Article

Bankruptcy as a National Security Risk

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Defense contractors lie at the heart of the U.S. national security regime. Each year, over half of the federal defense budget is allocated to contracts outsourcing military operations, projects, and services to private companies. However, defense outsourcing carries a ticking time bomb: mounting private debt. Today, the defense industry is among the nation's most indebted sectors, fueled largely by the rise of private equity. Over the past two decades, more than 1,500 defense contractors have been acquired by private equity firms through leveraged buyouts (LBOs)—high-risk takeovers funded almost entirely by debt. At any moment, this private debt time bomb could detonate, triggering a cascade of financial failures destabilizing the defense supply chain.

This rapid debt accumulation has introduced a new national security risk: bankruptcy. Private equity's aggressive use of debt in LBOs has heightened the risks of default and foreclosure of defense contractors they acquire. Yet, private equity firms shield themselves from these risks through "bankruptcy-remote" structuring. As a result, a rising tide of LBO-induced defense contractor bankruptcies have disrupted critical defense supply chains, jeopardizing national security.

The existing legal regime is ill-suited to address this risk. Despite the interconnectedness between bankruptcy and national security, Congress has designed them as separate regimes

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with conflicting goals. The Bankruptcy Code respects contractual freedom and prioritizes efficient debtor rehabilitation through private ordering. In contrast, the Anti-Assignment Acts impose strict limits on contractual freedom when national security is at stake. Private equity exploits this gap by operating beyond both regimes. Though the Bankruptcy Code prevents third-party abuses that hinder debtor rehabilitation, it does not address risks outside of bankruptcy where LBO-induced risks originate. Likewise, private equity exploits a loophole in the Anti-Assignment Acts, which restrict contract assignments but do not prevent entire companies from being resold. This allows private equity to extract value from defense contractors and exit without accountability.

This Article proposes ex ante risk mitigation as a solution. Existing law offers only ex post remedies after a defense contractor files for bankruptcy, even though the seeds of failure are often sewn years before filing, when private equity completes an LBO. The proposed solution has three components: (1) deleverage the defense industry by altering incentives for debt financing; (2) hold private equity accountable through an LBO review mechanism; and (3) make defense contractors less vulnerable in bankruptcy by amending the executory contract exception in the Bankruptcy Code.

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INTRODUCTION

National defense is a public good.[1] Yet, it is increasingly privatized through "defense outsourcing"[2]—the delegation of military tasks, services, and operations to private contractors via public contracts awarded by the Department of Defense (DoD).[3] Today, private contractors are the primary suppliers of national defense systems.[4] They "manufacture arms, manage complex logistics operations, support military bases overseas, protect embassies, analyze intelligence, and carry our cyber operations."[5] In 2023 alone, the DoD spent $431.4 billion on goods and services supplied by private contractors,[6] more than half of the yeaxs total national defense budget of $820 billion.[7] As one congressional report states, "[w]ithout contractor support, the United States

1. Tyler Cowen, *Public Goods*, ECONLIB, https://www.econlib.org/library/Enc/PublicGoods.html [https://perma.cc/F3VT-ZLFV]. Public goods are characterized by two key features: non-excludability and non-rivalrous consumption. *Id.* Economists often cite national defense as the quintessential example of a public good. *See id.*

2. *See generally* THOMAS C. BRUNEAU, OUTSOURCING NATIONAL DEFENSE: WHY AND HOW PRIVATE CONTRACTORS ARE PROVIDING PUBLIC SERVICES (2023).

3. ALEXANDRA G. NEENAN, CONG. RSCH. SERV., IF10600, DEFENSE PRIMER: DEPARTMENT OF DEFENSE CONTRACTORS 1 (2024).

4. *See id.* ("During U.S. military operations in Iraq and Afghanistan between 2001 and 2020, contractors frequently accounted for 50% or more of the total DOD presence in country."); *see also* Connor Echols, *Private Equity Gobbling Up Defense Firms at a Frightening Pace*, RESPONSIBLE STATECRAFT (Mar. 22, 2023), https://responsiblestatecraft.org/2023/03/22/as-private-equity-buys-up-defense-firms-transparency-is-already-suffering [https://perma.cc/U8AM-3W3C] (highlighting that more than half of the requested 2024 defense budget would go to contractors).

5. Charles W. Mahoney et al., *Leveraging National Security: Private Equity and Bankruptcy in the United States Defense Industry*, 26 BUS. & POL. 362, 362 (2024).

6. Alimat Aliyeva, *Pentagon Contract Costs Totaled $431.4 Billion in Fiscal Year 2023*, AZERNEWS (Oct. 16, 2024), https://www.azernews.az/region/232656.html [https://perma.cc/8HN7-7PUE].

7. *Budget Basics: National Defense*, PETER G. PETERSON FOUND. (last updated Sept. 9, 2025), https://www.pgpf.org/article/budget-explainer-national-defense [https://perma.cc/5WB6-PTGH]. Among all defense contractors, Lockheed Martin received the highest funds ($61.4 billion), followed by RTX Corporation ($24.1 billion), General Dynamics ($22.9 billion), Boeing ($20.1 billion), Humana ($7.8 billion), L3Harris Technologies ($7.5 billion), BAE Systems ($7 billion), and Cencora ($4.4 billion). Aliyeva, *supra* note 6.

would not be able to arm and field an effective fighting force."[8] Defense contractors have thus become integral to the U.S. national security regime.

However, defense outsourcing carries a ticking time bomb: mounting private debt. Today, the defense industry carries a high level of debt, largely due to the rise of private equity.[9] Private equity's involvement has spurred an unprecedented wave of defense contractor mergers and acquisitions (M&A) financed through leveraged buyouts (LBOs)[10]—corporate takeovers where the acquiring company borrows funds by pledging the target company's assets and future cash flows as collateral.[11] Between 2000 and 2022, private equity firms acquired over 1,500 defense contractors,[12] typically using LBOs.[13] These LBOs drastically heighten credit default risks for the defense contractors, as the acquisitions are almost entirely debt-financed.[14] LBOs also increase foreclosure risks, since defense contractors' assets are pledged as collateral, giving lenders repossession rights in the event of default.[15] From 2020 to 2022, private equity firms arranged more than forty percent of all M&A deals in the defense

8. MOSHE SCHWARTZ ET AL., CONG. RSCH. SERV., R44010, DEFENSE ACQUISITIONS: HOW AND WHERE DOD SPENDS ITS CONTRACTING DOLLARS 1 (2018).

9. *See* Echols, *supra* note 4 (noting that private equity invested fifteen billion dollars in defense-related deals in 2021).

10. *See Unpacking Leveraged Buyouts (LBOs): How PE Firms Engineer Growth Through Debt*, ALTVIA: BLOG, https://altvia.com/unpacking-leveraged-buyouts [https://perma.cc/2W59-TR4Y] (describing the process of acquiring a company through an LBO).

11. *See* Laura Femino, Note, *Ex Ante Review of Leveraged Buyouts*, 123 YALE L.J. 1830, 1834 (2014).

12. Mahoney et al., *supra* note 5, at 362.

13. *See id.* at 364 (describing private equity firms' practice of typically acquiring established companies through LBOs).

14. *See id.* at 364–65 (citing critics' concerns that higher debt ratios increase default risk). An LBO occurs when one company acquires another using a substantial amount of debt to finance the purchase. *See* Will Kenton, *Understanding Leveraged Buyouts (LBOs): Fundamentals and Examples*, INVESTOPEDIA (last updated Aug. 11, 2025), https://www.investopedia.com/terms/l/leveragedbuyout.asp [https://perma.cc/4SPY-43GH]. The debt can take the form of bonds (securities) or loans (non-securities). *See id.* Both the acquiror-company's and target-company's assets are often pledged as collateral for the loan. *See id.*

15. *See* Kenton, *supra* note 14 (noting that the acquired firm's capital is used as collateral); *see also* Mahoney et al., *supra* note 5, at 375 (highlighting the national security risk of losing intellectual property to adversaries seeking to exploit a defense contractor in bankruptcy).

industry.[16] At any moment, this private debt time bomb could detonate, unleashing a cascade of financial failures that threaten the stability of the entire defense supply chain.[17]

This surge in private debt within the defense industry introduces a new national security risk: bankruptcy. Specifically, excessive private debt accumulation can set off a chain reaction of financial failures that entrap a defense contractor in prolonged insolvency, endangering the stability of the national defense supply chain. First, excessive debt accumulation heightens the likelihood of a defense contractor defaulting on its debt obligations, leading to financial distress and triggering cross-defaults among its lenders.[18] Second, these cross-defaults enable lenders to foreclose and seize contractor assets pledged as collateral, potentially jeopardizing critical military projects under contract.[19] Third, in an effort to protect assets from seizure, defense contractors file for bankruptcy, causing significant business disruptions, mass layoffs, and breaches of DoD contracts.[20] Fourth, once in bankruptcy, contractors may be forced to liquidate assets to satisfy debt obligations or reorganize under unfavorable terms, leaving them more vulnerable to predatory buyouts,

16. *Aerospace & Defense M&A 2023*, KPMG 5 (2023), https://kpmg.com/kpmg-us/content/dam/kpmg/pdf/2023/aerospace-defence-outlook-2023.pdf [https://perma.cc/R395-R7AU].

17. *See* Exec. Order No. 13806, 82 Fed. Reg. 34597 (July 26, 2017) (noting the loss of companies in the U.S. defense supply chain that can disrupt U.S. military operations and calling for a report that identifies economic issues that could endanger this supply chain).

18. "Cross default is a provision in a bond indenture or loan agreement that puts a borrower in default if the borrower defaults on another debt obligation." James Chen, *Cross Default: Definition, How It Works, and Consequences*, INVESTOPEDIA (last updated May 15, 2021), https://www.investopedia.com/terms/c/crossdefault.asp [https://perma.cc/H39V-V8UL]. For example, a cross-default clause may say that the borrower automatically defaults on obligation A, if the borrower defaults on obligation B.

19. Assets pledged as collateral to secure multiple loans are known as "cross-collateralized" assets. James Chen, *Cross Collateralization: Definition, Risks and Benefits*, INVESTOPEDIA (last updated Oct. 23, 2024), https://www.investopedia.com/terms/c/cross-collateralization.asp [https://perma.cc/7G2A-9ZQJ]. They typically involve two or more secured loans, tied together by cross-default clauses. *See id.* If the debtor defaults on one loan, cross-default clauses enable another secured lender to seize the cross-collateralized asset. *See id.*

20. *See generally* Michael McGill & Thomas A. Pettit, *Navigating the Bankruptcy Process to Acquire Distressed Government Contractors or Their Assets*, ARNOLD & PORTER (Dec. 18, 2020), https://www.arnoldporter.com/en/perspectives/advisories/2020/12/navigating-the-bankruptcy-process [https://perma.cc/GG5R-5TUN] (discussing the consequences of filing for bankruptcy).

distressed lending from foreign entities, or the loss of defense-critical assets to unsafe hands.[21] Finally, even after emerging from bankruptcy, these contractors often remain encumbered by new debt, increasing the likelihood of a bankruptcy re-filing.[22] Collectively, these risks expose critical national security operations to potential business tampering.

Yet, the existing legal regime is ill-suited to address the national security risks arising from defense contractor bankruptcies. Despite the interrelated nature of bankruptcy and national security, Congress has designed them as separate statutory regimes with opposing legislative goals: Bankruptcy law promotes market-oriented debt resolution through private ordering, while national security law restricts private ordering where public interests are at stake.[23]

The corporate bankruptcy regime is primarily designed to ensure orderly and efficient debtor rehabilitation by promoting value-maximizing debt resolution plans that provide the debtor with a fresh start after bankruptcy.[24] At the heart of the

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21. *See id.* (highlighting complications in the bankruptcy process when government contracts and assets are involved).

22. *See generally* James Nani, *Repeat Chapter 11 Filers Dominate 2023 Bankruptcy Landscape*, BLOOMBERG L. (Jan. 10, 2024), https://news.bloomberglaw.com/bankruptcy-law/repeat-chapter-11-filers-dominate-2023-bankruptcy-landscape [https://perma.cc/F3J9-NFY2] (documenting the increasing frequency of repeat bankruptcy proceedings, sometimes from the retention of too much debt after the first chapter 11 filing).

23. For purposes of this Article, I focus on legislative intent behind federal statutes, rather than engaging in normative debates about what the proper statutory goals should be. In the bankruptcy context, some scholars contend that economic efficiency is the sole purpose of the Bankruptcy Code, while others emphasize the importance of rehabilitating troubled debtors and ensuring equitable distribution to creditors. *See* Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 331 (2002). There is even disagreement among academics over whether the Bankruptcy Code should allow inherently failing businesses to reorganize. *Id.* To avoid being sidetracked by these unsettled debates, my analysis centers on the legislative objectives outlined by Congress and interpreted by the courts. For general background on the normative debates on statutory purpose, see *id.* at 329–44.

24. *See* Truck Ins. Exch. v. Kaiser Gypsum Co., 144 S. Ct. 1414, 1420–21 (2024) ("Bankruptcy offers individuals and businesses in financial distress a fresh start to reorganize, discharge their debts, and maximize the property available to creditors."); Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 453 (1999) (noting that "maximizing property available to satisfy creditors" is a valid bankruptcy purpose); MICHAEL D. CONTINO, CONG. RSCH. SERV., R45137, BANKRUPTCY BASICS: A PRIMER 1 (2022)

Bankruptcy Code lies the freedom of contract, a core principle enabling parties to negotiate exit packages that leave debtors and creditors collectively better off.[25] Courts generally uphold this principle,[26] respecting the integrity and assignability of pre-bankruptcy contracts while minimizing interference with private ordering,[27] except in exigent circumstances such as fraudulent transfers[28] and preferences.[29]

("'Congress and the judiciary are constantly striving to achieve a wise balance' between 'offering a fresh start for debtors' and 'ensuring fairness to creditors.'").

25. *See* Matthew P. Goren, *Chip Away at the Stone: The Validity of Pre-Bankruptcy Clauses Contracting Around Section 363 of the Bankruptcy Code*, 51 N.Y.L. SCH. L. REV. 1077, 1081 (2006) (noting "the Bankruptcy Code's policy of favoring out-of-court settlements and freedom to contract").

26. The freedom of contract in bankruptcy is not absolute. *See* Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 664 (2009). To reach value-maximizing outcomes and resolve collective action problems inherent in the restructuring process, bankruptcy courts sometimes alter parties' rights under otherwise applicable non-bankruptcy law. *See id.*

27. *See In re* Cardillo, 172 B.R. 146, 152 (Bankr. N.D. Ga. 1994) ("A major premise underlying the framework of rights and restraints in the Bankruptcy Code is that collective action promotes efficiency. It insures an opportunity to use or to liquidate the common pool of assets available to pay claims in a manner that maximizes the value of the pool."); *see also* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 822–23 (1987) (theorizing bankruptcy as a process that should preserve pre-bankruptcy contractual entitlements, similar to how non-bankruptcy loss distribution works).

28. A "fraudulent transfer" is a transfer of property from a debtor to another (1) "with actual intent to hinder, delay, or defraud" its creditors; or (2) for less than the property's value while in or expecting financial trouble or to benefit another outside the normal course of business. 11 U.S.C. § 548(a)(1)(A)–(B). The trustee has the power to avoid a fraudulent transfer. *See id.* § 548(a)(1); *see also id.* § 544(b) ("[T]he trustee may avoid transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor . . . ."). The "applicable law" referenced in section 544(b) is, most commonly, state fraudulent transfer law. Daniel A. Lowenthal, *Bankruptcy Avoidance Actions Under Section 544(b): State Fraudulent Transfer Statutes and More*, PATTERSON BELKNAP (May 16, 2019), https://www.pbwt.com/bankruptcy-update-blog/bankruptcy-avoidance-actions-under-section-544b-state-fraudulent-transfer-statutes-and-more [https://perma.cc/BQ3G-LXYJ].

29. A "preference" is a transfer of property from a debtor to a creditor made within ninety days before a bankruptcy filing. *See* § 547. Such transfers are prohibited because they subvert the absolute priority rule established by the Bankruptcy Code. *See* Femino, *supra* note 11, at 1835 ("The Bankruptcy Code uses an absolute priority rule to establish the order in which stakeholders receive money when a company goes bankrupt." (citing § 1129(b)(2))). Section 547 empowers the trustee to claw back preference payments to ensure fair and

National security law, by contrast, prioritizes the stability and integrity of critical defense supply chains over economic efficiency.[30] This goal becomes particularly vital when the federal government acts as a market participant in arms acquisition through defense outsourcing. Defense contracts are governed by two key federal statutes—the Assignment of Claims Act[31] and the Assignment of Contracts Act[32]—collectively known as the Anti-Assignment Acts.[33] These statutes "generally prohibit the transfer of government contracts and the assignment of claims against the government."[34] Their purposes are twofold: (1) to prevent unknown third parties from acquiring claims against the federal government and using them to exert undue influence or threaten critical supply chains; and (2) to safeguard government assets by ensuring that the federal government deals exclusively with the original contracting party.[35]

However, neither the Bankruptcy Code nor the Anti-Assignment Acts alone can tackle the emerging national security risks posed by piling private debt in the defense industry. Although

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equitable distribution among creditors. *See* § 547(b) (enabling the trustee to avoid transfers with preferential traits).

30. *See, e.g.*, Worldwide Language Res., LLC v. United States, 127 Fed. Cl. 125, 135 (2016) (noting that "[o]f paramount import[ance] is the public interest in national defense and national security" (quoting Linc Gov't Servs., LLC v. United States, 96 Fed. Cl. 672, 702 (2010))); Haig v. Agee, 453 U.S. 280, 307 (1981) ("It is 'obvious and unarguable' that no governmental interest is more compelling than the security of the Nation." (citing Aptheker v. Sec'y of State, 378 U.S. 500, 509 (1964))). *See also* Owen E. Salyers, *National Security Versus Full and Open Competition: When Two Roads Diverge in a Yellow Wood*, 32 FED. CIR. BAR J. 217, 217 (2024) (arguing that, while "the United States has built its acquisition regulations around a central dedication to full and open competition," the dedication should, and sometimes does, "yield to the national security concerns of the day").

31. 31 U.S.C. § 3727.

32. 41 U.S.C. § 6305.

33. "The Anti-Assignment Acts are implemented by Federal Acquisition Regulation (FAR) subparts 32.8 and 42.12." Karen L. Manos, *Novation Agreements in Corporate Restructuring: The Government's Contractual Stealth Weapon*, 26 PUB. CONT. L.J. 339, 340 (1997). The FAR contains the principal rules of the federal acquisition system. *See* DAVID H. CARPENTER ET AL., CONG. RSCH. SERV., R42826, THE FEDERAL ACQUISITION REGULATION (FAR): ANSWERS TO FREQUENTLY ASKED QUESTIONS 7 (2024).

34. Westinghouse Elec. Co. v. United States, 56 Fed. Cl. 564, 569 (2003).

35. *See* Chung Kun Kevin Park, *Removing Uncertainty for the Most Uncertain Times: The Need for Amending the Anti-Assignment Acts to Better Prepare for a Financial Crisis*, 47 PUB. CONT. L.J. 307, 318–19 (2018) (describing the origins and purposes of the Anti-Assignment Acts).

the Bankruptcy Code equips courts with tools to prevent abuses that stymie efficient debtor rehabilitation, it does not address risks outside of bankruptcy, where private equity-induced national security risks originate. In defense contractor bankruptcies, financial failure is often set in motion years before filing, beginning with the initial LBO.[36] Bankruptcy merely materializes the risks already embedded during private equity's control and management. Similarly, private equity firms exploit a loophole in the Anti-Assignment Acts, as they themselves are not bound by the statutes' restrictions on contract assignments.[37] Though the Acts prevent the unilateral transfer or modification of defense contracts, they do not prohibit entire companies from being reorganized and resold, effectively allowing private equity firms to extract value and exit without accountability.[38] Despite being the primary drivers of defense contractor bankruptcies, private equity firms remain beyond the reach of either legal regime. This regulatory gap demands immediate scrutiny and legislative action.

This Article investigates how private equity drives defense contractor bankruptcies in ways that endanger national security and what regulators can do to stop it. The discussion is structured into four parts. Part I provides a factual overview of private equity's role in the defense industry, addressing three key questions: What makes private equity firms unique? How do they heighten bankruptcy risks for the companies they acquire? Why have they come to dominate the defense industry? These questions reveal the political-economic underpinnings of private

36. See *infra* Part I.B for a discussion of how the involvement of private equity increases default risk. For further background on how LBOs lead to prolonged financial distress and heighten bankruptcy risk, see generally Brian Ayash & Mahdi Rastad, *Leveraged Buyouts and Financial Distress*, FIN. RSCH. LETTERS, Jan. 2021.

37. The Anti-Assignment Acts do not prohibit contract transfers that occur "by operation of law," including those transferring a target company's contracts to a successor-in-interest through a corporate merger. *See* Liberty Ammunition, Inc. v. United States, 101 Fed. Cl. 581, 589 (2011) ("Perhaps the most significant exception [to the Anti-Assignment Acts] . . . is when transfer of a . . . contract is effected by consolidation or merger to the successor of a claimant corporation." (citing Tuftco Corp. v. United States, 614 F.2d 740, 745 (Ct. Cl. 1980))).

38. *See* L-3 Commc'ns Integrated Sys., L.P. v. United States, 84 Fed. Cl. 768, 777 (2008) ("Where a transfer is incident to the sale of an entire business or the sale of an entire portion of a business, . . . the assignment is exempt from the anti-assignment statute." (citing Lyons Sec. Servs., Inc. v. United States, 38 Fed. Cl. 783, 786 (1997))).

equity's rise, setting the stage for a deeper analysis of its ramifications for the national security regime.

Part II explores the consequences of private equity's dominance through three case studies, each representing a distinct archetype of defense contractor bankruptcy linked to private equity ownership: bankruptcy driven by excessive debt accumulation, bankruptcy caused by private equity mismanagement, and insolvency shaped by misaligned incentives. These case studies offer insights into how private-equity-induced financial distress can undermine the stability of defense contractors, creating unique supply chain vulnerabilities that threaten national security.

Part III examines the existing legal framework governing defense contractor bankruptcies, focusing on the intersection between the Bankruptcy Code and the Anti-Assignment Acts. Although these statutory regimes were designed with distinct legislative objectives,[39] the rising tide of defense contractor bankruptcies has placed them in direct conflict, where enforcing one undermines the other. This Part also evaluates how courts have attempted, but ultimately failed, to resolve this conflict through statutory interpretation. Struggling to reconcile the text and purpose of these statutes, courts have often introduced greater legal uncertainty, compounding the very issues they seek to resolve.

Part IV argues that this failure stems from a fundamental disconnect between legislative intent and the contemporary realities of defense outsourcing. Congress originally sought to safeguard national security by keeping business out of defense.[40] Yet, as the federal government deepens its reliance on private contractors, the line between business and defense has blurred. Current judicial attempts to redraw this line have largely proven futile given this shifting reality. To tackle the root cause of this issue, this Article proposes a new legal mechanism for ex ante private equity risk mitigation in defense contractor acquisitions.

39. *See infra* Part III.A for a comparison of the Bankruptcy Code and Anti-Assignment Acts.

40. *See infra* Part IV for a discussion of congressional intent in creating these distinct legal frameworks.

I. THE RISE OF PRIVATE EQUITY IN THE DEFENSE INDUSTRY

Private equity has become a dominant force reshaping the U.S. defense industry. Since the turn of the century, private equity firms have gobbled up defense contractors via LBOs at an alarming pace, growing from only a few takeovers in 2000 to executing more than forty percent of all acquisitions in the defense industry by 2024.[41] These takeovers are almost entirely financed with debt, exposing defense contractors to heightened risks of financial distress and insolvency.[42] Unlike publicly listed companies, private equity firms operate under a veil of secrecy due to exemption from public financial reporting obligations.[43] While this trend extends beyond the defense industry, it poses unique national security risks because it can jeopardize defense-critical assets vital to U.S. military operations, both domestic and overseas.[44]

This trend warrants regulatory scrutiny. Yet, current research on the scale and impact of private equity involvement in the defense industry remains inadequate. To address this gap, this Part explores the causes and consequences of private equity takeovers of defense contractors in three Sections: Section A outlines the business model and legal characteristics of private equity. Section B examines the heightened bankruptcy risks and financial failures linked to these takeovers. Section C analyzes their broader implications for the defense industry.

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41. *See* Echols, *supra* note 4 (pegging the beginning of private equity's involvement with defense contractors to the 2000s); Dylan Thomas & Neel Hiteshbhai Bharucha, *PE Defense Investment Surges in Early 2025 as Geopolitics Drives Change*, S&P GLOB. (Mar. 21, 2025), https://www.spglobal.com/market-intelligence/en/news-insights/articles/2025/3/pe-defense-investment-surges-in-early-2025-as-geopolitics-drives-change-88086420 [https://perma.cc/2Y4T-7GLN] (charting the number and value of deals completed by private equity and venture capital by year); Mahoney et al., *supra* note 5, at 365 (noting that private equity accounted for forty percent of acquisitions in the U.S. defense industry in recent years).

42. *See* Mahoney et al., *supra* note 5, at 364 ("In a leveraged buyout, a private equity firm typically uses 60 to 90 percent debt capital to finance the acquisition of a company.").

43. *See* Lorenzo Scarazzato & Madison Lipson, *Going Private (Equity): A New Challenge to Transparency in the Arms Industry*, SEC. IN CONTEXT, Aug. 14, 2023, at 2, 6 (2023).

44. *Id.* at 2.

A. WHAT IS PRIVATE EQUITY?

Private equity firms are investment management companies that specialize in buying and selling businesses.[45] Private equity ranks among the fastest growing and most profitable sectors of the economy.[46] In 2024, the U.S. private equity market recorded $460 billion in deal volume and is projected to grow at a compound annual rate exceeding ten percent through 2030.[47] Companies like Blackstone, Carlyle, KKR, Bain Capital, and Apollo Global Management dominate the market.[48] What sets private equity firms apart from typical business acquirers is their unique business model and distinct legal status under federal securities laws.[49]

The core business model of a private equity firm revolves around buying businesses, repackaging them into portfolio companies, increasing their value through high-risk management tactics, and cashing out.[50] Unlike typical business acquirers that "buy to keep," private equity firms "buy to sell."[51] Private equity firms are "financial buyers"—business acquirers aiming for short-term investment return—as opposed to "strategic buyers"

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45. *See* James Chen, *Private Equity Explained with Examples and Ways to Invest*, INVESTOPEDIA (last updated Sept. 2, 2025), https://www.investopedia.com/terms/p/privateequity.asp [https://perma.cc/NH5L-VR7C].

46. *United States Private Equity Market Competition, Forecast and Opportunities, 2024-2025 & 2030: Growing Trend Towards ESG Integration, Private Equity Firms Targeting Middle-Market Opportunities*, YAHOO! FIN. (Jan. 31, 2025), https://finance.yahoo.com/news/united-states-private-equity-market-134100186.html [https://perma.cc/3W2K-6NG9].

47. *United States Private Equity Market Size & Share Analysis – Growth Trends & Forecasts (2025-2030)*, MORDOR INTEL. (last updated June 16, 2025), https://www.mordorintelligence.com/industry-reports/united-states-private-equity-market/market-size [https://perma.cc/MT6U-3ZU8].

48. *See* Chris Morran & Daniel Petty, *What Private Equity Firms Are and How They Operate*, PROPUBLICA: REGUL. (Aug. 3, 2022), https://www.propublica.org/article/what-is-private-equity [https://perma.cc/DKR9-MYUN] (noting these firms typify the private equity industry).

49. *See infra* notes 50–69 (discussing unique aspects of private equity).

50. Private equity firms typically cash out their portfolio companies through one of six ways: initial public offering, trade sale, secondary sale, recapitalization, management buyout, or liquidation. *6 Private Equity Exit Strategies for PE Investors*, ENTRUST GRP. (July 19, 2024), https://www.theentrustgroup.com/blog/private-equity-exit-strategies [https://perma.cc/VS8V-WF49].

51. *See* Felix Barber & Michael Goold, *The Strategic Secret of Private Equity*, HARV. BUS. REV.: PRIV. EQUITY (Sept. 2007), https://hbr.org/2007/09/the-strategic-secret-of-private-equity [https://perma.cc/CW9D-WDBP] (comparing the buy to sell model to an embedded buy to keep strategy).

who acquire firms to capture long-term post-merger synergies in the same industry.[52] On average, private equity firms hold acquired businesses for three to five years before resale.[53] For instance, private equity giant Blackstone, a "financial buyer," acquired auto manufacturer TRW Automotive from defense contractor Northrop Grumman in 2002,[54] only to resell it to German car parts manufacturer ZF Friedrichshafen in 2015.[55] In contrast, Lockheed Martin, a "strategic buyer," acquired aircraft manufacturer Sikorsky to vertically integrate its aerospace supply chain.[56]

The defining legal characteristic of private equity is its inaccessibility to public investors.[57] Under section 3(c)(1) of the Investment Company Act,[58] private equity firms are exempt from Securities and Exchange Commission (SEC) registration if they have no more than 100 beneficial owners, all of whom qualify as

52. *Strategic vs Financial Buyer*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/valuation/strategic-buyer-vs-financial-buyer [https://perma.cc/N7HL-EFK4].

53. *How Long Does a Private Equity Group Wait Before Selling Your Company Again?*, CLEARRIDGE, https://clearridgecapital.com/articles/how-long-does-a-private-equity-group-wait-before-selling-your-company-again [https://perma.cc/35EK-JSMP] (finding that private equity companies tend to keep acquisitions for longer than many expect).

54. *Northrop Grumman to Sell TRW's Automotive Business to The Blackstone Group*, BLACKSTONE (Nov. 19, 2002), https://www.blackstone.com/news/press/northrop-grumman-to-sell-trws-automotive-business-to-the-blackstone-group [https://perma.cc/LF3U-FU29] (announcing that Blackstone raised the biggest private equity fund and that TRW was its first purchase).

55. *ZF Completes Acquisition of TRW Automotive*, AUTO. WORLD (May 15, 2015), https://www.automotiveworld.com/news-releases/zf-completes-acquisition-trw-automotive [https://perma.cc/KND2-KV5Z].

56. *See* Press Release, Lockheed Martin, Lockheed Martin to Acquire Sikorsky Aircraft and Conduct Strategic Review of IT and Technical Services Business (July 20, 2015), https://news.lockheedmartin.com/2015-07-20-Lockheed-Martin-to-Acquire-Sikorsky-Aircraft-and-Conduct-Strategic-Review-of-IT-and-Technical-Services-Businesses [https://perma.cc/VY25-8QU2] (highlighting the asset that the acquisition would be to Lockheed Martin's expanding portfolio).

57. *See infra* notes 58–64 (explaining why private equity funds restrict access to private institutional investors).

58. *See* 15 U.S.C. § 80a-3(c)(1) (exempting "[a]ny issuer whose outstanding securities . . . are beneficially owned by not more than one hundred persons" from requirements of the Investment Company Act).

"accredited investors."[59] Accredited investors are high net-worth individuals, entities, banks, or SEC-registered broker-dealers.[60] Similarly, under section 4(a)(2) of the Securities Act,[61] private equity firms are exempt from publicly disclosing financial information about the companies they acquire, provided that they pool capital exclusively from "accredited investors."[62] To comply with these requirements, private equity firms establish investment funds that restrict access to private institutional investors.[63] These funds are typically structured as limited partnerships, granting investors rights to profits but not decision-making authority.[64] This exclusivity sharply contrasts with publicly listed companies, which raise capital through issuing publicly traded securities and are subject to stringent SEC registration and periodic disclosure mandates.[65] Unlike private equity

59. *See* Holli Heiles Pandol, *Sections 3(c)(1) and 3(c)(7) of the Investment Company Act*, CARTA (Apr. 17, 2025), https://carta.com/learn/private-funds/regulations/3c1-3c7 [https://perma.cc/LA9V-8FZP] (describing the requirements of exemption under section 3(c)(1)).

60. *See* James Garrett Baldwin, *How to Become an Accredited Investor*, INVESTOPEDIA (last updated Sept. 9, 2024), https://www.investopedia.com/articles/investing/092815/how-become-accredited-investor.asp [https://perma.cc/7YZZ-KWCY] (locating the requirements for being an "accredited investor" in rule 501 of Regulation D of the Securities Act of 1933).

61. Section 4(a)(2) of the Securities Act of 1933 exempts from registration "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(a)(2). It permits an issuer to sell securities in a "private placement" without registering with the SEC. *Private Placements - Rule 506(b)*, U.S. SEC. & EXCH. COMM'N (Nov. 14, 2024), https://www.sec.gov/resources-small-businesses/exempt-offerings/private-placements-rule-506b [https://perma.cc/MFJ7-B9W4]; *see* § 77d(a)(3). Under the SEC's private placement safe harbor, "[c]ompanies conducting an offer under Rule 506(b) can raise an unlimited amount of money and can sell securities to an unlimited number of accredited investors." *Private Placements - Rule 506(b)*, *supra*.

62. To qualify as an "accredited investor," the individual must have a net worth in excess of one million dollars. *See "Accredited Investor" Net Worth Standard*, U.S. SEC. & EXCH. COMM'N (last updated Feb. 5, 2024), https://www.sec.gov/resources-small-businesses/small-business-compliance-guides/accredited-investor-net-worth-standard [https://perma.cc/4P7T-8MCH].

63. *See id.* (alerting issuers of the requirement to "know or have a reasonable basis to believe" that investors in their unregistered or illiquid securities are accredited investors).

64. Mike Hinckley, *How Are Private Equity Funds Structured? A Complete Overview*, GROWTH EQUITY INTERVIEW GUIDE (last updated May 29, 2025), https://growthequityinterviewguide.com/private-equity-fund-structure [https://perma.cc/27UF-PBHN].

65. *See* Pamela Espinosa, *Private vs Public Equity*, MOONFARE (last updated July 2, 2025), https://www.moonfare.com/pe-masterclass/private-vs

transactions, M&A deals involving publicly listed companies must adhere to the SEC's financial reporting obligations, ensuring greater transparency.[66]

These distinctive features of private equity—business short-termism and legal exclusivity—make it the ideal vehicle for debt-financed M&A deals. Business short-termism incentivizes high-risk, high-return acquisition strategies centered on the aggressive use of debt, which offers tax advantages over traditional equity-based financing.[67] Meanwhile, legal exclusivity allows private equity firms to pool capital from a restricted "club" of sophisticated investors, without being burdened by the stringent disclosure requirements of federal securities laws.[68] Corporate debt is particularly attractive to private equity because it remains inaccessible to public investors and benefits from favorable treatment under U.S. tax law.[69]

Private equity's preference for debt drives its aggressive use of LBOs.[70] A typical LBO is structured with approximately "90%

-public-equity [https://perma.cc/W6VQ-YY8B] (outlining the funding mechanism and financial disclosures that public companies must make).

