

ARTICLES

The Myth of Creditor Sabotage

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Since credit derivatives began to substantially influence financial markets a decade ago, rumors have circulated about so-called “net-short” creditors who seek to damage promising, albeit financially distressed, companies. A recent episode pitting the hedge fund Aurelius against broadband provider Windstream is widely supposed to be a case in point and has at once fueled calls for law reform and yielded an effigy of ostensible Wall Street predation.

This Article argues that creditor sabotage is a myth. Net-short strategies work, if at all, by in effect burning money. When an activist creditor shows its cards, as all activists must eventually do, it also reveals an opportunity for others to profit by thwarting the activist’s plans and saving threatened surplus. We discuss three sources of liquidity that targeted firms could tap to block a saboteur—“net-long” derivatives speculators, the target’s own investors, and bankruptcy. We conclude that it is exceedingly difficult for creditors to make money hobbling debtors and that there is little reason to believe anyone tries. We then examine the Windstream case and find, consistent with our theory, that the strongest reason for thinking Aurelius aimed at sabotage—namely that everyone says so—is weak indeed. Our analysis suggests that calls for law reform are addressed to a nonexistent or, at worst, self-correcting problem. Precisely for this reason, however, the persistent appeal of the sabotage myth is a lesson in political rhetoric. A story needn’t be true for some to find it useful.

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INTRODUCTION

A basic assumption in the standard paradigm of corporate finance is that a company's investors want the company to succeed. To be sure, investors of different classes—stockholders and bondholders, for example—bear risk and reward unequally.¹ Conflict over corporate policy is thus sometimes inevitable. But misaligned interests, however fraught they may be in a given case, are a second-order detail in the standard paradigm. The fundamental fact is that a company's investors all do better if the business thrives, and the various rights investors are given to influence

¹ See Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J Fin Econ 305, 334 (1976). There is nothing special in this regard about the equity-debt distinction. Any two investments with distinctive priority or maturity profiles can yield conflict. See, for example, Kenneth M. Ayotte and Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J Legal Analysis 511, 526 (2009).

corporate activity reflect their common aim as much as their distinctive interests.²

The rapid growth of derivatives contracting during the first decade of the millennium threatened this basic assumption's continued validity. Professors Henry Hu and Bernard Black, among others, noticed that derivatives could be used to decouple investors' governance rights from their economic stake in a company's fate.³ Credit derivatives—financial contracts with payoffs that are linked to, or derive from, the value of one or more companies' debt obligations—appeared to give rise to a troubling dynamic. Creditors who place a sufficiently large bet against their own loans or bonds stand to profit from the debtor's failure. For “net-short” creditors, failure means a derivative payoff more than sufficient to offset a loss on the underlying investment. Almost as soon as credit derivatives became widely traded, some of the legal academy's leading lights identified a perverse possibility. Nothing stood in the way of a net-short activist using its governance rights *as a creditor* to bring ruin on the debtor—to reduce its value and prompt default.⁴

² See, for example, George G. Triantis and Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 Cal L Rev 1073, 1078–79 (1995) (discussing complementarity of shareholder and creditor governance rights).

³ See Henry T.C. Hu and Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U Pa L Rev 625, 632–33 (2008); Henry T.C. Hu and Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 Eur Fin Mgmt 663, 664–66 (2008); Henry T.C. Hu and Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J Corp Fin 343, 344 (2007); Henry T.C. Hu and Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S Cal L Rev 811, 815 (2006).

⁴ See Douglas G. Baird and Robert K. Rasmussen, *Antibankruptcy*, 119 Yale L J 648, 651 (2010) (noting that in the modern investment paradigm “failure of the business can mean large returns to some creditors”); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L Rev 115, 167–69 (2009) (discussing perversity of an “overhedged” creditor who “would profit from the borrower's default”); Hu and Black, 156 U Pa L Rev at 731, 734 (cited in note 3) (noting that a creditor with “negative net economic ownership” has “an incentive to . . . reduce the value of the debt class it holds”); Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 Am Bankr L J 405, 427–28 (2007) (indicating that “as maturity dates approach on outstanding credit default swaps, protected creditors will have an increasing disincentive to work with the debtor”); Frank Partnoy and David A. Skeel Jr, *The Promise and Perils of Credit Derivatives*, 75 U Cin L Rev 1019, 1034–35 (2007) (explaining that “a lender that has purchased credit default swaps may have an incentive to use its position as a lender to affirmatively destroy value”).

A recent episode pitting the telecommunications company Windstream Services against the hedge fund Aurelius has crystallized anxiety about net-short sabotage.⁵ In 2017, two years after Windstream spun off certain real estate assets, Aurelius concluded that the transaction had violated a covenant in one of the company's note indentures. The notes were now trading at a discount, and Aurelius promptly bought enough so that, under the terms of the indenture, it could demand immediate repayment of the notes' full principal amount. Aurelius won a judgment ordering exactly that.⁶ Soon thereafter, Windstream tumbled into bankruptcy seemingly unprepared for the contingency.⁷

But why did Aurelius litigate? Debt-market observers were unequivocal about the fund's motivations. "[E]veryone," Matt Levine reported, "assumes that Aurelius [] owned a lot of credit default swaps on Windstream [] that would pay out if Windstream defaulted on its debt."⁸ That is, the consensus has Aurelius aiming at and wreaking havoc. One observer situating the case in a broader context has nicely summarized anxiety about the status quo: "Real people's jobs in real companies—13,000 of them at-risk at Windstream—are being lost as a result of [derivatives] chicanery."⁹

Net-short creditor activism has been a hot topic in Windstream's wake.¹⁰ Law reform is in the air. Proposals to enhance

⁵ Disclosure: One of us (Buccola) has represented Aurelius in litigation. He has had no affiliation with it or its principals since 2012, however, and this Article reflects no non-public information about Aurelius's investments or decisions.

⁶ See *US Bank National Association v Windstream Services, LLC*, 2019 WL 948120 *22–23 (SDNY).

⁷ See Declaration of Tony Thomas, Chief Executive Officer and President of Windstream Holdings, Inc., (I) In Support of Debtors' Chapter 11 Petitions and First Day Motions and (II) Pursuant to Local Bankruptcy Rule 1007-2, *In re Windstream Holdings, Inc.*, No 19-22312, *2, 5 (Bankr SDNY filed Feb 25, 2019) (Thomas Declaration).

⁸ Matt Levine, *Maybe Companies Will Get Rid of CDS* (Bloomberg, May 23, 2019) (emphasis in original), online at <https://www.bloomberg.com/opinion/articles/2019-05-23/maybe-companies-will-get-rid-of-cds> (visited July 17, 2020) (Perma archive unavailable). See also, for example, Henry T.C. Hu, *Corporate Distress, Credit Default Swaps, and Defaults: Information and Traditional, Contingent, and Empty Creditors*, 13 Brooklyn J Corp, Fin & Comm L 5, 28 (2018) (noting that debt decoupling "helps explain Aurelius's behavior").

⁹ Martin Hutchinson, *The Bear's Lair: Time to Close Down the CDS Market* (True Blue Will Never Stain, Mar 4, 2019), archived at <https://perma.cc/TSR9-P7NP>.

¹⁰ See, for example, John Williams, James Warbey, Ben Kastner, and Elizabeth A. Martinez, *Net Short Lender Disenfranchisement: Is the New Anti-CDS Vaccine Safe and Effective?* *1 (Milbank, June 11, 2019), archived at <https://perma.cc/NA9W-FCG7> (noting that the Windstream bankruptcy "has rekindled market participants' concerns over the effects of so-called 'net short debt activism'").

creditors' disclosure obligations and to strip governance rights from conflicted investors are being seriously aired, and experiments are underway.¹¹ But although Windstream has become a focal point for indignation and a catalyst of policy analysis, it is only that. Worries about the influence of net-short creditors and their cousins—so-called “empty” creditors¹²—have circulated for more than a decade.¹³ The same concerns continue to inform educated projections of the future. Prominent restructuring lawyers at Wachtell, Lipton, Rosen & Katz, for example, have issued a series of memoranda warning about what they call “The Rise of the Net-Short Debt Activist.”¹⁴ The fate of a single broadband provider is not the main issue. The issue is instead a sense that sophisticated funds are willing and able to wreck financially distressed but fundamentally promising businesses—a vision of the debt markets as a playground for investment advisers but “a disaster for everyone else.”¹⁵

Despite the earnestness of scholars' and market participants' concerns, however, we argue in this Article that creditor sabotage is a myth. Sabotage is best understood, we contend, as a kind of

¹¹ Some loans now feature what are being called “Windstream Provisions.” See Todd Koretzky, *Anti-Net Short Provisions in Syndicated Credit Facilities* *1 (Allen & Overy, Sept 3, 2019), archived at <https://perma.cc/VT6Y-GH87>. For further discussion, see note 180 and accompanying text.

¹² An “empty” creditor has fully hedged its investment in the debtor but is not short. For further discussion, see note 50 and accompanying text.

¹³ See, for example, Edward J. Janger and Adam J. Levitin, *One Dollar, One Vote: Mark-to-Market Governance in Bankruptcy*, 104 Iowa L Rev 1857, 1871–72 (2019) (summarizing representative rumors). Professors Edward Janger and Adam Levitin report that hedged creditors have been “a driving force in the run-up to many of the most contested bankruptcies of recent years.” Id at 1871.

¹⁴ Joshua A. Feltman, Emil A. Kleinhaus, and John R. Sobolewski, *The Rise of the Net-Short Debt Activist* (Harvard Law School Forum on Corporate Governance, Aug 7, 2018), archived at <https://perma.cc/YD6H-YKJY>. See also Joshua A. Feltman, Emil A. Kleinhaus, and John R. Sobolewski, *Debt Default Activism: After Windstream, the Winds of Change* (Harvard Law School Forum on Corporate Governance, June 18, 2019), archived at <https://perma.cc/G3JA-X6PV>; Eric M. Rosof, Gregory E. Pessin, Michael S. Benn, Tijana J. Dvornic, and John R. Sobolewski, *Wachtell Lipton Looks at Acquisition Financing in 2017 and the Year Ahead* (The CLS Blue Sky Blog, Jan 17, 2018), archived at <https://perma.cc/KGR5-R3P5>; Steven A. Cohen, Emil A. Kleinhaus, and John R. Sobolewski, *Default Activism in the Debt Market* (Harvard Law School Forum on Corporate Governance, Dec 4, 2018), archived at <https://perma.cc/J4HE-XNZY>.

¹⁵ William D. Cohan, *What Hedge Funds Consider a Win Is a Disaster for Everyone Else* (NY Times, May 12, 2019), archived at <https://perma.cc/KC8L-TZ9C>.

urban legend, a cautionary story in wide circulation but of dubious plausibility and lacking a basis in observable fact.¹⁶ The obvious upshot, if we are right, is to cast doubt on the value of responsive law reform. But our conclusion also yields more general insights about corporate legal theory and economic rhetoric.¹⁷

Our reasoning starts with an observation about the nature of creditor governance. Creditors rarely exert direct control. Instead, they influence corporate activity indirectly through a credible threat to withdraw capital if the debtor will not behave. Covenants on their face restrict the debtor, but they bind in fact only to the extent the debtor's managers fear a reaction to breach. The power to accelerate a debtor's repayment obligation is, in the end, a creditor's biggest stick.¹⁸ If the debtor can refinance cheaply enough, it is no stick at all.¹⁹

Net-short creditor sabotage must then work, if it works, by provoking a crisis of liquidity for the debtor. The saboteur must be able to produce a sudden inability to fund near-term operations that leads, in turn, to a loss of enterprise value and crashing debt prices. In other words, for a saboteur to succeed, it must be able to cut off the debtor's access to cash just when cash is needed. But if in a given instance cash can preserve value, then there is, by definition, money to be made supplying it. The inner logic of net-short sabotage thus implies the existence of one or more trades

¹⁶ Two recent papers document instances of short sellers performing what might be fairly called sabotage. See Barbara A. Bliss, Peter Molk, and Frank Partnoy, *Negative Activism*, 97 Wash U L Rev 1333, 1335–39, 1345–46 (2020); Joshua Mitts, *Short and Distort* *7–11 (Columbia Law and Economics Working Paper No 592, Feb 2020), archived at <https://perma.cc/4GGZ-6DYQ>. We take no issue with their intriguing findings. But the saboteurs they discuss (with arguably one or two exceptions) are outsiders to the targeted firms. Their tactics do not include using governance rights conferred by investment in the targets. For this reason, the legal and theoretical issues implicated, while important, do not challenge the foundations of corporate governance as such.

¹⁷ In calling creditor sabotage a myth, we mean to say more than that it is literally false. We mean to say that the story, despite its lack of empirical foundation, seems to help market participants and critics “make sense” of their world. Two contemporaneously authored papers explore in depth the power of mythmaking for corporate law and governance. See Jonathan R. Macey, *Corporate Law Myths* *7–9 (European Corporate Governance Institute Law Working Paper No 519, May 2020), archived at <https://perma.cc/HTF7-2LQ8>; Mark J. Roe and Roy Shapira, *The Power of the Corporate Short-Termism Narrative* *4, 8–9 (unpublished manuscript, July 31, 2019) (on file with authors). We see a parallel between creditor sabotage and the short-termism story described by Professors Mark Roe and Roy Shapira. See note 197 and accompanying text.

¹⁸ See Vincent S.J. Buccola, *Opportunism and Internal Affairs*, 93 Tulane L Rev 339, 363 (2018); Marcel Kahan and Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 Nw U L Rev 281, 302–04 (2009).

¹⁹ See Buccola, 93 Tulane L Rev at 363 (cited in note 18).

that others could make to block the saboteur and punish its ambitions. The problem with the sabotage story is not that it misapprehends net-short creditors' incentives, but that it ignores everyone else's.²⁰

The insight is straightforwardly Coasean.²¹ Our burden is to show that transaction costs are unlikely to prevent a company targeted for sabotage from procuring liquidity. To that end, we identify and discuss three sources of liquidity that financially distressed companies could be expected to tap in case of an attempted sabotage: "net-long" derivatives speculators, the target's investors (other than the saboteur itself), and bankruptcy.²² There is no guarantee that a deal to thwart net-short activism would be struck in any particular case. We conclude, however, that barriers to coordination are sufficiently modest relative to prospective benefits that a deal ought generally to be expected. In particular, the greater the dislocation an activist's tactics might cause (and so the more tempting sabotage might be to it), the more likely others are to frustrate the activist's plans.²³ Sophisticated investors, adept as they are at backward induction, are thus unlikely to bet on their own capacities for sabotage in the first instance.²⁴

To test our reasoning, we present a case study of Windstream's recent travails. Lacking access to Aurelius's books, we can't say definitively what the fund's motivations were or are. But we show that publicly available data point not to sabotage at all, despite the consensus view. Instead, Aurelius seems to have tried to impose what is, in effect, a tax on Windstream's covenant

²⁰ For a parallel argument, see Frank H. Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U Chi L Rev 263, 265–318 (1981) (criticizing predatory pricing theories for parallel failure to account for likely reactions of the theory's supposed victims).

²¹ See generally R.H. Coase, *The Problem of Social Cost*, 3 J L & Econ 1 (1960).

²² The role of net-long derivatives investors in particular has been almost uniformly ignored in popular as well as academic analysis. For one notable exception, see Yesha Yadav, *The Case for a Market in Debt Governance*, 67 Vand L Rev 771, 776, 805–14 (2014). Likewise, in a contemporaneously authored paper, Professors András Danis and Andrea Gamba have developed a useful, general model of the effects of credit insurance on reorganization outcomes that incorporates the possibility of the insurers intervening. See András Danis and Andrea Gamba, *Dark Knights: The Rise in Firm Intervention by CDS Investors* *7–24 (WBS Finance Group Research Paper No 265, Nov 2019), archived at <https://perma.cc/62VZ-UV4R>.

²³ This observation suggests a reason why some credit-derivative machinations (such as engineered defaults and orphaning transactions)—but not sabotage—may work. For further discussion, see note 76.

²⁴ If any do—and prevail—they should, we suggest, be regarded as lucky fools rather than strategic masterminds.

breach.²⁵ To implement this strategy, Aurelius would have used credit derivatives, if at all, only to hedge economic exposure to Windstream's business until the tax could be collected, not to bet on the company's failure. Moreover, we conclude that if Aurelius really did profit from a net-short gambit, as the consensus holds, then a series of unforced (and *ex ante* unforeseeable) errors committed by Windstream and others *after* the fund made its litigation stance public was a but-for cause.

One case study does not, of course, rule out net-short tactics as a general matter. No number of case studies can. But together with our theoretical argument, it should cause observers to question their assumptions not only about Windstream, but about the plausibility of sabotage more generally.

Our analysis has practical as well as theoretical implications. The principal policy implication is essentially negative. Advocates of law reform threaten to impose rules, such as enhanced disclosure requirements, that may reduce debt-market liquidity and make borrowing more expensive. They do so on the basis of a bogeyman story and without clear evidence of a single case of creditor sabotage. We argue that the lack of evidence is no accident, because the threat, so to speak, doesn't exist or is, at worst, self-correcting. This is not to say that the law as it stands is perfect, or to rule out any single proposal to alter creditors' rights, whether in or out of bankruptcy. There may be sound reasons for change. But sabotage is not one.

