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Panel: Who Holds the Cards? Examining the Evolving Role of Shareholder Interests in Bankruptcy

Panel:

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Overview: Who Holds the Cards?

These materials accompany a panel examining the power of shareholders—and particularly controlling shareholders and private equity sponsors—in corporate restructurings across four major jurisdictions: the United States, the United Kingdom, Germany, and Brazil. The panel is organized around three questions. First, what leverage do owners hold before a filing? In every jurisdiction, the owner's most valuable card is some measure of control over whether, when, and where a proceeding is commenced, but the strength of that card varies dramatically with the local law of directors' duties. Second, what role does the owner play in the governance of the case after filing? Here the jurisdictions diverge sharply: Brazil preserves substantial equity control over the debtor and the plan process, while the United States and Germany largely disenfranchise the owner as a formal matter—even as sponsors have found practical workarounds through board appointments and transaction design. Third, who is entitled to the value at the end of the case? The United States enforces a (qualified) absolute priority rule; Brazil has no equivalent; and the United Kingdom and Germany occupy intermediate positions.

The materials begin with two influential accounts of the modern American landscape—the rise of sponsor control and of so-called bankruptcy directors—and then turn to comparative perspectives from the United Kingdom, Germany, and Brazil. Sections IV and V take up two cross-cutting themes: the comparative law of the filing decision and the distributional baselines that frame plan negotiations.

I. Sponsor Control

The increase in private equity control of large debtors has prompted new scrutiny of how that control affects restructuring. The new paradigm represents a shift from the conventional account of bankruptcy in the early 2000s. At that time, it was thought that banks and other lenders exercised outsized influence over the bankruptcy process. By this new account, proactive private equity sponsors have seized that control, shifting the dynamics.

In a recent article, Professor Vince Buccola examines this phenomenon and explores its implications. Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporate Reorganization*, 90 University of Chicago Law Review 1 (2023).

In the following excerpt, Professor Buccola discusses the limitations of the conventional lender-control account of the bankruptcy process and introduces the new paradigm of sponsor control in the modern Chapter 11 landscape:

> Bankruptcy scholars have long organized their field around a stylized story, a paradigm, of lender control. When lenders extend credit, the story goes, they insist on the borrower agreeing to strict covenants and granting blanket liens on its assets; then, if the borrower later encounters financial distress, they use their bargained-for rights as prods to steer the company toward a resolution favorable to themselves, whether or not that resolution is value maximizing for the investors as a group. As fruitful as the lender-control heuristic has been, however, it no longer corresponds to reality.
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> This Article introduces a new interpretive paradigm that better accounts for a changed world. Today, more often than not, equity sponsors rather than senior lenders have practical control over the way that distressed companies respond to their financial problems. Lenders no longer hold the big sticks that they once wielded to establish precedence, and the people guiding today's modal large, distressed business have powerful incentives to preserve the value of sponsor investments. The predictable effect of the new locus of control has been to stand familiar restructuring dynamics on their head. Indeed, a number of seemingly unconnected trends in reorganization practice may best be understood as resulting from sponsors' first-order incentives to postpone a reckoning that might crystallize losses. Identifying the dynamics of sponsor control thus promises to shed light on a variety of scholarly and policy debates around corporate reorganization.

Buccola goes on to contrast the rise of sponsor control to the earlier move from debtor to bank control:

> By common account, two contrasting eras have defined largescale corporate reorganization since the Bankruptcy Code was enacted in 1978.[1] For much of the Code’s first twenty years, incumbent managers dominated the process. They chose when to invoke Chapter 11 on a company’s behalf. They were difficult to unseat once there and, with the help of indulgent bankruptcy judges, could cause proceedings to drag on for years.
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> Starting in the late 1990s, however, reorganization practice underwent a marked shift. The formal law of bankruptcy had not changed, but Chapter 11 cases were proceeding

differently. Incumbent managers were being fired.2 Debtors were relying on bankruptcy-specific loans to fund their time in Chapter 11 and could no longer linger indefinitely. Cases were concluding more rapidly, often through a quick sale of the business as a going concern.

