AMERICAN BANKRUPTCY INSTITUTE

Delaware Views from the Bench

The Implementation and Role of Independent Directors

Jason D. Angelo
Reed Smith LLP | Wilmington, Del.

L. Katherine Good
Potter Anderson & Corroon LLP | Wilmington, Del.

Hon. Karen B. Owens
U.S. Bankruptcy Court (D. Del.) | Wilmington

Hon. Christopher S. Sontchi (ret.)
Sontchi, LLC | Wilmington, Del.

Zachary J. Javorsky, Facilitator
Richards, Layton & Finger, P.A. | Wilmington, Del.

2024

DELAWARE VIEWS FROM THE BENCH: THE IMPLEMENTATION AND ROLE OF INDEPENDENT DIRECTORS

PANELISTS: HON. KAREN B. OWENS, HON. CHRISTOPHER S. SONTCHI (RET.), JASON D. ANGELO, L. KATHERINE GOOD, AND ZACHARY J. JAVORSKY (FACILITATOR)

HOTEL DU PONT - OCTOBER 24, 2024

BACKGROUND: THE ROLE OF INDEPENDENT DIRECTORS IN A BANKRUPTCY CASE

- Over the last two decades, independent directors have become more prevalent in bankruptcy cases. They may be referred to as "Bankruptcy Directors."
  - One study found that the percentage of chapter 11 cases with at least one independent director increased from 3.7% in 2004 to 48.3% in 2019.[1]
- Typically, independent directors are former bankruptcy lawyers, judges, or other restructuring professionals that join a Debtor's board shortly before of after filing.
- These independent directors can be influential – playing a key role in shaping a company's restructuring strategy and the outcome of a bankruptcy case.

BACKGROUND: APPOINTMENT AND INDEPENDENCE

- In a restructuring scenario, independent directors are often appointed (i) to analyze and insulate prepetition transactions and decisions, such as bonuses and insider transactions and (ii) to conduct or control post-petition investigations into prepetition conduct. This may include prosecuting, compromising, or abandoning claims or causes of action that a Debtor may have against insiders or even other board members. Independence is key to an independent director's function, but what is independence?
  - Independence under Delaware Corporate Law: Generally, no bright line rule, but rather court's focus on a fact-intensive inquire on whether a "director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind."[2]
    - Factors courts consider include: (i) whether the director is dominated or controlled by any party, (ii) have the power to say "No," (iii) can negotiate freely on an arm's length basis.[3]

BACKGROUND: APPOINTMENT AND INDEPENDENCE (CONTINUED)

- Determining whether a director is independent in the bankruptcy context is complicated by a variety of factors, including the small universe of restructuring professionals where the same professionals interact across multiple cases in various capacities.
  - Directors may serve on many boards and considering who nominated them to their role is an important consideration in determining their independence. This is especially true given that these positions may be short-term, leaving the director dependent on the nominator for future work.
    - One study found that several independent directors had a median of 13 directorships.[4]
- Bankruptcy judges routinely determine independence in other contexts, such as the retention of professionals. Those cases may serve as a guide for determining if an independent director is truly independent.

BACKGROUND: ARE INDEPENDENT DIRECTORS BENEFICIAL TO THE ESTATE?

- Whether independent directors are beneficial to the estate is hotly contested.
  - By one estimate, unsecured creditor recoveries are 20% lower in cases with independent directors vs those without.[5]
- One often expressed concern is that independent directors are appointed by equity holders or lenders and may focus on their interests over other constituencies. This may ultimately harm creditors, especially if the independent director cuts a deal to quickly resolve potential claims.
- On the other hand, independent directors may help a bankrupt entity navigate the chapter 11 process and avoid costly pitfalls.

PRACTICAL CONSIDERATIONS: SELECTING AN INDEPENDENT DIRECTOR

- Restructuring professionals may be asked to advise on whether an independent director is needed, and if so, who should be appointed.
- Factors to consider when deciding if an independent director is needed, include (i) whether the current board is conflicted with key bankruptcy constituencies such as lenders or major creditors and (ii) whether there are significant pre-petition transactions, such as payments made to insiders that will be scrutinized in the bankruptcy process.
- Factors to consider when deciding who to appoint as an independent director, include (i) the potential independent director's expertise in the Debtors' industry and in bankruptcy generally and (ii) whether there is an appearance of any potential conflict with any party in the case, including the the law firm representing the debtor.
  - Both Debtor and the potential director should conduct due-diligence before the director is appointed

PRACTICAL CONSIDERATION: EXPERTISE AND GUIDANCE FOR BOARD MEMBERS

- Often times non-bankruptcy directors are highly experienced in the Debtor's industry, but lack familiarity and knowledge of bankruptcy and restructuring issues. These board members may not know the right questions to ask.
- This lack of familiarity presents an opportunity for independent directors to guide the board through the restructuring process, as they know the right questions to ask. One of an independent director's key roles is to educate the board on a variety of restructuring issues.
  - Independent directors may provide guidance on issues, including professional retentions, interactions with committees and other constituencies, and the DIP financing process.

PRACTICAL CONSIDERATIONS: INDEPENDENT DIRECTORS AND THE UNSECURED CREDITORS' COMMITTEE

- The unsecured creditors' committee can play a key role in keeping independent directors honest, and such committees may challenge an independent director's independence and their ultimate findings.
  - Key considerations for committees, include whether (i) the independent director is qualified, (ii) did the Debtor interview multiple candidates or consider alternatives to an independent director, and (iii) does the independent director have an appropriate role with appropriate corporate authority to bind a Debtor.
- Often an independent director's role overlaps with a committee's investigatory role. This can create friction and potentially overlapping and duplicative investigations, which can be costly for the estate.
- However, independent directors and committees can collaborate with various tasks, including discovery and document collection. Often times this may result in a committee gaining access to documents and other key information quickly and efficiently.
  - However, independent directors likely have access to privileged documents that the committee will never see.

PRACTICAL CONSIDERATIONS: PRIVILEGE

- The use of independent directors in a bankruptcy case raises several issues with privilege and lawyers must take steps to ensure that privilege is not inadvertently blown.
  - Independent directors may retain their own counsel and other restructuring professionals and it is important to ensure these professionals and their advice is adequately protected from unaffiliated professionals.
  - Independent directors may also oversee the preparation of reports and other materials relating to their investigation of claims and causes of action. These reports are typically highly confidential and closely guarded. When preparing such a report, it is important to keep in mind that:
    - Various parties may seek to obtain these reports through discovery
    - The parties the independent director is to investigate may ultimately control the privilege relating to the report, if such party acquires the company through a 363 sale.

CASE STUDY: ENERGY FUTURE HOLDINGS CORP., ET AL., CASE NO. 14-10979 (CSS) (BANKR. D. DEL. 2014)

- EFH involved various subsidiaries, each with their own boards, and substantial cross-claims. Directors between these subsidiaries overlapped with many directors serving on multiple boards. From the outset of the case, various creditors challenged the independence of these directors and their ability to make impartial decisions for the company.
- Following a dispute regarding the approval of the bidding procedures and sale process, Judge Sontchi held, among other things, that while the sale process may go forward all actions taken in relation to that process must be approved by independent directors of each company. He also stressed that these independent directors should get their own attorneys and professionals.
- Once in place, the independent directors and their professionals helped facilitate a global settlement that resolved many previously contentious issues.
- EFH highlights the importance of ensuring that independent directors are in place and receive their own counsel from restructuring professionals.

CASE STUDY: IN RE NINE WEST HOLDINGS, INC., NO. 18-10947 (BANKR. S.D.N.Y. 2019)

- Nine West sought to file bankruptcy, but quickly emerge from Chapter 11. This goal was threatened by the prospect of expansive and costly creditor litigation relating to more than $1 Billion allegedly taken from the company by Sycamore Partners, an insider of Nine West.
- Nine West's board was conflicted due to its relationship with Sycamore and therefore could not investigate the claims.
- Nine West appointed two independent bankruptcy directors to investigate these claims, however these directors' independence was challenged by Nine West's creditors as Sycamore had stood behind their appointment.
- The Court dispensed with the challenge and permitted the independent directors to control the litigation and resolution of the claims. The directors blocked any creditor litigation and ultimately settled the claims for $100 million.

FUTURE FLASH POINTS: A FORMAL RETENTION PROCESS?

- Unlike other estate professionals, there is no formal mechanism or disclosure requirements for the appointment of independent directors.
- This lack of process, may lead to questions regarding an independent director's independence, especially if they were nominated by a key lender or equity holder.
- One possible solution is to require a formal retention process for independent directors, much like other estate professionals, that would allow the Court and other interested parties to test an independent director's independence.

FUTURE FLASH POINTS: LEGISLATIVE INTERVENTIONS AND REFORMS

- With the increased prevalence of independent directors, at least one prominent senator has proposed legislative reforms to reign in an independent director's ability to settle claims and estate causes of action.[6]
  - Senator Warren's proposal would prevent debtors from settling any claims against insiders, instead, creditors would control such claims.
  - To date, Senator Warren's proposal has not gained traction.
- Other scholars have proposed a variety of reforms relating to independent bankruptcy directors, including having the Office of the United States Trustee involved in the appointment process and mandating that courts apply the entire fairness standard to evaluate whether independent bankruptcy directors have a cleansing effect.[7]

CITATIONS AND ADDITIONAL RESOURCES

1. Jared A. Ellias Ehud Kamar, and Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. 1083, 1087 (2022).
2. *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917, 920 (Del. Ch. 2003).
3. *See, e.g.*, *In re MAXXAM, Inc.*, 659 A.2d 760, 773 (Del. Ch. 1995); *see also Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).
4. Ellias, supra slide 2, at 1088.
5. *Id.*
6. See Alexander Saeedy, *Elizabeth Warren Floats Expanded Powers for Bankruptcy Creditors Against Private Equity*, Wall St. J. (Oct. 20, 2021, 1:17 PM), https://www.wsj.com/articles/elizabeth-warren-floats-expanded-powers-for-bankruptcy-creditors-against-private-equity-11634750237.
7. Robert W. Miller, *Everyone is Talking About Bankruptcy Directors*, Florida State University Business Review (invited symposium article)(2024)

THE RISE OF BANKRUPTCY DIRECTORS

JARED A. ELLIAS,* EHUD KAMAR† & KOBI KASTIEL‡

ABSTRACT

In this Article, we use hand-collected data to shed light on a troubling development in bankruptcy practice: distressed companies, especially those controlled by private equity sponsors, often now prepare for a Chapter 11 filing by appointing bankruptcy experts to their boards of directors and giving them the board's power to make key bankruptcy decisions. These directors often seek to wrest control of self-dealing claims against shareholders from creditors. We call these directors "bankruptcy directors" and conduct the first empirical study of their rise as key players in corporate bankruptcies. While these directors claim to be neutral experts that act to maximize value for the benefit of creditors, we argue that they suffer from a structural bias because they often receive their appointment from a small community of repeat private equity sponsors and law firms. Securing

* Professor of Law, Harvard Law School.

† Professor of Law, Tel Aviv University, Faculty of Law.

‡ Associate Professor, Tel Aviv University, Faculty of Law; Lecturer on Law, Harvard Law School. We thank Kenneth Ayotte, Lucian Bebchuk, Vincent Buccola, Anthony Casey, Alma Cohen, Elisabeth de Fontenay, Jesse Fried, Lynn LoPucki, Tobias Keller, Michael Klausner, Michael Ohlrogge, Adam Levitin, Robert Rasmussen, Adriana Robertson, Mark Roe, Daniel Sokol, Robert Stark, Roberto Tallarita, Robert Tennenbaum, and seminar and conference audiences at the Annual Meeting of the American Law and Economics Association, Bay Area Corporate Law Scholars Workshop, the Bar Ilan University Law Faculty Seminar, the Corporate Law Academic Webinar Series (CLAWS), the Duke Faculty Workshop, Florida-Michigan-Virginia Virtual Law and Economics Seminar, the Harvard Law School Empirical Law and Economics Seminar, the Harvard Law School Faculty Workshop, Harvard Law School Law and Economics Workshop, Tel Aviv University Faculty of Law Workshop, the Turnaround Management Association, the University of Toronto Seminar in Law and Economics, and the University of California, Berkeley Law, Economics, and Accounting Workshop for helpful comments. We also thank Noy Abramov, Jacob Barrera, Jade Henry Kang, Spencer Kau, Victor Mungary, Julia Staudinger, Or Sternberg, Jonathan Tzuriel, and Sara Zoakei for excellent research assistance. This research was supported by The Israel Science Foundation (Grant No. 2138/19).

future directorships may require pleasing this clientele at the expense of creditors. Indeed, we find that unsecured creditors recover on average 20% less when the company appoints a bankruptcy director. While other explanations are possible, this finding shifts the burden of proof to those claiming that bankruptcy directors improve the governance of distressed companies. Our policy recommendation, however, does not require a resolution of this controversy. Rather, we propose that courts regard bankruptcy directors as independent only if an overwhelming majority of creditors whose claims are at risk supports their appointment, making them accountable to all sides of the bankruptcy dispute.

TABLE OF CONTENTS

INTRODUCTION

In August 2017, the board of directors of shoe retailer Nine West confronted a problem. The firm would soon file for Chapter 11 protection, and its hopes to emerge quickly from the proceeding were in danger due to the high probability of creditor litigation alleging that the firm's controlling shareholder, private equity fund Sycamore Partners Management, had looted more than $1 billion from the firm's creditors.[1] The board could not investigate or settle this litigation because it had a conflict of interest.[2]

To take control of the litigation, the board appointed two bankruptcy experts as new directors who claimed that, because they had no prior ties to Sycamore or Nine West, they were independent and could handle those claims.[3] Once the firm filed for bankruptcy, its creditors objected. They argued that the new directors still favored Sycamore because it stood behind their appointment, so the directors would "hamstring any serious inquiry into [its] misconduct."[4] Nevertheless, the gambit was successful. The bankruptcy

1. *See* Notice of Motion of the 2034 Notes Trustee for Entry of an Order Granting Leave, Standing, and Authority to Commence and Prosecute a Certain Claim on Behalf of the NWHI Estate at 15, *In re* Nine West Holdings, Inc., No. 18-10947 (Bankr. S.D.N.Y. Jan. 31, 2019) [hereinafter Notice of Motion of the 2034 Notes Trustee]; Kenneth Ayotte & Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 YALE L.J.F. 363, 373 (2021) (describing some of the transfers in detail). For example, the private equity sponsor had allegedly purchased the assets of Kurt Geiger for $136 million in April 2014 and sold them in December 2015 for $371 million. *See* Notice of Motion of the 2034 Notes Trustee, *supra*, at 34.

2. *See* Motion of the Official Committee of Unsecured Creditors for Entry of an Order Granting Leave, Standing, and Authority to Commence and Prosecute Certain Claims on Behalf of the NWHI Estate and Exclusive Settlement Authority in Respect of Such Claims at 17, *In re* Nine West Holdings, Inc., No. 18-10947 (Bankr. S.D.N.Y. Oct. 22, 2018) [hereinafter Nine West Standing Motion].

3. *See* Transcript of Hearing at 43, *In re* Nine West Holdings, Inc., No. 18-10947 (Bankr. S.D.N.Y. May 7, 2018).

4. *See* Nine West Standing Motion, *supra* note 2, at 34 ("[The lawyers for the independent

court allowed the new directors to take control of the litigation.[5] The new directors blocked creditor attempts to file lawsuits on their own[6] and ultimately settled the claims for about $100 million.[7]

The Nine West story illustrates the emergence of important new players in corporate bankruptcies: bankruptcy experts who join boards of directors shortly before or after the filing of the bankruptcy petition and claim to be independent.[8] The new directors—typically former bankruptcy lawyers, investment bankers, or distressed debt traders—often receive the board's power to make important Chapter 11 decisions or become loud voices in the boardroom shaping the company's bankruptcy strategy.[9] We call them "bankruptcy directors."

The rising prominence of bankruptcy directors has made them controversial. Proponents tout their experience and ability to expedite the reorganization and thus protect the firm's viability and its employees' jobs.[10] Opponents argue that they suffer from conflicts of interest that harm creditors.[11]

---

directors] attended . . . depositions . . . but asked just a handful of questions of a single witness . . . . [And they] chose not to demand and review the Debtors' privileged documents relating to the LBO . . . .").

5. *See* Nine West Standing Motion, *supra* note 2, at 13 ("The Debtors have barred the Committee from participating in its settlement negotiations with Sycamore . . . .").

6. Shortly after the unsecured creditors proposed to put the claims against the private equity sponsor into a trust for prosecution after bankruptcy, the independent directors unveiled their own settlement plan. *See* Notice of Filing of the Debtors' Disclosure Statement for the Debtors' First Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code at 1–3, *In re* Nine West Holdings, Inc., No. 18-10947 (Bankr. S.D.N.Y. Oct. 17, 2018) [hereinafter Nine West Disclosure Statement Announcing Settlement].

7. *See* Nine West Standing Motion, *supra* note 2, at 11 (seeking permission to prosecute claims for "well over $1 billion"); Soma Biswas, *Nine West Settles Potential Lawsuits Against Sycamore Partners*, WALL ST. J. (Oct. 18, 2018, 2:12 PM), https://www.wsj.com/articles/nine-west-settles-potential-lawsuits-against-sycamore-partners-1539886331 [https://perma.cc/RLH4-M9EU] ("Nine West Holdings Inc. unveiled Wednesday an amended restructuring plan that settles potential lawsuits against private-equity owner Sycamore Partners LP for $105 million in cash, far less than the amount the unsecured creditors committee is seeking.").

8. *See, e.g.*, *Notice of Appearance–Lisa Donahue, AlixPartners*, PETITION (Feb. 19, 2020), https://www.petition11.com/news/2020/2/19/notice-of-appearance-lisa-donahue-alixpartners [https://perma.cc/NA6H-69AT] (noting that "[independent directors in bankruptcy have] . . . become the latest cottage industry in the restructuring space").

9. *See* REGINA STANGO KELBON, MICHAEL DEBAECKE & JONATHAN K. COOPER, APPOINTMENT OF INDEPENDENT DIRECTORS ON THE EVE OF BANKRUPTCY: WHY THE GROWING TREND? 17 (2014) ("Employing an outside director to exercise independent judgment as to corporate transactions in bankruptcy may not only provide additional guidance to a suffering business, but can make the decision-making process seem right in the eyes of stakeholders and ultimately, the court.").

10. *See* Robert Gayda & Catherine LoTempio, *Independent Director Investigations Can Benefit Creditors*, LAW360 (July 24, 2019, 3:55 PM), https://www.law360.com/articles/1174248/independent-director-investigations-can-benefit-creditors [https://web.archive.org/web/20220401015757/https://www.law360.com/articles/1174248/independent-director-investigations-can-benefit-creditors] (noting that independent directors are helpful in bankruptcy where "speed to exit is paramount").

11. *See, e.g.*, *"Independent" Directors Under Attack*, PETITION (May 16, 2018), https://petition.substack.com/p/independent-directors-under-attack [https://perma.cc/G9RY-U9D4]; Lisa

This Article is the first empirical study of these directors. While a voluminous literature has considered the governance of Chapter 11 firms, this Article breaks new ground in shining a light on an important change in the way these firms make decisions in bankruptcy and resolve conflicts with creditors.[12] It does so by analyzing a hand-collected sample of all large firms that filed for Chapter 11 between 2004 and 2019 that disclosed the identity of their directors to the bankruptcy court.[13] To our knowledge, it is the largest sample of boards of directors of Chapter 11 firms yet studied.[14]

We find that the percentage of firms in Chapter 11 proceedings claiming to have an independent director increased from 3.7% in 2004 to 48.3% in 2019.[15] Over 60% of the firms that appointed bankruptcy directors had a controlling shareholder and about half were under the control of private equity funds.

After controlling for firm and bankruptcy characteristics, we find that the recovery rate for unsecured creditors, whose claims are typically most at

Abramowicz, *Private Equity Examines Its Distressed Navel*, BLOOMBERG (May 26, 2017), https://www.bloomberg.com/opinion/articles/2017-05-26/payless-shoesource-private-equity-examines-its-distressed-navel [https://perma.cc/NC4H-DK9M]; Mark Vandevelde & Sujeet Indap, *Neiman Marcus Director Lambasted by Bankruptcy Judge*, FIN. TIMES (June 1, 2020), https://www.ft.com/content/0166cb87-ea50-40ce-9ea3-b829de95f676 [https://perma.cc/5VY4-VQA8]; American Bankruptcy Institute, *RDW 12 21 2018*, YOUTUBE (Dec. 20, 2018), https://www.youtube.com/watch?v=Ah8RkXYdraI&ab_channel=AmericanBankruptcyInstitute [https://perma.cc/KG37-TJUC]; *The "Weil Bankruptcy Blog Index,"* PETITION (Jan. 10, 2021), https://petition.substack.com/p/weilbankruptcy blogindex [https://perma.cc/L356-TFPY] (calling the Nine West case a "standard episode of 'independent director' nonsense").

12. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 651 (2010) (considering creditor conflict); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 784 (2002); David A. Skeel Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 919 (2003) (considering the role of secured creditors); Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 VAND L. REV. 749, 754–56 (2011) (considering the role of unsecured creditors). For other articles that, like this Article, criticize recent changes in Chapter 11 practice, see generally Adam J. Levitin, *Purdue's Poison Pill: The Breakdown of Chapter 11's Checks and Balances*, 100 TEX. L. REV. 1079 (2022); Lynn M. LoPucki, *Chapter 11's Descent into Lawlessness*, 96 AM. BANKR. L.J. 247 (2022).

13. Our full dataset consists of the boards of directors of 528 firms and the 2,895 individuals who collectively hold 3,038 directorships at these firms. While all Chapter 11 firms are required to provide information on their board to the bankruptcy court, not all comply with the law. For more on our sample, see *infra* Part III.

14. *See infra* note 152 and accompanying text.