Our analysis also informs one of the central (if frequently unstated) live questions in bankruptcy and reorganization theory: Namely, what should be made of increasing complexity in capital markets and financial contracting? The relevant facts are not in dispute. Debt markets today are much more liquid—and the players and techniques that constitute them much more sophisticated—than even, say, two decades ago. But what do these trends mean for law? An optimistic view of private ordering sees the case for

²⁵ See Yesha Yadav, *Debt Buybacks and the Myth of Creditor Power* *20–23 (Vanderbilt Law Research Paper No 19-37, Feb 2020), archived at <https://perma.cc/Q968-NCQL> (discussing recent examples of lender oversight of defaults); Kahan and Rock, 103 *Nw U L Rev* at 284–306 (cited in note 18) (describing the generic strategy). The euphemistic term for the strategy in some distressed-debt circles is “covenant arbitrage.” See Lisa Abramowicz and Richard Bravo, *Covenant Arbitrage Exploited in High-Yield Bonds: Credit Markets* (Bloomberg, Mar 7, 2013), online at <https://www.bloomberg.com/news/articles/2013-03-07/covenant-arbitrage-exploited-in-high-yield-bonds-credit-markets> (visited July 17, 2020) (Perma archive unavailable).

distress-specific legal intervention, including bankruptcy, fading.²⁶ The idea is that sophistication and liquidity point toward complete contracting, so investors increasingly can prevent and solve coordination problems on their own.²⁷ A more pessimistic view holds, on the contrary, that complexity justifies a greater mandate for law to dispense with bargained-for terms.²⁸ Complexity begets fragility, is the idea, so that intervention to repair the wreckage of private ordering may grow more important with time. The creditor sabotage myth, if it were true, would bolster this pessimistic view. The reasons the myth is false support the more optimistic view.

One can zoom out even farther. The view from thirty thousand feet suggests a question about the sabotage story's appeal: Why does the story persist if it is theoretically dubious and lacks grounding in observation? Although we can only speculate, we suggest that the story serves useful functions for those who tell and hear it. For corporate managers, the story provides a ready explanation for executive failure. For distress investors, it serves as a totem of the industry's ideals and a warning against incompetence. For members of the public, it embodies and expresses anxiety about the fragility of economic life and the willingness of financiers to take advantage of that fragility. As with any good piece of folklore, none of the story's functions depends on it being true.

I. THE NET-SHORT CREDITOR SABOTAGE STORY

Our claim is that net-short creditor sabotage is only a story. But it is a story, and an intriguing one at that—compelling enough if one doesn't ask too many questions. This Part explains its logic.

²⁶ See Douglas G. Baird and Robert K. Rasmussen, *The End of Bankruptcy*, 55 *Stan L Rev* 751, 777–87 (2002).

²⁷ See Vincent S.J. Buccola, *Bankruptcy's Cathedral: Property Rules, Liability Rules, and Distress*, 114 *Nw U L Rev* 705, 713–19 (2019); Vincent S.J. Buccola, *The Bankruptcy Firm*, 167 *U Pa L Rev Online* 1, 5–8 (2019); Barry E. Adler, *The Creditors' Bargain Revisited*, 166 *U Pa L Rev* 1853, 1856–59 (2018); Alan Schwartz, *Bankruptcy Related Contracting and Bankruptcy Functions* *1–2, 27–28 (Yale Law and Economics Research Paper No 553, Oct 2017) (on file with authors).

²⁸ See Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, *Colum L Rev* *1–4 (forthcoming), archived at <https://perma.cc/79D4-3B3H>; Robert K. Rasmussen and Michael Simkovic, *Bounties for Errors: Market Testing Contracts*, 10 *Harv Bus L Rev* 117, 148–51 (2020) (discussing the Hovnanian case in detail); Jared A. Ellias and Robert J. Stark, *Bankruptcy Hardball*, 108 *Cal L Rev* 745, 784–86 (2020); Kenneth Ayotte, *Disagreement and Capital Structure Complexity*, 49 *J Legal Stud* 1, 1–4 (2020).

The traditional picture of the debtor-creditor relationship is of an uneasy partnership. The parties have different interests. Debtors tend to tolerate more risk of loss, and creditors tend to be more cautious.²⁹ They resolve conflict imperfectly with diplomacy and a formal debt contract that says who can end the relationship and on what terms. Still, debtor and creditor interests are roughly aligned. Everyone in the traditional picture is hoping for a profitable business.

The prospect of net-short creditor sabotage arises from a subversion of the traditional relationship. An investor can at once become a company's creditor—by buying a bond, say—and, with the help of a derivative contract, arrange to make money, on net, if the bond loses value and the debtor defaults. The net-short saboteur is thus a villain who first arranges its affairs to create conflict with a company and then takes matters into its own hands.

In outline, the story is that simple. To fully grasp its particulars, however, one needs to understand also the terms of the relevant contracts and the means of execution. In principle, there are a number of ways activists can establish a net-short position.³⁰ The most straightforward way, though, and by far the most widely alleged, is with credit default swaps (CDS). We therefore start by describing CDS and the market in which they trade and are settled. We then describe the incentives that a hedged or net-short position established through CDS creates, and the kinds of tactics a net-short activist creditor might use to undermine its debtor.

A. How CDS Work

A credit default swap is a bilateral trade transferring from one party to another the credit risk of a third.³¹ The CDS was invented in the 1990s as a way for banks to shed exposure to large borrowers' default risk.³² Today a CDS is used mainly as a speculative instrument, a convenient way to bet on changes in one or

²⁹ See, for example, Jensen and Meckling, 3 *J Fin Econ* at 333–43 (cited in note 1).

³⁰ See Janger and Levitin, 104 *Iowa L Rev* at 1878–83 (cited in note 13) (describing such mechanisms, including put options, total return swaps, and investment in a competitor).

³¹ The third party, known as the “reference entity,” can be a single debtor or a (synthetic) basket of debtors. M. Todd Henderson, *Credit Derivatives Are Not “Insurance”*, 16 *Conn Ins L J* 1, 11 (2009). Swaps written on just one debtor, known as “single-name” CDS, are of primary interest to us.

³² New Basel (international banking) regulations were the immediate impetus. See *The Swaps Emperor's New Clothes* (The Economist, Feb 8, 2001), online at <https://www.economist.com/finance-and-economics/2001/02/08/the-swaps-emperors-new-clothes?>

more issuers' credit quality. But to grasp the swap's logic, it is easiest to consider it in the context of its original, insurance-like function—for a CDS resembles an insurance contract where the hazard insured against is a debt default instead of fire, flood, or the like.³³ Party *A* (the “protection buyer”) pays *B* (the “protection seller”) an upfront sum and a quarterly premium in exchange for *B*'s obligation to pay *A* the difference between the par and market value of *C*'s debt if *C* (the “reference entity”) should default.

To illustrate, consider how CDS can be used to create a perfect hedge of debt. Suppose that *C* issues a \$1,000 face-value bond at par.³⁴ *A* wants to buy the bond without bearing the risk that *C* will default. The answer is for *A* to go to *B* and buy a perfectly offsetting amount of CDS protection—in swap lingo, a \$1,000 “notional” amount. The trade will require *A* to pay *B* an upfront fee tailored to the circumstances of *C*'s bond plus a quarterly premium of 1.25 percent of the notional amount of the swap for the swap's duration.³⁵

If the swap matures without incident, that's the end of things. *B* takes home the upfront fee and quarterly premiums. But if *C* defaults, then *B* must make *A* whole for any loss it suffers from the default. Today, CDS settle mainly on a cash basis, with *B* paying *A* the notional amount of the swap times the difference between par and the bond's value, as determined by an auction, at the time of default.³⁶ For example, if after default *C*'s bond trades at 40 cents on the dollar, then *B* simply pays \$600.³⁷

Creditors who buy CDS protection need not seek a perfect hedge. An investor with a given amount of a reference entity's debt can tailor its exposure to the risk of default by adjusting the notional amount of protection it procures. For example, suppose that *A* wants only a partial hedge. If *A* wants to retain half of its

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³³ Not that a CDS is “insurance” in the legal sense of the word. See, for example, Henderson, 16 Conn Ins L J at 22–55 (cited in note 31).

³⁴ That is, for \$1,000 today, *C* sells a promise to pay \$1,000 at maturity.

³⁵ There are two standard annualized coupon rates for CDS: 1 percent for investment-grade reference entities and 5 percent for high-yield reference entities. As a consequence of this standardization, the market's assessment of variables relating to a particular swap—interest rates, the reference entity's current bond prices, and so on—are reflected entirely in the size of the upfront fee a protection buyer must pay.

³⁶ See Rasmussen and Simkovic, 10 Harv Bus L Rev at 125–29 (cited in note 28) (describing and explaining the logic of the CDS auction mechanism).

³⁷ $(\$1,000) \times (1.00 - 0.40) = \600 .

exposure to *C*'s credit risk, it buys \$500 rather than \$1,000 notional of protection. Now if *C* defaults, *B* pays \$300.³⁸ In this case, *A* takes \$700—greater than \$400 (no protection) but less than \$1,000 (perfect hedge).

Credit default swaps are traded in a highly standardized and mediated market. In principle, any two investors could privately negotiate bespoke rules of exchange and settlement. In practice, a trade organization, the International Swaps and Derivatives Association (ISDA), oversees the settlement of virtually all CDS.³⁹ ISDA's form Master Agreement allows contractors to conclude a swap by specifying just a few rudimentary terms—the reference entity, the notional amount, the size of the upfront fee, and the like.⁴⁰

The prosaic ambiguities of CDS are difficult to encapsulate in a single set of rules. ISDA's response to ambiguity has textual as well as institutional components. A swap terminates and obliges the protection seller to pay if the reference entity experiences a "credit event."⁴¹ This category includes obvious markers of peril, most importantly "bankruptcy" and "failure to pay."⁴² (Voluntary debt exchanges, even those effected as part of a general restructuring, are not credit events for most North American companies—a point to which we shall return.)⁴³ A committee composed of representatives of ISDA's membership, the Determinations Committee, has the final say and oversees an auction of the reference entity's debt instruments to establish the amount that protection sellers must pay in settlement.

The CDS market is dealer based.⁴⁴ Thousands of investors buy or sell protection on an annual basis, but the bulge bracket

³⁸ $(\$500) \times (1.00 - 0.40) = \300 .

³⁹ See International Swaps and Derivatives Association, *About ISDA*, archived at <https://perma.cc/W4LU-L3T8>.

⁴⁰ See generally International Swaps and Derivatives Association, *Legal Guidelines for Smart Derivatives Contracts: The ISDA Master Agreement* (Feb 2019), archived at <https://perma.cc/7AAU-U69W>.

⁴¹ See International Swaps and Derivatives Association, *2014 ISDA Credit Derivatives Definitions Art 4* (2014) (defining "Credit Events").

⁴² *Id.* § 4.2 (defining "Bankruptcy"); *id.* § 4.5 (defining "Failure to Pay").

⁴³ See *id.* § 4.7(a) (defining "Restructuring"). See also Daniel Hemel, Comment, *Empty Creditors and Debt Exchanges*, 27 *Yale J Reg* 159, 161–63 (2010) (distinguishing binding from voluntary restructurings).

⁴⁴ Title VII of the Dodd-Frank Act directed the Securities and Exchange Commission (SEC) to promulgate rules establishing central clearing, but that has not happened. See 15 USC § 8302.

banks are party to 99 percent of swaps worldwide.⁴⁵ If an investor wants to buy protection on a particular company, it goes to, say, Bank of America, who will accommodate the trade and seek to offset its exposure either by selling the reference entity's debt or by buying CDS protection from someone else who wants to take the opposite side.⁴⁶ If the investor later wants to close out the position, the dealer will, for a fee, unwind the swap at its then-current value and look to remove its own hedge.⁴⁷

Standardization and mediation together imply a market. Some participants come to hedge, some to speculate, and some to arbitrage.⁴⁸ The key point for present purposes is that the CDS market allows investors, in combination with the reference entity's debt instruments or not, to establish a wide variety of economic interests in the reference entity's financial performance.⁴⁹

B. CDS and Creditor Payoffs

Creditors with CDS protection face the prospect of default differently than do otherwise identically situated creditors without protection. The precise contours of this difference vary from case to case. The principal factor, and the one we wish to make clear, is the ratio of debt to CDS an investor holds.⁵⁰ On this dimension, we can for simplicity divide hedged creditors into three types: net-long, empty, and net-short. There are two distinctive

⁴⁵ See Securities and Exchange Commission, Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, 80 Fed Reg 48964, 48998 n 293 (2015), amending 17 CFR §§ 240, 249.

⁴⁶ Dealers also trade with one another to absorb and lay off risk. Approximately two-thirds of all CDS trading volume is between dealers for this purpose. See *id.* at 49001.

⁴⁷ An investor can also get out of its position by novation or by entering a new swap with opposite terms. But these options are generally more cumbersome, because dealers specialize in information about willing traders.

⁴⁸ The arbitrage possibility arises from the strong correlation between a CDS and the bonds and notes of the entity it references. Buying a bond and selling CDS protection roughly offset each other, as do selling a bond and buying CDS protection. The correlations are imperfect, however. Spreads diverge on account of counterparty and other risks of CDS, see Jennie Bai and Pierre Collin-Dufresne, *The CDS-Bond Basis*, 48 Fin Mgmt 417, 419 (2019), and because of the value of control rights provided by debt instruments but not by CDS, see Peter Feldhütter, Edith Hotchkiss, and Oğuzhan Karakaş, *The Value of Creditor Control in Corporate Bonds*, 121 J Fin Econ 1, 4 (2016).

⁴⁹ For additional detail on the functioning of the CDS market, see Gina-Gail S. Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?*, 94 NYU L Rev 1073, 1081–93 (2019).

⁵⁰ Other determinants include: mismatched maturity profiles between debt and CDS, see Lubben, 81 Am Bankr L J at 427–28 (cited in note 4); mismatched seniority (that is, where the debt is senior to the obligations delivered to auction); and lumpy payment schedules (that is, upfront-coupon mismatch).

ways that owning CDS can cause a creditor to want to undermine its debtor's value: (1) net-long and empty creditors, although generally sympathetic to traditional investors, may reject certain value-maximizing restructurings that fail to trigger CDS; and (2) net-short creditors outright prefer value destruction and default.

In general, net-long creditors—those who hold more of a company's debt than CDS protection on it—prefer that the debtor succeed. To illustrate, recall the net-long investor *A*, who owns a \$1,000 bond issued by *C* and \$500 notional of CDS written on *C*. Suppose the bond matures tomorrow, so that *C* will either pay principal or file for bankruptcy. If *C* files for bankruptcy, the bond will be worth \$400. In this scenario, *A* is strictly better off if *C* performs. If *C* pays the bond, *A* gets \$1,000; but if *C* files for bankruptcy, triggering the CDS, then *A* gets a cash CDS payment of \$300 [because $(\$500) \times (1.00 - 0.40) = \300] and a bankruptcy claim worth \$400, for a total of \$700. All else equal, net-long creditors prefer their debt instruments to be worth more, and so in general their interests align with those of traditional creditors.

All else is not always equal, however. In one narrow class of situations, namely when a distressed company seeks to renegotiate its debts, the interests of net-long and unhedged creditors can diverge. In order to trigger CDS, net-long creditors may turn down debt exchanges they believe to be value preserving. Under the ISDA definitions applicable in North America, a voluntary restructuring doesn't qualify as a credit event.⁵¹ Net-long creditors thus may hold out for a value-destroying bankruptcy—at least if they can't cheaply unwind their swap.⁵² They have an incentive to do so in particular when the securities offered in a debt exchange are worth less than the sum of what the creditor can expect to recover in bankruptcy and through its CDS.⁵³

⁵¹ See *2014 ISDA Credit Derivatives Definitions* § 4.7(b) (cited in note 41) (defining "Restructuring"). See also Hemel, Comment, 27 *Yale J Reg* at 161–63 (cited in note 43) (discussing strategic implications).

⁵² See Hemel, Comment, 27 *Yale J Reg* at 160, 164 (cited in note 43).

⁵³ Net-long and unhedged creditors are apt to disagree about the desirability of a debt exchange in another way, too. When information is asymmetric, hedged creditors are less willing to bow to a debtor's representations of doom when it seeks to restructure. Hedged creditors can afford more skepticism because they "stand to lose less in default" than unhedged creditors do. Patrick Bolton and Martin Oehmke, *Credit Default Swaps and the Empty Creditor Problem*, 24 *Rev Fin Stud* 2617, 2618 (2011). Under certain assumptions, the very reluctance of net-long creditors to compromise their claims can discipline managers and so increase a company's borrowing capacity ex ante. See *id.* at 2619.

Empty creditors—those whose debt is perfectly hedged—have broadly similar interests. They are less keen on the debtor’s success than net-long creditors are, but they are generally happy to see the debtor thrive. Roughly speaking, an empty creditor is equally pleased if its bond performs or if it loses value and a credit event occurs. What the empty creditor really does not want is for the value of its debt to decline without a credit event being triggered.

The net-short creditor stands apart. Only the net-short creditor relishes bad news. Hedged and empty creditors may want to trigger a credit event if the value of their debt is impaired, and they may tolerate some loss of value to achieve a credit event; but only the net-short creditor profits as a general matter when its debtor loses value.

To see why, consider the net-short creditor *A*, who has a \$1,000 bond issued by *C* and \$2,000 notional of CDS written on *C*. And suppose there are just four possible states of the world: the bond can be worth either \$1,000 or \$400, and in either case *C* can either experience a credit event or not. Below is a summary of the net-short creditor’s payoffs (treating the cost of the CDS as sunk). Crucially, *A* can benefit from, and can’t be hurt by, a credit event.