66. *See Public Companies*, U.S. SEC. & EXCH. COMM'N (last updated Aug. 8, 2025), https://www.sec.gov/resources-small-businesses/capital-raising-building-blocks/public-companies [https://perma.cc/5ZWT-A772] ("To register its offering, a company must file a registration statement with the SEC that provides business and financial information.").

67. Debt financing receives preferential treatment under U.S. tax law. Businesses can deduct interest payments on loans or bonds, reducing the overall cost of financing. In contrast, equity financing incurs higher tax liabilities because dividend payments are not tax-deductible. Additionally, equity financing for C-corporations is subject to double taxation: first, on the corporation's earnings and, again, when dividends are distributed to investors. Heather B. Jourdan, *Tax Implications of Debt and Equity Financing*, CARR, RIGGS & INGRAM (Nov. 15, 2023), https://www.criadv.com/insight/tax-implications-of-debt-and-equity-financing [https://perma.cc/BWM6-5B8A].

68. *See* Elizabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 447–48 (2017) (discussing how private companies utilize exemptions from federal securities laws to raise capital from a select group of investors without adhering to the stringent disclosure requirements imposed on public companies).

69. Jourdan, *supra* note 67.

70. *See* Himani Singh, *Evolution of Leveraged Buyouts: A New Era or Back to Square One?*, N.Y.U. J.L. & BUS. ONLINE (Jan. 18, 2020), https://www.nyujlb.org/single-post/2020/01/18/evolving-of-leveraged-buyouts-a-new-era-or-back-to-square-one [https://perma.cc/9F49-7QUJ] ("[N]on-banks are the most aggressive lenders similar to the subprime lenders and CLO issuance has been increasing significantly.").

debt and 10% equity."[71] However, not all debt is the same. The types of debt utilized vary based on the risk tolerance of the private equity firm and their investors.[72] To finance an LBO, private equity firms typically issue multiple tranches of debt.[73] The five most common types include: revolving credit facilities, bank loans, high-yield bonds, mezzanine debt, and seller's notes.[74]

Revolving Credit Facilities are lines of credit that allow the borrower to draw funds as needed and repay them once excess cash is available, functioning similarly to a credit card.[75] They offer borrowers flexibility in managing short-term capital needs and provide quick access to cash without requiring new debt issuances.[76] However, they are expensive, often carrying high interest rates and commitment fees paid to the lender for unused funds.[77] Due to their costliness, revolving credit facilities are typically reserved only for more complex LBOs where financial flexibility is essential.[78]

Bank Loans are secured debt extended by depositary financial institutions, typically federally chartered banks.[79] They are usually senior in the capital structure, meaning that they hold repayment priority over junior debt in the event of default.[80]

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71. Ivy Wang, *Leveraged Buyout*, FIN. EDGE (Apr. 14, 2022), https://www.fe.training/free-resources/lbo/leveraged-buyout [https://perma.cc/4TPL-ZMDX].

72. *See id.* (describing the risks associated with each type of debt).

73. *See id.*

74. *See id.*

75. *See Transaction Structuring: Types of Debt in a Leveraged Buyout*, SYMMETRICAL M&A ADVISORY [hereinafter *Transaction Structuring*], https://symmetricaladvisory.com/transaction-structuring-types-of-debt-in-a-leveraged-buyout [https://perma.cc/452V-24ZX].

76. *See id.*

77. *See* Matt, *LBO Modelling: Bank Revolver, Minimum Cash Balance and Cash Sweep*, SELL SIDE HANDBOOK (Nov. 23, 2017), http://sellside handbook.com/2017/11/23/lbo-modelling-bank-revolver-minimum-cash -balance-cash-sweep [https://perma.cc/ART3-2YKX].

78. *See* Julia Kagan, *Revolving Loan Facility Explained: How Does it Work?*, INVESTOPEDIA (last updated Aug. 2, 2025), https://www .investopedia.com/terms/r/revolving-loan-facility.asp [https://perma.cc/W6L9 -9NMG].

79. *See Capital Structure of an LBO*, MACABACUS, https://macabacus .com/valuation/lbo-capital-structure [https://perma.cc/4MT5-L6VP].

80. *See id.* (discussing how bank debt is secured by the financial institution).

Structured as term loans,[81] bank loans carry relatively low interest rates but come with significant trade-offs. Borrowers must pledge assets as collateral, comply with restrictive financial covenants, and adhere to strict repayment schedules.[82] While commonly used in LBOs, bank loans are often combined with other forms of debt—such as high-yield bonds—to complete the financing package.[83]

High-Yield Bonds (or junk bonds) are unsecured debt instruments that offer high interest rates to compensate for their elevated credit risk.[84] They are typically junior to bank loans in repayment priority, meaning their rightsholders are repaid only after senior obligations are fully satisfied in the event of default.[85] The SEC defines high-yield bonds as debt securities rated below "investment-grade" by the major credit rating agencies.[86] Although risky, they attract investors with the potential for high returns. Since the early 1980s, high-yield bonds have been a primary source of debt capital for LBOs[87] and remain a dominant financing tool in private equity today.[88]

Mezzanine Debt is a hybrid debt instrument that combines elements of high-yield bonds with an equity conversion option, which allows investors to convert debt into equity at a predetermined price.[89] It occupies the middle layer of the capital

81. *See id.* For background, term loans are loans where the borrower receives a lump sum money upfront and repays the debt in fixed installments over a specified repayment schedule.

82. *See id.*

83. *See Transaction Structuring*, *supra* note 75 (referencing how transactions combine "multiple types of debt" to complete a transaction).

84. *See id.*

85. *See* 11 U.S.C. § 507(a).

86. *What Are High-Yield Corporate Bonds?*, SEC. & EXCH. COMM'N: OFF. OF INV. EDUC. & ADVOC. (2013), https://www.sec.gov/files/ib_high-yield.pdf [https://perma.cc/LDT4-MVZ3].

87. *See* Singh, s*upra* note 70 ("The first LBO wave started in early 1980s with high yield bonds invented by Michael Milken (commonly called 'junk bonds') being an essential source of financing.").

88. *See U.S. Leveraged Loan and High Yield M&A and LBO Activity Rises in 3Q24*, FITCH RATINGS (Oct. 31, 2024), https://www.fitchratings.com/research/structured-finance/us-leveraged-loan-high-yield-m-a-lbo-activity-rises-in-3q24-31-10-2024 [https://perma.cc/2MSC-AKQN] ("U.S. high-yield (HY) bond issuance totaled $74.5 billion in 3Q24 comprised predominantly of refinancing and repricing activity.").

89. Wang, *supra* note 71.

structure, bridging the gap between debt and equity.[90] Like high-yield bonds, mezzanine debt is junior and unsecured, but it offers greater flexibility in terms and structure.[91] However, mezzanine debt lacks the liquidity of high-yield bonds because it is typically customized for each lender and difficult to trade on secondary markets.[92]

Seller's Notes are subordinated promissory notes that sit at the bottom of the repayment hierarchy.[93] Subordination means the debt ranks below other obligations in repayment priority by contractual agreement.[94] Private equity firms often use seller's notes to acquire smaller businesses on a quick turnaround, since their straightforward, boilerplate terms make them easier and faster to access than other forms of debt.[95] While simpler to structure than high-yield bonds or mezzanine debt, seller's notes carry higher credit default risk.[96]

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90. *See* Tim Vipond, *LBO Model*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/financial-modeling/lbo-model [https://perma.cc/94UV-HRH5] ("Mezzanine debt is a small middle layer in the LBO capital structure that is a hybrid of debt and equity and is junior or subordinate to other debt financing options.").

91. Mezzanine debt often includes warrants, which are embedded equity instruments that give lenders the right to purchase equity in the company at a predetermined price. These warrants enhance the value of the subordinated debt, providing additional upside for investors and offering greater flexibility in dealing with bondholders. *See* Adam Hayes, *Understanding Mezzanine Financing: How It Works and Its Uses*, INVESTOPEDIA (last updated Aug. 20, 2025), https://www.investopedia.com/terms/m/mezzaninefinancing.asp [https://perma.cc/5NQR-LYXV].

92. *See* Arthur D. Robinson et al., *Mezzanine Finance: Overview*, PRAC. L. CO. (2013), https://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/pub1580.pdf [https://perma.cc/QB4C-EJ5S] ("[M]any mezzanine investments have limited liquidity.").

93. *See* Sharvari Desai, *Why Seller Note is a Win-Win Alternative?*, COLUM. PAC. CAP. PARTNERS, https://cpcp.ca/investment-banking/ma/why-seller-note-is-a-win-win-alternative [https://perma.cc/76NA-Q2LC] ("Seller Note is a provision where the seller of the business pays some portion of the purchase price in the form of a promissory note.").

94. James Chen, *Subordinated Debt: What It Is, How It Works, Risks*, INVESTOPEDIA (last updated Aug. 8, 2025), https://www.investopedia.com/terms/s/subordinateddebt.asp [https://perma.cc/F9Q7-BCZU].

95. *See* Brian Dukes, *Seller Notes in M&A Transactions Explained in Simple Terms*, EXITWISE, https://exitwise.com/blog/seller-notes [https://perma.cc/5UJ8-TCC9] ("Seller notes are prevalent in small business acquisitions because they mutually benefit both the seller and buyer.").

96. *See* Fitz Dickes, *Seller Notes: What Are They Are and How They Work*, HADLEY CAP. (July 26, 2021), https://www.hadleycapital.com/insights/selling-a-

This variety of debt capital enables private equity firms to structure LBOs with maximum flexibility, allowing them to secure more funding than other financing strategies. Through LBOs, private equity firms can acquire companies significantly larger than themselves while committing minimal capital of their own.[97]

B. HOW PRIVATE EQUITY INCREASES BANKRUPTCY RISK

Private equity's aggressive use of LBOs significantly increases the bankruptcy risks of the target company. In 2024, companies owned by private equity firms "accounted for 16% of all U.S. bankruptcy filings"—the "largest share" of corporate bankruptcies since 2010.[98] Across industries, "private equity-owned companies are twice as likely" to file for bankruptcy as publicly-listed companies, primarily due to the heavy debt loads associated with LBOs.[99] "Approximately 20% of large [companies acquired through LBOs] go bankrupt within ten years," compared to a 2% bankruptcy rate for companies acquired through other financing methods.[100] As illustrated by Figure 1 below, bankruptcies among private equity-owned companies are on track to reach a fourteen-year high.[101]

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small-business/seller-notes#section-4 [https://perma.cc/A2M8-SR4R] ("Most seller notes are unsecured. This means if the business were to fail, and the seller note defaults, there may not be any collateral to cover the seller note.").

97. *See What is LBO (Leveraged Buyout)? Explanation of Its Mechanism, Advantages, Disadvantages*, INMERGERS (June 24, 2025), https://inmergers.com/en/lbo-leveraged-buyout [https://perma.cc/UAF8-KV4G] ("LBOs allow acquirers to purchase larger companies using limited equity capital.").

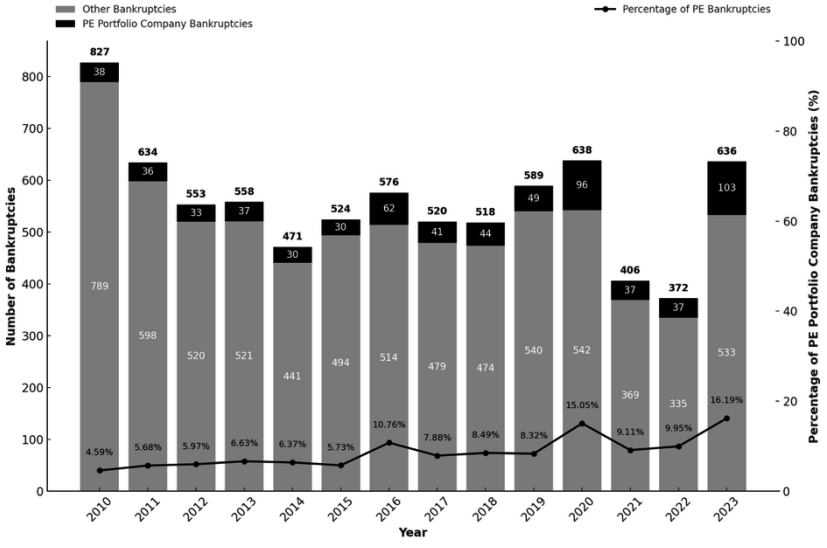
98. Dylan Thomas & Annie Sabater, *Private Equity Portfolio Company Bankruptcies Maintain Record Pace*, S&P GLOB. (May 15, 2024), https://www.spglobal.com/market-intelligence/en/news-insights/articles/2024/5/private-equity-portfolio-company-bankruptcies-maintain-record-pace-81665915 [https://perma.cc/HH8E-T73A].

99. Valentina Dabos, *Don't Blame the Shrimp: How Private Equity Is Bankrupting America*, PRIV. EQUITY STAKEHOLDER PROJECT: NEWS & BLOG (June 20, 2024), https://pestakeholder.org/news/dont-blame-the-shrimp-how-private-equity-is-bankrupting-america [https://perma.cc/8XF6-QBM6].

100. Alicia McElhaney, *LBOs Make (More) Companies Go Bankrupt, Research Shows*, INSTITUTIONAL INV. (July 26, 2019), https://www.institutionalinvestor.com/article/2bswdyzrxjjh0cc1n1lvk/corner-office/lbos-make-more-companies-go-bankrupt-research-shows [https://perma.cc/K6NA-7KFM].

101. Figure 1 is created based on a study by S&P Global. *See* Thomas & Sabater, *supra* note 98.

Figure 1. Bankruptcy Filings of U.S. Private Equity Portfolio Companies (2010-2023)



What explains the link between the rise in LBOs and the heightened bankruptcy rates of private equity-owned companies? While the causal mechanism remains a subject of debate, scholars point to two key factors: debt overhang and interest rate risk. Debt overhang occurs when the borrower incurs so much debt that it cannot attract new investments.[102] Interest rate risk, on the other hand, arises when debt accumulation makes the borrower vulnerable to interest rate fluctuations.[103]

Debt Overhang is the phenomenon whereby the cost of securing new investment necessary for business operations is increased because the existing debt obligations receive priority on

102. *See Debt Overhang*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/commercial-lending/debt-overhang [https://perma.cc/5FH5-KAUU] ("When an organization . . . incurs debt at such a high rate that they incur too much debt and are unable to fund future projects.").

103. *See* Julien Fissette, *The Advantages and Risks of Leveraged Buyouts*, ROUNDTABLE (Mar. 20, 2024), https://www.roundtable.eu/learn/the-advantages-and-risks-of-leveraged-buyouts [https://perma.cc/8GH4-TKWV] ("[V]ariable interest rates amid economic fluctuations could exacerbate [a company's] financial challenges.").

generated returns.[104] This makes investors reluctant to provide funding unless offered exceptionally high returns.[105] As a result, debt overhang incentivizes companies to make inefficient decisions that undermine long-term value. To meet debt obligations, companies may cut essential expenditures that maintain enterprise value, lay off employees, or sell assets piecemeal.[106] Additionally, debt overhang often encourages companies to distribute earnings as dividends to shareholders rather than reinvesting them as working capital to generate future income.[107] In short, debt overhang "distorts" a company's financial priorities and spending decisions, increasing the likelihood of bankruptcy.[108]

Interest Rate Risk refers to the potential for fluctuating market interest rates to increase the cost of servicing existing debt obligations, reducing aggregate enterprise value.[109] In the context of LBOs, where companies take on substantial debt, this risk is magnified. Even minor increases in market interest rates can sharply raise repayment costs, increasing the likelihood of financial distress.[110] This issue is exacerbated by the fact that most common debt types used in LBOs—other than high-yield bonds—are based on variable interest rates rather than fixed

104. *See* Thomas Philippon, *The Macroeconomics of Debt Overhang*, INT'L MONETARY FUND 2 (2009), https://www.imf.org/external/np/res/seminars/2009/arc/pdf/Philippon.pdf [https://perma.cc/L62Z-FHUK] ("Firms in financial distress find it difficult to raise capital for new investments because the proceeds from these new investments mostly serve to increase the value of the existing debt instead of equity.").

105. *See id.*

106. *See* Markus Brunnermeier & Arvind Krishnamurthy, *Corporate Debt Overhang and Credit Policy*, 2 BROOKINGS PAPERS ECON. ACTIVITY 447, 452, 472 (2020) ("Firms will choose enterprise value-reducing actions, such as laying off employees, selling assets piecemeal, and forgoing maintenance investments in this case.").

107. *See id.* at 472.

108. *Id.* ("Debt overhang distorts this investment decision by raising the right-hand side of this expression leading firms to forgo investments that increase the entire firm value.").

109. *See* James Chen, *Interest Rate Risk: Definition and Impact on Bond Prices*, INVESTOPEDIA (last updated June 26, 2025), https://www.investopedia.com/terms/i/interestraterisk.asp [https://perma.cc/R8DF-L6DY] ("Interest rate risk is the potential for investment losses that can be triggered by a move upward in the prevailing rates for new debt instruments.").

110. *See Types of LBO Risk*, M&C PARTNERS, https://mecpartners.it/en/types-of-lbo-risk [https://perma.cc/LK6T-335D] (stating that increases in interest rate can cause a firm to go into bankruptcy).

rates.[111] A variable rate loan is one "where the interest rate changes according to changes in market interest rates."[112] "Unlike a fixed rate loan," which maintains a constant interest rate over time, variable rate instruments fluctuate according to market conditions, resulting in changing monthly interest payments.[113] Typically, lenders determine variable rate interests by adding a customized margin to a market benchmark, such as the Secured Overnight Financing Rate (SOFR).[114] This structure—commonly referred to as "SOFR plus"—means borrowers are exposed to both the market base rate and the added margin.[115] As a result, even modest increases in SOFR due to macroeconomic shifts can dramatically inflate repayment costs. In a typical LBO scenario with a 9:1 debt-to-equity ratio, such changes can multiply debt servicing burdens by up to nine times, pushing companies to the brink of bankruptcy.[116]

Why, then, do private equity LBOs continue to soar despite their strong association with heightened bankruptcy risks? The answer lies in how private equity conceals bankruptcy risk and shields itself from financial fallout by structuring LBOs to be

111. Jeremiah S. Lane et al., *Fixed or Floating: How We're Assessing Relative Value in Leveraged Credit*, KOHLBERG KRAVIS ROBERTS & CO.: INV. INSIGHTS (Oct. 2023), https://www.kkr.com/insights/fixed-or-floating-assessing-relative-value-in-leveraged-credit [https://perma.cc/3ENL-VYZP].

112. *Variable Rate Loans*, CORP. FIN. INST. (last updated Aug. 21, 2025), https://corporatefinanceinstitute.com/resources/commercial-lending/variable-rate-loans [https://perma.cc/88U3-JCG5].

113. *Id.*

114. SOFR is an interest rate that banks use to price "dollar-denominated derivatives and loans." Cedric Thompson, *Secured Overnight Financing Rate (SOFR) Definition and History*, INVESTOPEDIA (last updated June 2, 2025), https://www.investopedia.com/secured-overnight-financing-rate-sofr-4683954 [https://perma.cc/9HJN-UK3P]. The daily SOFR is based on transactions in the Treasury repurchase market, where investors offer banks overnight loans backed by their bond assets. *See id.*

115. *See* Joyce Frost, *SOFR Loans Are Here: SOFR Credit Adjustment Spread*, ASS'N FOR FIN. PROS. (Feb. 7, 2022), https://www.afponline.org/training-resources/resources/articles/details/sofr-loans-are-here-what-you-need-to-know-now [https://perma.cc/B6ET-M6CF] (describing the formula for SOFR adjustments).

116. *See* Michael C. Jensen, *Active Investors, LBOs, and the Privatization of Bankruptcy*, *in* FOUNDATIONS OF CORPORATE LAW 135 (Roberta Romano ed., 1st ed. 1993) ("The debt-to-value ratio in the business units of these organizations average close to 90 percent on a book value basis.").

"bankruptcy-remote."[117] In an LBO, the debt is shifted to the balance sheet of the target company, which is structured as a separate portfolio company.[118] To further insulate themselves from default risks, private equity firms often set up "limited liability special purpose vehicles (SPVs) to [own these] portfolio compan[ies]."[119] After the acquisition, the portfolio company is solely responsible for repaying the debt.[120] The private equity firm itself bears no obligation for repayment. In the event of default, creditors are limited to enforcing their claims against the portfolio company's assets.[121] They have no recourse against the private equity firm or the SPV's assets.[122] This "bankruptcy-remoteness" allows private equity firms to extract substantial profits from LBOs while shielding themselves from the associated bankruptcy risks.[123]

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117. "Bankruptcy remoteness" describes "the combination of rights, duties, and covenants found in the organizational documents or loan documents of a legal entity intended to minimize the risk that the entity will enter into bankruptcy, either voluntarily or involuntarily." Comm. on Securitization & Structured Fin., *Bankruptcy Remoteness: A Summary Analysis*, 77 A.B.A. BUS. L. SEC. 1105, 1105 (2022); *see also In re* Gen. Growth Props., Inc., 409 B.R. 43, 49 n.15 (Bankr. S.D.N.Y. 2009) (defining a "bankruptcy remote entity" as "[a] entity . . . one purpose of which is to isolate the financial assets from the potential bankruptcy estate of the original entity" which minimizes the risk of becoming a debtor in a bankruptcy case).

118. *See Accounting for Rising Leveraged Buyout Activity*, EUR. CENT. BANK 172 (2007), https://www.ecb.europa.eu/pub/pdf/fsr/art/ecb.fsrart200706_05.en.pdf [https://perma.cc/JKY2-HPAB] ("The debt usually appears on the acquired company's balance sheet and its free cash flow is used to repay the debt.").

119. Bobby V. Reddy, *Private Equity and Net Asset Value Debt—Ripping-Up the Rules of Private Equity*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 15, 2024), https://corpgov.law.harvard.edu/2024/07/15/private-equity-and-net-asset-value-loans-ticking-time-bomb-or-ticking-all-the-right-boxes [https://perma.cc/G2SS-RW7J].

120. *See id.* ("[T]he relevant portfolio company guarantees the repayment of the debt used for its acquisition.").

121. *See id.* ("If there is a default on the acquisition debt, the relevant lender can only enforce against the assets of the portfolio company for which the debt was incurred to acquire.").

122. *See id.* ("[The lender] cannot attach to any other assets of the fund, including any other portfolio company owned by the fund.").

123. The "bankruptcy-remoteness" of SPVs is ensured by an "array of constraints designed to eliminate, to the extent possible, the risk [of the SPV] . . . becom[ing] subject to a proceeding under the Bankruptcy Code" in the future, "whether involuntarily, voluntarily, or through the [SPV] being substantively consolidated with [the subsidiary] in the event of [the subsidiary's] bankruptcy." Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of*

Because private equity firms are insulated from the bankruptcy risks of LBOs, these transactions often distort the financial management of target companies.[124] When an LBO "is financed almost entirely by debt"—or when the private equity firm quickly extracts value "through dividends, management fees, or [other similar] device[s]" after the LBO—the private equity firm enjoys all the upside gains without any "downside risk of loss."[125] The private equity firm, "therefore[,] has strong incentives to [direct the target company] to pursue risky strategies,"[126] including incurring additional debt, asset divestitures, or roll-ups.[127]

Financial Product Development, 29 CARDOZO L. REV. 1553, 1564–65 (2008). One of the mechanisms ensuring bankruptcy-remoteness is asset securitization (i.e., the pooling of loans and selling the rights to their repayment as securities to investors as a legally distinct asset bundle), which transfers the SPV's assets out of the reach of the subsidiary's bankruptcy estate. *See id.* at 1565–66. "Because the securitized assets are the property of the [SPV], they will not be part of the [subsidiary's] bankruptcy estate" and are therefore "practically immune from becom[ing] the subject of a bankruptcy proceeding in its own right . . . ." *Id.* at 1566. Asset securitization through SPVs "shield[s] investors from virtually all the credit and litigation risk associated with predatory loans." Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2041 (2007). Private equity firms routinely employ asset securitization to structure their investments as bankruptcy-remote, thereby insulating those assets from the insolvency risks of their portfolio companies. *See* Sandeep Singh Dhaliwal, *Investing in Abolition*, 112 GEO. L.J. 1, 17 (2023) (arguing that "private equity's entrance into [asset securitization] was an intensely intricate and coordinated process, involving legal engineering, underwriting banks, debt investors, property management companies, [and] newly established bankruptcy remote entities"); *see also* Melissa B. Jacoby, Essay, *Fake and Real People in Bankruptcy*, 39 EMORY BANKR. DEV. J. 497, 516 (2023) ("Structures like securitization render assets bankruptcy-remote, bolstered by state commercial laws meant to deter bankruptcy courts from recharacterization.").

124. *See* Samir D. Parikh, *Financial Disequilibrium*, 171 U. PA. L. REV. 1925, 1942 (2023) (describing how private equity disrupts traditional creditor-debtor relationships by insulating itself from downside bankruptcy risk while capturing the upside gains of high-risk financial strategies).

125. Michael Simkovic & Benjamin S. Kaminetzky, *Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution*, 2011 COLUM. BUS. L. REV. 118, 217–18 (2011).

126. *Id.* at 218.

127. Also known as a "roll-over," a roll-up is a financial arrangement in which a debtor in bankruptcy solicits additional financing from some of its existing lenders to pay off existing outstanding debt. This process effectively converts old debt into new debt, typically at higher interest rates or under more burdensome terms. *See* PRAC. L. BANKR. & RESTRUCTURING & PRAC. L. FIN., ROLL-UP DIP FINANCING, Westlaw 1-386-8691.

This misalignment of incentives often harms the target companies' pre-LBO unsecured creditors who receive little to no benefit from the LBO but see the value of their claims diluted.[128] As the company takes on new senior secured debt to finance the acquisition, the priority of unsecured claims is effectively pushed lower in the repayment hierarchy.[129] If the LBO fails and the company enters bankruptcy, unsecured creditors are the ones who bear the losses.[130] In contrast, other parties face minimal or no exposure. Secured creditors are always repaid first in bankruptcy, ahead of unsecured creditors.[131] Whereas the target company's former shareholders—who sold their equity interest at the time of the LBO—have already exited with full payment.[132] As a result, unsecured creditors disproportionately absorb the downside risks of an LBO, without sharing any of the potential upsides.[133]

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128. Unlike secured creditors, whose claims are backed by collateral that can be repossessed upon default, "unsecured creditor[s] rel[y] solely [on] the debtor's promise to repay." Bernard A. Burk, *Preserving the Purchase Money Status of Refinanced or Commingled Purchase Money Debt*, 35 STAN. L. REV. 1133, 1134 (1983). In bankruptcy, unsecured creditors typically recover only "a pro rata share of the debtor's nonexempt assets" remaining after satisfaction of secured creditor and administrative priority claims. *Id.* at 1134–35.

129. *See* Mary Goulet, *The Rights of Debtholders When a Leveraged Corporation Fails*, 15 J. CORP. L. 257, 259 (1990) ("[U]nless the lender's security interest is avoided after an LBO, the corporation has new, secured debt. The existence of this debt would diminish the pro rata recovery of the corporation's unsecured creditors if the corporation were to go bankrupt.").

130. *See id.* ("[C]ritics fear that the LBOs' creation of corporate debt will be the catalyst for a chain reaction of business bankruptcies.").

131. *See* Stephen J. Lubben, *The Overstated Absolute Priority Rule*, 21 FORDHAM J. CORP. & FIN. L. 581, 581 (2016) ("The absolute priority rule describes the basic order of payment in corporate bankruptcy: secured creditors get paid first, unsecured creditors get paid next, and only then do shareholders get paid, if at all."); *see also* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202 (1988) ("[T]he absolute priority rule 'provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property.'" (quoting *In re* Ahlers, 794 F.2d 388, 406 (8th Cir. 1986) (Gibson, J., dissenting))).

132. *See* Femino, *supra* note 11, at 1835 ("It allows the shareholders to cash out in full—at a premium, no less—at the time of the acquisition, while the creditors get paid—if they get paid at all—months after the acquisition when the company finally enters bankruptcy.").

133. *See* John H. Ginsberg et al., *Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justices to Ascertain Fraudulent Transfers in Leveraged Buyouts*, 19 AM. BANKR. INST. L. REV. 71, 78 (2011) ("Because all parties to LBOs enjoy greater returns on risk than unsecured creditors, they expose unsecured creditors to more risk than unsecured creditors would choose for

The unsecured creditors' position is particularly dire if the target company is already near insolvency at the time of the LBO. The Bankruptcy Code's absolute priority rule dictates the order of repayment during restructuring or liquidation. Under the absolute priority rule, shareholders get paid only after all creditors' claims are satisfied in full.[134] Yet, an LBO can subvert this rule. By executing an LBO on the eve of bankruptcy, the private equity firm enables shareholders to cash out fully the moment the target company is acquired.[135] This leaves prior unsecured creditors effectively at the bottom of the repayment hierarchy.[136] If they want to recover anything, they must wait for the company to formally file for bankruptcy—at which point the company's depleted assets often leave them with no meaningful recovery.

C. HOW PRIVATE EQUITY DOMINATES THE DEFENSE INDUSTRY

Over the past two decades, private equity firms have aggressively expanded their footprint in the defense industry through LBOs. Before the 2000s, private equity conducted only a small number of defense industry M&A deals.[137] Since 2002, however, private equity M&A activities have soared, limited only by a brief stint in 2010 due to federal defense budget cuts following the Great Recession.[138] Beyond that dip, private equity takeovers have skyrocketed, showing no signs of slowing down.[139] Figure 2 below illustrates this steady upward trend, underscoring the ascendancy of private equity in the defense industry.[140]

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themselves. The risk to unsecured creditors is a cost of leveraged buyouts that is, in economics parlance, 'externalized' onto unsecured creditors.").

134. *See* 11 U.S.C. § 1129(b)(2) (describing the order in which creditors and shareholder claims are paid in a title 11 bankruptcy proceeding).

135. *See* Femino, *supra* note 11, at 1835 ("It allows the shareholders to cash out in full—at a premium, no less—at the time of the acquisition, while the creditors get paid—if they get paid at all—months after the acquisition when the company finally enters bankruptcy.").

136. *See id.* at 1835 ("The failed LBO described above subverts the absolute priority rule.").

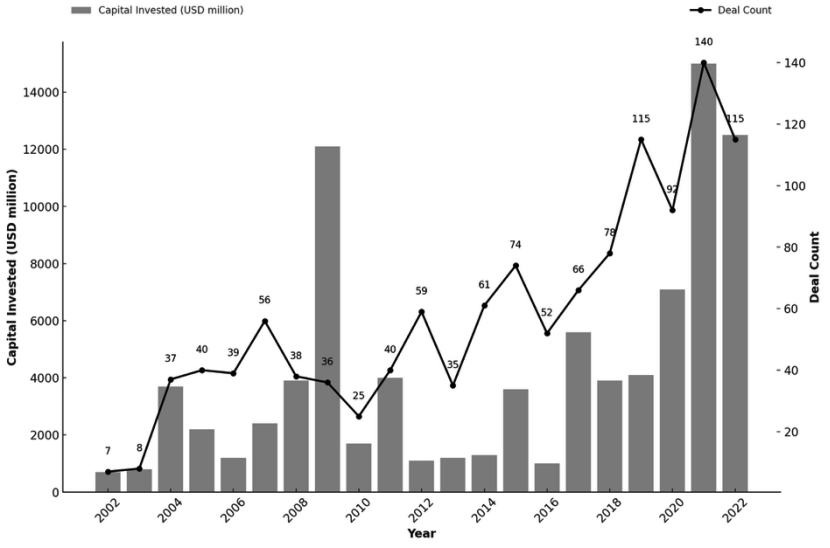
137. *See* Mahoney et al., *supra* note 5, at 365.

138. *See id.* ("In the early 2010s, the Great Recession and federal budget sequestration slowed the pace of private equity deals marginally.").

139. *See id.* ("[B]etween 2015 and 2022, private equity investment in the defense industry climbed again.").

140. Figure 2 is created based on two studies on private equity M&A activity in the U.S. defense industry. *See id.* at 366; *see also* Scarazzato & Lipson, *supra* note 43, at 3.

Figure 2. Number and Value of Private Equity M&A Deals in the Defense Industry (2002-2022)



What explains the surge in private equity M&A activity within the defense industry? Although no single factor fully accounts for this trend, several political-economic conditions have fueled private equity's growing dominance in the sector.

First, the corporate debt market's growing appetite for private credit has driven private equity firms to expand into the defense industry.[141] After the dot-com bubble collapsed in the

141. Traditionally, corporations have borrowed on a secured basis directly from banks. *See generally* Joshua D. Rauh & Amir Sufi, *Capital Structure and Debt Structure*, 23 REV. FIN. STUD. 4242, 4251 (2010). After the 2000s global financial crisis, "syndicated lending had grown to be a multitrillion-dollar market, exceeding the bond market as a source of debt finance for large corporations." Jared A. Ellias & Elisabeth de Fontenay, *The Credit Markets Go Dark*, 134 YALE L.J. 779, 798 (2025). Today, private credit is replacing bank syndication as the dominant form of corporate lending. "Borrowers are choosing private credit loans over alternatives because private credit funds can deploy capital quickly, flexibly, and with greater confidentiality and certainty than is possible in public debt markets." *Id.* at 786. According to Ellias and de Fontenay, "the modal firm may very soon be one that is owned by a private equity fund and financed by a private credit fund." *Id.* at 787. Against this backdrop, private equity has aggressively expanded into the defense industry over the past fifteen years. *See generally* Michael Sion et al., *Rethinking Defense: The Role of Private Capital*, BAIN & CO. (Dec. 31, 2024), https://www.bain.com/insights/rethinking-defense-the-role-of-private-capital [https://perma.cc/265F-ELEQ].

early 2000s, institutional investors sought diversification by turning to private equity firms, known for generating high short-term returns through LBOs.[142] This surge in investor demand pushed private equity into new frontiers, including defense and related industries.[143]

Second, U.S. military involvement in the Middle East has deepened the government's reliance on defense outsourcing, which propelled defense contractors to expand through M&A.[144] The federal defense budget grew rapidly in response to the war on terror and subsequent U.S. military operations in Afghanistan and Iraq.[145] This global expansion of the U.S. military-

142. *See* Hugh H. MacArthur et al., *Global Private Equity Report 2010*, BAIN & CO. 1–2 (2010), https://reseaucapital.com/wp-content/uploads/2020/06/global_pe_report_2010_pr.pdf [https://perma.cc/BZL4-J25A] ("This time, the boom ended when the technology bubble burst and debt markets tightened, followed by the relatively short and shallow recession of 2001. But PE was quick to recover: By 2003, deal activity exceeded the pre-recession peak.").