15. We identified bankruptcy directors using information from each firm's disclosure statement. We then searched those disclosure statements and identified 78 cases in which the debtor represented that its board was "independent" or "disinterested." *See infra* Section III.C.1. Independent directors are not new to bankruptcy. WorldCom, for example, used independent directors as part of its strategy to get through the bankruptcy process in its 2003 Chapter 11 filing. *See* KELBON, *supra* note 9, at 20. The change is that a practice that was once relatively uncommon has become ubiquitous and a central and standard part of the process of preparing for a Chapter 11 bankruptcy filing, leading to the growth of an industry of professional bankruptcy directors who fill this new demand for bankruptcy experts on the board of distressed firms. *See infra* Section III.C.1

risk in bankruptcy, is on average 20% lower in the presence of bankruptcy directors. We cannot rule out the possibility that the firms appointing bankruptcy directors are more insolvent and that this explains their negative association with creditor recoveries. Still, this finding at least shifts the burden of proof to those claiming that bankruptcy directors improve the governance of distressed companies to present evidence supporting their view in this emerging debate.

We also examine a mechanism through which bankruptcy directors may reduce creditor recoveries. In about half of the cases, these directors investigate claims against insiders,[16] negotiate a quick settlement, and argue that the court should approve it to save the company and the jobs of its employees.[17] We supplement these statistics with two in-depth studies of cases in which bankruptcy directors defused creditor claims against controlling shareholders: Neiman Marcus and Payless Holdings.

Finally, we consider possible sources of pro-shareholder bias among bankruptcy directors. Shareholders usually appoint bankruptcy directors without consulting creditors. These directors may therefore prefer to facilitate a graceful exit for the shareholders. Moreover, bankruptcy directorships are short-term positions, and the world of corporate bankruptcy is small, with private equity sponsors and a handful of law firms generating most of the demand. Bankruptcy directors depend on this clientele for future engagements and may exhibit what we call "auditioning bias."

In our data, we observe several individuals appointed to these directorships repeatedly. These "super-repeaters" had a median of 13 directorships and about 44% of them were in companies that went into bankruptcy when they served on the board or up to a year before their appointment.[18] Our data also show that super-repeaters have strong ties to two leading bankruptcy law firms.[19] Putting these pieces together, our data reveal an ecosystem of a small number of individuals who specialize in sitting on the boards of companies that are going into or emerging from bankruptcy, often with private equity controllers and the same law firms.

These findings support the claim that bankruptcy directors are a new weapon in the private equity playbook. In effect, bankruptcy directors assist with shielding self-dealing transactions from judicial intervention. Private equity sponsors know that if the portfolio firm fails, they could appoint

16. *See infra* Table 2.

17. In many cases, a debtor-in-possession contract that requires the firm to leave bankruptcy quickly heightens the debtor's urgency. *See, e.g.*, Frederick Tung, *Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis*, 37 YALE J. ON REGUL. 651, 672 (2020).

18. *See infra* Section III.C.4.

19. *See infra* Section III.C.5.

bankruptcy directors to handle creditor claims, file for bankruptcy, and force the creditors to accept a cheap settlement.[20] Importantly, the ease of handling self-dealing claims in the bankruptcy court may fuel more aggressive self-dealing in the future.[21]

Our findings have important policy implications. Bankruptcy law strives to protect businesses while also protecting creditors. These goals can clash when creditors bring suits that threaten to delay the emergence from bankruptcy. While bankruptcy directors may aim for speedy resolution of these suits, their independence may be questionable because the defendants in these suits are often the ones who appoint them. Moreover, bankruptcy directors often bypass the checks and balances that Congress built into Chapter 11 when they seek to replace the role of the official committee of unsecured creditors ("UCC") as the primary check on management's use of the powers of a Chapter 11 debtor.

We argue that the contribution of bankruptcy directors to streamlining bankruptcies should not come at the expense of creditors. We therefore propose a new procedure that bankruptcy judges can implement without new legislation: the bankruptcy court should treat as independent only bankruptcy directors who, in an early court hearing, earn overwhelming support of the creditors whose claims are at risk, such as unsecured creditors or secured creditors whom the debtor may not be able to pay in full. Bankruptcy directors without such support should not be treated as independent and therefore should not prevent creditors from investigating and pursuing claims.

The creditors will likely need information on the bankruptcy directors to form their opinion, and bankruptcy judges can rule on what information requests are reasonable. This will create standardization and predictability. However, disclosure is no substitute for creditor support. Requiring disclosure without heeding creditors on the selection of bankruptcy directors will not cure bankruptcy directors' structural biases.

Some might argue that our solution is impractical or otherwise lacking. We answer these claims. More importantly, our solution is the only way to ensure that bankruptcy directors are truly independent. If it cannot be made

20. *See* Telephonic/Video Disclosure Statement and KEIP Motion Hearing at 34, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. July 30, 2020) [hereinafter Neiman Marcus Settlement Transcript] (arguing that independent directors are changing incentives for private equity sponsors, who will be "encouraged to asset strip").

21. As Sujeet Indap and Max Frumes write, a leading bankruptcy law firm that advises debtors "developed a reputation for keeping a stable of 'independent' board of director candidates who could parachute in to bless controversial deal making." SUJEET INDAP & MAX FRUMES, THE CAESARS PALACE COUP: HOW A BILLIONAIRE BRAWL OVER THE FAMOUS CASINO EXPOSED THE POWER AND GREED OF WALL STREET 419 (2021).

to work, bankruptcy law should revert to the way it was before the invention of bankruptcy directors, where federal bankruptcy judges were the only impartial actors in most large Chapter 11 cases. In such a scenario, debtors will be free to hire whomever they want to help them navigate financial distress, but the court will regard these bankruptcy directors as ordinary professionals retained by the debtor. The court should weigh the bankruptcy directors' position against the creditors', allow the creditors to conduct their own investigation and sue over the bankruptcy directors' objections, and not approve settlements merely because the bankruptcy directors endorse them.

Our study also lends support to the bill recently introduced by Senator Elizabeth Warren to prevent debtors from prosecuting and settling claims against insiders.[22] Like our proposal, this bill would restore the traditional checks and balances of the bankruptcy process while allowing distressed firms to appoint directors of their choice. Still, our proposal has several advantages. It does not require new legislation, it preserves greater flexibility for the bankruptcy court and, by requiring that bankruptcy directors be acceptable to creditors, it ensures that all board decisions in bankruptcy, not just decisions regarding claims against insiders, advance creditor interests.

Our analysis also has implications for corporate law. Much of the literature on director independence in corporate law has focused on director ties to the corporation, to management, or to the controlling shareholder.[23] We explore another powerful source of dependence: dependence on future engagements by other corporations and the lawyers advising them.

This Article proceeds as follows. Part I lays out the theoretical background to our discussion, showing how the use of independent directors has migrated from corporate law into bankruptcy law. Part II presents examples of bankruptcy director engagements from the high-profile bankruptcies of Neiman Marcus and Payless Holdings. Part III demonstrates empirically how large firms use bankruptcy directors in Chapter 11. Part IV discusses concerns that bankruptcy directors create for the integrity of the bankruptcy system and puts forward policy recommendations.

---

22. *See* Alexander Saeedy, *Elizabeth Warren Floats Expanded Powers for Bankruptcy Creditors Against Private Equity*, WALL ST. J. (Oct. 20, 2021, 1:17 PM), https://www.wsj.com/articles/elizabeth-warren-floats-expanded-powers-for-bankruptcy-creditors-against-private-equity-11634750237 [https://perma.cc/P3XE-U24Y].

23. *See generally* Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271 (2017); Da Lin, *Beyond Beholden*, 44 J. CORP. L. 515 (2019).

I. THE TRANSPLANTATION OF INDEPENDENT DIRECTORS INTO BANKRUPTCY LAW

In this Part, we discuss how reliance on independent directors has become a core feature of corporate law and how this practice has recently migrated into bankruptcy law. First, we explain how regulators, courts, and commentators have encouraged firms to put important decisions outside bankruptcy in the hands of independent directors and summarize the main criticisms of this practice. Next, we discuss how this norm has recently been transplanted into bankruptcy law. Finally, we analyze concerns unique to bankruptcy law that this practice raises.

A. INDEPENDENT DIRECTORS IN CORPORATE LAW

1. The Rise of Independent Directors in Corporate Law

The premise in corporate law is that the board of directors supervises management.[24] The board is in charge because it possesses the expertise and the information needed to evaluate corporate decisions.[25] When the board has conflicts of interest, it delegates its authority to independent directors.[26]

Over the last few decades, American public companies have come to rely on independent directors.[27] There were several driving forces behind this shift. First, it was a response to the difficulty of dispersed shareholders of public firms in supervising management themselves.[28] The idea was that independent board members elected by shareholders could monitor managers and reduce the agency costs associated with the separation of ownership and control.[29] Second, federal mandates adopted after the Enron and WorldCom scandals, such as the Sarbanes-Oxley Act of 2002 and related stock exchange listing rules, tightened independence standards and required public corporations to populate their boards and their committees with independent directors.[30] Third, institutional investors with ever-increasing

24. *See* Del. Code Ann. tit. 8, § 141(a) (2021).

25. *See, e.g.*, Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 117–24 (2004) (explaining the common rationale for the business judgment rule which suggests that business experts may know business better than judges).

26. *See, e.g.*, Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1523–26 (2007) (discussing the role of independent directors in vetting transactions involving conflicts of interests); Bebchuk & Hamdani, *supra* note 23, at 1281–82.

27. *See* Gordon, *supra* note 26, at 1465; Kobi Kastiel & Yaron Nili, *"Captured Boards": The Rise of "Super Directors" and the Case for a Board Suite*, 2017 WIS. L. REV. 19, 22.

28. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932).

29. *See* Gordon, *supra* note 26, at 1468.

30. *See* N.Y. STOCK EXCH., NYSE LISTED COMPANY MANUAL §§ 303A.01, .04–.06 (2021);

shareholdings emphasized board independence.[31] Last, corporate managers embraced board independence to avoid intrusive regulation and preserve their autonomy.[32]

State courts have also played an important role in encouraging the use of independent directors. They did so by showing greater deference to board decisions made by independent directors.[33]

For example, in corporate freeze-outs, a controlling shareholder acquires the shares of public shareholders and takes the company private, often provoking minority shareholder lawsuits.[34] These transactions raise the concern that the controlling shareholder will use its influence, its informational advantage, and its choice of timing to pay too little to public shareholders.[35] Due to the inherent conflict of interest and the coercive nature of these transactions, Delaware courts have traditionally subjected them to the highest level of scrutiny, entire fairness, as the default standard of review.[36] However, a freeze-out negotiated and approved by a committee of independent directors enjoys a presumption of fairness and is almost litigation-proof when also conditioned on minority shareholder approval.[37]

Reliance on these committees to vet freeze-outs has become the norm.[38] To qualify for deferential review, Delaware courts require that the controlling shareholder meet a number of conditions designed to enhance the committee's effectiveness and mimic the dynamics of an arm's-length bargain. The courts examine whether the committee is truly independent and

NASDAQ, THE NASDAQ STOCK MKT LLC RULES § 5605(b)(1), (c)(2), (d)(2), (e) (2021). *See also Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2187, 2194 (2004) ("The revised listing standards of both the NYSE [New York Stock Exchange] and NASDAQ . . . require (with a few exceptions) that listed-company boards have a majority of independent directors . . . .").

31. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0: An Introduction*, 74 BUS. LAW. 351, 356 (2019).

32. *See, e.g.*, Gordon, *supra* note 26, at 1523–26; Urska Velikonja, *The Political Economy of Board Independence*, 92 N.C. L. REV. 855, 897–98 (2014).

33. *See, e.g.*, Bebchuk & Hamdani, *supra* note 23, at 1281–82; Gordon, *supra* note 26, at 1484–87 (reviewing the role that Delaware courts played in encouraging public companies to give more power to independent directors).

34. *See, e.g.*, Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 8–10 (2005).

35. *See, e.g.*, Lucian Arye Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freezeouts*, *in* CONCENTRATED CORPORATE OWNERSHIP 247, 248–49 (Randall K. Morck ed., 2000); Subramanian, *supra* note 34, at 32–38.

36. *See* Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) ("[W]hen a controlling shareholder stands on both sides of the transaction the conduct of the parties will be viewed under the more exacting standard of entire fairness . . . ."); *see also* Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983); *In re* Pure Res., Inc. S'holders Litig., 808 A.2d 421, 436 (Del. Ch. 2002).

37. *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994); Kahn v. M & F Worldwide Corp., 88 A.3d 635, 642 (Del. 2014).

38. *See* Fernán Restrepo, *Judicial Deference, Procedural Protections, and Deal Outcomes in Freezeout Transactions: Evidence from the Effect of* MFW, 6 J.L. FIN. & ACCT. 353, 371 (2021) (finding that special committees were formed in over 90% of post-*MFW* freeze-outs).

disinterested, whether it had a sufficiently broad mandate from the board (including the power to reject the transaction), whether it received independent financial and legal advice, whether it negotiated diligently and with no outside influence, and whether it possessed all material information.[39]

Derivative litigation is another area where Delaware courts defer to independent directors.[40] A derivative plaintiff who wishes to sue insiders on behalf of the corporation for breach of fiduciary duty must first show the court that it is futile to make a demand on the board to sue.[41] A board with a majority of independent directors can successfully seek dismissal of the suit on these grounds.[42]

Even when Delaware courts excuse demand as futile, they permit the board to form a special litigation committee ("SLC") of independent directors that may wrest control of the litigation from the derivative plaintiff.[43] Here, too, Delaware judges have developed an elaborate jurisprudence.[44] First, they hold SLC directors to a higher independence standard than the regular standard.[45] Second, they often exercise their own business judgment on the viability of the suit.[46] A recent empirical study

---

39. *See M & F Worldwide Corp.*, 88 A.3d at 646–47; *see also* Andrew R. Brownstein, Benjamin M. Roth & Elina Tetelbaum, *Use of Special Committees in Conflict Transactions*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 23, 2019), https://corpgov.law.harvard.edu/2019/09/23/use-of-special-committees-in-conflict-transactions/ [https://perma.cc/A39V-HJKS].

40. *See* Bebchuk & Hamdani, *supra* note 23, at 1288–89.

41. *See* DEL. CT. CH. R. 23.1.

42. *See* Aronson v. Lewis, 473 A.2d 805, 817 (Del. 1984). A Delaware court held that for plaintiffs to establish the futility of making a demand on the board to sue the controller, it is not enough to charge that a director was nominated by or elected at the behest of the controlling shareholder. *See id.*; *see also* Friedman v. Dolan, No. 9425, 2015 Del. Ch. LEXIS 178, at *22 (Del. Ch. June 30, 2015) (stating that "[t]he mere fact that one [director] was appointed by a controller" does not suffice to overcome the presumption of her independence); Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1051 (Del. 2004) (holding that 94% voting power was not enough to create reasonable doubt of independence). However, in two recent cases, Delaware courts expressed concerns about directors operating in a highly networked community, such as the Silicon Valley community, noting that this may undermine their independence. *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 54 (Del. Ch. 2013); Sandys v. Pincus, 152 A.3d 124, 134 (Del. 2016).

43. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787–89 (Del. 1981).

44. *See generally* Minor Myers, *The Decisions of the Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309 (2009) (discussing SLCs).

45. *See, e.g.*, *Beam*, 845 A.2d at 1055 ("[T]he SLC has the burden of establishing its own independence by a yardstick that must be 'like Caesar's wife'—above reproach."); *see also* London v. Tyrrell, No. 3321, 2010 Del. Ch. LEXIS 54, at *40 (Del. Ch. Mar. 11, 2010) ("SLC members are not given the benefit of the doubt as to their impartiality and objectivity. They, rather than plaintiffs, bear the burden of proving that there is no material question of fact about their independence. The composition of an SLC must be such that it fully convinces the Court that the SLC can act with integrity and objectivity, because the situation is typically one in which the board as a whole is incapable of impartially considering the merits of the suit.").

46. Under Delaware law, the court first inquires whether the SLC was independent, acted in good faith, and made a reasonable investigation, and then may apply its own independent business judgement

shows that such "legal standards matter," as "in states with the lowest level of judicial review, outcomes are more likely to be favorable for defendants."[47]

2. Reasons to Doubt Independent Directors in Corporate Law

The increasing reliance on independent directors has been subject to criticism. Three decades ago, Jay Lorsch concluded from numerous personal interviews and questionnaire responses that director independence was merely an aspiration.[48] Still today, Lucian Bebchuk and Assaf Hamdani argue that independent directors are likely to accommodate the controlling shareholder's wishes because the controlling shareholder is the one making director appointments and these directors seek reappointment.[49] Lisa Fairfax explains that independent directors may have an unconscious bias in favor of other directors because they view them as part of their group.[50] Yaron Nili argues that boards have too much discretion in classifying directors as independent and provide investors with insufficient information.[51]

These criticisms are relevant when considering whether to encourage bankruptcy judges to give independent directors a larger role in Chapter 11 cases, especially in vetting conflict transactions.

---

to decide whether to grant the motion. This standard of review is higher than the business judgment rule. *See Zapata*, 430 A.2d at 787–89.

47. *See* C.N.V. Krishnan, Steven Davidoff Solomon & Randall S. Thomas, *How Do Legal Standards Matter? An Empirical Study of Special Litigation Committees*, 60 J. CORP. FIN. 1, 2 (2020) ("[W]e find an SLC report recommending case dismissal in Delaware court in the post-*Oracle* period is significantly and negatively associated with the probability of a case dismissal. Thus, the change in the legal standard appears to have made the Delaware courts more skeptical of SLC recommendations calling for case dismissals.").

48. *See* JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 13–14, 83–88, 96 (1989). *See also* Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 460 (2008).

49. *See* Bebchuk & Hamdani, *supra* note 23, at 1274 (arguing that because "controllers [have] decisive power to appoint independent directors and decide whether to retain them, independent directors have significant incentives to side with the controller and insufficient countervailing incentives to protect public investors in conflicted decisions").

50. *See* Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 153 (2010) ("[T]he psychological research with respect to structural bias is particularly relevant in the context of boards, highlighting the degree to which such bias undermines directors' ability to be critical of their fellow directors."); *cf.* Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 252 ("Directors, even those defined as independent, are members of the board of directors and, so the theory goes, are likely to be biased in favor of other directors.").

51. *See* Yaron Nili, *The Fallacy of Director Independence*, 2020 WIS. L. REV. 491, 503–04; Yaron Nili, *Out of Sight, Out of Mind: The Case for Improving Director Independence Disclosure*, 43 J. CORP. L. 35, 53–54, 58–62 (2017).

B. The Rise of Independent Bankruptcy Directors

Until recently, corporate law's infatuation with independent directors has had no parallel in bankruptcy law. As Congress designed bankruptcy law, the role of the board in vetting conflict transactions is only to propose actions for the judge's approval.[52] In deciding whether to grant a board's request, the judge considers the input of creditors, who are usually sophisticated investors who can offer independent analysis.[53] Bankruptcy law amplifies creditor voice by allowing the appointment of a UCC that acts as a check on the board.[54]

Traditionally, there has thus been little need to focus on the independence of board members. A federal bankruptcy judge was the final decision-maker, and creditors were ready to weigh in on important bankruptcy decisions and state their position. As we demonstrate below, this is no longer the case. Independent directors that join boards shortly before filing for bankruptcy increasingly make important decisions during the bankruptcy process that judges endorse.

1. Factors Contributing to the Growing Popularity of Bankruptcy Directors

While we cannot definitively identify the causes of the rise of independent directors in bankruptcy, we can point to possible theories.

First, as boards developed a practice of looking to expert directors for major decisions outside bankruptcy, it was perhaps natural that similar thinking would carry over to financial distress. A corporate board may want to have an expert in financial distress to enliven board deliberations and help the board meet its fiduciary duty, especially if it is unclear whether the firm will end up in bankruptcy and the board worries about lawsuits.

Second, the lawyers who advise financially distressed companies may see independent directors as helpful in persuading bankruptcy judges to issue orders that allow their clients to leave bankruptcy. Since state court judges

52. *See* John A. E. Pottow, *Bankruptcy Fiduciary Duties in the World of Claims Trading*, 13 BROOK. J. CORP. FIN. & COM. L. 87, 93 (2018) (noting that creditors serve as a check on a Chapter 11 firm and that the bankruptcy court's oversight means that fiduciary duties are less important since investor conflicts are usually resolved in open court).

53. *See, e.g.*, Wei Jiang, Kai Li & Wei Wang, *Hedge Funds and Chapter 11*, 67 J. FIN. 513, 556 (2012); Jared A. Ellias, *Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?: Evidence from Junior Activist Investing*, 8 J. LEGAL ANALYSIS 493, 499 (2016); Michelle M. Harner, Jamie Marincic Griffin & Jennifer Ivey-Crickenberger, *Activist Investors, Distressed Companies, and Value Uncertainty*, 22 AM. BANKR. INST. L. REV. 167, 178–80 (2014).

54. *See* Gayda & LoTempio, *supra* note 10 ("Some commentators view these 'internal' investigations as infringing on the role of unsecured creditors' committees, which had historically reviewed and analyzed prepetition conduct of a debtor and the debtor's management/ownership for potential causes of action.").

are more deferential to independent directors who make decisions that shareholders oppose, these lawyers may have reasoned that bankruptcy judges would also be more deferential to independent directors who make decisions that creditors oppose.[55]

Third, changing practices in the debt markets, especially among private equity firms, may have increased the need for bankruptcy directors. As we show below, many of the cases involving bankruptcy directors resemble the bankruptcy of Nine West, where a financially distressed company with a private equity sponsor files for bankruptcy and faces creditor litigation alleging looting by the sponsor. As robust debt markets have allowed highly leveraged firms to delay filing for bankruptcy, they may have expanded the space for potential self-dealing, fueling the demand for bankruptcy directors that could manage creditor claims. As bankruptcy directors achieve favorable outcomes, the liability calculus associated with self-dealing changes, generating further demand for bankruptcy directors.

The concentration of the market for bankruptcy services amplifies the effect of these factors. A handful of law firms, financial advisors, and other professionals play a key role as advisors to distressed companies. In other contexts, lawyers disseminate new practices.[56] When bankruptcy directors have important wins or are involved in high-profile cases, additional lawyers counsel their clients to add bankruptcy directors to their boards as a growing consensus develops that this is the best practice.

2. Reasons to Doubt the Independence of Bankruptcy Directors

In the context of a firm under bankruptcy court protection, there are additional reasons to question the use of independent directors.

