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THE SHADOWY CONTOURS OF BANKRUPTCY RESISTANT INVESTMENTS

*Jared A. Ellias**

Response to: Douglas G. Baird & Anthony J. Casey, No Exit? Withdrawal Rights and the Law of Corporate Reorganizations, 113 Colum. L. Rev. 1 (2013).

Baird and Casey recently argued in favor of contractual innovations that allow lenders to contract around bankruptcy law. These innovations, which they call withdrawal rights, are said to increase the efficiency of financing in many cases, and Baird and Casey urge judges to enforce them. This brief Essay uses a case study of a Chapter 11 bankruptcy where withdrawal rights were enforced by operation of foreign law to challenge Baird and Casey's assumptions. The case study suggests that managers may lack a full understanding of how their actions ex ante affect bankruptcy outcomes. Substantial changes for managerial behavior and corporate regulation may be needed to allow managers and investors to utilize withdrawal rights when doing so would enhance the efficiency of financing.

INTRODUCTION

In their recent *Columbia Law Review* article, Douglas G. Baird and Anthony J. Casey bring much-needed scholarly attention to "bankruptcy resistant" loans that provide "withdrawal rights" to the lender.[1] Withdrawal rights "resist bankruptcy law" by changing the treatment of secured debt. Normally, bankruptcy law limits the rights of secured creditors by blocking them from foreclosing and providing them with priority over unsecured creditors only to the extent of the market value of their collateral.[2] If the secured creditor is owed more than her collateral is

* Associate Professor of Law, University of California, Hastings College of the Law. Thanks to Kenneth Ayotte, Douglas Baird, Anthony Casey, John Crawford, and Elizabeth Pollman for helpful comments.

1. Douglas G. Baird & Anthony J. Casey, No Exit? Withdrawal Rights and the Law of Corporate Reorganizations, 113 Colum. L. Rev. 1 (2013).

2. Of course, the bankruptcy judge can issue an order allowing foreclosure to go forward when it is warranted. See 11 U.S.C. § 362(d)(1) (2012) (stating relief from automatic stay shall be granted "for cause").

worth, the amount of the deficiency will be demoted to the same priority level as unsecured creditors.[3] Withdrawal rights protect secured creditors from this demotion—referred to as "cramdown"—by using contractual structures to keep the collateral outside of the jurisdiction of a bankruptcy court.[4] Unconstrained by bankruptcy law, the secured creditors can credibly threaten to foreclose on the collateral and destroy the firm's going-concern value.[5] The secured creditor's improved bargaining position might allow her to extract a higher recovery than the market value of the collateral implies.[6] Baird and Casey argue persuasively that withdrawal rights can be a useful financial tool that allows some investors to finance projects more efficiently.[7] Accordingly, they urge bankruptcy judges to respect the limits of their jurisdiction by enforcing withdrawal rights that place collateral beyond their reach.[8]

The trouble is, as Baird and Casey acknowledge, withdrawal rights generate costs that might offset any associated benefits.[9] Consider a firm that owes some money to secured lenders and wants to obtain additional financing on an unsecured basis. An investor who is considering extending an unsecured loan to the firm will project its likely recovery in bankruptcy to determine the price of the loan.[10] In a world without withdrawal rights, the new investor would estimate the projected going-concern value of the firm in bad states of the world and subtract the projected market value of the collateral to understand how much value might remain for unsecured creditors.[11] If the secured lender has a withdrawal right, however, the ultimate recovery will instead be a function of the lender's bargaining power, defined by how the collateral fits into the

3. See id. § 506(a)(1) (defining secured and unsecured limits of secured creditor's claims).

4. See Baird & Casey, supra note 1, at 8–13 (examining costs and benefits of withdrawal rights).

5. See id. at 10 (noting withdrawal threat "allows the investor to capture a share of the firm's value as a going concern" through negotiation).

6. See id. at 16 (finding creditor captures some of firm's value above value of collateral). The secured lender may also achieve more than full recovery and extract value from other creditors based on the value of the collateral relative to the enterprise value as a whole. See id. at 19–20 & n.69 (providing as example firm "not limited [in negotiations] by the amount it was owed" by debtor).

7. See id. at 8–11 (arguing increase in business's value offsets "costs from the risk of bargaining failure").

8. See id. at 24 (claiming bankruptcy judges tend to treat firms formally divided in separate corporations as "single corporate entity" resulting in "[i]nvestors in each entity [being] treated as investors in the whole" and concluding arrangement is "worst of both worlds").

9. See id. at 13 (discussing costs withdrawal rights impose on other lenders).

10. Cf. id. (noting lenders "must understand . . . what priority and withdrawal rights other[] [lenders] might have").

11. See id. at 8 (discussing withdrawal rights risks and benefits).

business as a whole.[12] Instead of simply estimating the market value of the collateral, the investor will need to expend time and money to understand how that collateral fits into the overall business—a substantially more difficult and expensive inquiry.[13]

Baird and Casey acknowledge this problem and argue that the increase in information-search costs can be minimized when the withdrawal right is created by "entity partitioning."[14] By entity partitioning, Baird and Casey mean the decision of a manager to transfer some of the firm's assets to a new subsidiary instead of leaving them in the asset pool owned by one of the firm's existing corporate entities.[15] A manager can create a withdrawal right for a secured lender by providing the lender with a lien on the new subsidiary—as opposed to the assets themselves—if the manager also takes steps to make it impossible for him and his successors to force the new subsidiary into bankruptcy.[16] When a firm creates a new subsidiary, it must take overt acts such as making a public filing.[17] Investors already examine public filings in the course of their normal due diligence, limiting the incremental increase in due-diligence costs.[18] Thus, by relying on legal entities as building blocks, investors can increase the efficiency of some secured financings by acquiring withdrawal rights.[19]

Baird and Casey contrast the observable nature of entity partitioning with the hidden efforts of other creditors to enhance their own bankruptcy priority.[20] For example, consider the bargaining power of a franchisor that is owed a large amount of money by a franchisee pursuant to a franchise agreement.[21] The franchisee's going-concern value may very well depend on continuing to affiliate with the franchisor after the reorganization. The Bankruptcy Code provides a debtor with the ability to "assume" a contract by curing past defaults and agreeing to abide by the

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12. See id. at 10 n.34 (claiming "loss of value" created by withdrawal of collateral "drives the bargaining").