To account for these new realities, leading commentators developed a stylized story, or paradigm, centered on lender control. When advancing credit to a leveraged borrower, senior lenders had begun taking a "blanket" lien on the borrower's assets and insisting on tightly calibrated covenants designed to be breached at the first sign of trouble. These newly standard terms could be expected to give lenders clout if the borrower's financial condition were to deteriorate. Lenders would not have de jure power to manage the business, but the prospect of their exercise of remedies would hang like a sword over the borrower and induce management to resolve distress in ways favorable to the lenders. A new pattern in the financing of leveraged but otherwise healthy businesses had thus given rise to a new power dynamic in distress.

…

Over the last decade, however, reorganization practice has once again decoupled from the prevailing model. A move out of court, so to speak, has been the most striking change. Increasingly, distressed companies seek to raise new capital and restructure old debts without recourse to bankruptcy. Such recapitalization transactions are often directly contrary to the interests of senior lenders. The recent vogue for contentious "liability management" transactions that subordinate ostensibly first-lien loans would have been unimaginable fifteen years ago and is impossible to square with a regime of lender control. Trends in Chapter 11 practice likewise signal a shift in the locus of power. For example, the extensive use of multilateral agenda-setting devices known as restructuring-support agreements (RSAs) fits uncomfortably with the notion that lenders tacitly run the show.

…

The other part of the story has largely hidden in plain sight. The equity ownership of distressed businesses has transformed in the decades since scholars first called attention to lender control. The quintessential large corporate debtor of the late 1990s and early 2000s was publicly traded. Its board was populated by independent directors who, in distress, sought continuity in the business they superintended and had little reason to hold out for shareholders' distinctive interests. Stringent loan contracts may have been the most remarkable feature of the lender control era, but lender power was always also predicated on the reluctance of the boards of distressed companies to play with fire. Such caution has become the exception rather than the rule. Now, most large businesses encountering distress are controlled by a private equity fund. The strategic decision-makers are not staid parttimers whose fortunes were made and lie elsewhere. They are operators with powerful incentives to ensure that equity investors recover what they can.

At first approximation, the interests of equity sponsors are a mirror image of those of senior lenders. To the shareholders of a distressed company, private equity fund or otherwise, a volatile future is not an enemy but a friend. Shareholders capture most of the upside if a company performs well but, because of limited liability, have little to lose if it performs poorly. For that reason, they are keen—from a social perspective, excessively keen—to avoid the kind of realization event that the absolute-priority rule catalyzes. Sponsors have especially strong incentives in this regard. In addition to benefiting from the prospect of future dividends and stock-price appreciation, sponsors typically draw advisory fees from their portfolio companies. A realization event that wipes out equity interests will also turn off the fee spigot. Moreover, in the event of a bankruptcy, sponsors are uniquely likely to face litigation seeking to claw back dividends and other asset transfers, recover for breach of fiduciary duty, and the like.

Sponsors' prominence and effective power may thus help explain important trends in reorganization. For example, it figures that the vogue for liability management emerged only after private equity had taken over a large share of the market and that sponsor-owned companies are responsible for almost every hardball priming transaction to date.18 Such transactions "extend runway" for the distressed company but heighten litigation risk and the odds of reputational damage to the individuals behind them, a combination well matched to sponsors' incentives. The same incentives can help account for the greater complexity in the capital structures of deeply distressed businesses and for what may be socially excessive delays in invoking Chapter 11 by some companies.

II. Independent Directors

Another recent and related phenomenon that has caught the attention of scholars and commentators is the increased use of independent directors leading up to and during Chapter 11 proceedings. Most notable is the commentary by Professors Jared Ellias, Ehud Kamar, and Kobi Kastiel. Jared A. Ellias, Ehud Kamar & Kobi Kastiel, The Rise of Bankruptcy Directors, 95 Southern California Law Review 1387 (2022). Their article examines the increasing use of independent directors, especially when the debtor is controlled by private equity sponsors, and questions the selection and independence of these directors.