Outside bankruptcy, shareholder power to elect directors aligns directors with shareholders. In fact, courts have relied on shareholders' ability to displace directors as a reason for deferring to directors.[57] Recent

55. *See* KELBON et al., *supra* note 9, at 17 ("Employing an outside director to exercise independent judgment as to corporate transactions in bankruptcy may not only provide additional guidance to a suffering business, but can make the decision-making process seem right in the eyes of stakeholders and ultimately, the court").

56. John Coates finds that clients of larger law firms with more takeover experience adopt more defenses in charters of firms conducting an initial public offering. *See* John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CALIF. L. REV. 1301, 1304 (2001). Other studies find that large law firms are responsible for the adoption of exclusive forum-selection provisions and that three Silicon Valley law firms drive the use of certain dual-class structures. *See* Roberta Romano & Sarath Sanga, *The Private Ordering Solution to Multiforum Shareholder Litigation*, J. EMPIRICAL LEGAL STUD. 31, 35 (2017); Andrew William Winden, *Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures*, 2018 COLUM. BUS. L. REV. 852, 886–89.

57. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005) ("The redress for [directors'] failures . . . must come . . . through the action of shareholders . . . and not from

evidence supports this view, showing that the number of directors who fail to receive shareholder support is on the rise, meaning that shareholders use their votes.[58] These disciplinary mechanisms do not exist in bankruptcy. Creditors cannot influence the election of directors, so bankruptcy directors lack incentives to advance creditors' interests.

Additionally, unlike corporate law, bankruptcy law already contemplates other representatives of creditors. Importantly, a UCC acts as a court-appointed fiduciary to maximize firm value while protecting creditor rights.[59] Courts have interpreted this broad authority to permit the UCC to participate in all aspects of a bankruptcy case and to initiate legal actions to recover transferred assets or to sue officers and directors.[60] Moreover, bankruptcy law allows creditors to hire their own lawyers and join the bargaining process in addition to the UCC, and sophisticated investors take advantage of these rights.[61]

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

Moreover, in Chapter 11 proceedings, creditors are usually sophisticated investors advised by expert lawyers.[62] They can protect their interests. There is no obvious reason to let shareholder appointees prevent creditors from representing themselves in matters on which creditors and shareholders disagree.

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

First, bankruptcy professionals—lawyers, investment bankers, and bankruptcy directors—form a much smaller community than the corporate

this Court."); *see also* Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342, 1351 (D. Nev. 1997) ("[O]ne of the justifications for the business judgment rule's insulation of directors from liability . . . is that unhappy shareholders can always vote the directors out of office." (internal quotation marks omitted) (quoting Shoen v. AMERCO, 885 F. Supp. 1332, 1340 (D. Nev. 1994)); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) ("[T]he Rights Plan will not have a severe impact upon proxy contests . . . .").

58. *See* Kobi Kastiel & Yaron Nili, *Competing for Votes*, 10 HARV. BUS. L. REV. 287, 319–20 (2020) (showing that in 2019, the number of directors failing to receive majority support from their shareholders rose to 478, and the number of directors failing to receive at least 70% support rose to 1726).

59. *See, e.g.*, 11 U.S.C. § 1102 (2019); Peter C. Blain & Diane Harrison O'Gawa, *Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers, and Duties*, 73 MARQ. L. REV. 581, 605–09 (1990).

60. *See* Blain & O'Gawa, *supra* note 59, at 605–09.

61. *See, e.g.*, Jiang et al., *supra* note 53, at 513–14.

62. *See supra* note 53 and accompanying text.

governance community generally.[63] In this environment, it is likely that bankruptcy directors will work with the same professionals on their next engagement. Indeed, the evidence we present below reveals a group of super-repeater directors who have developed a profession of sitting on the boards of bankrupt companies.

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

Third, about half of the firms appointing bankruptcy directors are private equity-controlled firms.[64] Private equity sponsors are repeat players that can appoint individuals to many boards.[65] They can thus reward a director who has served them well on the board of one bankrupt company by placing her on other boards.[66] Conversely, a bankruptcy director who harms the interests of a private equity controller will likely jeopardize future board appointments at other portfolio companies of the same private equity firm.

Moreover, bankruptcy court dockets are public and make the work of one private equity sponsor visible to other private equity firms: a private equity firm may readily note the favorable outcome that the bankruptcy directors achieved for other private equity sponsors in previous bankruptcies and consider appointing those same directors to the boards of its own troubled portfolio companies. Conversely, an unfavorable outcome may chill the demand for a director's services among private equity sponsors.

In short, bankruptcy directors can be a challenge for bankruptcy law's structured bargaining process, which Congress intended to not only be fair but seem fair.[67]

---

63. *Cf.* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1013 (1997).

64. *See infra* Section IV.C. By comparison, a recent study of controlling shareholders that form special committees of independent directors to negotiate freeze-outs finds that only 12.5% of the controlling shareholders involved in these such transactions are investment managers. *See* Lin, *supra* note 23, at 536.

65. *See, e.g.*, Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 222–23 (2009) (explaining that private equity firms typically control their portfolio companies' operations through control of their boards of directors); William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1861 (2018) ("Since private equity firms control the boards of their portfolio companies, they can easily add directors to fill specific gaps in expertise, and they can compensate these board members highly.").

66. *See* Lin, *supra* note 23, at 543.

67. Before the enactment of the modern bankruptcy code, Judge Henry Friendly famously

II. EXAMPLES

In this Part, we present two case studies of how bankruptcy directors can alter the course of a Chapter 11 case. We first present a detailed treatment of the 2020 bankruptcy of department store conglomerate Neiman Marcus. We then present a more cursory treatment of the 2017 bankruptcy of shoe retailer Payless Holdings. In both cases, bankruptcy directors diffused creditor claims against private equity sponsors that controlled the bankrupt firms.

A. NEIMAN MARCUS

In 2017, the private equity sponsors of retailer Neiman Marcus ("Neiman") searched for a way to protect their investments in the struggling retailer.[68] They focused on MyTheresa, a Neiman subsidiary that sold luxury goods online.[69] The private equity sponsors consulted the investment bank Lazard Limited ("Lazard"), which recommended "moving certain assets with strategic value, such as the MyTheresa business [away from creditors]."[70] This, according to Lazard, would "allow[] the accrual of future MyTheresa value appreciation" for the private equity sponsors only, leaving creditors with no claim against what most observers considered the firm's most valuable asset.[71] Lazard anticipated that the transfer could be subject to

---

expressed the sentiment that "[t]he conduct of bankruptcy proceedings not only should be right but must seem right." *In re* Ira Haupt & Co., 361 F.2d 164, 168 (2d Cir. 1966).

68. *See* Declaration of Mark Weinsten, Chief Restructuring Officer, of Neiman Marcus Group LTD LLC, In Support of the Debtors' Chapter 11 Petitions and First Day Motions at 2, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. May 7, 2020) [hereinafter Declaration of Mark Weinsten]; Preliminary Report of the Official Committee of Unsecured Creditors Regarding the Bankruptcy Estates' Litigation Claims Against Neiman Marcus Group, Inc., The Equity Sponsors and Directors of Neiman Marcus Group, Inc., and Other Parties at 25–26, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. July 24, 2020) [hereinafter UCC Report] (describing capital structure post-LBO).

69. *See* Neiman Marcus Discussion Materials, Lazard Presentation at 2, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. July 24, 2020) [hereinafter Lazard Presentation]; *see* UCC Report, *supra* note 68, at 30 ("In an email dated June 15, 2016, Ares (Rachel Lee) stated that 'we had talked a few weeks ago about separating the MyTheresa asset' and asked Proskauer Rose LLP . . . '[i]f we wanted to "dividend" the stock of MyTheresa to existing NMG shareholders, could we do that and what are the implications?' ").

70. *See* Lazard Presentation, *supra* note 69, at 1.

71. *Id.* at 19 ("Dividending the MyTheresa business out of the loan group using Restricted Payment basket capacity would allow the accrual of future MyTheresa value appreciation to the Sponsors."). This sort of scheming has become typical in the 2010s by private equity sponsors, who often greet financial distress by engaging in transactions that shift value to shareholders and away from creditors. *See generally* Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745 (2020) (explaining tactics employed by distressed firms that benefit some stakeholders while harming some creditors). The Financial Times would later report that creditor anger over the transaction and "private equity aggression . . . struck a chord with many in the distressed debt market." *See* Sujeet Indap & Mark Vandevelde, *Neiman Marcus: How a Creditor's Crusade Against Private Equity Power Went Wrong*, FIN. TIMES (Oct. 3, 2020), https://www.ft.com/content/3856bb04-b3ac-4935-8dbf-e0f2fdc090ea

"challenges from creditors"[72] over "fraudulent conveyance / fiduciary duty considerations"[73] and offered its help in dealing with such "complexities."[74]

In 2018, the idea became a reality through a series of stock dividends that transferred control of MyTheresa to Neiman's private equity-owned parent and beyond the reach of the creditors of Neiman's $6 billion debt.[75] The transfer caused the value of the debt to collapse, spurring threats and negotiations between the creditors and Neiman.[76] A few months later, the private equity sponsors agreed to return some of MyTheresa's assets to creditors in exchange for a two-year extension of the debt's maturity date and other credit support.[77]

However, this did not solve Neiman's problems, which the COVID-19 pandemic made worse,[78] and in May 2020, the company filed for bankruptcy.[79] Before the filing, the company agreed with its private equity sponsors and most of its creditors on a plan that would reduce debt by $4

[https://perma.cc/FN32-3BKM].

72. *See* Lazard Presentation, *supra* note 69, at 1.

73. *See id.* at 10; *see also* UCC Report, *supra* note 68, at 80.

74. *See* Lazard Presentation, *supra* note 69, at 1.

75. *See* UCC Report, *supra* note 68, at 39–42; George Ticknor, Jason Ulezalka & Jonathan Young, *Neiman Marcus Capitalizes on Weak Covenant Package to Transfer Valuable Assets Beyond the Reach of Certain Creditors*, JD SUPRA (Oct. 19, 2018), https://www.jdsupra.com/legalnews/neiman-marcus-capitalizes-on-weak-26232/ [https://perma.cc/DUB4-H7TZ]. The private equity owners would later justify the moves as making it easier to manage MyTheresa without the weight of the Neiman's' debt weighing down the online retailer in negotiations with vendors. *See* Counter-Report of Ares Management Corp. and Canada Pension Plan Investment Board in Response to Preliminary Report of the Official Committee of Unsecured Creditors at 12, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. July 24, 2020) [hereinafter Counter-Report of Ares Mgmt.].

76. *See* Soma Biswas, *Neiman Marcus Bondholder Criticizes Transfer of Valuable Online Business*, WALL ST. J. (Sept. 21, 2018), https://www.wsj.com/articles/neiman-marcus-bondholder-criticizes-transfer-of-valuable-online-business-1537557060 [https://perma.cc/AR4S-C3UL].

77. *See generally* Neiman Marcus Grp. Ltd. LLC, Current Report (Form 8-K) (Mar. 1, 2019). As part of the exchange, the company's secured creditors received a partial payment and agreed to extend the maturity date of the loan by two years. *See id.* The secured term lenders received a pay-down of $550 million of approximately $2.8 billion in debt. *See id.* They also received additional collateral, which was an important part of the deal. *See* UCC Report, *supra* note 68, at 49. The company's unsecured creditors exchanged their debt for a mixture of new secured debt, supported by a lien on MyTheresa's assets, and MyTheresa preferred stock. *See* Neiman Marcus Grp. Ltd. LLC, Current Report (Form 8–K) (Mar. 1, 2019). In many ways, the transfer was a challenge to creditors: Should they negotiate to get part (or all) of the assets back or should they litigate? The creditors appear to have chosen to settle for the return of some of MyTheresa, which would not preclude them from filing a lawsuit if the company later filed for bankruptcy. One dissident creditor tried to bring the lawsuit on its own but lacked standing to do so without the support of a larger number of creditors. *See* Order Granting Defendants' Plea to the Jurisdiction and Alternatively, Special Exceptions, Marble Ridge Cap. LP v. Neiman Marcus Grp., Inc., No. DC-18-18371 (Tex. Dist. Ct. Mar. 19, 2019).

78. *See* Declaration of Mark Weinsten, *supra* note 68, at 3–4.

79. Lauren Hirsch & Lauren Thomas, *Luxury Retailer Neiman Marcus Files for Bankruptcy as It Struggles with Debt and Coronavirus Fallout*, CNBC (May 7, 2020), https://www.cnbc.com/2020/05/07/neiman-marcus-files-for-bankruptcy.html [https://perma.cc/WXT4-NMWS].

billion.[80] Neiman intended to seek a court order discharging the private equity sponsors from liability over the MyTheresa transfer.[81]

In planning its bankruptcy filing, Neiman took steps to hobble the ability of the UCC to pursue the MyTheresa claims. First, the terms of the bankruptcy financing constrained the UCC's investigation budget and required the company to leave bankruptcy in 120 days, limiting the time the UCC could investigate and litigate.[82] Second, a month prior to the bankruptcy filing, the private equity sponsors appointed two new directors: former bankruptcy lawyer Marc Beilinson and former distressed debt trader Scott Vogel.[83] The two received the board's power to handle conflicts between Neiman and its private equity sponsors, including the MyTheresa transfer.[84] Each of these bankruptcy directors received a $250,000 flat fee plus $500 an hour.[85]

Immediately after the bankruptcy filing, a creditor filed a motion to appoint an independent examiner to investigate the MyTheresa transfer.[86]

80. *See* Declaration of Mark Weinsten, *supra* note 68, at 5, 37. Companies filing for Chapter 11 bankruptcy typically arrive with ready Restructuring Support Agreements ("RSAs") tied to bankruptcy financing arrangements, as was the case for Neiman. *See* Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale*, 39 YALE J. REG. 1 (2022); Anthony J. Casey, Frederick Tung & Katherine Waldock, *Restructuring Support Agreements: An Empirical Analysis* (2022) (working paper) (on file with authors). For more on RSAs, *see generally* Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593 (2017); Edward J. Janger & Adam J. Levitin, *Badges of Opportunism: Principles for Policing Restructuring Support Agreements*, 13 BROOK. J. CORP. FIN. & COM. L. 169, 169 (2018).

81. *See* Marble Ridge Capital LP and Marble Ridge Master Fund LP's Statement in Response to the Declaration of Mark Weinsten and Limited Objection to Debtors' Emergency Motion for Postpetition Financing at 17, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. May 8, 2020).

82. For governance through debtor-in-possession lending, *see generally* Ayotte & Ellias, *supra* note 80; George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 901 (1993); Barry E. Adler, Vedran Capkun & Lawrence A. Weiss, *Value Destruction in the New Era of Chapter 11*, 29 J.L. ECON. & ORG. 461 (2013); Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 12, 12 (2003); Kenneth Ayotte & David A. Skeel, *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557 (2013).

83. Specifically, the private equity sponsors appointed Beilinson and Vogel as "independent managers" at an intermediate holding company, NMG Ltd. LLC. The control of the ultimate parent remained in the hands of the board appointed by the private equity sponsors. *See* Transcript of Trial at 38, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex May 29, 2020) [hereinafter Neiman Marcus Trial].

84. *See* Neiman Marcus Trial, *supra* note 83, at 71.

85. *See id.* at 72.

86. Marble Ridge Capital LP and Marble Ridge Master Fund LP's Expedited Motion, Pursuant to Bankruptcy Code Sections 105(a), 1104(c), 1106(b), and 1107(a) and Federal Rule of Bankruptcy Procedure 2007, For Entry of an Order Appointing an Examiner with Duties to Prosecute, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. Mar. 15, 2020) [hereinafter Marble Ridge Examiner Motion]. The bankruptcy code provides creditors with the ability to seek the appointment of an examiner as an independent fiduciary to investigate potential wrongdoing. *See generally* Jonathan C. Lipson, *Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies*, 84 AM. BANKR. L.J. 1 (2010). Neiman Marcus argued that there was no need for an examiner investigation since the UCC and the bankruptcy directors were already investigating the transaction. *See* Neiman Marcus Trial, *supra* note 83, at 41.

The creditor also asked to bar the bankruptcy directors from investigating the MyTheresa transaction.[87]

On the witness stand, Beilinson stumbled.[88] He could not provide satisfying answers to questions from the bench about the investigation he oversaw,[89] and his answers revealed that it had not gone very far.[90] Frustrated, the judge warned that if Beilinson was to remain the firm's bankruptcy director, "he needs to understand his job, and he cannot simply give lip service, knowing a bunch of buzzwords, and think that I'm going to accept that as evidence of someone doing their job."[91] In an extraordinary exchange, the judge warned Neiman that "I do not want to see a fiduciary to this estate ever appear in front of me ever again unprepared, uneducated, and borderline incompetent."[92] Nevertheless, the judge indicated he would not grant all of the requested relief in the motion to appoint an independent examiner, and the motion was withdrawn.[93]

Three weeks later, Beilinson resigned, and Vogel remained the sole bankruptcy director.[94] Vogel's own résumé raised questions for creditors, as

87. *See* Neiman Marcus Trial, *supra* note 83, at 130–31 ("For all of the reasons, Your Honor, we're not in a position to trust that we're going to get a good faith, independent examination report that does anything other than say, in order to get out of bankruptcy fast and given the fact that the unsecured creditors aren't entitled to any distribution because we got to satisfy all of the claims of the senior creditors—too bad. Sorry. We know that's the result we're more than likely to get.").

88. *See* Neiman Marcus Trial, *supra* note 83, at 53–191.

89. Under questioning from the judge, Beilinson identified as one of the issues whether the MyTheresa dividend was an intentional fraudulent conveyance, but, when asked what mattered for this determination, he gave an answer that the judge described as "completely wrong." *See id.* at 109. Beilinson testified that what mattered as whether "the recovery or the unwinding would benefit or not benefit the bankruptcy estate, and whether it should impact the currently negotiated RSA, which has substantial amount of the debt structure supporting it." *Id.* at 109. In reality, intentional fraudulent transfer claims require investigating evidence that the transfer of value was with an "actual intent" to defraud, hinder, or delay creditors. *See* 28 U.S.C. § 3304; *see also* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 830–32 (1985).

90. The judge then asked him for specific examples of what he had done in the past thirty days on the investigation, and Beilinson responded by saying he and Vogel had "spoken with Counsel," that "document requests have gone out" and "[they had] accumulated over 3,000 documents." *See* Neiman Marcus Trial, *supra* note 83, at 109.

91. *Id.* at 171–72. The bankruptcy judge asked why Vogel had not offered his testimony given that "[he] had a deposition" and "[he] had to know that" Beilinson's testimony would have gone "bad[ly]." *Id.* at 172.

92. *See id.* at 188. A news report at the time referred to the "extraordinary" exchange as "blistering criticism." *See* Vandevelde & Indap, *supra* note 11. Another observer later noted that the case was too important for "shenanigans" such as "independent directors doing the bidding of a private equity sponsor (and/or themselves)." *See Our "Matter of the Year,"* PETITION (Dec. 23, 2020), https://petition.substack.com/p/our-matter-of-the-year [https://perma.cc/MM72-US6K].

93. The judge was willing to grant only a cursory investigation of whether the bankruptcy directors were doing their job, which would not have been very useful to the creditor as it would not be hard for the directors to prove they were not wholly absentee. *See* Neiman Marcus Trial, *supra* note 83, at 196.

94. Anna Zwettler, *Marc Beilinson Resigns as Board Member of Neiman Marcus*, FASHION UNITED (June 22, 2020), https://fashionunited.uk/news/people/marc-beilinson-resigns-as-board-member-of-neiman-marcus/2020062249476 [https://perma.cc/9G56-7V7T]; *see also* Neiman

he was a former employee of a lender that extended a loan to Neiman in the bankruptcy with conditions that made the prosecution of fraudulent-transfer claims against the private equity sponsors more difficult.[95]

The UCC began investigating the transaction and quickly concluded that the claims were valuable.[96] It then filed a motion informing the court of this conclusion. The motion suggested that if the claims did not settle then the UCC should preserve them for prosecution after the bankruptcy case ended.[97] A few days later, the UCC indicated it was ready to make the results of its six-week investigation public.[98]

As the UCC was investigating, so too was Vogel. A day before the UCC's report would become public, his lawyers announced in court that he had also concluded there were viable fraudulent conveyance claims against the private equity sponsors and that he was negotiating a settlement.[99] In response, the UCC's lawyers said they had played no role in those negotiations and expressed concern that the settlement amount would be "too low."[100]

On July 24, 2020, the UCC released the preliminary results of its

---

Marcus Trial, *supra* note 83, at 159 ("[Y]ou didn't hear anything about Mr. Vogel, and you didn't hear any challenges to his independence.").

95. *See* Marble Ridge Examiner Motion, *supra* note 86, at 10.

96. *See UCC, Neiman Sponsors File Dueling Reports Disputing Neiman Marcus, MyTheresa Valuations, Solvency, Strategic Rationale for MyTheresa Distribution*, REORG (July 27, 2020), https://reorg.com/ucc-neiman-sponsors-file-dueling-reports/ [https://perma.cc/9N9M-X76C].

97. *See* Motion of Official Committee of Unsecured Creditors for Entry of an Order (I) Terminating Only as to the Committee the Debtors' Exclusive Periods to File a Plan and Solicit Acceptances Thereof Pursuant to Section 1121 of the Bankruptcy Code; and (II) Authorizing the Committee to File Its Own Plan and Disclosure Statement at 10, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. June 26, 2020). The UCC sought to give the judge an option of confirming a plan that would be identical to the plan that the debtor had submitted with the exception of not releasing the claims against the private equity sponsors and board members and reserving those claims for a litigation trust. *See id.*

98. *See* Motion of the Official Committee of Unsecured Creditors to File Under Seal the Emergency Motion of the Official Committee of Unsecured Creditors to Unseal (I) Preliminary Report of the Official Committee of Unsecured Creditors Regarding the Litigation Claims against Neiman Marcus Group, Inc., and Other Parties and Appendix Thereto and (II) Initial Expert Report of the Michel-Shaked Group and Executive Summary Thereof and Declaration of Alan J. Kornfeld in Support, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. July 22, 2020). Prior to the UCC report becoming public, the private equity sponsors filed a "counter report" with their own analysis of the strength of the claims against them. *See generally* Counter-Report of Ares Mgmt., *supra* note 75.