13. See id. at 13 (noting typical bankruptcy requires "deeper investigations" of asset structures).

14. See id. at 6 (stating "use of legal entities as building blocks" in tailored bankruptcy reduces information costs).

15. See id. at 8 (discussing how "ability to place assets in discrete legal entities" captures certain benefits).

16. There would typically be some sort of intracompany contract that creates a repayment obligation, such as the lease agreement in the Los Angeles Dodgers example. See id. at 14 (explaining lease-payment obligations in simplified Dodgers example).

17. Id. at 13.

18. See id. ("[V]erification of ownership is a common and necessary practice under any bankruptcy regime.").

19. See id. at 12 (identifying avoided collective-action problems and "hidden costs").

20. See id. at 45–48 (arguing withdrawal rights absent entity partitioning "exist, but . . . existing law does too little to make them discrete and readily visible").

21. This is a simplified version of the sports-league example of Baird and Casey. Id. at 14.

terms in the contract.[22] Thus, if the agreement is assumable, the franchisor will be entitled to receive the payment agreed to in the contract.[23] However, if the franchise agreement is nonassumable, the franchisor may have a valuable withdrawal right that can be used to extract a higher payout than provided for by the contract.[24] The assumability of a contract is a technical determination based on the specific language of the contract.[25] Investors may be unaware that this hidden withdrawal right lurks in the background. Even if they do know, they may not be able to analyze the likelihood that the withdrawal right will exist because the contract may not be publicly disclosed.[26] In these cases, investors have "no easy way to learn [the withdrawal right's] contours or how it changes over time." Unlike withdrawal rights created by entity partitioning, Baird and Casey believe that "existing law does too little to make [these withdrawal rights] discrete and readily visible"[27] and, as a result, they are not a useful financing tool.[28]

This Essay argues that, as things stand, entity partitioning may be less useful in limiting the associated increase in information-search costs than Baird and Casey believe. The readily visible withdrawal rights created by entity partitioning may be just as shadowy as those created by executory contracts. In at least some cases, the boundaries of the corporation are only the starting point for understanding how withdrawal rights can reshape bankruptcy outcomes. Subsidiaries are bound together by webs of contracts, informal practices, and intercompany claims. An investor needs some knowledge of all of these to form reliable recovery expectations about how withdrawal rights can affect bankruptcy outcomes in bad states of the world. As regulation stands, even firms with public-filing obligations may consider this information unnecessary to disclose.[29] Moreover, managers may not even have a grasp of the universe of

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22. 11 U.S.C. § 365(a) (2012); see Baird & Casey, supra note 1, at 47 n.205 (discussing structure of Spansion Japan financing).

23. See Baird & Casey, supra note 1, at 47 (noting assumable franchise is "treated like a lease").

24. See id. (stating nonassumable holders of franchise may "withdraw the franchise notwithstanding the bankruptcy").

25. See id. at 47 n.206 (discussing particular iteration of issue).

26. Public companies do have disclosure obligations when they sign material contracts. See Valerie Ford Jacob et al., The New Form 8-K: Fifteen Items Every General Counsel Needs to Know, 60 Consumer Fin. L.Q. Rep. 42, 43 (2006) (discussing disclosure requirement for material amendments to material contracts). Materiality, of course, is a subjective determination reached by a firm's managers and attorneys. Managers may not believe that contracts creating or enhancing withdrawal rights are material because courts rarely enforce them. See infra note 103 and accompanying text (noting subordination often prevents such claims from coming before federal courts).

27. Baird & Casey, supra note 1, at 47.

28. See id. at 35–48 (typifying examples of hidden withdrawal rights from bankruptcy cases in airline, automobile-supply, and real-estate industries).

29. See supra note 26 and accompanying text (noting existing disclosure obligations may not extend to withdrawal rights).

material facts because they may not consider withdrawal rights when they structure relationships between entities in the first place. Bankruptcy courts have historically found ways to avoid enforcing withdrawal rights and this may have created an expectation that secured lenders will not be able to escape bankruptcy-court jurisdiction.[30] This Essay's main claim is that substantial changes in regulation and corporate practice may be necessary before entity partitioning may be relied upon to yield many beneficial withdrawal rights. In short, managers may need to start taking intercompany contracting more seriously and to disclose the information investors need to predict bankruptcy outcomes.

A case study of a recent bankruptcy in which a secured lender had an enforceable withdrawal right supports this argument.[31] Prior to its bankruptcy, Spansion, an American semiconductor manufacturer, built a new plant in Japan.[32] To fund the project, Spansion borrowed money from a syndicate of lenders and provided them with a withdrawal right on the plant by placing the asset in a subsidiary and giving the lenders a security interest in the subsidiary's assets.[33] The subsidiary was governed by foreign law and the lenders were able to enforce the withdrawal right to gain bargaining leverage.[34] The main insight of the case study is that investors could not have foreseen the true costs of the withdrawal right

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30. It is worth noting that only one of Baird and Casey's case studies, in which a judge upheld a withdrawal right, involved a court of appeals; the remaining cases were all decided by bankruptcy judges. See Baird & Casey, supra note 1, at 44 (discussing Seventh Circuit's decision in United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609 (7th Cir. 2005)).