143. *See generally* John F. Lehman & Stephen L. Brooks, *Rapid Escalation: An Overview of Private Equity Investing in the Aerospace and Defense Industry*, J. PRIV. EQUITY, Winter/Spring 2000, at 7 (describing how, since the 1990s, the rise of LBOs created new private equity investment opportunities in the defense industry); *see also* Vidhan K. Goyal et al., *Growth Opportunities and Corporate Debt Policy: The Case of the U.S. Defense Industry*, 64 J. FIN. ECON. 35 (2002) (examining the relationship between corporate debt policy and private investment in the defense industry).

144. *See, e.g.*, Esther Pan, *IRAQ: Military Outsourcing*, COUNCIL ON FOREIGN RELS. (Feb. 2, 2005), https://www.cfr.org/backgrounder/iraq-military-outsourcing [https://perma.cc/E4FT-YB4U] (arguing that, while "[t]he United States would be unable to sustain its military operation in Iraq, or anywhere else in the world, without the use of private contractors," these "private contractors . . . are operating outside the military chain of command"); Peter W. Singer, *Outsourcing the War*, BROOKINGS COMMENT. (Apr. 16, 2004), https://www.brookings.edu/articles/outsourcing-the-war [https://perma.cc/5MQ9-MEMF] (noting that "[p]rivate military contractors in Iraq are present in unprecedented numbers, more than 15,000, and they engage in a range of mission-critical activities—often armed combat—contrary to the U.S. military's own doctrine of how civilians should be employed in the field"). More recently, in Europe, the intensification "of the Russia-Ukraine war and the U.S. pullback as the primary provider of European defense" has driven increased private equity investment in the defense industry. Dylan Thomas & Neel Hiteshbhai Bharucha, *PE Defense Investment Surges in Early 2025 as Geopolitics Drives Change*, S&P GLOBAL: MKT. INTEL. (Mar. 21, 2025), https://www.spglobal.com/market-intelligence/en/news-insights/articles/2025/3/pe-defense-investment-surges-in-early-2025-as-geopolitics-drives-change-88086420 [https://perma.cc/295M-UA4S].

145. *See, e.g.*, Rhys McCormick, *Defense Acquisition Trends 2019: Topline DoD Trends*, CTR. STRATEGIC & INT'L STUD. (Oct. 10, 2019), https://www.csis.org/analysis/defense-acquisition-trends-2019-topline-dod-

industrial complex generated unprecedented demand for defense equipment, services, technology, and intelligence—prompting the DoD to accelerate outsourcing to private contractors.

Third, an ideological shift within the Pentagon towards favoring defense outsourcing further encouraged private equity's expansion into the defense industry.[146] As private equity firms gained control over the corporate decision-making of defense contractors, they devoted substantial resources to lobbying elected officials and DoD leadership to expand the scale of defense outsourcing.[147] Financial incentives also fueled a revolving door between DoD officials and the corporate executives in the defense industry, further eroding the distinction between public and private roles in national defense.[148]

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trends [https://perma.cc/ZD6L-XP72] (describing DoD contract spending over twenty years); *see also* Jill Kimball, *Costs of the 20-Year War on Terror: $8 Trillion and 900,000 Deaths*, BROWN UNIV. (Sept. 1, 2021), https://www.brown.edu/news/2021-09-01/costsofwar [https://perma.cc/5F7S-LJAR] ("The Pentagon and the U.S. military have now absorbed the great majority of the federal discretionary budget, and most people don't know that."); Neta C. Crawford, *The U.S. Budgetary Costs of the Post-9/11 Wars*, BROWN UNIV. WATSON INST. FOR INT'L & PUB. AFFS. 1 (2021), https://watson.brown.edu/costsofwar/figures/2021/BudgetaryCosts [https://perma.cc/6USK-49TY] ("The United States, over the last two decades, has already spent and the Biden administration has requested about $5.8 trillion in reaction to the 9/11 attacks.").

146. *See* U.S. DEP'T OF DEF., 2022 NATIONAL DEFENSE STRATEGY 6, 20 (2022) (viewing private sector corporations as crucial to U.S. national security operations, especially in artificial intelligence, automation, quantum science, biotechnology, and space technology).

147. *See* Ryan Summers, *The Pentagon's Revolving Door Keeps Spinning: 2021 in Review*, PROJECT ON GOV'T OVERSIGHT (Jan. 20, 2022), https://www.pogo.org/analysis/the-pentagons-revolving-door-keeps-spinning-2021-in-review [https://perma.cc/GP6T-WUWK] ("[D]efense contractors hired 23 officials, consulting firms hired 14, lobbying firms hired six, and trade associations and private equity firms in the defense and national security sectors hired two and one individuals, respectively."); *see also* Dan Abule, *Capitalizing on Conflict: How Defense Contractors and Foreign Nations Lobby for Arms Sales*, OPEN SECRETS (Feb. 25, 2021), https://www.opensecrets.org/news/reports/capitalizing-on-conflict/defense-contractors [https://perma.cc/ER8A-YTWX] ("Defense companies spend millions every year lobbying politicians and donating to their campaigns.").

148. *See* Freddy Brewster, *The Publicly Funded Defense Contractor Revolving Door*, JACOBIN (Apr. 23, 2024), https://jacobin.com/2024/04/pentagon-fellows-program-sdef-defense-contractors [https://perma.cc/7TM2-9XAW] ("For nearly three decades, the Department of Defense has used taxpayer money to send elite military officers to work for some of the Pentagon's top private contractors."); *see also Brass Parachutes: Defense Contractors' Capture of Pentagon Officials*

Finally, the defense industry underwent significant market consolidation since the mid-2000s, making defense contractors attractive takeover targets for private equity firms.[149] Rising industry concentration created economic agglomeration effects that enhanced economies of scale and improved the efficiency of arms acquisition.[150] Private equity firms captured these economies of scale by using LBOs to acquire defense contractors far larger than themselves.[151]

Together, these conditions have accelerated private equity's dominance in the defense industry, reshaping its complexity, scale, and scope. Once limited in function, defense contractors now operate across a vast array of nontraditional military capabilities spanning naval, land, aerospace, and electronic systems.[152] Today, the industry supports both current and future

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Through the Revolving Door, PROJECT ON GOV'T OVERSIGHT 9 (2018), https://docs.pogo.org/report/2018/POGO_Brass_Parachutes_DoD_Revolving_Door_Report_2018-11-05.pdf [https://perma.cc/RH2P-MGVG] ("There were 645 instances of the top 20 defense contractors in fiscal year 2016 hiring former senior government officials, military officers, Members of Congress, and senior legislative staff as lobbyists, board members, or senior executives in 2018.").

149. *See* Rodrigo Carril & Mark Duggan, *The Impact of Industry Consolidation on Government Procurement: Evidence from Department of Defense Contracting*, J. PUB. ECON., Feb. 29, 2020, at 1, 1 ("We find that market concentration caused the procurement process to become less competitive, with an increase in the share of spending awarded without competition, or via single-bid solicitations. Increased concentration also induced a shift from the use of fixed-price contracts towards cost-plus contracts."); *see also* Nayantara Hensel, *Can Industry Consolidation Lead to Greater Efficiency? Evidence from the U.S. Defense Industry*, 45 BUS. ECON. 187, 187 (2010) ("This analysis focuses on the impact of consolidation in the U.S. defense industry over the past [twenty] years and examines the reasons behind the wave of defense consolidation, the results in terms of the reduction in contractors, the antitrust response to mergers, and evidence on the impact of the mergers on weapons systems' total and per-unit costs.").

150. *See* Mahoney et al., *supra* note 5, at 366 ("High industry concentration rates transformed defense contractors into attractive takeover targets for private equity firms . . . .").

151. *See* Eric Bergin, *Leveraged Buyout (LBO)*, 3E MGMT. (Oct. 18, 2022), https://3emanagement.org/whitepapers/leveraged-buyout [https://perma.cc/6XTA-XBTT] ("Utilizing leverage allows investors to purchase assets they would not normally be able to afford. This is beneficial for the investors as it allows them to capture any benefits associated with the economies of scale.").

152. *See Defence Industry*, SCIENCEDIRECT, https://www.sciencedirect.com/topics/economics-econometrics-and-finance/defence-industry [https://perma.cc/95NF-FRE4] ("The defense industry is defined as a capital-intensive sector that focuses on producing goods and services essential for national defense, often requiring long research and development cycles, and typically

national defense operations, including arms manufacturing, defense technology development, cyber operations, private protection services, military training and simulation, and intelligence analysis.[153]

This transformation has also created a highly fragmented market in which the defense contractors operate.[154] Core military technologies and weapons are predominately produced by the "big five" defense contractors—Lockheed Martin, Boeing, General Dynamics, Northrop Grumman, and RTX—each of which receive over ten billion dollars annually in DoD contracts.[155] Meanwhile, over 12,000 small and medium-sized firms operate as subcontractors to the "big five."[156] As assignees that are not included in the original defense contracts, these subcontractors' capacities and identities are often not fully visible to the DoD.[157] They have become the primary targets for private equity LBOs.

Yet, despite this fragmented downstream market, the defense industry remains highly concentrated upstream. Unlike other industries, the entire defense supply chain relies on a single customer—the federal government—whose decisions are frequently driven by national security priorities rather than

necessitating government subsidies and protections due to its incompatibility with competitive market dynamics.").

153. *See generally* James Pattison, *From Defense to Offense: The Ethics of Private Cybersecurity*, 5 EUR. J. NAT'L SEC. 233 (2020) (describing private sector involvement in military cyber operations); SEAN MCFATE, THE MODERN MERCENARY: PRIVATE ARMIES AND WHAT THEY MEAN FOR WORLD ORDER (2014) (describing the outsourcing of combat and military operations to private mercenary groups); CHRISTOPHER KINSEY, PRIVATE CONTRACTORS AND THE RECONSTRUCTION OF IRAQ: TRANSFORMING MILITARY LOGISTICS (2009) (describing private contractors' central role in maintaining military logistics and leading reconstruction efforts in the United States' war in Iraq).

154. *See* Michael E. O'Hanlon & Alejandra Rocha, *Strengthening America's Defense Industrial Base*, BROOKINGS: COMMENT. (June 20, 2024), https://www.brookings.edu/articles/strengthening-americas-defense-industrial-base [https://perma.cc/DVM6-BWP7] ("[M]ore than half of all defense dollars are spent through contracts with private companies.").

155. *See id.*

156. *See* U.S. DEP'T OF DEF., SECURING DEFENSE-CRITICAL SUPPLY CHAINS 5 (2022).

157. *See id.* (explaining how limited transparency in subcontracting arrangements can obscure identities of downstream defense suppliers from Department of Defense oversight).

market dynamics.[158] Federal defense contracts, often the most valuable assets of a defense contractor, are central to their business success.[159] Building and maintaining strong relations with federal contracting officers and DoD officials is critical to their business operations. Thus, when a private equity firm acquires a defense contractor through an LBO, it not only purchases the contractor's assets but also effectively inherits its government relations and contract obligations as a successor-in-interest.[160]

This distinct characteristic means that returns on capital investments in defense contractors follow different dynamics compared to other companies. The profitability of a defense contractor often hinges on geopolitical factors rather than purely economic ones.[161] This presents a unique challenge for private

158. *See* John T. Bennett, *Defense Industry Woos GOP Freshmen in Hopes of Fighting Spending Cuts*, THE HILL: LOBBYING (Jan. 17, 2011), https://thehill.com/business-a-lobbying/79833-defense-industry-woos-gop-freshmen-in-hopes-of-fighting-spending-cuts [https://perma.cc/HJL4-H4AJ] ("The defense industry only has one customer, and that customer is a political system. That means contractors must get along with whoever is in power, regardless of ideology.").

159. For further information on how DoD defense contracts are valued, see generally ALEXANDRA G. NEENAN, CONG. RSCH. SERV., R47879, DEPARTMENT OF DEFENSE CONTRACT PRICING (2023).

160. Recent case law reinforces the well-established principle that a company inheriting government contracts through a corporate transaction can be deemed a "successor-in-interest," even without an approved novation agreement—notwithstanding the Anti-Assignment Acts' prohibition on such transfers. *See* Oxy USA, Inc. v. United States, 163 Fed. Cl. 75, 75 (2023) (holding that the Anti-Assignment Acts do not bar the assignment of government contracts to a successor through a corporate reorganization); *see also* Brad Jorgensen et al., *Are You the Successor-in-Interest? When a Company Inherits a Government Contract Through a Corporate Transaction*, DLA PIPER (Feb. 24, 2023), https://www.dlapiper.com/en/insights/publications/2023/02/are-you-the-successor-in-interest [https://perma.cc/HGK7-DLFF] (explaining how government contractors may assume contractual obligations through corporate transactions without formal novation).

161. *See* Melissa B. Mahle & Thomas Goldstein, *Geopolitical Risks Drive Opportunities in the US Defense Industrial Base*, STEPTOE (Apr. 18, 2025), https://www.steptoe.com/en/news-publications/stepwise-risk-outlook/geopolitical-risks-drive-opportunities-in-the-us-defense-industrial-base.html [https://perma.cc/UNN5-UFSR] (identifying geopolitical factors as a primary driver of investment in the U.S. defense industry). Moreover, defense contractors often have specialized procurement expertise and compliance mechanisms that differ drastically from those in civilian markets:

> Companies that specialize in defense . . . may not know much about commercial sectors, but they know a lot about the art of selling to the government. They have invested in specialized accounting systems,

equity firms aiming to resell acquired defense contractors by maximizing shareholder value in the short term. Common strategies that private equity firms employ to deliver high returns—such as downsizing management, cutting personnel costs, streamlining production, or increasing offshoring and subcontracting—may be a poor fit for defense contractors.[162] These approaches risk conflicting with national security requirements or damaging essential government relationships, ultimately undermining the contractor's core business. Despite these risks, private equity firms frequently pursue high-risk, short-term management tactics, driven by their narrow focus on resale of defense contractors through exit mergers.[163]

Figure 3 provides a breakdown of private equity M&A deals in the defense industry by segment.[164] Of the 1,221 deals completed between 2017 and 2020, information technology and software comprised the largest share (19.2%).[165] This was followed

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> cyber and information security systems, and sprawling teams of professionals who are trained to understand how the government buys and what it wants.

Gregory C. Allen & Doug Berenson, *Why Is the U.S. Defense Industrial Base So Isolated from the U.S. Economy?*, CTR. FOR STRATEGIC & INT'L STUD. (Aug. 20, 2024), https://www.csis.org/analysis/why-us-defense-industrial-base-so-isolated-us-economy [https://perma.cc/2J7Z-RYCY].

162. *See* Jon White, *10 Cost Optimization Strategies for Private Equity Portfolio Companies*, RINGSTONE (last updated Aug. 25, 2023), https://www.ringstonetech.com/post/10-cost-optimization-strategies-for-private-equity-portfolio-companies [https://perma.cc/BS3Q-TRN7] (describing cost optimization, reorganizing teams, and outsourcing as common strategies private equity firms use to increase portfolio company value in the short term); *see also* Mayra Rodriguez Valladares, *Private Equity Firms Have Caused Painful Job Losses and More Are Coming*, FORBES (last updated June 28, 2021), https://www.forbes.com/sites/mayrarodriguezvalladares/2019/10/30/private-equity-firms-have-caused-painful-job-losses-and-more-are-coming [https://perma.cc/F6CN-JZJW] ("To avoid defaulting, these distressed rated private-equity backed companies are likely to be pressured to lay off employees to service their debt.").

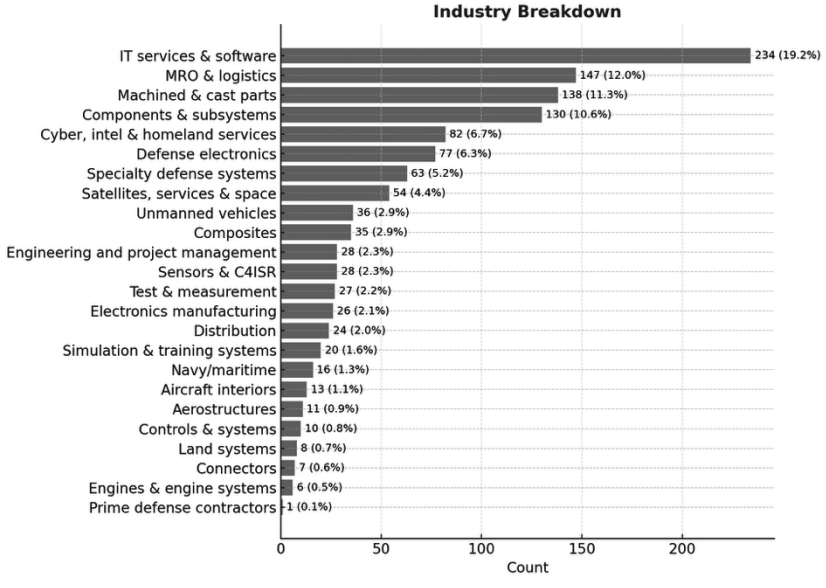
163. *See, e.g.*, Sean Carberry, *Private Equity Fueling Growth of Defense Mergers*, NAT'L DEF.: ACQUISITION (Feb. 27, 2023), https://www.nationaldefensemagazine.org/articles/2023/2/27/private-equity-fueling-growth-of-defense-mergers [https://perma.cc/8LMK-T78T] (discussing reasons for the continued growth of M&A in the defense industry).

164. Figure 3 is created based on data provided by KPMG. *See Future of M&A in Aerospace and Defense*, KPMG 14 (2021), https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2021/05/future-of-m-and-a-in-aerospace-and-defense.pdf [https://perma.cc/NK58-97AM] (underlying data for Figure 3 on private-equity M&A by segment, 2017–2020).

165. *See id.*

by maintenance, repair, and operations (MRO) and logistics (12.0%); machined and cast parts (11.3%); components and subsystems (10.6%); cyber, intel and homeland services (6.7%); defense electronics (6.3%); specialty defense systems (5.2%); satellites, services and space (4.4%); unmanned vehicles (2.9%); composites (2.9%); engineering and project management (2.3%); command, control, communications, computers, intelligence, surveillance, and reconnaissance (C4ISR) systems (2.3%); test and measurement (2.2%); electronics manufacturing (2.1%); distribution (2.0%); and miscellaneous categories (each <2%).[166]

Figure 3. Defense Industry Private Equity M&A Deals by Industry Segment (2017-2020)



In sum, private equity has become a formidable force—permanently reshaping the defense industry. As defense contractors integrate further into the U.S. national security regime through defense outsourcing, their private equity owners wield significant control over the commercial supply chains that sustain critical defense operations. However, this rise in private equity ownership has also left the sector highly leveraged, turning the defense industry into one of the most indebted sectors in the

166. *See id.*

United States, and heightening its vulnerability to financial distress.[167] The next Part examines the financial and operational consequences of private equity ownership for defense contractors.

II. ARCHETYPES OF DEFENSE CONTRACTOR BANKRUPTCIES

The rampant growth of private equity involvement in the defense industry has produced several adverse consequences for the national security regime. Chief among these is bankruptcy, which often triggers mass layoffs, asset liquidation, supply chain interruptions, and, in some cases, corporate dissolution.[168] Defense contractor bankruptcies raise national security concerns because they disrupt the commercial lifeline supporting critical defense operations. They also compel the federal government to deal with previously unknown parties—such as creditors, investors, assignees, and successors-in-interest—who hold claims against defense contractors but remain outside the government's

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167. Debt-to-EBITDA ratio risk is usually categorized as follows:

> [I]n the defense industry a corporate debt-to-EBITDA ratio between 0x and 2.0x is considered low risk for credit default while a ratio of 2.0x to 3.0x is considered moderately risky. Contractors with a debt-to-EBITDA ratios above 3.0x are judged to be at substantial risk, while a ratio above 6.0x is an indicator of very high risk for credit default.

Mahoney et al., *supra* note 5, at 372.

According to data from N.Y.U. Stern School of Business, the average debt-to-EBITDA ratio across all companies in the defense and aerospace sector is 4.48x. *See* Aswath Damodaran, *Debt Fundamentals by Sector (US)*, N.Y.U. STERN SCH. OF BUS. (last updated Jan. 2025), https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/dbtfund.html [https://perma.cc/R3US-HTXY].

168. Other negative consequences of private equity involvement include heightened susceptibility to credit default and harmful costs for both employees and customers. *See* Eileen Appelbaum & Rosemary Batt, *Private Equity Buyouts in Healthcare: Who Wins, Who Loses?*, INST. FOR NEW ECON. THINKING: HEALTH (Mar. 25, 2020), https://www.ineteconomics.org/perspectives/blog/private-equity-buyouts-in-healthcare-who-wins-who-loses [https://perma.cc/V5JH-9DD2] (reporting higher costs and reduced quality of care associated with private equity ownership in healthcare). *See generally* Charlie Eaton et al., *When Investor Incentives and Consumer Interests Diverge: Private Equity in Higher Education* (Nat'l Bureau of Econ. Rsch., Working Paper No. 23976, 2019) (associating private equity investment with higher tuition costs, lower graduation rates, and increased student debt).

oversight.[169] Furthermore, because private equity firms are exempt from financial reporting and disclosure obligations under federal securities laws,[170] defense contractors owned by private equity entities can maintain undisclosed foreign ties, further heightening national security risks.

However, not all bankruptcies present the same challenges. This Part explores three paradigmatic defense contractor bankruptcy cases, each exemplifying a distinct archetype of private equity-induced bankruptcy risk. Section A investigates Intelsat where excessive debt accumulation triggered prolonged financial distress and eventual bankruptcy. Section B analyzes MD Helicopters whose bankruptcy stemmed from private equity mismanagement and aggressive short-termism. Section C focuses on Constellis, highlighting its prolonged financial distress and failure to secure a fresh start through out-of-court restructuring—an outcome shaped by misaligned incentives between the company and its private equity owner.

A. INTELSAT: BANKRUPTCY CAUSED BY DEBT DEATH SPIRAL

The quintessential debt death spiral case is Intelsat. A "debt death spiral" occurs when private equity ownership turns a financially healthy defense contractor into a debt-ridden entity, often triggered by an LBO.[171] The resulting financial pressure forces the company into a cycle of risky transactions, repeated

169. When defense contracts become subject to assignment in bankruptcy, purchasers or other acquirers typically seek recognition as successors-in-interest and may assert rights to payment under the affected contracts, subject to the federal anti-assignment regime. The Anti-Assignment Acts restrict transfers of government contracts and claims without government consent, thereby protecting the U.S. government from exposure to unknown third-party risks. *See* 41 U.S.C. § 6305; 31 U.S.C. § 3727. See *infra* Part III for a discussion of how the executory contract doctrine complicates the application of Anti-Assignment Acts in defense contractor bankruptcies. *See also* Ronald G. Morgan, *Foreign Military Sales Cash Procurements: Additional Liability Considerations*, 25 PUB. CONT. L.J. 617, 618 (1996) (arguing that, in foreign military sales procurements, there is an additional risk where a "foreign purchaser's status as a third-party beneficiary" may disrupt the standard contractual relationship "between the U.S. Government and the contractor").

170. *See supra* note 58 and accompanying text.

171. My use of the term "debt death spiral" differs from the commonly used term "death spiral debt." *Cf.* Will Kenton, *Death Spiral Debt: What It Is, How It Works, Why It's Created*, INVESTOPEDIA (last updated Aug. 30, 2023), https://www.investopedia.com/terms/d/deathspiral.asp [https://perma.cc/7CZW-Y728] (defining death spiral debt as a type of convertible debt instrument that allows debt holders to convert their holdings into common stock).

ownership changes, and, ultimately, bankruptcy.[172] This debt death spiral poses serious national security risks by frequently shifting corporate ownership to potentially unsafe hands and exposing defense-critical assets to business interference.[173]

Intelsat is a multinational satellite services provider with administrative headquarters in Tysons, Virginia.[174] Originally established in 1964 by treaty as an international organization, Intelsat was tasked with providing satellite services to over 139 national governments.[175] However, by the early 1990s, U.S. satellite companies began lobbying for Intelsat's privatization.[176] In response, Congress enacted the Open-Market Reorganization for the Betterment of Telecommunications Act in 2001, which mandated Intelsat's transformation into a U.S.-based multinational corporation.[177]

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172. *See id.* (noting death spiral debt as a convertible instrument that can often trigger a sharp decline in stock prices and heighten bank risk).

173. "[F]oreign adversaries have taken note of struggling defense suppliers," and U.S. counterintelligence officials have warned that "hostile actors [may] use strategic investments to exploit vulnerable tech startups." *Business Viability Risks Are Often Overlooked During National Security Vetting*, 3GIMBALS BLOG (Apr. 4, 2025), https://3gimbals.com/insights/business-viability-risks-are-often-overlooked-during-national-security-vetting [https://perma.cc/SHZ2-XFFU]; *see also Safeguarding Our Innovation: Protecting U.S. Emerging Technology Companies from Investment by Foreign Threat Actors*, NAT'L COUNTERINTEL. & SEC. CTR., https://www.dni.gov/files/NCSC/documents/products/FINALSafeguardingOurInnovationBulletin.pdf [https://perma.cc/6QW3-ANQD].

174. *See Administrative Headquarters*, INTELSAT, https://www.intelsat.com/contact-us/locations [https://perma.cc/ERM2-CLCP] (providing the addresses associated with the company and listing the Virginia headquarters); *see also Intelsat Headquarters*, GENSLER, https://www.gensler.com/projects/intelsat-headquarters [https://perma.cc/RP45-9HXE] (stating that Intelsat's Headquarters are located in Tysons Corner, Virginia).

175. *See Towards Competition in International Satellite Services: Rethinking the Role of INTELSAT*, THE WHITE HOUSE (June 1995), https://clintonwhitehouse5.archives.gov/WH/EOP/CEA/html/paper.html [https://perma.cc/RX68-D7K7] ("The International Telecommunications Satellite Organization (INTELSAT) was formed by international treaty in 1964 to improve global communication, particularly between developing and developed economies . . . . By 1994, 132 governments had signed the treaty and INTELSAT was providing international satellite services to more than 219 countries, territories, and dependencies.").

176. *See id.* (emphasizing the U.S. policy to foster competition and private participation in international satellite services).

177. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-04-891, TELECOMMUNICATIONS: INTELSAT PRIVATIZATION AND THE IMPLEMENTATION OF THE ORBIT ACT (2004), https://www.gao.gov/products/gao-04-891

Since its privatization, Intelsat has been a critical supplier of surveillance and communication services to the U.S. armed forces and defense industrial bases. For example, Intelsat manages roughly twenty-five percent of all satellite communications for the DoD.[178] During the Gulf War, U.S. forces in Afghanistan and Iraq relied heavily on Intelsat's communication services.[179] Additionally, Intelsat provides broadband network access for unmanned aerial vehicles, enabling drones to conduct remote reconnaissance and surveillance for U.S. military and intelligence agencies.[180]

However, Intelsat's trajectory took a downturn when it became a takeover target for private equity firms.[181] In 2004, Intelsat's shareholders sold the company to four private equity

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[https://perma.cc/5V7K-XRVS] (assessing Intelsat's transition from an intergovernmental organization to a private corporation and the Federal Communications Commission's oversight of the ORBIT Act's implementation).

178. *See* James Walker & James T. Hooper, *Space Warriors: The Army Space Support Team*, GOVINFO 14 (July 2003) https://www.govinfo.gov/app/details/GOVPUB-D114-PURL-gpo89025 [https://perma.cc/5P2P-GXBJ] (detailing the Army's early integration of space-based assets and command teams into operational planning); *see also Taking Advantage of Opportunities for Commercial Satellite Communication Services: Report to the Secretary of Defense*, DEFENSE BUS. BD. 1 (2013), https://dbb.defense.gov/Portals/35/Documents/Reports/2013/FY1302%20Taking%20Advantage%20of%20Opportunities%20for%20Commercial%20Satellite%20Communications%20Services.pdf [https://perma.cc/9YQ2-KHQL] (explaining that the Department of Defense relies on commercial satellite private sector to provide forty percent of its satellite communication services).

179. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-777, TELECOMMUNICATIONS: COMPETITION, CAPACITY, AND COSTS IN THE FIXED SATELLITE SERVICES INDUSTRY 12–13 (2011) (explaining that U.S. military engagement in overseas conflicts accelerated the government's structural dependence on commercial satellite networks).

180. *See id.* at 13 (discussing the growing role of commercial providers in meeting military satellite communication needs); *see also* Sandra Erwin, *Intelsat Launches Mobile Broadband Service Aimed at Military Users*, SPACENEWS (June 15, 2020), https://spacenews.com/intelsat-launches-mobile-broadband-service-aimed-at-military-users [https://perma.cc/PX9R-RDHZ] (reporting Intelsat's development of broadband services tailored for U.S. and allied defense customers).

181. *See* Owen D. Kurtin, *Intelsat's Restructuring is not a Private Equity Success Story*, VIA SATELLITE (Mar. 2, 2021), https://www.satellitetoday.com/opinion/2021/03/02/intelsats-restructuring-is-not-a-private-equity-success-story [https://perma.cc/EY64-YDG6] (discussing repeated buyouts by private equity and increasing debt over time).

firms through an LBO.[182] The buyers—Apollo Global Management, Apax Partners, Madison Dearborn Partners, and Permira—agreed to acquire Intelsat for $5 billion.[183] Following the acquisition, the private equity firms collectively managed Intelsat through a consortium, known as Zeus Holdings Limited.[184] The LBO saddled Intelsat with over $2 billion in debt.[185] Shortly after the deal closed, Zeus Holdings directed Intelsat to distribute $350 million in special dividends to its new shareholders—effectively paying them with borrowed funds and further depleting Intelsat's corporate treasury.[186]

Under Zeus Holding's control, Intelsat pursued a series of risky corporate transactions despite already struggling to service its existing debt. In 2006, Zeus Holdings directed Intelsat to acquire PanAmSat, another satellite services provider, in a $3.2 billion LBO financed entirely with debt.[187] While the acquisition expanded Intelsat's business, it also increased the company's total debt liabilities to over $11 billion.[188] In 2007, Zeus Holdings sold Intelsat to British private equity firm BC Partners in yet

182. *See* Press Release, Intelsat, Intelsat to Be Acquired by Consortium of Private Investors (Aug. 16, 2004), https://www.sec.gov/Archives/edgar/data/1156871/000095013304003275/w00699exv1.htm [https://perma.cc/JWM9-FE6T] (announcing the sale of Intelsat to a private equity consortium, marking the company's transition from intergovernmental ownership to private control).

183. *See id.*

184. *See id.* (highlighting that the buyout reflected a broader wave of private investment reshaping the global satellite industry).

185. *See id.* (noting that the acquisition was framed as a strategic move to increase competitiveness and operational flexibility in the global satellite market).

186. *See* Dennis K. Berman et al., *Intelsat Owners Ready to Cash Out*, WALL ST. J. (Apr. 17, 2007), https://www.wsj.com/articles/SB117676583664571887 [https://perma.cc/2DBH-3A2A] (detailing private equity investors' plans to exit their Intelsat holdings through a sale or initial public offering as market interest in satellite companies surged).

187. *See Intelsat Agrees to Buy PanAmSat for $3.2 Billion*, NBC NEWS: BUS. NEWS (Apr. 25, 2005), https://www.nbcnews.com/id/wbna9114889 [https://perma.cc/BY62-KAW3] (reporting Intelsat's acquisition of PanAmSat, a deal that consolidated two of the largest commercial satellite operators).

188. *See* Steven Pearlstein, *Sweet Deals Buried Intelsat in Debt*, WASH. POST (Aug. 17, 2006), https://www.washingtonpost.com/archive/business/2006/08/18/sweet-deals-buried-intelsat-in-debt/6c369db9-9085-451c-9940-77643e222392 [https://perma.cc/3T6S-AN6G] (explaining that the private-equity consortium's LBO left Intelsat with significant debt and limited financial flexibility).

another LBO.[189] To address its mounting debt, BC Partners directed Intelsat to list twenty percent of its shares on the New York Stock Exchange through an initial public offering (IPO).[190] However, the IPO raised only $348 million,[191] which was insufficient to meaningfully improve Intelsat's financial position, as the company remained insolvent with over $15.9 billion in outstanding debt.[192]

In a last-ditch effort to stabilize its finances, Intelsat announced a proposed merger in 2017 with OneWeb, a satellite services start-up backed by SoftBank's venture capital fund.[193] Due to Intelsat's substantial "legacy debt," the merger was contingent on its creditors accepting less than the principal value of their debts.[194] Unsurprisingly, the creditors rejected SoftBank's

189. *See* Heidi Moore, *Intelsat: The Last of the LBO High Wire Acts*, WALL ST. J. (Feb. 5, 2008), https://www.wsj.com/articles/BL-DLB-1910 [https://perma.cc/L2H2-BY7Z] (analyzing how Intelsat's LBO highly tested the limits of private equity financing and tightened credit markets).

190. *See Intelsat Lists on the New York Stock Exchange*, BC PARTNERS (Apr. 17, 2013), https://www.bcpartners.com/news-and-insights/intelsat-lists-on-the-new-york-stock-exchange [https://perma.cc/8JSL-D8BM] (announcing Intelsat's initial public offering on the New York Stock Exchange, following years of private equity ownership).

191. *See* Renaissance Cap., *Intelsat Prices Downsized IPO Below the Range at $18, Raising $348 Million*, NASDAQ (Apr. 18, 2013), https://www.nasdaq.com/articles/intelsat-prices-downsized-ipo-below-range-18-raising-348-million-2013-04-17 [https://perma.cc/P6BX-QAJ9] (reporting Intelsat's reduced initial public offering price and the muted market response to Intelsat's public debut).

192. *See* Olivia Oran, *Intelsat to Test Investors' Love for Leverage*, REUTERS (Apr. 11, 2013), https://www.reuters.com/article/world/americas/intelsat-to-test-investors-love-for-leverage-idUSBRE93A0P7 [https://perma.cc/GCZ4-UC64] (noting that Intelsat initially aimed to raise $500 million through the IPO, an amount insufficient to offset its $15.9 billion debt obligations).