TABLE 1: NET-SHORT CREDITOR’S PAYOFF WITH CDS

	Credit Event	No Credit Event
Bond: \$1,000	\$1,000 + \$0 [$(\$2,000) * (1.00 - 1.00) = \0]	\$1,000
Bond: \$400	\$400 + \$1,200 [$(\$2,000) * (1.00 - 0.40) = \$1,200$]	\$400

C. Net-Short Sabotage Tactics

A net-short saboteur is thus a net-short creditor who actively uses its rights as creditor to bring about the debtor’s ruin.⁵⁴ The prospect of sabotage was evident to thoughtful observers almost as soon as CDS became widely traded and has been a staple of complaints about distressed-debt markets ever since.⁵⁵

⁵⁴ Others have dubbed this kind of creditor a “Darth Vader” or a “Trojan Horse” creditor. See Partnoy and Skeel, 75 U Cin L Rev at 1035 (cited in note 4) (using Darth Vader); Janger and Levitin, 104 Iowa L Rev at 1865 (cited in note 13) (using Trojan Horse).

⁵⁵ See, for example, Baird and Rasmussen, 119 Yale L J at 651 (cited in note 4); Hu and Black, 156 U Pa L Rev at 731, 734 (cited in note 3); Tung, 57 UCLA L Rev at 167–69

But how exactly can a saboteur achieve its aims? Creditors' direct governance rights are limited. A net-short shareholder might wage a proxy campaign to install like-minded saboteurs on the board, or threaten to do so, and cajole directors of good faith but weak stomachs.⁵⁶ Bondholders, by contrast, don't customarily have voting rights or board representation.

Creditor influence is instead a function of the debtor's liquidity. Nominally, to be sure, indentures and loan agreements assign creditors power to veto specified corporate acts. Covenants forbid debtors from one or another course of action and leave it to the discretion of bondholders or lenders, as the case may be, to waive their strictures. But the consequence of a debtor's breach of covenant is to allow the creditors to pull out capital by accelerating repayment obligations.⁵⁷ If the debtor has the cash needed to repay the principal, the creditors have no complaint. Put differently, creditors' governance rights, however broadly worded, are in the end limited by the debtor's capacity to refinance.

The means of creditor sabotage must then involve provoking, or at least exacerbating, a liquidity crisis at the targeted company. Two tactics are discussed in the literature. As we shall see, both require the activist to assemble a relatively large position in at least one tranche of the target's bonds or notes.⁵⁸ This fact, in turn, implies that sabotage entails a large capital outlay because

(cited in note 4); Partnoy and Skeel, 75 U Cin L Rev at 1034–35 (cited in note 4); Lubben, 81 Am Bankr L J at 427–28 (cited in note 4). See also Stephen J. Lubben and Rajesh P. Narayanan, *CDS and the Resolution of Financial Distress*, 24 J Applied Corp Fin 129, 131 (Fall 2012) (noting that “the holder of a large, speculative CDS position could acquire a position in a distressed firm's traded debt with the *intent* of blocking a potential workout”) (emphasis in original).

⁵⁶ A net-short shareholder would also presumably vote against corporate interests with respect to transactions requiring a shareholder vote. For a case where a fully hedged shareholder arguably tried (unsuccessfully) to push through a value-destroying merger, see Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 21C of the Securities Exchange Act of 1934 and Section 203(e) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, *In re Perry Corp*, Securities Exchange Act of 1934 Release No 60351, SEC Administrative Proceeding No 3-13561 *2 (July 21, 2009) (available on Westlaw at 2009 WL 2163550).

⁵⁷ See Kahan and Rock, 103 Nw U L Rev at 283–84 (cited in note 18) (sketching the significance of the fact that acceleration is effectively the sole remedy for a covenant violation). Lenders with a security interest in the debtor's property also enjoy a foreclosure remedy, of course.

⁵⁸ Loans are harder to use because many credit agreements give the borrower power to prevent a fund it mistrusts from becoming a lender. See Michael Bellucci and Jerome McCluskey, *The LSTA's Complete Credit Agreement Guide* 554–58 (McGraw-Hill 2d ed 2017) (describing disqualified lender provisions).

the saboteur profits only to the extent its short position in CDS is larger (in notional terms) than its long position in the target's debt.

The first tactic we have already briefly mentioned: holding out to frustrate a debtor's commercially reasonable attempt to restructure its balance sheet. The idea is to force a payment default and liquidation, or at least a disorderly bankruptcy filing. To illustrate the logic, consider a company, Acme Inc, with a simple capital structure. Acme's only obligation is to pay \$1,000 of bonds due next year. If the company continues as a going concern, investors expect it to generate future cash flows with a present value of \$800. If instead Acme is liquidated, investors expect its assets to fetch just \$400. Traditional creditors should be willing to restructure their claims to forestall liquidation. Traditional creditors want one another to agree to restructure because they would rather recover eighty cents on the dollar than forty.⁵⁹

A net-short activist creditor, by contrast, wants Acme's bonds to diminish in value. It wants liquidation and so wants any workout to fail.⁶⁰ The activist can help make this happen if it acquires a substantial amount of Acme's bonds (which should trade between forty and eighty cents) and simply refuses to tender them in any exchange offer no matter how generous the terms. If the saboteur acquires too little of Acme's debt, holding out will not prevent the workout's success; other bondholders' decisions to exchange will give the company the liquidity it needs to continue as a going concern. But if the saboteur's position is big enough, it can scuttle exchange offers predicated on a minimum-participation threshold and discourage other bondholders from accepting diminished claims.

The potency of "workout frustration," as we might call it, is clear, even if it has purchase only when a debtor is already at the point of a pending liquidity crunch. Its prevalence, however, is another question. The tactics are observationally identical to what one would expect from an empty or even net-long (but

⁵⁹ See also Buccola, 114 Nw U L Rev at 711–13 (cited in note 27) (discussing collective-action problem).

⁶⁰ See also Tung, 57 UCLA L Rev at 168 (cited in note 4):

[A] lender with a \$100 million exposure on a loan may have purchased protection for a notional amount of \$200 million. In that case, the lender holds a net negative position in the debt, which means it would profit from the borrower's default. That creditor would be worse than indifferent to a workout; it would gain the most by affirmatively sabotaging any workout effort and causing the borrower to fail.

hedged) creditor.⁶¹ Thus, rumors have circulated since the early days of CDS about creditors blocking commercially reasonable workouts in favor of default. Instances such as AbitibiBowater,⁶² Six Flags,⁶³ and LyondellBasell⁶⁴ are just a few examples. But it is not always clear whether the holdouts are supposed simply to have agitated for a credit event or else, more troublingly, to have sought to undermine valuable operations.

The other way to sabotage a distressed debtor involves litigation. The activist locates a covenant violation that cannot be easily cured and surprises the debtor with a suit to accelerate repayment obligations,⁶⁵ despite knowing (or rather *because* it knows) full well that the debtor will be unable to make good on those obligations.⁶⁶ The idea, as with workout frustration, is to create a scenario where the targeted company's illiquidity prevents it from realizing its highest value as a going concern. To return to the Acme example above, sabotage-by-litigation works in effect by accelerating the company's \$1,000 repayment obligation from the next period to this one.

Sabotage-by-litigation appears to give an activist bang for its buck. Acceleration doesn't just force a targeted company to (in effect) buy back the activist's series of bonds or notes at par.⁶⁷ For debtors of any substantial size and complexity, an adverse judgment threatens to create a cascade of repayment obligations. The

⁶¹ See note 52 and accompanying text.

⁶² See Lubben and Narayanan, 24 J Applied Corp Fin at 132 (cited in note 55); George Soros, *The Three Steps to Financial Reform* (Financial Times, June 16, 2009), online at <https://www.ft.com/content/b62b1bd4-5aa3-11de-8c14-00144feabdc0> (visited July 18, 2020) (Perma archive unavailable).

⁶³ See Hemel, Comment, 27 Yale J Reg at 159–60 (cited in note 43) (recounting rumor while acknowledging its speculative quality); *CDSs and Bankruptcy: No Empty Threat* (The Economist, June 18, 2009), archived at <https://perma.cc/UNG5-MLN7>.

⁶⁴ See *In Re Lyondell Chemical Co*, 402 Bankr 571, 585 n 26 (Bankr SDNY 2009) (noting rumor that some creditors of the debtors' European parent were seeking to accelerate repayment obligations on their notes in order to trigger CDS payouts); John A.E. Pottow, *Bankruptcy Fiduciary Duties in the World of Claims Trading*, 13 Brooklyn J Corp, Fin & Comm L 87, 94 n 44 (2018) (asserting that CDS “made some creditors impervious, even gleeful, regarding the prospect of nonpayment”).

⁶⁵ See Ad Hoc Committee for Revision of the 1983 Model Simplified Indenture, *Revised Model Simplified Indenture*, 55 Bus L 1115, 1136 (2000) (containing a draft model provision, § 6.02).

⁶⁶ This is Aurelius's supposed tactic in Windstream. See note 144 and accompanying text.

⁶⁷ Ad Hoc Committee, 55 Bus L at 1136 (cited in note 65) (containing a draft model provision, § 6.08).

acceleration of an obligation to repay one class of security frequently itself constitutes a default on others,⁶⁸ so most if not all of a company's debt might come due at once and suddenly. For leveraged firms, that spells bankruptcy.

Nevertheless, it is worth noticing that sabotage-by-litigation requires the activist to assemble a large position in the target's debt. Standard indentures allow either the trustee or the holders of 25 percent of the outstanding amount of the relevant bonds or notes to assert a covenant violation.⁶⁹ But indenture trustees are famously passive, and would-be saboteurs, given their aims and the imperative of secrecy, may struggle to line up confederates. They must therefore regard 25 percent as a minimum. But indentures also allow the holders of more than 50 percent of the bonds issued under them to waive asserted defaults.⁷⁰ Because by hypothesis saboteurs are trying to diminish the value of the securities, they must expect a waiver vote to be forthcoming. So, in practice, a net-short activist may need to acquire an outright majority of at least one tranche of the targeted company's debt.

II. SOURCES OF LIQUIDITY AND COASEAN SKEPTICISM

Despite the fact that scholars and market participants worry earnestly about creditor sabotage, there is good reason to doubt its factual basis. In brief, the story's logic overlooks the interests and reactive capacities of actors other than the would-be saboteur.⁷¹ Only a foolish investor would aim at sabotage—which, after all, is costly to undertake—if it anticipated that others would scotch its plans. The story's plausibility thus turns on whether

⁶⁸ Such "cross-default" provisions are a staple of credit agreements, see Bellucci and McCluskey, *The LSTA's Complete Credit Agreement Guide* at 446–49 (cited in note 58), as well as indentures, see, for example, Ad Hoc Committee, 55 Bus L at 1187–88 (cited in note 65) (containing a draft model provision, § 6.01).

⁶⁹ See, for example, Ad Hoc Committee, 55 Bus L at 1136 (cited in note 65) (containing a draft model provision, § 6.02). See also Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights*, 77 NYU L Rev 1040, 1049 (2002) ("A breach of the indenture other than a payment default generally becomes an 'Event of Default' only if either the trustee or holders of 25% of the bonds give a 'Notice of Default' to the company and the company fails to cure the default within a specified time period.").

⁷⁰ See, for example, Ad Hoc Committee, 55 Bus L at 1136 (cited in note 65) (containing a draft model provision, § 6.01, and defining "Event of Default" as a default not waived and continuing sixty days after notice).

⁷¹ See Yadav, 67 Vand L Rev at 776 (cited in note 22) ("In the established account, scholars focus on the incentives of a company's lenders of record. . . . Remarkably, scholarship entirely overlooks the role played by those who sell credit protection to lenders and assume the risk of a loan.").

targets of sabotage should be expected to procure the liquidity they need to preserve economic value after a net-short activist reveals itself. We argue that one should expect exactly that, because targets will invariably have allies with reasons and, often, with means to thwart and punish the saboteur.

a) Reasons. Straightforward Coasean analysis shows why attempts at net-short sabotage imply the existence of parties willing, if not able, to pay to undermine the saboteur.⁷² Indeed, other parties will inevitably have more to gain from stopping the activist than it will have to lose from being stopped. As we have seen, the idea of net-short sabotage is to provoke a liquidity crisis that destroys value and prompts a credit event. But swaps are zero-sum trades—whatever one side receives in settlement, the other side pays. The net effect of sabotage, then, taking into account investors in the targeted company as well as the swap counterparties, must be to reduce total economic value. It follows that economic value is maximized if sabotage can be forestalled. Those who will capture the surplus should be willing to supply liquidity to thwart the activist.⁷³

A variation on the Acme hypothetical described previously will illustrate the intuition. To recap, the company's sole obligations are \$1,000 face value of bonds outstanding and payable soon. But Acme can't afford to pay the bonds and so seeks to restructure them. If the company can continue beyond the current period as a going concern, it will generate cash flows with a present value of \$800. If, on the other hand, it is liquidated now, its assets will fetch \$400. Traditional bondholders should restructure their claims, pushing out maturities and perhaps reducing principal. They (as a group) are \$400 better off if they do so. Now to complicate things, suppose that one of Acme's bondholders, Activist, is net short. Activist has, let us say, \$1,000 of CDS protection and \$200 of bonds, which it plans to use to try to scuttle a restructuring.

A complete picture of the landscape takes into account the interests of three investors or groups of investors. First, there is Activist. As one would expect, Activist comes out ahead if Acme liquidates. In that case, its CDS pays out \$600 [because

⁷² See generally Coase, 3 J L & Econ 1 (cited in note 21).

⁷³ The classic Coasean trade would have the nonactivist parties pay the activist to back off. But often the better trade for them will be to supply liquidity to the targeted company so that the activist will lose on its CDS position.

$(\$1,000) \times (1.00 - 0.40) = \600], and its bonds recover \$80 [because $(\$200) \times (0.4) = \80], for a total of \$680.⁷⁴ Activist's payout if Acme continues as a going concern, on the other hand, is just the value of its share of the bonds, which is \$160 [because $(\$200) \times (0.8) = \160]. Second, there are the bondholders other than Activist. Consistent with the traditional theory of corporate finance, they do better if Acme continues as a going concern. In that case, their bonds will recover \$640 [because $(\$800) \times (0.8) = \640]. If, on the other hand, Acme liquidates, their bonds will recover only \$320 [because $(\$800) \times (0.4) = \320]. Finally, there is Activist's swap counterparty, Dealer. Dealer pays \$600 if Acme defaults and nothing if it survives as a going concern.

TABLE 2: PAYOFFS IF ACME DEFAULTS

	Going Concern	Liquidation	Net
Activist	\$160	\$680	(\$520)
Bondholders	\$640	\$320	\$320
Dealer	\$0	(\$600)	\$600
Total	\$800	\$400	\$400

All together the parties are better off if Acme survives. More specifically, they are better off by \$400—that is, the amount of economic surplus Acme's survival preserves. More to the point, Dealer and Acme's bondholders combined (other than Activist) are \$920 better off if a restructuring succeeds. Together they should, in other words, be willing to spend almost \$1,000 to ensure Acme's continuity.⁷⁵

This analysis suggests a more general observation about the difficulty of profiting from sabotage. A net-short creditor's returns from sabotage depend on the magnitude of the dislocation it causes. If the liquidity crisis it provokes leads to a big loss, such that the price of the target company's debt tumbles, then the activist's CDS payout will also be big. If, on the other hand, the target's illiquidity leads to a credit event but no change in the value of its debt—no real social loss—then the activist's CDS payout will be modest. But because the return to other parties from providing responsive liquidity is a function of the economic value

⁷⁴ The costs of CDS protection up until the current period are sunk, and, for the sake of simplicity, we ignore periodic coupons.

⁷⁵ The model can be complicated to account for the interests of other Acme stakeholders, such as employees.

that liquidity will preserve, their incentive to prevent sabotage is strongest in those cases where a net-short activist would otherwise profit. In short, the chances of successful sabotage, given responsive incentives, are inversely related to the strategy's prospective profitability for the saboteur.

b) Means. Those who stand to benefit from thwarting sabotage might not do so. The Coasean form of our reasoning suggests as much. There may be—and are—transaction costs that could prevent those opposed to the would-be saboteur from striking a mutually advantageous deal in any given case. We conclude that activist investors looking forward ought almost invariably to expect that such a deal would be struck, and so ought to expect sabotage to fail, but the case needs to be made.⁷⁶ To that end, the rest of this Part describes the three principal sources of liquidity targeted firms could be expected to tap—CDS protection sellers, the target's own net-long investors, and bankruptcy—and weighs the significance of obstacles to their use. Our judgment is that no one source of liquidity is foolproof, but that betting against all three would be reckless.

A. Liquidity from CDS Protection Seller(s)

The most obvious source of liquidity for a company targeted by a net-short saboteur is a party or consortium of parties who

⁷⁶ We do not reach the same conclusion with respect to some other kinds of CDS activism (recently much in the news), even though they also turn on a negative-sum trade that juices the return of one swap participant at the other's expense. A CDS participant can try to influence the value of its position by intervening in the reference entity's affairs in one of two basic (and inversely related) ways. One way is sabotage. The other is a kind of persuasion. In a persuasive strategy, the swap participant offers cheap financing to the reference entity conditional on the company doing something, such as paying or defaulting on its bonds, that will affect the swap's payout. Recent years have seen a variety of iterations on the theme, including much-publicized "engineered defaults" and "orphaning" transactions. See, for example, Fletcher, 94 NYU L Rev at 1093–1103 (cited in note 49) (discussing leading cases). But both strategies have a singular theme: persuasion and sabotage involve (1) a zero-sum bet and (2) an economic dislocation. They are inversely related, however, because one works by reducing and the other by increasing the reference entity's financing costs. That difference means that the economic dislocation is borne differently, and it produces totally different political economies. In the case of sabotage, those who are harmed (other than swap counterparties) are, as we have emphasized, investors in the targeted company. They are a natural constituency and can be expected to coordinate. In the case of persuasive activism, by contrast, those harmed (other than swap counterparties) are scattered across the world. They are all the people whose financing costs are marginally higher due to the subsidy of the target. They do not even know who they are, and coordination is impossible. On any practical Coasean analysis, then, persuasive strategies pose a zero- rather than negative-sum prospect.

have sold CDS protection on the target. In principle, any financier will do. But investors exposed to the consequences of sabotage should be poised to offer liquidity cheaply. Their motivation to see the target avoid a credit event means that they should be willing to fund at a discount. Protection sellers should also be able to act relatively quickly, as they will already have analyzed the target's financial condition.