31. The Spansion Japan example does not map perfectly onto Baird and Casey's paradigm of the ideal withdrawal right. There is no evidence regarding whether management's misbehavior was deterred. Whether GE was able to monitor Spansion less than it would have if the Japanese plant had not been financed through asset partitioning remains unknown. It is also not clear whether the highest valued use of the Japanese plants was as part of the Spansion corporate family. Texas Instruments may have expertise or other synergies that improved Spansion Japan's value and may be better positioned to sell services to other customers than Spansion would have been. Nonetheless, the case study does provide some insight into how the enforcement of withdrawal rights might affect bankruptcy outcomes.

32. See infra notes 40–48 and accompanying text (discussing details of financing transaction for Spansion LLC's new plant).

33. Infra notes 40–48 and accompanying text (examining Spansion Japan's loan characteristics).

34. This example is similar to some cited in the Baird and Casey article. For example, the lenders took a security interest in Harborplace's assets to engineer a withdrawal right. See Baird & Casey, supra note 1, at 25–31 (discussing General Growth bankruptcy and bankruptcy filing of its "healthy and solvent subsidiary," Harborplace). The purpose of that withdrawal right was different, as it was meant to prevent healthy subsidiaries from financing the reorganization of other subsidiaries. See id. Here, the lender who funded the Japanese plant appears to have been interested in extracting going-concern value in bad states of the world. This case study is in contrast to the examples cited in the article because, as they note, bankruptcy judges tend to look for ways to avoid enforcing withdrawal rights. Id. at 24–35.

based on the information they had in their possession. The corporate structure was only the beginning of the analysis. The lenders' bargaining power actually stemmed from their rights under a perpetual supply contract between parent and subsidiary that was not disclosed to the investing public.[35] Importantly, the facts suggest that Spansion's managers were unaware of the potential bargaining power created by the supply contract in bad states of the world.[36] They did not manage with a withdrawal-rights lens, which led them to provide more credit protection to the lenders than they seem to have understood, let alone disclosed to their unsecured creditors and shareholders.

The first Part of this Essay presents the case study of Spansion. The second Part briefly discusses what the case study suggests about how the benefits of withdrawal rights can be realized. Regulators may need to require firms to disclose more information about subsidiaries that are subject to withdrawal. Further, managers may need to manage those subsidiaries as if they were potential third parties, contracting with them at arm's length and preparing for what might result if the assets were withdrawn.

I. A CASE STUDY OF WITHDRAWAL RIGHTS: SPANSION AND ITS JAPANESE SUBSIDIARY

Prior to its descent into bankruptcy, the semiconductor manufacturer Spansion produced flash-memory products with a global supply chain.[37] The supply chain included semiconductor fabrication facilities located in Japan.[38] These plants were owned by Spansion Japan Limited ("Spansion Japan"), a wholly owned subsidiary of the operating company, Spansion LLC ("LLC").[39] In 2006, LLC's managers anticipated a substantial rise in demand and decided to increase capacity by building a new factory in Japan.[40] To finance the new plant, Spansion Japan borrowed approximately $400 million from a syndicate of lenders led by GE

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35. See infra notes 49–59 and accompanying text (describing opaque relationship between parent Spansion LLC and subsidiary Spansion Japan as misleading to investors).

36. See infra notes 49–59 and accompanying text (discussing intracompany contracts).

37. See Pre-trial Memorandum of Claims Agent at 3–4, Claims Agent of Spansion Inc. v. Spansion Japan Ltd. (In re Spansion Inc.), Ch. 11 Case No. 09-10690 (KJC), Adv. No. 10-51300 (KJC) (Bankr. D. Del. Oct. 15, 2010) (introducing Spansion LLC and Spansion Japan in statement of facts).

38. Id.

39. Id. To aid the reader, this Essay will refer to the actions of Spansion's managers as LLC's actions. In reality, the managers of LLC were the managers of the entire firm. See infra note 64 (showing LLC negotiated contract for Spansion without Spansion's input).

40. See Pre-trial Memorandum of Spansion Japan Ltd. at 7, Claims Agent of Spansion Inc. v. Spansion Japan Ltd. (In re Spansion Inc.), Ch. 11 Case No. 09-10690 (KJC), Adv. No. 10-51300 (KJC) (Bankr. D. Del. Oct. 15, 2010) (discussing new manufacturing facility and related financing transaction).

Capital Leasing Corporation ("GE").[41] As collateral for the loan, GE took a lien on substantially all of Spansion Japan's assets.[42] At the time of the loan, LLC owed about $450 million to unsecured bondholders for unrelated loans.[43] LLC did not guarantee this new debt and GE did not become a creditor of any Spansion entity other than Spansion Japan, meaning GE could only look to Spansion Japan for repayment.[44]

By placing the Japanese assets in a Japanese subsidiary, LLC's managers provided GE with a withdrawal right. As a Japanese company, Spansion Japan could file for bankruptcy relief in Japan.[45] In bad states of the world, this would take the Japanese plants out of the jurisdiction of any American bankruptcy court.[46] Accordingly, GE could possibly obtain bargaining leverage by threatening to shut down the plants and destroy part of LLC's going-concern value.[47] In considering this danger, investors in LLC might have been comforted by the fact that the Japanese plants only accounted for a small portion of LLC's overall revenue.[48]

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41. Pre-trial Memorandum of Claims Agent, supra note 37, at 4.

42. Id.

43. See Spansion Inc., Annual Report (Form 10-K), at 54–58 (Feb. 28, 2008) (describing capital structure as including $250 million in unsecured senior notes and $207 million in unsecured debentures).

44. See Pre-trial Memorandum of Claims Agent, supra note 37, at 4–5 (discussing details of financing transaction for new manufacturing facility).