99. *See Neiman Disinterested Manager Says Viable Fraudulent Conveyance Claims Tied to MyTheresa Transfer Exist; Ares Has Agreed to Requested 'Number' in Settlement Talks; UCC Has Had No Direct Talks with Ares*, REORG (July 23, 2020), https://reorg.com/neiman-manager-viable-fraudulent-conveyance-claims/ [https://perma.cc/7U3U-L2WV] [hereinafter Viable Fraudulent Conveyance Claims]; *see also* Hearing at 4–7, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. July 23, 2020).

100. *See* Viable Fraudulent Conveyance Claims, *supra* note 99.

investigation.[101] The report concluded that the transaction constituted a constructive fraudulent transfer and likely also an intentional fraudulent transfer.[102] It added that these claims would merit release only in return for an amount close to their estimated value of the transferred assets—about $1 billion.[103]

However, six days later, Neiman announced that Vogel had negotiated with the private equity sponsors a much smaller settlement.[104] The settlement included a package of cash and stock that, using the UCC's estimate of MyTheresa's value, would be worth $172 million.[105]

While the UCC accepted the deal given the economy's fragility and Neiman's need to reorganize quickly,[106] it expressed concerns about the role that the bankruptcy director had played in the process.[107] The UCC's lead lawyer stated that Vogel sabotaged the UCC's litigation process.[108] He noted that Vogel secretly met with the private equity sponsors on his own and made offers that were "horrif[ying]" and "so low" that it "put [the UCC] in a deep hole."[109]

The UCC's lead lawyer described a collusive process in which Vogel told the private equity sponsors that, "if [you] hit a certain bid," Vogel would "force a settlement down [the UCC's] throat."[110] He explained that countering Vogel's settlement offer with a higher one "would have been a massive waste of time because of what had already been told . . . to the sponsors. So I was going to be completely wasting my time. And let me be frank, Your Honor, the sponsors had zero interest, zero, in speaking to me."[111]

More broadly, he offered a grim assessment of the effect of bankruptcy

101. The investigation had taken place in the fifty-one days between the filing of the report and the UCC's retention of counsel. While the investigation involved the review of more than 800,000 pages of documents and eight depositions, it clearly was only at a preliminary stage and could have expanded to cover a wider range of witnesses. *See* UCC Report, *supra* note 68, at 13.

102. *Id.* at 66.

103. *See id.* at 13.

104. *See* Notice of Filing of Disclosure Statement for the Debtors' First Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code at 52, *In re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. July 30, 2020).

105. *See* Statement on Behalf of Scott Vogel, Disinterested Manager of Neiman Marcus Group LTD LLC, Regarding the Debtors' Proposed Disclosure Statement and Global Settlement, *In Re* Neiman Marcus Grp. Ltd. LLC, No. 20-32519 (Bankr. S.D. Tex. July 30, 2020).

106. *See id.* at 2.

107. *See* Neiman Marcus Settlement Transcript, *supra* note 20, at 19–20.

108. *Id.* at 29.

109. *Id.*

110. *Id.* at 29–30.

111. *Id.* at 30.

directors on creditor recovery and thus on the message to private equity sponsors:

> With that said, Your Honor, my goal in doing this . . . is for Your Honor to understand why it is that the system was rigged in this case, and why sponsors going forward and in the past are encouraged to asset strip, because that's just how our system is set up. And until Congress or someone does something about it, that's how it's going to remain.[112]

Without changes, he said, bankruptcy directors would turn the system of governance designed by Congress into a "sham."[113] He urged the judge to scrutinize the conflicts of bankruptcy directors in future cases by scrutinizing "their relationship with the law firms, . . . their relationship with the sponsors, and . . . the[ir] true independence. And that's not just . . . the . . . [bankruptcy directors, it is also] their counsel."[114] In the case at bar, he noted that the law firm for the bankruptcy directors had previously represented the private equity sponsors.[115]

Subsequent events proved the UCC was conservative in its valuation of MyTheresa. Four months after Neiman left bankruptcy, the private equity sponsors took MyTheresa public at a valuation of $2.2 billion, more than twice the UCC valuation, which the private equity sponsors had disparaged as "astronomical" back when the company was in bankruptcy.[116]

Was the $172 million settlement fair given the information available at that time? After all, the UCC did agree to it. Moreover, as the private equity sponsors argued, a sale process a year earlier had failed to produce a buyer willing to pay more than $500 million for MyTheresa.[117] There will always be questions when the economy changes and assets fluctuate in value after a bankruptcy process. But these unanswerable questions would be less

112. *Id.* at 34.

113. *Id.* at 36. A postscript to this story is that the creditor who sought the appointment of the examiner had to close his hedge fund after trying to deter an investment bank from making a competing bid for MyTheresa stock in violation of his fiduciary duty as a member of the UCC. *See* Andrew Scurria & Alexander Gladstone, *Hedge Fund Marble Ridge to Close After Scathing Neiman Report*, WALL ST. J. (Aug. 21, 2020), https://www.wsj.com/articles/hedge-fund-marble-ridge-to-shut-down-11598014779 [https://perma.cc/FJQ5-LK2S]; Sujeet Indap & Mark Vandevelde, *Hedge Fund Manager Admits 'Grave Mistake' in Neiman Marcus Battle*, FIN. TIMES (Aug. 20, 2020), https://www.ft.com/content/084ba24b-a96b-4888-9bd4-c80001c0be07 [https://perma.cc/M9FT-ER4G].

114. *See* Neiman Marcus Settlement Transcript, *supra* note 20, at 35.

115. *See id.* at 30, 37. When Willkie Farr & Gallagher LLP joined, it asked the two independent directors for permission to continue to work with the sponsors, and it received this permission. *See id.*

116. *See* David Carnevali & Sujeet Indap, *German Online Retailer MyTheresa Valued at $3bn after US Listing*, FIN. TIMES (January 21, 2021), https://www.ft.com/content/e8254ebd-700b-441d-a430-33811e63f1fe [https://perma.cc/9EF9-22J8].

117. *See* Counter-Report of Ares Mgmt, *supra* note 75, at 5 n.15. Most importantly, they already returned part of MyTheresa, which meant that they could argue the amount they had actually received was less than $1 billion, perhaps $500 million or even less.

pressing if the UCC had itself negotiated the settlement without the bankruptcy directors looming in the background.

B. PAYLESS HOLDINGS

The 2017 bankruptcy of shoe retailer Payless Holdings ("Payless") is another example of how bankruptcy directors can shape a Chapter 11 case. As with Neiman, Payless filed for bankruptcy after an ill-fated leveraged buyout.[118] Following the buyout, Payless conducted a series of transactions with its private equity sponsors, including a distribution of $350 million in dividends.[119]

A few years later, in April 2017, Payless filed for bankruptcy in the Eastern District of Missouri.[120] As with Neiman, Payless's private equity sponsors could expect self-dealing claims to dominate the bankruptcy case, with the dividend payout occupying center stage. Consequently, as with Neiman, Payless appointed a bankruptcy director. This director would alter the ability of unsecured creditors to bring claims related to the dividends and settle the claims for a fraction of their potential value.

Prior to filing for bankruptcy, Payless appointed Charles H. Cremens to its board.[121] Payless described Cremens as a seasoned independent director with vast business and restructuring experience.[122] Cremens joined the board at the suggestion of the debtors' lead law firm, Kirkland & Ellis LLP[123] ("Kirkland") and immediately began investigating the claims against the private equity sponsors.[124] He also hired Munger, Tolles & Olson LLP ("Munger") to represent him in the Chapter 11 case.[125] As is often the case

---

118. In 2012, a private equity group led by Golden Gate Capital and Blum Capital took over Payless Holdings LLC, a retail company specializing in selling low-priced footwear, in a $2 billion acquisition and became the owner of 98.5% of the company's equity. *See* Neil Irwin, *How Private Equity Buried Payless*, N.Y. TIMES (Jan. 31, 2020), https://www.nytimes.com/2020/01/31/upshot/payless-private-equity-capitalism.html [https://perma.cc/27ZN-HT2J]; *Payless UCC Objects to 'Placeholder' DS and Fast-Track Plan Process*, REORG (May 25, 2017), https://app.reorg.com/v3#/items/intel/4744?item_id=36001 [https://perma.cc/CAA6-KPXD].

119. Notice of Filing of Disclosure Statement for the Debtors' Fourth Amended Joint Plan of Reorganization of Payless Holdings LLC and Its Debtor Affiliates Pursuant to Chapter 11 of the Bankruptcy Code, Ex. 1, at 23–24, *In re* Payless Holdings LLC, No. 17-42267-659 (Bankr. E.D. Mo. June 23, 2017) [hereinafter Payless Disclosure].

120. Lauren Debter, *Payless Files for Bankruptcy, Will Close 400 Stores Right Away*, FORBES (Apr. 4, 2017, 4:05 PM), https://www.forbes.com/sites/laurengensler/2017/04/04/payless-shoesource-bankruptcy-store-closures/?sh=26fb7d645560 [https://perma.cc/JYQ6-22QN].

121. *Id.* at 23.

122. *Id.*

123. *See* Transcript of Hearing at 46, *In re* Payless Holdings LLC, No. 17-42267 (Bankr. E.D. Mo. June 14, 2017) [hereinafter Payless Hearing].

124. Payless Disclosure, *supra* note 119, at 23.

125. Debtors' Application for Entry of an Order Authorizing the Retention and Employment of Kirkland & Ellis LLP and Kirkland and Ellis International LLP as Attorneys for the Debtors and Debtors

with bankruptcy directors, his bankruptcy experience raised questions about the extent to which he was truly objective. Cremens had extensive ties to Kirkland[126] and Munger, and he had recently worked as bankruptcy director with both firms.[127] He also had ties to one of the private equity owners.[128]

After filing for Chapter 11, Cremens fought to limit the ability of the unsecured creditors to investigate the dividend payout. When the unsecured creditors sought to hire their own financial advisor to study the strength of the claims, Cremens objected, claiming that he was in the midst of such an investigation and that any effort by the unsecured creditors to study the potential causes of action would be "duplicative."[129] He also claimed that he wanted to meet the conditions of the debtor's bankruptcy financing which, as in the Neiman Marcus case, required exit from Chapter 11 within ninety

---

in Possession Effective *Nunc Pro Tunc* to the Petition Date at 6, *In re* Patriot Coal Corp., No. 15-32450 (Bankr. E.D. Va. May 20, 2015) [hereinafter Kirkland Employment Application]; Payless Hearing, *supra* note 123, at 46.

126. Cremens had worked at other companies represented in bankruptcy by Kirkland. "Three of the Debtors' current directors—Eugene I. Davis, Charles H. Cremens, and Timothy J. Bernlohr—currently serve, and have served in the past, as officers and directors of certain of K&E's clients or affiliates from time to time." *See* Kirkland Employment Application, *supra* note 125, at 1–13, Ex. B 18–19. Cremens also served as a disinterested director of Energy Future Intermediate Holding, a private equity-owned power company that filed for bankruptcy in 2017 with Kirkland as its lawyers. *See* Debtors' Application for Entry of an Order Authorizing the Retention and Employment of Kirkland & Ellis LLP as Attorneys for the Debtors and Debtors in Possession Effective *Nunc Pro Tunc* to the Petition Date at Ex. B 16–17, *In re* Energy Future Holdings Corp., No. 14-10979 (Bankr. D. Del. May 29, 2014).

127. *See* Declaration of Charles H. Cremens in Support of Confirmation of the Modified Fifth Amended Joint Chapter 11 Plan of Reorganization of iHeartMedia, Inc. and Its Debtor Affiliates Pursuant to Chapter 11 of the Bankruptcy Code at 1–2, *In re* iHeartMedia, Inc., No. 18-31274 (Bankr. S.D. Tex. Jan. 7, 2019).

128. Objection of the Official Committee of Unsecured Creditors to Debtors' Motion for Entry of an Order (I) Approving the Adequacy of the Debtors' First Amended Disclosure Statement, (II) Fixing Dates and Deadlines Related to Confirmation of the Plan, (III) Approving Certain Procedures for Soliciting and Tabulating the Votes on, and for Objecting to, the Plan, (IV) Approving the Rights Offering Procedures, Subscription Form and Authorizing the Retention of Financial Balloting Group LLC in Connection Therewith, and (V) Approving the Manner and Form of the Notices and Other Documents Related Thereto at 13–14, *In re* Payless Holdings, LLC, No. 17-42267-659 (Bankr. E.D. Mo. June 12, 2017) [hereinafter Objection of the Official Committee of Unsecured Creditors to Debtors' Motion for Entry of an Order].

> Cremens has served on the boards of Aspect Software and/or Bluestem Group with at least three managing directors of Golden Gate Capital, (ii) Aspect Software is owned in part by Angel Island Capital, an affiliate of Golden Gate Capital that currently holds part of the Debtors' term loan debt, (iii) Cremens was on the board of Conexant Systems, which was acquired by an affiliate of Golden Gate Capital, and (iv) Cremens was on the board of Tactical Holdings, which is a portfolio company of Golden Gate Capital.

Id. Cremens had also worked on other cases alongside Kirkland, as had his lawyers at Munger. *See id.*

129. *See* Response of Debtors to Application of the Official Committee of Unsecured Creditors for Entry of an Order Authorizing Retention of Back Bay Management Corporation and Its Division, the Michel-Shaked Group, as Expert Consultant and Dr. Israel Shaked as Expert Witness *Nunc Pro Tunc* at 2–3, *In re* Payless Holdings LLC, No. 17-42267-659 (Bankr. E.D. Mo. May 24, 2017) [hereinafter Response of Debtors].

days, limiting the ability of unsecured creditors to investigate the claims.[130] By attempting to keep the unsecured creditors from hiring professionals, Cremens undermined their ability to proceed quickly.[131]

Cremens ran an investigation that was—in the eyes of unsecured creditors—flawed and superficial. On the one hand, he and his lawyers reviewed hundreds of documents and interviewed twelve witnesses.[132] On the other hand, he failed to obtain tolling agreements from the private equity sponsors for claims that could have expired during the time of the investigation[133] and declined to hire his own solvency expert to determine whether Payless was solvent at the time of the dividends. This was the most critical question for determining the strength of the claims.[134] Both of these actions raised questions as to how serious Cremens was about litigating the claim. Unsecured creditors would later characterize Cremens's effort as an attempt to "sweep these [claims against the private equity sponsor] under the rug, to do a cursory examination, to talk to a few people . . . and come up with a conclusion."[135]

Cremens's lawyers explained that he did not consider it his role to litigate the claims because he was more of a mediator:

> [A]s the case has developed, the independent director, knowing that the committee and other parties were looking into these issues, believed that it was in the best interests of these estates to not disclose a position over these issues, but rather to allow the committee and others to complete their examination, so he could act—if you will—as a mediator, and help to

130. *Id.* at 7.

131. *See* Tracy Rucinski, *Payless to Try Fending Off Creditor Probe of Owners with Own Review*, REUTERS (May 25, 2017, 8:55 AM), https://www.reuters.com/article/us-payless-bankruptcy-pprivateequity/payless-to-try-fending-off-creditor-probe-of-owners-with-own-review-idUSKBN18L27K [https://perma.cc/W8MW-JJCC].

132. Payless Hearing, *supra* note 123, at 47.

133. *Id.* at 52–53.

134. *Id.* at 47–48.

> So now you have Mr. Cremens and Munger Tolles & Olson reporting to him, beginning their investigation in January, basically five, six months ago. They describe in the disclosure statement what was done: we looked at 500 documents, we talked to twelve people. Interesting what they didn't do, which was hire—as the committee did—hire a valuation expert to go look at the 2012 LBO, the 2013 dividend recap, the 2014 dividend recap. Because the fraudulent transfer claims—potential claims that arise out of those transactions all turn on the issue of whether or not Payless was insolvent at the time or was left insolvent after it made these dividend payments to their shareholders, Golden Gate and Blum. So without really taking a hard look at the insolvency issue, I'm not sure how the independent director is going to reach a conclusion that we can all trust and count on.

Id.

135. *Id.* at 48.

> resolve the issues rather than polarize the case by coming out strongly one way or another.[136]

This response infuriated the lawyers for the unsecured creditors, who argued that Cremens misunderstood his role.[137] Moreover, Cremens tried to block the unsecured creditors from hiring a financial advisor because he was "conducting an investigation."[138] The unsecured creditors called this an effort to "usurp [their] role [in] conduct[ing] this kind of investigation."[139]

The unsecured creditors continued to prepare to prosecute the claims, but their backs were against the wall because their investigation appeared to be at odds with the goal of saving the company. The unsecured creditors announced that they had "accomplished in six weeks what Mr. Cremens has apparently been unable, or unwilling to do in six months—reach a conclusion that [claims should be brought against the private equity sponsors]."[140] The private equity sponsors retorted that the claims were weak[141] and that the unsecured creditors' plan to litigate the claims "threaten[ed] the feasibility of any successful plan for [Payless's] reorganization."[142] The unsecured creditors called this a "false narrative" and "fake news" and pointed out that there should not be a conflict between recovering property from the sponsors and reorganizing the firm: they could litigate the claims after bankruptcy.[143]

However, the unsecured creditors' bargaining power collapsed as the clock continued to run on the debtors' short timeline, perhaps contributing to their decision to accept a settlement of $21 million for claims of $350 million.[144] The unsecured creditors had seen this coming, noting earlier in a court hearing,

> [W]hat we're terribly afraid of, Your Honor, given the conduct thus far, is that we'll get a late-breaking bulletin on the eve of confirmation, hey, we've decided that there are some claims here, but you know what, it's too inconvenient to bring them; it's too late. We're at confirmation; we're

136. *Id.* at 66.

137. *Id.* at 80.

138. Response of Debtors, *supra* note 129, at 4.

139. Payless Hearing, *supra* note 123, at 45.

140. *See* Objection of the Official Committee of Unsecured Creditors to Debtors' Motion for Entry of an Order, *supra* note 128, at 2.

141. *See* Reply of Certain Entities Advised by Golden Gate Private Equity, Inc. and Blum Capital Partners, L.P., to the Objection of the Official Committee of Unsecured Creditors to the Debtors' Motion for Entry of an Order Approving the Adequacy of the Debtors' First Amended Disclosure Statement and Related Relief at 3, *In re* Payless Holdings, LLC, No. 17-42267-659 (Bankr. E.D. Mo. June 13, 2017).

142. *Id.* at 12 (emphasis omitted).

143. *See* Payless Hearing, *supra* note 123, at 50–51.

144. *See* Fourth Amended Joint Plan of Reorganization of Payless Holdings LLC and Its Debtor Affiliates Pursuant to Chapter 11 of the Bankruptcy Code at 18, *In re* Payless Holdings LLC, No. 17-42267-659 (Bankr. E.D. Mo. June 23, 2017).

> going to get out of bankruptcy. Let's declare victory. We're going to reorganize Payless; we're going to save jobs; we're going to save stores, et cetera, et cetera. But these claims, they're going to fall by the wayside. . . . [W]hat we're seeing is a concerted effort to sweep these claims under the rug for the benefit of insiders: the sponsors and the directors.[145]

Following the high-profile examples of Neiman and Payless, it is hard to imagine the private equity industry not noticing how bankruptcy directors can settle disputes regarding risky dividends for a fraction of the dividend amount.

III. EMPIRICAL ANALYSIS

In this Part, we study bankruptcy directors using a comprehensive hand-collected sample of Chapter 11 boards in the past fifteen years. We begin by describing our data. As a threshold finding, we document a significant rise in bankruptcy expertise on Chapter 11 boards during the sample period. We then examine the role that bankruptcy directors played in the sample cases.

We first show that the percentage of firms in Chapter 11 claiming to have "independent directors"—a claim that usually only arises in the context of bankruptcy directors purporting to exercise board authority as neutral experts—increased from 3.7% in 2004 to 48.3% in 2019. Over 60% of the firms that appointed bankruptcy directors had controlling shareholders, typically private equity funds. The appointment of bankruptcy directors usually occurs in the months leading to the bankruptcy filing and, in about half of the cases, they investigate claims against insiders. Importantly, after controlling for firm characteristics—including the reported ratio of assets to liabilities—the presence of bankruptcy directors is associated with 20% lower recoveries for unsecured creditors, whose claims are typically the most at risk in bankruptcy.[146] This finding raises the possibility that bankruptcy

145. *See* Payless Hearing, *supra* note 123, at 51–52.

146. Bankruptcy law is generally recognized as a process designed to serve unsecured creditors, whose claims are seen as most at risk in Chapter 11 cases. *See, e.g.*, Charles W. Mooney, Jr., *The (Il)Legitimacy of Bankruptcies for the Benefit of Secured* Creditors, 2015 U. ILL. L. REV. 735, 753 ("Bankruptcy has traditionally been a collective proceeding with the goal of enhancing recoveries for unsecured creditors beyond those that state court remedies could provide to the creditors as a body." (emphasis omitted)). Existing research focuses on unsecured creditor recoveries when examining the determinants of successful bankruptcy proceedings. *See, e.g.*, Elizabeth Tashjian, Ronald C. Lease & John J. McConnell, *An Empirical Analysis of Prepackaged Bankruptcies*, 40 J. FIN. ECON. 135 (1996) (finding that unsecured creditor recoveries are higher in prepackaged bankruptcies); Viral V. Acharya, Sreedhar T. Bharath & Anand Srinivasan, *Does Industry-Wide Distress Affect Defaulted Firms? Evidence from Creditor Recoveries*, 85 J. FIN. ECON. 787 (2007) (noting that the conditions of bankruptcy appear to affect senior unsecured debt); Andrew A. Wood, *The Decline of Unsecured Creditor and Shareholder Recoveries in Large Public Company Bankruptcies*, 85 AM. BANKR. L.J. 429 (2011); Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L.Q. 1341 (2004). A similarly

directors make decisions that are not value maximizing.