193. *See* Irene Klotz & Narottam Medhora, *SoftBank-Backed OneWeb to Merge with Intelsat*, REUTERS (Feb. 28, 2017), https://www.reuters.com/article/technology/softbank-backed-oneweb-to-merge-with-intelsat-idUSKBN1671R7 [https://perma.cc/N3F3-NRDM] (reporting that Intelsat agreed to merge with OneWeb, in a deal aimed at reducing debt and expanding broadband satellite coverage).

194. *See* Jessica DiNapoli & Liana B. Baker, *Exclusive: SoftBank to Let OneWeb-Intelsat Merger Collapse*, REUTERS (May 31, 2017), https://www.reuters.com/article/world/exclusive-softbank-to-let-oneweb-intelsat-merger-collapse-sources-idUSKBN18S3Q5 [https://perma.cc/2ZLU-MA5N] (reporting that SoftBank withdrew support for the proposed merger between OneWeb and Intelsat, after bondholders refused to participate in a related debt-exchange offer).

proposal, and the merger failed.[195] Shortly afterwards, Intelsat declared bankruptcy, triggering a cascade of defaults.[196]

In 2020, Intelsat filed for bankruptcy protection in the Eastern District of Virginia.[197] At the time, it held several defense contracts with the DoD and broadband licenses with the Federal Communications Commission (FCC).[198] To prevent immediate disruptions to critical military operations, Intelsat excluded its subsidiary, Intelsat General—responsible for military satellite communications—from the bankruptcy proceedings.[199] Nevertheless, the DoD raised national security concerns, citing Intelsat's financial instability as a vulnerability to predatory foreign buyouts during the bankruptcy process.[200] Specifically, the DoD feared that foreign companies could acquire Intelsat's defense-critical assets—including production equipment, technical know-how, and trade secrets—at distressed prices and transfer them to entities linked to foreign governments.[201]

195. *See id.* (demonstrating that the failed merger underscored Intelsat's continuing debt challenges and SoftBank's strategic shift toward investing directly in OneWeb).

196. *See* Kaye Wiggins & James Fontanella-Khan, *Intelsat Files for Bankruptcy Under Burden of Legacy Debt*, FIN. TIMES (May 14, 2020), https://www.ft.com/content/4e3ae5eb-75c5-4682-943e-bb49b41126c8 [https://perma.cc/K2PA-93GN] (reporting that Intelsat filed for chapter 11 bankruptcy protection, after failing to manage debt accumulation from years of LBOs).

197. *See In re* Intelsat S.A., No. 20-32299, 2022 WL 5240070, at *1 (Bankr. E.D. Va. Oct. 5, 2022) (approving confirmation of Intelsat's reorganization plan and concluding proceedings in the chapter 11 case).

198. *See* Second Amended Disclosure Statement for the Second Amended Joint Chapter 11 Plan of Reorganization of Intelsat S.A. and Its Debtor Affiliates at 1, 2, 59, *In re* Intelsat S.A., No. 20-32299 (Bankr. E.D. Va. Aug. 31, 2021) (detailing Intelsat's proposed plan of reorganization, creditor classes, and financial projections under chapter 11).

199. *See* Nathan Strout & Valerie Insinna, *Intelsat Declares Bankruptcy*, C4ISR: SPACE (May 14, 2020), https://www.c4isrnet.com/battlefield-tech/space/2020/05/14/intelsat-declares-bankruptcy [https://perma.cc/76B5-H7RL] (reporting that Intelsat filed for chapter 11 protection, amid declining revenues and delays in expected government compensation for satellite-band reallocation).

200. *See id.* (noting the Department of Defense had security concerns about Intelsat's bankruptcy).

201. *See id.* (emphasizing the fear that Intelsat's defense assets and technical expertise were vulnerable to foreign acquisition).

Intelsat ultimately emerged from bankruptcy in 2022 under a reorganization plan that reduced its debt by half.[202] However, the case remained open until 2024 due to ongoing litigation over creditors' claims tied to government contracts.[203] Although Intelsat avoided acquisition by unauthorized foreign entities, its bankruptcy raised significant national security concerns since one of Intelsat's prospective buyers had a strategic partnership with a Chinese satellite company tied to the People's Liberation Army.[204] The Intelsat case exemplifies how private equity ownership can drive a company into a debt death spiral, leading not

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202. *See* Rachel Jewett, *Intelsat Emerges from Bankruptcy as a Private Company*, VIA SATELLITE: FIN. (Feb. 24, 2022), https://www.satellitetoday.com/finance/2022/02/24/intelsat-emerges-from-bankruptcy-as-a-private-company [https://perma.cc/XW7B-ZKP3] (reporting that Intelsat exited chapter 11 proceedings as a privately held company, after restructuring billions in debt).

203. *See* SES Americom Inc. v. Intelsat US, No. 3:22-cv-688, 2023 WL 4137469, at *1 (E.D. Va. June 22, 2023); *see also Intelsat Bankruptcy: "Case Closed"*, ADVANCED TELEVISION (June 11, 2024), https://advanced-television.com/2024/06/11/intelsat-bankruptcy-case-closed [https://perma.cc/KK72-XEKT] (noting Intelsat's chapter 11 case was formally closed following resolution of related litigation).

204. Before Intelsat emerged from bankruptcy in 2022, Luxembourg-based satellite company SES explored a distressed merger to acquire Intelsat. *See* Olivier Sorgho, *Satellite Firm SES to Buy Intelsat for $3.1 Billion, Debt Concerns Sink Shares*, REUTERS (Apr. 30, 2024), https://www.reuters.com/markets/deals/satellites-company-ses-buy-intelsat-31-billion-2024-04-30/ [https://perma.cc/NN69-EF7S]. Negotiations continued post-emergence and collapsed in mid-2023. *See id.* In 2024, however, merger talks resumed, and the companies announced a deal in April 2024. *See id. The* proposed SES-Intelsat merger raised significant national security concerns after reports emerged that SES maintained a strategic partnership, known as "Open Orbits," with AeroSat Link, a subsidiary of China Satellite Communications Co. Ltd. (ChinaSat). *See* Bill Gertz, *Merger of European-U.S. Satellite Companies Raises Fears of Chinese Access to Military Communication*, WASH. TIMES (July 21, 2025), https://www.washingtontimes.com/news/2025/jul/21/merger-european-us-satellite-companies-raises-fears-chinese-access [https://perma.cc/3T8Q-GK6W]. ChinaSat is part of the China Aerospace Science and Technology Corporation (CASC), a state-owned conglomerate with documented ties to the People's Liberation Army. *Id.* The SES-Intelsat merger underwent regulatory review by multiple federal agencies, and on July 11, 2025, the FCC approved the merger subject to conditions requiring SES to terminate its partnerships with Chinese entities and to comply with a National Security Agreement executed among SES, its affiliates, the FCC, the DoD, the DOJ, and the Department of Homeland Security. *See* FED. COMM'CNS COMM'N, MEMORANDUM OPINION AND ORDER, *In the Matter of Applications of SES S.A. and Intelsat S.A.*, DA 25-614 (2025), https://docs.fcc.gov/public/attachments/DA-25-614A1.pdf [https://perma.cc/JGX4-J7VT].

only to financial failure but also to national security risks that threaten critical defense supply chains.

B. MD HELICOPTERS: BANKRUPTCY DRIVEN BY MISMANAGEMENT

The case of MD Helicopters illustrates a different type of private equity-induced bankruptcy risk: financial distress arising from aggressive risk-taking and short-term management by its private equity owners. Unlike Intelsat, MD Helicopters' bankruptcy was not driven by mounting "legacy debt" but rather by gross mismanagement under private equity control.[205] Such mismanagement not only disrupts critical defense supply chains, but it also jeopardizes the integrity of the national security regime by fostering misconduct and, in some cases, outright fraud against the federal government—as evidenced in MD Helicopters' case.

MD Helicopters is a leading aerospace manufacturer based in Mesa, Arizona.[206] It specializes in producing light utility rotorcraft for both military and civilian applications;[207] notably, MD Helicopters manufactures the iconic AH-64 Apache attack helicopter which was extensively deployed in the Vietnam and Gulf Wars.[208] Its origins date back to 1955 when its parent company, Hughes Tools Company, began designing lightweight dual-use helicopters for the U.S. army.[209] In 1984, McDonnell Douglas acquired Hughes Tools Company.[210] In 1997,

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205. *See infra* notes 219–28 (discussing a private equity firm's acquisition of MD Helicopters, and the mismanagement that followed).

206. *See MD Helicopters Overview*, PITCHBOOK, https://pitchbook.com/profiles/company/40465-27#overview [https://perma.cc/L75J-7L36] (providing corporate and financial information on MD Helicopters).

207. *See About MD Helicopters LLC.*, INT'L DEF. & AEROSPACE GRP., https://idagcorp.com/md-helicopters [https://perma.cc/87VU-UAEB] (describing MD Helicopters' ownership and defense-sector operations).

208. *See id.*; *see also* Herbert P. Lepore, *The Coming of Age: The Role of the Helicopter in the Vietnam War*, 29 ARMY HIST. 29, 34 (1994) (tracing the expansion of helicopter technology during the Vietnam War).

209. *See MD Helicopters*, BUS. JET TRAVELER, https://www.bjtonline.com/company/md-helicopters [https://perma.cc/LF2J-4E8Z] (giving an overview of the history of MD Helicopters).

210. *See* Thomas C. Hayes, *McDonnel to Purchase Hughes Helicopter Unit*, N.Y. TIMES (Dec. 17, 1983), https://www.nytimes.com/1983/12/17/business/mcdonnel-to-purchase-hughes-helicopter-unit.html [https://perma.cc/AG63-PNUK] (announcing that the McDonnell Douglas Corporation would acquire

McDonnell Douglas merged with Boeing.[211] Two years later, in 1999, Boeing resold McDonnell Douglas to MD Helicopter Holdings.[212]

In 2005, MD Helicopters was acquired via an LBO by private equity firm Patriarch Partners (Patriarch), led by businesswoman Lynn Tilton.[213] Patriarch specializes in purchasing ailing businesses at low costs and attempting to revive them through aggressive short-term management strategies—earning Tilton the nickname "Diva of Distressed" on Wall Street.[214] Patriarch's portfolio spans seventy-five companies across fourteen sectors, concentrating in heavy industries, aerospace, and automotives.[215] After the acquisition, Tilton took direct control of MD Helicopters as its CEO.[216] Under her leadership, the company implemented significant cost-cutting measures, including management regrouping, production outsourcing, and mass

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Hughes Helicopter Inc.); *MD Helicopters*, *supra* note 209 (stating that McDonnell Douglas purchased Hughes in 1984).

211. *See* Press Release, Boeing, Boeing Completes McDonnell Douglas Merger (July 31, 1997), https://boeing.mediaroom.com/1997-07-31-Boeing-Completes-McDonnell-Douglas-Merger [https://perma.cc/8Z74-9BXY] (announcing Boeing's merger with McDonnell Douglas).

212. *See MD Helicopters*, *supra* note 209 ("Boeing sold the commercial rotorcraft lines formerly produced by McDonnell Douglas to MD Helicopter Holdings, an umbrella company of Dutch RDM Holding.").

213. *See* Mark Huber, *Q&A: MD Helicopters' Lynn Tilton*, BUS. JET TRAVELER (Apr. 2009), https://bjtonline.com/business-jet-news/qa-md-helicopters-lynn-tilton [https://perma.cc/KV3C-Z9HZ] (interviewing CEO Lynn Tilton about MD Helicopters' turnaround strategy and management style).

214. *See* Jonathan Marino, *It Keeps Getting Worse for "The Diva of Distressed" Lynn Tilton*, BUS. INSIDER: FIN. (Oct. 6, 2015), https://www.businessinsider.com/it-keeps-getting-worse-for-the-diva-of-distress-lynn-tilton-2015-10 [https://perma.cc/CD34-BD5V] (detailing legal and financial controversies surrounding Lynn Tilton and Patriarch Partners).

215. *See Lynn Tilton's Story*, PATRIARCH PARTNERS, LLC, https://www.patriarchpartners.com/lynn-tilton [https://perma.cc/3V8U-HKHW] ("Patriarch Partners, LLC, is an investment firm with investments in more than 75 companies across 14 industry sectors."); *see also* Erin Mendell, *How Patriarch Partners CEO Lynn Tilton Built Her Empire*, WALL ST. J. (June 5, 2014), https://www.wsj.com/articles/how-patriarch-partners-ceo-lynn-tilton-built-her-empire-wsj-money-june-2014-1401979500 [https://perma.cc/6DKK-EXXJ] (profiling Tilton's private equity career and her acquisition of struggling industrial companies).

216. *See After 10 Years as a Lynn Tilton Company, MD Helicopters Is Poised for Growth Across All Market Segments*, MD HELICOPTERS (Mar. 3, 2015), https://www.mdhelicopters.com/after-10-years-as-a-lynn-tilton-company-md-helicopters-is-poised-for-growth-across-all-market-segments [https://perma.cc/VGQ7-U9E6] (reflecting on Tilton's ten years as CEO of MD Helicopters).

layoffs.[217] From 2005 to 2015, MD Helicopters recorded double-digit revenue growth each year.[218]

However, this apparent success masked a hidden crisis: Tilton's aggressive use of debt capital through structured financial instruments.[219] Alongside MD Helicopters, Patriarch also managed three collateralized loan obligation (CLO) funds,[220] all directed by Tilton as CEO.[221] These CLO funds issued securitized notes backed by the debt obligations of Patriarch's portfolio companies—with MD Helicopters' LBO debt representing the largest share of the loans.[222] The funds promised to repay investors using the portfolio companies' future cash flows.[223] This strategy, however, left MD Helicopters vulnerable to legal

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217. *See* Jenna Goudreau, *Lynn Tilton: Managing Through Fear*, FORBES (Apr. 18, 2011), https://www.forbes.com/sites/jennagoudreau/2011/04/18/lynn-tilton-managing-through-fear [https://perma.cc/6ZKN-QZ72] (describing frequent personnel changes as part of Tilton's management style).

218. *See id.* (identifying key changes signifying success under Tilton's leadership).

219. *See* Eliza Haverstock, *A Decade After Forbes' Investigation, 'Diva of Distressed' Lynn Tilton Hit With $38 Million Fine Following Dozens of Lawsuits*, FORBES (last updated Jan. 27, 2022), https://www.forbes.com/sites/elizahaverstock/2021/10/14/a-decade-after-forbes-investigation-diva-of-distressed-lynn-tilton-hit-with-38-million-fine-after-dozens-of-lawsuits [https://perma.cc/X757-593F] (reporting that Tilton's firm bought the "distressed debt of troubled companies and re-packaged them into financial instruments known as collateralized loan obligations").

220. A collateralized loan obligation (CLO) is single security backed by a pool of loans. A CLO fund functions as a securitization vehicle in which a special entity, known as the issuer, raises capital by issuing securitized notes and uses the proceeds to purchase a portfolio of commercial loans. An investment advisor, acting as the collateral manager, selects and manages the loans for the CLO fund. Cash flows and other proceeds generated by the collateral are used to repay the noteholders who invest in the CLO fund. *See* Troy Segal, *Collateralized Loan Obligation (CLO) Structure, Benefits, and Risks*, INVESTOPEDIA (last updated Sept. 1, 2025), https://www.investopedia.com/terms/c/clo.asp [https://perma.cc/XZF2-7QHJ] (explaining the structure and investment function of CLO funds).

221. *See In the Matter of Lynn Tilton et al., Before the U.S. Securities and Exchange Commission,* ANALYSIS GRP., https://www.analysisgroup.com/Insights/cases/in-the-matter-of-lynn-tilton-et-al-before-the-us-securities-and-exchange-commission [https://perma.cc/9RQN-RUDK] (summarizing expert involvement in the SEC's administrative proceedings against Lynn Tilton and Patriarch Partners).

222. *See* Order Instituting Administrative and Cease-and-Desist Proceedings, Investment Company Act Release No. 31,539 (proposed Mar. 13, 2015) (alleging that Tilton and her firms misled investors regarding valuation methods used in Patriarch Partners' collateralized loan obligation funds).

223. *See id.* (explaining how the CLO funds were structured).

liabilities tied to Patriarch's CLO funds. In 2009, investors in the CLOs sued Tilton and Patriarch, alleging material misrepresentation of the funds' value and failure to disclose conflicts of interest, constituting breaches of fiduciary duty.[224] The lawsuit ultimately resulted in Patriarch owing over $1.7 billion to the CLO investors.[225]

To make matters worse, Tilton's aggressive management of MD Helicopters also led to illegal conduct that damaged its relationship with its largest customer—the federal government.[226] In 2013, MD Helicopters secured three defense contracts with the U.S. Army, valued at up to $36.8 million, to supply helicopters to three U.S. allies: Saudi Arabia, El Salvador, and Costa Rica.[227] However, a Department of Justice investigation revealed that Tilton had improperly offered the U.S. Army's contracting officer an executive position at MD Helicopters as an incentive for securing the contracts.[228] In 2021, a federal jury in the Northern District of Alabama convicted MD Helicopters of fraudulently inducing the U.S. Army to award the contracts.[229]

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224. *See id.* (noting that, after investors filed their lawsuit in 2009, the SEC charged Lynn Tilton and Patriarch Partners with securities fraud in 2015); *see also* Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Fraud Charges Against Investment Adviser Accused of Concealing Poor Performance of Fund Assets from Investors (Mar. 30, 2015), https://www.sec.gov/newsroom/press-releases/2015-52 [https://perma.cc/X5AW-D2LT] (announcing enforcement action against Lynn Tilton and Patriarch Partners for allegedly misrepresenting fund performance to investors).

225. *See* Elan Head, *Lynn Tilton Gives Up CEO Role at MD Helicopters*, VERTICAL (Mar. 26, 2020), https://verticalmag.com/news/lynn-tilton-resigns-md-helicopters [https://perma.cc/HV3M-2JLZ] (reporting Tilton's resignation as MD Helicopters' CEO, following years of litigation and financial restructuring).

226. *See infra* notes 227–30 (describing Tilton's illegal conduct).

227. *See* Daniel Seiden, *Whistleblowers Get $100 Million Win Against MD Helicopters*, BLOOMBERG L.: FED. CONTRACTING (Sept. 27, 2021), https://news.bloomberglaw.com/federal-contracting/whistleblowers-get-100-million-fraud-win-against-md-helicopters [https://perma.cc/7UJX-KHP5] (reporting that a federal jury found MD Helicopters liable under the False Claims Act).

228. *See* Peter Lattman, *U.S. Securitizes Private Equity Hiring of Ex-Army Officer*, N.Y. TIMES (Aug. 29, 2013), https://archive.nytimes.com/dealbook.nytimes.com/2013/08/29/u-s-scrutinizes-private-equity-hiring-of-ex-army-officer [https://perma.cc/4EKV-NUWH] (describing federal scrutiny of private equity firms' recruitment of military officials with defense contracting ties).

229. *See* Graham Cotton, *Defense Contractor Hit with Potentially More Than $100 Million in Damages Following Huntsville Jury Verdict*, PRICE ARMSTRONG COMPLEX LITIG. (Oct. 22, 2021), https://pricearmstrong.com/blog/defense-contractor-hit-with-100-million-in-

Under the False Claims Act, MD Helicopters was ordered to pay treble damages for each violation, resulting in fines exceeding $100 million.[230]

Faced with mounting judgment debt from both the CLO lawsuit and the False Claims Act damages, MD Helicopters filed for bankruptcy in 2022 in the District of Delaware.[231] As part of the bankruptcy process, the court mandated a judicial sale of the company to satisfy both the federal government and CLO investors' claims.[232] Following court approval, MD Helicopters agreed to sell the company to an investor consortium led by three private equity firms: Bardin Hill, MBIA Insurance, and MB Global Partners.[233] The consortium also committed a $60 million distressed loan to MD Helicopters to repay its outstanding debt.[234]

In essence, private equity ownership often fuels short-term management behavior, driving risky operations that benefit

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damages-following-huntsville-jury-verdict [https://perma.cc/FQ6X-RZB6] (summarizing the jury verdict and implications for MD Helicopters' liability under the False Claims Act).

230. *See* United States *ex rel.* Marsteller v. MD Helicopters, Inc., No. 5:12-cv-00830, 2021 WL 4409093, at *8 (N.D. Ala. Sept. 27, 2021); Seiden, *supra* note 227 (stating that the thirty-six million dollar verdict will be trebled).

231. *See In re* MD Helicopters, Inc., 641 B.R. 96, 96 (Bankr. D. Del. 2022); *see also MacD Helicopters, Inc., f.k.a. MD Helicopters, Inc.*, KROLL, https://cases.ra.kroll.com/MDHelicopters [https://perma.cc/7AJL-LVLN] (providing docket materials and creditor notices from MD Helicopters' bankruptcy proceedings).

232. *See* Maria Chutchian, *Military Helicopter Contractor Enters Bankruptcy with Sale Plans*, REUTERS (Mar. 31, 2022), https://www.reuters.com/legal/transactional/military-helicopter-contractor-enters-bankruptcy-with-sale-plans-2022-03-31 [https://perma.cc/RH38-87JE] (reporting MD Helicopters filed for chapter 11 bankruptcy and sought court approval to sell the company to its creditors).

233. *See, e.g.*, *MD Helicopters Announces New Ownership and Leadership*, PR NEWSWIRE (Sept. 9, 2022), https://www.prnewswire.com/news-releases/md-helicopters-announces-new-ownership-and-leadership-301620965.html [https://perma.cc/6N9Z-4HWX] (announcing MD Helicopters' emergence from bankruptcy, under new ownership and the appointment of a new executive team); *MD Helicopters Files Chapter 11 Bankruptcy*, ASIAN SKY GRP. (Apr. 6, 2022), https://www.asianskygroup.com/md-helicopters-files-chapter-11-bankruptcy-123 [https://perma.cc/RS2F-9E38] (reporting MD Helicopters' chapter 11 filings and reorganization plans).

234. *See* Andrew Scurria, *MD Helicopters Can Tap $60 Million Loan Ahead of Bankruptcy Sale*, WALL ST. J. (Apr. 1, 2022), https://www.wsj.com/articles/md-helicopters-can-tap-60-million-loan-ahead-of-bankruptcy-sale-11648853565 [https://perma.cc/L6S7-N54F] (noting that the bankruptcy court authorized MD Helicopters to borrow debtor-in-possession financing to fund operations before its sale).

private equity owners at the expense of the acquired firm. While MD Helicopters exemplifies an egregious case—where management defrauded the DoD to secure defense contracts—gross mismanagement fueled by private equity-driven short-termism is not uncommon.[235] This arises because private equity firms are typically insulated from bankruptcy risks, leaving the acquired companies solely responsible for servicing the resulting debt.[236] Such misaligned incentives can have dire consequences for national security, undermining the quality and reliability of goods and services supplied under the defense contracts.[237]

C. CONSTELLIS: FAILED RESTRUCTURING CAUSED BY MISALIGNED INCENTIVES

Constellis represents the third archetype of defense contractor bankruptcy induced by private equity ownership: prolonged financial distress driven by misaligned incentives. Unlike Intelsat and MD Helicopters, Constellis did not file a formal bankruptcy petition with the court.[238] Instead, it opted for an out-of-court restructuring.[239] Yet, that restructuring failed to resolve its underlying financial issues, leaving the company undercapitalized and unable to achieve a true fresh start. Out-of-court restructuring is uncommon among defense contractors because it lacks the safeguards of formal bankruptcy proceedings, such as

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235. *See, e.g.*, Alex Blasdel, *Slash and Burn: Is Private Equity Out of Control?*, GUARDIAN (Oct. 10, 2024), https://www.theguardian.com/business/2024/oct/10/slash-and-burn-is-private-equity-out-of-control [https://perma.cc/79D9-L7ZJ] (examining how private equity firms' pursuit of rapid returns often leads to mass layoffs, asset stripping, and long-term harm to acquired companies); Brendan Ballou, *Private Equity Is Gutting America—and Getting Away with It*, N.Y. TIMES (Apr. 28, 2023), https://www.nytimes.com/2023/04/28/opinion/private-equity.html [https://perma.cc/WRC8-L29D] (arguing private equity's profit-driven structure erodes public institutions and undermines economic stability).

236. *See supra* notes 117–22 (explaining how private equity firms insulate themselves from bankruptcy risks).

237. *See* Cotton, *supra* note 229 ("By dealing falsely with the U.S. government on military contracts, defense contractors . . . do not simply steal from taxpayers, they endanger our national security.").

238. *See supra* notes 197 and 231 (stating that Intelsat and MD Helicopters filed bankruptcy petitions); *see also* Alexander Gladstone, *Contract Losses Sink Apollo's Defense Bet*, WALL ST. J. BANKR. (Jan. 19, 2020), https://www.wsj.com/articles/contract-losses-sink-apollos-defense-bet-11579429800 [https://perma.cc/MY2R-KDSJ] (stating that Constellis opted to restructure out of court rather than file a formal bankruptcy petition).

239. *See* Gladstone, *supra* note 238.

mandatory financial disclosure, court oversight, and protection against competing creditor claims.[240] However, as demonstrated in the case of Constellis, private equity owners may favor out-of-court restructuring to maintain secrecy and selectively restructure debt, prioritizing short-term financial gains over the contractor's long-term financial health and operational stability—often at the expense of national security interests.[241]

Constellis, formerly known as Blackwater, is a Virginia-based private military company that provides security services to U.S. embassies and critical government facilities overseas.[242] During the War on Terror, Blackwater was tasked with protecting the Central Intelligence Agency's headquarters and its overseas bases responsible for tracking Al-Qaeda.[243] Domestically, it played a significant role in disaster relief operations, including a 2005 contract with the Department of Homeland Security to

240. Out-of-court restructurings lack both the protection of the automatic stay and the debtor's discretionary authority to assume or reject executory contracts. *See Out-of-Court Restructuring or Bankruptcy?: Pros and Cons*, CFGI (Feb. 24, 2022), https://www.cfgi.com/resources/articles/out-of-court-restructuring-or-bankruptcy-pros-and-cons [https://perma.cc/BQ5E-949U]. These features—the automatic stay and control over executory contracts—are often central to defense contractors. *See infra* Part III.B–C.

241. Out-of-court restructurings can be attractive to private equity investors because they can permit selective defaults that "benefit some lenders at the expense of others." Diane Lourdes Dick, *Tactical Restructurings*, 93 FORDHAM L. REV. 1, 5 n.20 (2024). More recently, liability management exercises (LMEs) have become a dominant form of out-of-court restructuring. An LME is a type of selective restructuring that favors certain creditors over others and is designed to avoid bankruptcy by, among other means, "amending limitations on additional debt and delaying the maturity on existing debts[.]" *Lead Article: Liability Management Exercises: What They Are and What They Mean for Market Participants*, QUINN EMANUEL BUS. LITIG. REPORT (Jan. 15, 2025), https://www.quinnemanuel.com/the-firm/publications/lead-article-liability-management-exercises-what-they-are-and-what-they-mean-for-market-participants [https://perma.cc/V9QF-ZYU3].

242. *See* Ryan J. Hite, *The Transformation of Blackwater: A Journey from Controversy to Constellis Holdings*, RYAN J. HITE BLOG (May 25, 2024), https://www.ryanjhite.com/2024/05/25/the-transformation-of-blackwater-a-journey-from-controversy-to-constellis-holdings [https://perma.cc/QK5Q-W7NG].

243. *See generally* ERIK PRINCE, CIVILIAN WARRIORS: THE INSIDE STORY OF BLACKWATER AND THE UNSUNG HEROES OF THE WAR ON TERROR (2013) (recounting Blackwater's rise and history by the company's founder).

protect government facilities and deploy rescue teams in the aftermath of Hurricane Katrina.[244]

Between 2005 and 2007, Blackwater gained widespread notoriety for high-profile security incidents, including allegations of wrongful killings, arms smuggling, and human rights violations.[245] The most infamous of these was the Nisour Square massacre in 2007, where Blackwater employees in Iraq killed seventeen Iraqi civilians and injured twenty while escorting DoD officials.[246] Facing mounting legal actions and negative publicity, Blackwater rebranded as Xe Services in 2009 and began pivoting away from private military services.[247] Its founder, Erik Prince, stepped down as CEO and solicited a management buyout.[248] In 2010, private equity firms Forte Capital Advisors and Manhattan Partners acquired Xe Services through an LBO,[249]

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244. *See* Dina Temple-Raston, *Blackwater Eyes Domestic Contracts in U.S.*, NPR (Sept. 28, 2007), https://www.npr.org/2007/09/28/14707922/blackwater-eyes-domestic-contracts-in-u-s [https://perma.cc/2E8F-RER3].

245. *See generally* Anupam Siddhartha & Bharat Joshi, *Blackwater – The Private Military and Security Company*, 13 J. INT'L ISSUES 106 (2009) (discussing Blackwater's rise and notoriety due to shootings, civilian deaths, and human rights abuse allegations in Iraq).

246. Four Blackwater employees were later convicted of murder for their roles in the incident but were pardoned by President Trump in 2020. *See* Dara Lind, *Why Four Blackwater Contractors Were Just Now Convicted of Killing 17 Iraqi Civilians in 2007*, VOX (Oct. 13, 2014), https://www.vox.com/2014/10/23/7047519/blackwater-trial-nisour-square-massacre-2007-guilty-convicted [https://perma.cc/D33Y-S8C9]; *see also* Dan Roberts, *US Jury Convicts Blackwater Guards in 2007 Killing of Iraqi Civilians*, GUARDIAN: U.S. FOREIGN POL'Y (Oct. 23, 2014), https://www.theguardian.com/us-news/2014/oct/22/us-jury-convicts-blackwater-security-guards-iraq [https://perma.cc/82KH-F3AL].

247. *See, e.g.*, *Blackwater Renames Itself, And Wants to Go Back to Iraq*, ABC NEWS (Dec. 12, 2011), https://abcnews.go.com/Blotter/blackwater-renames/story?id=15140210 [https://perma.cc/A5ND-MVMF]; *Former Blackwater Firm Renamed Again*, BBC (Dec. 12, 2011), https://www.bbc.com/news/world-us-canada-16149971 [https://perma.cc/AKG2-SHW4].

248. *See Scandal-Ridden Blackwater CEO Steps Down*, ABC NEWS (Jan. 30, 2009), https://abcnews.go.com/Blotter/Blackwater/story?id=6988962 [https://perma.cc/53H3-ZHMU].

249. The exact terms of the deal were undisclosed. *See* Dow Jones Newswires, *Private Equity Buys Controversial Defence Contractor*, PRIV. EQUITY NEWS (Dec. 20, 2010), https://www.penews.com/articles/blackwater-defence-20101220 [https://perma.cc/9P6J-GS7E]; Nicholas Donato, *Former Blackwater Now in Hands of Private Equity*, PRIV. EQUITY INT'L (Dec. 21, 2010), https://www.privateequityinternational.com/former-blackwater-now-in-hands-of-private-equity [https://perma.cc/59P9-Y6FQ].

and the company rebranded again as Academi in 2011.[250] Since then, the company has focused on providing security and training services for emergency response, disaster relief, hazardous waste disposal, and nuclear facilities protection—distancing itself from its controversial Blackwater legacy.[251]

Despite the LBO and subsequent rebranding, the company continued to struggle financially, largely due to its inability to distance itself from its Blackwater legacy. In 2014, under the direction of Forte Capital and Manhattan Partners, Academi merged with five other private security companies—Triple Canopy, AMK9, Centerra, Edinburgh International, and Olive Group[252]—to form a new entity named Constellis.[253] However, the merger did little to repair the company's tarnished reputation,[254] especially after a high-profile federal jury trial of former Blackwater employees involved in the 2007 Nisour Square massacre reignited public scrutiny.[255] Unable to rehabilitate Constellis, Forte Capital and Manhattan resold the company in 2016 through another LBO to private equity giant Apollo Global Management.[256] Although the terms of the deal were not disclosed,

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250. Kate Mackenzie, *Firm Formerly Known as Blackwater Changes Name*, FIN. TIMES: OP. (Dec. 11, 2011), https://www.ft.com/content/d0a04314-7d68-3f5c-8fcd-2835deca6931 [https://perma.cc/4TYG-32G5].

251. *See Emergency/Disaster Response, Relief, & Recovery*, CONSTELLIS, https://constellis.com/what-we-do/humanitarian/emergency-disaster-response-relief-recovery [https://perma.cc/5U8G-5DUY] (discussing Constellis's efforts to send aid to communities impacted by disasters).

252. Michael Picard & Colby Goodman, *Hidden Costs: US Private Military and Security Companies and the Risks of Corruption and Conflict*, TRANSPARENCY INT'L 16 (2022), https://ti-defence.org/wp-content/uploads/2022/08/Hidden-Costs-US-Private-Military-and-Security-Companies-and-the-Risks-of-Corruption-and-Conflict-Web-PDF.pdf [https://perma.cc/ZH9E-XQFW].

253. Ross Wilkers, *Apollo Group, Constellis Executives to Buy Out Security Services Contractor*, GOVCON WIRE (Aug. 15, 2016), https://www.govconwire.com/2016/08/apollo-group-constellis-executives-to-buy-out-security-services-contractor [https://perma.cc/HC36-F4CY].

254. *See* Mike Stone, *Apollo Global in Talks to Buy Constellis*, REUTERS (Aug. 5, 2016), https://www.reuters.com/article/world/europe/apollo-global-in-talks-to-buy-constellis-idUSKCN10G26N [https://perma.cc/GC9R-JM7H] (discussing the company's multiple rebranding attempts).

255. *See* Matt Apuzzo, *Blackwater Guards Found Guilty in 2007 Iraq Killings*, N.Y. TIMES (Oct. 22, 2014), https://www.nytimes.com/2014/10/23/us/blackwater-verdict.html [https://perma.cc/L8AB-4M8R].

256. Katherine Doherty & Sally Bakewell, *Apollo-Backed Security Firm in Talks for Debt Restructuring*, BLOOMBERG: MKTS. (Jan. 4, 2020),

the LBO left Constellis burdened with over one billion dollars in debt.[257]

However, unlike its predecessors, Apollo acquired Constellis with a singular aim: immediate resale and cashing out.[258] It had no intention of rehabilitating its tarnished reputation. Shortly after the 2016 acquisition, Apollo entered negotiations with Canadian security provider Garda World Security to sell Constellis.[259] The deal fell through in 2018 for undisclosed reasons.[260] While the terms of the deal were kept secret, commentators speculate that the collapse was due to Constellis' substantial outstanding debt and the parties' disagreements over its equity value.[261]

Things worsened for Constellis due to misaligned incentives with its private equity owner, as Apollo prioritized short-term gains over the company's long-term financial health.[262] After taking control, Apollo implemented a series of expenditure-cutting measures aimed at improving Constellis' balance sheet to attract potential buyers.[263] However, this narrow focus on resale backfired when Constellis lost key government contracts, including bids for the State Department's Worldwide Protective Services program,[264] pushing the company closer to bankruptcy.[265] The tipping point came in 2020, when Constellis defaulted on an

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https://www.bloomberg.com/news/articles/2020-01-04/apollo-backed-security-contractor-in-talks-on-debt-restructuring [https://perma.cc/2GR6-72MS].