45. Spansion Japan could have also voluntarily filed for bankruptcy in the United States. See, e.g., In re Aerovias Nacionales de Colom. S.A. Avianca, 303 B.R. 1, 17–18 (Bankr. S.D.N.Y. 2003) (finding U.S. bankruptcy courts may exercise jurisdiction over company's reorganization with "center of main activities abroad"). Spansion Japan also could have been left outside of bankruptcy even if LLC sought to restructure its own debt. LLC could do this to abandon the Japanese plants, see Baird & Casey, supra note 1, at 30–31, or to simply make payments on them if the Japanese business were viewed as solvent, see id. at 3–4 (discussing the Dodgers' parking lot).

46. Once Spansion Japan filed for Japanese bankruptcy, the Japanese plant would be under the control of the Japanese bankruptcy trustee as part of the bankruptcy estate in Japan. As proved to be the case, this trustee would be unlikely to subordinate her fiduciary duty to Spansion Japan's creditors to maximize the value of LLC's estate. For more on Japanese bankruptcy law, see Samuel L. Bufford & Kazuhiro Yanagida, Japan's Revised Laws on Business Reorganization: An Analysis, 39 Cornell Int'l L.J. 1 (2006).

47. See Spansion Inc., Annual Report (Form 10-K), at 6 (May 12, 2009) (stating LLC's business would be "materially adversely affected" if Spansion Japan stopped doing business with LLC).

48. Spansion Japan later estimated that the loss of Spansion Japan would cause LLC's revenue to fall by $43 million in the fourth quarter of 2009. See Objection of Spansion Japan Ltd. to Debtors' Motion for Authority to Reject the Second Amended & Restated Foundry Agreement with Spansion Japan Ltd. at 3, In re Spansion Inc., No. 09-10690 (KJC) (Bankr. D. Del. Oct. 22, 2009) (indicating approximate 2009 revenue shortfall). LLC reported net sales of $307 million for the quarter, suggesting Spansion Japan might be responsible for roughly 14% of Spansion's overall revenue. See Press Release, Spansion Inc., Spansion Inc. Reports Fourth Quarter 2009 Results: Company Posts Second Consecutive Profitable Quarter (Jan. 15, 2010), http://investor.spansion.com/phoenix.zhtml?c=189782&p=irol-newsArticle&id=1405135 (on file with the *Columbia Law Review*) (showing Japanese plants accounted for small percentage of LLC's revenue).

Unfortunately, these investors would have been misled by the opaque relationship between LLC and Spansion Japan. To ensure profits are taxed in the right jurisdictions, international-tax regulations require corporations that are part of the same corporate family to do business as if they were operating at arm's length.[49] Accordingly, LLC agreed to pay Spansion Japan a quarterly payment equal to Spansion Japan's production costs plus a 6% return in an intercompany foundry agreement ("Foundry Agreement").[50] Importantly, the Foundry Agreement expired only upon mutual consent—it was a perpetual supply contract with no date of termination.[51]

As part of the loan negotiations, GE asked for changes to the Foundry Agreement. Most importantly, GE wanted LLC to be required to purchase at least "95% of the total capacity" of Spansion Japan in each quarter.[52] LLC seems to have spent little time thinking about this request before agreeing to it.[53] The request "received little to no attention from the personnel at Spansion Japan and Spansion LLC, except from the companies' respective tax and finance departments for purposes of ensuring that the transfer pricing met the arm's-length standard."[54] GE also inserted a provision in the loan contract that forbade Spansion Japan from amending the Foundry Agreement.[55]

While the GE loan contract was publicly disclosed to LLC's investors, the Foundry Agreement itself does not appear to have been filed publicly with the SEC.[56] That is unfortunate, because Spansion Japan was more than LLC's subsidiary. It was also a contract creditor under the Foundry Agreement. After GE's changes were implemented, LLC had agreed to "purchase 95% of the total capacity" of Spansion Japan's plants for a

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49. See generally Richard M. Hammer et al., International Transfer Pricing: OECD Guidelines ¶ 3.01 (2014), 1998 WL 1038572 ("The arm's-length standard is the [OECD's] touchstone of transfer pricing."). The idea is that the price between two related entities should reflect the best term each could get if contracting on the open market. Spansion Japan should charge the highest amount it can, and LLC should pay the lowest amount it can. Id.

50. See Pre-trial Memorandum of Claims Agent, supra note 37, at 6–7 ("At the end of each quarter, Spansion Japan would calculate its actual costs based on the number of wafers that Spansion LLC actually purchased, and the parties would make a 'true up' adjustment."). The parties would first estimate the payment and then compare that estimate to actual costs to ensure that the final price was always costs plus 6%. Id. at 2, 7.

51. See Pre-trial Memorandum of Spansion Japan Ltd., supra note 40, at 11 (discussing mutual-consent requirement for agreement's termination).

52. Id. at 8.

53. See Pre-trial Memorandum of Claims Agent, supra note 37, at 5 ("There were no negotiations respecting the GE Mark-Up, which was simply incorporated into the Foundry Agreement after Spansion LLC's tax personnel confirmed that the revisions would not impact the transfer pricing that the parties had historically utilized.").

54. Id. at 4–5.

55. Spansion Inc., Quarterly Report (Form 10-Q) exh. 10.65, at 41 (May 9, 2007).

56. Based on the author's review of all of Spansion's SEC filings, one possible explanation for this is that LLC appears to have viewed GE as oversecured.

perpetual duration.[57] In bad states of the world, LLC could always assert offsetting counterclaims and argue for an alternative interpretation of the contract. However, Spansion Japan was now potentially its largest creditor, with claims equal in priority to the $450 million in unsecured bonds. To induce GE to make the loan, LLC had agreed to a large contingent liability that was hidden from public view.