We also observe 15 individuals appointed to these directorships repeatedly. Each of these super-repeaters had on average 17 directorships (the median is 13), and 44% of these directorships were in companies that went into bankruptcy when the super-repeaters served on the board or up to a year before their appointment. Our data also show that the super-repeaters had close connections to certain private equity funds and to two law firms. These law firms represented 47% of the companies in our sample that had super-repeaters on their boards.

A. DATA

For this study, we had to build a large dataset of directors of Chapter 11 firms because no commercial dataset contains this information. We began with New Generation Research's list of Chapter 11 debtors that filed for bankruptcy between January 1, 2004, and December 31, 2019.[147] Our initial list of the debtors consisted of 770 firms with more than $250 million in assets or liabilities on their bankruptcy petitions.

We then looked in each court docket for two documents. First, we required the firm to have filed with the bankruptcy court a Statement of Financial Affairs ("SOFA").[148] Chapter 11 firms must list all current and former officers and directors in this document, and firms that did not comply with this requirement did not meet the sample criteria.[149] Second, we required the firm to have filed with the bankruptcy court a disclosure statement. As part of the creditor voting on the bankruptcy plan, Chapter 11 firms must summarize in this document important developments before and during the proceeding and draw attention to facts relevant for the consideration of either the judge or voting creditors.[150]

---

voluminous literature in financial economics examines bondholder recoveries. *See, e.g.*, Rainer Jankowitsch, Florian Nagler & Marti G. Subrahmanyam, *The Determinants of Recovery Rates in the US Corporate Bond Market*, 114 J. FIN. ECON. 155 (2014).

147. This list often serves for empirical research. *See, e.g.*, Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 517 (2009); Jared A. Ellias, *What Drives Bankruptcy Forum Shopping? Evidence from Market Data*, 47 J. LEGAL STUD. 119 app. (2018); Wei Jiang et al., *supra* note 53, at 518. Court dockets are available on the federal court website for bankruptcy filings starting 2004.

148. 11 U.S.C. § 521(a)(B)(iii).

149. For example, the SOFA filed by K–V Pharmaceutical Company contains the following entry: "If the debtor is a corporation, list all officers and directors of the corporation, and each stockholder who directly or indirectly owns, controls, or holds 5 percent or more of the voting or equity securities of the corporation." *See* Statement of Financial Affairs at 19, *In re* K–V Pharmaceutical Company, No. 12-13347 (Bankr. S.D.N.Y. Sept. 17, 2012). The firms that ignored this requirement tend to have either had quick sales or were prepackaged bankruptcy filers that ignored the SOFA requirement during their brief stay in bankruptcy.

150. *See, e.g.*, Glenn W. Merrick, *The Chapter 11 Disclosure Statement in a Strategic Environment*,

Of the 528 firms with SOFAs listing their board members, we were able to obtain disclosure statements for 454 firms.[151] The SOFAs identified 2,549 individuals who served on the boards of these firms on the petition date, including 78 who sat on two boards and 12 who sat on more than two boards. To our knowledge, this is by far the largest sample of Chapter 11 directors ever studied.[152]

Next, we hand-matched each individual with BoardEx's dataset of corporate directors to obtain director characteristics and employment history before the sample period. We were able to match 2,009 individuals from 454 boards in our sample.[153] Finally, we added firm characteristics from CompuStat and bankruptcy information from New Generation Research to all 454 firms.

B. CHANGES IN CHAPTER 11 BOARDS OVER TIME

We begin our analysis by examining how a board's bankruptcy expertise on the petition date has changed. Our proxy for bankruptcy expertise is whether a director on a Chapter 11 board had been a director on a prior Chapter 11 board on the petition date or up to a year thereafter. We find that the likelihood that Chapter 11 boards have at least one director with Chapter 11 experience ("Chapter 11 repeater") is 15.4% between 2004 and 2010, 33.5% between 2014 and 2019, and 41.3% in 2019. This reveals a transformation in bankruptcy expertise, with boards becoming more Chapter 11-savvy over the course of the 2000s.

---

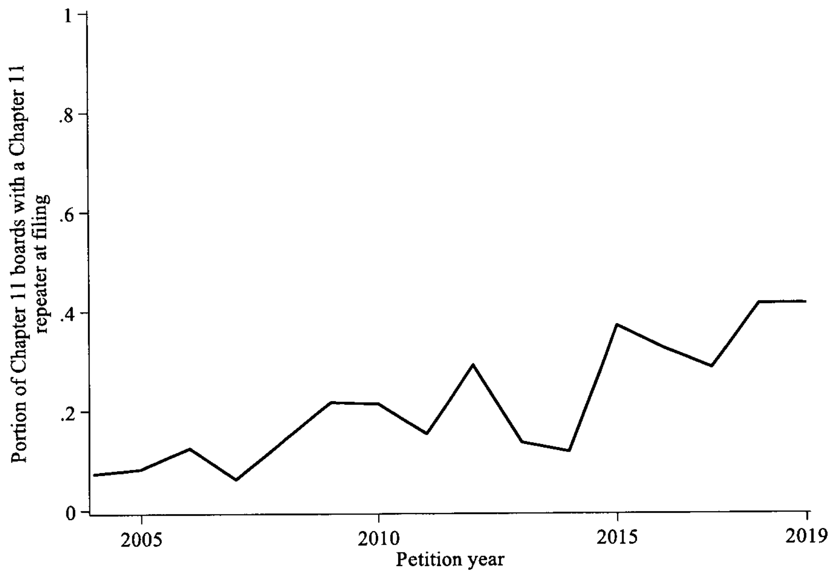
44 BUS. LAW. 103, 103 (1988).

151. The remaining debtors never filed a disclosure statement. This usually happens when a debtor sells its assets and does not file a disclosure statement for a liquidation plan.

152. *See* Radhakrishnan Gopalan, Todd A. Gormley & Ankit Kalda, *It's Not So Bad: Director Bankruptcy Experience and Corporate Risk-Taking,* 142 J. FIN. ECON. 261, 265–66 (2021) (studying 356 firms that filed for bankruptcy between 1994 and 2013); Megan Rainville, Essay 1: Bankruptcy and Director Reputation, *in* Essays in Corporate Finance 1, 2 (Apr. 2020) (Ph. D. dissertation, University of Nebraska) (ProQuest) (studying 142 firms with 1,089 directors that filed for bankruptcy between 2003 and 2013); Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders*, 27 J. FIN. ECON. 355, 356 (1990) (studying sixty-one firms that filed for bankruptcy between 1979 and 1985).

153. We matched the BoardEx directors with CompuStat firm characteristics using the WRDS BoardEx CRSP CompuStat Company linking table. For BoardEx companies with multiple potential matches in the BoardEx data, we took the lowest scoring match, which indicates the best match according to WRDS' methodology. In specifications that involve four-digit SIC codes, we omitted twenty-two firms with two SIC codes in CompuStat.

FIGURE 1. The Portion of Chapter 11 Boards with a Chapter 11 Repeater



Note: Figure 1 shows the portion of 454 boards of firms with assets or liabilities of $250 million or more that filed for Chapter 11 bankruptcy between 2004 and 2019 with a director who had previously been on the board of another firm when it filed for Chapter 11 bankruptcy (Chapter 11 repeater). Director work history (including history before the sample period) is from BoardEx, with the director work history supplemented by the information from our court document data gathering.

C. WHAT BANKRUPTCY DIRECTORS DO

While the increase in bankruptcy expertise on Chapter 11 boards is interesting, it does not alone show a change in the role of directors in Chapter 11 proceedings. In this Section, we dive deeper into the data to identify the directors who played an active role in the bankruptcy case. We find that the directors with Chapter 11 expertise are the ones playing this role.

1. The Rise of Bankruptcy Directors

We focus on directors presented to the bankruptcy judge as independent. With some exceptions, we find that Chapter 11 firms label their directors as independent only if they receive board power in connection with the bankruptcy and not merely by meeting general independence criteria.[154]

154. Bankruptcy commentators and practitioners usually refer to these directors as "independent directors." *See, e.g.*, KELBON et al., *supra* note 9. We use the term "bankruptcy director" to capture the

Accordingly, we call these directors "bankruptcy directors." We require them to be independent directors who are not currently working as firm officers, including as chief restructuring officers.

First, we ran a series of searches that was roughly equivalent to searching all disclosure statements for mentions of the terms "independent director," "independent directors," "disinterested director," or "disinterested directors." After eliminating false positives, we identified 78 disclosure statements that discussed the presence of a bankruptcy director.[155] For example, in the Nine West bankruptcy, the disclosure statement provided:

> As the Debtors worked on this business turnaround, in mid-2017 the Debtors also commenced negotiations with their creditors regarding a comprehensive restructuring of their debt obligations. In connection therewith, the Debtors engaged two independent directors in August 2017, who, in turn, directed the Debtors to hire an independent counsel and financial advisor to act at the direction of the independent directors. These directors took an active role in overseeing restructuring negotiations and in reviewing potential claims and causes of action related to the [leveraged buyout] . . . and other potential conflict matters between the Debtors and their private equity owners.[156]

Similarly, Cobalt International Energy, Inc. relied on the investigation that the bankruptcy directors performed to justify releasing lawsuits against lenders:

> Kirkland conferred with the independent and disinterested directors of the Board about the investigation on multiple occasions. After completing its work concerning those potential claims, Kirkland presented the results of the investigation and bases therefor three times to the independent and disinterested directors before the independent and disinterested directors voted regarding those claims.[157]

---

unique aspects of serving as a purported independent director in Chapter 11 proceedings. As we discuss below, this service raises particular concerns.

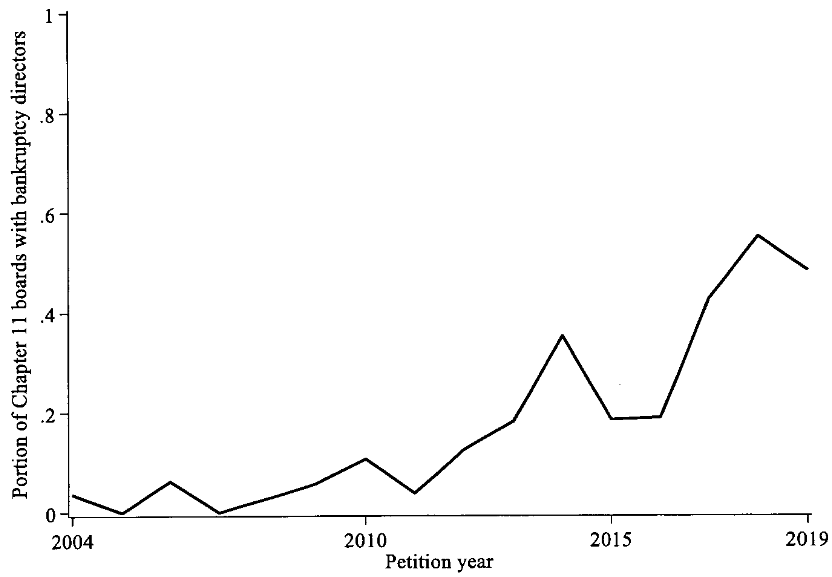
155. We ran a series of three searches. First, we searched for mentions of "disinterested" or "independent." We then searched a block of text that was [–50 words, +150 words] around the search word to see if it included the word "Manager" or "Director." To ensure we did not miss anything, we also searched for mentions of "committee" near "Manager" or "Director," and for "Special Committee." Our search identified 3,913 potential matching text blocks corresponding to 422 of the 454 sample cases. We then hand-reviewed the 3,913 potential matching text blocks and identified 100 disclosure statements in which the text block appeared to discuss the independence of a director or a committee of directors. We then read those 100 disclosure statements and identified 78 cases involving bankruptcy directors. In 21 of the 78 cases involving bankruptcy directors, the disclosure statement referred to the bankruptcy director using a defined term (for example, "Our Independent Director") without identifying the person by name.

156. *See* Notice of Filing Solicitation Version of the Debtors' Disclosure Statement for the Debtors First Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code at 4, *In re* Nine West Holdings, Inc., No. 18-10947 (Bankr. S.D.N.Y. Nov. 14, 2018).

157. *See* Disclosure Statement for the Fourth Amended Joint Chapter 11 Plan of Cobalt International Energy, Inc. and Its Debtor Affiliates at 45, *In re* Cobalt Int'l Energy, Inc., No. 17-36709

As Figure 2 shows, bankruptcy directors were uncommon in the late 2000s and became a prominent part of Chapter 11 practice only in the 2010s. In 2009, at the height of a worldwide financial crisis, only 5.7% of Chapter 11 firms represented to the bankruptcy court that at least one of their directors was independent. By 2018, that number had increased to 55.2%.

FIGURE 2. The Portion of Chapter 11 Firms with Bankruptcy Directors



Note: Figure 2 shows the portion of Chapter 11 firms that represented to the bankruptcy court that some of their directors were independent or disinterested. The sample includes 454 firms with assets or liabilities of $250 million or more that filed for Chapter 11 bankruptcy between 2004 and 2019.

2. The Characteristics of Firms and Bankruptcies with Bankruptcy Directors

Table 1 compares firms with bankruptcy directors to other firms. Firms with bankruptcy directors are significantly more likely to have private equity sponsors (45% versus 30%) and somewhat less likely to have publicly traded shares (31% versus 42%).[158]

(Bankr. S.D. Tex. Mar. 8, 2018).

158. A number of public firms in our sample have a controlling private owner, a structure that is especially common in the energy industry.

TABLE 1. Characteristics of Firms, Bankruptcies, and Boards

	Bankruptcy director firms		Non bankruptcy director firms		Difference in means	T-statistic
	Mean	Std. Dev.	Mean	Std. Dev.		
Financial characteristics						
Assets in millions of U.S. dollars	2,928.85	5,673.52	2,373.37	5,287.25	555.48	–0.83
Liabilities in millions of U.S. dollars	3,566.58	7,261.92	2,664.85	5,969.52	901.74	–1.11
Debt to assets ratio	1.24	0.81	1.47	3.11	–0.23	0.62
Secured debt to total debt ratio	0.37	0.36	0.34	0.36	0.03	–0.56
Private equity control	0.45	0.50	0.30	0.46	0.15**	–2.50
Family control or individual investor control	0.17	0.38	0.10	0.31	0.06	–1.59
Any controlling shareholder	0.62	0.49	0.41	0.49	0.21***	–3.41
Public company	0.31	0.46	0.42	0.49	–0.12*	1.89
Bankruptcy characteristics						
Prepackaged bankruptcy	0.12	0.32	0.11	0.32	0.00	–0.09
Delaware venue	0.45	0.50	0.42	0.49	0.03	–0.51
Southern District of New York venue	0.29	0.46	0.24	0.43	0.06	–1.03
Southern District of Texas venue	0.10	0.31	0.07	0.25	0.03	–1.02
Eastern District of Virginia venue	0.03	0.16	0.02	0.14	0.00	–0.24
Debtor counsel is Kirkland	0.32	0.47	0.16	0.37	0.16***	–3.28
Debtor counsel is Weil	0.15	0.36	0.06	0.23	0.10***	–3.06
Restructuring Support Agreement	0.58	0.50	0.38	0.49	0.19***	–3.19
Bankruptcy duration in days	333.17	344.35	362.44	329.46	–29.27	0.62
Percentage of unsecured creditor recovery	0.28	0.36	0.37	0.40	–0.09	1.62
Board characteristics						
Size	6.15	2.89	5.82	3.15	0.34	–0.87
Board includes a lawyer	0.53	0.50	0.38	0.49	0.14**	–2.34
Board includes a Chapter 11 repeater	0.40	0.49	0.19	0.39	0.21***	–4.01

Note: Table 1 summarizes firm characteristics and bankruptcy characteristics from bankruptcy court dockets, and board characteristics from BoardEx for 454 firms that filed a Chapter 11 petition between January 1, 2004, and December 31, 2019, and whose court filings include a SOFA and a disclosure statement. Bankruptcy director firms are firms that note in their disclosure statement that they have a bankruptcy director. *** p<0.01, ** p<0.05, * p<0.1

In unreported results, we find that the percentage of Chapter 11 firms with private equity ownership is stable over time. The growing percentage of bankruptcy directors thus reflects a change in how firms, including those with private equity sponsors, prepare for bankruptcy, not a change in the percentage of private equity portfolio firms among Chapter 11 filers.

There are additional differences worth noting. Firms with bankruptcy directors are significantly more likely to engage one of the two leading debtor-side bankruptcy law firms, Kirkland (32% versus 16%) and Weil, Gotshal & Manges LLP ("Weil") (15% versus 6%).[159] Firms with bankruptcy directors are also significantly more likely to sign a restructuring support agreement, a document outlining a proposed Chapter 11 plan (58% versus 38%). The sample disclosure statements suggest that the bankruptcy directors are often the ones negotiating this document. Finally, boards with bankruptcy directors are significantly more likely to have a director who is a lawyer (53% versus 38%) and a director who was on the board of another Chapter 11 firm prior to their current appointment (40% versus 19%).[160] As we will discuss, the biographies of bankruptcy directors reveal that many more of them have experience in restructuring beyond what this measure captures.

In Table 1, bankruptcy directors are not associated with significantly shorter durations of bankruptcy proceedings (about 333 days versus about 362 days) or significantly lower recoveries for unsecured creditors (28% versus 37%). Nevertheless, as we show below, the difference in unsecured creditor recoveries between cases with bankruptcy directors and cases without them becomes significant when we use multivariate regression to control for other factors that can affect recoveries. The difference in the average duration of bankruptcy proceedings remains insignificant even in multivariate regressions. We turn to this analysis next.

3. The Role of Bankruptcy Directors

Debtors typically tout their bankruptcy directors to win judicial deference.[161] They do so in two ways, as statements by one bankruptcy director in the Gymboree Corporation bankruptcy in 2017 illustrate.

159. *See* Tom Corrigan, Joel Eastwood & Jennifer S. Forsyth, *The Power Players that Dominate Chapter 11 Bankruptcy*, WALL ST. J. (May 24, 2019, 5:30 AM), https://www.wsj.com/graphics/bankruptcy-power-players/ [https://perma.cc/H7AZ-AKPM].

160. We use BoardEx data to identify the directors' entire biographies, including Chapter 11 boards outside of our sample period.

161. *See, e.g.*, The Second Lien Noteholders' Objection to Confirmation of the Debtors' Modified Second Amended Joint Chapter 11 Plan at 54, *In re* LBI Media, Inc., No. 18-12655 (Bankr. D. Del. Mar. 18, 2019) [hereinafter LBI Plan Objection] (alleging that the "appointment of [the bankruptcy director] is a figleaf [sic] that the Debtors and [the controlling shareholder] are attempting to hide behind").

The first way is to claim that a board decision in the bankruptcy process (like financing terms[162] or the administration of an auction[163]) deserves deference because the bankruptcy directors who made it are independent. In the Gymboree case, for example, the bankruptcy director explained that he had no prior material relationship with the firm or with its private equity sponsor.[164] The second way is to claim that the board decision deserves deference because the bankruptcy directors who made it are restructuring experts. In the Gymboree case, for example, the bankruptcy director noted his experience in Chapter 11 cases and his background in investment banking.[165]

The strategy is to convince the bankruptcy court that the combination of independence and expertise means that the court should view the bankruptcy directors' conclusions as those of a neutral expert—almost as it views decisions of a court-appointed trustee. For example, in the rue21 bankruptcy in 2017, a bankruptcy director cited his independence, expertise, and the investigation he had led to urge the court to overrule creditor objections.[166]

We read each disclosure statement to learn about the tasks that bankruptcy directors perform. Table 2 summarizes our findings. It shows that bankruptcy directors led the restructuring process in 71% of their engagements and investigated claims against insiders (shareholders or lenders) in 46% of their engagements. They joined the board before the bankruptcy filing in 84% of their engagements.[167] They hired their own legal or financial advisors in 49% of their engagements. These numbers are lower bounds for the role that bankruptcy directors played in the sample cases, as

162. *See, e.g.*, Adam C. Rogoff & Priya Baranpuria, *United States: Exercising Independence in Restructuring: The Path to Better Governance*, MONDAQ (Oct. 2, 2018), https://www.mondaq.com/unitedstates/financial-restructuring/741656/exercising-independence-in-restructuring-the-path-to-better-governance [https://perma.cc/R55P-BC5S] (discussing the BCBG bankruptcy case).

163. *See* LBI Plan Objection, *supra* note 161, at 7 (alleging that the bankruptcy directors deliberately ran the auction so to produce a "low-ball valuation").

164. *See* Declaration of Steven Winograd in Support of Confirmation of the Amended Joint Chapter 11 Plan of Reorganization of the Gymboree Corporation and Its Debtor Affiliates at 3, *In re* The Gymboree Corp., No. 17-32986 (Bankr. E.D. Va. Sept. 2, 2017).

165. *See id.* at 2–3.

166. *See* Declaration of Neal Goldman in Support of Debtors' Reply to Limited Objection of the Official Committee of Unsecured Creditors to the Debtors' First Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code at 2–3, *In re* rue21, Inc., No. 17-22045 (Bankr. W.D. Pa. Aug. 28, 2017). The director first noted his expertise, his independence, the work he had done to investigate claims against insiders, and his conclusion that legal claims against insiders should be released. *See id.* at 2–3, 6–7. He then rejected the creditors' objections to his conclusion and asked the judge to defer to his business judgment. *See id.* at 7–8.

167. In unreported results, we find that for the forty-two sample cases with detailed information on director join dates the average bankruptcy director joined the board seven months prior to the petition date.

the debtors in the remaining cases did not state that the bankruptcy directors *did not* do these things. In unreported results, we find that, when firms identify their bankruptcy directors by name, both the mean and the median of the number of bankruptcy directors per firm are two and the maximum is five.