To illustrate the intuition, return to the Acme hypothetical. Acme has outstanding one series of bonds, and there is just one swap referencing its debt. The obvious financier is Dealer. Dealer must pay \$600 if Acme suffers a credit event and \$0 if it avoids one. Dealer is thus willing to incur a (nominal) loss of up to \$600 to prevent the default. That is, Dealer is willing to buy new stock or debt issued by Acme at up to a \$600 discount, or even simply to gift up to \$600 to preserve Acme. Because the principal amount of Activist's bonds is just \$200, Dealer can afford to finance a redemption or pay a judgment to make Activist go away.

The real world is, of course, more complicated. It presents obstacles to value-maximizing transactions that chalkboard hypotheticals by their nature obscure. What in particular might prevent a CDS protection seller from blocking sabotage? Three obstacles merit discussion: swap market fragmentation, debt covenants, and general bargaining problems.

1. Swap market fragmentation.

Where multiple firms have sold CDS protection on a sabotage target, coordination may prove difficult. The issue is a hold-out problem similar in character to the classic dilemma confronting creditors of a distressed firm.⁷⁷ Each protection seller wants the target to receive the liquidity it needs to stay afloat but prefers

⁷⁷ See Buccola, 114 Nw U L Rev at 730 (cited in note 27) (emphasis in original):

It may be sensible for bondholders (viewed as a group) to restructure their claims. Even where this is so, however, each bondholder acting alone has an incentive not to agree to restructure her own claim. Even if she is better off compromising than holding out and watching a restructuring attempt fail, she is *best off* holding out while a sufficient number of fellow bondholders compromise.

See also Kahan, 77 NYU L Rev at 1053–54 (cited in note 69); Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J L & Econ 595, 596 (1993); Robert Gertner and David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J Fin 1189, 1191 (1991); Stuart C. Gilson, Kose John, and Larry H.P. Lang, *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J Fin Econ 315, 322–23 (1990); Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 Yale L J 232, 237–39 (1987).

that others provide it. The cumulative effect if each balks can be to undercut the financing altogether and produce the worst-case scenario.

Return to Acme, but suppose that, instead of buying \$600 notional of CDS protection from Dealer, Activist buys \$100 of protection from each of six counterparties—Dealer₁ through Dealer₆. The cumulative interests are the same. Each of the six dealers should be willing to finance Acme's liquidity at a (nominal) loss of up to \$100.

TABLE 3: PAYOFFS IF ACME DEFAULTS (WITH SIX CDS DEALERS)

	Going Concern	Liquidation	Net
Activist	\$160	\$680	(\$520)
Bondholders	\$640	\$320	\$320
Dealer ₁	\$0	(\$100)	\$100
Dealer ₂	\$0	(\$100)	\$100
Dealer ₃	\$0	(\$100)	\$100
Dealer ₄	\$0	(\$100)	\$100
Dealer ₅	\$0	(\$100)	\$100
Dealer ₆	\$0	(\$100)	\$100
Total	\$800	\$400	\$400

If the Dealers had a mechanism by which they could first identify and then force one another to bear a pro rata share of the costs of thwarting Activist, their fragmentation would be trivial. Suppose, for example, that it is clear that the cheapest way to defeat Activist's attempted sabotage is to call the outstanding bonds and refinance with new debt. This kind of transaction does not constitute a credit event,⁷⁸ so the Dealers can avoid paying anything on their CDS. Under this plan, Acme will redeem the bonds for \$1,000 (that is, par) and issue new bonds worth \$800 in their place. It is in the Dealers' collective interest to finance the recapitalization and bear the (nominal) \$200 loss, because by doing so they avoid having to pay \$600 to settle their CDS with Activist. If each Dealer agrees to bear its pro rata share of the refinancing cost, each is \$67 better off than if Activist were allowed to sabotage Acme.

⁷⁸ See 2014 ISDA *Credit Derivatives Definitions* § 4.7(b) (cited in note 41) (defining "Restructuring").

But there is no mechanism to bind protection sellers. Dealer₁ would rather be up \$67 than not, to be sure, but better yet, it could rely on Dealer₂ through Dealer₆ to cover refinancing costs and be up \$100. If the Dealers' positions were common knowledge, the imperative to maintain a reputation might mitigate hold-out incentives. But CDS positions are private, to say nothing of the variety of non-CDS but potentially offsetting positions an investor might have. Net-long protection sellers with sufficiently small stakes are thus likely to have at least some incentive to demur from joining a financing consortium. Fragmentation threatens to make the perfect the enemy of the good.

At the same time, there are reasons to think swap-market fragmentation is not an insuperable obstacle in most cases. The most obvious reason is empirical. In recent years, there have in fact been a number of cases where funds that have written CDS protection on a distressed company offer the company attractive financing. It is widely rumored, for example, that RadioShack, in an effort to postpone bankruptcy, got cheap financing from hedge funds who had sold CDS protection on it.⁷⁹ More recently, protection sellers have provided liquidity at below-market price to SuperValu⁸⁰ and McClatchy⁸¹ as part of so-called "orphaning" transactions. The protection sellers refinanced all of the reference entities' outstanding debt, at a discount, so that a credit event would become logically impossible.⁸² Sears also appears to have gotten cheap financing, albeit in bankruptcy rather than to avoid it, from a fund that had sold CDS protection on the company.⁸³

There are also theoretical reasons, grounded in market dynamics, to think that fragmentation is unlikely to be decisive in most cases. Hold-out problems arise only where lots of parties each have small stakes. The bigger a position a party has, and the

⁷⁹ See Fletcher, 94 NYU L Rev at 1098–1101 (cited in note 49).

⁸⁰ See Meyer Dworkin, Jason Kyrwood, Michael Fan, and Michele Babkine, *A Deep Dive into the CDS and Syndicated Financing Markets* *4 (Law360, Mar 14, 2019), archived at <https://perma.cc/4K23-FVXB>.

⁸¹ See Fletcher, 94 NYU L Rev at 1101–03 (cited in note 49); Matt Levine, *Credit Derivatives Bring People Together* (Bloomberg, June 28, 2018), online at <https://www.bloomberg.com/opinion/articles/2018-06-28/credit-derivatives-bring-people-together> (visited July 26, 2020) (Perma archive unavailable).

⁸² See Gavan Nolan, *Orphaning Risk Drives Tightening on European Pair* (IHS Markit, Sept 15, 2017), archived at <https://perma.cc/Q3AS-AUZ7>. See also *Credit Derivatives: The Tender Age* (The Economist, Apr 20, 2006), archived at <https://perma.cc/KF45-V6HT> (discussing cases where "holders of CDS contracts suddenly found themselves committed to paying for protection on bonds on the verge of extinction").

⁸³ See Dworkin, et al, *CDS and Syndicated Financing Markets* at *5 (cited in note 80).

more concentrated the holdings are perceived to be in general, the less likely it is to hold out. So if the net-long CDS protection sellers tend to have fairly large stakes, or believe they do, they should be willing to form consortia or even unilaterally to offer liquidity.

In the case of sabotage, there is an arbitrage opportunity in assembling a blocking position. One or a small group of arbitrageurs can consolidate positions in order to overcome a potential hold-out scenario. Distressed-debt investors have been doing exactly this in the loan and bond markets for a quarter century. A fund can agree to have others assign it their positions or can accomplish what comes to the same thing indirectly through a dealer (who would buy protection from the arbitrageur and unwind its equivalent positions). Consolidation can't happen overnight in most cases, we suspect. The CDS market is not liquid like the public-equity markets are. But net-short sabotage also does not occur overnight. There is time to respond after a would-be saboteur makes its play public.

2. Debt covenants.

A company targeted for sabotage is likely to have promised its creditors a variety of things. Some of the most attractive ways for CDS protection sellers to provide liquidity may require the company to countermand those promises. Two kinds of action are especially likely to raise issues: electing to prepay the would-be saboteur's claim (to neuter its governance rights) and incurring incremental debt (to finance prepayment or otherwise). Common covenants might get in the way.⁸⁴ These covenants seek to prevent debtors from subordinating or diluting existing creditors' claims

⁸⁴ Relevant covenants include: (1) maintenance of a range of financial conditions that paying bond debt or raising new debt might violate, see Bellucci and McCluskey, *The LSTA's Complete Credit Agreement Guide* at 312–27 (cited in note 58); (2) prohibition on incurring new debt, see *id.* at 370–74 (discussing typical credit agreement provision); William J. Whelan III, *Bond Indentures and Bond Characteristics*, in William F. Maxwell and Mark R. Shenkman, eds, *Leveraged Financial Markets: A Comprehensive Guide to High-Yield Bonds, Loans, and Other Instruments* 171, 185–88 (McGraw-Hill 2010) (discussing debt incurrence covenants commonly found in high-yield indentures); (3) prohibition on prepaying or otherwise modifying other debt, see Bellucci and McCluskey, *The LSTA's Complete Credit Agreement Guide* at 396–98 (cited in note 58) (discussing typical credit agreement provision); Whelan, *Bond Indentures and Bond Characteristics* at 181–85 (cited in note 84) (discussing effect of “restricted payments” provisions found in high-yield indentures); and (4) cross defaults, which cause a default on one debt instrument to ripple through the capital structure, see Bellucci and McCluskey, *The LSTA's Complete Credit Agreement Guide* at 446–49 (cited in note 58).

or diverting assets that might be used to satisfy those claims. At least in principle, these covenants might limit the practical ability of protection sellers to supply liquidity on attractive terms.

There are two basic responses to this concern. First, the creditors to whom promises have been made have the ability, and will typically have an incentive, to permit protection sellers to advance new liquidity on commercially reasonable terms. By hypothesis, the creditors are at risk of loss if a saboteur succeeds in destroying the debtor's value. As we shall explain shortly, creditors of a targeted company should themselves be willing to provide discounted financing to forestall a saboteur. They should therefore be all the more willing to allow others to do so. And hold-out is unlikely to be a problem, because most debt instruments allow a simple majority of the relevant debt to bless acts (other than payment failure) that would otherwise count as a default.⁸⁵

Second, there are ways for CDS protection sellers to extend liquidity that are unlikely to run afoul of the target's covenants. Buying newly issued equity is one example. Relevant covenants address transactions that (1) increase the amount of senior and equal-priority claims, (2) accelerate repayment of claims maturing at the same time as or later than the relevant debt, or (3) diminish the asset base available to pay the debt. Equity issuance is typically allowed. So even if for some reason the target's creditors won't allow commercially reasonable—indeed unreasonably cheap—new debt financing, the target could issue new equity. Ultimately, protection sellers should even be willing, if necessary, to make a cash infusion sufficient to cover whatever capital the saboteur seeks to withdraw.

3. General bargaining problems.

Striking a deal can be hard even when failure to do so would leave money on the table. Given infinite time, CDS protection sellers would come to an agreement among themselves and with the targeted company's managers and creditors. But time is finite. The supposed techniques of net-short sabotage cannot be implemented overnight, but they also do not necessarily take years to pull off. Given this reality, some value-maximizing deals will fail. There is not much to say about this. But we must remember

⁸⁵ See Bellucci and McCluskey, *The LSTA's Complete Credit Agreement Guide* at 510–12 (cited in note 58); Ad Hoc Committee, 55 Bus L at 1136, 1137 (cited in note 65) (containing draft model provisions, §§ 6.01, 6.04).

that the incentives for protection sellers to put a deal together increase with the stakes of sabotage.

B. Liquidity from the Target's (Other) Creditors

The creditors of a targeted company other than the would-be saboteur are alternative sources of liquidity. Their reasons for wanting to prevent a crisis should by now be familiar. A saboteur hopes to be paid by whoever is on the other side of its CDS, not by fellow creditors. But fellow creditors are anticipated collateral damage. A saboteur profits by reducing the value of the target's enterprise, which in turn reduces the value of its debt and increases the settlement price for CDS. The Acme example in the previous Section illustrates the idea. If a net-short activist were to provoke a credit event without affecting the price of the target's securities, fellow creditors would have no reason to intervene.⁸⁶ A credit event with no effect on debt prices only shuffles funds between the derivative counterparties. But as we have discussed, the real money in sabotage comes from driving down the prices of reference debt securities. The important thing to see is that, this being so, a would-be saboteur's fellow creditors should be willing to accept a (nominal) loss on their investments to avoid a bigger (real) loss.

A target's creditors have a variety of ways to provide liquidity, depending on the type of sabotage in issue. Most obviously, they can contribute new cash, and they can do so severally or through a consortium. In this respect, they are no different from CDS protection sellers.

But creditors also have means for infusing liquidity that we can generically call forbearance. The liquidity crisis a saboteur seeks to provoke is a condition of having too little cash to pay current obligations. Increasing cash or decreasing current obligations solves the problem equally well. The financial creditors of a sabotage target are uniquely positioned to help with the latter. They don't control all of the demands on the target. They can't relieve the company of the need to pay wages, rent, taxes, and so on. But they do have governance levers they can use to ameliorate liquidity crunches.

⁸⁶ This explains why creditors haven't objected in the manufactured-default cases. If anything, investors are happy about manufactured defaults because the reference entity gets new, below-market financing in exchange for its willingness to default.

Forbearance proper is an important means. As we have seen, one reported sabotage tactic is to litigate a covenant default with an eye to tripping cross defaults and so causing a cash crunch.⁸⁷ A judgment can dry up the targeted company's access to working capital under its revolving credit facility⁸⁸ and, more generally, give rise to the acceleration of most or all of its financial debt. But those consequences needn't follow. The most extreme consequences of an adverse judgment depend on the acquiescence (and sometimes action) of the very creditors whose claims the saboteur hopes a liquidity crisis will impair. Generally speaking, whether under a credit agreement or a bond indenture, a majority vote of the relevant creditors waives the consequences of an adverse judgment.⁸⁹ Thus, without advancing any new cash, creditors can by agreement limit the liquidity effect of sabotage-by-litigation to the size of any adverse judgment.

Creditors can also provide liquidity by restructuring their claims. A simple debt exchange, in which creditors swap instruments maturing soon for instruments with a longer-dated maturity, is the most straightforward way to do so. More complicated exchanges can undercut a saboteur more directly. If, for example, an activist pursues sabotage-by-litigation under an indenture that permits additional debt to be issued, creditors can swap into newly issued bonds and vote them against the saboteur. As we shall see, Windstream and its creditors tried but failed to properly execute this kind of exchange.⁹⁰

Two obstacles stand in the way of creditor-provided liquidity. First, fragmented ownership of debt can lead to a hold-out problem akin to the problem we discussed in relation to CDS protection sellers. Depending on the facts of a given case, creditors might need to offer liquidity at a discount to the then-prevailing market rate—that is, at a (nominal) loss. They might in principle argue without end about who should bear the cost, and so fail to strike a mutually advantageous deal. The more complicated a sabotage target's capital structure is, and the more fragmented the holders within each tranche and across tranches are, the harder it may be to resolve disagreement.

⁸⁷ See notes 67–68 and accompanying text.

⁸⁸ See Bellucci and McCluskey, *The LSTA's Complete Credit Agreement Guide* at 463–65 (§§ 9.2.1, 9.2.2) (cited in note 58).

⁸⁹ See *id.* at 510–17 (cited in note 58); Ad Hoc Committee, 55 *Bus L* at 1136, 1137 (cited in note 65) (containing draft model provisions, §§ 6.01, 6.04).

⁹⁰ See text accompanying notes 123–33.

Second, not all creditors have the institutional capacity to respond actively even if doing so in a particular case would maximize the value of their holdings. Collateralized loan obligations (CLOs), for example, which now hold half of all outstanding leveraged loans to US borrowers,⁹¹ may be diversified to such an extent that managers have weak incentives to intervene. Some bondholders likewise—and even more so—are designed to be passive. The managers of bond mutual and exchange-traded funds (ETFs), in particular, may lack flexibility to invest new money opportunistically. Consistent with the imperative to diversity, they, like some CLO managers, have only dull incentives to engage in the kind of diligence and negotiation that might be needed to optimize individual investments in the portfolio. Collateralized debt obligations (CDOs) can, depending on details, face similar hurdles, although CDOs today tend to be designed to allow opportunistic trading strategies.⁹² In general, as the fraction of a sabotage target's debt held by de facto passive investors grows, the deterrent effect of possible responsive intervention could weaken.

The significance of these impediments to cooperation should not, however, be overstated. Fragmentation and passivity are, after all, generic features of the debt markets. They pose potential barriers to efficient renegotiation in general, not only in cases of threatened sabotage. Yet debt investors commonly reach cooperative solutions. One should expect them to do so all the more readily were they to face an acknowledged common enemy and a potentially large surplus.

