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Stop Looting the Bankruptcy Code: Stop Wall Street Looting Act Proposes Substantial Changes to the Bankruptcy Code and Key Principles of Corporate Law

Attorneys
Gregg M. Galardi
Ryan Preston Dahl
Mark Maciuch

On October 20, 2021, Democratic senators Elizabeth Warren (D-Mass.), Tammy Baldwin (D-Wisc.), Sherrod Brown (D-Ohio), and Jeff Merkley (D-Oregon), and Independent senator Bernard Sanders (I-Vermont), introduced to the United States Senate proposed legislation S. 3022, the **Stop Wall Street Looting Act of 2021** (the "SWSLA"),[1] as a reworked version of legislation previously proposed in 2019.

In what appears to be an attempt at wholesale reform of the private equity industry and bankruptcy practice, the SWSLA proposes to:

- require "controlling private funds" and certain other insiders to be "jointly and severally liable for all liabilities of each target firm [and its affiliates]," including any debt, legal judgments, WARN act violations, and pension-related obligations;

- carve out transfers made in connection with "change in control transactions"[2] from the safe harbor protections of Section 546(e) of the Bankruptcy Code, and impose a statutory presumption that both a constructive and actual fraudulent transfer under Section 548 of the Bankruptcy Code has occurred with respect to various "change in control transactions" undertaken in the eight years prior to a bankruptcy filing;

- address so-called "sham" independent directors by vesting an unsecured creditors committee, as opposed to a debtor in possession, with certain chapter 5 causes of action and claims against company insiders; and

- increase protections for employees in bankruptcy cases by increasing wage claim amounts and priority status, limiting payments to executives, and directing bankruptcy courts to favor employee-friendly bids for a debtor's assets.[3]

The notion that core legal concepts of corporate separation and limited liability are considered "looting" suggests that clinical analysis may not be the order of the day—with at least a few unintentional echoes of Atlas Shrugged. And, despite its breadth, the SWSLA seems almost singularly focused on the interests of very specific creditor constituencies, as opposed to representing a measured approach to legislative reform. In many respects, the SWSLA seems almost to have been drafted as a "wish list" from a highly litigious plaintiff rather than reflecting a holistic analysis of key bankruptcy principles. Regardless, the SWSLA presents perhaps the most substantial proposed re-write of core bankruptcy concepts since the Bankruptcy Code's enactment. And, viewed together with the Nondebtor Release

[1] The full text of the SWSLA, as introduced, can be found here. A sister version of the SWSLA, H.R.5648, was also introduced in the United States House of Representatives by Democratic representatives Mark Pocan (D-Wisc.), Pramila Jayapal (D-Wash.), Eleanor Norton (D-D.C.), and Jesús García (D-Ill.).
[2] Generally, the SWSLA defines a "change in control transaction" as a change of economic interest with respect to "the power to vote more than 50 per centum of any class of voting securities of a corporation that engages in interstate commerce" or any lesser percentage that gives the acquirer the "the ability to direct the actions of that corporation."
[3] The SWSLA also proposes to implement substantial changes to the Internal Revenue Code with respect to the tax treatment of private equity investments, particularly regarding carried interest. The SWSLA's tax implications are beyond the scope of this alert. We encourage you to contact your Ropes & Gray team to discuss these provisions more fully.

Prohibition Act of 2021,[4] practitioners should be mindful of the extent to which 'bankruptcy reform' may become the latest soundbite in legislative discourse.

SWSLA Title I

The twin concepts of corporate separateness and limited liability are cornerstones of American corporate law. SWSLA Title I proposes a significant departure from these core principles by (i) requiring "controlling private funds" to be jointly and severally liable for all liabilities of the private fund's portfolio companies, including their debt, employee, and pension obligations, and (ii) voiding any obligation of a portfolio company to indemnify a "controlling private fund" or certain related parties as against public policy. Broadly speaking, the SWSLA defines a "controlling private fund" to be any private fund that becomes a "control person" through a "change in control transaction" in that it (i) owns, controls, or holds with power to vote, 20% or more of the outstanding voting interests of a portfolio company, (ii) operates the portfolio company or substantially all of the property of a portfolio company under a lease or an operating or management agreement, or (iii) otherwise has the ability to direct the actions of a portfolio company.

The legal and economic rationales for demanding that equityholders guaranty substantially all the debts of a wholly separate corporate entity are, at best, unclear. As noted above, limited liability and corporate separation are core principles of American corporate law and capital markets generally. Put another way, causing equityholders to become de facto (and de jure) guarantors for substantially all corporate debts is difficult to square with a capital market and legal system predicated on concepts of limited liability. In any event, if passed in its present form, the SWSLA would require any "controlling private fund" to literally guaranty substantially all liabilities of its respective portfolio companies.

SWSLA Title II

SWSLA Title II proposes, among other things, to carve out "change in control transactions" from the safe harbor protections of Section 546(e) of the Bankruptcy Code,[5] and create the presumption that (i) any "change in control transaction" occurring in the eight years prior to the bankruptcy filing, or (ii) any transfer made or obligation incurred by the debtor to or from a "control person," affiliate, or insider during a "protected period"[6] are both constructively and actually fraudulent transfers under Section 548(a)(1) of the Bankruptcy Code. Again, it is unclear how a statutory presumption of fraudulent conduct, let alone such a presumption with an eight-year lookback, could be squared with traditional legal concepts regarding what is (or is not) "fraud."[7] It is also unclear how the SWSLA's authors believe that providers of capital will react when required to fund transactions that are quite literally presumed to be frauds.