In the following excerpt, Ellias and his co-authors document this development:

> We show that distressed companies, especially those controlled by private-equity sponsors, often now prepare for a Chapter 11 filing by appointing bankruptcy experts to their boards of directors and giving them the board's power to make key bankruptcy decisions. These directors often seek to wrest control of self-dealing claims against shareholders from creditors. We call these directors "bankruptcy directors" and conduct the first empirical study of their rise as key players in corporate bankruptcies. While these directors claim to be neutral experts that act to maximize value for the benefit of creditors, we argue that they suffer from a structural bias because they often receive their appointment from a small community of repeat private-equity sponsors and law firms. Securing future directorships may require pleasing this clientele at the expense of creditors. Indeed, we find that unsecured creditors recover on average 20% less when the company appoints a bankruptcy director. While other explanations are possible, this finding shifts the burden of proof to those claiming that bankruptcy directors improve the governance of distressed companies. Our policy recommendation, however, does not require a resolution of this controversy: we propose that the court regard bankruptcy directors as independent only if an overwhelming majority of creditors whose claims are at risk supports their appointment, making them accountable to all sides of the bankruptcy dispute.

The authors go on to discuss the structural incentives that undermine the independence of these directors:

By appointing bankruptcy directors, debtor firms and their lawyers seek to use the claimed objectivity of these directors to wrest control of self-dealing claims against shareholders from creditors and the court. This sidesteps the checks and balances in Chapter 11 and can undermine the goals of the bankruptcy process.

Moreover, in Chapter 11 proceedings, creditors are usually sophisticated investors advised by expert lawyers. They can protect their interests. There is no obvious reason to let shareholder appointees prevent creditors from representing themselves in matters on which creditors and shareholders disagree.

There are also concerns specific to bankruptcy law that amplify the structural bias of independent directors in the bankruptcy law context.

First, bankruptcy professionals—lawyers, investment bankers, and bankruptcy directors—form a much smaller community than the corporate governance community generally. In this environment, it is likely that bankruptcy directors will work with the same professionals on their next engagement. Indeed, the evidence we present below reveals a group of super-repeater directors who have developed a profession of sitting on the board of bankrupt companies.

Second, financial distress is an extraordinary event in the life of a corporation that can justify the appointment of specialized directors. It provides a natural setting for adding experts to the board to vet conflict transactions without raising suspicion. In contrast, outside bankruptcy, firms are limited in their ability to appoint new directors to investigate a potential derivative claim or negotiate a freeze-out.

Third, about half of the firms appointing bankruptcy directors are private equity-controlled firms. Private-equity sponsors are repeat players that can appoint individuals to many boards. They can thus reward a director who has served them well on the board of one bankrupt company by placing her on other boards. Conversely, a bankruptcy director who harms the interests of a private equity controller will likely jeopardize future board appointments at other portfolio companies of the same private-equity firm.

Moreover, bankruptcy court dockets are public and make the work of one private equity sponsor visible to other private-equity firms: a private-equity firm may readily note the favorable outcome that the bankruptcy directors achieved for other private-

> equity sponsors in previous bankruptcies and consider appointing those same directors to the boards of its own troubled portfolio companies. Conversely, an unfavorable outcome may chill the demand for a director's services among private-equity sponsors.
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> In short, bankruptcy directors can be a challenge for bankruptcy law's structured bargaining process, which Congress intended, as Judge Friendly put it, to "not only be fair but seem fair."

The selection and compensation of these directors has itself become a point of negotiation. Candidates are frequently drawn from a small group of repeat players, and in recent practice dominant creditor groups have pressed for—or insisted upon—particular appointees as a condition of forbearance or new money, raising the mirror-image question of whether a director chosen by creditors is any more "independent" than one chosen by the sponsor.

Notably, the procedural rigor that Delaware courts demand of special committees in the transactional context—genuine independence, a clear and effectively irrevocable mandate, separate advisors, and arm's-length bargaining—has no formal analogue in Chapter 11. The delegation of restructuring authority is ordinarily revocable by the full board, and no court passes on the committee's independence at the time of appointment. Whether bankruptcy practice should import something like Delaware's special-committee discipline, or instead adopt the creditor-approval mechanism proposed by Ellias, Kamar, and Kastiel, is a question the panel will take up.

III. Comparative Perspectives

This panel addresses the implications of changes to shareholder control dynamics in various jurisdictions. This section provides some materials related to sponsor control over distressed companies and the role of independent directors in three other major restructuring jurisdictions: the United Kingdom, Germany, and Brazil.

A. United Kingdom

The leading academic source on this topic in the United Kingdom is an article by Jennifer Payne. Jennifer Payne, Debt Restructuring in Transition, Oxford Legal Studies Research Paper

(2022). In her article, she describes several recent changes to restructuring procedures, including those related to shareholder control.