Trading is the key. Credit pools that lack capacity to intervene effectively can sell their stakes. (Mutual funds and ETFs tracking an index cannot, but they are exceptional in this regard.) The conventional buyers of distressed debt are precisely those private equity and hedge funds who specialize in adding value through activism. Their function is at once to concentrate ownership and convert the owner base from passive to active.

The mechanism is fallible. Not every deal that could be made is made in fact. We would not expect a sabotage target's creditors

⁹¹ Emily Liu and Tim Schmidt-Eisenlohr, *FEDS Notes: Who Owns U.S. CLO Securities?* (Board of Governors of the Federal Reserve System, July 19, 2019), archived at <https://perma.cc/2KZ9-V28Q>.

⁹² See Matt Wirz and Cezary Podkul, *Hedge Funds Revive the Junk Bond CDO* (Wall St J, Nov 7, 2018), online at <https://www.wsj.com/articles/hedge-funds-revive-the-junk-bond-cdo-1541592000> (visited Apr 4, 2020) (Perma archive unavailable) (describing the new breed of corporate-debt CDOs as vehicles for credit hedge funds to leverage capital).

to be unfailingly reliable sources of liquidity. But our argument demands far less than ideal conditions. It is important only to establish that a potential saboteur *ex ante* has reason to think its fellow creditors would undermine the plot by providing liquidity on their own.

C. Liquidity from Bankruptcy

Bankruptcy can offer liquidity to a sabotage target if the obstacles to an out-of-court solution involving CDS protection sellers and the target's investors prove insurmountable.⁹³ If the target uses Chapter 11 judiciously and with the support of its investors, it can avoid the disruption to and uncertainty about its operations that a saboteur hopes to provoke. To be sure, bankruptcy ought usually to be a last resort. The filing of a Chapter 11 petition is a credit event for CDS purposes,⁹⁴ which means that protection sellers will not emerge unscathed. Bankruptcy can be expensive, both in reputational and out-of-pocket terms.⁹⁵ A surgical and short proceeding is therefore imperative. But if the target has sufficient backing for a plan to neuter the saboteur, bankruptcy can also overcome hold-out obstacles in short order and so preserve expectations of value, the loss of which would enhance the saboteur's recovery.⁹⁶ And because an activist investor weighing up its options cannot assume its putative target will fail to plan properly, bankruptcy stands as a reason not to try sabotage.

Chapter 11 gives debtors access to liquidity in several ways. Most obviously, the filing of a petition stays creditors' collection efforts.⁹⁷ The stay allows a debtor to keep valuable combinations of assets together for a time, provided it has access to enough cash to cover ongoing expenses. More importantly for our purposes,

⁹³ More precisely, bankruptcy establishes conditions that make it relatively easy for the debtor to procure liquidity it could not otherwise arrange.

⁹⁴ *2014 ISDA Credit Derivatives Definitions* § 4.2 (cited in note 41) (defining "Bankruptcy").

⁹⁵ There have been many attempts to quantify the costs of bankruptcy. For a now somewhat dated survey, see Ben Branch, *The Costs of Bankruptcy: A Review*, 11 *Intl Rev Fin Analysis* 39, 40–42 (2002). None of these attempts, however, isolate the costs of bankruptcy in cases with the features one would expect to find in sabotage-inspired filings.

⁹⁶ Generally speaking, bankruptcy overcomes the kinds of hold-out dynamics described above by providing a binding mechanism to value creditors' claims. See Buccola, 114 *Nw U L Rev* at 722–27 (cited in note 27). Bankruptcy's capacity to do so has long been recognized as one of its principal justifications. See, for example, Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 *Yale L J* 857, 861–64 (1982).

⁹⁷ 11 USC § 362(a).

though, bankruptcy can enhance liquidity because it encourages deals to restructure debts (relieving immediate cash needs) and to raise incremental borrowing through debtor-in-possession financing (satisfying immediate cash needs).⁹⁸

A confirmed plan of reorganization creates restructuring liquidity. If liquidity is the debtor's only need, as by hypothesis it is in a sabotage case, the simplest plan simply forces creditors to exchange claims with short-dated maturities for new, longer-dated claims. Such a plan can be speedily confirmed if each class of creditor to be impaired votes to approve it.⁹⁹ Depending on the facts, a plan may be able to classify claims so that the saboteur has less than a blocking position. If so, the saboteur's claim can be restructured along with those of similarly situated creditors.¹⁰⁰ If not, a plan can pay the saboteur's claim in full, restructuring other claims to pay for it, and so render its opposition to the plan immaterial.¹⁰¹

The important point either way is to file for bankruptcy with the full-throated support of most or all creditors other than the saboteur itself. That way a case can move quickly at minimum cost. One recent prepackaged plan was confirmed less than twenty-four hours after the petition was filed.¹⁰² Most cases take longer, of course, but the proof of concept is meaningful. A bankruptcy judge who believes sabotage prompted the case before her is apt to act with dispatch. A plan could easily be confirmed before ISDA even holds the associated CDS settlement auction.

Incremental borrowing liquidity is available without the baroque procedures of plan confirmation. As we have seen, covenants in a targeted company's existing debt contracts might preclude

⁹⁸ See generally Kenneth Ayotte and David A. Skeel Jr, *Bankruptcy Law as a Liquidity Provider*, 80 U Chi L Rev 1557 (2013) (analyzing the mechanisms by which bankruptcy provides liquidity).

⁹⁹ 11 USC § 1129(a)(7)(A)(i). Approval requires creditors holding two-thirds of a class's claims by value and more than half by number to vote in favor. 11 USC § 1126(c).

¹⁰⁰ At minimum, a restructuring support agreement documenting the support of most or all creditors other than the saboteur can speed the confirmation process. See Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 Am Bankr L J 593, 603–04 (2017).

¹⁰¹ See 11 USC § 1129(a)(8)(B). Alternatively, the target could seek to have the saboteur's vote designated under 11 USC § 1126(e) or a plan crammed down over its veto per 11 USC § 1129(b), but these maneuvers require time-consuming litigation.

¹⁰² Katherine Doherty, *Sungard Availability Sets Record for Fastest Chapter 11 Approval* (Bloomberg, May 2, 2019), online at <https://www.bloomberg.com/news/articles/2019-05-02/sungard-availability-sets-record-for-fastest-chapter-11-approval> (visited July 26, 2020) (Perma archive unavailable).

additional borrowing needed to preserve value. Coordination difficulties might prevent the beneficiaries of those covenants from waiving them. Chapter 11 answers this contingency. It dispenses with contractual restrictions on new debt and permits debtors to borrow additional funds, on a priority basis, at the judge's say-so.¹⁰³ An order granting debtor-in-possession financing on an interim basis is customarily entered on the first day of proceedings, and a final order follows as soon thereafter as a briefing schedule permits. To the extent a saboteur's tactics threaten liquidity in the very near term—that is, before a plan of reorganization can be confirmed—debtor-in-possession financing offers relief.

There are downsides to a sabotage target's use of bankruptcy for liquidity. Two in particular are worth bearing in mind. First, a bankruptcy filing reduces the marginal incentive of CDS protection sellers to provide financing. The fact of a Chapter 11 case means that CDS will pay out. Depending on how far below par the target's bonds are trading at the time, that can be a substantial sum; and the protection sellers don't get their money back if the target's fortunes improve. Second, bankruptcy is typically more expensive than an out-of-court workout. The difference in a sabotage case, where the mass of creditors are (by hypothesis) aligned with the debtor, is hard to estimate. It is probably relatively small. But it is a difference, and the difference should be expected to reduce debt prices at least marginally, juicing the saboteur's CDS payoff.

Nevertheless, bankruptcy provides a liquidity backstop. And, because workout negotiations occur in Chapter 11's shadow, the very existence of a bankruptcy option should make it easier to overcome hold-out problems without the need for compulsory process.¹⁰⁴ In a given case, CDS protection sellers or the target's investors might not provide valuable liquidity without bankruptcy, or even with it. But in light of their interests and capacities, it seems to us that to bet against some kind of deal—a bet that sabotage entails—would be foolish in nearly every case. And the more one might hope to profit from sabotage, the more foolish the bet that one can pull it off seems to be.

¹⁰³ 11 USC § 364.

¹⁰⁴ See Schwartz, 36 J L & Econ at 602–03 (cited in note 77).

III. WINDSTREAM: A CASE STUDY

We have said why we think sabotage is hard in general to pull off and suggested that activist investors, seeing this, are unlikely to try it. Our reasons are speculative, however. They depend on a particular model of debt markets. It is not a demanding model. It requires only that investors be reasonably good at coordinating when the alternative is millions of dollars of losses on top of humiliation at the hands of a rival. But facts can prove the model wrong. If it turns out that activist funds do in fact execute net-short sabotage tactics, and do in fact profit from them, then our model is wrong.

As an attempt at falsification, we seek to reconstruct Aurelius's intervention in Windstream. The consensus that Aurelius performed sabotage makes it a useful case study. If upon examination there is good reason to think this consensus is right, then reality will have marked at least a limit to our general theory. But if, on the other hand, examination of the case suggests that Aurelius aimed at something different from sabotage, then our theory will at least have survived a meaningful attempt at falsification and we will have learned something about gullibility.

To preview, we find that Aurelius likely sought to impose what we consider a "breach tax" on Windstream for violating its sale-leaseback covenant. Publicly available facts do not allow us to rule out sabotage, but they point toward an alternative account of the case.

A. The Facts

1. The spin-off.

The story starts in 2013, when Windstream Services, a telecommunications provider with operations in eighteen states, began to consider spinning off some of its real estate assets into a separate, publicly traded company.¹⁰⁵ The reason to do so was not to restructure operations. Windstream's management were clear that the fiber optic cables and copper wires to be spun off were "essential and the only means for [the company] to serve clients."¹⁰⁶ The reason, as in so many real estate spin-offs, was tax

¹⁰⁵ *US Bank National Association v Windstream Services, LLC*, 2019 WL 948120 *2 (SDNY).

¹⁰⁶ *Id.* at *5.

minimization.¹⁰⁷ A plan was thus hatched to separate the company's assets formally but functionally to keep them together. Windstream and its subsidiaries would transfer real estate assets to an investment trust—to become known as Uniti Group, Inc—but would at the same time enter a long-term lease with the trust ensuring continued use rights.¹⁰⁸

There was just one problem. Windstream had covenanted in its debt contracts that it wouldn't do the kind of transaction most natural in the circumstances, namely a sale-leaseback.¹⁰⁹ Rather than seek a waiver from its noteholders, however, Windstream sought to structure a transaction that would replicate the economics of a sale-leaseback without running afoul of the technical terms of its covenants. Its credit agreement and note indentures arguably prohibited only bilateral deals, arrangements in which a single entity sells and leases back an asset.¹¹⁰ So Windstream structured a triangular deal involving a newly incorporated holding company, Windstream Holdings, Inc. Roughly speaking, the arrangement was to work as follows: (1) Windstream Services

¹⁰⁷ Then-prevailing tax rules allowed a company to avoid double taxation on real estate assets if it did a spin-off correctly. See, for example, Austan Goolsbee and Edward Maydew, *Taxes and Organizational Form: The Case of REIT Spin-Offs*, 55 *Natl Tax J* 441, 445–46 (2002). Legislation taking effect in December 2015 largely closed off the tax benefit. Even so, there can be administrative and financial reasons to separate assets even where operations will remain entwined. See generally Emilie R. Feldman, *Corporate Spinoffs and Analysts' Coverage Decisions: The Implications for Diversified Firms*, 37 *Strategic Mgmt J* 1196 (2016) (finding that companies that divest legacy businesses enjoy greater improvements in forecast accuracy and stock market performance); Emilie R. Feldman, *Legacy Divestitures: Motives and Implications*, 25 *Org Sci* 815 (2014) (discussing various reasons why corporations divest their legacy businesses). Windstream's CEO would later cite some generic rationales for the transaction in this vein. See Thomas Declaration ¶ 26 at *14–15 (cited in note 7). But tax benefits must have been an important motivation.

¹⁰⁸ See generally Windstream Holdings, Inc, Master Lease (Apr 24, 2015), archived at <https://perma.cc/77DP-KXHM>.

¹⁰⁹ See Windstream Corporation 6 ³/₈ % Senior Notes Due 2023 Indenture Dated as of January 23, 2013 § 4.19, *71 (Jan 23, 2013), archived at <https://perma.cc/2KQU-5J7G> (“2013 Indenture”) (“The Company shall not, and shall not permit any of its Restricted Subsidiaries to, enter into any Sale and Leaseback Transaction.”). Sale-leaseback covenants are common. A sale-leaseback reduces the debtor's asset base and can be used, in effect, to borrow additional amounts and so dilute existing creditors' claims.

¹¹⁰ See id § 1.01 at *24:

“**Sale and Leaseback Transaction**” means with respect to any Person, any transaction involving any of the assets or properties of such Person whether now owned or hereafter acquired, whereby such Person sells or otherwise transfers such assets or properties and then or thereafter leases such assets or properties or any part thereof or any other assets or properties which such Person intends to use for substantially the same purpose or purposes as the assets or properties sold or transferred.

transfers assets to Uniti; (2) Uniti leases the assets to Windstream Holdings; and (3) Windstream Services pays Windstream Holdings to use the assets under its lease.¹¹¹ Windstream Services would transfer assets and then pay a periodic sum to continue using them, but at least arguably not on account of a “Sale and Leaseback Transaction” as defined in the company’s debt documents. The spin-off closed in 2015, and for two years no one objected.¹¹²

2. The litigation.

Then, in 2017, Aurelius entered the scene. That summer its flagship fund bought a large fraction of a certain series of unsecured Windstream notes—the “6 $\frac{3}{8}$ % Notes.”¹¹³ These Notes stood junior to approximately \$2 billion of Windstream’s secured obligations and on par with, but maturing later than, more than \$2 billion of other unsecured debt.¹¹⁴ The Notes traded at a discount reflecting their junior status and the market’s concern over Windstream’s financial health. Aurelius was therefore able to acquire its stake—\$310 million face value of the 6 $\frac{3}{8}$ % Notes, amounting to approximately 6 percent of Windstream’s total outstanding long-term obligations¹¹⁵—for what we estimate to be a little over \$230 million.¹¹⁶

Under the relevant indenture’s (standard) terms, a holder of more than 25 percent of the 6 $\frac{3}{8}$ % Notes can assert a covenant default and accelerate Windstream’s obligation to repay the principal and accrued interest.¹¹⁷ Less than \$600 million of 6 $\frac{3}{8}$ %

¹¹¹ See *Windstream Services*, 2019 WL 948120 at *3–5; Thomas Declaration ¶¶ 24–26 at *13–15 (cited in note 7).

¹¹² See Thomas Declaration ¶¶ 8, 24 at *5, *13 (cited in note 7).

¹¹³ See *Windstream Services*, 2019 WL 948120 at *6.

¹¹⁴ See Windstream Holdings, Inc, *Form 10-K*, F-61 (SEC filed Mar 1, 2017) (“Windstream 2016 Annual Report”), archived at <https://perma.cc/9A6X-8HCL>; Windstream Holdings, Inc, *Form 10-K*, F-72 (SEC filed Feb 28, 2018) (“Windstream 2017 Annual Report”), archived at <https://perma.cc/VN2H-FHKS>.

¹¹⁵ See Windstream 2016 Annual Report at F-61 (cited in note 114).

¹¹⁶ We have no way of knowing when exactly Aurelius amassed its position or what it paid. We therefore use the volume-weighted average daily price of the 6 $\frac{3}{8}$ % Notes during the month before Aurelius revealed its position—that is, between August 21 and September 21, 2017. This is \$0.75, based on TRACE data (on file with authors). Note that here and wherever we discuss TRACE data we followed the Dick-Nielsen method for cleaning. See generally Jens Dick-Nielsen, *Liquidity Biases in TRACE*, 19 J Fixed Income 43 (2009).

¹¹⁷ 2013 Indenture § 6.01(a)(v) at *73–74 (cited in note 109):

(a) Each of the following is an “**Event of Default**” with respect to the Notes:

...

Notes were outstanding,¹¹⁸ meaning that Aurelius held far more than the requisite share, indeed a majority.¹¹⁹ Aurelius promptly asserted that spinning off Uniti breached Windstream's sale-leaseback covenant,¹²⁰ and after some procedural wrangling, litigation commenced in the Southern District of New York.

Windstream denied that the spin-off had violated its covenant. But the company also sought to moot the significance of the question. The relevant indenture, as is typical, allows the holders of more than 50 percent of the 6 ³/₈ % Notes to waive the consequences of a default.¹²¹ That of course would be impossible as long as Aurelius held a majority. But the indenture also permitted Windstream to issue additional 6 ³/₈ % Notes. If it could dilute Aurelius's stake sufficiently, it could perhaps procure a majority to bless the spin-off retroactively.

Windstream settled on a consent solicitation and exchange offer. It would offer existing creditors to swap their securities for newly issued 6 ³/₈ % Notes—conditional, it goes without saying, on the creditors' consenting to waive the putative default.¹²² The ploy proved successful on its face. Windstream issued \$560 mil-

(v) failure by the Company or any of its Restricted Subsidiaries for 60 days after written notice by the Trustee or Holders representing 25% or more of the aggregate principal amount of Notes then outstanding to comply with any of the other agreements in this Indenture;

See also id § 6.02(a) at *75:

. . . If any other Event of Default occurs and is continuing with respect to Notes, the Trustee or the Holders of at least 25% in principal amount of the then outstanding Notes may declare all the Notes to be due and payable immediately by notice in writing to the Company specifying the Event of Default. . . .