TABLE 2. Board and Director Characteristics of Firms with Bankruptcy Directors

Characteristics	% of bankruptcy-director firms
Board tasks (N=78)	
Evaluate restructuring proposals and negotiate with creditors	0.71
Run sale process	0.15
Provide independent directors for subsidiary conflicts	0.13
Investigate private equity sponsor or controlling shareholder	0.44
Investigate claims against pre-bankruptcy lenders	0.17
Investigate private equity sponsor or pre-bankruptcy lenders	0.46
Board independent advisors (N=78)	
Bankruptcy directors engaged own law firm	0.26
Bankruptcy directors engaged own financial advisor	0.15
Bankruptcy directors engaged own law firm OR financial advisor	0.32
Timing of bankruptcy director appointment (N=57)	
All independent directors joined firm pre-bankruptcy	0.84
Expertise that named bankruptcy directors collectively bring (N=57)	
Experience in restructuring or distressed companies	0.81
Lawyer	0.42
Investment banker	0.61
Distressed debt trader	0.21

Note: Table 2 summarizes the role of bankruptcy directors and board characteristics at the firm level

Next, we use regression analysis to learn more about differences between cases with bankruptcy directors and cases without them. As Table 1 shows, while average recoveries for unsecured creditors are 32% lower when debtors appoint bankruptcy directors, the difference is not statistically significant. The lack of statistical significance may result from variation in firm characteristics. A multivariate regression can overcome this problem by controlling for additional factors that may affect recoveries to isolate the contribution of bankruptcy directors.

Table 3 presents the results of such a regression.[168] Specifically, it presents the estimates of an ordinary-least-squares regression examining the relation between unsecured creditor recoveries and the presence of bankruptcy directors while controlling for firm financial and bankruptcy characteristics. It shows that, with full control variables, bankruptcy directors are associated with roughly 20% lower creditor recoveries.[169]

168. Table 3 studies a subsample for which we were able to obtain financial control variables (the ratio of debt to assets and the ratio of secured debt to total debt) from court documents. We omit one outlying case with a debt-to-asset ratio of approximately 244:1 (the sample mean is 1.45:1). The outlying firm, nCoat Inc., reported $914 million in debt and sold its assets in bankruptcy for $1 million less than the $3.76 million accounting value of the assets before the sale. This debt amount may have been a scrivener's error of the firm, but contemporaneous press accounts do not question it. *See, e.g.*, *Specialty Coatings Maker nCoat Files for Bankruptcy*, REUTERS (Aug. 16, 2010), https://www.reuters.com/article/ncoat/update-1-specialty-coatings-maker-ncoat-files-for-bankruptcy-idUSSGE67F0KR20100816 [https://perma.cc/6XFU-DCEE]. Including this firm does not materially change the coefficient of firms with bankruptcy directors.

169. The industry-fixed effects and the year-fixed effects in Columns 4–5 reassuringly increase the explanatory power of the regressions. In unreported regressions, the coefficient of firms with bankruptcy directors remains negative and significant when we examine the same specifications using a two-limit Tobit model. In another unreported regression, the coefficient of firms with bankruptcy directors remains negative and significant also when we add to the specification in Column 5 of Table 3 indicators for the venue (Delaware, Southern District of New York, Southern District of Texas, Eastern District of Virginia venue), for a public firm, for a firm that entered into a restructuring support agreement, for a firm represented by Kirkland, for a firm represented by Weil, for a board that includes a lawyer, and for a board that includes a Chapter 11 repeater. None of these additional variables other than the public firm indicator (which is positively and significantly related to unsecured creditor recovery) is significantly related to unsecured creditor recovery.

TABLE 3. Determinants of the Percentage of Unsecured Debt Paid

	(1)	(2)	(3)	(4)	(5)
Bankruptcy director appointed	−0.19***	−0.18***	−0.18***	−0.16**	−0.20***
	(0.05)	(0.05)	(0.05)	(0.06)	(0.08)
Ratio of debt to assets		−0.04***	−0.05***	−0.05***	−0.08***
		(0.01)	(0.01)	(0.02)	(0.03)
Ratio of secured debt to total debt		−0.49*	−0.51**	−0.41	0.06
		(0.25)	(0.25)	(0.26)	(0.33)
(Ratio of secured debt to total debt)^2		0.78***	0.75***	0.65**	0.24
		(0.28)	(0.28)	(0.29)	(0.37)
Prepackaged			0.19**	0.21**	0.16
			(0.10)	(0.10)	(0.11)
Private equity or controlling shareholder ownership			0.02	0.02	0.01
			(0.05)	(0.06)	(0.06)
Constant	0.36***	0.39***	0.37***	0.50***	1.01***
	(0.03)	(0.05)	(0.05)	(0.11)	(0.37)
Observations	194	194	194	194	193
R-squared	0.04	0.13	0.16	0.23	0.42
Year fixed effects	No	No	No	Yes	Yes
Industry fixed effects	No	No	No	No	Yes

Note: Table 3 shows the results of ordinary least squares regressions with robust standard errors. The dependent variable is the midpoint of the estimated unsecured creditor recovery retrieved from the disclosure statement that the firm filed in connection with the plan of reorganization. For example, Legacy Reserves Inc., which filed for bankruptcy in 2019, stated in its disclosure statement that unsecured noteholders would receive 3.1% to 4.8% of the amount it owed them, with a midpoint of 3.95%. The independent variable of interest is an indicator that equals one if the firm stated that it appointed a bankruptcy director to manage the restructuring process, and zero otherwise. *Ratio of debt to assets* is the ratio of the firm's consolidated liabilities to its assets in the bankruptcy petition. *Ratio of secured debt to total debt* is the amount of debt to secured creditors divided by the amount of debt to all creditors in the firm's disclosure statement. To minimize measurement error, we exclude debt incurred after the bankruptcy filing, intercompany debt, and tax liabilities. *Prepackaged* is an indicator that equals one if the firm reorganized in a bankruptcy plan that creditors had approved before the petition date, and zero otherwise. *Private equity or controlling shareholder ownership* is an indicator that equals one if the firm has a private equity sponsor or another controlling shareholder, and zero otherwise. In Column 4, we introduce year-fixed effects and in Column 5 we add Fama-French 48 industry-fixed effects. *** $p<0.01$, ** $p<0.05$, * $p<0.1$.

To be sure, this association does not prove that the bankruptcy directors cause the lower recoveries. One could always argue that firms appoint bankruptcy directors when facing difficult bankruptcies and that this explains the low recoveries. While we use standard financial controls, including the ratio of debt to assets, the ratio of secured debt to total debt,[170] and indicators for private equity ownership and for prepackaged bankruptcy filings, these controls likely capture only part of the story of each Chapter 11 case.

Moreover, a bankruptcy could be difficult for reasons unrelated to the firm's ability to pay. For example, there could be inter-creditor disputes or regulatory issues. We do not observe these factors and cannot control for them. If firms appoint bankruptcy directors precisely when these factors are present, we might wrongly attribute the low recoveries to these directors instead of to the firm's underlying circumstances.

We note, however, a possible explanation that *would not* clear the bankruptcy directors of responsibility for the lower recoveries. A potential omitted variable in our analysis could be that firms with bankruptcy directors are also ones in which the insiders siphoned value. To the extent bankruptcy directors may then steer the bankruptcy case to a relatively lower settlement, this could also explain the relationships we observe in the data.

At the very least, our findings explain why bankruptcy directors are controversial: all else being equal, firms that hire them end up paying on average 20% less to unsecured creditors than do other firms.[171] These

170. In unreported results, we observe that unsecured creditor recoveries first decrease, and then increase, in the ratio of secured debt to all debt. Accordingly, Columns 2 through 5 of Table 3 include both the ratio of secured debt to total debt (the "untransformed ratio") and that ratio squared. In Columns 2 and 3, the coefficient of the untransformed ratio is statistically significant and negative while, in Columns 2–4, the coefficient of the squared ratio is statistically significant and positive. This curvilinear relationship may reflect a common Chapter 11 tactic: when unsecured debt is small relative to total debt, the firm may choose to pay the unsecured debt in full rather than deal with a litigious UCC. For example, in the 2019 bankruptcy of sample firm Hexion Holdings, the firm paid unsecured creditors (trade debt, pension debt, environmental claims) all of their claims, while only paying junior secured creditors about 25% of their claims and paying senior creditors about 87% of their claims. *See* Disclosure Statement for Second Amended Joint Chapter 11 Plan of Reorganization of Hexion Holdings LLC and Its Debtor Affiliates Under Chapter 11 of the Bankruptcy Code, *In re* Hexion Holdings LLC, No. 19-10684 (Bankr. D. Del. May 22, 2019). In that case, the unsecured debt represented less than 20% of total debt, and the firm needed to pay the unsecured debt in full for business reasons. *Id.* The results are qualitatively similar without the squared term, and the statistical significance of the bankruptcy director's indicator variable does not depend on including the squared term.

171. In unreported regressions, when we add an indicator for the presence of a bankruptcy director who investigated claims against insiders to the specifications in Table 3, that variable is not statistically significant, while the indicator for the presence of a bankruptcy director retains its statistical significance. This is consistent with bankruptcy directors reducing creditor recoveries not necessarily through their handling of claims against insiders. Alternatively, firms may underreport investigations by bankruptcy directors of claims against insiders (according to Table 2, they do so in only 46% of the cases involving bankruptcy directors).

differences are statistically significant and likely visible to bankruptcy lawyers and investors active in Chapter 11 cases, who may associate bankruptcy directors with relatively lower creditor recoveries. In our view, these findings at least shift the burden of proof to those claiming that bankruptcy directors improve bankruptcy outcomes.

Finally, on the benefits side, bankruptcy directors may use their expertise to reduce the length and litigiousness of complex cases. While both of these claims are hard to measure, our data allow us to try. In unreported regression models, we investigate how the duration of the bankruptcy case or the number of objections that creditors file on the court docket relate to the presence of bankruptcy directors. We find no statistically significant relationship. That is not to say that bankruptcy directors do not offer these benefits—we could be examining the wrong variables—but we do not find evidence for them in our data.

4. The Biographies of Bankruptcy Directors

To learn more about the backgrounds of bankruptcy directors, we collected biographical characteristics for the 86 named bankruptcy directors in our sample from information in the disclosure statements and supplemented those data with Internet research.[172]

Table 4 summarizes our findings. Forty-eight percent of the named bankruptcy directors in our sample are bankruptcy experts. Table 1 above shows that 83% of the boards appointing bankruptcy directors report having a director with bankruptcy expertise. This means that firms often pair a Chapter 11 expert with a non-Chapter 11 expert as their bankruptcy directors. Table 4 further shows that the named bankruptcy directors are more likely to be former investment bankers (41%) than lawyers (19%), although a small number of bankruptcy directors were both.

172. Of 78 disclosure statements in our sample that mentioned bankruptcy directors, 57 identified 119 bankruptcy directors by name, leading to our sample of 86 unique names holding those 119 directorships. *See supra* note 155 and the accompanying text. Other disclosure statements mentioned bankruptcy directors active in the bankruptcy without identifying them by name.

TABLE 4. Characteristics of Named Bankruptcy Directors

Characteristic	% of identified bankruptcy directors
Director Background (N=86)	
Expertise in restructuring or distressed companies	0.48
Lawyer	0.19
Investment banker	0.41
Distressed debt trader	0.16

Note: Table 4 summarizes the background of directors that the disclosure statement identified as bankruptcy directors. Each individual corresponds to one observation even if serving on multiple boards in the sample.

A subset of individuals within this group of 86 named bankruptcy directors holds many directorships, including in bankrupt companies. We call them "super-repeaters." As one of the bankruptcy directors noted in a court hearing, they "specialize in going on the boards of companies that are emerging from bankruptcy or going into bankruptcy."[173]

To study the super-repeaters, we dived deeper into the background of the most active bankruptcy directors. First, we identified the individuals named as bankruptcy directors in more than one disclosure statement. To this list, we added individuals who appeared at least three times in our broader sample of 2,895 unique petition-date directors. After eliminating duplicates, we constructed an initial list of 20 directors.[174]

We then obtained information from BoardEx on the background and additional independent directorships of these directors.[175] We reviewed each directorship and eliminated duplicates or directorships for which we do not have service dates.[176] Finally, we identified which additional directorships were in companies that went into bankruptcy during our sample period by matching the list of additional directorships from BoardEx with New

173. *See* Certification of Transcript at 45, *In re* rue21, Inc., No. 17-22045 (Bankr. W.D. Pa. Sept. 1, 2017) [hereinafter Rue21 Transcript].

174. We dropped one director who appeared three or more times in the data but was an employee of a private equity firm and thus an inside director.

175. If an individual also serves as an officer in the company, we excluded that directorship from our list.

176. Occasionally, BoardEx includes multiple entries associated with the same directorship. For example, these entries may appear when companies change names, when the directors change position (for example, from a director to a chair of the board), or when directors sit on boards of affiliated companies (for example, a parent and a subsidiary). We eliminated these duplicative entries.

Generation Research's list of Chapter 11 firms. BoardEx does not always provide data on directorship dates. However, when that data were available, we also examined whether the director was on the board of the company on the day of its bankruptcy filing or joined within a year after the bankruptcy filing.[177] After eliminating directors who had only one confirmed directorship of bankrupt companies, a list of 15 directors remained.

These directors have developed a profession of sitting on boards of bankrupt companies. Leading the list is a director who has sat on 96 boards, for which we were able to find the dates of his service, and we confirmed that in 31 of these cases he served on boards of companies at the times of their bankruptcy filings or within a year thereafter.[178]

Overall, we find that the 15 super-repeaters on our list had 252 independent directorships, with an average of 17 directorships and a median of 13 directorships per director. Of these 252 directorships for which we have service dates, we find that, in 44% of the cases, the super-repeaters sat on the boards at the time of their bankruptcy filings or within a year thereafter.[179]

Finally, we looked at the law firms that represented the bankrupt companies. As we will discuss below, the evidence suggests that these law firms exert significant influence over the selection of bankruptcy directors. Our data show that two law firms, Kirkland and Weil, have a particularly strong connection to super-repeaters. This is unsurprising, as Kirkland and Weil are the two preeminent law firms specializing in the representation of distressed companies.[180]

In 76 cases, we were able to find information on the identity of law

177. Due to data limitation, we are unable to confirm whether all of these directors who served on the board of a company on the day of its bankruptcy filing were eventually delegated with the authority to vet conflicted decisions by the board of the company or its controlling shareholders.

178. In addition to his bankruptcy work, this director also had a career as an activist investor nominee to boards of firms not in bankruptcy. *See, e.g.*, RBC Cap. Mkts., LLC v. Jervis, 129 A.3d 816, 826 (Del. 2015). In at least one of those cases, a trial court found him to be "largely an absentee director." *See id.* at 835. In one of his bankruptcy director engagements, the director testified that he was not sure how many boards he was simultaneously serving on or whether that number was higher than forty. *See* Ad Hoc Group of Unsecured Noteholders' Emergency Motion, Pursuant to Sections 105(a), 1104(c), 1106(b), and 1107(a) of the Bankruptcy Code and Federal Rule of Bankruptcy Procedure 2007.1, for Entry of an Order Appointing an Examiner with Power to Prosecute at 17, *In re* Sanchez Energy Corp., No. 19-34508 (Bankr. S.D. Tex. Nov. 26, 2019). In that case, creditors accused him of abdicating his role and allowing the law firm that he was supposedly overseeing to conduct an investigation with no oversight. *See id.* at 20.

179. Our data are likely to underestimate the number of directorships in bankrupt companies that super-repeaters have held. This is because we eliminated from our sample entries for which BoardEx does not provide exact directorship dates to confirm that the super-repeaters indeed served on the board at the time of the bankruptcy (or within a year thereafter). It is possible that some of the directorships we eliminated are of bankrupt companies.

180. *See* Corrigan et al., *supra* note 159.

firms that represented bankrupt companies with at least one super-repeater on the board. Kirkland represented the bankrupt firm in 33% of these cases, and Weil represented it in 14% of these cases.

Putting all the pieces together, our data reveal an ecosystem of a small number of individuals who specialize in sitting on the boards of companies that are going into or emerging from bankruptcy. This group includes 10 individuals with 10 or more directorships—many of them in bankrupt companies. Next, we will discuss evidence on how these directors are selected.

5. The Selection of Bankruptcy Directors

While firms do not systematically disclose how they select their bankruptcy directors, when they do, they usually describe the appointment as made by shareholders, often on the advice of the debtor's bankruptcy lawyers.[181] For example, Neiman's lawyers recruited the firm's bankruptcy directors after an employee of the private equity sponsor reached out to them.[182]

The ultimate decision to appoint a specific person to a directorship belongs to a firm's shareholders, and the law firms merely play an advisory role.[183] Nevertheless, the role of the debtor's law firm in advising on the candidate raises concerns because a handful of law firms dominate the market for representing companies on their journeys through Chapter 11. As Table 5 shows, Kirkland and Weil command a particularly large share of this market.[184] One bankruptcy director noted in a court hearing that prior history with the dominant law firms is hard to avoid, as Kirkland has an "80 percent market share in debtor cases."[185] While that number is exaggerated, the

181. *See* Declaration of Alan J. Carr in Support of Restructuring Subcommittee's Response to the Objection of the Official Committee of Unsecured Creditors to the Sale of Substantially All of the Debtors' Assets to ESL Investments, Inc. at 3–4, *In re* Sears Holdings Corp., No. 18-23538 (Bankr. S.D.N.Y. Feb. 1, 2019) (a bankruptcy director noting that "[i]n late September 2018, I was contacted by [one of the debtor's lawyers] about possibly joining the Sears Board as an independent director"). For private equity-controlled firms, there may not be much of a distinction between the board and the shareholders since the board often comprises insiders of the private equity sponsor.

182. *See* Neiman Marcus Trial, *supra* note 83, at 54. The employee of the private equity firm who recruited Beilinson had worked with him on a prior Chapter 11 case. *See id.* The employee asked Beilinson if he was available for an "undisclosed assignment," and two lawyers from Kirkland subsequently called to clarify the engagement. *See id.* at 54–55.

183. As one super-repeater bankruptcy director noted, "Kirkland doesn't decide who goes on the board of directors of companies, owners do." *See* Rue21 Transcript, *supra* note 173, at 45.

184. Because debtors sometimes hired multiple law firms (for example, a national law firm and local counsel), law firm engagements can overlap. For example, Kirkland represented 16% of debtors in the sample, 25% of debtors with a Chapter 11 repeater, 32% of debtors with a bankruptcy director, and 44% of the debtors in which a bankruptcy director investigated claims against insiders.

185. *See* Rue21 Transcript, *supra* note 173, at 36.

potential for a handful of law firms to influence appointment of these directorships can create what we call "auditioning bias." We discuss this in detail next.

TABLE 5. Law Firms' Share of Cases

Law firm	% of cases	% of boards with Chapter 11 repeaters	% of boards with bankruptcy directors	% of boards with bankruptcy directors who conducted an investigation
Kirkland & Ellis LLP	0.19	0.29	0.32	0.44
Richards, Layton & Finger PA	0.12	0.16	0.18	0.17
Young Conaway Stargatt & Taylor LLP	0.11	0.13	0.09	0.03
Weil, Gotshal & Manges LLP	0.08	0.13	0.17	0.14
Skadden, Arps, Slate, Meagher & Flom LLP	0.06	0.07	0.05	0.06
Paculski Stang Ziehl & Jones LLP	0.06	0.05	0.04	0.03
Jones Day	0.04	0.05	0.03	0.03
Latham & Watkins LLP	0.03	0.03	0.05	0.00
DLA Piper LLP	0.02	0.02	0.01	0.03
Akin Gump Strauss Hauer & Feld LLP	0.02	0.07	0.04	0.08
Willkie Farr & Gallagher LLP	0.02	0.01	0.00	0.00
Sidley Austin LLP	0.02	0.03	0.01	0.00
Paul, Weiss, Rifkind, Wharton & Garrison LLP	0.02	0.01	0.01	0.03
Kutak Rock LLP	0.02	0.04	0.03	0.03
Gibson, Dunn & Crutcher LLP	0.02	0.00	0.00	0.00
Davis Polk & Wardwell LLP	0.02	0.01	0.00	0.00
Jackson Walker LLP	0.02	0.06	0.05	0.08
Cole, Schotz, Meisel, Forman & Leonard PA	0.02	0.01	0.01	0.00
Greenberg Traurig LLP	0.02	0.00	0.03	0.03

Note: Table 5 summarizes the market shares of the 19 law firms advising the most debtors in our sample.

IV. POLICY IMPLICATIONS

In this Part, we consider the policy implications of our analysis. First, we argue that judges should defer to the business judgment of bankruptcy directors only after verifying their neutrality. Second, we claim that bankruptcy directors cannot be neutral if shareholders alone select them or if they have the support of only some of the creditor classes. We thus propose that bankruptcy judges hold a hearing at the beginning of the bankruptcy process to present prospective or existing bankruptcy directors, their credentials, and their potential conflicts of interest. If these individuals then win overwhelming creditor support, the bankruptcy judge should treat them as independent. Otherwise, the judge should regard them without any type of special judicial deference. We further explain why our proposal will not discourage the use of bankruptcy directors or erode the benefits they can bring, such as adding expertise to the boardroom, streamlining the bankruptcy proceedings, and blocking frivolous litigation. We close by considering the recent proposal of Senator Elizabeth Warren, which would accomplish through federal legislation the same goals of restoring the balance of power between debtors and creditors.

A. THE CASE AGAINST DEFERRING TO BANKRUPTCY DIRECTORS IN CONFLICTS WITH CREDITORS

The creation of the new role of bankruptcy directors in the past decade is the work of entrepreneurial bankruptcy lawyers and restructuring professionals. They have cleverly blended corporate law's deference to independent directors with bankruptcy law's faith in neutral trustees.[186]

It is easy to see how this innovation might appeal to bankruptcy judges.[187] Chapter 11 cases are contentious and require the bankruptcy judge to navigate the proceedings while understanding the firm's business to a lesser extent than the parties.[188] A neutral expert could assist the court in this task, smooth the path to settlement, and counteract the problems associated with leaving a self-interested board in control.[189] In theory, neutral bankruptcy directors could give the judge some of the benefits of a court-

186. *See supra* Section I.B.

187. *See* Barry E. Adler, *Game-Theoretic Bankruptcy Valuation*, 41 J. LEGAL STUD. 209, 215 (2012) (discussing the judge's awareness of creditors' biases).

