 9th Cir. 1992); *In re* Belk Props., LLC, 421 B.R. 221, 225–26 (Bankr. N.D. Miss. 2009); *In re* Chevy Devco, 78 B.R. 585, 589 (Bankr. C.D. Cal. 1987)).

agreements that "fix . . . some of the terms of a plan yet to be filed."[263] And although prepetition financing is not normally subject to plan confirmation requirements, the absolute priority rule is "triggered" when financial benefits are distributed to persons—such as equity owners—on account of their junior interests.[264] When the agreement also contains a provision that the confirmation of an alternative Chapter 11 plan not approved by the debtor will constitute an event of default, the arrangement "effectively lock[s] up any future plan of reorganization to be only the Debtors' plan."[265]

Applying these principles to Serta, the 2020 restructuring clearly adjusted the company's restructuring attributes in strategic and tactical ways, fixing the terms of a subsequent bankruptcy plan. As a focus on restructuring attributes demonstrates, the 2020 restructuring had the effect of shifting the creditor classes in a future Chapter 11 case and locking into place bankruptcy priorities. In essence, when examined from the perspective of a future bankruptcy proceeding that would impose a final day of reckoning, the 2020 restructuring should be understood as the first step of an integrated sub rosa plan transaction that spanned more than two years. Once a court makes a finding of this sort, the appropriate remedy would be to disregard the purported priorities for the purposes of the bankruptcy case only. In other words, the underlying transaction would remain effective for all nonbankruptcy purposes but would be disregarded for plan confirmation purposes.

This doctrinal pathway allows a bankruptcy court to make substantive decisions with respect to prepetition transactions without having to resort to the same fact-intensive judicial doctrines that dominate the traditional legal account, such as fraudulent conveyance law. Although these legal pathways would remain available to courts and litigants seeking to fully unwind these prior transactions, parties would no longer be required to meet such high evidentiary and legal standards simply to challenge prior transactions for the purposes of confirming a plan of reorganization that locks in the effects of those transactions. In this way, a focus on restructuring attributes allows courts to engage in a substantive review that is not only more holistic, but also more efficient in terms of the decisions that must be made under bankruptcy law.

From a broader perspective, a focus on restructuring attributes reveals some major shortcomings in Chapter 11. The system's adherence to a default rule of absolute priority—along with its imposition of a forced day of reckoning to determine bankruptcy rights and entitlements—contributes to economic distortions by promoting investments in distressed or apparently distressed companies that are principally motivated by a desire to capture the highest levels of the priority ladder. Meanwhile, the application of the rule of absolute priority on a class-by-class basis invites the sort of strategy plays

263. *Id.* at 819.

264. Any such distribution to or retention of value by junior persons would violate the "fair and equitable" requirement set forth in § 1129(b)(2)(B).

265. *See In re* LATAM Airlines Grp. S.A., 620 B.R. at 820.

detailed in this Article, as persons who are part of a large fulcrum security class are highly incentivized to find some way to splinter the class into two classes: a smaller and more senior class that will receive all of the value, and a larger, residual class that will be left out entirely. Prevailing norms in commercial finance exacerbate these dynamics, pursuant to which large syndicates of lenders who stand on equal footing with one another effectuate corporate borrowings. When courts and litigants lack any reasonable opportunity to challenge parties' prebankruptcy tactical moves, Chapter 11's application of absolute priority on a class-by-class basis in a forced day of reckoning serves to lock in the benefits of these carefully planned transactions.

CONCLUSION

By narrowly focusing on legal rights and obligations, bankruptcy courts have sidestepped opportunities to probe corporate debtors' prior transactions, even when these transactions have the effect of adjusting important restructuring attributes to achieve desired bankruptcy outcomes. As a result, debtors and their preferred stakeholders engage in sophisticated tactical prebankruptcy planning to ensure that the debtor will interact with bankruptcy laws, procedures, and prevailing practices in predictable ways.

Acknowledging this reality and acknowledging that restructuring attributes are the centerpiece of corporate bankruptcy strategies leads to a richer understanding of the modern Chapter 11 landscape. But a theory of tactical restructuring is not simply useful as a descriptive model; it also has predictive power, in that these adjustments to important restructuring attributes often signal the debtor's future Chapter 11 plan proposal. For instance, notwithstanding the debtor's contemporaneous pronouncements in public press releases, market participants and observers should pay special attention to out-of-court restructuring transactions that have the effect of shifting or introducing new secured debt subhurdles.

Finally, a theory of tactical restructuring opens new doctrinal pathways for bankruptcy courts to regulate some of the most egregious hostile restructuring transactions. For these transactions—which tend to be mired in state and federal court litigation claims for years—bankruptcy is the final step in locking in priorities and enforcing a financial day of reckoning to extinguish out-of-the-money claims and interests. Although the traditional legal account would have the bankruptcy court mired in the underlying litigation claims, a theory of tactical restructuring invites courts to focus on the practical effects of these underlying transactions from a bankruptcy law perspective. In essence, the approach respects the rights and powers of parties to engage in restructuring transactions, including hostile restructurings, which may or may not be lawful under the relevant agreements and substantive laws. Instead of having bankruptcy courts serve as the final arbiter of these thorny questions of state contract and related commercial law, it asks them to zero in on a more fundamental question: whether, in light of the facts and circumstances of a given case, bankruptcy

law's broad powers should be used to lend finality to these carefully calibrated adjustments to critical restructuring attributes, or whether those adjustments should be recharacterized for the purposes of the bankruptcy case.