In effect, the changes to the Foundry Agreement allowed GE to seek repayment of the Spansion Japan loan directly from LLC. This structure might have been used because LLC was contractually restricted from borrowing additional amounts of money under the bond indenture for its existing debt.[58] The Foundry Agreement thus provided GE with an indirect route to seek repayment from the parent entity.[59] LLC's bondholders may have identified and analyzed GE's withdrawal right as a lender to a subsidiary, but they had no visibility whatsoever into the claims Spansion Japan might have had against LLC or any offsetting counterclaims.

Spansion's business collapsed as the financial crisis of 2008 ravaged the semiconductor industry.[60] After LLC's financial struggles became public knowledge, Spansion Japan's lenders informed the company that they would not advance additional funds.[61] This prompted Spansion Japan to file reorganization proceedings in Tokyo District Court on February 10, 2009.[62] LLC soon followed its subsidiary, seeking its own bankruptcy protection in Delaware on March 1, 2009.[63]

The foreign bankruptcy filing dramatically altered the day-to-day life at Spansion Japan. Historically, Spansion Japan's employees took orders directly from LLC's senior managers as part of a fully integrated conglomerate.[64] Now, an employee of Spansion Japan was appointed by the

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57. Supra notes 51–52 and accompanying text.

58. See Pre-trial Memorandum of Claims Agent, supra note 37, at 5 ("GE initially sought a parent guarantee from Spansion LLC on the loan facility, but such a guarantee would have constituted a breach of certain covenants in Spansion LLC's preexisting debt agreements.").

59. Cf. id. (indicating lack of guarantee by LLC led "GE [to seek] other ways to reduce its credit risk on the GE Facility," including changes to Foundry Agreement).

60. See Pre-trial Memorandum of Spansion Japan Ltd., supra note 40, at 8 ("In the second half of 2008, there was a significant downturn in the semiconductor industry . . . . In the meantime, . . . [Spansion] filed chapter 11 bankruptcy petitions . . . .").

61. See Verified Petition of Masao Taguchi, as Foreign Representative of Spansion Japan Ltd., for Recognition of Foreign Main Proceeding Pursuant to 11 U.S.C. §§ 1515 & 1517 & Relief Pursuant to 11 U.S.C. §§ 1520 & 1521 at 5–6, In re Spansion Japan Ltd., No. 09-11480 (Bankr. D. Del. Apr. 30, 2009) [hereinafter Spansion Japan Petition] ("[E]xisting lenders gave notice that they did not intend to fund under their revolving loan arrangement . . . .").

62. See Pre-trial Memorandum of Spansion Japan Ltd., supra note 40, at 8 (noting commencement of reorganization proceedings).

63. Id. at 8–9.

64. Cf Pre-trial Memorandum of Claims Agent, supra note 37, at 4–5 (showing Spansion Japan's automatic acceptance of transactions it entered through Spansion LLC).

Japanese court to run the company as bankruptcy trustee.[65] If the Spansion Japan assets had come under the jurisdiction of the Delaware bankruptcy court, LLC's managers could have attempted to pay GE the market value of its collateral in a cramdown plan.[66] The foreign bankruptcy filing removed this option and the American bankruptcy judge could not block GE from foreclosing on the Japanese plants.[67]

LLC's managers immediately tried to renegotiate the Foundry Agreement with Spansion Japan's new Japanese bankruptcy trustee.[68] The pricing formula from the Foundry Agreement required LLC to pay substantially above the true market price for each wafer.[69] This practice was not offensive when the extra value inured to the benefit of LLC's investors because they were the ultimate residual claimants of Spansion Japan. However, Spansion Japan's bankruptcy estate would now capture all overpayments for the benefit of GE and other Spansion Japan creditors.[70] After two months of bargaining, LLC and Spansion Japan reached an oral agreement on amendments to the Foundry Agreement and the parties agreed to continue doing business at a lower price.[71] Spansion Japan's trustee began to craft a reorganization plan that would return

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65. See Spansion Japan Petition, supra note 61, at 4 (noting Masao Taguchi's appointment as trustee to administer Foreign Debtor's estate). GE complained that Spansion Japan, in the initial months of its bankruptcy, continued to behave as if it were still controlled by LLC's managers. See Motion of GE Financial Services Corp. (f/k/a GE Capital Leasing Corp.) for Allowance & Payment of Administrative Expense Claim at 5, In re Spansion Inc., No. 09-10690 (KJC) (Bankr. D. Del. Sept. 24, 2009) [hereinafter GE Motion] ("[T]he post-petition conduct . . . strongly suggests that [Spansion Japan] continues to be a captive business . . . .").

66. See supra text accompanying note 4 (describing collateral structures used to protect secured creditors and keep collateral outside of jurisdiction). Note that GE could have fought a cramdown plan. GE could have asserted that it was actually owed damages under the Foundry Agreement as well as the market value of the collateral.

67. The bankruptcy judge could have crafted an alternative solution that had the same effect as ignoring the withdrawal right—such as equitably subordinating Spansion Japan's claim—but he never had the opportunity to rule on it as the parties settled. See infra notes 81–97 and accompanying text (detailing terms of settlement between Spansion Japan and LLC).

68. See Motion of the Debtors for Entry of an Order Pursuant to 11 U.S.C. § 365 & Fed. R. Bankr. P. 6006 Authorizing the Rejection of Second Amended & Restated Foundry Agreement with Spansion Japan Ltd. at 4, In re Spansion Inc., No. 09-10690 (KJC) (Bankr. D. Del. Oct. 9, 2009) (detailing negotiations between Spansion Japan and Spansion LLC to amend Foundry Agreement).

69. See id. (noting LLC sought to amend Foundry Agreement to "more closely conform to market prices"). Spansion Japan operated two plants, referred to as JV3 and SP1. SP1 was the new plant built with the GE loan. Spansion estimated SP1 wafer pricing as 370% more than market price and JV3 pricing as 40% more than market price. Id. at 3–4.

70. See id. at 3 ("[A]bove-market amounts . . . would effectively become trapped in Spansion Japan's bankruptcy estate . . . .").