In addition, SWSLA Title II attempts to address the issue of so-called "sham" independent directors by giving an unsecured creditors' committee the exclusive right to bring an action (i) to avoid transfers in connection with "change of control transactions," or (ii) against insiders of the debtor. SWSLA Title II, in particular, seems to underscore the extent

[4] *See* Gregg M. Galardi, Ryan Preston Dahl & Mark Maciuch, *The Way Is Shut: Nondebtor Release Legislation Proposes Mandatory Dismissal on Account of Pre-Bankruptcy Liability Management Transactions*, Ropes & Gray LLP, https://www.ropesgray.com/en/newsroom/alerts/2021/October/The-Way-Is-Shut-Nondebtor-Release-Legislation-Proposes-Mandatory-Dismissal-On-Account.

[5] Section 546(e) of the Bankruptcy Code provides that a trustee may not avoid certain payments made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or a transfer made by or to (or for the benefit of) such entities in connection with a securities contract, commodity contract, or forward contract as such terms are defined in the Bankruptcy Code. *See* 11 U.S.C. § 546(e); 5 Collier on Bankruptcy ⁋ 546.06 (16th 2021).

[6] The SWSLA defines the "protected period" to be "(i) the eight-year period beginning on the date on which a change in control transaction closed; or (ii) the period beginning on the date on which a change in control transaction closed and ending on the earliest subsequent date on which a public offering of a controlling share of the common equity securities of the target firm occurs."

[7] *See, e.g.*, Fed. R. Civ. P. 9(b).

to which the SWSLA appears to serve as an advocacy piece for a particular creditor class in a manner that is fundamentally at odds with core principles of the Bankruptcy Code.

SWSLA Title II presents a particularly unique departure in this regard. It is a baseline proposition of American bankruptcy law that the debtor in possession stands as a fiduciary for all stakeholders in bankruptcy. This reality reflects the fact that the bankruptcy process involves the balancing of a number of competing stakeholder interests: administrative creditors, priority creditors, secured creditors of different priority and with different collateral rights, unsecured creditors, and others. To this end, the prosecution of estate causes of action is not typically viewed through the narrow lens of how such prosecution benefits any one stakeholder constituency.[8]

The SWSLA proposes to turn this proposition on its head. The SWSLA would entrust a particular asset class (i.e., estate causes of action) to a single stakeholder constituency—an official committee of unsecured creditors (a "UCC"). In this regard, it is difficult to read Title II as something other than an attempt to create a favored creditor class at the expense of all stakeholders. Nowhere else does the Bankruptcy Code vest a particular stakeholder class with control over any particular estate asset in this fashion, and a UCC is particularly ill-suited to the task as the SWSLA proposes. At the risk of stating the obvious, a UCC is not a fiduciary for all stakeholders; a UCC serves as a fiduciary for unsecured creditors alone. A UCC has no fiduciary obligation to maximize value for administrative creditors, priority creditors, secured creditors, or equityholders—indeed, a UCC can be (and often is) directly adverse to some or all of those stakeholders, and a UCC can be incentivized to use litigation, or the threat of litigation, as a means to an end where unsecured creditor recoveries may otherwise be de minimis when viewed in terms of unencumbered value.

Yet unsecured creditors stand junior in priority to administrative and priority creditors (with respect to unencumbered assets) and also to secured creditors (with respect to encumbered assets). But the SWSLA disregards this baseline priority system by, in effect, handing the disposition of a particular class of estate assets to a stakeholder that may have no economic interest in the asset at issue and that has no duty, fiduciary or otherwise, to consider the interests of any other stakeholder in that analysis. Such an approach makes little sense under the Bankruptcy Code, although it would perhaps serve the interests of a narrow set of favored constituents.

SWSLA Title III

SWSLA Title III seeks to, among other things, (i) increase priority claim amounts for unpaid wages, severance, and employee benefit plan contributions from $10,000 to $20,000 and eliminate the 180-day prepetition cut off date, (ii) elevate the priority status of claims relating to unpaid wages, severance, employee benefit plan contributions, and damages arising from WARN Act violations to administrative expense status, (iii) condition or limit payments to executives, and (iv) direct bankruptcy courts to favor employee-friendly asset sales under Section 363 of the Bankruptcy Code.

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At the risk of understatement, the SWSLA, in its present form, proposes a fundamental re-write of core principles. It remains to be seen how, if at all, this legislation will progress. We encourage you to contact your Ropes & Gray team to discuss this matter more fully.

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[8] *See In re STN Enterprises*, 779 F.2d 901, 905 (2d Cir. 2000) ("In order to decide whether the debtor unjustifiably failed to bring suit so as to give the creditors' committee standing to bring an action, the court must also examine . . . whether an action asserting such claim(s) is likely to benefit the reorganization estate.") (citation omitted); *In re Sabine Oil & Gas Corp.*, 547 B.R. 503, 568 (Bankr. S.D.N.Y. 2016) ("The Court must determine whether the Debtors' refusal to bring [fraudulent transfer] claims is in the best interests of the estates, *i.e.,* whether, when considering the effect of the litigation on the estates and conducting a cost-benefit analysis, the potential benefits of the litigation outweigh the costs, monetary and otherwise, to the Debtors' reorganization.").