¹¹⁸ Windstream issued \$700 million of the 6 ³/₈ % Notes in January 2013. But it repurchased some in 2016, so that by the summer of 2017, \$585.7 million were outstanding. See Windstream 2016 Annual Report at F-61 (cited in note 114).

¹¹⁹ See Windstream 2017 Annual Report at F-72 (cited in note 114).

¹²⁰ *Windstream Services*, 2019 WL 948120 at *6–7; Thomas Declaration ¶ 32 at *18 (cited in note 7).

¹²¹ 2013 Indenture § 6.04 at *76 (cited in note 109):

Holders of a majority in aggregate principal amount of the Notes then outstanding by notice to the Trustee may on behalf of the Holders of all of the Notes waive any existing Default or Event of Default and its consequences hereunder except a continuing Default or Event of Default in the payment of interest or Additional Interest on, or the principal of, the Notes.

¹²² For detail on the terms of Windstream's consent solicitation and exchange offer, see *Legal Analysis: Windstream Exchange Offers Face Aurelius Criticism over Bankruptcy Claim Value* (Debtwire, Oct 30, 2017), archived at <https://perma.cc/RPY2-PXZH>.

lion of new 6 ³/₈ % Notes, canceling \$520 million of other outstanding notes in the process, and so was able to procure a waiver by a slim margin.¹²³

Aurelius contested the waiver's validity. The fund acknowledged that new 6 ³/₈ % Notes could, if properly issued, dilute its vote; but it argued that the exchange offer was improper. The argument's logic is intricate but worth rehearsing if only to show just how sensitive Aurelius's position was to events beyond its control, even by its own lights. The argument goes generally as follows:

1. Newly issued 6 ³/₈ % Notes count for voting purposes only if they are "Additional Notes."¹²⁴
2. Additional Notes include only new notes issued in compliance with § 4.09 of the indenture.¹²⁵
3. Section 4.09 prohibits Windstream and its restricted subsidiaries from incurring indebtedness when their consolidated debt-to-cash-flow ratio exceeds 4.5-to-1—which all acknowledge it did at the time of the exchange offer (conditional on the spinoff counting as a Sale and Leaseback Transaction)¹²⁶—except insofar as the indebtedness counts as "Permitted Debt."¹²⁷
4. The exchange offer increased indebtedness by \$40 million, namely the difference between the \$560 million in new 6 ³/₈ %

¹²³ *Windstream Services*, 2019 WL 948120 at *8–9; Thomas Declaration ¶¶ 34–35 at *18–19 (cited in note 7).

¹²⁴ 2013 Indenture § 2.02 at *29 (cited in note 109).

¹²⁵ *Id.* § 1.01 at *1:

"**Additional Notes**" means an unlimited maximum aggregate principal amount of Notes (other than the Notes issued on the date hereof) issued under this Indenture in accordance with Sections 2.02 and 4.09 and having the same terms in all respects as the Notes, or similar in all respects to the Notes, except that interest will accrue on the Additional Notes from their date of issuance.

¹²⁶ See *Windstream Services*, 2019 WL 948120 at *19–20.

¹²⁷ 2013 Indenture § 4.09(a) at *61 (cited in note 109) (emphasis in original):

The Company shall not, and shall not permit any of its Restricted Subsidiaries to, directly or indirectly, Incur any Indebtedness; *provided, however*, that the Company or any of its Restricted Subsidiaries that are Guarantors may Incur Indebtedness, if the Company's Consolidated Leverage Ratio at the time of the Incurrence of such additional Indebtedness, and after giving effect thereto, is less than 4.50 to 1.

See also *id.* § 4.09(b) at *61 ("Section 4.09(a) shall not prohibit the Incurrence of any of the following items of Indebtedness (collectively, '**Permitted Debt**') . . .").

Notes and the \$520 million of other notes retired in the exchange. So the new notes are not Additional Notes, and can't vote on a waiver, unless they are Permitted Debt.¹²⁸

5. The only kind of Permitted Debt that arguably describes the new 6 ³/₈ % Notes is "Permitted Refinancing Indebtedness."¹²⁹

6. Permitted Refinancing Indebtedness includes debt issued "in exchange for" other indebtedness of the company—a limitation the new 6 ³/₈ % Notes satisfy—but only if the amount newly issued (that is, \$560 million) does not exceed the amount being refinanced (that is, \$520 million) plus accrued interest (not important here) and "the amount of any reasonably determined premium necessary to accomplish such refinancing and such reasonable expenses incurred in connection therewith."¹³⁰

7. Windstream stated in binding interrogatories that it paid no premium at all in the exchange.¹³¹ Therefore, the new 6 ³/₈ % Notes are not Permitted Refinancing Indebtedness; are not Permitted Debt; are not Additional Notes; and so can't vote to waive a default.

The case thus turned on two legal issues. First, was the spin-off a Sale and Leaseback Transaction? Second, if it was, had Windstream dodged the consequences of default by procuring a valid waiver? Judge Jesse Furman ruled for Aurelius on both questions. He concluded that the interposition of Windstream Holdings between Uniti and Windstream Services was an empty formality. Windstream Services's continued "use and enjoyment" of the assets it had transferred to Uniti "walk[ed] like a lease and talk[ed] like a lease."¹³² And Aurelius's argument on the issue of

¹²⁸ Id § 4.09(b) at *61.

¹²⁹ Id § 4.09(b)(v) at *61:

[allowing] the Incurrence by the Company or any Restricted Subsidiary thereof of Permitted Refinancing Indebtedness in exchange for, or the net proceeds of which are used to refund, refinance or replace Indebtedness (other than inter-company Indebtedness) that was permitted by this Indenture to be Incurred under Section 4.09(a) or clauses (ii), (iii), (iv), (v), (xiv) or (xv) of this Section 4.09(b)).

¹³⁰ Id § 1.01 at *22.

¹³¹ See *Windstream Services*, 2019 WL 948120 at *21.

¹³² Id at *17.

waiver was sound. Judgment was entered for Aurelius, for \$310 million plus interest, on February 15, 2019.¹³³

3. The aftermath.

Less than two weeks later, Windstream was in bankruptcy.¹³⁴ As its CEO, Tony Thomas, explained, the Aurelius judgment caused a default under Windstream's other note indentures and more importantly under its credit agreement.¹³⁵ The company kept very little cash on hand, relying instead on its revolving credit facility to finance day-to-day operations. The judgment thus meant that Windstream's liquidity would be cut off unless a majority of its lenders voted to waive the default.¹³⁶ But the lenders were unwilling to give more than a brief respite.¹³⁷ Other financiers apparently offered to arrange a substantial out-of-court refinancing—the details are not public—but Windstream's management didn't think the necessary waivers and consents could be procured quickly enough, if ever, and the board concluded that Chapter 11 was the remaining option.¹³⁸

The value of Windstream's securities tumbled. The price of its stock dropped from \$3.37 on the eve of Judge Furman's decision to just \$0.45 when Windstream filed its Chapter 11 petition.¹³⁹ Its notes plunged to around 20 cents on the dollar,¹⁴⁰ settling a month later at the CDS auction for 29.5 cents.¹⁴¹ In all, Windstream suffered a market-implied loss of enterprise value of approximately \$1.7 billion.¹⁴²

¹³³ Id at *22–23.

¹³⁴ See generally Voluntary Petition for Non-Individuals Filing for Bankruptcy, *In re Windstream Holdings, Inc*, No 19-22312 (Bankr SDNY filed Feb 25, 2019).

¹³⁵ Thomas Declaration ¶¶ 11–12 at *6 (cited in note 7).

¹³⁶ Id.

¹³⁷ Id ¶ 39 at *20–21.

¹³⁸ Id ¶¶ 39–44 at *21–22.

¹³⁹ *Windstream Holdings, Inc (WINMQ)* (Yahoo Finance, Mar 1, 2020), archived at <https://perma.cc/8X29-8P5A> (reporting the stock price as of February 25, 2019, the date Windstream filed for bankruptcy).

¹⁴⁰ Source: TRACE (data on file with authors). For more on our methodology, see note 116.

¹⁴¹ *Windstream Services LLC Auction Results* (Credit Fixings, Apr 3, 2019), online at <http://www.creditfixings.com/CreditEventAuctions/results.jsp?ticker=WINDSSE> (visited July 18, 2020) (Perma archive unavailable).

¹⁴² Source: Bloomberg (data on file with authors).

B. The Sabotage Interpretation

One interpretation of the facts is that Aurelius attempted and performed a sabotage. On this interpretation, in addition to the Notes used to force litigation, the fund also bought some amount more than \$310 million notional of CDS protection that would pay out if Windstream were to default. If the lawsuit were to succeed, the idea goes, the dominos would fall neatly for Aurelius. Windstream's repayment obligation on more than \$500 million of long-term liabilities would be accelerated; its secured lenders would spook about the prospect of so much cash flowing to nominally junior creditors and cut off lending; other junior lenders would accelerate their own notes if the lenders did not; and Windstream would have to file for bankruptcy protection, crashing debt prices and triggering CDS settlement obligations. In point of fact, more or less this sequence of events came to pass. The sabotage interpretation says that Aurelius planned on it and made a lot of money.

This is the dominant interpretation. Windstream's CEO, Tony Thomas, has made clear it is his. On the eve of bankruptcy, he declared that Windstream "believes Aurelius engaged in predatory market manipulation to advance its own financial position through credit default swaps at the expense of many thousands of shareholders, employees, customers, vendors and business partners."¹⁴³ But Thomas is not alone. The view that Aurelius sought to drive down Windstream's value and induce a credit event is the consensus view.¹⁴⁴

¹⁴³ Soma Biswas, *Windstream Files for Bankruptcy After Legal Loss* (Wall St J, Feb 25, 2019), online at <https://www.wsj.com/articles/windstream-preparing-to-file-for-bankruptcy-as-early-as-monday-11551113664> (visited Apr 5, 2020) (Perma archive unavailable).

¹⁴⁴ See Matt Levine, *Aurelius Wins Against Windstream* (Bloomberg, Feb 19, 2019), online at <https://www.bloomberg.com/opinion/articles/2019-02-19/aurelius-wins-against-windstream> (visited July 26, 2020) (Perma archive unavailable) ("[T]he universal assumption is that Aurelius has also bought a lot of credit-default swaps that will pay out if Windstream defaults on its debt: By pushing Windstream into default, Aurelius will make a profit on its CDS, even if it loses money on the bonds."). See also Boris J. Steffen, *The Evolution of CDS: From Net-Short Debt Activism to Manufactured Defaults*, 38 Am Bankr Inst J 22, 62 (Nov 2019) ("The litigation between Aurelius Capital Management LP and Windstream Holdings Inc. is an illustration of the net-short debt-activist strategy.") (citation omitted); Carl N. Wedoff and Michael K. Ballew Jr., *Outrageous Fortune: Making Money by Engineering Defaults*, 38 Am Bankr Inst J 36, 70 (July 2019) ("In 2017, Aurelius began purchasing [Windstream debt], and market participants believed that the firm built a large CDS position as well."); Stephen Lubben, *CDS Strikes Again (Aurelius and Windstream)* (Credit Slips, Feb 24, 2019), archived at <https://perma.cc/JZ76-LQA8> (concluding that "damage to Windstream will actually increase the value of [Aurelius's] CDS position");

C. The “Breach Tax” Interpretation

An alternative interpretation is also possible. The facts are as consistent with an Aurelius strategy seeking to, in effect, tax Windstream for its covenant breach as they are with the sabotage theory. Such a breach tax strategy would not have been particularly novel. Professors Marcel Kahan and Edward Rock identified it more than a decade ago,¹⁴⁵ and Wachtell Lipton’s restructuring lawyers attest to its continued appeal.¹⁴⁶

The idea of a “breach tax” strategy is to punish violations after the fact without undermining profitable operations. The conventional remedy assigned to bondholders for an issuer’s breach of covenant is acceleration. In case of a breach, the bondholders or the indenture trustee can send the issuer a notice of default and, if the issuer fails to cure the breach, demand immediate repayment of principal.¹⁴⁷ Acceleration is, however, historically uncommon. Trustees of their own accord scarcely if ever assert defaults other than for nonpayment. Acceleration for breach of other covenants thus happens only if the holders of 25 percent of the relevant bonds demand it. But widely scattered investors may

Tiffany Kary, Emma Orr, and Eliza Ronalds-Hannon, *Hedge Fund and Rural Phone Company Face Off in Court over Debt Drama* (Bloomberg, Dec 13, 2017), online at <https://www.bloomberg.com/news/articles/2017-12-13/aurelius-and-windstream-s-game-of-debt-chess-heads-to-court> (visited July 29, 2020) (Perma archive unavailable) (noting “Aurelius’ ulterior motives (i.e., CDS position)”; *Windstream’s Grim Refi Prospects and Aurelius Sideshow Bring Recovery Valuations to the Forefront* (Debtwire, Oct 2, 2017), online at <https://www.debtwire.com/intelligence/view/prime-2512261> (visited July 29, 2020) (Perma archive unavailable) (reporting that Aurelius “holds CDS tied to the credit”).

¹⁴⁵ See Kahan and Rock, 103 Nw U L Rev at 283–306 (cited in note 18). See also Yadav, *Debt Buybacks* at *20–23 (cited in note 25) (discussing recent episodes where this strategy was used).

¹⁴⁶ See Cohen, Kleinhaus, and Sobolewski, *Default Activism* (cited in note 14). The authors call the strategy “greenmail.” Id. Whether it merits a pejorative label is, however, an open question. The strategy has a disciplinary function with presumably at least some systemic benefits. Corporate managers may take advantage of bondholders’ coordination problem. The threat that a hedge fund may solve that problem tomorrow disciplines managers today. For an analysis of an analogous monitoring function of greenmail in the equity context, see Jonathan R. Macey and Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 Yale L J 13, 29–31 (1985). That said, as Professors Kahan and Rock have shown, the acceleration remedy is poorly calibrated to the economic injury a particular breach produces. The remedy encourages sometimes too much and sometimes too little enforcement, see Kahan and Rock, 103 Nw U L Rev at 301–02 (cited in note 18), and hedge fund activism presumably reflects those incentives for better and worse.

¹⁴⁷ See Kahan and Rock, 103 Nw U L Rev at 302 (cited in note 18) (“Economically, the acceleration remedy resembles a liquidated damages clause where the amount of liquidated damages is equal to the difference between par and the nonaccelerated bond value.”); Kahan, 77 NYU L Rev at 1049 (cited in note 69).

find coordination difficult and so fail to accelerate or extract compensatory concessions even if coordination would be to their collective advantage.¹⁴⁸ As a result, issuers have traditionally been more complacent about breaking covenants than a naïve observer might suppose.

With respect to bonds trading below par, an activist hedge fund can supply the coordination and capture some of its value. To do so, the fund quietly buys up the relevant bonds in the secondary market. When it holds more than 25 percent, it threatens the issuer with acceleration unless the issuer pays the fund to go away.¹⁴⁹

The economics point to a mutually advantageous settlement. This is so because the value to the issuer of preventing acceleration will frequently be greater than the value to the activist of causing acceleration. Acceleration forces the issuer (in effect) to buy back at par an entire series of bonds worth something less than par, but the activist captures only a fraction of that difference corresponding to its share of the bonds. To illustrate, suppose that Issuer has \$4 million of bonds outstanding. They trade at \$0.75. Activist buys up 25 percent of them—\$1 million face value—for \$750,000 and contemplates suit. If Activist accelerates, Issuer must (in effect) buy back \$3 million worth of bonds for \$4 million; but Issuer receives only a quarter of the million-dollar premium. Issuer and Activist should thus settle for something between \$250,000 and \$1 million.¹⁵⁰

An activist fund pursuing a breach-tax strategy may, but need not, procure CDS protection. We have so far described the strategy as applied to an obvious and uncontested breach. Sometimes, however, the issuer will dispute allegations of breach, and litigation might follow. Judicial process takes time. Meanwhile, the fund is carrying a large (long) position in the issuer's bonds.

¹⁴⁸ See Kahan, 77 NYU L Rev at 1054–55 (cited in note 69).

¹⁴⁹ See Kahan and Rock, 103 Nw U L Rev at 295–98 (cited in note 18).

¹⁵⁰ A recent decision out of the US District Court for the Southern District of New York holds that so-called make-whole premiums payable to bondholders when an issuer chooses to redeem the bonds before they mature must also be paid when bondholders choose to accelerate repayment after an issuer defaults. *Wilmington Savings Fund Society v Cash America International, Inc.*, 2016 WL 5092594 *8 (SDNY). See also Mitu Gulati and Marcel Kahan, *Cash America and the Structure of Bondholder Remedies*, 13 Cap Markets L J 570, 570–72 (2018). The decision expands the universe of bonds on which an activist can profitably seek to impose a breach tax. Until *Cash America*, profitable opportunities existed only with respect to bonds trading at a deep discount to par. Now it may be open season on bonds trading near or even at par. See Cohen, Kleinhaus, and Sobolewski, *Default Activism* (cited in note 14).

If the issuer prevails, the fund will have been exposed to the bonds' price movements over the duration of the trade. The fund might be happy to take on that risk. But exposure to price movements is not fundamental to the strategy. The strategy is about the legal significance of some specific action the issuer has taken, not about the issuer's general economic prospects. So, the fund may wish to buy CDS protection at the same time it establishes its bond position. In the strategy's purest form, the amount of protection perfectly hedges the bonds' exposure.