71. See id. at 4–5 (discussing process of reaching oral agreement).

Spansion Japan to LLC's control.[72]

After a brief period of compliance, Spansion Japan reneged on the deal under pressure from GE.[73] GE appears to have been more focused on preserving its bargaining leverage than in stabilizing the business and preserving going-concern value.[74] For example, GE loudly threatened to seize and shut down the two Spansion Japan plants.[75] GE's obstinance may have been motivated by a May 2009 appraisal of Spansion Japan's major assets that estimated the value of the plants and their equipment as falling between $216 million and $364 million, implying that GE could have been undersecured by tens of millions of dollars.[76]

As negotiations foundered, LLC's managers began to make contingency plans to continue to sell wafers and service Japanese customers in the event GE exercised its withdrawal right and shut the plants down.[77] The Japanese market and customer relationships were too important to be held hostage by GE.[78] Accordingly, LLC filed a motion with the bankruptcy court to create a new subsidiary called "Spansion KK" to replace Spansion Japan.[79] There was no alternative supplier in the market, so LLC was forced to find a way to replace Spansion Japan's plants using

72. See GE Motion, supra note 65, at 5 ("The [Spansion Japan] Trustee has, until recently, focused entirely on a plan of reorganization based upon the acquisition of all the equity of a reorganized [Spansion Japan] by LLC as a 'sponsor' . . . ."). After reaching the accommodation on wafer prices, LLC sought to come to a long-term arrangement with Spansion Japan. See Debtors' Motion for Order Under 11 U.S.C. §§ 105, 502(c), 503(b) & 1129(a)(11) Determining & Estimating Amount of Administrative Expense Claim of Spansion Japan Ltd. Relating to Manufacture of Integrated Flash Memory Circuits at 8, In re Spansion Inc., No. 09-10690 (KJC) (Bankr. D. Del. Nov. 13, 2009) [hereinafter Claim Estimation Motion] ("The Debtors also made a number of proposals to Spansion Japan for their overall long-term relationship . . . .").

73. See Claim Estimation Motion, supra note 72, at 9–10 (reporting assertion of claims by Spansion Japan and GE under original Foundry Agreement and noting "Spansion Japan and GE have persisted in their positions that the terms and conditions of the Prepetition Foundry Agreement continue to apply").

74. See Pre-trial Memorandum of Claims Agent, supra note 37, at 10–11 (stating "GE maintained that Spansion Japan should 'take advantage' of the favorable cost plus 6% pricing under the existing Founding Agreement" and threatened to shut down two Spansion Japan plants in protest of Foundry Agreement amendment). GE described the attempt to amend the Foundry Agreement as follows: "Because the revenue stream under the Foundry Agreement—the receivables due to [Spansion Japan] from LLC—secure the advances made by [GE], this purported amendment was a direct post-petition attack on [GE's] collateral . . . ." GE Motion, supra note 65, at 7.

75. Pre-trial Memorandum of Claims Agent, supra note 37, at 11 & n.18.

76. See id (detailing equipment fair market value).

77. Id.

78. Cf. id. ("A sudden shutdown of JV3 would have impacted Spansion LLC's ability to service its customers.").

79. Motion of the Debtors for an Order Authorizing the Debtors to Form & Provide Initial Funding for a New Subsidiary, In re Spansion Inc., No. 09-10690 (KJC) (Bankr. D. Del. Nov. 25, 2009) [hereinafter New Subsidiary Motion].

LLC's own plants in the United States.[80]

After months of litigation, LLC and Spansion Japan came to an agreement on a "messy divorce."[81] LLC agreed to continue purchasing manufacturing services from Spansion Japan for six quarters, which allowed LLC to continue to serve its customers and Spansion Japan to generate revenue to fund its quest for an independent business model.[82] LLC's agreement to purchase wafers from Spansion Japan sacrificed millions in EBITDA savings that could have been realized if LLC had made the wafers itself.[83] LLC also agreed to pay Spansion Japan $5 million for technical information,[84] $13 million to purchase Spansion Japan's distribution business,[85] and $45 million for the wafers LLC obtained from Spansion Japan in the months between the bankruptcy filing and the settlement.[86]

The settlement left open one important issue: the size of the claim that Spansion Japan had against LLC for breaching the Foundry Agreement.[87] This number was very important, because it was equal in priority to the claim of LLC's bondholders, who were not going to be paid in full.[88] A large number would further reduce the recovery of LLC's investors, to the benefit of GE and Spansion Japan's other creditors. The

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80. See Objection of GE Financial Services. Corp. (f/k/a GE Capital Leasing Corp.) to the Motion of the Debtors for Entry of an Order Pursuant to 11 U.S.C. Section 365 & Fed R. Bankr. P. 6006 Authorizing the Rejection of Second Amended & Restated Foundry Agreement with Spansion Japan Ltd. at 9, In re Spansion Inc., No. 09-10690 (KJC) (Bankr. D. Del. Oct. 20, 2009) (noting lack of "readily available open-market substitute").

81. See Objection of Spansion Japan Ltd. to Motion of the Debtors for an Order Authorizing the Debtors to Form & Provide Initial Funding for a New Subsidiary at 3, In re Spansion Inc., No. 09-10690 (KJC) (Bankr. D. Del. Dec. 9, 2009) (terming split "messy divorce"). See generally Joint Motion for Order Pursuant to 11 U.S.C. § 105, 363, 1501 & 1521 & Fed. R. Bankr. P. 6004 and 9019 Approving Settlement Between Spansion LLC & Spansion Japan, In re Spansion Inc., No. 09-10690 (KJC) (Bankr. D. Del. Jan. 18, 2010) [hereinafter Settlement Motion] (outlining entrance into settlement and resulting terms).

82. See Settlement Motion, supra note 81, at 9–10 (highlighting mutual benefits arising from revised Foundry Agreement for LLC and Spansion Japan).