The following excerpt explains these changes and examines their impact. She ultimately concludes that the full consequences of these changes remain to be seen:

> UK debt restructuring is undergoing a period of immense change. Two developments in particular have contributed to this transformation. The first is legislative: the Corporate Insolvency and Governance Act 2020 (CIGA) introduced a number of powerful new tools into the armoury of financially distressed companies wishing to restructure their debt. The second is political: the UK's exit from the EU has impacted on UK debt restructuring, particularly the use of English restructuring tools involving companies with creditors in EU member states. These developments have four major implications for UK debt restructuring, namely (i) a shift from a creditor-focused regime to one which is more pro-debtor; (ii) the development of a modular system for debt restructuring and insolvency more generally; (iii) a blurring of the boundary between restructuring and insolvency; and (iv) a more complex cross-border regime. In combination these amount to a seismic shift in the UK debt restructuring landscape. The full consequences of these changes, however, remains to be seen as we are currently in a period of transition. The final impact of these developments will only emerge as commercial parties negotiate new arrangements or renegotiate existing ones against the backdrop of judicial decisions and the effects of regulatory competition. Nevertheless, as this paper examines, it is clear that there will be profound implications for companies, their creditors, employees, customers and other stakeholders, and for the UK's role as a global player.

In the time since Payne wrote the article, the most consequential of the CIGA 2020 tools has proven to be the Part 26A restructuring plan, which for the first time allows an English court to sanction a plan over the dissent of an entire class—including the class of existing shareholders—through cross-class cram down. The principal statutory safeguard is the "no worse off" test: a dissenting class may be crammed down only if none of its members would be worse off under the plan than in the "relevant alternative," typically an administration or liquidation.

The early case law shows English courts policing that safeguard with some vigor where shareholders are the dissenting class. In *Re Hurricane Energy plc* [2021] EWHC 1759 (Ch), Mr Justice Zacaroli declined to sanction a plan that would have transferred 95 percent of the company's equity to its bondholders, holding that the company had not shown its shareholders would be no worse off. The decision underscores that, absent a formal insolvency, English shareholders retain meaningful cards—including their power to replace the board.

More recent decisions test the boundaries of the new tool. In *Re AGPS BondCo plc* [2024] EWCA Civ 24 (the *Adler* case), the Court of Appeal—in the first appeal of a sanctioned restructuring plan—reversed the sanction of a plan for a German real estate group, emphasizing that departures from the pari passu treatment that would obtain in the relevant alternative must be justified and that the court's discretion at sanction is a genuine check rather than a rubber stamp. Weeks later, in *Re CB&I UK Ltd* [2024] EWHC 398 (Ch), the High Court sanctioned the McDermott group's heavily contested plan.

McDermott also illustrates the cross-border dimension. English plans have proven readily exportable to the United States, where bankruptcy courts have granted Chapter 15 recognition and enforcement. Recognition within the European Union is more precarious: following Brexit, English proceedings no longer benefit from the EU insolvency and judgments regimes, and plan companies must rely on parallel proceedings, private international law, or contractual architecture. The persistence of the rule in *Gibbs* channels restructurings of English-law debt into London, and debtors have shifted their center of main interests into, rather than out of, England to access these tools. The panel will consider whether this competitive landscape disciplines or distorts the allocation of value between owners and creditors—and what, if anything, would make Part 26A "fair" to dissenting stakeholders.

B. Germany

A recent article by Horst Eidenmüller compares recent developments across various jurisdictions and provides a view of control dynamics in German proceedings. Horst Eidenmüller, Comparative Corporate Insolvency Law, ECGI Law Working Paper No. 319/2016 (revised Nov. 2023).