257. *See id.*

258. *See* Joshua Franklin & Mike Stone, *Apollo Pauses Plans to Sell Security Firm Constellis: Sources*, REUTERS (June 14, 2018), https://www.reuters.com/article/world/americas/apollo-pauses-plans-to-sell-security-firm-constellis-sources-idUSKBN1JA2W5 [https://perma.cc/74LJ-RM2E] (noting Apollo's focus on short-term gain rather than the long-term financial stability of Constellis).

259. *See id.*

260. *See id.*

261. *See id.*; *Apollo Halts Talks on $2.5B Military Exit*, PITCHBOOK (June 18, 2018), https://pitchbook.com/newsletter/apollo-halts-talks-on-25b-military-exit [https://perma.cc/FS8F-TJQH] (announcing that the deal to sell Constellis was called off when the parties would not meet the asking price).

262. *See* Franklin & Stone, *supra* note 258.

263. *See* Katherine Doherty & Rick Green, *Apollo-Backed Constellis's Debt Hits Lows as Restructuring Looms*, BLOOMBERG L.: BANKR. (Jan. 6, 2020), https://news.bloomberglaw.com/bankruptcy-law/apollo-backed-constelliss-debt-hit-lows-as-restructuring-looms [https://perma.cc/9YUQ-4CPY].

264. *See* Gladstone, *supra* note 238.

265. *See id.* (discussing Constellis's financial difficulties and efforts to restructure its debt).

$872 million debt obligation.[266] This default led to its credit rating downgrading from "B" to "C," effectively categorizing the company's debts as junk bonds.[267]

In response, Constellis entered negotiations with its existing creditors to arrange an out-of-court restructuring deal.[268] Although the restructuring was completed in 2024 and reduced the company's outstanding debt, it failed to meaningfully improve its financial position.[269] Constellis remained severely undercapitalized, forcing it to rely on new loans to service its existing debt obligations.[270] By 2024, Constellis' credit rating had plunged to "D"—the lowest possible rating on S&P's credit rating scale, underscoring its prolonged financial distress post-restructuring and failure to achieve a fresh start.[271]

The case of Constellis highlights how misaligned incentives between a defense contractor and its private equity owner can exacerbate financial distress. Typically, a distressed defense contractor would file for bankruptcy to shield itself from competing creditor claims and seek a fresh start.[272] They rarely pursue out-of-court restructuring, since it often comes with strings attached—such as conditioning debt write-offs on obtaining new loans or granting super-prime liens to certain creditors—leaving

266. Marjorie Censer, *S&P Lowers Constellis Rating, Says Debt Restructuring Plan Due Next Month*, INSIDE DEF. (Jan. 3, 2020), https://insidedefense.com/insider/sp-lowers-constellis-rating-says-debt-restructuring-plan-due-next-month [https://perma.cc/7NME-6LGU].

267. Moody's, *New Constellis Borrower LLC—Moody's Downgrades New Constellis Borrower LLC's CFR to Caa1; Outlook Negative*, YAHOO FIN. (Mar. 23, 2022), https://finance.yahoo.com/news/constellis-borrower-llc-moodys-downgrades-022206273.html [https://perma.cc/632Y-A9UG].

268. *See* Gladstone, *supra* note 238.

269. Constellis, *Constellis Holdings, LLC Completes a Recapitalization Transaction with Existing Investors*, PR NEWSWIRE (Sept. 17, 2024), https://www.prnewswire.com/news-releases/constellis-holdings-llc-completes-a-recapitalization-transaction-with-existing-investors-302250372.html [https://perma.cc/N6R2-WT6P]; *New Constellis Borrower LLC Upgraded To 'CCC+' From 'SD' On Refinancing; Outlook Negative; Debt Ratings Raised*, S&P GLOB. (Oct. 11, 2024), https://www.spglobal.com/ratings/es/regulatory/article/-/view/type/HTML/id/3266553 [https://perma.cc/6AUT-VBQJ].

270. *See* Constellis, *supra* note 269.

271. *See* Christopher Bousquet & Ben Tsocanos, *New Constellis Borrower LLC Downgraded to 'SD' On Distressed Exchange; Debt Ratings Lowered to 'D'*, S&P GLOB. (Oct. 2, 2024), https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/3260812 [https://perma.cc/4PHU-SKAB].

272. *See, e.g.*, *supra* notes 197 and 231 (providing examples of defense contractors filing bankruptcy).

the company saddled with new debt post-restructuring.[273] However, their private equity owners may favor out-of-court restructuring over formal bankruptcy proceedings for two reasons.[274] First, it avoids the financial disclosures and court approvals required in bankruptcy, enabling private equity firms to keep financials private.[275] Second, it allows firms to only partially restructure their debt, creating the opportunity for selective defaults.[276] This gives private equity firms leverage to extract more financial gains in a subsequent resale than they would have in a formal bankruptcy.[277]

While these outcomes serve the interests of the private equity owner, they frequently conflict with the objectives of the defense contractor—namely, to regain financial stability, prevent creditor enforcement against government contract assets, and preserve eligibility for future contracts.[278] Failing to secure a genuine fresh start hampers the contractor's ability meet their existing contractual obligations and erodes trust with key

273. For example, out-of-court restructuring enables "uptier exchange transactions," where a borrower collaborates with a select majority of its creditors to amend existing financing agreements and issue new senior priming debt—effectively subordinating the claims of the minority creditors. *See* Jackson Skeen, *Uptier Exchange Transactions: Lawful Innovation or Lender-on-Lender Violence*, 40 YALE J. REGUL. 408, 410–11 (2023). In December 2024, the Fifth Circuit held that certain "uptier transactions" could be deemed illegal if they violate the explicit terms of the underlying financing agreements. *See In re* Serta Simmons Bedding, L.L.C., 125 F.4th 555, 567 (5th Cir. 2024).

274. *See* Mark S. Chehi et al., *An Out-of-Court Restructuring or a Chapter 11 Case: When and How to Choose*, *in* REORGANIZING FAILING BUSINESSES 5–7 (Megan Adeyemo & Rafael Zahralddin-Aravena eds., 3d ed. 2017).

275. *See id.*

276. *See id.*

277. In an out-of-court restructuring, "a private investor may have the ability under a loan agreement or bond indenture to withhold a vote to restructure a company before bankruptcy, and thus extract rents from other investors." Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1670 (2009). As Lipson further explains:

> Holding certain claims or interests might, for example, create the power to block an out-of-court restructuring of a firm's debt, or [to] confirm[] . . . a reorganization plan, neither of which can occur without the support of a certain number and amount of claims and interests. This leverage might, in turn, enable the investor to extract rents from other stakeholders who are committed to supporting the plan.

Id. at 1617.

278. *See* Michael D. McGill et al., *The Intersection of Bankruptcy and Government Contracting and Impact of Bankruptcy on Government Contractors and the Acquisition of Government Contract Assets*, BRIEFING PAPERS, Aug. 2023, at 1, 2.

government stakeholders.[279] More broadly, this misalignment also jeopardizes the public interest, as prolonged insolvency can disrupt national security operations and compromise the integrity of the defense supply chain.[280]

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To summarize, the cases discussed above illustrate three distinct archetypes of private equity-induced bankruptcy risks. Intelsat demonstrates how private equity ownership can result in excessive debt accumulation, crippling the contractor's operations and financial stability. MD Helicopters exemplifies how private equity-driven mismanagement can erode public trust and compromise the contractor's capacity to support critical defense operations. Constellis underscores how misaligned incentives under private equity ownership can leave a defense contractor burdened with additional debt even after restructuring—jeopardizing its long-term stability.

Each of these cases demonstrates how private equity ownership can create and amplify bankruptcy risks for defense contractors, introducing distinct national security challenges that threaten the stability and integrity of the defense supply chain. The next Part analyzes the existing legal framework for addressing such challenges in defense contractor bankruptcies, focusing on the intersection between bankruptcy and national security law. It also examines the limitations of the current legal regime in effectively mitigating these challenges.

III. WHERE BANKRUPTCY MEETS NATIONAL SECURITY

Bankruptcy and national security law reflect two inherently conflicting aims. The corporate bankruptcy regime is designed to promote efficient debtor rehabilitation while balancing creditor protection.[281] To achieve this goal, the Bankruptcy Code grants

279. *See id.* at 7; *see also* Anthony G. Bower & Steven Garber, *Statistical Forecasting of Bankruptcy of Defense Contractors*, RAND (1994), https://www.rand.org/pubs/monograph_reports/MR410.html [https://perma.cc/J6WG-U4BW].

280. *See* McGill et al., *supra* note 278, at 8.

281. *See* NLRB. v. Bildisco & Bildisco, 465 U.S. 513, 527 (1984) ("[T]he policy of Chapter 11 is to permit successful rehabilitation of debtors . . . ."); *see also* Anthony J. Casey & Joshua C. Macey, *In Defense of Chapter 11 for Mass Torts*, 90 U. CHI. L. REV. 973, 976 (2023) ("Bankruptcy law resolves the collective action problem that arises when creditors pursue their claims in a variety of separate proceedings.").

bankruptcy judges broad equitable powers to do whatever is "necessary or appropriate"[282] to implement value-maximizing restructuring plans that benefit both debtors and creditors collectively.[283] In contrast, national security law—particularly, statutes governing the award and performance of federal defense contracts—prioritizes the stability and integrity of national defense systems over economic efficiency. The Anti-Assignment Acts[284] prohibit the unauthorized transfer of government contracts to third parties.[285] Their purpose is to prevent unknown third parties from acquiring claims against the federal government and using them to exert undue influence over the government or threaten critical supply chains.[286]

Ordinarily, the Bankruptcy Code and the Anti-Assignment Acts do not interact.[287] Afterall, it is not uncommon for Congress

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282. 11 U.S.C. § 105(a) ("The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."); *see* United States v. Energy Res. Co., 495 U.S. 545, 549 (1990) (describing section 105(a) as "consistent with the traditional understanding that bankruptcy courts, as courts of equity, have broad authority to modify creditor-debtor relationships"); Young v. United States, 535 U.S. 43, 50 (2002) ("[B]ankruptcy courts . . . are courts of equity [that] 'apply the principles and rules of equity jurisprudence.'" (quoting Pepper v. Litton, 308 U.S. 295, 304 (1939))).

283. *See* Truck Ins. Exch. v. Kaiser Gypsum Co., 144 S. Ct. 1414, 1420–21 (2024) (noting that a core purpose of bankruptcy is to offer "individuals and businesses in financial distress a fresh start to reorganize, discharge their debts, and maximize the property available to creditors").

284. *See supra* notes 31–32 and accompanying text.

285. *See* 41 U.S.C. § 6305(a) ("The party to whom the Federal Government gives a contract or order may not transfer the contract or order, or any interest in the contract or order, to another party. A purported transfer in violation of this subsection annuls the contract or order so far as the Federal Government is concerned, except that all rights of action for breach of contract are reserved to the Federal Government."); *see also* 31 U.S.C. § 3727 (addressing the assignment of claims under federal government contracts).

286. *See, e.g.*, United States v. Shannon, 342 U.S. 288, 293 (1952) ("One of Congress' [sic] basic purposes in passing the Act was 'that the government might not be harassed by multiplying the number of persons with whom it had to deal.'" (quoting Hobbs v. McLean, 117 U.S. 567, 576 (1886))); United States v. Aetna Cas. & Sur. Co., 338 U.S. 366, 373 (1949) (explaining that the primary purpose of the Anti-Assignment Acts is "to prevent persons of influence from buying up claims against the United States, which might be improperly urged upon officers of the Government") ("Another purpose . . . [is] to prevent possible multiple payment of claims, to make unnecessary the investigation of alleged assignments, and to enable the Government to deal only with the original claimant.").

287. *See* Major Scott E. Ransick, *Adverse Impact of the Federal Bankruptcy Law on the Government's Rights in Relationship to the Contractor in Default*,

to enact two separate statutes addressing distinct national priorities.[288] However, the rising tide of defense contractor bankruptcies has brought the two statutes into direct conflict. Specifically, the Bankruptcy Code's preference for market-oriented solutions and respect for freedom of contract[289] clashes with the Anti-Assignment Acts' prohibition on the free assignability of government contracts and its focus on preventing external business interference with defense operations.[290] In addressing this tension, courts often resolve defense contractor bankruptcy claims on an ad hoc, case-by-case basis.[291] This approach has resulted in significant legal inconsistencies across bankruptcy venues.[292] The Supreme Court has yet to provide guidance on this unresolved conflict.[293]

This Part examines how existing law addresses the tension between bankruptcy and national security. The analysis proceeds as follows: Section A explores the conflict between the Bankruptcy Code and the Anti-Assignment Acts in their

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124 MIL. L. REV. 65, 65 (1989) (arguing that "the Bankruptcy Code and the federal statutes underpinning the [federal] procurement system reveals only haphazard coordination between the two"); *see also* Ha Khuong, *Bankruptcy and the Anti-Assignment Acts: A New Approach to the Issue of Assumption and Assignability of Government Contracts*, 38 EMORY BANKR. DEVS. J. 97, 104 (2022) (explaining that 11 U.S.C. § 365(c) establishes an "applicable law" exception that limits a debtor's ability to assume or assign executory contracts).

288. Inconsistencies among different statutes—or among provisions within the same statute—often arise because they are "enacted by different sessions of Congress, arose out of different contexts, and concerned different subjects." William W. Buzbee, *The One-Congress Fiction in Statutory Interpretation*, 149 U. PA. L. REV. 171, 171 (2000). Yet many linguistic cannons of statutory interpretation rest on the assumption "that Congress, in legislating, is in a conversation only with itself." *Id.* This "one-Congress fiction" obscures the reality that "legislation arises out of a dynamic process involving many actors." *Id.* at 171–72*; see also* Richard K. Neumann Jr., *Why Congress Drafts Gibberish*, 16 LEGAL COMM. & RHETORIC: JALWD 111, 135 (2019) (arguing that "[a] lot of legislative incoherence is caused by mistakenly conflating" the distinct functions of "designing law and enacting it").

289. *See* Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 517–21 (1999).

290. *See* Park, *supra* note 35, at 318–19.

291. One of the greatest sources of legal uncertainty is whether the Bankruptcy Code permits debtors to assume and continue performance under a pre-bankruptcy executory contract, when applicable non-bankruptcy law prohibits assignment. Courts remain divided on this question. *See* Heather Hili, *Assumption Under Section 365(c)(1) Creates Uncertainty for Debtors*, 4 ST. JOHN'S BANKR. RSCH. LIBR., 2012, at 1, 1–3.

292. *See id.* at 11.

293. *See id.* at 2.

legislative objectives, with a focus on their divergent policies regarding contractual freedom; Section B analyzes how this statutory conflict constrains defense contractors' ability to seek insolvency relief when facing financial distress; and Section C examines how this conflict raises critical issues of statutory interpretation regarding the treatment of executory contracts in bankruptcy. It also considers the challenges that courts face in reconciling the text and purpose of these conflicting statutes.

A. CONFLICTING POLICIES BETWEEN BANKRUPTCY AND ANTI-ASSIGNMENT ACTS

When it comes to the freedom of contract, the Bankruptcy Code and the Anti-Assignment Acts embody opposing principles.[294] Generally, the Bankruptcy Code upholds the freedom of contract, viewing it as essential for enabling parties to develop market-oriented, value-maximizing debt resolution plans.[295] In line with this objective, bankruptcy courts typically refrain from rejecting, altering, or interfering with private agreements between debtors and creditors to resolve debt.[296] Absent exigent circumstances, such as fraudulent transfers or preferences, courts recognize the free assignability of contracts—allowing debtors to negotiate reorganization plans or exit packages that benefit both creditors and debtors economically.[297]

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294. *See generally* Khuong, *supra* note 287.

295. *See* Goren, *supra* note 25, at 1081 (noting "the Bankruptcy Code's policy of favoring out-of-court settlements and freedom to contract").

296. Jonathan L. Flaxer, *Bankruptcy Court Power to Adjudicate Contract Disputes*, 2 AM. BANKR. INST. L. REV. 369, 369–73 (1994) (describing the bankruptcy court's jurisdiction to review, adjudicate, or alter state contract disputes as limited to matters that are "core" to the bankruptcy process).

297. Although the Bankruptcy Code empowers courts to alter contractual rights, it has a default policy favoring the free assignability of contracts. *See* Peter S. Menell, *Bankruptcy Treatment of Intellectual Property Assets: An Economic Analysis*, 22 BERKELEY TECH. L.J. 733, 785 (2007). Bankruptcy courts generally respect and apply established principles of contract law that protect free assignability. *See id.* at 785 n.179; *see also* 3 RESTATEMENT (SECOND) OF CONTRACTS § 317(2) (AM. L. INST. 1981), which states:

> A contractual right can be assigned unless (a) the substitution of a right of the assignee for the right of the assignor would materially change the duty of the obligor, or materially increase the burden or risk imposed on him by his contract, or materially impair his chance of obtaining return performance, or materially reduce its value to him, or (b) the assignment is forbidden by statute or is otherwise inoperative on grounds of public policy, or (c) assignment is validly precluded by contract.

In contrast, the Anti-Assignment Acts impose strict restrictions on the free assignability of contracts—directly contradicting the Bankruptcy Code's policy of respecting contractual freedom.[298] The Anti-Assignment Acts treat the performance of government contracts as non-delegable duties of the contractor, akin to customized personal service contracts.[299] From a national security standpoint, free assignability of contracts poses risks that critical government assets, expertise, or services could be transferred to unsafe or unauthorized hands.[300] These concerns are particularly acute when private equity firms and investment funds—often opaque regarding their foreign ties[301]—play dominant roles in bankruptcy turnarounds and distressed M&A transactions.[302]

Another area of tension lies in the statutes' differing approaches to discrimination against bankrupt firms in contracting.[303] Section 525 of the Bankruptcy Code prevents the federal government from denying licenses, permits, or grants solely

298. *See* Michelle Morgan Harner et al., *Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 AM. BANKR. INST. L. REV. 187, 224–45 (2005) (describing government contracts as non-assignable in bankruptcy).

299. *Id.*

300. Park, *supra* note 35, at 316, 322 (stating that the Anti-Assignment Acts were designed to prevent fraudulent claims and harm to the government from counterparties).

301. *See, e.g.*, Ariel Cohen & J. Adam Ereli, *Foreign Penetration of Private Equity Endangers America*, THE HILL: OP. (Oct. 4, 2019), https://thehill.com/opinion/cybersecurity/464356-foreign-penetration-of-private-equity-endangers-america [https://perma.cc/QUQ9-NVUQ]; Press Release, Fact Coal., Massive and Opaque U.S. Private Investment Industry Presents Major National Security and Corruption Threats (Dec. 2, 2021), https://thefactcoalition.org/massive-and-opaque-u-s-private-investment-industry-presents-major-national-security-and-corruption-threats [https://perma.cc/9VVA-5CEZ].

302. *See, e.g.*, *Private Equity and Distressed Debt Funds Emerging Role in Preventing and Participating in Restructurings*, *in* THE LAW AND PRACTICE OF RESTRUCTURING IN THE UK AND US 221 (Christopher Mallon et al. eds., 2017) (discussing private equity's increasing role in restructurings); *Ways Private Equity Firms Can Deal With Distressed Debt*, AM. BANKR. INST., https://www.abi.org/feed-item/ways-private-equity-firms-can-deal-with-distressed-debt [https://perma.cc/4UN6-5LDY] (describing how private equity firms engage in distressed M&A).

303. *Bankruptcy, Overview – Protection Against Bankruptcy Discrimination*, BLOOMBERG L. (2025), https://www.bloomberglaw.com/external/document/XGTETGS000000/bankruptcy-overview-protection-against-bankruptcy-discrimination [https://perma.cc/PWA8-B97R].

because a contractor has filed for bankruptcy.[304] While the Bankruptcy Code does not expressly bar the government from declining to award contracts to bankruptcy contractors, courts have interpreted the anti-discrimination principle in section 525 as extending to contract awards.[305] Section 365(e)(1) goes a step further by invalidating *ipso facto* clauses—contractual provisions that treat bankruptcy filings as automatic breaches of contract—within bankruptcy proceedings.[306] These anti-discrimination protections reflect Congress's recognition that a financially distressed firm can face bankruptcy risks for reasons unrelated to its economic vitality or operational strength.[307]

Conversely, the Anti-Assignment Acts require government agencies to evaluate a prospective contractor's "responsibility" before awarding a contract.[308] The concept of responsibility is extremely broad. Responsibility encompasses everything from concrete requirements, like a contractor's technical capacity to perform contracts and maintain operational resilience during

304. 11 U.S.C. § 525.

305. *In re* Exquisito Servs., Inc., 823 F.2d 151, 155 (5th Cir. 1987) (holding that the government's refusal to renew a procurement contract with a company participating in the Small Business Administration program for economically disadvantaged businesses violated section 525(a) of the Bankruptcy Code, which prohibits government discrimination against debtors solely because they filed for bankruptcy protection); *In re* Walker, 927 F.2d 1138, 1142–43 (10th Cir. 1991) (holding that a state statute automatically revoking a real estate license based on the licensee's bankruptcy violates section 525(a) of the Bankruptcy Code); *In re* Son-Shine Grading, Inc., 27 B.R. 693, 695–96 (Bankr. E.D.N.C. 1983) (holding that the North Carolina Department of Transportation violated section 525(a) by disqualifying the debtor from bidding on public contracts solely because it filed a chapter 11 petition).

306. 11 U.S.C. § 365(e)(1). The Latin term *ipso facto* means "by the fact itself." *Bankruptcy, Overview – Ipso Facto Clauses in Bankruptcy*, BLOOMBERG L. (2025), https://www.bloomberglaw.com/external/document/X9BMJJQC000000/bankruptcy-overview-ipso-facto-clauses-in-bankruptcy [https://perma.cc/X2QX-PREH].

307. *See* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 581 (1998) (noting that Congress understood that "there is no necessary link between financial and economic distress" and that "[a] firm can be well-run yet unable to pay creditors"); *see also In re* Lutz, 82 B.R. 699, 703 (Bankr. M.D. Pa. 1988) ("The legislative history of [section 525] makes clear that Congress intended to prevent governmental units from interfering with the debtor's discharge and opportunity for a fresh start as provided by federal bankruptcy laws.").

308. *See* 48 C.F.R. § 9.103(a)–(b) (2025) ("Purchases shall be made from, and contracts shall be awarded to, responsible prospective contractors only . . . . No purchase or award shall be made unless the contracting officer makes an affirmative determination of responsibility.").

financial distress, to more subjective standards, such as sound business ethics.[309] Responsibility determinations are often shrouded in a black box: The federal contracting officer has broad discretion to accept or deny awards without explanation.[310] Thus, contrary to the Bankruptcy Code, the Anti-Assignment Acts not only permit but also mandate agencies to consider the financial insolvency and bankrupt statuses of prospective contractors.[311] Both the Government Accountability Office and the Court of Federal Claims have upheld agency determinations finding contractors "not responsible" due to past or present insolvency, denying bid protests from contractors challenging these decisions.[312]

This inherent conflict between the Bankruptcy Code's anti-discrimination principle and the Anti-Assignment Acts' responsibility requirement underscores a broader tension between the statutes' objectives: fostering market-oriented debtor rehabilitation versus maintaining government control over contracting. The Bankruptcy Code reflects Congress's policy of minimizing

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309. The Federal Acquisition Regulation (FAR), which implements the Anti-Assignment Acts and establishes the administrative rules for the federal government's award of public contracts, sets forth seven general standards for determining responsibility:

> [A] prospective contractor must—(a) Have adequate financial resources to perform the contract, or the ability to obtain them . . . ; (b) Be able to comply with the required or proposed delivery or performance schedule, taking into consideration all existing commercial and governmental business commitments; (c) Have a satisfactory performance record . . . ; (d) Have a satisfactory record of integrity and business ethics . . . ; (e) Have the necessary organization, experience, accounting and operational controls, and technical skills, or the ability to obtain them . . . ; (f) Have the necessary production, construction, and technical equipment facilities, or the ability to obtain them . . . ; and (g) Be otherwise qualified and eligible to receive an award under applicable laws and regulations.

Id. § 9.104-1 (2025).

310. *See* Caroline Guensberg, *What Were They Thinking? How the FAR Makes Responsibility Determinations a Guessing Game*, 27 FED. CIR. BAR J. 69, 85 (2017) (finding that contracting officers are "generally given wide discretion" in making responsibility determinations and in deciding the amount of information necessary to make these determinations).

311. *See* 48 C.F.R. § 9.104-1(a) (2025) (requiring prospective contractors to have adequate financial resources to perform the contract).

312. *See generally* McGill & Pettit, *supra* note 20 ("[T]he Government Accountability Office [] and the Court of Federal Claims [] have denied bid protests challenging agency non-responsibility determinations based on an offeror's bankruptcy.").

the negative externalities of large corporate bankruptcies by enabling distressed firms to devise market-oriented debt resolutions through private ordering.[313] It includes safeguards to protect contractual freedom, prevent market discrimination, and ensure that non-debtor entities do not disrupt the debt resolution process—a process that Congress and courts viewed as a collective effort among debtors, creditors, and other claimants.[314] Yet this policy directly conflicts with the Anti-Assignment Acts' purpose. By restricting contractual assignability and imposing responsibility requirements on government contractors, the Acts reflect Congress's recognition that a debtor's contractual freedom must yield whenever national security interests may be at stake.[315] In essence, the Anti-Assignment Acts reject the private ordering of public contracts.

However, in today's era of rampant defense outsourcing—where private and public functions are deeply intertwined—the tension between these statutes becomes particularly problematic for defense contractors.[316] For one thing, the financial stability of defense contractors is crucial to safeguarding national security interests.[317] Distressed contractors require market flexibility to assign, alter, or renegotiate contracts to regain

313. *See* Harrington v. Purdue Pharma L.P., 144 S. Ct. 2071, 2088 (2024) (Kavanaugh, J., dissenting) ("Bankruptcy seeks to solve a collective-action problem and prevent a race to the courthouse by individual creditors who, if successful, could obtain all of a company's assets, leaving nothing for all the other creditors.").

314. *See id.* at 2092 ("For many decades now, bankruptcy law has stepped in as a coordinating tribunal . . . [that] enables [claimants] who are seeking relief from the bankrupt company to work together to reach a fair and equitable distribution of the company's assets.").

315. *See In re* TechDyn Sys. Corp., 235 B.R. 857, 859–60 (Bankr. E.D. Va. 1999) (agreeing with the government's position that the Anti-Assignment Acts bar a debtor's assignment of government contracts because "national security interests at stake outweigh any benefit to the debtor and its estate from assumption of the contracts").

316. *See, e.g.*, Peter Gruskin, *The Public Sphere's Private Intelligence*, 4 CORNELL INT'L AFFS. REV. 35, 38 (2010) (noting that many industry observers argue that defense agencies have become too dependent on contractors who remove labor from the governmental sector); *see also* Mahlon Apgar, IV & John M. Keane, *New Business with the New Military*, HARV. BUS. REV. MAG. (Sept. 2004), https://hbr.org/2004/09/new-business-with-the-new-military [https://perma.cc/E4NG-7ZQA] (describing the Department of Defense's strategy to outsource its national security capabilities to contractors).

317. *See* Gruskin, *supra* note 316, at 41 (describing the ubiquity of contractors in the defense and intelligence community as emblematic of the government's heavy reliance on the private sector for its core functions).

financial stability and maintain performance on pre-bankruptcy defense contracts.[318] For another thing, the federal government has a vested interest in ensuring these contractors remain alive, as they possess substantial defense expertise, established relationships, and access to defense-critical resources vital for supporting federal projects and military operations.[319] Allowing these contractors to fail would not only result in mass layoffs and the loss of specialized defense expertise, but also the potential leakage of classified information.[320] It could also lead to the liquidation of defense-critical assets, causing systemic disruptions to national defense supply chains.[321] But the conflict between the Bankruptcy Code and the Anti-Assignment Acts prevents distressed defense contractors from harnessing the full range of debt resolution tools to regain financial stability and achieve a fresh start.[322] The next Section explores how distressed contractors navigate the bankruptcy process under the current legal regime despite this statutory conflict.

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318. *See* Apgar, IV & Keane, *supra* note 316 (describing the predominance of market flexibility that makes outsourcing and privatization of defense work enticing).

319. *See generally id.* (detailing the Department of Defense's reliance on corporate resources and capabilities to enhance its performance).

320. *See* Oscar Couwenberg & Stephen J. Lubben, *Not a Bank, Not a SIFI; Still Too Big to Fail*, 35 EMORY BANKR. DEVS. J. 53, 78–79 (2019) (describing defense contractors as non-bank entities whose financial distress may trigger systemic economic disruptions).

321. *See generally id.* at 79 (indicating that the government allowing defense-contractor Lockheed to fail in the early 1970s could have led to a "slippery slope" of national security considerations).

322. *See* Perry Cockerell & Robert A. Bartlett, *A Government Contract and Bankruptcy Law Conundrum: Interpretation of the Anti-Assignment Act and Related Matters*, 43 PROCUREMENT LAW. 12, 12 (2007) ("When it comes to the application of the Anti-Assignment Act in bankruptcy[,] . . . a fundamental schism has developed among the various federal circuit courts regarding the impact of the Anti-Assignment Act on the process by which a government contractor in financial straits seeks to reorganize or restructure its business operations for the benefit of itself and its creditors."). This statutory conflict may prevent defense contractors from fully exercising their authority to assume or assign executory contracts under section 365 of the Bankruptcy Code, or to conduct distressed asset sales under section 363. *See infra* Part III.C (explaining how conflicts between the Bankruptcy Code and the Anti-Assignment Acts create legal complications that can stymie a defense contractor's reorganization efforts).

B. How Defense Contractors Navigate the Bankruptcy Process

Ordinarily, companies in financial distress may explore various contractual options to restructure debt, such as stock sales, debt-equity swaps, and write-offs.[323] They may also pursue out-of-court restructuring or pre-packaged bankruptcy plans to resolve their debt obligations.[324] However, for defense contractors, these options are often unavailable due to national security restrictions and the government's interest in safeguarding critical assets from business interference.[325] Additionally, these options could jeopardize essential government relationships on which defense contractors rely, leaving formal bankruptcy proceedings, in-court asset sales, or a combination of both as the most realistic options.[326]

A distressed defense contractor typically resorts to one of two methods for insolvency relief: chapter 7 liquidation or chapter 11 reorganization.[327] Under chapter 7, the debtor's assets are placed into an estate managed by a court-appointed trustee (i.e., the bankruptcy trustee), who is in charge of liquidating the assets in the order established by the Bankruptcy Code's absolute

323. *See* Jason Jia-Xi Wu, *How Do "Bankruptcy Grifters" Destroy Value in Mass Tort Settlements?* In re Purdue Pharma *as a Bargaining Failure*, 32 AM. BANKR. INST. L. REV. 243, 245 (2024) ("In fact, the norm of business reorganization is to resolve debtor-creditor conflicts through negotiation rather than adjudication. In the United States, the vast majority of business insolvencies are resolved contractually via out-of-court restructurings."); McGill & Pettit, *supra* note 20.

324. *See, e.g.*, Dennis F. Dunne et al., *Prepackaged Chapter 11 in the United States: An Overview*, GLOB. RESTRUCTURING REV. (Mar. 4, 2022), https://globalrestructuringreview.com/guide/the-art-of-the-pre-pack/edition-2/article/prepackaged-chapter-11-in-the-united-states-overview [https://perma.cc/X8GJ-VBMM] (discussing the mechanics of different options for chapter 11 prepackaged bankruptcy plans); *see also* Chehi et al., *supra* note 274, at 1–2 (overviewing out-of-court restructuring and pre-packaged bankruptcy plans).

325. *See generally* McGill & Pettit, *supra* note 20 (describing the challenges associated with foreign ownership, control, or influence requirements in bankruptcy proceedings and issues involving government property considerations).

326. *See id.* (detailing supply chain risks and organizational conflicts of interest that may be salient when acquiring a distressed company that is a government contractor).

327. *See id.* (describing these types of insolvency relief as options that government contractors consider when in financial distress).

priority rule.[328] In contrast, chapter 11 allows the debtor to retain possession and control over its assets while continuing to operate its business during the bankruptcy process.[329] The debtor, simultaneously acting as the bankruptcy trustee, is often referred to as the "debtor-in-possession."[330] Large corporations often prefer chapter 11 over chapter 7 because it provides them a fresh start without significantly disrupting their business operations.[331] However, if the debtor's assets are insufficient to cover the creditors' claims to facilitate a chapter 11 reorganization, the court may convert the proceeding into a chapter 7 liquidation to protect the creditors' interests.[332]

In both chapter 7 and chapter 11 proceedings, the debtor-in-possession may sell portions of the debtor's assets, subject to the court's approval.[333] These in-court asset sales are governed by

328. *See* Liliya Gritsenko, *Everybody Wins! Elimination of the Absolute Priority Rule for Individuals Under BAPCA: A Middle Ground*, 35 CARDOZO L. REV. 1255, 1260 n.31 (2014) ("In a Chapter 7 case, all prepetition assets are liquidated in a trustee sale for the benefit of creditors.").

329. The court rarely appoints a trustee in a chapter 11 reorganization case. Instead, courts usually leave the existing management of the debtor intact and allow it to act as the functional trustee because the debtor's management typically has a better understanding of their own businesses than an outsider appointed by the court. *See* Khuong, *supra* note 287, at 104–05 (describing the pitfalls related to appointing a trustee in a chapter 11 reorganization case).

330. *See* Scott M. Reddie, *Section 546(a) of the Bankruptcy Code: A Plea for Predictability*, 4 J. BANKR. L. & PRAC. 3, 31–32 (1994) ("The debtor becomes a debtor-in-possession upon the commencement of a Chapter 11 case and remains a debtor-in-possession unless a trustee is appointed.").