83. Id. at 10.

84. Id.

85. See Spansion Inc., Annual Report (Form 10-K), at 45 (Feb. 22, 2011) [hereinafter Spansion 2011 Annual Report] (reporting $13.1 million purchase price for Spansion Japan's distribution business).

86. See Settlement Motion, supra note 81, at 12 (listing payment terms).

87. See In re Spansion Inc., No. 09-10690, slip op. at 2 (Bankr. D. Del. Nov. 19, 2009) (order granting motion authorizing rejection of amended Foundry Agreement) (ordering Spansion Japan and GE to file claims for damages resulting from rejection of Foundry Agreement). Under the Bankruptcy Code, a contract creditor whose contract is rejected by the debtor is provided with a prepetition unsecured claim in the amount of the damages. 11 U.S.C. § 502(g)(1) (2012).

88. See Second Amended Disclosure Statement for Debtors' Second Amended Joint Plan of Reorganization Dated December 16, 2009 at 9, In re Spansion Inc., No. 09-10690 (KJC) (Bankr. D. Del. Dec. 17, 2009) (projecting 31% to 45% recovery for general unsecured creditors, constituting loss of hundreds of millions of dollars).

Foundry Agreement required LLC to purchase 95% of Spansion Japan's capacity with no termination date.[89] Accordingly, Spansion Japan argued that LLC owed it a payment equal to the value of that entire lost revenue stream or nearly $900 million.[90] LLC responded that Spansion Japan was only owed $118 to $229 million and asserted various counterclaims.[91] After months of litigation, LLC settled the claim by paying Spansion Japan an additional $100 million in cash.[92]

When the dust settled, LLC paid GE $130 million to settle claims and buy equipment from Spansion Japan. LLC also spent $8.4 million to set up replacement operations in Japan, meaning the total loss was nearly $140 million.[93] Spansion Japan's independence was short lived—Texas Instruments later bought substantially all of Spansion Japan's assets for $143 million.[94] If this was the "market value" of the Spansion Japan assets, it suggests that LLC could have retained the assets for a similar price that it paid to settle the claims if cramdown had been available. After the sale closed, Spansion contracted with Texas Instruments for the same services it had previously purchased from its Japanese subsidiary.[95] In effect, Spansion Japan's rights under the Foundry Agreement allowed GE to double dip—it sold the collateral and also extracted going-concern value from LLC's creditors. GE's loan was repaid in full.[96] Spansion Japan's unsecured creditors appear to have received a substantial recovery, suggesting that LLC's creditors paid Spansion Japan more than the amount that GE was owed.[97]

From GE's perspective, the withdrawal right may have always involved both the right to sell the collateral as well as the right to seek

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89. Supra notes 51–52 and accompanying text.

90. See Pre-trial Memorandum of Spansion Japan Ltd., supra note 40, at 10–13. Spansion Japan's expert decided to use December 31, 2016 as the end date because the technologies used by Spansion Japan would have been obsolete after that point. Id. at 11.

91. Id. at 13.

92. See Transcript of Proceedings at 6, Claims Agent of Spansion, Inc. v. Spansion Japan Ltd. (In re Spansion Inc.), Ch. 11 Case No. 09-10690-KJC, Adv. No. 10-51300-KJC (Bankr. D. Del. Nov. 16, 2010) [hereinafter Settlement Transcript] (noting settlement amounts).

93. See In re Spansion Inc., No. 09-10690, slip op. at 1–2 (Bankr. D. Del. Dec. 18, 2009) (order authorizing debtors to form subsidiary and provide funding) (authorizing up to approximately $8.4 million of startup funding).

94. Pre-trial Memorandum of Claims Agent, supra note 37, at 10.

95. See Spansion 2011 Annual Report, supra note 85, at 15–16 (discussing dependence on Texas Instruments to produce products of acceptable quality). Spansion's new subsidiary, Spansion Nihon, handled the other aspects of its Japanese business. Id. at 8.

96. See Settlement Transcript, supra note 92, at 11 (noting settlement with LLC "will provide for a cash recovery to [Spansion Japan's] secured creditors of one hundred percent of their claim . . . .").

97. See id. (highlighting cash recovery to be "more than ten times what their expected recovery was at the outset"). Some of Spansion Japan's unsecured creditors might have had various claims under Japanese reorganization law providing them with the equivalent of administrative-expense priority, so this analysis is uncertain.

repayment for contract damages under the Foundry Agreement. LLC's investors, on the other hand, appear to have had insufficient information to analyze GE's withdrawal right. Based on the information that appears to have been public, LLC's creditors could have imagined two possibilities after LLC lost control of Spansion Japan. First, they could have anticipated incurring costs associated with finding a new supplier. Alternatively, they might have imagined having to pay GE some portion of LLC's going-concern value to keep Spansion Japan as a supplier. Instead, GE was able to use its contractual rights under the Foundry Agreement to force LLC's creditors to do both. LLC made payments of nearly $140 million and lost its right to collateral that sold for $143 million, suggesting that the total loss to creditors was at least $280 million. This is more than the $272 million GE was owed when Spansion filed for bankruptcy.[98] Spansion Japan's rights under the Foundry Agreement allowed GE to receive a full recovery on its unsecured deficiency claim of about $130 million, in contrast to the 31% to 45% recovery received by the unsecured bondholders of LLC whose claims were of equal structural priority.[99] Additionally, LLC paid its lawyers more than $4.7 million to negotiate and litigate with Spansion Japan.[100] The amount that Spansion Japan and GE spent on lawyers and other advisors is not publicly available, but it is likely similar, implying that the cost of bargaining could be fairly estimated at more than $15 million.