D. Weighing the Alternatives

Which strategy is Aurelius more likely to have pursued in Windstream? We think the evidence suggests, although it doesn't prove, that Aurelius sought to impose a breach tax. The reason is that the economics would have appeared much better in the summer of 2017. A breach-tax strategy would have offered a solid return at low cost and with almost no downside risk. A sabotage strategy, by contrast, could have been expected to fetch a huge return if successful, but it also would have been easy to thwart and entailed large losses upon failure. We cannot, of course, say definitively what Aurelius did. The consensus interpretation may be correct. But it seems to us that the strength of rumor is the only reason to think so.

1. The futility of sabotage.

How would Aurelius in 2017 have looked at the prospect of sabotage? Let's first consider the costs and benefits to the fund assuming its sabotage were to prove successful.

The best-case scenario Aurelius would have contemplated is highly speculative. No one claims to know just how big a net-short position Aurelius established (if any). Moreover, the return to successful sabotage depends on factors that are hard to predict *ex ante*—including macroeconomic variables such as interest rate changes, as well as target-specific factors such as operational success. It is therefore impossible to say exactly how much Aurelius could have reasonably hoped to make from sabotage. That said, some simple arithmetic can approximate the way this strategy would have paid out in fact.

A general model of the return to successful sabotage has three components: (1) the net amount the saboteur gains from its

CDS, minus the net amount it loses on both (2) its debt instruments and (3) the out-of-pocket and opportunity costs of prosecuting the sabotage. For simplicity, we can set aside item (3). This item is similar to, although systematically larger than, the cost of imposing a breach tax.¹⁵¹ So let's think about items (1) and (2).

Start with the CDS. Because we don't know how much protection Aurelius is supposed to have bought, it will be useful to express returns as a percentage of each dollar invested. At the CDS auction held after Windstream's bankruptcy filing, Windstream's debt obligations settled at a price of \$0.295.¹⁵² Aurelius, like all protection buyers, would therefore have received \$0.705 per notional dollar of protection purchased.¹⁵³ To procure protection, Aurelius would have paid an upfront fee and a quarterly premium of 1.25 percent. The average upfront fee for Windstream CDS between August 21 and September 21, 2017, when Aurelius presumably would have entered its swaps, was \$0.29. The running premiums from summer 2017 until Windstream's bankruptcy would have come to \$0.075.¹⁵⁴ Subtracting the costs of procuring CDS from its ultimate payout in 2019 would leave Aurelius with a net return of approximately \$0.34 per notional dollar of CDS protection bought.

Now consider the loss Aurelius would have taken on its 6 ³/₈ % Notes. As we have said, a sensible estimate puts the Notes' average cost to Aurelius at \$0.75.¹⁵⁵ Assuming the fund unwound its position in the CDS auction, as it would have reason to do if it was net-short,¹⁵⁶ Aurelius realized \$0.295 on their disposition.

¹⁵¹ Sabotage systematically requires more capital because it requires the activist to carry the same amount of debt as a breach tax does plus strictly more CDS protection.

¹⁵² *Windstream Services LLC Auction Results* (cited in note 141).

¹⁵³ *Id.*

¹⁵⁴ The dates of quarterly CDS premium payments have been standardized. Premiums are due on the twentieth of March, June, September, and December. See Jennifer Grady, Jon Kibbe, and Julia Lu, *Understanding the New Standard North American Credit Default Swap: Evolving Documentation and Market Practice* (Richards Kibbe & Orbe LLP, Mar 18, 2009), archived at <https://perma.cc/4BNJ-EJ76>. Depending on when exactly Aurelius is supposed to have entered its swap positions, it would have had to pay five or six quarterly payments. Needless to say, Aurelius could not have known how long litigation would last.

¹⁵⁵ See note 116 and accompanying text.

¹⁵⁶ If Aurelius was net-short, it would have wanted the price of Windstream's debt to settle as low as possible at auction. By selling its Notes in the auction, Aurelius could increase the supply of Windstream debt, which in turn can be expected to drive down its price.

The Notes' coupon over the duration of the trade returned approximately \$0.095.¹⁵⁷ Subtracting the returns from the Notes from the cost of procuring them, we find that Aurelius lost approximately \$0.36 per dollar of Notes it held.

The return to sabotage thus would have depended entirely on the amount of CDS procured. If Aurelius bought exactly as much CDS protection as it held in Notes, then, just as theory would predict, the strategy would have returned approximately zero.¹⁵⁸ We know Aurelius had roughly \$310 million of 6 ³/₈ % Notes,¹⁵⁹ implying a loss on that half of the trade of some \$112 million. If Aurelius bought CDS protection in a notional amount of, say, two or three times the size of its Note position, it would have realized a net gain of approximately \$99 million or \$204 million, respectively.¹⁶⁰

But sabotage threatens the activist with large losses if it is unsuccessful. If no credit event comes to pass or the target's debt appreciates in value, the upfront fee for CDS protection is lost. If Aurelius bought a notional amount of three times the size of its Note position, for example, the upfront fee it would have had to put at risk would have come to some \$270 million.¹⁶¹ This is just a way of saying that a saboteur makes a directional bet on the target's fortunes. Taking a short position is in itself neither unreasonable nor objectionable. But by definition a saboteur's justification for going short is its belief that it can cause the target to decline in value, not simply that the market has overvalued the target's debt. In thinking about Aurelius's position in the summer of 2017, one wants to gauge whether it might have thought its ability to cause Windstream to lose value and default justified putting \$100 million or more at risk.

We think not. Consistent with our discussion in Part II, Windstream had at least three means to block Aurelius and impose a loss. Aurelius would not, presumably, have been able to foresee all of the precise details, but the outlines, because they apply generally, would have been clear enough.

¹⁵⁷ Three coupon payments would have come due: February 1, 2018; August 1, 2018; and February 1, 2019.

¹⁵⁸ More precisely, the strategy is expected to return just about the risk-free interest rate on the notional amount. See, for example, Feldhütter, Hotchkiss, and Karakas, 121 *J Fin Econ* at 4 (cited in note 48).

¹⁵⁹ *Windstream Services*, 2019 WL 948120 at *22.

¹⁶⁰ Two times Note position: (\$620 million)*(0.34) - (\$112 million) = \$99 million. Three times Note position: (\$930 million)*(0.34) - (\$112 million) = \$204 million.

¹⁶¹ (0.29)*(\$930 million) = \$270 million.

First, CDS protection sellers could have funded whatever liquidity Windstream would have needed to pay an adverse judgment. As we have said, the best-case judgment Aurelius could have hoped to win—the judgment it won in fact—amounts to an order allowing the fund to put its below-par-value Notes to Windstream for par. The maximum incremental liquidity Windstream would need to be able to finance such a judgment is thus the difference between the Notes’ par and market values. In the summer of 2017, this difference was, as we have said, approximately \$78 million.¹⁶² So, in expectation, CDS protection sellers would be able to forestall an Aurelius-induced bankruptcy for no more than that amount. This figure is an outside limit, because it assumes that Windstream’s existing investors would contribute nothing to the cause.

How realistic would the prospect of protection-seller financing be? In his declaration supporting Windstream’s Chapter 11 petition, CEO Thomas noted that, after the judgment but before the bankruptcy filing, a consortium of financial institutions proposed a financing package that would have kept Windstream out of bankruptcy.¹⁶³ We don’t know the details. We don’t know how attractive the offer was, nor whether protection sellers were behind it. But the offer’s timing is suggestive. The point is not that a responsive financing deal was inevitable; but that Aurelius had no reason in 2017 to think a consortium couldn’t form to block sabotage.

Second, Windstream could execute a consent solicitation and exchange offer. Windstream tried that and botched the attempt. But Aurelius had no way of knowing it would. Windstream’s debt exchange failed because the company increased its indebtedness by \$40 million and declared in binding interrogatories that the incremental debt did not count as a “reasonably determined premium necessary to accomplish” a refinancing.¹⁶⁴ In retrospect,

¹⁶² \$310 million – \$232 million = \$78 million. See notes 170–71 and accompanying text.

¹⁶³ Thomas Declaration ¶¶ 45–48 at *23–24 (cited in note 7). See also Declaration of Nicholas Leone in Support of Debtors’ Motion for Entry of Interim and Final Orders Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364, 503, and 507 (I) Authorizing the Debtors to Obtain Senior Secured Superpriority Postpetition Financing, (II) Granting Liens and Superpriority Administrative Expense Claims, (III) Authorizing Use of Cash Collateral, (IV) Granting Adequate Protection, (V) Modifying the Automatic Stay; (VI) Scheduling a Final Hearing, and (VII) Granting Related Relief, *In re Windstream Holdings, Inc.*, No 19-22312, ¶¶ 11–12 *6–7 (Bankr SDNY filed Feb 26, 2019) (discussing the offer).

¹⁶⁴ See text accompanying notes 130–31.

that declaration looks not only unwise as a matter of litigation strategy, but also probably incorrect. One feels for the law-firm associate who presumably drafted it. Aurelius could not have known that Windstream and its other creditors would conspire to block a sabotage *but* fail to apprehend the significance of the relevant indenture's restrictions on new indebtedness. Moreover, for all Aurelius could have known, Windstream might have persuaded its creditors to accept a debt exchange *without* paying them a consent fee. In retrospect, because the exchange creditors' claims ultimately dropped by much more than \$40 million,¹⁶⁵ such a deal would have been good for all involved.

Finally, Aurelius could not have known in August 2017 that if it were to win a judgment, Windstream would free fall into bankruptcy. In any event, that's exactly what happened. Windstream filed its Chapter 11 petition without any plan in place for what it would accomplish in bankruptcy or when or how it would emerge. Investors' perception that Windstream had no idea what to do about the judgment against it presumably depressed its debt prices. Ordinarily when a company faces a potential bankruptcy, it tries to line up substantial support from creditors. Whether through informal canvas or with a formal restructuring support agreement, getting creditors to commit to a concept for the reorganization minimizes the duration and uncertainty of bankruptcy.¹⁶⁶ The expectation that a debtor would arrange for the contingency of a bankruptcy ought to be all the greater in the case of a perceived sabotage. The theory of sabotage-induced bankruptcy is that creditors *other than* the saboteur are satisfied, if not pleased, with the target's performance. It should thus be relatively easy in a sabotage case to generate support for a fast proceeding that aims only, or at least primarily, at dealing with the saboteur. Windstream did nothing of the sort. But Aurelius couldn't have predicted that.

A detail that emerged only after the litigation ended seems to buttress the view that Aurelius did not seek sabotage. Shortly after Judge Furman entered judgment, Windstream issued a statement noting the company's disappointment in and surprise at the ruling.¹⁶⁷ Aurelius responded with a press release of its own. The

¹⁶⁵ Source: Bloomberg (data on file with authors).

¹⁶⁶ See Baird, 91 *Am Bankr L J* at 603–04 (cited in note 100) (discussing the rise of restructuring support agreement use).

¹⁶⁷ Windstream Holdings, Inc, Press Release, *Windstream Statement on Court Ruling in Bondholder Dispute* (Intrado, Feb 15, 2019), archived at <https://perma.cc/YUA5-3CCR>.

statement attracted attention for its apparent gloating. But the statement did something more. It suggested that settlement had been a viable option for Windstream. “We take no pleasure in Windstream’s [] financial predicament,” Aurelius began. Then came the interesting bit:

Windstream could easily have averted it—first by not playing fast and loose with its noteholders in 2015, hoping nobody would hold the company to account, and second by settling. Instead, Windstream wasted an exorbitant amount—more than would have been needed to settle with us at the time—on an ineffective exchange offer and then on litigation.¹⁶⁸

But why would Aurelius have offered to settle for an amount less than the cost of Windstream’s exchange offer and litigation tab? If the fund’s goal was to provoke a liquidity crisis to drive down Windstream’s bond prices and force a credit event, then settling would have been counterproductive. If, on the other hand, Aurelius simply sought to tax Windstream’s covenant breach, then settling for an amount greater than the litigation’s expected value to it, but less than the expected cost to Windstream, would have made good sense.

2. The promise of a breach tax.

How would the economics of a breach-tax strategy in Windstream have looked to Aurelius in August 2017? Consider first the anticipated costs of pursuing it. The 6 ³/₈ % Notes were trading, as we have said, in the neighborhood of 75 cents on the dollar.¹⁶⁹ Aurelius acquired roughly \$310 million face value of them.¹⁷⁰ A fair estimate of its total outlay, then, is \$232 million.¹⁷¹ If Aurelius also wanted to hedge its exposure to the Notes’ value, bringing the risk of loss on the trade essentially to zero, the upfront fee for \$310 million of CDS protection would have added \$90 million.¹⁷²

¹⁶⁸ Aurelius Capital Management, LP, Press Release, *Aurelius Responds to Windstream’s Statement Regarding Court Decision* (Cision, Feb 19, 2019), archived at <https://perma.cc/CV43-JQ47>.

¹⁶⁹ See note 116 and accompanying text.

¹⁷⁰ *Windstream Services*, 2019 WL 948120 at *22.

¹⁷¹ $(0.75) \times \$310 \text{ million} = \232.5 million .

¹⁷² This number is the face value of notes Aurelius purchased (\$310 million) multiplied by the average upfront fee for Windstream CDS between August 21 and September 21, 2017 (\$0.29 per notional dollar) (data on file with authors). See notes 152–54 and accompanying text.

These amounts would be tied up for the duration of the trade. In other words, Aurelius would have needed to consider the opportunity cost of investing \$232 million or \$322 million elsewhere for the trade's duration. Aurelius would also have contemplated the out-of-pocket costs of litigation, principally legal fees. We can generously estimate these at \$100,000 per month for the duration of the case.

It is hard to say how long Aurelius should have expected to bear these capital and legal costs. In the event, litigation to a judgment took approximately eighteen months. It could have taken longer, but probably not a lot longer. The issues in the case concerned contract interpretation. They were thus good candidates for swift resolution on a motion to dismiss or for summary judgment and, in any event, did not call for voluminous discovery. Moreover, Aurelius presumably expected to settle the dispute.¹⁷³

What about the expected benefits of a breach-tax strategy? These are harder to assess, because there are more contingencies. But it may be useful, by way of suggestion, to discuss two figures relevant to a settlement value: Aurelius's expected recovery from litigating to judgment, and the amount Windstream seems in fact to have spent trying to end the litigation.

CDS prices are often quoted as a spread. We obtained the spreads in this case from CMAN (ICE Credit Market Analysis). The quoting convention reflects an outdated pricing structure. It used to be that protection buyers' periodic premiums varied with the reference entity's creditworthiness at the time of the swap. The spread was the key salient variable. Now, however, the periodic payment for high-yield CDS has been standardized at 5 percent, so pricing variability is reflected entirely in the size of the upfront fee a protection buyer must pay. To estimate the upfront fee in this case, we used the standard assumptions of Markit's Spread Converter.

¹⁷³ This presumes that Windstream would have been *able* to settle for a reasonable amount. That is, Aurelius could have hoped to extract a settlement only if Windstream had access to sufficient liquidity and freedom within the constraints of its debt contracts. It did. Windstream's credit agreement placed a meaningful limit on the amount of distributions the company could make to debtholders other than the lenders themselves. In particular, the credit agreement capped such a distribution at the amount of "available equity proceeds" and conditioned it on the maintenance of a two-to-one "secured leverage ratio." See Sixth Amended and Restated Credit Agreement, § 6.08(b)(v) *93 (Apr 24, 2015), archived at <https://perma.cc/2PB7-S8UA>. But Windstream had plenty of room. We calculate that in the third quarter of 2017, when Aurelius brought its suit, Windstream's capacity was \$3.33 billion, or two times the last twelve months' operating income before depreciation and amortization ("OIBDA") of \$1.67 billion. Gross first-lien debt at the time totaled \$3.01 billion. Windstream Holdings, Inc, *Form 10-Q* *22 (SEC filed Nov 9, 2017), archived at <https://perma.cc/SJ5H-EQAT>. Thus, Windstream appears to have been able, consistent with its credit agreement, to settle with Aurelius for up to approximately \$320 million [$\$3.33 \text{ billion} - \$3.01 \text{ billion} = \320 million].

The best-case scenario for Aurelius, if it litigated to a judgment, would be to receive the par value of its Notes—that is, approximately \$310 million.¹⁷⁴ The net value of a total win would be that figure minus the strategy's costs: \$232 million needed to acquire the Notes; legal fees of, say, \$2 million; and the opportunity cost of Aurelius's capital investment. Call it, then, \$76 million minus capital costs. But the merits were uncertain. There was a significant risk, if the parties litigated to judgment, that Windstream would win and leave Aurelius a recovery of zero. Estimates of the merits are subjective. But suppose Aurelius thought it had a one-third chance of prevailing. That would peg a floor, for negotiation purposes, at, say, \$25 million minus capital costs. That is, Aurelius might expect to settle for something between that figure and the cost to Windstream of an acceleration event.

How much might Windstream have been willing to pay as a breach tax? One proxy is the amount the company paid in fact to try to moot the litigation. The consent solicitation and exchange offer described above was an effort to do just that. So how much did Windstream pay? The debt exchanges increased Windstream's indebtedness by some \$40 million.¹⁷⁵ The raw change in the company's principal obligations is not the whole story, however. The offer was to exchange existing notes for new 6 ³/₈ % Notes.¹⁷⁶ The existing notes paid higher coupons—some paid 7.75 percent; others, 7.5 percent—meaning that by swapping into the 6 ³/₈ % Notes the exchanging noteholders were surrendering expected future interest. To capture the value paid by Windstream to achieve the exchange, one therefore has to net Windstream's projected interest savings against its increased indebtedness. We calculate the net amount paid by Windstream to be \$37.5 million.¹⁷⁷

Windstream presumably believed (incorrectly) that the exchange offer would moot litigation. For that reason, \$37.5 million

¹⁷⁴ See *Windstream Services*, 2019 WL 948120 at *22.