188. Conflict between creditors is one of the defining aspects of modern bankruptcy practice. *See, e.g.*, Baird & Rasmussen, *supra* note 12. The judge's distance from the business often leaves her reliant on the creditors and the debtor to help her understand the facts. *See* Jared A. Ellias, *Regulating Bankruptcy Bonuses*, 92 S. CAL. L. REV. 653, 657 (2019) (discussing the difficulty that judges have evaluating business decisions).

189. The distortions caused by allocating control of Chapter 11 to shareholders are the subject of extensive literature. *See, e.g.*, Lucian Arye Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 J. FIN. 445, 447 (2002). Bankruptcy law generally relies on the bankruptcy judge, rather than fiduciary duties, to ensure that decisions in the course of the bankruptcy are fair to creditors. *See* John A. E. Pottow, *Bankruptcy Fiduciary Duties in the World of Claims Trading*, 13 BROOK. J. CORP. FIN. & COM. L. 87, 93 (2018) (noting that creditors serve as a check on a Chapter 11 firm and that the bankruptcy court's oversight means that fiduciary duties are less important).

appointed trustee without the judge having to appoint one.[190]

However, bankruptcy directors are not necessarily neutral. Shareholders usually appoint them on the advice of their lawyers.[191] It is reasonable to assume that they would be hard-pressed to disappoint those who chose them for this lucrative engagement. Moreover, a bankruptcy directorship is a short-term engagement that creates incentives to treat it as an audition for the next engagements. The dependence on future engagements strengthens a bankruptcy director's desire to be helpful to shareholders and their lawyers. A bias in favor of shareholders can result in cheap settlements of claims against shareholders and in restructurings that let shareholders retain more equity. A bias in favor of lawyers can result in quick settlements to make the lawyers look good at the expense of creditors.[192] In short, shareholders' control of the appointments of bankruptcy directors undermines the directors' independence.

These conflicts become worse when the controlling shareholder and its lawyers are repeat players in the bankruptcy arena who can influence future nominations to the position of bankruptcy directors.[193] Those connections among bankruptcy directors, a group of private equity funds, and law firms are key to understanding the environment in which bankruptcy directors operate. To become a bankruptcy director, one must work with the leading law firms and private equity firms in the bankruptcy practice.

Therefore, bankruptcy judges should treat the decisions of bankruptcy directors in conflicts with creditors as they would treat the conclusions of any other professional a Chapter 11 firm hires.

B. ENHANCING CREDITOR VOICE AND INVESTIGATIVE POWER

In this Section, we argue that enhancing the voice of creditors can cure the structural bias of bankruptcy directors. Creditors in Chapter 11 proceedings are usually sophisticated investors with expert lawyers. There is no reason to let shareholders' appointees prevent creditors from representing

190. The role of a bankruptcy judge is both challenging and, in the current administration of bankruptcy law, somewhat ambiguous. *See* Melissa B. Jacoby, *What Should Judges Do in Chapter 11*, 2015 U. ILL. L. REV. 571, 573 (2015).

191. *See supra* Section III.C.5.

192. For discussion of the power of law firms in the bankruptcy process, *see generally* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (2005).

193. Compare this to directors operating in a highly networked community, such as venture-capital nominees. Because of the significant business relationships of these directors with the controlling shareholder or the CEO and other insiders across ventures, the Delaware courts—in two recent cases—expressed concerns that the decision of these directors whether to reject a lawsuit against insiders would have had significant financial and relationship externalities that would have affected other investments and interests of these directors. *See supra* note 42 and accompanying text.

themselves in matters on which creditors and shareholders disagree. Doing so sidesteps the checks and balances built into Chapter 11.[194]

Bankruptcy law requires a public hearing to ensure that professionals retained for the proceedings have no conflicts.[195] Both debtor lawyers and UCC lawyers undergo this vetting.[196] Can a similar procedure ensure the neutrality of bankruptcy directors?[197] We believe the answer is no. The current market for bankruptcy directorships creates a structural bias in favor of the shareholders and the law firms that hire these directors. Even a bankruptcy director with no prior connection to the debtor firm or its lawyers may not want to disappoint them and jeopardize future engagements. This structural bias will remain as long as shareholders and their lawyers alone dominate the selection of bankruptcy directors.

The solution is to involve creditors in the selection of bankruptcy directors. In some cases, this is already taking place.[198]

Accordingly, we urge bankruptcy judges to use their broad discretion to implement a new procedure that is likely to solve many of the problems we have identified.[199] They should hold a hearing early in the bankruptcy process in which the debtor will present any bankruptcy directors it appointed, or plans to appoint, and the creditors will express their opinions. The court will then treat the bankruptcy directors as neutral actors only if an overwhelming majority of creditors whose claims are at risk support the appointments. The expression "creditors whose claims are at risk" typically means the unsecured creditors and the UCC representing them. However, depending on the facts, the judge may also include in this category any other

194. *See infra* Section I.B.

195. *See* 11 U.S.C. § 327(a).

196. *See, e.g.*, *In re* Project Orange Assocs., LLC, 431 B.R. 363, 366 (Bankr. S.D.N.Y. 2010) (denying a Chapter 11 firm's request to retain a major law firm because of a conflict of interest with the firm's major unsecured creditor). *See also In re* Glenview Health Care Facility, Inc., 620 B.R. 582 (B.A.P. 6th Cir. 2020) (considering the conflicts of interest of the UCC's counsel).

197. As the judge in the Neiman bankruptcy noted, there is no Chapter 11 vehicle to look at the conflicts of bankruptcy directors—no "application to hire those folks" and "no pleading or contested matter for me to look at the independence of an independent director." *See* Neiman Marcus Settlement Transcript, *supra* note 20, at 35.

198. In five of our sample cases, we observe the appointment of bankruptcy directors during the bankruptcy case with some, but not necessarily unanimous, creditor support. In those cases, the bankruptcy directors are something of an alternative to the appointment of a Chapter 11 trustee.

199. *See* 11 U.S.C. § 105. Creditors can already investigate potential conflicts of interest by seeking the appointment of an examiner under 11 U.S.C. § 1104 or seeking discovery under Federal Rule of Bankruptcy Procedure 2004. However, bankruptcy judges are reluctant to appoint examiners, partly due to the costs and the delay that such an appointment entails. *See generally* Lipson, *supra* note 86. Moreover, our proposal offers at least three advantages. First, it ensures that the examination of potential conflicts of interest takes place at the beginning of the bankruptcy process. Second, it empowers bankruptcy directors who received creditor support as they conduct investigations and negotiations. Third, it encourages firms to ensure that their bankruptcy director picks can withstand scrutiny.

creditors whose rights are subject to modification, including some secured creditors. As for the standard of "overwhelming support," it should be a qualitative equivalent of the two-thirds majority needed to approve a reorganization plan.[200]

Absent such support, the court should regard the bankruptcy directors as ordinary professionals retained by the debtor: it should weigh their position against creditors',[201] allow creditors to conduct their own investigation and sue,[202] and not approve proposed settlements merely because the bankruptcy directors endorse them. Dissenting creditors should be able to present their own analysis using both time and estate funds, as Congress envisioned. This approach reclaims judicial discretion, rather than limits it: when the judge concludes that the bankruptcy director is not neutral, the judge has wide discretion regarding the disposition of the case, as a bankruptcy judge traditionally would.

We realize that allowing creditors to conduct a parallel investigation can delay the proceedings. We will address this concern in Section IV.C below. In any event, debtors wishing to ensure that the court will treat their bankruptcy directors as neutral actors could seek creditors' blessing of their selection in advance or select individuals likely to receive this blessing. Similarly, bankruptcy directors could gather evidence before the bankruptcy petition to immediately turn over to creditors for their analysis. Streamlining the bankruptcy process should not come at creditors' expense.

Creditors will likely need information on the bankruptcy directors to form their opinion. Bankruptcy judges could rule what information requests are reasonable to create standardization and predictability. Importantly, however, disclosure cannot substitute for creditor support. Requiring disclosure without giving creditors power over the selection of bankruptcy directors will not cure bankruptcy directors' structural bias.[203]

---

200. *See* 11 U.S.C. § 1126 (2019).

201. Bankruptcy directors resemble SLCs that boards sometimes form to handle shareholder derivative suits. In Section I.B, we noted important differences between the two institutions that make bankruptcy directors more controversial. However, under Delaware law, even when a court finds that a SLC was independent, acted in good faith, and made a reasonable investigation, it may reject the committee's recommendations based on the court's own business judgement. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787–89 (Del. 1981). Consistently, a recent empirical study found that Delaware courts are skeptical of recommendations by SLCs calling for case dismissals. *See* Krishnan et al., *supra* note 47.

202. Derivative standing for creditors is a matter of bankruptcy common law, and some judges and circuits have not embraced the concept. *Compare* Off. Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 552 (3d Cir. 2003), *with In re* Cooper, 405 B.R. 801, 807 (Bankr. N.D. Tex. 2009).

203. *See* Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 738–40 (2011).

Requiring bipartisan support to ensure director neutrality is an old idea. In the corporate law context, Lucian Bebchuk and Assaf Hamdani proposed to let public investors appoint—or at least substantially influence—the appointment of independent directors who vet decisions in which the interests of public investors and the controlling shareholder diverge.[204] The American Stock Exchange used to require issuers with a dual-class share structure to adopt this mechanism to protect the holders of the low-voting shares.[205] A similar requirement exists for listed controlled companies in the United Kingdom,[206] Italy,[207] and Israel.[208] Using this approach to make bankruptcy directors accountable also to creditors will protect creditors while preserving bankruptcy directors' ability to streamline the bankruptcy process.

C. OBJECTIONS

In this Section, we respond to possible objections to our recommendations. In particular, we examine the arguments that bankruptcy directors bring expertise to the boardroom, streamline the bankruptcy process, and rid the debtor firm of meritless suits. While these claims are possible, we find no evidence in our data to support them. Either way, our proposal would allow bankruptcy directors to continue to contribute to the bankruptcy process while restoring the balance of power between debtors and creditors.

---

204. *See* Bebchuk & Hamdani, *supra* note 23, at 1304–11.

205. *See* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 704 n.90 (1986) ("The limited voting class of the common must have the ability—voting as a class—to elect not less than 25% of the board of directors."); *see also* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 92, 126–27, 127 n.212 (2016) (discussing the procedures for appointing minority directors in controlled companies and presenting prominent examples).

206. In 2014, the United Kingdom's Financial Conduct Authority adopted new listing rules, which require subjecting the election or reelection of independent directors in controlled companies to approval by both a majority of shareholders and a majority of minority shareholders. *See* FIN. CONDUCT AUTH., FCA 2014/33, LISTING RULES (LISTING REGIME ENHANCEMENTS) INSTRUMENT 2014, at 12 (2014), https://www.handbook.fca.org.uk/instrument/2014/FCA_2014_33.pdf [https://perma.cc/WT3A-KLZD].

207. Italian law requires public companies to provide public investors with the power to elect at least one member to the board. *See* Massimo Belcredi & Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 383 (Jennifer G. Hill & Randall S. Thomas eds., 2015).

208. Israeli law requires public companies to have at least two "outside directors" who are independent of the controlling shareholder. Public investors hold veto rights over their election. Public investors also have the power to reelect these directors over the controller's objection. Removal of these directors is possible only for cause. *See* §§ 239, 245, Companies Law, 5759-1999, LSI 44 72, 74 (1999), (Isr.).

1. Expertise

A common argument for using bankruptcy directors is that their expertise enhances board deliberations and improves the bankruptcy process.[209] In an unreported regression controlling for other determinants of litigiousness, we find no evidence of such an advantage: there is no apparent relation between the presence of bankruptcy directors and the number of objections filed in court. Given that sophisticated attorneys advise all of the firms in our sample, the benefits of expertise that bankruptcy directors might bring, beyond what the lawyers do, are questionable.[210]

Moreover, expertise does not compensate for bias. When bias exists, even knowledgeable bankruptcy directors will not examine creditor claims objectively. The reality is that bankruptcy directors will usually not earn more money if creditors have the best possible outcome.

Our two case studies illustrate this point. Marc Beilinson, a bankruptcy director in the Neiman case, had served on fifteen boards, about half of them bankrupt companies. He clearly had significant experience. However, when he took the witness stand, he was unable to answer questions about the investigation he oversaw, and his answers revealed it had not gone very far.[211]

Similarly, when Payless appointed Charles Cremens as bankruptcy director, the company described him as having vast restructuring experience, which was true.[212] Nevertheless, he conducted a flawed investigation in the eyes of unsecured creditors: he failed to obtain tolling agreements from the private equity sponsors for claims that could expire during his investigation, and he declined to hire an expert to determine whether Payless had been solvent when it paid dividends. This was the most critical question for the creditors' claims.[213] Yet it is clear from his own representations that he did not see his role to be zealously prosecuting the self-dealing claims.

Finally, there are ways to bring bankruptcy expertise to the board while protecting creditors. As we suggest above, creditors should have a say on the

---

209. For studies finding that directors with related-industry expertise contribute positively to firm performance, *see* DAVID LARCKER & BRIAN TAYAN, THE FIRST OUTSIDE DIRECTOR (2020). *See also* Felix von Meyerinck, David Oesch & Markus Schmid, *Is Director Industry Experience Valuable?*, 45 FIN. MGMT. 207 (2016) (finding significantly higher announcement returns upon appointments of experienced versus inexperienced directors). For a study finding that private equity-backed firms navigate Chapter 11 more smoothly than other firms do, *see* Edith S. Hotchkiss, David C. Smith & Per Strömberg, *Private Equity and the Resolution of Financial Distress*, 10 REV. CORP. FIN. STUD. 694 (2021).

210. Bankruptcy directors may help the firm manage financial distress outside bankruptcy. This possibility is beyond the scope of our study, which focuses on how the bankruptcy court should treat them.

211. *See supra* notes 88–90.

212. *See* Payless Disclosure, *supra* note 119.

213. *See supra* note 134 and accompanying text.

identity of the bankruptcy directors.[214] This will allow the appointment of professional directors who do not owe their appointment only to shareholders. Shareholders could also appoint bankruptcy experts to the board who do not win creditor support, but the court should not treat these directors as independent. Alternatively, boards can acquire bankruptcy expertise by hiring legal and financial advisors rather than appointing new directors.

2. Speed and Practicality

Another argument for the use of bankruptcy directors is that they streamline the bankruptcy process. Here too, we find no evidence of such an advantage: the duration of bankruptcy proceedings in the presence of bankruptcy directors is similar to its duration in their absence both on average and in an unreported regression controlling for other factors that may affect the duration of bankruptcy.[215]

Even if such an advantage existed, it would not alter the calculus. Emerging from bankruptcy quickly at the expense of creditor recoveries undermines an important bankruptcy policy goal.[216] Bankruptcy directors could achieve speedy results by undercutting rights of creditors and by deflating claims against the shareholders who appointed them. Our finding of lower creditor recoveries in the presence of bankruptcy directors is consistent with this prediction. And the two case studies we presented above illustrate the dynamics. In both of them, the bankruptcy directors prevented unsecured creditors from conducting their own investigations and quickly settled fraudulent transfer claims.[217]

Another objection to our proposal is that it is impractical because bankruptcy directors are usually appointed ahead of the bankruptcy filing and well before the bankruptcy judge and UCC arrive on the scene. However, in modern bankruptcy practice, creditor groups usually organize and enter into negotiations with debtors prior to any bankruptcy filings. The appointment of directors can be part of those negotiations, and courts could take into account prior creditor support when weighing the independence of a director of a firm that enters Chapter 11.

Objectors might also claim that our solution is impractical because creditors will never support debtors' picks for bankruptcy directors. However, we see no reason to assume that this will be the case. Creditors

214. *See supra* Section IV.B.
215. *See supra* Table 1.
216. *See* Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 909 (2014).
217. *See supra* notes 88–117, 133–35 and accompanying text.

may well oppose some of the current selections for bankruptcy directors, as no one asked for their opinion when making these selections. But both the selections and creditor views about them will likely be different once debtors know that their selections must receive creditor support. And one can imagine compromise slates of bankruptcy directors appointed to represent diverse creditor constituencies.

More importantly, our solution is the only way to ensure that the bankruptcy process retains the appearance of fairness. If it cannot be made to work, bankruptcy law should revert to the way it was before the invention of bankruptcy directors, where federal bankruptcy judges were the impartial actor in most large Chapter 11 cases whose credibility was key to winning public and creditor acceptance of the legitimacy of the proceeding.[218]

3. Avoiding Meritless Litigation

Finally, one could argue that unsecured creditors might pursue meritless claims in the hopes of extracting a holdup-value settlement.[219] In theory, bankruptcy directors could prevent this by analyzing claims and settling them with minimal delay to the firm's emergence from bankruptcy.[220] In our view, however, this argument is not persuasive. The traditional tools of litigation management—motions to dismiss and summary judgment hearings—address this concern. Bankruptcy judges are experts in identifying meritless claims and can reduce the bargaining power of litigants with weak claims. There is no need to allow bankruptcy directors to preclude unsecured creditors from getting their day in court.

D. SENATOR WARREN'S PROPOSAL FOR FEDERAL LEGISLATION

In October 2021, after the publication of a draft of this Article, Senator Elizabeth Warren introduced draft legislation to curb the ability of bankruptcy directors to undermine creditor rights.[221] The proposed legislation has two components. First, it would give exclusive power to the

218. *See generally* Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235 (2013) (discussing the historical cycling in bankruptcy practice, in which creditor groups compete through rent-seeking activity and judges and Congress occasionally restore the balance).

219. One of us has found no empirical support for the view that creditors prosecute meritless lawsuits in pursuit of holdup-value settlements. *See* Jared A. Ellias, *supra* note 53, at 498. Nevertheless, the perception that they do is a powerful narrative in bankruptcy practice. *See, e.g.*, Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709, 1711 (2020); Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1932 (2006).

220. *See generally* Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199 (2005) (arguing that the potential for protracted bankruptcy proceedings can raise capital costs).

221. *See* Saeedy, *supra* note 22 and accompanying text.

UCC to prosecute and settle claims against insiders.[222] Second, it would provide the UCC the power to demand a court hearing to examine potential conflicts of interest of any director.[223]

Senator Warren's proposal is consistent with our findings and has similar goals to our proposal. Her proposal also has the benefit of simplicity and, if adopted, will ensure consistent application by different judges. Still, our proposal has two further advantages. First, it lets the debtor firm appoint experts to navigate the bankruptcy process and receive judicial deference as long as these appointees are acceptable to creditors. Second, by requiring that bankruptcy directors be acceptable to creditors, our proposal ensures that all board actions in bankruptcy, not just decisions regarding claims against insiders, advance creditor interests. This is important as we find that bankruptcy directors are associated with lower creditor returns even when not investigating claims against insiders.

CONCLUSION

In this Article, we present new data that reveal that boards of directors of bankrupt companies increasingly delegate important Chapter 11 decisions to bankruptcy directors. These directors have taken on a quasi-trustee role in Chapter 11, holding themselves out to the bankruptcy court as independent even though they owe their appointments to shareholders. They suffer from a structural bias resulting from being part of a closely-knit community: a handful of private equity sponsors that control distressed companies routinely turn to a handful of law firms for representation and—per their advice—pick these bankruptcy directors from a small pool.

Our analysis reveals that these directors are ill-suited to vet claims against insiders and that their presence is associated with lower recoveries for unsecured creditors. This finding at least shifts the burden of proof to those claiming that bankruptcy directors do not favor the shareholders who hire them. Our policy recommendation, however, does not require a resolution of this controversy. We propose that courts regard bankruptcy directors as independent only if the overwhelming majority of creditors whose claims are at risk in a Chapter 11 case supports their appointment, making bankruptcy directors equally dependent on both sides to the dispute.

---

222. *See* Stop Wall Street Looting Act, S. 3022, 117th Cong. § 202(e) (2021).
223. *See id.* § 202(d).

EVERYONE IS TALKING ABOUT BANKRUPTCY DIRECTORS

Robert W. Miller[*]

Abstract

The proliferation of bankruptcy directors represents a controversial shift in the corporate governance landscape. Delegating corporate decision-making to bankruptcy directors insulates conflicted transactions and claims from the traditional protections provided by derivative standing and entire fairness. However, critics have questioned their independence and cleansing effect. Are bankruptcy directors really independent when their role includes negotiation with and/or investigation into the same parties who appoint them? Should their decisions be given deference when their appointment is associated with lower recoveries for creditors? Bankruptcy directors' salience is best illustrated by the numerous proposals made for evaluating their cleansing effect, including Professors Ellias, Kamar, and Kastiel's ground-breaking evaluation. None of these suggestions, however, reflect the history of bankruptcy case control, the development of safeguards covering conflicted corporate governance in bankruptcy, and the realities of bankruptcy case administration.

This article applies those lessons to explain why bankruptcy courts should apply the entire fairness standard to evaluate whether bankruptcy directors have cleansing effect. A standardized protocol promotes disclosure while a heightened burden for approval reflects the structural bias endemic to bankruptcy directors' relationship with the insiders who appoint them and the risk they pose to creditors.

---

[*] Associate Professor, University of South Dakota Knudson School of Law. I owe special thanks to Alexandra Dugan, Ralph Brubaker, Jared Ellias, Bruce Markell, and Daniel Waxman, as well as participants at the Florida State University Business Review's Perspectives in Bankruptcy Law Symposium. Jenna Riedel provided excellent research assistance. Any errors are my own.

Introduction

A new character has recently entered the bankruptcy ecosystem, bankruptcy directors. They are appointed on the eve of bankruptcy to serve as independent directors negotiating on behalf of the debtor; they cleanse what would otherwise be conflicted settlements and transactions. Bankruptcy directors' cozy relationship with equity holders who arrange their appointment and then sit on the other side of the bargaining table is controversial. At least five proposals from four different types of commentators (law professors, senators, practitioners, and judges) exist for handling how bankruptcy directors' appointment, roles, and powers vis-a-vis other stakeholders.[1]

This article suggests applying the entire fairness doctrine to evaluate whether bankruptcy directors cleanse the debtor's decisions of conflicts. Bankruptcy directors should be classified as neutral actors only when they are selected by a fair process and the appropriate persons are chosen. The process would include a form questionnaire created by the United States Trustee's office. The completed questionnaire should identify the relevant connections between the bankruptcy director and other parties, including the equity holders and the debtor's law firm. Any party in interest can object. If the bankruptcy court does not find that the debtor has satisfied the entire fairness standard, the bankruptcy directors will not have a cleansing effect. If the bankruptcy directors' appointment process satisfies the entire fairness standard, their approval of transactions and settlements will be given deference. The heightened burden imposed by entire fairness is appropriate because bankruptcy directors are prone to structural bias and they have been associated with lower recoveries for creditors.