331. *See* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 72 (1992) (describing chapter 11 bankruptcies as preferable to chapter 7 bankruptcies because chapter 11 bankruptcies, unlike chapter 7 bankruptcies, enable current management to retain control of the company during bankruptcy proceedings).

332. *See* PRAC. L. BANKR. & RESTRUCTURING, DISMISSING OR CONVERTING A CHAPTER 11 CASE TO A CHAPTER 7 CASE, Westlaw (listing sixteen grounds for cause to convert a chapter 11 case to a chapter 7 case under section 1112(b)(4)).

333. Section 363(b) allows a trustee or a debtor-in-possession, "after notice and a hearing," to sell, use, or lease estate property outside the ordinary course of business, subject to court approval and requirements such as providing adequate protection to secured creditors. *See* 11 U.S.C. § 363(b). By contrast, sales or uses of estate property in the ordinary course of business—such as routine corporate expenditures and maintenance costs—do not require court approval or notice. *See* 11 U.S.C. § 363(c). Corporate debtors frequently invoke section 363(b) to conduct all-asset sales. Courts evaluate such sales under the "business justification" test. *See* Jason Brege, Note, *An Efficiency Model of Section 363(b) Sales*, 92 VA. L. REV. 1639, 1646 (2006). Debtors often prefer a section 363 sale as a means of exiting chapter 11 in lieu of confirming a reorganization plan. *See*

section 363 of the Bankruptcy Code, commonly referred to as "section 363 sales."[334] For starters, a section 363 sale is an in-court M&A transaction where the debtor sells all or substantially most of its assets while the bankruptcy is pending.[335] Because the assets sold are legally owned by the bankruptcy estate, held in trust for the benefit of creditors, a section 363 sale requires court approval.[336] Once approved, assets sold under section 363 are transferred to the purchaser "free and clear of any interest in such property"—including any liens, claims, and encumbrances—provided that the statutory conditions are met.[337] As such, section 363 remains the default mechanism for distressed M&A deals.[338]

To effectuate a section 363 sale or reorganization process, the debtor-in-possession must identify all valuable assets that can be leveraged to negotiate a value-maximizing exit package.[339] For defense contractors, contracts with material customers, particularly those with the federal government, are often their most valuable assets.[340] Given that the federal government

id. at 1657–58. However, bankruptcy courts retain discretion under section 1112 to deny a section 363 sale and convert the chapter 11 case to chapter 7 liquidation. *See* 11 U.S.C. § 1112(b)(1) (authorizing dismissal or conversion "for cause").

334. *See* 11 U.S.C. § 363 (outlining the guidelines governing the use, sale, or lease of property in these situations).

335. *See generally* Michael H. Goldstein et al., *Top 10 Questions About Bankruptcy Sales – A Primer on Sales Under Section 363 of the Bankruptcy Code*, GOODWIN (May 29, 2024), https://www.goodwinlaw.com/en/insights/publications/2024/05/insights-finance-frg-top-10-questions-about-bankruptcy-sales [https://perma.cc/WWF6-LHXV] (answering frequently asked questions about section 363 sales).

336. *See id.* ("The debtor-seller [in a section 363 sale] does not need to obtain shareholder approval to sell all or substantially [sic] of its assets[;] the filing of the motion and bankruptcy court approval of the sale is all that is necessary.").

337. 11 U.S.C. § 363(f) ("The trustee may sell property . . . free and clear of any interest in such property of an entity other than the estate . . . .").

338. *See Distressed M&A Transactions: Step-by-Step Guide to Understanding Distressed M&A (Section 363)*, WALL ST. PREP (last updated Jan. 24, 2024), https://www.wallstreetprep.com/knowledge/distressed-ma-primer [https://perma.cc/S4RH-FKT2] ("Distressed M&A refers to transactions [under section 363 of the Bankruptcy Code] whereby the assets of a seller in financial distress can be purchased at bargain prices for qualified bidders.").

339. *See* Melissa B. Jacoby, *Unbundling Business Bankruptcy Law*, 101 N.C. L. REV. 1703, 1710–11 (2023) (describing chapter 11 as a package deal of obligations and rights, allowing the debtor to sell them for value maximization through the reorganization process).

340. *See* Edward H. Tillinghast, III & Blanka K. Wolfe, *Preserving Value for Government Contractors in Bankruptcy*, METRO. CORP. COUNS. (2015),

is typically their most important—and sometimes their only—customer, prospective acquirers often participate in the section 363 bidding process, with the expectation of acquiring contractual rights to these government contracts.[341] The assignability of federal defense contracts, therefore, can significantly impact whether a distressed defense contractor can successfully resolve its debt and achieve a fresh start after bankruptcy.[342]

Thus, the Anti-Assignment Acts' prohibition on the free assignment of defense contracts can impede value-maximizing deals that might otherwise enable a distressed defense contractor to successfully exit bankruptcy. The Anti-Assignment Acts' characterization of defense contracts as non-delegable duties directly subverts the Bankruptcy Code's mission to facilitate efficient debtor rehabilitation.[343] Although the Bankruptcy Code contains statutory carve-outs that resolve this tension, such fixes create more problems than they resolve. The next Section discusses these carve-outs in detail and how courts struggle to interpret their scope in the context of defense contractor bankruptcies.

C. TREATMENT OF EXECUTORY CONTRACTS IN BANKRUPTCY

Once the debtor files a bankruptcy petition, all claims against the debtor's assets are automatically stayed.[344] This automatic stay is a cornerstone of the Bankruptcy Code, designed to prevent creditors from "rac[ing] to the courthouse"[345] to seize

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https://www.sheppardmullin.com/assets/htmldocuments/Preserving%20Value%20for%20Government.pdf [https://perma.cc/NWB9-U8HP] (recognizing that government contractors filing for bankruptcy risk losing their ability to retain their valuable contracts).

341. *Cf. id.* (detailing the ability of a debtor to retain valuable contracts as one of the most useful tools offered by the Bankruptcy Code).

342. *See generally id.* (describing the limited ability of government contractors to assume or assign their contracts with the government).

343. *See In re* Adana Mortg. Bankers, Inc., 12 B.R. 977, 984 n.2 (Bankr. N.D. Ga. 1980) (noting that the Anti-Assignment Acts apply to public contracts where the federal government depends on the specific, non-delegable capabilities of contractors) ("If the contract is of the sort where the government depends upon certain characteristics or abilities of the contractor, then the prohibition of 41 U.S.C. § 15 will apply." (citing Thompson v. Comm'r, 205 F.2d 73, 77 (3d Cir. 1953))).

344. *See* 11 U.S.C. § 362(a)(3) (recognizing this protection once the debtor files a bankruptcy petition).

345. *See* Eletson Holdings, Inc. v. Levona Holdings Ltd., 731 F. Supp. 3d 531, 600 (S.D.N.Y. 2024) ("The right to file a bankruptcy petition exists not

the debtor's property in a scramble for relief.[346] By halting debt enforcement actions, the stay facilitates the orderly resolution of liabilities within a centralized forum.[347] It provides the debtor with breathing room, creating time to assess its financial situation, negotiate with creditors, and determine which assets are worth preserving.[348]

However, the Bankruptcy Code carves out exceptions to the automatic stay. One of the most important exceptions in defense contractor bankruptcies is the "executory contract exception," which grants counterparties to a debtor's pre-bankruptcy executory contract relief from the automatic stay.[349] Yet, the legal

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purely to protect the personal interests of the debtor but also to protect the interests of the community of all of the creditors and the economy generally against the destructive race to the courthouse that would ensue if a single forum were not permitted to adjudicate, all at once, the interests of all with a claim against the debtor."); *see also* Sherwood Partners, Inc. v. Lycos, Inc., 394 F.3d 1198, 1203 (9th Cir. 2005) ("In a world of individual actions . . . [t]he creditors race to the courthouse, all demanding immediate payment of their entire debt.").

346. *See In re* Quality Health Care, 215 B.R. 543, 575 (Bankr. N.D. Ind. 1997) ("The object of the automatic stay provision is essentially to solve a collective action problem—to make sure that creditors do not destroy the bankruptcy estate in their scramble for relief." (quoting United States v. Inslaw, Inc., 932 F.2d 1467, 1473 (D.C. Cir. 1991))). An automatic stay goes into effect the moment when a debtor files for bankruptcy. *See* 11 U.S.C. § 362; *see also* Julia Kagan, *Automatic Stay: What It Is, How It Works, Example*, INVESTOPEDIA (last updated Mar. 26, 2024), https://www.investopedia.com/terms/a/automaticstay.asp [https://perma.cc/D5AC-8MTW] ("An automatic stay is a provision in United States bankruptcy law that temporarily prevents creditors, collection agencies, government entities, and others from pursuing debtors for money that they are owed.").

347. *See* Douglas G. Smith, *Resolution of Mass Tort Claims in the Bankruptcy System*, 41 U.C. DAVIS L. REV. 1613, 1639–40 (2008) ("The automatic stay . . . afford[s] the parties and the [c]ourt an opportunity to appropriately resolve competing economic interests in an orderly and effective way." (internal quotations omitted)); *see also* Jonathan L. Goldberg, *"Otherwise Consistent": A Due Process Framework for Mass-Tort Bankruptcies*, 98 N.Y.U. L. REV. 1696, 1704 (2023) ("The bankruptcy court becomes the central forum where creditors can litigate or bargain to arrive at an acceptable collective resolution.").

348. *See* Khuong, *supra* note 287, at 113 (describing an automatic stay as a tool to buy time for debtors and to prevent creditors from dismantling debtors' assets).

349. *See* Samuel R. Maizel & Tracy J. Whitaker, *The Government's Contractual Rights and Bankruptcy's Automatic Stay: Irreconcilable Differences?*, 25 PUB. CONT. L.J. 711, 722 (1996) (enabling the debtor to assume or reject these contracts); *see also* 11 U.S.C. § 365(f)(1) (outlining this exception); *In re* Ames Dep't Stores, Inc., 287 B.R. 112, 118–19 (Bankr. S.D.N.Y. 2002) (noting that "debtors may assume and assign their interests in leases even without lessor consent" under 11 U.S.C. § 365(f)(1)); *In re* Off. Prods. of Am., Inc., 136 B.R.

doctrine governing the treatment of executory contracts in bankruptcy is anything but clear. Courts have described the case law as "hopelessly convoluted"[350] and a "bramble-filled thicket."[351] Given this uncertainty, the executory contract exception remains one of the most highly litigated issues in defense contractor bankruptcies.[352] The following discussion unpacks the framework of this exception, explores competing judicial interpretations, and examines why this issue has long perplexed the bankruptcy bar.

1. Executory Contract Exception: A Primer

Under section 365 of the Bankruptcy Code, a debtor-in-possession may reject or continue its performance under an executory contract which would otherwise be enjoined by the automatic stay.[353] Though the Bankruptcy Code does not define "executory contract,"[354] the accepted definition is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material

992, 996–97 (Bankr. W.D. Tex. 1992) (noting that 11 U.S.C. § 365(f)(1) generally permits a debtor to assume and assign executory contracts notwithstanding the automatic stay).

350. *In re* Drexel Burnham Lambert Grp., Inc., 138 B.R. 687, 690 (Bankr. S.D.N.Y. 1992) (quoting Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1, 1 (1991)).

351. *Id.*

352. *See* Scott E. Ransick, *Adverse Impact of the Federal Bankruptcy Law on the Government's Rights in Relationship to the Contractor in Default*, 124 MIL. L. REV. 65, 92–93 (1989) (noting that disputes over government procurement (an executory contract) and "status of funds and inventory held by the contractor" are among the "most bitterly disputed issues involving government procurement and bankruptcy"); *see also* Major Kathyrn R. Sommerkamp et al., *Developments of 1996—The Year in Review*, 1997 ARMY LAW. 3, 82–83 (1997) (reviewing 1996 case law developments on executory contracts); Major Steven N. Tomanelli et al., *1993 Contract Law Developments—The Year in Review*, 1994 ARMY LAW. 3, 77 (1994) (surveying 1993 case law on executory contracts); Major Harry L. Dorsey et al., *1990 Contract Law Developments—The Year in Review*, 1991 ARMY LAW. 3, 76–77 (1991) (describing 1990 case law on executory contracts).

353. *See* 11 U.S.C. § 365.

354. *See* S. REP. NO. 95-989, at 58 (1978) ("Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides.").

breach excusing the performance of the other."[355] In other words, section 365 enables the debtor-in-possession to pick which contracts are valuable enough to survive bankruptcy.[356]

Section 365(a) grants the debtor-in-possession "the power to assume—that is, to continue to receive the benefits of, while also continuing to perform its obligations under—the debtor's [unexpired] leases [and] ongoing [executory] contracts[.]"[357] To exercise this power, the debtor-in-possession need only demonstrate to the court that the assumption falls within its sound business judgment—an extremely deferential standard.[358] This power is further reinforced by section 365(f), which allows a debtor-in-possession, with court approval, to assign an executory contract to a third party without requiring the consent of the counterparty to the contract.[359]

However, under section 365(c), a trustee (usually the debtor-in-possession) may not assume or assign an executory contract, if:

> [A]pplicable law excuses a party, other than the debtor, to [an executory contract] from accepting performance from or rendering

355. Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973); *see In re* C & S Grain Co., 47 F.3d 233, 237 (7th Cir. 1995) (adopting Vern Countryman's definition of "executory contracts").

356. Rejection of the executory contract relieves the debtor of its future obligation to perform, but it does not make the contract disappear. Instead, the rejection is treated as a breach effective as of the bankruptcy filing date, enabling the counterparty to assert a breach of contract claim. But the breach of contract claim will be treated as a claim in bankruptcy that must wait in line under the absolute priority rule. *See Lead Article: Does Assuming a Contract in Bankruptcy Waive Later Attacks on the Contract?*, QUINN EMANUEL: BUS. LITIG. REPS. (Oct. 17, 2022), https://www.quinnemanuel.com/the-firm/publications/lead-article-does-assuming-a-contract-in-bankruptcy-waive-later-attacks-on-the-contract [https://perma.cc/7F7W-WWQB] (explaining the process surrounding rejection of executory contracts under 11 U.S.C. § 365).

357. N.C.P. Mktg. Grp., Inc. v. BG Star Prods., Inc., 556 U.S. 1145, 1145 (2009).

358. The bankruptcy court must review and approve the debtor-in-possession's decision to assume or reject executory contracts. *In re* Astria Health, 640 B.R. 758, 767 (Bankr. E.D. Wash. 2022). However, this is typically conducted as a summary proceeding, where the court applies a deferential standard to the debtor-in-possession's exercise of business judgment. *See id.* Due to the summary nature of the proceeding, the court's decision is not considered a ruling on the merits of any contractual issues and does not carry collateral estoppel effects. *See id.* at 773 n.58 (noting that, due to the lack of preclusive effect, another court, or the same bankruptcy court, may reach a different conclusion after it tries the underlying dispute).

359. 11 U.S.C. § 365(f).

> performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and such party does not consent to such assumption or assignment . . . .[360]

Simply put, section 365(c) prevents a debtor-in-possession from assigning an executory contract if applicable non-bankruptcy law prohibits such assignment.[361] This provision seeks to strike a balance between the debtor-in-possession's power to assign contracts with "the rights of third parties" who "may be prejudiced by having the contract . . . performed by an entity with which they did not enter into the agreement."[362] It embodies the overarching bankruptcy policy that efficient debtor rehabilitation should not excessively interfere with third-party contractual rights.[363] Courts generally interpret section 365(c) to mean that, if applicable non-bankruptcy law prohibits assignment of executory contracts, a debtor-in-possession's ability to assume or assign those contracts under section 365(a) is correspondingly limited—despite bankruptcy law's general policy of favoring the free assignability of contracts.[364] Courts also consistently recognize

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360. *Id.* § 365(c)(1)(A)–(B).

361. Although section 365(c)(1) is often referred to as the "personal services contract" exception, it is not limited to personal service contracts. Courts have interpreted section 365(c) as applying to "circumstances as contracts for the performance of nondelegable duties." *In re* Taylor Mfg., Inc., 6 B.R. 370, 372 (Bankr. N.D. Ga. 1980). As noted in *In re Lil' Things, Inc.*, "personal services contracts are merely one type of contract which fell under the [section] 365(c)(1)(A) exception, and not the only type." 220 B.R. 583, 587–88 (Bankr. N.D. Tex. 1998).

362. *In re Lil' Things*, 220 B.R. at 591.

363. *See, e.g.*, *In re* C.W. Mining Co., 422 B.R. 746, 759 (B.A.P. 10th Cir. 2010) ("The purpose behind § 365 is to balance the state law contract right of the creditor to receive the benefit of his bargain with the federal law equitable right of the debtor to have an opportunity to reorganize."); *In re* Circle K Corp., 190 B.R. 370, 376 (B.A.P. 9th Cir. 1996) (noting that the purpose of § 365 is "accomplished by forcing the debtor to abide by the contract provisions during pendency of the bankruptcy and cure any prepetition defaults upon assumption while prohibiting the creditor from enforcing any prepetition default remedies"); *In re* Joshua Slocum Ltd., 922 F.2d 1081, 1091 (3d Cir. 1990) ("[M]odification of a contracting party's rights is not to be taken lightly. Rather, a bankruptcy court in authorizing assumptions and assignment . . . must be sensitive to the rights of the non-debtor contracting party . . . and the policy requiring that non-debtor receive the full benefit of his or her bargain.").

364. *See, e.g.*, *In re* Catapult Ent., Inc., 165 F.3d 747, 749–50 (9th Cir. 1998); *In re* Catron, 158 B.R. 629, 632–33 (E.D. Va. 1993); *In re* Cardinal Indus., Inc., 116 B.R. 964, 978–80 (Bankr. S.D. Ohio 1990) (analyzing the legislative history behind section 365(c)).

the Anti-Assignment Acts as "applicable law" within the meaning of section 365(c).[365]

2. Assumption of Executory Contracts: A Circuit Split

But section 365(c) leaves one critical question unanswered: If applicable non-bankruptcy law—such as the Anti-Assignment Acts—prohibits the assignment of an executory contract, can the debtor-in-possession nevertheless assume the contract without intending to assign it to a third party?[366] Courts are sharply divided on this issue.[367] To address this statutory gap, courts have adopted two distinct approaches: the "hypothetical test" and the "actual test."[368]

Hypothetical Test: The majority rule holds that "if applicable law prevents the assignment of the executory contract, both assumption and assignment are prohibited even if the debtor does not intend on assigning the contract."[369] That is to say, the debtor-in-possession cannot assume the executory contract—regardless of whether the debtor actually intends to assign it. Most appellate courts, including the Third, Fourth, Ninth, and Eleventh Circuits, have interpreted section 365(c) to mean that "a debtor-in-possession may assume an executory contract only if hypothetically it may assign that contract to a third party."[370] In

365. *See, e.g.*, *In re* W. Elecs., Inc., 852 F.2d 79, 82 (3d Cir. 1988) (noting that the Anti-Assignment Acts are "applicable law," restricting assignment under section 365(c)); *In re* TechDYN Sys. Corp., 235 B.R. 857, 861 (Bankr. E.D. Va. 1999) (holding that the Anti-Assignment Acts constitute "applicable law" prohibiting assignment of an executory contract); *see also* Evan C. Hollander et al., Commentary, *The Impact of Prime Contractor Bankruptcy on U.S. Government Contracts*, WESTLAW J. GOV'T CONT., May 27, 2014, at 1, 6 ("[T]hose cases analyzing the statute in the context of the anti-assignment provision of [s]ection 365(c) . . . leave little doubt that a court would conclude that the Anti-Assignment Act is an applicable law prohibiting or restricting assignment."); *cf. In re* Mirant Corp., 440 F.3d 238, 253 (5th Cir. 2006) (noting in dicta that the Anti-Assignment Acts might not be considered "applicable law," until an actual assignment occurs).

366. *See* Hili, *supra* note 291 ("But courts relying on [s]ection 365(c)(1) to resolve this issue have interpreted it in different ways, creating a split among the circuits.").

367. *See infra* notes 369–79 (discussing the two court approaches to this issue).

368. *See id.*

369. *In re* Welcome Grp. 2, LLC, 660 B.R. 874, 880 (Bankr. S.D. Ohio 2024).

370. N.C.P. Mktg. Grp., Inc. v. BG Star Prods., Inc., 556 U.S. 1145, 1145 (2009) (explaining the "hypothetical test," as articulated by the Third, Fourth, Ninth, and Eleventh Circuits).

other words, "if the debtor-in-possession lacks hypothetical authority to assign a contract, then it may not assume it—even if the debtor-in-possession has no actual intention of assigning the contract to another."[371]

Courts applying the "hypothetical test" focus on what they assert is the plain meaning of the statute.[372] They emphasize the statutory language being written in the disjunctive—assume *or* assign—and conclude that allowing a debtor to assume an executory contract, when applicable law bars the assignment of the same, essentially reads the "or" out of the statute and replaces it with "and."[373] Under this interpretation, the actual intent of the debtor is irrelevant to the court's analysis. However, as the Supreme Court noted in *N.C.P. Marketing Group*, the "hypothetical test" "is not without its detractors":

> One arguable criticism of the hypothetical approach is that it purchases fidelity to the Bankruptcy Code's text by sacrificing sound bankruptcy policy. For one thing, the hypothetical test may prevent debtors-in-possession from continuing to exercise their rights under nonassignable contracts, such as patent and copyright licenses. Without these contracts, some debtors-in-possession may be unable to effect the successful reorganization that [c]hapter 11 was designed to promote. For another thing, the hypothetical test provides a windfall to nondebtor parties to valuable executory contracts: If the debtor . . . seeks bankruptcy protection, then the nondebtor obtains the power to reclaim—and resell at the prevailing, potentially higher market rate—the rights it sold to the debtor.[374]

Actual Test: To better align section 365(c) with the Bankruptcy Code's policy of promoting efficient debtor rehabilitation, one appellate court, along with most bankruptcy courts, has rejected the "hypothetical test" in favor of the "actual test."[375]

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371. *Id.* (citing *In re* Catapult Ent., Inc., 165 F.3d 747, 747 (9th Cir. 1998)).

372. *See id.* ("[T]he actual test aligns [section] 365(c) with sound bankruptcy policy only at the cost of departing from at least one interpretation of the plain text of the law.").

373. *See id.* ("[A] debtor-in-possession may assume an executory contract only if hypothetically it might assign that contract to a third party.").

374. *Id.*

375. *See, e.g.*, Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir. 1997); Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608, 612 (1st Cir. 1995) (adopting the "actual test"); *see also In re* Footstar, Inc., 323 B.R. 566, 569 (Bankr. S.D.N.Y. 2005) ("[T]he great majority of lower courts have taken the view that the courts should apply an 'actual test' in construing the statutory language so as to permit assumption where the debtor in possession in fact does not intend to assign the contract."); *In re* Mirant Corp., 303 B.R. 319, 331–34

Under the "actual test," courts assess, on a case-by-case basis, whether the counterparty to the executory contract is "*actually* . . . being 'forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.'"[376] Courts adopting this approach maintain that the debtor-in-possession retains the same contractual rights and obligations they held prior to filing for bankruptcy.[377] By focusing on the parties' actual intent, the test prevents nondebtor counterparties from disrupting the debtor's reorganization process and ensures that the debtor "receive[s] the full benefit of its bargain."[378] As the U.S. Bankruptcy Court for the Southern District of New York clarified in *Footstar*:

> The courts applying the "actual test" reject an interpretation based on a "hypothetical" (but not real) intent to assign the contract in contravention of the balance of the statutory provision. These courts emphasize the fact that a literal interpretation of the disjunctive "or" is utterly incongruent with the objectives of the Bankruptcy Code and would lead to the anomalous result that a debtor in possession would be deprived of its valuable but unassignable contract solely by reason of having sought the protection of the Bankruptcy Court, even though it did not intend to assign it.[379]

However, neither test fully resolves the underlying issue. While the "actual test" purports to adhere more closely with the Bankruptcy Code's policy, it fails to provide meaningful legal guidance for courts dealing with complex defense contractor bankruptcies due to its reliance on a case-by-case approach. In practice, this means courts must scrutinize the specific facts of each case and exercise broad discretion to determine

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(Bankr. N.D. Tex. 2003) (adopting the "actual test"); *In re* Cajun Elec. Power Coop., 230 B.R. 693, 705 (Bankr. M.D. La. 1999) (adopting the "actual test"); *In re* GP Express Airlines, Inc., 200 B.R. 222, 231–32 (Bankr. D. Neb. 1996) (adopting the "actual test"); *In re* Am. Ship Bldg. Co., 164 B.R. 358, 362–63 (Bankr. M.D. Fla. 1994) (adopting the "actual test"); *In re* Ont. Locomotive & Indus. Ry. Supplies (U.S.), Inc., 126 B.R. 146, 147–48 (Bankr. W.D.N.Y. 1991) (adopting the "actual test"); *In re* Cardinal Indus., Inc., 116 B.R. 964, 978–79 (Bankr. S.D. Ohio 1990) (adopting the "actual test").

376. *Cambridge Biotech*, 104 F.3d at 493 (quoting *Leroux*, 69 F.3d at 612).

377. *See id.* ("Where the particular transaction envisions that the debtor-in-possession would assume and continue to perform under an executory contract, the bankruptcy court cannot simply presume as a matter of law that the debtor-in-possession is a legal entity *materially* distinct from the prepetition debtor with whom the nondebtor party (*viz*, Pasteur) contracted.").

378. *In re Footstar*, 323 B.R. at 570 (internal quotations omitted) (quoting *Cambridge Biotech*, 104 F.3d at 493).

379. *Id.*

assumability of executory contracts—a process that effectively resembles the absence of a consistent legal standard.

3. Failed Judicial Attempts to Resolve Ambiguities in Section 365(c)

To address this legal inconsistency, some bankruptcy courts have modified the "actual test" to reconcile sound bankruptcy policy with the text of section 365(c). In *Footstar*, the U.S. Bankruptcy Court for the Southern District of New York held that section 365(c) only prohibits a court-appointed trustee—but not a debtor-in-possession—from assuming an unassignable executory contract.[380] The court's reasoning centered on the distinction that "the debtor and the trustee in a [c]hapter 11 case are entirely different parties."[381] As the court observed in *Footstar*, the text of section 365(c) states that "the trustee may not assume or assign," without explicitly referencing the debtor-in-possession.[382] Thus, in a chapter 11 proceeding, where a trustee is rarely appointed, a debtor-in-possession may assume valuable executory contracts without requiring counterparty consent.[383] This interpretation removes the counterparty's ability to withhold consent, preventing them from leveraging their position to extract windfalls and obstruct the debtor's reorganization process.[384] Although the *Footstar* decision has "no binding authority

380. *Id.* at 570–71.

381. *Id.* at 571 ("A basic misconception, in this Court's view, underlies the three Circuit Court decisions adopting the 'hypothetical' test, in that all three proceed from the premise, expressed or unstated, that 'trustee' as used in [s]ection 365(c)(1) means 'debtor-in-possession.'").

382. *Id.* at 570.

383. Traditionally, the incumbent managers of the debtor continue to administer the bankruptcy estate in a chapter 11 proceeding as the debtor-in-possession. *See* A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875, 898 (2009) ("Though the Code provides that managers can be replaced or supervised by a public trustee, trustee appointments are, and always have been, rare."). In the wake of "the Enron and WorldCom scandals, Congress has made it easier to displace managers. Managers are now replaceable by a statutory trustee 'for cause' if they are found to be fraudulent, dishonest, or incompetent, or to have grossly mismanaged the company." *Id.* (citing 11 U.S.C. § 1104(a)(1)). Yet trustee appointments in chapter 11 remain uncommon because "[t]he required showing of ineptitude or incompetence to appoint a statutory trustee is high." *Id.* at 899.

384. *See* Jennifer Ying, *The Plain Meaning of Section 365(c): The Tension Between Bankruptcy and Patent Law in Patent Licensing*, 158 U. PA. L. REV. 1225, 1256 (2010) (arguing that, under *Footstar*, "the debtor party is protected

on other federal court," it has substantial persuasive influence within the Second Circuit and has been adopted by courts outside the circuit,[385] including the U.S. Bankruptcy Court for the District of New Mexico.[386]

Yet, even modified tests such as the *Footstar* approach fail to address the root cause of this legal inconsistency: the indistinguishability between public and private duties embedded in government contracts held by bankrupt contractors. What *Footstar* fails to clarify is which types of defense contracts qualify as "executory contracts" rendered unassignable by the Anti-Assignment Acts under section 365(c).

This issue is particularly salient when defense contracts span a wide array of goods and services that extend beyond traditional military supplies. In *West Electronics*, the Third Circuit held that a debtor-in-possession "could not force the government to accept the 'personal attention and services' of a third party without its consent" because contractual duties concerning the supply of military equipment were "what Congress had in mind when it passed the Anti-Assignment Acts."[387] *West Electronics*, however, was silent on the status of defense contracts unrelated to military equipment—such as those for defense logistics,

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by avoiding 'the perverse and anomalous consequences of the "hypothetical test" rule under which a debtor may lose the benefit of a non-assignable contract vital to its economic future solely because it filed for bankruptcy.'" (citation omitted)); *see also* Mark Douglas, *IP Perspective: Actual Test and* Footstar *Approach Govern DIP's Ability to Assume Patent and Technology License*, CORP. COUNSEL'S LICENSING LETTER, No. 86, at 4 (May 2008) (noting that "*Footstar* was a welcome development for debtors, particularly for licenses of intellectual property and patents, but the ruling did little to end the debate concerning § 365(c)(1).").

385. Thomas M. Mackey, *Post-Footstar Balancing: Toward Better Constructions of § 365(c)(1) and Beyond*, 84 AM. BANKR. L.J. 405, 405 (2010).

386. *See In re* Aerobox Composite Structures, LLC, 373 B.R. 135, 142 (Bankr. D.N.M. 2007) ("[T]he Court finds that the 'actual test' articulated in *Cambridge Biotech*, and the reasoning of the court in *Footstar*, is the better approach to [section] 365(c)(1) when determining whether a debtor-in-possession is precluded from assuming an executory contract."). *But see In re* Taylor Inv. Partners II, LLC, 533 B.R. 837, 841 (Bankr. N.D. Ga. 2015) (declining to follow the *Footstar* approach).

387. *In re* W. Elecs., Inc., 852 F.2d 79, 83 (3d Cir. 1988) (holding that federal defense contracts for the supply of military equipment are executory contracts within the meaning of section 365(c)(1)); *see* Tanya M. Kiatkulpiboone, *Keeping Score When Bankruptcy Principles and the Federal Anti-Assignment Act Collide: Government Contractors' Options Concerning Executory Contracts*, 3 J. BUS. ENTREPRENEURSHIP & L. 281, 294 (2010).

services, and intelligence.[388] These types of contracts, while crucial to the modern national security regime, were not contemplated by Congress when it enacted the Anti-Assignment Acts.[389]

Following *West Electronics*, courts have struggled to navigate the doctrinal ambiguities of section 365(c), as courts resort to a flurry of makeshift multi-factor tests to discern what "Congress must have contemplated."[390] In *Carolina Parachute*, the U.S. District Court for the Middle District of North Carolina considered whether the U.S. Air Force could unilaterally prevent a bankrupt contractor from assuming and assigning a defense contract for the supply of dual-use parachutes, pursuant to the Anti-Assignment Acts.[391] Applying a "totality of the circumstances" test—which examines whether "the government, through its knowledge, consent, and actions, has acquiesced in an assignment"—the court ruled in favor of the government.[392]

However, beneath the court's ruling in *Carolina Parachute* was a purely economic, rather than legal, consideration. The

388. *See In re W. Elecs., Inc.*, 852 F.2d at 83.

389. The history of the Anti-Assignment Acts can be traced to 1853, when Congress—seeking to prevent fraudulent claims against the federal government—enacted "An Act to Prevent Frauds Upon the Treasury of the United States." *See* Yingzhi Li, *Including a Definition of "Operation of Law" in the Federal Acquisition Regulation: A Roadmap for Government Contractors Engaging in Merger and Acquisition Transactions*, 48 PUB. CONT. L.J. 819, 823 (2019) (citing An Act to Prevent Frauds Upon the Treasury of the United States, ch. 81, § 1, 10 Stat. 170 (1853)). The original 1853 Act addressed only fraudulent claims in government contracting. *See id.* at 823–24. In 1862, Congress enacted "An Act to define the Pay and Emoluments of certain Officers of the Army, and for other Purposes," which later became the statutory foundation for the Assignment of Claims Act. *See id.* at 824 (citing ch. 200, § 14, 12 Stat. 594 (1862)). In 1940, Congress again amended the framework through the Assignment of Claims Act, which was enacted "in response to the need for national defense financing," with the principal purpose of allowing assignment to "'a bank, trust company or other financing institution' of moneys due or to become due under government contracts." *Unassignable Claims Against the United States: A Commercial Anachronism*, 68 YALE L.J. 515 (1959); *see also* H.R. REP. NO. 77-2925, at 1–2 (1940). Neither Act defined which categories of federal contracts were "unassignable."

390. *See* Thomas M. Mackey, *Post*-Footstar *Balancing: Toward Better Constructions of § 365(c)(1) and Beyond*, 84 AM. BANKR. L.J. 405, 435 (2010) (citing Brett W. King, *Assuming and Assigning Executory Contracts: A History of Indeterminate "Applicable Law,"* 70 AM. BANKR. L.J. 122 (1996)).

391. *In re* Carolina Parachute Corp., 108 B.R. 100, 101 (M.D.N.C. 1989), *rev'd on other grounds*, 907 F.2d 1469 (4th Cir. 1990).

392. *Id.* at 103 (citing Tuftco Corp. v. United States, 614 F.2d 740 (1980)).

court weighed heavily on the fact that the "debtor was 40% delinquent in performing [their delivery obligations]" and that such failure "paralyzed the parachute training program in the Seymour-Johnson Air Force Base."[393] Yet, rather than clarifying whether the defense contract qualified as an "executory contract[]" under section 365(c), the court uncritically adopted the government's position.[394]

Notably, the *Carolina Parachute* court reached its conclusion without meaningfully applying "totality of the circumstances" test on a factor-by-factor basis.[395] Instead, it relied on the contractor's delinquency rate, despite the fact that this rate did not constitute a contractual breach and was irrelevant to the debtor's rights under the Bankruptcy Code.[396] Given the timing of the litigation, one could reasonably infer that the government's true motive for termination was not a genuine intent to prohibit assignment at the time of contracting, but a retrospective decision to exit an unprofitable contract after the contractor's bankruptcy filing.[397] By allowing the government to retroactively terminate a contract that had not been breached, the court effectively granted it a windfall, sanctioning a post hoc economic judgment rather than enforcing the original bargain. In doing so, the court appeared to bend over backwards to legitimize government protectionism under the guise of statutory interpretation.[398]

The same judicial bias towards government protectionism is evident in *Plum Run Service*, where the U.S. Bankruptcy Court

393. *Id.* at 101–02.