In the following excerpt, Professor Eidenmüller discusses why insolvency governance should be viewed as a specialized form of corporate governance, thus tying bankruptcy law to nonbankruptcy law regarding shareholder-management relations:

> Corporate law and governance on the one hand and insolvency/bankruptcy law on the other have long been viewed as distinct disciplines: whereas the former deal with legal issues associated with the organization and operation of a solvent corporation, the latter is meant to address a new set of legal problems arising once a corporation finds itself in severe financial distress. Agency conflicts between shareholders and management and between majority and minority shareholders figure prominently in corporate law and governance. Agency conflicts between the corporation and its creditors and within the creditor community are at the centre of insolvency law.
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> The divide between these two spheres of law and academic discipline becomes less clear, however, once one conceives of insolvency law as "corporate governance under financial distress." Indeed, "insolvency governance" can be characterized as a special form (or case) of "corporate governance." The conceptual apparatus to understand the regulatory problems and develop potential policy responses is the same; it is only the framework conditions which change, and possibly only to a small degree: laws on the (financial) restructuring of businesses pre-insolvency are gaining increasing importance, for example in the European Union with the "European Restructuring Directive" (2019).

Professor Eidenmüller later discusses how different insolvency regimes allocate control, with particular attention to England and Germany:

> Who sits "in the driver's seat" in various jurisdictions? Again, jurisdictions worldwide differ significantly in the governance mechanisms employed. Mirroring an earlier categorization of different jurisdictions being more or less creditor or debtor oriented, creditors enjoy a very strong position both in England and in Germany. This holds true for the various (insolvency) proceedings in England, especially for the CVA and the SoA, which do not involve an insolvency administrator/receiver, but also, albeit to a somewhat lesser degree, for the German Insolvenzordnung under which the appointment of at least a supervisor is mandatory if no insolvency administrator is installed. Such a supervisor functions as a controller for significant transactions but also

as a mediator between the interests of all other stakeholders. Both in England and in Germany, the insolvency courts are of course in the picture, too. However, they do not actively "manage" the case but rather function as an arbiter that makes sure that fundamental procedural rules and rights are observed.

Two features of German law sharpen the contrast with the United States. The first concerns timing. Under § 15a of the Insolvenzordnung, the managing directors of an illiquid or over-indebted company must file for insolvency without undue delay on pain of personal civil liability and criminal sanction. The filing decision is thus not an open-ended option held by the owner, as it functionally is under Delaware law, but a legal duty imposed on management; a shareholder who pressures directors to delay risks liability of its own as a de facto director. The second concerns the owner's position once proceedings begin. Since the 2012 ESUG reforms, § 225a of the Insolvenzordnung has permitted an insolvency plan to convert debt to equity and to modify or cancel shareholders' interests over their objection: shareholders vote as a class but can be crammed down. The 2021 StaRUG, implementing the European Restructuring Directive, extends similar tools to the pre-insolvency stage. The net effect is a regime in which the owner's clock starts early and its governance rights end early—nearly the inverse of Brazil, to which these materials now turn.

C. Brazil

Turning to Brazil, a recent book chapter by Marcelo Sampaio G. Ricupero & Giovanna Campedelli provides a snapshot of control dynamics there. Marcelo Sampaio G. Ricupero & Giovanna Campedelli, Shareholders in Brazilian Bankruptcy: Power Dynamics and Legal Challenges in Judicial Reorganisations, in The Guide to Restructuring (5th ed., Latin Lawyer 2024).

In the following excerpt, Ricupero and Campedelli discuss how controlling shareholders can influence management and restructuring decisions in Brazilian judicial reorganizations:

> In many companies with a controlling shareholder (especially in private companies that are not required to follow governance rules applicable to listed companies), there may not be clear separation between the controlling shareholder and the management of the company, so the controlling shareholder exerts

> significant influence over companies through their appointees or by themselves, if they hold a management position.
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> It is also true that the Brazilian Corporations Law provides for fiduciary duties of directors and officers and those fiduciary duties are towards the company and not the controlling shareholder, and, in this sense, the law also disciplines situations of abuse of controlling power. However, if one were to compare the independence of directors and officers of companies without a controlling shareholder and those of companies with a controlling shareholder, it will probably be concluded that directors and officers tend to be more independent in the first case as compared to the latter.
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> As in Chapter 11 proceedings under the US Bankruptcy Code, the management of companies in judicial reorganisation remains in place (and may only be removed in cases of mismanagement). Such management is ultimately the one responsible for deciding to file for a judicial reorganisation (or other insolvency proceeding) and for taking the decisions throughout the process, including and especially preparing and negotiating the reorganisation plan with the creditors.