¹⁷⁵ *Id.* at *9.

¹⁷⁶ Press Release, *Windstream Announces Results of Consent Solicitations and Exchange Offers* (Markets Insider, Nov 1, 2017), archived at <https://perma.cc/9ZEK-GYDX>. See also *Windstream Exchange Offers Face Aurelius Criticism* (cited in note 122).

¹⁷⁷ We compared, on the date of the exchange, the net present value of holding the relevant amount of 6 ³/₈ % Notes against the net present value of holding the relevant amount of old notes, using yield-to-maturity. Source: TRACE.

signifies both a floor and ceiling: a floor on the damage Windstream believed Aurelius's claim could do to it, and a ceiling on the amount for which it would be willing to settle.

It would be vain to declare what value Aurelius would have placed on a breach-tax strategy in the summer of 2017, much less to describe the entire probability distribution it would have contemplated. We have too little information. But our aim is not to exhaust all factors relevant to the likelihood and size of a settlement. Our aim is more modestly to show that the economics of a breach-tax strategy look pretty good. A settlement in the neighborhood of \$30 million must have seemed reasonable. The strategy's cost would have been comparatively small, especially if, as was true of most leveraged credit-oriented funds during the relevant timeframe, Aurelius's alternative uses of capital were unattractive.¹⁷⁸ And with CDS protection, downside risk would have been close to zero. If, that is, Windstream wouldn't settle and the judge were to hold that the Uniti spin-off was not a sale-lease-back, Aurelius could simply unwind its positions and be down only legal fees.

* * *

We don't know which bets Aurelius took relative to Windstream. But neither does anyone else who has opined on the topic. The public facts are really very scant: Aurelius bought a large amount of 6 ³/₈ % Notes at a discount to par and then sued Windstream for repayment of their full principal. The facts are consistent with a well-known and (as we see it) risk- and cost-justified strategy. But public discourse has ignored the breach-tax strategy altogether. Instead, market participants and observers say it was sabotage, but in 2017 sabotage would have looked a very unlikely way to make money. If Windstream is the leading real-world illustration of creditor sabotage, then the sabotage story's plausibility is doubtful.

¹⁷⁸ See, for example, Allison McNeely and Katherine Doherty, *Distressed Debt Traders Have Tons of Cash and Nothing to Buy* (Bloomberg, July 19, 2019), online at <https://www.bloomberg.com/news/articles/2019-07-19/distressed-debt-traders-have-tons-of-cash-and-nothing-to-buy> (visited at July 18, 2020) (Perma archive unavailable).

IV. IMPLICATIONS

A. For Policy

The principal policy implication of our analysis is negative. We conclude that net-short creditor sabotage poses no appreciable threat to operating companies. Either sabotage is so manifestly unprofitable in expectation that no one tries it, or else, more modestly, it is a self-correcting problem because those who do try are systematically punished for doing so. If this is right, then it is unwise to change law to head off sabotage at the expense of other values.

Proposals for legal reforms that curb creditor sabotage take two basic forms. One type would simply mandate greater disclosure obligations for investors with cross-cutting economic interests.¹⁷⁹ Under current law, hedge funds needn't say much about their investments. Outside bankruptcy, they have no obligation to disclose debt ownership or positions in credit derivatives at all. Even in bankruptcy, disclosure requirements are minimal. Creditors must file a proof of claim for all debts on which they hope to recover, but they needn't disclose cross-cutting derivatives positions as a general matter.¹⁸⁰ The idea of enhanced-disclosure proposals is just to force net-short creditors to reveal themselves earlier than they otherwise might, so that companies and their net-long creditor allies can prepare for what they might later regard as antisocial enforcement.

The other type of proposal goes a step further. More muscular proposals typically entail enhanced disclosure but also would curtail the governance rights of hedged and net-short creditors. Net-short creditors' standard nonbankruptcy governance rights could be cabined with more aggressive credit documents. For example, a recently negotiated credit agreement involving Sirius Computer Solutions prohibits net-short syndicate lenders from voting on

¹⁷⁹ See, for example, Bolton and Oehmke, 24 *Rev Fin Stud* at 2622–23 (cited in note 53); Kevin J. Coco, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 *Colum Bus L Rev* 610, 637–38; Hu and Black, 156 *U Pa L Rev* at 734–35 (cited in note 3).

¹⁸⁰ An investor who wishes to serve on a committee or participate in the bankruptcy as part of a group must disclose much more. See FRBP 2019. Additionally, the bankruptcy court can order discovery relevant to arguments for vote designation, equitable subordination, or equitable disallowance.

proposed amendments and waivers.¹⁸¹ The intended effect of such a provision is clear, even if important details remain to be worked out and may ultimately prove fatal.¹⁸² Changes to governance rights could also take place in bankruptcy. Professors Edward Janger and Adam Levitin, for example, have proposed what they call a “mark-to-interest” rule that would nullify net-short creditors’ influence in Chapter 11.¹⁸³

Reform proposals have costs.¹⁸⁴ Enhancing required disclosures, in particular, would entail significant dislocations. (And disclosure of one kind or another is implied in proposals to alter governance rights.) Hedge funds make money by keeping their trading and investment decisions secret. Requiring them to share their positions would, if nothing else, change the terms on which they deploy capital.

This is not to say that any particular intervention is a bad idea all told. Proposals for change might have substantial advantages well apart from their supposed impact on net-short sabotage. The idea of Professors Janger and Levitin to graduate voting power in Chapter 11 would substantially reduce rent-seeking by creditors holding multiple classes of claim, for example—assuming their system could be administered cheaply.¹⁸⁵ We won’t try to give a full accounting here. The implication of our analysis is only that stamping out sabotage is not a reason to alter creditors’ rights.

¹⁸¹ See Kristen Haunss, *Sirius Computer Moves to Block Derivatives Holders from Speculation* (Reuters, May 22, 2019), archived at <https://perma.cc/9V4L-JCMY>. See also Levine, *Maybe Companies Will Get Rid of CDS* (cited in note 8) (discussing the provision).

¹⁸² See Williams, et al, *Net Short Lender Disenfranchisement* at *2–4 (cited in note 10) (describing practical difficulties with the Sirius net short provision).

¹⁸³ Janger and Levitin, 104 Iowa L Rev at 1906–16 (cited in note 13). See also *CDSs and Bankruptcy* (cited in note 63) (“Longer-term solutions rest on an overhaul of the bankruptcy code and debt agreements to award votes and control based on net economic exposure, rather than the nominal amount of debt owned.”); Hu and Black, 156 U Pa L Rev at 735 (cited in note 3) (“[V]oting rights in bankruptcy may need to be based on net economic ownership instead of gross ownership of debt.”).

¹⁸⁴ We should note that there are also calls to change how CDS function. ISDA, for example, is considering one set of amendments already. But proposals to change CDS—at least those we are aware of—do not seem to be about creditor sabotage. Instead, they seem to be designed either to alter the incentives of hedged (but not net-short) creditors to seek a bankruptcy filing, see, for example, Hemel, Comment, 27 Yale J Reg at 167–69 (cited in note 43), or to undermine “manufactured” default tactics, see, for example, International Swaps and Derivatives Association, *Proposed Amendments to the 2014 ISDA Credit Derivatives Definitions Relating to Narrowly Tailored Credit Events* *3–4 (Mar 6, 2019), archived at <https://perma.cc/62MW-7ZBG>.

¹⁸⁵ See Janger and Levitin, 104 Iowa L Rev at 1901–03 (cited in note 13).

B. For Theory

One of the live questions in reorganization and bankruptcy theory today concerns the significance for law of longstanding trends in capital markets and financial contracting. These trends are toward increasing liquidity, sophistication, and complexity. Distressed-debt markets are becoming more liquid; distressed-debt investors are becoming more sophisticated; and the capital structures of distressed companies are becoming more complex. No one doubts the facts. But scholars disagree, sometimes explicitly but more often implicitly, about what the trends mean for optimal bankruptcy policy—in particular, what they mean for the relative status of contractual flexibility as against mandatory rules.

Most theorists writing today think bankruptcy law should be concerned at least primarily with allocating assets to their highest-value use.¹⁸⁶ The open question is whether, given that aim, changes in corporate finance call for more or less judicial deference to observed patterns of organization and contract. One cannot say a priori, even if one aims solely for efficient capital allocation, whether the law should police or otherwise limit the effect of innovations

¹⁸⁶ In this sense, the character of the debate is different from that of the private-ordering debate of the 1990s and 2000s. At issue then were the normative foundations of reorganization and especially bankruptcy law—whether it was a mere branch of contract interpretation or, alternatively, served other political functions. The practical question was the extent to which investors should be able to decide in good times how financial distress would be resolved in bad. But skepticism about contract was not so much about its capacity to deal with distressed companies efficiently. Rather, contract skeptics saw in bankruptcy a stabilizing economic institution and posited stability, or status-quo bias, as a positive good in competition with allocative efficiency. See Vincent S.J. Buccola, *The Janus Faces of Reorganization Law*, 44 J Corp L 1, 5–9 (2018) (describing this conflict).

such as intercreditor agreements,¹⁸⁷ restructuring support agreements,¹⁸⁸ claim trading in bankruptcy,¹⁸⁹ and claim aggregation before bankruptcy.¹⁹⁰

Each innovation ought to be separately analyzed. The costs and benefits of every development are distinctive. At the same time, it is inevitable that—as in a pointillist painting—intuitions on discrete matters together will form a gestalt, and that one’s gestalt in turn informs intuitions on discrete matters.

Taken at face value, the net-short creditor sabotage story is evidence of the capacity of financial engineering to yield predictably pathological governance. It is also, for that reason, evidence for the view that optimal law may need increasingly to intervene to set aside the output of private ordering as markets develop.¹⁹¹ Our analysis says this is wrong. Indeed, one draws exactly the opposite inference after examining the predicament of net-short creditors carefully. It is true that CDS considered in isolation can produce antisocial incentives. But along with those incentives come powerful disincentives, because investors are embedded in

¹⁸⁷ See David A. Skeel Jr and George Triantis, *Bankruptcy’s Uneasy Shift to a Contract Paradigm*, 166 U Pa L Rev 1777, 1806–07 (2018); Kenneth Ayotte, Anthony J. Casey, and David A. Skeel Jr, *Bankruptcy on the Side*, 112 Nw U L Rev 255, 264–72 (2017); Edward R. Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015 U Ill L Rev 721, 723.

¹⁸⁸ See generally Baird, 91 Am Bankr L J 593 (cited in note 100). See also Edward J. Janger and Adam J. Levitin, *Badges of Opportunism: Principles for Policing Restructuring Support Agreements*, 13 Brooklyn J Corp Fin & Comm L 169, 176–82 (2018).

¹⁸⁹ See Jared A. Ellias, *Bankruptcy Claims Trading*, 15 J Empirical Legal Stud 772, 773 (2018):

One group of scholars and lawyers . . . worry that claims trading destabilizes the bankruptcy negotiating process. . . . On the other hand, proponents of claims trading argue that claims trading makes bargaining more efficient by consolidating smaller claims into the hands of larger holders and permitting activist investors to enter the firm’s capital structure.

See also Victoria Ivashina, Benjamin Iverson, and David C. Smith, *The Ownership and Trading of Debt Claims in Chapter 11 Restructurings*, 119 J Fin Econ 316, 318 (2016); Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 Brooklyn J Corp Fin & Comm L 64, 68–77 (2010); Edward J. Janger, *The Costs of Liquidity Enhancement: Transparency Cost, Risk Alteration, and Coordination Problems*, 4 Brooklyn J Corp Fin & Comm L 39, 44–45 (2009); Baird and Rasmussen, 119 Yale L J at 651 (cited in note 4); Frederick Tung, *Confirmation and Claims Trading*, 90 Nw U L Rev 1684, 1699–1705 (1996).

¹⁹⁰ See Jared A. Ellias, *Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?: Evidence from Junior Activist Investing*, 8 J Legal Analysis 493, 493–94, 500 (2016).

¹⁹¹ See Casey, Colum L Rev at *1–4 (cited in note 28); Rasmussen and Simkovic, 10 Harv Bus L Rev at 148–151 (cited in note 28); Ellias and Stark, 108 Cal L Rev at 784–86 (cited in note 28); Ayotte, *Disagreement* at *2–6 (cited in note 28).

responsive markets. The liquidity of modern distressed-debt markets, considered dynamically, doesn't exacerbate but instead ameliorates incentives to try sabotage.¹⁹²

C. For Rhetoric

It's worth asking why the creditor sabotage story is so popular, so readily digested, if its predicates are implausible and unobserved. A partial explanation may lie in the superficial similarity, noted above, between sabotage and other activist tactics that aim to affect credit-derivative payoffs.¹⁹³ But a deeper answer, we think, lies in the story's rhetorical uses. Myths persist on account of the social and psychological functions they play, irrespective of literal truth.¹⁹⁴

We see three overlapping functions. Most obviously, the story is attractive to corporate managers. Sabotage is, after all, an alternative to executive failure.¹⁹⁵ It presupposes that another's criminality, or at least bad faith, is to blame for whatever problems are manifest—not the executive's own mismanagement. Sabotage thus at once supplies a reason for investors to give more leash than they otherwise might be inclined to do—after all, it's irrational to blame management for unforeseeable shocks—and offers psychological comfort to the executive himself. So it is no accident that Windstream's CEO, Tony Thomas, has been among the most aggressive proponents of the view that Aurelius engaged in “predatory market manipulation” to undermine the company.¹⁹⁶ In this sense, cries of sabotage work in the *creditor* context in much the same way as allegations of “short-termism” work relative to activist *equity* investors—as rhetorical sword and psychological shield.¹⁹⁷

¹⁹² See Buccola, 167 U Pa L Rev Online at 5–8 (cited in note 27); Adler, 166 U Pa L Rev at 1856–59 (cited in note 27); Schwartz, *Bankruptcy Related Contracting* at *1–2 (cited in note 27).

¹⁹³ See note 76.

¹⁹⁴ For an introduction and connection to corporate law, see generally Macey, *Corporate Law Myths* (cited in note 17).

¹⁹⁵ See, for example, Marina Koren, *Elon Musk's Long Obsession with Sabotage* (The Atlantic, June 19, 2018), archived at <https://perma.cc/ETM8-YWA7>.

¹⁹⁶ Press Release, *Windstream Holdings, Inc. Files for Voluntary Reorganization Under Chapter 11 of the U.S. Bankruptcy Code Following Judge Furman's Decision* (Feb 25, 2019), archived at <https://perma.cc/YL8W-VG6U>.

¹⁹⁷ See Roe and Shapira, *The Power of the Corporate Short-Termism Narrative* at *4 (cited in note 17). See also Mark J. Roe, *Stock Market Short-Termism's Impact*, 167 U Pa L Rev 71, 77–86, 104–05 (2018); J.B. Heaton, *The “Long Term” in Corporate Law*, 72 Bus Law 353, 355 (2017) (“[T]here is virtually no evidence that shareholders ever prefer short-term

Second, the story is attractive to distressed-debt investors. This is true not so much because the story's telling yields practical benefits for them—the opposite is likelier—as because it confirms a certain self-conception. It hardly overstates things to say that distress investors revel in a Machiavellian ethos. As a rule, they prize intelligence and cunning over the principle of equal treatment, and they want to inhabit a professional world in which the values they hold dear are rewarded and their opposites punished. In this sense, the net-short saboteur, with its superior skill and essential disregard for others, acts almost as a totem of the industry, at once an ideal to strive toward and a warning of the fate that awaits insufficiently attentive investors.

Finally, and perhaps most importantly, the story encapsulates and expresses a more general anxiety about financialization. Taken at a certain level of abstraction, net-short creditor sabotage is but one of many stories in circulation featuring wealthy and—okay—clever Wall Street figures willing to destroy Main Street business for a few dollars more. The complexity of the tactics, the esoteric instruments used, the element of surprise are reminiscent of a “heist” film inverted so that the villains make off with the loot. Each time the story is told, it confirms the truth of a more general, cynical perspective on what modern financial markets deliver. Maybe that fear is well justified, and maybe not.

Viewed as myth, the net-short creditor sabotage story takes on new meaning. It becomes, in one sense, trivial to advocate that people stop telling the story. We think sabotage doesn't exist as an empirical phenomenon, but that may hardly be the point.

CONCLUSION

In this Article, we have sought to show that the net-short creditor saboteur is an urban legend—a cautionary story widely circulated but lacking a substantial basis in fact. The problem with the story is not that it misapprehends the incentives of creditors who buy large amounts of CDS protection, but rather that it ignores everyone else. Other actors with countervailing incentives have, we have argued, the means as well as the reasons to thwart attempted sabotage. And because this state of affairs is common knowledge, sophisticated investors would be rash to try it. Indeed,

gains that are smaller than larger (discounted) long-term gains.”) (citation omitted); Robert Anderson IV, *The Long and Short of Corporate Governance*, 23 *Geo Mason L Rev* 19, 22–23 (2015).

the episode in which market watchers most confidently spot net-short sabotage—Aurelius against Windstream—appears on closer examination to involve nothing of the sort. What in the end is most interesting about net-short creditor sabotage is not, therefore, the threat it poses to viable businesses but, like all folklore, the fact that the story continues to be told despite its implausibility.