394. *See id.* at 103 ("[I]mplementation of the automatic stay left the government with no choice but to maintain the *status quo* with regard to the executory contracts.").

395. *See id.* at 103–04 (acknowledging the existence of the test without addressing its factors).

396. *See id.* at 103 ("[T]he bankruptcy judge's order affords debtor relief to which, were debtor not in bankruptcy, it would not be entitled . . . .").

397. *See id.* Notably, *Carolina Parachute* appears to give the government a green light to unilaterally terminate an executory contract solely because the contractor has filed for bankruptcy. This outcome conflicts with the Bankruptcy Code's broader policy against *ipso facto* clauses, which generally prohibit creditors from terminating a contract or deeming it breached merely because the debtor has filed for bankruptcy. 11 U.S.C. § 365(e)(1).

398. *See In re Carolina Parachute Corp.*, 108 B.R. at 103. This issue is even more problematic for courts in circuits that adopt the "hypothetical test," as the test prohibits both assignment and assumption if an executory contract is deemed unassignable under applicable law.

for the Southern District of Ohio reached a similar decision despite adopting a brightline rule that strives to resolve the ambiguities of section 365(c).[399] In *Plum Run Service*, the court considered whether a service contract for maintaining the U.S. Naval Base in Guantanamo Bay fell within the category of contracts that Congress intended to make unassignable under the Anti-Assignment Acts.[400] Ruling for the government, the court held that the Anti-Assignment Acts grant the U.S. Navy a unilateral right to terminate executory contracts with the debtor upon its bankruptcy filing.[401]

Central to the court's reasoning in *Plum Run Service* was its interpretation of section 365(c) as creating a legal "distinction between a pre-petition debtor and the debtor-in-possession"—treating them as two separate entities with distinct rights and obligations before and after filing a bankruptcy petition.[402] By adopting this unique perspective, the court characterized a debtor-in-possession's assumption of an executory contract as tantamount to an assignment from the pre-petition debtor to the post-petition debtor-in-possession.[403] Essentially, it merges assumption and assignment into a single act. Under jurisdictions that adopt a "hypothetical test," the rule in *Plum Run Service* effectively bars a debtor-in-possession from both assuming and assigning an executory contract if the government withholds consent to assignment.[404] This creates a troubling outcome: The government can unilaterally alter its contractual obligations, bypass the automatic stay, and reap extortive concessions from bankrupt defense contractors the moment they seek bankruptcy protection. In practice, this rule operates as a blanket justification for government favoritism under the guise of legal doctrine.[405]

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399. *See In re* Plum Run Serv. Corp., 159 B.R. 496, 499–500 (Bankr. S.D. Ohio 1993) ("[T]his Court cannot find that the Navy violated [section] 525 in refusing to exercise the relevant contract options.").

400. *Id.* at 497.

401. *Id.* at 498, 501.

402. *Id.* at 501.

403. *See id.* ("To allow a debtor-in-possession to assume a contract, in essence, creates an assignment of the contract from the prepetition debtor to the debtor-in-possession.").

404. *See id.*

405. Nonetheless, government favoritism has its limits. In *Ontario Locomotive*, the U.S. Bankruptcy Court for the Western District of New York held that

Despite employing opposite approaches to statutory interpretation, both *Carolina Parachute* and *Plum Run Service* reflect a similar judicial bias favoring government interests over efficient rehabilitation of bankrupt contractors. Although the bankrupt contractor in *Plum Run Service* was not in the risk of delinquency[406]—a key factual distinction from *Carolina Parachute*—the brightline rule in *Plum Run Service* nonetheless produced the same outcome as the "totality of the circumstances" test applied in *Carolina Parachute*.[407] In this light, both rulings directly subvert the very bankruptcy policy that the "actual test" seeks to uphold—that is, preventing the government from extracting a windfall from the bankrupt contractor and unilaterally altering the terms of their pre-bankruptcy bargain to the detriment of the debtor's rehabilitation.[408]

4. Consequences of Ambiguity: Inconsistencies and Abuse

For bankrupt defense contractors, this judicial penchant for government favoritism poses an obstacle to financial rehabilitation: It encourages courts to put the cart before the horse, allowing political considerations of perceived national security risks to take precedence over rigorous legal analysis. This approach is problematic because courts, while adept at legal reasoning, lack the expertise and visibility to accurately assess how such risks might materialize—especially in an era of extensive defense outsourcing, where the lines between public and private actors blur. Today, government contracts have grown increasingly

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unjustified pretexts, such as termination "for the convenience of the government," do not constitute sufficient cause to prohibit the assumption and assignment of executory contracts in bankruptcy. *See In re* Ont. Locomotive & Indus. Ry. Supplies (U.S.) Inc., 126 B.R. 146, 146 (Bankr. W.D.N.Y. 1991). There, the court rejected the government's proposal that section 365(c) and the Anti-Assignment Acts automatically bar "transfer of public contracts." *Id.*

406. In fact, the court recognized that the debtor-in-possession had "performed satisfactorily under the [defense] contract, especially after filing Chapter 11 . . . and that the Navy refused to exercise the option due solely, or in significant part to the Chapter 11 filing by [the debtor-in-possession], in violation of 11 U.S.C. § 525." *In re Plum Run Serv.*, 159 B.R. at 497–98.

407. *See In re* Carolina Parachute Corp., 108 B.R. 100, 103 (M.D.N.C. 1989), *rev'd on other grounds*, 907 F.2d 1469 (4th Cir. 1990) (granting the government mobility).

408. *See* N.C.P. Mktg. Grp. Inc. v. BG Star Prods., Inc., 556 U.S. 1145, 1145 (2009) (explaining the policy of the "actual test").

complex.[409] Government actors, operating as market participants in public procurement, frequently use restrictive covenants to structure their commercial relations with defense contractors.[410] While it may be true that "national security interests at stake outweigh any benefit to the debtor and its estate from assumption of the contracts,"[411] adopting a sweeping approach to government favoritism, without considering the potential economic consequences, risks undermining national security itself by preventing defense contractors from recovering from financial distress.

Perhaps more alarmingly, despite the courts' bias toward government favoritism, the fragmented approaches courts have adopted fail to meaningfully safeguard national security from business interference. In the absence of a unifying legal theory, ambiguities in section 365(c) create loopholes that enable corporate abuse. For instance, inconsistencies across jurisdictions regarding the assumability and assignability of government contracts incentivize bankruptcy forum shopping.[412] Business

409. *See* Melissa Angell, *Government Contracts Are So Confusing That Congress Just Wrote a Bill to Simplify Them*, INC. (Apr. 18, 2024), https://www.inc.com/melissa-angell/government-contracts-are-so-confusing-that-congress-just-wrote-a-bill-to-try-simplify-them.html [https://perma.cc/M5AP-GQN5] (describing government contracts as overly complex.); *see also* Megan Brown et al., *Federal Procurement Needs More Updates, Fewer Compliance Rules*, BLOOMBERG L.: U.S. L. WK. (Nov. 26, 2024), https://news.bloomberglaw.com/us-law-week/federal-procurement-needs-more-updates-fewer-compliance-hurdles [https://perma.cc/5QDG-YTVN] ("[E]xisting procurement policies and processes have been criticized for being outdated, overly complex, and ill-suited to economic needs.").

410. *See* 48 C.F.R. § 32.409-3 (2025) ("[T]he contracting officer shall enter into an agreement with the contractor covering special accounts and suitable covenants protecting the Government's interest . . . .").

411. *In re* TechDYN Sys. Corp., 235 B.R. 857, 859–60 (Bankr. E.D. Va. 1999).

412. The Bankruptcy Code has notoriously liberal venue selection rules. Under 28 U.S.C. § 1408, a debtor may file for bankruptcy in any district: (1) where there is a pending bankruptcy case concerning the debtor's affiliate, general partner, or partnership; or (2) where the debtor's domicile, residence, principal place of business, or principal assets have been located for 180 or more days preceding the filing. *See In re* Broady, 247 B.R. 470, 472 (B.A.P. 8th Cir. 2000); *see also In re* Fishman, 205 B.R. 147, 149 (Bankr. E.D. Ark. 1997) (explaining the plain meaning of section 1408). This latitude in venue selection has led to a significant uptick in forum shopping, where debtors strategically select venues that are perceived to offer more favorable legal outcomes, at the expense of creditors or other stakeholders. For example, in 2020, nearly eighty percent of large, public companies facing chapter 11 cases forum shopped—meaning that they filed in a district other than the location of the debtor's headquarters. *See* Brief

affiliates, such as private equity owners influencing the corporate decisions of defense contractors, may exploit circuit splits by steering bankrupt subsidiaries to file in jurisdictions that adopt variations of the "actual test."[413] Conversely, governmental actors may push for involuntary bankruptcies in jurisdictions favoring the "hypothetical test" or multi-factor tests prioritizing political considerations of government favoritism.[414]

These dynamics create a "race to the bottom," where the incumbent management of distressed defense contractors may be incentivized to manipulate bankruptcy procedure to the detriment of the creditors, thereby hampering the contractor's ability to regain financial stability through the federal bankruptcy regime.[415] This failure not only undermines the congressional purpose of the Anti-Assignment Acts to protect defense-critical contracts but also contradicts the twin aims of the Bankruptcy Code: "[e]nsuring an equitable distribution of the debtor's assets to [its] creditors" and "giving the debtor a 'fresh start.'"[416] The next Part

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of the Com. L. League of Am. & the Nat'l Bankr. Venue Reform Comm. as Amici Curiae in Support of Neither Party at 20, Harrington v. Purdue Pharma L.P., 144 S. Ct. 2071 (2024) (No. 23-124).

413. *See generally* Anthony J. Casey & Joshua C. Macey, *Bankruptcy Shopping: Domestic Venue Races and Global Forum Wars*, 37 EMORY BANKR. DEVS. J. 463, 496 (2021) (noting that "a circuit split leads to strategic filings"); *see also* Michelle Morgan Harner et al., *Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 AM. BANKR. INST. L. REV. 187, 242 (2005) (noting that the "actual test" is more debtor-friendly and that the "courts have found that the actual test is more compatible with the goal of maximizing the value of the bankruptcy estate").

414. *See* Jay R. Indyke et al., *Ending the "Hypothetical" vs. "Actual" Test Debate: A New Way to Read Section 365(c)(1)*, 16 J. BANKR. L. & PRAC. 2 ART. 3, at 4 (2007) (noting that the "hypothetical test" can allow the "nondebtor party to the executory contract" to obtain "a windfall based on the fortuity of the debtor's bankruptcy," a result that the "actual test" seeks to prevent).

415. *See* Todd J. Zywicki, *Is Forum Shopping Corrupting America's Bankruptcy Courts?*, 94 GEO. L.J. 1141, 1161 (2006) (noting that the "incumbent management of a failing firm has both the opportunity and the incentives to forum-shop the firm's bankruptcy proceeding into a venue that will be responsive to their interests, rather than the firm's creditors," a dynamic that may produce a "race to the bottom"); *see also* Nancy B. Rapoport, *Our House, Our Rules: The Need for a Uniform Code of Bankruptcy Ethics*, 6 AM. BANKR. INST. L. REV. 45, 92 (1988) (advocating for a uniform bankruptcy ethics code to curb this "race to the bottom").

416. *In re* Sherman, 658 F.3d 1009, 1015 (9th Cir. 2011) (citing BFP v. Resol. Tr. Corp., 511 U.S. 531, 563 (1994)); *see also In re* Neff, 824 F.3d 1181, 1187 (9th Cir. 2016) ("At the core of the Bankruptcy Code are the twin goals of ensuring an equitable distribution of the debtor's assets to his creditors and giving the debtor a 'fresh start.'").

examines why judicial efforts to reconcile the conflict between the two statutes have ultimately fallen short, what deeper systemic issues this conflict reveals about the current legal regime, and potential pathways for reform to address these challenges effectively.

IV. PATHWAYS TO LEGAL REFORM: PROBLEMS AND SOLUTIONS

At the heart of the conflict between the Bankruptcy Code and the Anti-Assignment Acts lies a fundamental mismatch between legislative intent and contemporary realities. When Congress designed these statutory regimes, it envisioned them as distinct frameworks—premised on the belief that national security could be best served by keeping business interests out of the defense supply chain.[417] This is evident in the Anti-Assignment Acts' restrictions on unilateral contract modifications and the Bankruptcy Code's executory contract exception, which provides a statutory carve-out for non-bankruptcy limitations on contractual freedom.[418]

While this separation may have been effective at the time of enactment, it is no longer viable in today's economic landscape. As private equity-owned defense contractors become deeply embedded within the national defense supply chain through outsourcing,[419] the lines between business and national security have blurred, making their separation impractical. Courts, grappling with outdated statutes, face increasing doctrinal confusion—particularly with the executory contract exception in the Bankruptcy Code—as they attempt to adapt old legal frameworks to new realities of complex defense contractor bankruptcies.[420]

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417. *See* 41 U.S.C. § 6305 ("The purpose of this Act . . . is to enact certain laws relating to public contracts . . . ."). *See generally* 11 U.S.C. § 365 (setting forth rules for privately contracting parties).

418. *See supra* Part III.A (discussing the legislative purpose of the Anti-Assignment Acts) and Part III.C (analyzing the statutory policy underlying the executory contract exception in section 365 of Bankruptcy Code).

419. See *supra* Part I.C for a discussion of private equity's expanding role in the defense industry amidst shifting geopolitical dynamics and the broader trend of defense outsourcing.

420. See *supra* Part III.C for a discussion of judicial handling of the executory contract exception.

As Part III demonstrated, judicial attempts to redraw the dividing lines between business and defense have only deepened legal inconsistencies, complicating the resolution of defense contractor bankruptcies.[421] Part IV addresses this problem in three Sections. Section A explains the economic theory behind Congress's separation of the Bankruptcy Code and Anti-Assignment Acts, reflecting an idealized public-private distinction. Section B examines how private equity exploits this distinction by extracting value from defense contractors through LBOs while remaining beyond the reach of both statutory regimes. Section C proposes a new legal mechanism to tackle private equity-induced risks, focusing on ex ante risk mitigation rather than conventional ex post remedies.

A. THE PUBLIC-PRIVATE DISTINCTION UNDER EXISTING LAW

At its core, confusion surrounding the treatment of defense contracts in bankruptcy arises from the courts' inability to distinguish between public and private functions of defense contracts—a distinction artificially imposed by the existing statutory framework. When Congress enacted the Bankruptcy Code and the Anti-Assignment Acts, it created them as separate legal regimes governing distinct domains: The Anti-Assignment Acts regulate the public rights and duties of defense contractors, while the Bankruptcy Code governs their private rights and duties.[422] Courts have attempted to reconcile this artificial divide with the complex realities of contemporary defense contracting through creative statutory interpretation.[423] But these efforts have largely been unsuccessful.[424]

The problem is structural. The Anti-Assignment Acts impose strict scrutiny, stringent responsibility review, and assignment restrictions on public contractors without regard to their private commercial interests.[425] These requirements ensure that the goods and services they provide to the federal government serve the public good—akin to the regulatory treatment of

421. See *supra* Part III for a discussion of such legal inconsistencies.
422. *See supra* note 23 and accompanying text.
423. See *supra* Part III.C.3 for a discussion of such judicial efforts.
424. *See supra* Part III.C.3.
425. *See supra* Part III.A for a discussion of these conflicting interests.

common carriers and public utilities in other statutory contexts.[426] This framework prevents holders of public contracts from exploiting their privileged access to public resources for excessive private gain. In economic terms, this means that entities within the purview of the Anti-Assignment Acts are expected to give up certain private contractual rights—such as the right to assignment—to generate positive externalities for the public.[427]

Conversely, the Bankruptcy Code provides a centralized forum for adjudicating the private rights and duties of claimants to a bankrupt debtor's assets.[428] This explains why bankruptcy law prioritizes contractual freedom, as it enables claimants to maximize value through private ordering in debt resolution. The Bankruptcy Code's commitment to private ordering is embodied in what scholars call the "Creditors' Bargain Theory": the idea that a fair and equitable system of asset distribution should respect creditors' pre-bankruptcy legal entitlements, ensuring they receive the full benefits of their bargain within statutory

426. In the common law tradition, courts developed the public utility doctrine to ensure that industries providing essential goods and services operate "under rates and practices that [are] just, reasonable, and non-discriminatory." Joseph D. Kearney & Thomas W. Merrill, *The Great Transformation of Regulated Industries Law*, 98 COLUM. L. REV. 1323, 1331 (1998). Industries classified as "public utilities" typically satisfy two criteria: (1) they exhibit characteristics of "natural monopolies," and (2) they are "affected with a public interest." *See* K. Sabeel Rahman, *Regulating Informational Infrastructure: Internet Platform as the New Public Utilities*, 2 GEO. L. TECH. REV. 234, 238–39 (2018); *see also id.* at 236 ("In economistic terms, public control over infrastructure is warranted in conditions of natural monopoly, where high sunk costs and increasing returns to scale suggest that private market competition is likely to under-supply the good in question."); Munn v. Illinois, 94 U.S. 113, 126, 129 (1876) ("[W]hen private property is affected with a public interest, it ceases to be *juris privati* only; and, in case of its dedication to such a purpose as this, the owners cannot take arbitrary and excessive duties, but the duties must be reasonable.").

427. *See* Wendy Netter Epstein, *Contract Theory and the Failures of Public-Private Contracting*, 34 CARDOZO L. REV. 2211, 2252 (2013) (arguing that although "contract law is conceived of as 'private law,'" parties to government contracts "have obligations of fairness beyond those of the ordinary citizen," which necessitates a "doctrine of contract interpretation [that] . . . serves the public interest"); *see also* John A. Rothchild, *The Social Costs of Technological Protection Measures*, 34 FLA. ST. U. L. REV. 1181, 1187–88 (2007) ("[I]f the consequence of an activity is a public good, then that activity has positive externalities. It is the nonexcludability of public goods that gives rise to positive externalities.").

428. *See* Lindsey D. Simon, *Bankruptcy Grifters*, 131 YALE L.J. 1154, 1154 (2022) ("Bankruptcy provides a centralized proceeding for resolving claims and a forum of last resort for many companies to aggregate [claims].").

limits.[429] From this perspective, corporate bankruptcy law functions primarily as a procedural mechanism for aggregating state contract rights in federal court to provide a collective remedy.[430] It aims to preserve those rights while facilitating an efficient and orderly debtor rehabilitation process.[431] By implication, corporate bankruptcy law seeks to minimize the redistribution of value away from rightful claimants in favor of third parties outside of the bankruptcy proceeding.[432]

This public-private distinction—rooted in the separation of these two legal regimes—rests on the economic theory that the production and consumption of public and private goods generates different spillover effects.[433] Public goods *externalize* the costs and benefits on society, while private goods *internalize* those effects within contracting parties.[434] From a legal perspective, an optimal system of rules should align legal entitlements with the nature of the goods provided: Entities responsible for public goods should bear heightened public rights and duties. Those providing only private goods should subject solely to private rights and duties.

A public good, such as national defense, creates spillover effects extending to all citizens, regardless of their individual

429. *See generally* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 871 (1982) ("The creditors' bargain model, then, provides a satisfying theoretical explanation of why bankruptcy law should make a fundamental decision to honor negotiated nonbankruptcy entitlements.").

430. *See generally* Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy as (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931 (2004) (discussing bankruptcy law under procedural theory).

431. *See id.* at 957 ("A second interest is that of the reorganization or rehabilitation of debtors.").

432. *See id.* at 964–65 ("[R]edistribution of wealth in bankruptcy away from those who hold legal entitlements to those who do not . . . is a corruption of civil justice.").

433. Beyond the context of defense contractor bankruptcies, this public-private distinction is reflected elsewhere in bankruptcy law. *See generally* Laura N. Coordes, *Bankruptcy and the Public-Private Divide*, 43 YALE L. & POL'Y REV. 418 (2025) (examining the public-private divide through the lens of municipal bankruptcies under chapter 9).

434. *See generally* Thomas Helbling, *Externalities: Prices Do Not Capture All Costs*, INT'L MONETARY FUND FIN. & DEV. MAG., https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/Externalities [https://perma.cc/N7U5-TZYB] (distinguishing the effects of public and private goods).

contributions.[435] It is non-rivalrous and non-excludable—meaning that one person's benefit does not diminish another's, and no one can be excluded from enjoying it.[436] Defense contractors, entrusted with this responsibility, are granted public rights, including ownership of and preferential access to defense-critical knowhow, assets, intellectual property, and classified information unavailable to their market competitors.[437] In return, they bear public duties, such as ensuring that products and services critical to national defense meet the highest quality and safety, even when doing so is not optimally cost-efficient.[438]

A private good, by contrast, is both rivalrous and excludable—its consumption by one party prevents another from consuming it.[439] The risks associated with private goods are typically allocated through private rights, such as contract remedies, assignment provisions, security interests, and financial covenants.[440] Unlike public goods, private goods do not generate

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435. Benjamin Zycher, *Defense*, ECONLIB, https://www.econlib.org/library/Enc/Defense.html [https://perma.cc/5QJP-AFDY].

436. *See id.* ("National defense is in many ways a public, or 'collective' good, which means two things. First, consumption of the good by one person does not reduce the amount available for others to consume . . . . Second, the benefits that a given person derives from the provision of a collective good do not depend on that individual's contribution to funding it.").

437. *See State of Competition within the Defense Industrial Base*, U.S. DEP'T OF DEF. 7 (2022), https://media.defense.gov/2022/feb/15/2002939087/-1/-1/1/state-of-competition-within-the-defense-industrial-base.pdf [https://perma.cc/K626-UW49] (describing a defense-specific "data rights" regime that gives defense contractors access to technical data, IP, and even sensitive or classified know-how unavailable to other market competitors).

438. *See* 48 C.F.R. § 9.104-1 (2025) (setting out the criteria a prospective contractor must satisfy to be deemed "responsible" and therefore eligible to receive a federal contract award); *see also Evaluating the Risks and Benefits of Defense Contractors*, KING AEROSPACE (June 28, 2022), https://kingaerospace.com/evaluating-the-risks-and-benefits-of-defense-contractors [https://perma.cc/DP8E-KGTZ] ("The quality and reliability of a contractor's internal control systems are paramount in helping reduce government's burden to provide external oversight.").

439. Lawrence Solum, *Legal Theory Lexicon: Public and Private Goods*, LEGAL THEORY BLOG (Jan. 25, 2015), https://lsolum.typepad.com/legaltheory/2015/01/legal-theory-lexicon-public-and-private-goods.html [https://perma.cc/W5CA-HWFG].

440. In many commercial contexts (including those outside the defense sector), private contracting is viewed as the optimal mechanism for allocating risk. There are three principal reasons:

spillover effects. Their benefits are shared only between contracting parties, and any associated costs are borne solely by those privy to the contract, whether as direct parties or third-party beneficiaries. When a defense contractor exercises a private right, the terms of enforcement remain within the four corners of the contract, reflecting the idiosyncratic risks and costs negotiated between the parties.[441] Absent market failures, the performance or breach of such contracts should not impose external costs for nonparties, ensuring that all costs remain internalized.

B. HOW PRIVATE EQUITY EXPLOITS THE PUBLIC-PRIVATE DISTINCTION

A defense contract straddles both public and private domains; it facilitates the provision of public goods while also allowing for private rights and remedies. Even within public goods, private aspects exist. For example, a contract providing for the manufacture and delivery of military equipment to the DoD enhances national defense capabilities. Regular citizens do not need to participate in this contract to enjoy better security protection by the government as a result of this contract's performance. At the same time, a defense contract is inherently private in form and execution. While the government is outsourcing the supply of a public good, it does so by negotiating contractual terms like any private market participant. The risks of breach, delay, or underperformance are borne by a limited group of parties whose rights are defined within the four corners of the contract: the government, the defense contractor, and any subcontractors or downstream suppliers.[442] Like any other commercial

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> First . . . [p]rivate risk allocations distribute . . . risk by either active risk shifting or passive risk shielding. Second, private risk allocations bind only the parties to the agreement. Between these private parties, the impairment of liability rights is justified by the efficiency gains realized through free market negotiations. Third, because third-party rights are not impaired, private risk allocations allow buyer and seller to allocate risk between themselves[.]

Thaddeus Bereday, *Contractual Transfers of Liability Under CERCLA Section 107(e)(1): For Enforcement of Private Risk Allocations in Real Property Transactions*, 43 CASE W. RSRV. L. REV. 161, 212–13 (1992).

441. *See id.* at 213 ("Third, because third-party rights are not impaired, private risk allocations allow buyer and seller to allocate risk between themselves, without diluting underlying liability to other CERCLA claimants.").

442. *See id.*

transaction, the government seeks lower prices, while the contractor aims to maximize profit—albeit within the constraints of federal procurement regulation and national security considerations.[443]

Nevertheless, this coexistence of public and private aspects is not inherently undesirable.[444] Coase's theory of externalities suggests that public goods should align with public rights and duties—and private goods with private rights and duties—to achieve optimal distributive outcomes.[445] However, a mismatch, as seen in defense contracts, does not necessarily result in inefficiencies because parties can contract around them.[446] The

443. In public-private contracting, "uncontrolled agency costs, misaligned incentives, costs akin to negative externalities, market failures, and difficulty in specifying tasks" can lead government contracts to compromise service quality, imposing social costs that "contract price does not reflect." Epstein, *supra* note 427, at 2235.

This results from two structural problems: First, "the government has strong incentives to cut costs through outsourcing, but limited incentives to guarantee good service. Second, even if the government were incentivized to provide good service, it is difficult to align those incentives with those of the private service provider." *See id.*

444. Many types of public goods can be produced privately without creating allocational inefficiencies. *See generally* Alexander Tabarrok, *The Private Provision of Public Goods via Dominant Assurance Contracts*, 96 PUB. CHOICE 345 (1998) (explaining how private entrepreneurs can use assurance contracts to provide public goods by creating inefficiencies).

445. *See generally* Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). The Coase Theorem implies that markets can solve externalities on their own unless: (1) Property rights are incomplete; or (2) negotiation is costly. *See generally id.* However, it is often misinterpreted, as claiming markets will always solve externalities. This is incorrect. The theorem holds that markets can address externalities only when private ordering conditions are met—specifically, when transaction costs are low and property rights are clearly defined. *See* Lecture Notes of David Autor, Professor of Econ., Mass. Inst. of Tech., Externalities, The Coase Theorem and Market Remedies 3–4 (Spring 2004), https://dspace.mit.edu/bitstream/handle/1721.1/71009/14-03-fall-2004/contents/lecture-notes/lecture17.pdf [https://perma.cc/D8RX-JV2Y] ("The Coase theorem is often misinterpreted to suggest that the market will solve all externalities. This is not true . . . .").

446. *See* Bryan Caplan, *Ronald Coase and Reciprocal Externalities: A Refresher*, ECONLIB (Feb. 2, 2021), https://www.econlib.org/reciprocal-externalities-a-refresher [https://perma.cc/6C3G-CD6G] ("A key insight of the Coase Theorem is that externalities are reciprocal . . . . [A] polluter imposes a negative externality on his neighbor. But if the neighbor insists on clean air, he imposes a negative externality on the polluter. While common-sense morality may [favor] the neighbor, economic efficiency urges you to keep an open mind. If the polluter's cost of reducing pollution greatly exceeds the neighbor's cost of enduring pollution, the Coase Theorem [weighs against the neighbor] . . . .").

strength of private ordering lies in its ability to allocate risks and costs to the most efficient cost bearer through contracting.

As long as contractual safeguards are adequate and both the government and defense contractors uphold their end of the bargain, risks remain contained. For instance, if the government seeks to limit exposure to third-party claims arising from contract assignments, it can mitigate that risk by requiring consent for any transfer or delegation of contract rights—preventing unilateral modifications to the bargain. This is precisely what the Anti-Assignment Acts aim to accomplish.[447] Similarly, if a defense contractor wishes to continue performing the contract after filing for bankruptcy, the Bankruptcy Code protects it by preventing the government from unilaterally terminating the contract solely due to the bankruptcy filing.[448] These statutory regimes ensure that, even when public and private functions intersect, the agreed-upon cost distribution and risk allocation remain intact.

However, private equity ownership disrupts this balance. It introduces unknown third parties—and their associated risks—into the government-contractor relationship, unilaterally altering the original bargain of defense contracts. Private equity firms extract substantial gains by purchasing, reorganizing, reselling defense contractors—along with their assets and contracts—effectively modifying the terms of the existing contracts.[449] In doing so, they inject new risks that neither the government nor the original contractor anticipated at the time

447. *See, e.g.*, United States v. Shannon, 342 U.S. 288, 293 (1952) ("One of Congress' [sic] basic purposes in passing the Act was 'that the government might not be harassed by multiplying the number of persons with whom it had to deal.'" (quoting Hobbs v. McLean, 117 U.S. 567, 576 (1886))); United States v. Aetna Cas. & Sur. Co., 338 U.S. 366, 373 (1949) (explaining that the primary purpose of the Anti-Assignment Acts is "to prevent persons of influence from buying up claims against the United States, which might then be improperly urged upon officers of the Government") ("Another purpose . . . [is] to prevent possible multiple payment of claims, to make unnecessary the investigation of alleged assignments, and to enable the Government to deal only with the original claimant.").

448. *See* 11 U.S.C. § 365(e) ("[A]n executory contract . . . of the debtor may not be terminated or modified . . . at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on . . . the commencement of a case under this title . . . .").

449. *See supra* Part I.B (discussing how private equity firms repackage portfolio company assets while remaining shielded from bankruptcy risks themselves through "bankruptcy-remote" structuring).

of contracting. Yet, private equity firms do not bear these risks themselves. If a defense contractor fails, its private equity owner remains insulated from liability.[450] But if the contractor succeeds, the private equity firm leverages its control over the contractor's management to redirect profits to itself.[451]

In essence, private equity *socializes* the risks of defense outsourcing while *privatizing* its profits—undermining the very public-private equilibrium that the existing legal regime is meant to uphold.[452] Private equity firms reap substantial gains from defense contractors but evade the risk and responsibilities of producing a public good.[453] This perverse incentive structure encourages risky financial behavior, creating moral hazards that increase the likelihood of defense contractor bankruptcies. Put simply, private equity externalizes the costs to the public when defense contractors fail but internalizes the gains when they succeed. The following paragraphs describe how private equity exploits gaps in the current legal regime.

Socializing Risks: Private equity shifts risks onto defense contractors by structuring LBO transactions to make themselves "bankruptcy-remote."[454] As discussed in Section I.B, private equity firms load debt onto the defense contractor's balance sheet while holding them indirectly as portfolio companies through special purpose vehicles.[455] This structure allows private equity firms to retain control over corporate decision-making for the

450. *See supra* notes 117–22 (explaining how private equity firms insulate themselves from bankruptcy risks).

451. *See id.*

452. The phrase "privatizing profits and socializing losses" originally described large banks, which were bailed out by the federal government despite their role in causing the 2008–2009 Great Recession. *See generally* Benjamin Bental & Dominique Demougin, *Privatizing Profits and Socializing Losses with Smoothly Operating Financial Markets*, EUR. J. POL. ECON., July 16, 2016, at 179 (assessing economic implications of government intervention in financial crises). Today, this phrase is widely used in academic debates on stakeholder versus shareholder capitalism—particularly in industries that provide public goods. *See generally* Joan C. Williams & Ro Khanna, *It's Time to End Slash-and-Burn Capitalism*, HARV. BUS. REV.: BUS. & SOC'Y (Oct. 28, 2020), https://hbr.org/2020/10/its-time-to-end-slash-and-burn-capitalism [https://perma.cc/FYR6-9F54] (arguing for a more holistic version of capitalism that considers the interests of all stakeholders, rather than solely emphasizing profits).

453. *See supra* notes 117–22 (explaining how private equity firms insulate themselves from bankruptcy risks).

454. *See id.*

455. *See supra* Part I.B (discussing the mechanisms by which private equity firms insulate themselves from risk).

defense contractor while shielding themselves from bankruptcy risk.[456] If the LBO fails—causing the defense contractor to go bankrupt—secured lenders who financed the LBO can only recover from the contractor's assets, not the private equity firm.[457] But if the LBO succeeds, private equity firms extract profits by directing defense contractors to issue dividends to themselves.[458] This subverts the Bankruptcy Code's absolute priority rule by allowing shareholders to effectively recover ahead of secured lenders and incentivizes excessive risk-taking, as private equity owners bear none of the consequences.

Beyond financial harm, defense contractor failures impose a negative externality on society. Because the DoD pays defense contractors with taxpayer money, ordinary citizens effectively subsidize these contracts.[459] As a result, when a defense contractor fails, the public bears part of the cost—both in lost value and diminished national security capacity. From a national security standpoint, bankruptcy-remote structuring allows private equity to extract value from government-funded contractor assets while shielding themselves from legal exposure. This dynamic not only increases the likelihood of a contractor failure but also erodes public trust, by enabling private equity firms to exploit taxpayer-funded resources without accountability.

Privatizing Profits: Private equity exploits a loophole in the Anti-Assignment Acts—the "operation of law" exception—to extract profits from defense contractors without government oversight.[460] Although the Anti-Assignment Acts restrict unilateral

456. *See supra* Part I.B.

457. *See supra* Part II.A (summarizing *Intelsat* and *MD Helicopters,* illustrating the safety of private equity assets).

458. *See supra* Part II.A.

459. *See* Sam Pizzigati, *How Contractor CEOs Get Rich Off Taxpayers*, FOREIGN POL'Y IN FOCUS (June 21, 2023), https://fpif.org/how-contractor-ceos-get-rich-off-taxpayers [https://perma.cc/C7NR-7QHX] (documenting the relationship between taxpayer dollars and defense contractor income).

460. *See* William A. Roberts, III & Kay Tatum, *The Novation of Government Contracts and the Unreliable and Unpredictable "Operation of Law" Exception*, 50 PROCUREMENT LAW. 1, 11 (2014) (arguing that, because the "'operation of law' exception is judicially created, the outer bounds of the exceptions are not precisely defined, and companies evaluating corporate transactions are faced with the difficult question of whether transactions that result in the transfer of federal contracts between companies are assignments by operation of law that are exempt from the Anti-Assignment Act[s]."); *see also* Shannon D. Kung, *The Reverse Triangular Merger Loophole and Enforcing Anti-Assignment Clauses*,

contract modifications and assignments without government consent, they do not prohibit assignments by "operation of law."[461] Under this exception, contract assignments incidental to an M&A transaction are exempt from the Acts' stringent restrictions.[462] This loophole enables private equity firms to bypass government security when purchasing, repacking, and reselling defense contractors.