Brazilian judicial reorganization has historically been the most equity-friendly of the regimes considered here: management (and through it, the controlling shareholder) remains in possession, proposes the plan, and, until recently, faced no rival. Law No. 14,112/2020, effective in 2021, introduced an important counterweight. If the debtor's plan is rejected at the general meeting of creditors, or the debtor fails to win approval within the statutory period, creditors may now propose an alternative plan rather than the case converting automatically to liquidation. Early experience suggests that the mere threat of a competing creditor plan has begun to shift bargaining leverage even where no such plan is ever filed, though the process remains equity-driven by comparison to Chapter 11.

Control also carries distinctive liability risks in Brazil. A creditor that converts its debt into a controlling equity stake in a reorganization may inherit those exposures, a consideration that shapes the willingness of financial creditors to take the keys. Absent a swap of that kind, creditor liability for the debtor's obligations remains the exception.

IV. Pre-Filing Leverage: The Timing Decision and Directors' Duties

Before any proceeding begins, the owner's principal card is control over the filing decision itself—whether, when, and where. The strength of that card is set by the background law of directors' duties, and here the four jurisdictions diverge sharply.

In the United States, the decision to commence a Chapter 11 case belongs to the board, and Delaware law imposes no duty to file at any particular time—or at all. Creditors of an insolvent Delaware corporation may pursue fiduciary claims only derivatively, on behalf of the corporation, and Delaware has rejected "deepening insolvency" as a cause of action. So long as directors pursue value in good faith, the business judgment rule protects a strategy of continued operation—even one that, in effect, gambles with what is functionally the creditors' money. The owner can therefore use time itself as leverage, extracting concessions from creditors as the price of an orderly process.

English and German law eliminate much of that leverage. In the United Kingdom, wrongful trading provisions expose directors to personal liability for continuing to trade past the point at which there was no reasonable prospect of avoiding insolvent liquidation or administration, and directors' duties shift toward creditor interests as insolvency approaches. In Germany, as noted above, the law converts the timing question into a mandatory duty. In both systems, moreover, a shareholder or lender that directs the board's conduct risks being characterized as a shadow or de facto director, importing the same liabilities. The practical consequence is visible in deal design: in the United Kingdom and Germany, restructuring negotiations are often run through specially appointed directors or officers with restructuring expertise, precisely because incumbent management and the owner cannot safely use the case clock the way an American sponsor can.

Brazil sits closer to the American end of the spectrum. Management decides whether and when to file, directors remain in office during the reorganization, and there is no analogue to wrongful trading; the meaningful constraints on the owner are the labor- and tax-liability exposures discussed in Section III.C above.

V. The Absolute Priority Rule and the Treatment of Equity

Distributional baselines frame every restructuring negotiation. In the United States, the absolute priority rule of 11 U.S.C. § 1129(b)(2)(B) provides that a dissenting class of unsecured creditors must be paid in full before old equity may retain or receive any property under the plan on account of its prior interests—subject to the contours of the new value doctrine explored in *Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999). The rule is the realization event that, on Buccola's account, sponsors structure their conduct to avoid.

None of the other three jurisdictions enforces so strict a baseline. Brazilian law contains no absolute priority rule: a plan approved by the requisite creditor majorities may leave existing equity in place and undisturbed, which is one structural reason the Brazilian process remains equity-run. The United Kingdom's Part 26A likewise contains no statutory priority rule; the court asks whether dissenting classes are "no worse off" than in the relevant alternative and whether the plan is one the court should sanction in its discretion—although *Adler* signals that unjustified departures from the priorities that would obtain in the relevant alternative will attract appellate scrutiny. Germany occupies a middle position: the Insolvenzordnung's plan provisions incorporate an absolute-priority-style protection through the prohibition on, while the StaRUG permits limited, justified deviations in the pre-insolvency setting, reflecting the European Restructuring Directive's tolerance for relative priority.

For the panel, the question is how these baselines feed back into the earlier stages of the game. Where equity cannot be eliminated over its objection (Brazil), or can be eliminated only after a searching judicial inquiry (the United Kingdom), the owner's pre-filing and in-case cards are correspondingly stronger; where equity can be cleanly wiped out (the United States and Germany), owners invest instead in controlling the path to that endgame—through filing timing, forum selection, board appointments, and transaction design.