II. REALIZING THE POTENTIAL OF WITHDRAWAL RIGHTS

Although caution is in order in interpreting the case study—the concerns raised by Spansion Japan may or may not be generalizable onto the larger universe of withdrawal rights—two lessons emerge that are worth considering.[101] First, the case suggests that the increase in information-search costs associated with enforcing even the most overt of withdrawal rights might be significant. Investors may be able to understand asset ownership by examining public filings, but these documents may provide only the broadest outline of the contours of the withdrawal rights. The Foundry Agreement that provided the true picture of GE's withdrawal

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98. See Spansion Inc., Quarterly Report (Form 10-Q), at 21 (Nov. 7, 2008) (detailing Spansion Japan's financial debt).

99. Supra note 88 and accompanying text.

100. See Second Interim & Final Fee Application of Skadden, Arps, Slate, Meagher & Flom LLP for Allowance of Compensation & Reimbursement of Expenses as Special Counsel for the Period from September 1, 2009 Through & Including May 10, 2010 at 1, 10, In re Spansion Inc., No. 09-10690 (Bankr. D. Del. July 7, 2010) (detailing fees and services provided).

101. Further research is needed to understand whether the case study is representative of how withdrawal rights might impact bankruptcy bargaining. It is possible, for example, that this case might be an outlier and bargaining in most cases could be relatively predictable and frictionless. A policy enforcing withdrawal rights might be net efficient even if the occasional Spansion-type situation upsets investor expectations.

right was not publicly disclosed to LLC's investors. Indeed, Spansion's managers considered it unimportant and thought it existed solely to satisfy tax regulations.[102] Accurately assessing the lenders' bargaining power would have required granular, detailed, and private information about hidden contractual relationships and practices between subsidiaries. The case study suggests that, in the short term, a change in policy that enforces the withdrawal rights created by entity partitioning might chill investment. Presumably, over time investors and firms would adjust and only create withdrawal rights when doing so would be net efficient. In the short term, however, investors may have reason to fear that they lack the information to understand how existing withdrawal rights might reshape bankruptcy.

Unfortunately, legal changes may be required before investors could expect to have that information. In particular, the Securities and Exchange Commission may need to consider changing regulation in light of the increasing popularity of bankruptcy-remote structures.[103] For example, the SEC could require corporations to consider any information that affects the bargaining power of a subsidiary subject to withdrawal rights to be material information that must be disclosed to investors. The sort of information that might be subject to such a disclosure regime could be intracompany contracts, the balance of payments between the parent and the subsidiary and detailed disclosures about the role of the particular subsidiary or asset subject to withdrawal rights in the company's overall business.

Second, the case suggests that managers may operate subsidiaries that are subject to withdrawal rights under the impression that bankruptcy law will keep the discrete corporate entities together. The decisions of bankruptcy judges, which mostly fail to respect withdrawal rights, may have created these expectations. Transactions between Spansion and its subsidiary were structured to satisfy tax rules. LLC's managers appear to have been caught completely unprepared when the Japanese plant was withdrawn. The result was bargaining failure, even though LLC's managers tried to maintain ownership of Spansion Japan. LLC's managers exac-

102. See supra note 54 and accompanying text (noting lack of attention paid to Foundry Agreement).

103. Traditionally, judicial interpretations of securities law have played an important role that informed a corporation's ex ante analysis of whether information is "material" (and thus, necessary to disclose) through ex post review of misstatements and failures to disclose. See, e.g., Basic, Inc. v. Levinson, 485 U.S. 224, 248–50 (1988) (holding fraud-on-the-market theory gives rise to rebuttable presumption of reliance in securities-fraud cases). However, the mandatory subordination of securities-law claims in bankruptcy makes it less likely that federal courts will see securities-law claims involving intracompany contracts that unexpectedly redistribute value away from unsecured creditors. See 11 U.S.C. § 501 (2012) (permitting creditors or indenture trustees to file proofs of claims or interests against insolvent entity). Of course, high-profile decisions of bankruptcy judges could have the same effect on corporate behavior that the federal courts have traditionally had through interpreting securities law.

erbated bargaining problems in Chapter 11 by operating LLC's business without taking steps to prepare for the possibility of withdrawal. Baird and Casey expressly acknowledge that the information-search costs of investing will increase if bankruptcy judges allow investors to contract around Chapter 11 and express their hope that managers will only offer investors withdrawal rights if the benefits exceed the costs they impose on others.[104] The analysis presented above suggests that managers may have an incomplete understanding of how their actions ex ante affect bankruptcy outcomes ex post. This informational asymmetry may only be solved as lawyers convince their clients to begin taking withdrawal rights—and the more general practice of intracompany contracting—more seriously.

CONCLUSION

Baird and Casey have provided a critical first step in their analysis of the benefits of enforcing withdrawal rights in Chapter 11. The next phase is to begin to think about what other changes might be needed for the potential of withdrawal rights created by entity partitioning to be realized. Managers may need to understand that a subsidiary subject to withdrawal should be viewed as a potential third party. This might require a cultural shift: structuring transactions between these subsidiaries and other corporate entities with an eye towards what might happen if the asset is withdrawn. Effective bargaining over withdrawal rights might be aided by planning for withdrawal ex ante. Having to take these actions could also help condition managers to the possibility that withdrawal may occur. Similarly, the law might need to change to require more public disclosure about contractual arrangements and transaction structures when a subsidiary is subject to withdrawal rights. These actions will enlarge the population of efficient withdrawal rights that could be created by entity partitioning. Baird and Casey have convincingly shown that bankruptcy law should respect withdrawal rights. This Essay identified other changes that may be needed to maximize the benefits (and minimize the costs) of such a dramatic change in the way bankruptcy judges have historically treated these attempts to contract around the rules of bankruptcy.

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104. See Baird & Casey, supra note 1, at 13 ("[Bargaining] must give the debtor the right set of incentives while at the same time ensuring that assets are still put to their best use.").