This loophole also threatens national security by allowing private equity firms to effectively transfer defense contracts to foreign buyers willing to pay the highest bid, without regard to public interests. It directly undermines the Anti-Assignment Acts' goal of preventing critical defense assets from falling into unsafe hands, as it exposes defense supply chains to unknown third-party risks. Yet, as long as private equity firms sell entire companies rather than directly transferring defense contracts, they remain largely unaccountable under the existing legal framework.

C. PROPOSAL: EX ANTE PRIVATE EQUITY RISK MITIGATION

Fundamentally, the current legal regime fails to address this novel national security risk because it overlooks the root

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103 NW. U. L. REV. 1037, 1045–46 (2009) (describing how firms employ sophisticated M&A structures, such as forward triangular mergers, to circumvent statutory or contractual anti-assignment restrictions).

461. *See* Liberty Ammunition, Inc. v. United States, 101 Fed. Cl. 581, 589 (2011) ("Perhaps the most significant exception [to the Anti-Assignment Acts] . . . is when transfer of a . . . contract is effected by consolidation or merger to the successor of a claimant corporation." (citing Tuftco Corp. v. United States, 614 F.2d 740, 745 (Ct. Cl. 1980))).

462. Although the Anti-Assignment Acts do not define "operation of law," courts have consistently interpreted the phrase to include contract assignments resulting from mergers and acquisitions. *See* Erwin v. United States, 97 U.S. 392, 397 (1878) (holding that the Captured and Abandoned Property Act of 1863—the precursor to the Anti-Assignment Acts— "does not embrace cases where there has been a transfer of title by operation of law. The passing of claims to heirs, devisees, or assignees in bankruptcy is not within the evil at which the statute aimed"). Following *Erwin*, courts have extended the "operation of law" exception to the Anti-Assignment Acts. In *Westinghouse Elec. Co. v. United States*, the Court of Federal Claims noted that assignments occurring by "operation of law"—i.e., corporate restructurings, mergers, and name changes, "where in essence the contract continues with the same entity, but in a different form"—are exempt from the Anti-Assignment Acts' application. 56 Fed. Cl. 564, 569 (2003). Similarly, in *ATS Trans LLC v. Department of Veterans Affairs*, the Civilian Board of Contract Appeals determined that the "operation of law" exception also applied to statutory mergers. CBCA 7163, 22-1 BCA ¶ 38,151.

cause: private equity-induced defense contractor failure. Existing law only provides ex post remedies.[463] The Bankruptcy Code contains only tools to address corporate abuses after the fact, such as empowering the bankruptcy trustee to avoid preference payments[464] or pursue fraudulent transfer litigation.[465] Similarly, the Anti-Assignment Acts grant the federal government broad discretion to withhold or deny consent to defense contract transfers.[466] However, as this Article has demonstrated, private equity firms evade both regimes. By the time a defense contractor enters bankruptcy, the damage is already done, and any underlying national security risks have already materialized.

To address the root cause, this Section explores ex ante risk mitigation as a potential solution. The solution consists of three components: (1) deleverage the defense industry by altering incentives for high-risk debt financing; (2) hold private equity accountable through an LBO review mechanism; and (3) make defense contractors less vulnerable in bankruptcy by amending the executory contract exception in the Bankruptcy Code.

1. Make Debt Financing Less Risky

Tax incentives shape financing practices. A key driver of private equity's aggressive debt use in LBOs is the tax advantages of debt financing.[467] Under the Tax Code, interest payments on debt are fully deductible, while dividends paid to equity

463. *See* D. P. Waddilove, *Anticontract*, 61 AM. BUS. L.J. 135, 136–37 (2024) (arguing that "[b]ankruptcy reorganization is fundamentally a framework of ex-post response to financial distress stemming from contractual incompleteness" and that a "reorganization plan . . . cannot be created ex ante, according to preset rules").

464. *See* 11 U.S.C. § 547(b)(3) (allowing a trustee to avoid a preferential transfer, if the transfer was "made while the debtor was insolvent"); *see also* Robert J. Stearn, Jr., *Proving Solvency: Defending Preference and Fraudulent Transfer Litigation*, 62 BUS. LAW. 359, 360 (2007).

465. *See* 11 U.S.C. § 548(a)(1)(B)(ii)(1) (permitting a trustee to avoid a fraudulent transfer, if the debtor "was insolvent on the date that such transfer was made or such obligation was incurred or became insolvent as a result of such transfer or obligation").

466. *See, e.g.*, *Westinghouse Elec. Co.*, 56 Fed. Cl. at 569 ("The government can, however, waive the effect of [legislation] by recognizing the validity of the contract and the assignment after the fact.").

467. *See* Kevin J. Liss, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491, 1492–93 (1987) ("Federal tax incentives are largely responsible for the sudden increase in the number and size of LBOs in recent years.").

shareholders are not.[468] The Tax Code thus favors debt over equity, creating a strong incentive for firms to finance acquisitions through leverage. Because an LBO is, at its core, "a large-scale substitution of debt for equity," it serves as a mechanism for "exploiting the Tax Code's disparate treatment of interest paid on debt and dividends distributed to equity holders."[469] Thus, when structured properly, an LBO can generate value for both the acquirer and the target company.

This tax advantage finds support in the Modigliani-Miller Theorem, one of the most influential theories in corporate finance.[470] In their seminal work, Modigliani and Miller posit that, in an ideal world—one without informational asymmetries, transaction costs, taxes, or bankruptcy—a firm's capital structure is irrelevant to its aggregate value.[471] But, of course, we live in the real world—where taxes, bankruptcy, and transaction costs matter.[472] This means that a firm's choice to use debt or equity to finance its operations carries significant consequences. Most importantly, in a regime with corporate taxes, debt financing enhances firm value due to the "tax shield" created by the deductibility of interest payments on debt. Theoretically, this

468. *See* I.R.C. § 163(a) ("There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."). For further discussion of the deductibility of corporate interest payments, see generally BORIS I. BITTKER & JAMES S. EUSTICE, 1 FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 5.03 (2007).

469. Liss, *supra* note 467, at 1494.

470. For much of the twentieth century, conventional corporate finance theory suggested that debt financing is inherently "cheaper" than equity financing. Modigliani and Miller challenged this idea, theorizing that a firm's value is not related to its capital structure—in particular, the debt-to-equity ratio. *See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 277 (1958); *see also* Robert P. Bartlett III, *Taking Finance Seriously: How Debt Financing Distorts Bidding Outcomes in Corporate Takeovers*, 76 FORDHAM L. REV. 1975, 1981–82 (2008).

471. Aurelio Gurrea Martínez, *The Impact of the Tax Benefits of Debt in the Capital Structure of Firms and the Stability of the Financial System*, OXFORD BUS. L. BLOG (Mar. 30, 2017), https://blogs.law.ox.ac.uk/business-law-blog/blog/2017/03/impact-tax-benefits-debt-capital-structure-firms-and-stability [https://perma.cc/BS4T-RDA8].

472. A direct implication of the Modigliani-Miller Theorem is that, if any of the assumptions are relaxed, then the results will change dramatically. This implication, commonly referred to as the "Modigliani-Miller Theorem II," is often used to illustrate the importance of tax in corporate finance. *See, e.g.*, Bartlett III, *supra* note 470, at 1985.

interest tax shield constitutes a valuable asset, increasing in proportion to a company's reliance on debt.

In this light, debt financing itself is not inherently problematic. The root problem, therefore, lies in excessive accumulation of high-risk debt. In today's corporate takeover market, where LBOs routinely feature debt-to-equity ratios nearing 9:1, the unchecked accumulation of debt can produce significant allocational inefficiencies.[473] Moral hazards, distorted incentives, interest rate volatilities, debt overhang, and excessive risk-taking are all phenomena not accounted for in the Modigliani-Miller Theorem.[474] As previously discussed, these inefficiencies are direct consequences of private equity involvement.[475]

To curb high-risk LBOs, Congress should adopt three measures to alter private equity incentives for debt financing: (1) reform the interest tax shield; (2) implement a leverage ceiling for defense contractors; and (3) establish a periodic leverage disclosure regime. These solutions directly target the root cause of excessive debt accumulation, ensuring greater financial stability within the defense industry.

First, Congress should amend the Tax Code to adjust the tax shield for speculative-grade or junk bonds while preserving it for investment-grade debt. Not all debt carries equal risk—some increases firm value, while others encourage excessive risk-taking that heighten financial instability. Using secured loans or investment-grade debt to finance corporate acquisitions can sometimes discipline management, as loan agreements often include covenants restricting additional borrowing, auditing rights for creditors, and monitoring collateralization ratios.[476] In contrast,

473. *See* Jensen, *supra* note 116, at 135 (noting the risks inherent in multiplying debt burdens).

474. The Modigliani-Miller Theorem assumes that financial markets are "perfectly competitive and without agency costs," thereby overlooking governance imperfections such as moral hazards and distorted managerial incentives. *See* Herbert Hovenkamp, *Neoclassicism and the Separation of Ownership and Control*, 4 VA. L. & BUS. REV. 373, 382–83 (2009).

475. *See supra* Part II.

476. *See* Tomer S. Stein, *Debt as Corporate Governance*, 74 HASTINGS L.J. 1281, 1283–84 (2023) (documenting the significant amount of control that debt covenants may grant a lender over a borrowing entity). For background discussion on the disciplinary impacts of corporate debt, see, for example, ASWATH DAMODARAN, APPLIED CORPORATE FINANCE 329 (Joel Hollenbeck et al. eds., 4th ed. 2015) (explaining the disciplinary role of debt over the life cycle of a firm); Greg Nini et al., *Creditor Control Rights, Corporate Governance, and Firm*

financing acquisitions with primarily speculative-grade debt, including junk bonds, may distort management incentive and increase agency costs, raising the likelihood of financial failure.[477] Eliminating or lowering the tax shield for speculative-grade debt would encourage safer financing practices in corporate takeovers. While congressional tax policy has not historically prioritized corporate takeover stability,[478] this Article argues that it should. Given the rise of private equity-driven LBOs in the defense industry—posing serious risks to national security—Congress has a compelling interest in enacting reforms to prevent excessive leveraging and protect the defense supply chain.

Value, 25 REV. FIN. STUD. 1713, 1715–16 (2016) (noting that creditors can impact corporate governance and enhance firm value); Eugene F. Fama & Michael C. Jensen, *Organizational Forms and Investment Decisions*, 14 J. FIN. ECON. 101, 113 (1985) (arguing that debt acts as a disciplinary mechanism, reducing agency costs).

477. "High-yield debt," or "junk bonds," are classified as "speculative-grade" by credit rating agencies. *See* José Gabilondo, *Leveraged Liquidity: Bear Raids and Junk Loans in the New Credit Market*, 34 J. CORP. L. 447, 453 n.30 (2009). "Highly publicized takeover battles are being financed with massive amounts of debt, especially junk bonds." Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 414 (1986); *see also* William W. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, 86 S. CAL. L. REV. 783, 785–86 (2013) (describing the role of junk bonds in facilitating major financial scandals).

478. "The current tax code uses policy-driven tax incentive provisions to induce taxpayers to alter their individual behavior to conform with Congress's preferences, based on political or social reasons." Bradley A. Ridlehoover, *Congress's Tax Incentives Send Mixed Signals for Automobile Buyers: Should Americans Buy Gas Guzzlers or Hybrids?*, 32 WM. & MARY ENV'T L. & POL'Y REV. 213, 236 (2007). Traditionally, debates over congressional tax priorities have centered on highly salient issues such as energy policy, family policy, or economic redistribution—not on corporate takeover stability. *See* Patricia L. Bryan, *Leveraged Buyouts and Tax Policy*, 65 N.C. L. REV. 1039, 1075–76 (1987) (noting that "[i]t is doubtful that Congress fully considered [the tax incentives of corporate debt financing] or intended these effects of the Tax Reform Act."); *see also* Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 763 (1985) (noting that, other than "Senator Long, [who] . . . told Congress in 1981 that [leveraged employee stock ownership plans] might be used in connection with corporate acquisitions," Congress probably did not "intend the tax laws to subsidize leveraged buyouts."). For debates regarding tax incentives and energy policy, *see, e.g.*, K. Alex Langley, *Clean Energy Tax Credits: Creating an Energy Welfare State or Saving the Planet?*, 1 BUS. ENTREPRENEURSHIP & TAX L. REV. 249 (2017). For family-policy debates, *see, e.g.*, William P. Kratzke, *The Defense of Marriage Act (DOMA) Is Bad Income Tax Policy*, 35 U. MEM. L. REV. 399 (2005). For redistribution debates, *see, e.g.*, Zachary Liscow, *Redistribution for Realists*, 107 IOWA L. REV. 495 (2022).

Second, Congress should amend the Federal Acquisition Regulations to impose a debt ceiling for defense contractors, as a condition for securing defense contracts. The optimal debt-to-equity ratio should not exceed 2:1.[479] This ceiling could be incorporated into the "responsibility" review that federal contracting officers already conduct when evaluating contract bids, replacing some of the more subjective criteria currently in place.[480] A debt ceiling would enhance accountability in the contract awarding process, while ensuring that defense contractors do not accumulate excessive debt that could jeopardize national security and supply chain resilience.

Third, to reinforce the above safeguards, Congress should establish a periodic disclosure regime to ensure that defense contractors remain financially stable after securing contracts. Under this regime, defense contractors would be required to report their debt-to-equity ratios quarterly, while the federal government would retain the right to conduct annual financial audits to verify their reports. This approach draws insight from prudential regulations governing systemically important financial institutions (SIFIs).[481] Just as excessive leverage in banking creates systemic risks, like bank runs and liquidity crises, excessive leverage in the defense industry threatens national security.[482] The federal government already possess the regulatory tools to

479. *See* Michael J. Boyle, *What Is a Good Debt-to-Equity Ratio and Why It Matters*, INVESTOPEDIA (last updated Nov. 15, 2024), https://www.investopedia.com/ask/answers/040915/what-considered-good-net-debttoequity-ratio.asp [https://perma.cc/N84M-SEEN].

480. *See* 48 C.F.R. § 9.104-1 (2025) ("To be determined responsible, a prospective contractor must—(a) Have adequate financial resources to perform the contract, or the ability to obtain them . . . ; (b) Be able to comply with the required or proposed delivery or performance schedule, taking into consideration all existing commercial and governmental business commitments; (c) Have a satisfactory performance record . . . ; (d) Have a satisfactory record of integrity and business ethics . . . ; (e) Have the necessary organization, experience, accounting and operational controls, and technical skills, or the ability to obtain them . . . ; (f) Have the necessary production, construction, and technical equipment facilities, or the ability to obtain them . . . ; and (g) Be otherwise qualified and eligible to receive an award under applicable laws and regulations.").

481. *See* Couwenberg & Lubben, *supra* note 320, at 78–79 (positing that defense contractors may be similar to non-bank entities whose financial distress may trigger systemic economic disruptions, such as SIFIs).

482. *See id.*

monitor systemic financial risks,[483] and there is no justifiable reason why similar oversight should not be extended to defense contractors.

2. Make Private Equity Firms More Accountable

Beyond reforming incentives for debt financing, Congress should establish new legal mechanisms to hold private equity firms directly accountable. Currently, the only mechanism for addressing private equity LBOs is constructive fraudulent transfer litigation—a reactive, ex post solution that applies only after a defense contractor files for bankruptcy.[484]

Under section 548 of the Bankruptcy Code, creditors can challenge transactions where, shortly before bankruptcy, a financially distressed debtor transfers assets away, without receiving reasonable value in return.[485] Courts have used this fraudulent transfer provision to invalidate liens granted in LBO transactions,[486] forcing lenders to stand in line with unsecured

483. *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008) (defining "systemic risk" as "the risk that (i) an economic shock such as market institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility"); *see also* Arthur W.S. Duff, *Central Bank Independence and Macroprudential Policy: A Critical Look at the U.S. Financial Stability Framework*, 11 BERKELEY BUS. L.J. 183, 208 (2014) (describing the existing macroprudential policy tools to monitor and regulate systemic risk).

484. *See* Laura Femino, *supra* note 11, at 1872 (observing that "constructive fraudulent transfer litigation" is currently the only mechanism for addressing LBOs, but arguing that it "suffers from problems of hindsight bias and inadequate remedy, add[ing] great uncertainty to potential transactions, and creates poor monitoring incentives regarding buyouts").

485. 11 U.S.C. §§ 548, 550.

486. *See, e.g.*, Boyer v. Crown Stock Distrib., Inc., 587 F.3d 787 (7th Cir. 2009); Lippi v. City Bank, 955 F.2d 599 (9th Cir. 1992); Mellon Bank, N.A. v. Metro Commc'ns, Inc., 945 F.2d 635 (3d Cir. 1991); United States v. Tabor Ct. Realty Corp., 803 F.2d 1288 (3d Cir. 1986); Zahn v. Yucaipa Cap. Fund, 218 B.R. 656 (D.R.I. 1998); Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488 (N.D. Ill. 1988); Credit Managers Ass'n of S. Cal. v. Fed. Co., 629 F. Supp. 175 (C.D. Cal. 1985); *In re* Charter Commc'ns, 419 B.R. 221 (Bankr. S.D.N.Y. 2009); *In re* Bay Plastics, Inc., 187 B.R. 315 (Bankr. C.D. Cal. 1995); *In re* Best Prods. Co., 168 B.R. 35 (Bankr. S.D.N.Y. 1994); *In re* O'Day Corp., 126 B.R. 370 (Bankr. D. Mass. 1991); *In re* Vadnais Lumber Supply, Inc., 100 B.R. 127 (Bankr. D. Mass. 1989); *In re* Ohio Corrugating Co., 91 B.R. 430 (Bankr. N.D. Ohio 1988).

creditors—or in some case behind them—when seeking repayment from a bankrupt target company.[487]

However, fraudulent transfer litigation is an inadequate tool for mitigating private equity-induced bankruptcy risks for several reasons. First, it is costly and time consuming.[488] These cases typically involve prolonged disputes over the valuation of the target firm at the time of the LBO.[489] Such post-hoc analyses are particularly susceptible to hindsight bias.[490] To prevail, creditors must prove that the LBO left the firm insolvent, unreasonably undercapitalized, or unable to pay its debts—essentially arguing that the LBO acquirer overpaid for the target company, burdening it with debt greater than its value. Yet, valuing a company at the time of an LBO is highly complex and often subject to manipulation by financial experts.[491] Since courts lack specialized expertise in determining a firm's hypothetical fair market value, litigation frequently devolves into a contest over who can afford the best expert witnesses. As a result, fraudulent transfer cases can drag on for months or even years, delaying debtor rehabilitation and exit from bankruptcy.[492] As one court notes:

> Valuation is a malleable concept, tough to measure and tougher to pin down without a host of explanations, sensitives and qualifiers. Because point of view is an important part of the process, outcomes are also highly dependent upon the perspectives and biases of those doing the measuring. When it comes to valuation, there is no revealed, objectively viable truth . . . and consistency among the valuation experts is rare[.][493]

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487. *See* 11 U.S.C. § 1129(b) (providing that, if the creditor's lien has been equitably subordinated, the creditor will stand behind the unsecured creditors, under the absolute priority rule).

488. *See Commission to Study the Reform of Chapter 11: 2012–2014 Final Report and Recommendations*, AM. BANKR. INST. 199 (2015) ("[V]aluation litigation can be time-consuming and expensive . . . ."), https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h [https://perma.cc/YW3H-8ALM].

489. *See* Laura Femino, *supra* note 11, at 1852 (discussing lender uncertainty regarding the valuation method courts will use).

490. *See id.* at 1848.

491. *See In re Charter Commc'ns*, 419 B.R. at 221 (discussing the difficulty with valuation).

492. *See In re Best Prods. Co.*, 168 B.R. at 60 (noting that fraudulent transfer litigation can take "years to try to [their] conclusion," given that they can involve "complex" and "protracted" litigation, including "extensive discovery, motion practice, and . . . interlocutory appeals" before trial).

493. *In re Charter Commc'ns*, 419 B.R. at 221.

Second, fraudulent transfer litigation creates a moral hazard. Scholars frequently compare fraudulent transfer litigation to insurance for creditors, as it provides an avenue to recover losses after an LBO renders a company insolvent.[494] However, fraudulent transfer litigation only accounts for whether an LBO renders the debtor insolvent, not the degree of leverage or risk exposure.[495] As a result, LBOs that pose the greatest risks of financial failure may escape scrutiny, leaving creditors to absorb losses from excessive debt accumulation.[496] This perverse incentive structure encourages risk-taking, as LBO lenders may gamble on high-risk transactions knowing that their losses may be recouped through litigating fraudulent transfer claims in bankruptcy court.[497] Fundamentally, fraudulent transfer litigation fails as a deterrent, as it neither prevents value-destructive behavior nor mitigates the systemic risks associated with LBO-driven financial instability.[498]

To address this, we need an ex ante mechanism to differentiate likely-to-fail LBOs from likely-to-succeed LBOs before they occur. A merger review process—similar to antitrust clearance

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494. *See* Jenny B. Wahl & Edward T. Wahl, *Fraudulent Conveyance Law and Leveraged Buyouts: Remedy or Insurance Policy?*, 16 WM. MITCHELL L. REV. 343, 368 (1990) (quoting Credit Managers Ass'n of S. Cal v. Fed. Co., 629 F. Supp. 175, 181 (C.D. Cal. 1985)).

495. *See* Alemante G. Selassie, *Valuation Issues in Applying Fraudulent Transfer Law to Leveraged Buyouts*, 32 B.C. L. REV. 377, 426 (1991) ("Fraudulent transfer law uses 'insolvency' and 'unreasonably small capital' as separate tests of a debtor's debt-paying ability. By comparing the present value of assets and liabilities, insolvency measures a debtor's present ability to make a gratuitous transfer without harming existing creditors. 'Unreasonably small capital,' a broader test, assesses the debtor's ability to pay both existing and future debts.").

496. Laura Femino argues that existing fraudulent transfer law fails to distinguish between "likely-to-pass LBOs" from "likely-to-fail LBOs" for several reasons: (1) "a hindsight-biased court might impose liability for a once-likely-to-pass buyout that, for unforeseeable reasons, went badly"; (2) "creditors may later be able to extract settlement value even if the fraudulent transfer claims are weak"; and (3) "courts may interpret the Bankruptcy Code's unpredictable standards of financial distress in some unanticipated way." Femino, *supra* note 11, at 1859–60. As a result, LBOs that pose the greatest systemic risk may escape judicial detection altogether.

497. *See* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 840 (1985) ("If creditors always can undo transactions afterwards, they have every incentive to wait and upset only those transactions that turn out unfavorably from their perspective.").

498. *See id.*

in M&A—should be implemented for LBOs involving defense contractors, with a specific focus on leverage levels. Unlike fraudulent transfer litigation, which provides legal remedy only after financial distress has already materialized, a prophylactic risk-mitigation framework would assess whether a proposed LBO introduces excessive financial risk, allowing regulators to intervene before a company is pushed to the brink of insolvency.[499]

Furthermore, an ex ante review mechanism directly addresses the hindsight bias problem inherent in fraudulent transfer litigation, where valuation disputes are clouded by indeterminate post-bankruptcy assessments.[500] By evaluating LBOs before they occur, this mechanism provides a clearer, objective standard for assessing financial viability, reducing the need for protracted litigation over whether an LBO left a firm insolvent. This prophylactic approach would enhance financial oversight, minimize systemic risks, and ensure that defense contractors remain capable of fulfilling their national security obligations.

Critics may argue that regulating private equity LBOs too aggressively could eliminate the benefits they provide.[501] Some scholars defend LBOs as a source of cheap capital, allowing companies to secure investment they might not otherwise obtain.[502] Indeed, not all LBOs are harmful: Some enhance efficiency and

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499. *See* Laura Femino, *supra* note 11, at 1873 ("Ex ante review of LBOs makes likely-to-pass or 'good' LBOs safer for the parties involved, while making likely-to-fail or 'bad' LBOs tougher to execute in the first place. With such ex ante review in place, any ex post litigation over LBOs would turn not on a second-guessing of projections made at the time of the transaction, but on the completeness and honesty of the target's disclosure of its financials . . . .").

500. *See* Michael Simkovic & Benjamin S. Kaminetzky, *Leveraged Buyout Bankruptcies, The Problem of Hindsight Bias, and The Credit Default Swap Solution*, 2011 COLUM. BUS. L. REV. 118, 144 (2011) (noting that "cash flow projections are inherently subjective and prone to hindsight bias").

501. Some scholars argue that LBOs offer indirect benefits to acquired companies, including: (1) relief from stock market pressures to meet short-term earnings expectations; (2) stronger management incentives through equity ownership; (3) greater efficiency gains driven by management discipline; and (4) cost savings from going private by eliminating the compliance costs of securities regulations. *See* Myron M. Sheinfeld & David H. Goodman, *LBO: Legitimate Business Reorganization or Large Bankruptcy Opportunity?*, 2 J. BANKR. L. & PRAC. 799, 811 (1993).

502. *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. (1989), https://hbr.org/1989/09/eclipse-of-the-public-corporation [https://perma.cc/52L5-UT25] (arguing that LBOs provide efficient financing that allows firms to access capital and improve management incentives).

revitalize struggling firms. However, the current problem is the absence of any ex ante framework to separate beneficial LBOs from those likely to fail and create negative spillovers. Without clear oversight mechanisms, the defense industry remains vulnerable to high-risk financial engineering, with severe consequences for both economic stability and national security.[503] Thus, the proposed ex ante merger review does not seek to dismantle LBOs but rather to introduce necessary safeguards to distinguish financially viable transactions from those posing systemic risks.

Ultimately, the goal is not to eliminate private equity LBOs altogether but, rather, to hold them accountable. A demand for risk capital will always exist; any regulation that completely bans a market only drives activity into regulatory arbitrage.[504] The objective is not to make private equity LBOs unprofitable but to ensure that LBOs do not undermine national security.

3. Make Defense Contractors Less Vulnerable in Bankruptcy

Finally, Congress should clarify its statutory policy by removing legal ambiguities surrounding the status of executory contracts in bankruptcy. Few issues have vexed the bankruptcy community as much as the proper treatment of executory

503. *See supra* Part III.

504. *See* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 229 (2010) (defining regulatory arbitrage as a phenomenon where firms exploit "the gap between the economic substance of a transaction and its legal or regulatory treatment . . . [to] tak[e] advantage of the legal system's intrinsically limited ability to attach formal labels that track the economics of transactions with sufficient precision"). Frank Partnoy defines the term more narrowly: "[r]egulatory arbitrage consists of those financial transactions designed specifically to reduce costs or capture profit opportunities by differential regulations or laws." Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 227 (1997). Regulatory arbitrage distinguishes from financial arbitrage in that it creates an economic inefficiency by pricing two identical transactions differently solely because they operate under different legal regimes. *See* Frank Partnoy, *The Law of Two Prices: Regulatory Arbitrage, Revisited*, 107 GEO. L.J. 1017, 1017 (2019) ("In contrast to financial arbitrage, which causes prices of economically equivalent transactions to converge in the direction of one price, regulatory arbitrage does not lead to such price convergence. In contrast, regulatory arbitrage tends to produce two different prices for economically equivalent transactions that are subject to different regulatory costs[.]").

contracts.[505] Its complexity stems from poor drafting in section 365, leading to conflicting interpretations of what qualifies as an executory contract and further exacerbating the artificial public-private divide that the Bankruptcy Code seeks to enforce—issues thoroughly explored in previous Parts.[506]

Congress now has a chance to cure that defect. To ensure clarity and consistency, Congress should amend section 365 to achieve two objectives. First, it should add a new subsection—section 365(q)—specifically for defense contracts.[507] Second, Congress should codify a new multi-factor test that more accurately reflects congressional intent regarding the assignment and assumption of executory contracts.

A new provision under section 365(q) should define defense contracts in a way that aligns with both the Bankruptcy Code and the Anti-Assignment Acts. Given the unique national security concerns involved, the proposed amendment must provide a clear and adaptable framework that courts can apply consistently. One approach is to define defense contracts through a multi-element test that considers:

1. whether the contracted goods or services are central to national defense;
2. whether the government intended to outsource a critical defense-function through the contract;
3. whether breach or underperformance would undermine national defense objectives that both parties recognized at the time of contracting; and
4. whether the government has no viable commercial alternatives readily available for the contracted goods or services.

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505. *See* John A.E. Pottow, *A New Approach to Executory Contracts*, 96 TEX. L. REV. 1437, 1437–38 (2018) (documenting the difficulty in determining "executoriness" under the Bankruptcy Code); *see also* Jessica L. Kotary & Nicole L. Inman, *Eliminating "Executory" From Section 365: The National Bankruptcy Review Commission's Panacea for an Ailing Statute*, 5 AM. BANKR. INST. L. REV. 513, 513 (1997) ("The term 'executory' has wreaked havoc in the bankruptcy world since the enactment of section 365 . . . . Defined by some as a 'hopeless convoluted and contradictory jurisprudence,' executory contracts in bankruptcy are becoming increasingly problematic.").

506. *See supra* Parts III.C, IV.A (discussing inconsistencies surrounding the treatment of executory contracts and the resultant muddling of the public-private distinction).

507. As of the time of this writing, section 365 of the Bankruptcy Code contains only subsections (a) through (p). If enacted, my proposed provision would likely be codified as subsection (q).

If all these elements are met, the contract would automatically qualify as a defense contract under section 365(q). In addition, the amendment should specify that the defense contracts are *per se* executory contracts entitled to relief under section 365(c). By eliminating the need for ad-hoc judicial determinations, this approach would provide much-needed legal predictability while ensuring that the statutory framework remains adaptable to future defense goods and services not yet devised.

The amendment should also resolve the long-standing uncertainty surrounding whether a debtor-in-possession can assume a defense contract despite the Anti-Assignment Acts' restrictions on contract assignment. Instead of relying on the existing "actual test" or "hypothetical test,"[508] Congress should codify a more precise standard that balances the bankruptcy policy of contractual freedom with the government's national security concerns. The appropriate test should consider:

1. whether the debtor actually intends to assign the contract in violation of the Anti-Assignment Acts, or merely assumes it for continued performance;
2. whether the assumption effectively transfers rights or delegates duties to a wholly distinct third party;
3. whether relevant pre-petition circumstances—such as contractual breaches and defaults—justify government intervention; and
4. whether the government should be entitled to relief from the automatic stay based on actual, rather than hypothetical, national security risks—with burden of proof resting on the government.[509]

By combining elements of both existing tests while refining the criteria for contract assumption, this approach would uphold the core principles of bankruptcy law while ensuring that courts have a structured, predictable framework for assessing defense contractor bankruptcies.

Beyond amending the Bankruptcy Code, Congress must also address a major loophole in the Anti-Assignment Acts—the "operation of law" exception, which has allowed private equity firms to exploit LBOs to transfer defense contracts without federal

508. *See supra* Part III.C.2.

509. *See* Kiatkulpiboone, *supra* note 387, at 304–06 (articulating these factors).

oversight.[510] The "operation of law" exception, originally intended for corporate restructurings and statutory mergers, has been manipulated by private equity firms to justify unilateral contract transfers in M&A transactions—effectively bypassing government consent requirements.[511] This directly subverts statutory policy. To close this loophole, Congress should amend the Anti-Assignment Acts to clarify that the "operation of law" exception does not apply to M&A transactions where the rights and duties of a defense contract are altered or transferred without government approval. This reform would ensure that private equity firms can no longer circumvent federal oversight, giving the government a meaningful opportunity to consent or object to the transfer of critical defense contracts when they are bundled into LBO transactions.

Ultimately, Congress bears the responsibility of closing loopholes that have enabled private equity abuse of the defense outsourcing regime at the expense of national security. While the proposals outlined here are by no means exhaustive, they provide a starting point for legislative reform, ensuring that the existing legal regime is equipped to meet the challenges posed by contemporary defense contractor bankruptcies. Without these changes, the intersection of private equity and national security will remain dangerously underregulated,[512] leaving the defense supply chain vulnerable to financial instability and foreign influence.

CONCLUSION

The financial instability of private equity-owned defense contractors is no longer just a business concern. It is a national security risk. Yet, the current legal framework remains blind to the ticking time bomb within the defense industry.[513] LBOs have burdened critical defense contracts with unsustainable debt,

510. *See* Liberty Ammunition, Inc. v. United States, 101 Fed. Cl. 581, 589 (2011) ("Perhaps the most significant exception [to the Anti-Assignment Acts] . . . is when transfer of a . . . contract is effected by consolidation or merger to the successor of a claimant corporation." (citing Tuftco Corp. v. United States, 614 F.2d 740, 745 (Ct. Cl. 1980))).

511. *See supra* Part IV.B.

512. See *supra* Part I for a discussion of how private equity's expansion into the defense sector heightens bankruptcy risks of the defense contractors in ways that generate systemic supply chain vulnerabilities.

513. *See supra* Part I.

leaving them on the brink of bankruptcy, while private equity firms extract profits and evade accountability.[514] Shielded by loopholes in the Bankruptcy Code and the Anti-Assignment Acts, private equity firms reap profits from defense contractors while the risks are borne by the government, the military, and, ultimately, the general public.[515]

The failure here is one of legal architecture. Existing law responds only after financial distress has materialized, offering ex post remedies that do little to prevent the underlying problem.[516] But by the time a defense contractor collapses, the damage has already been done—the supply chain disrupted, military capabilities weakened, and national security compromised.[517] The real issue is not just bankruptcy. It is the unchecked accumulation of debt driven by private equity's high-risk financing practices which our laws fail to regulate.

This Article offers a different approach: an ex ante solution that tackles the problem at its source. By reforming debt financing incentives, subjecting LBOs to merger review, and clarifying the treatment of defense contracts in bankruptcy, Congress can prevent financial failures before they occur.[518] Without these reforms, the U.S. risks allowing short-term financial engineering to undermine long-term national security. Congress needs to act now.

514. *See supra* Part I.

515. See *supra* Part IV.B for a discussion on how private equity firms privatize the gains of defense outsourcing while socializing its costs.

516. See *supra* Part IV.C for a discussion on how existing bankruptcy law operates primarily as an ex post response to financial failures, with no meaningful ex ante mechanism for risk detection or mitigation.

517. *See supra* Part IV.C.

518. *See supra* Part IV.C.