This article's contribution is to examine the debate over bankruptcy directors through the lens of bankruptcy law's historic struggles with

---

*Associate Professor, University of South Dakota Knudson School of Law.

[1] Justin Ellis & Ryan Yeh, *A Better Guard for the Henhouse: Should Creditors' Committees Control Estate Litigation?*, 40 YALE J. ON REG. BULL. 1, 7 (2022); Jared A. Ellias Ehud Kamar, and Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. 1083 (2022); *Warren, Baldwin, Brown, Pocan, Jayapal, Colleagues Reintroduce Bold Legislation to Fundamentally Reform the Private Equity Industry*, ELIZABETH WARREN (Oct. 20, 2021), https://www.warren.senate.gov/newsroom/press-releases/warren-baldwin-brown-pocan-jayapal-colleagues-reintroduce-bold-legislation-to-fundamentally-reform-the-private-equity-industry. Kenneth Rosen, Howard Brownstein, and Philip Gross, *Avoiding Independent Director Challenges In Ch. 11 Litigation* Law360, July 13, 2021 https://plus.lexis.com/newsstand/law360/article/1401938; *In re Mountain Express Oil Co.*, 23-90147 [hearing audio] [Dkt No. 460]; *see also* Independent Directors, Creditors Rights Coalition, April 13, 2022 https://creditorcoalition.org/independent-directors/.

conflicted corporate governance, informed by two recent cases that emphasize the need for a formal practice and show how this article's proposal could be applied. This article's framework for analyzing bankruptcy directors is rooted in the fact that while bankruptcy directors are new, the policy stakes here are not.

A bankruptcy case's trajectory is commonly a function of who controls the bankruptcy case.[2] When the statutory framework is flexible, market capacities and capital structures matter more and parties with leverage are positioned to seize control. When the statutory framework prioritizes fairness, mandatory rules and the actors they empower take center stage. One of the primary ways case control manifests is the identity of the people or entities who dominate the debtor's corporate governance. A subcategory reflects the allocation of control over discrete transactions where a conflict of interest exists.

Insider corporate governance and symbiotic control rights were a feature (or a bug) of the common law equity receiverships era and the initial codification of reorganization procedure under the 1898 Bankruptcy Act.[3] Investment bankers allied with management controlled the receivership process and installed former officers as receivers.[4] Given former officers' natural reluctance to investigate their own wrongdoing, courts appointed independent co-receivers to investigate insiders.[5] Co-receivers' role strongly resembles today's bankruptcy directors. Indeed, the critiques of their appointment process and unwillingness to aggressively investigate management present strong modern parallels.[6]

Responding to the chorus for reform, Congress enacted Chapter X of the Chandler Act, which replaced the receiver and debtor-in-possession ("DIP") model with a "mandatory" appointed trustee model in large cases.[7] Even sympathetic commentators, however, admitted that the process was too

---

[2] Recent literature has identified market capacities, capital structures, and statutory framework as affecting case control. Professor Roe ascribes the changes to market capacities and capital structures, *see* Mark J. Roe, *Three Ages of Bankruptcy*, 7 HARV. BUS. L. REV. 187, 188 (2017), while Professor Lubben pinpoints the statutory regimes. *See* Stephen J. Lubben, *Fairness and Flexibility: Understanding Corporate Bankruptcy's Arc*, 23 U. PA. J. BUS. L. 132 (2020). I do not intend to pick a side in this article (both have merit).

[3] For a critic's perspective on the similarities between practice under the equity receivership regime and the initial codification of Section 77 of the 1898 Bankruptcy Act, consider Max Lowenthal, *The Railroad Reorganization Act*, 47 HARV. L. REV. 18, 28 (1933).

[4] Jerome Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 VA. L. REV. 541, 554 (1933).

[5] *See infra* note 67.

[6] *See infra* note 73 and text accompanying.

[7] *See infra* note 100.

lengthy, too expensive, and too failure-prone.[8]

Recognizing the shortcomings of the Chandler Act, the Bankruptcy Code incorporated a default DIP model.[9] Judges realized the need for further oversight and more searching inquiry when conflicts of interest arose. They impose the entire fairness standard and grant derivative standing to dissuade management from trying to evade liability or grant sweetheart deals to insiders.[10]

Freed by the return to flexibility brought by the Bankruptcy Code's enactment, the three paradigms of corporate control during the Bankruptcy Code era reflected changes to market capacities and capital structures. At first, entrenched management retained power as creditors were unable to exert pressure.[11] Lenders then struck back using their blanket liens as swords to impose preferred case trajectories as consideration for providing DIP financing.[12] Lately, the locus of control and associated governance has shifted to Sponsors as portfolio company debtors become ubiquitous and Sponsors leverage their unified control of management and equity.[13]

Sponsors' corporate control presents a challenge when they negotiate with a portfolio company debtor over a transaction or a settlement: they are on both sides of the deal. The entire fairness inquiry will apply to a proposed transaction,[14] while an official committee of unsecured creditors ("Committee") may obtain derivative standing to prosecute the debtor's

---

[8] Lubben, *supra* note 2, at 167; Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1403 n.179 (2007).

[9] 11 U.S.C. § 1104.

[10] *See* Daniel J. Carragher, *Sales to Insiders: Are They Entirely Fair?,* AM. BANKR. INST. J., November 2010, at 52; Alan R. Lepene & Sean A. Gordon, *The Case for Derivative Standing in Chapter 11: "It's the Plain Meaning, Stupid,"* 11 AM. BANKR. INST. L. REV. 313, 318 (2003).

[11] Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporate Reorganization,* 90 U. Chi. L. Rev. 1, 7 (2022).

[12] *See, e.g.*, Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2021); Charles J. Tabb, *What's Wrong With Chapter 11?*, 71 SYRACUSE L. REV. 557 (2021); Oscar Couwenberg & Stephen J. Lubben, *Private Benefits Without Control? Modern Chapter 11 and the Market for Corporate Control*, 13 BROOK. J. CORP. FIN. & COM. L. 145 (2018); Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014); Melissa B. Jacoby, Corporate Bankruptcy Hybridity, 166 U. PA. L. REV. 1715 (2018); Jonathan C. Lipson, *Controlling Creditor Control: Jevic and the End (?) of LifeCare*, 27 NORTON J. BANKR. L. & PRAC. 563 (2018); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 925 (2003).

[13] Buccola, *supra* note 11, at 7.

[14] *In re* LATAM Airlines Grp. S.A., No. 20-11254 (JLG), 2022 WL 272167, at *14 (Bankr. S.D.N.Y. Jan. 28, 2022) (citing cases).

claims against the sponsor.[15] The Sponsor's control is at risk.

Sponsors have responded by arranging the appointment of bankruptcy directors who are then delegated the authority to act on behalf of the portfolio company in its dealings with the Sponsor.[16] Because courts have classified bankruptcy directors as independent, the associated inquiries into their decisions are less searching. The alternative and deferential business justification standard may apply, while a director's very presence suggests a fair decision-making process supporting approval.[17] Bankruptcy directors have even been able to usurp the Committee's traditional investigative role and short-circuit derivative standing.[18]

Bankruptcy directors' independence, however, is not unquestioned. Bankruptcy directors are appointed by the debtor's management, who is controlled by the Sponsor; the usual counter-party or beneficiary of the transactions or settlement evaluated by the bankruptcy directors.[19] Based on the repeated appointments and durable connections to Sponsors, some have suggested that bankruptcy directors are structurally biased - too close to Sponsors to be classified as independent.[20] Professors Ellias, Kamar, and Kastiel have also found a correlation between bankruptcy director appointments and lower creditor recoveries.[21] One interpretation is that bankruptcy director retentions allow insiders to retain more value at the expense of other stakeholders.[22] Paralleling the end of the equity receivership era, calls for reform are again ringing loudly. Highlighting the gravity of this issue, at least five proposals have been made. Yet, each alternative has an obvious weakness highlighted by the evolution of bankruptcy's treatment of conflicts of interest and control rights and the reality of bankruptcy practice.

Professors Ellias, Kamar, and Kastiel proposed that courts adopt a procedure allowing creditors affected by the conflicted transaction to vote on

---

[15] Lepene & Gordon, *supra* note 10 at 317-18.

[16] Ellias *et al*., *supra* note 1 at 1136.

[17] The deference manifests as either applying the business justification standard, *see In re* Sears Holdings Corporation, Case No. 18-23538 (Bankr. S.D.N.Y. Feb. 8, 2019) [Dkt Entry No. 2507] (applying business justification standard to sale to insiders negotiated by bankruptcy directors and overruling objections by Committee, among others) or the judge heavily weigh the use of the bankruptcy directors in favor of approving the proposed settlement or transaction. *See* Performance Power Sports

[18] *See* Ellias *et al.*, *supra* note 1, at 1099-1110 (2022)(describing successful attempts to obtain approval of settlements negotiated between bankruptcy directors and Sponsors over Committee objections in the Payless and Neiman Marcus cases).

[19] Ellias *et al.*, *supra* note 1 (coining term "bankruptcy directors").

[20] *Id.* at 1130.

[21] Ellias *et. al*., *supra* note 1, at 1122 &1129.

[22] *Id*. at 1122. A lower settlement or a release results in the Sponsor retaining money at the expense of creditors.

whether the bankruptcy directors should be considered independent.[23] Operationalizing their proposed protocol will be challenging. The identity of the impacted stakeholders can be uncertain as the proposed voting occurs early in the case when valuation is a moving target and the claim and lien reconciliation process have not yet begun.[24] An electoral process also adds significant complexity and it is unlikely to improve the quantity or quality of participation.[25]

Messrs. Ellis and Yeh suggest more liberal appointment of chapter 11 trustees and examiners and note the possibility of the bankruptcy judge selecting the bankruptcy directors.[26] Creditors have generally shunned court-appointed fiduciaries.[27] Examiner and trustee appointments remain rare.[28] Stakeholders naturally prefer to control the litigation of conflicted claims and transactions.

Senator Warren has proposed that the Committee should have the exclusive standing to pursue claims against insiders, including Sponsors.[29] Ignoring the capital structure and the identity of the fulcrum security can create inefficiencies.[30] It is the fulcrum creditors whose money is at stake in conflicted transactions.[31] Why should the Committee automatically enjoy power in excess of what they have traditionally possessed, when the Committee's constituents are often out of the money?

Former Bankruptcy Judge Jones and Messrs. Rosen, Brownstein, and Gross have separately made disclosure-focused proposals. Judge Jones suggested that bankruptcy directors' appointments should be evaluated as an "outside the ordinary course of business" transaction early in the case, which

---

[23] *Id.* at 1130.

[24] *See infra* notes 263 & 264 and text accompanying.

[25] *See infra* note 270 and text accompanying.

[26] Ellis & Yeh, *supra* note 20, at 11.

[27] John Wm. Butler, Jr. *et al.*, *Preserving State Corporate Governance Law in Chapter 11: Maximizing Value Through Traditional Fiduciaries*, 18 AM. BANKR. INST. L. REV. 337, 360 (2010).

[28] *See* Jonathan C. Lipson, *Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies*, 84 AM. BANKR. L.J. 1, 4 (2010).

[29] *Warren, Baldwin, Brown, Pocan, Jayapal, supra* note 1.

[30] *See* Josef S. Athanas *et al.*, *Bankruptcy Needs to Get Its Priorities Straight: A Proposal for Limiting the Leverage of Unsecured Creditors' Committees When Unsecured Creditors Are "Out-of-the-Money"*, 26 AM. BANKR. INST. L. REV. 93, 105-06 (2018)(suggesting that even though Committees and their constituents may be "out-of-the-money" based on the debtors' capital structure compared to its value, Committee's may leverage their hold-up power to obtain payment of professional fees and settlement distributions in excess of what constituents would obtain under the absolute priority rule).

[31] Christopher W. Frost, *Secured Credit and Effective Entity Priority*, 51 CONN. L. REV. 575, 621 (2019).

would allow affected parties to assess and contest the appointment.[32] Messrs. Rosen, Brownstein, and Gross propose targeted disclosure requirements to allow evaluation of independence.[33] Disclosure is certainly important, but making it the sole focus does not reflect the empirical findings of lower creditor recoveries. The risks are real and a higher burden is appropriate.

This article suggests a workable alternative that reflects the historical lessons of case control as well as conflicted corporate governance. The appointment of bankruptcy directors must meet the entire fairness standard – fair selection process and an appropriate person chosen – in order for their decisions to have a cleansing effect. Indeed, it is the use of this standard that distinguishes my proposal from the disclosure-focused recommendations. If the bankruptcy court does not find that the debtor has satisfied the entire fairness standard, the bankruptcy directors will not have a cleansing effect: the traditional standard for granting derivative standing would apply while the entire fairness standard will govern the transaction. Most importantly, fulcrum security holders and other stakeholders will have a real voice in whether bankruptcy directors' decisions should be granted deference.

In the first section, this Article will examine the evolution of bankruptcy control rights and the subcategory of discrete conflicted claims and transactions. The second section introduces bankruptcy directors. The third section summarizes and evaluates the five proposals for handling whether bankruptcy directors should be deemed neutral actors. The last section explains this Article's proposal and animates it using two recent bankruptcy director cases.

I. Historical Development of Case Control Paradigms and Treatment of Discrete Conflicted Claims and Transactions

Bankruptcy directors did not develop in a vacuum. Their rise can be traced to changes in case control paradigms that are the product of the statutory scheme, capital structures, and market capacities, plus the related treatment of conflicted claims and transactions.[34] This section is divided into three parts, one for each of the major eras, the equity receivership era, the Chandler Act era, and the Bankruptcy Code era. The treatment of discrete conflicted transactions and claims, including the development of derivative standing and the entire fairness standard, is interwoven throughout the section.

---

[32] *In re Mountain Express Oil Co.*, 23-90147 [hearing audio] [Dkt No. 460].
[33] Rosen *et al*, supra note 1.
[34] *See supra* note 2.

A. The Equity Receivership Era

During the initial era of corporate restructuring, investment bankers and management leveraged an ultra-flexible equity receivership regime to retain control rights.[35] Yet, when strong claims existed against management, it would be inappropriate for the same managers to oversee the investigation and litigation.[36] Enter the independent co-receiver, the predecessor to the bankruptcy director.[37] Just as in the case of today's bankruptcy directors, reformers strongly criticized the role and effect of co-receivers.[38]

Equity receivership procedure reflected the going-concern premium and capital structure of the archetypal debtor, the railroad.[39] Loans were secured on particular tracts, which lenders could individually foreclose upon following default.[40] The remedy was illusory as the collateral had little value unless the railroad continued to operate as a unit.[41] Yet, capital markets were too immature to support the sale of the whole railroad to a third-party[42] and no formal statutory scheme existed to facilitate a reorganization.[43] The solution was the equity receivership.

In the equity receivership context, the parties who sought to retain control during and after the restructuring were the railroad's management and the investment bankers who had arranged the issuance of the secured debt.[44] Managers' experience and expertise were necessary to operate the railroad

---

[35] *See infra* notes 52-59.

[36] *See infra* note 66.

[37] *See infra* notes 67-72.

[38] *See infra* notes 73-75.

[39] David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1356 (1998).

[40] *Id.*

[41] *Id.* Moreover, railroads were also too systemically important to the American economy for them to fail. Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420, 1441 (2004). The public importance of railroads was further recognized by the enactment of a separate subchapter of chapter 11 of the Bankruptcy Code. Robert W. Miller, *A New Bankruptcy Subchapter for Institutions of Higher Education: A Path but not a Destiny*, 97 AM. BANKR. L.J. 313, 373-74 (discussing enactment of subchapter IV of the Bankruptcy Code).

[42] Roe, *supra* note 2, at 195 (neither strategic nor financial buyers generally existed); Frank, *supra* note 4, at 554.

[43] Lubben, *supra* note 41, at 1440 (noting that prior to the enactment of Section 77 of the Bankruptcy Act of 1898 in 1933, federal corporate bankruptcy statutes either did not exist or could not be used to reorganize railroads).

[44] Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 Va. L. Rev. 921, 929 (2001); E. Merrick Dodd, Jr., *Reorganization Through Bankruptcy: A Remedy for What*?, 48 HARV. L. REV. 1100, 1104 (1935).

within the byzantine rail networks.[45] The investment bankers played a coordinating role.[46] Having originally underwritten the railroad's debt issuances, they were the natural party to serve as agents in negotiating a comprehensive restructuring.[47]

Even though the equity receivership was formally a sale, it was functionally a balance sheet recapitalization using the contemporarily available legal tools, the receivership and the foreclosure.[48] A friendly creditor would petition the court for appointment of a receiver "to gather the railroad's assets, receive its revenue, and operate its business."[49] Shortly thereafter, the corporation would file an answer consenting to the receiver's appointment.[50] A foreclosure suit would also be initiated, but it would be paused to facilitate formulation of a restructuring plan by the receiver and the investment bankers.[51]

Managers and investment bankers used the flexibility inherent in the receivership process to retain control. Secured creditors, who were organized as protective committees guided by the investment bankers, would agree upon a plan of reorganization creating a new capital structure, which often favored the secured creditors interests.[52] The protective committees would then combine to form a reorganization committee that collectively represented the consenting creditors.[53] If no creditors objected to the plan, the foreclosure was dismissed and the parties were bound to the new capital structure by contract, including any distributions to managers on account of

---

[45] Baird & Rasmussen, *supra* note 44, at 929-30. If the management was truly rotten, the investment bankers would force a replacement, but this happened rarely. *Id.*

[46] *Id.*; *Formulation of A Plan Under Section 77*, 47 YALE L.J. 247, 249 (1937); Max Lowenthal, THE INVESTOR PAYS, 77-78 (1933).

[47] The investment bankers were motivated by the importance of relationships with bondholders and the potential for future engagements. Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593, 604 (2017); Thomas E. Plank, *Bankruptcy Professionals, Debtor Dominance, and the Future of Bankruptcy: A Review and a Rhapsody on a Theme, Debt's Dominion: A History of Bankruptcy Law in America*. David A. Skeel, Jr., Princeton University Press, 281 Pp. (2001), 18 BANKR. DEV. J. 337, 341 (2002).

[48] *Id.*

[49] Roe, *supra* note 2, at 194. The artifice of friendly creditor initiation was necessary because the receivership is a creditor's remedy.

[50] Lubben, *supra* note 2, at 148. The debtor would also admit the validity of the debt and its inability to pay it, which allowed the court to move directly to the remedy stage and appoint the receiver. *Id.*

[51] Plank, *supra* note 47, at 341. An injunction, functioning like the modern automatic stay, maintained the status quo and provided breathing space for negotiations. *Id.*

[52] *See* William W. Bratton & David A. Skeel, Jr., *Bankruptcy's New and Old Frontiers*, 166 U. PA. L. REV. 1571, 1574 (2018).

[53] *Formulation*, *supra* note 46 at 249.

their equity.[54] When dissenters refused to consent to the plan, the reorganization committee pressed their foreclosure rights and the reorganization managers credit bid the value of the secured debt at the judicial sale.[55] Because third-parties would need to pay cash, the reorganization committee was almost always the only and highest bidder.[56] The protective committee would distribute the new securities pursuant to the plan of reorganization in general order of priority.[57] The rights of unsecured creditors were usually cut off,[58] while equity holders (including managers) could participate in the reorganized railroad if they contributed new value to help fund working capital.[59]

The identity of the receiver was critical and the appointment provided an opportunity to scrutinize current management and determine whether they should retain control during and after the reorganization.[60] Indeed, if management lost control, it was less likely they would be included as new equity in the post-reorganization capital structure because their expertise, which was their source of leverage, had been replaced.[61] In response to the risk of losing their control, the debtor's management commonly colluded with the investment bankers to appoint an "insider" receiver, who had previously served as an officer of the debtor.[62] Although the receiver possessed experience and an understanding of the debtor's business, he[63] was aligned with management's goals – namely a balance sheet restructuring where equity (including management) retained an interest and control of corporate governance while the bond debt was restructured.[64] As one

[54] Lubben, *supra* note2, at 151. As Professor Lubben recognizes, this is equivalent to a modern out-of-court workout. *Id.*

[55] Baird & Rasmussen, *supra* note 44, at 931; *see Formulation*, *supra* note 46. For a strong critique, consider Frank, *supra* note 4, at 554-55.

[56] *Id.* at 554.

[57] Baird & Rasmussen, *supra* note 44, at 931.

[58] Frank, *supra* note 4, at 542. This is because there was no value above the bondholders secured claims to distribute to lower priority creditors.

[59] Baird & Rasmussen, *supra* note 44, at 932.

Baird & Rasmussen, *supra* note 44, at 932.

[60] *Mismanagement Claims in Railroad Reorganizations*, 47 YALE L.J. 285 (1937); *see* Lowenthal, *supra* note 46, at 77-78 (likening receivers' powers to a "dictatorship").

[61] *C.f.* Baird & Rasmussen, *supra* note 44, at 932 (noting that management's expertise, along with their willingness to invest new capital, supported their inclusion in the capital structure).

[62] The receivership changed the source of the existing managers' power to run the railroad but not their ability to run it. Baird & Rasmussen, *supra* note 44, at 930; Skeel, *supra* note 39, at 1357.

[63] In that era, it was invariably a man.

[64] Baird & Rasmussen, *supra* note 44, at 931-32.

commentator put it, "corporate officials who have been appointed receivers in equity tend to think of themselves as corporate executives still, rather than loyal servants of the court which appointed them."[65] This cozy arrangement appeared unseemly when obvious claims existed against management or professionals.[66]

To provide a veneer of fairness and independence, investment bankers and management often requested the appointment of an outside, independent co-receiver.[67] Reformers were nonplussed and consistently complained that these co-receivers provided little oversight and were unwilling to actively investigate alleged misdeeds.[68] Indeed, their concerns started with the appointment process itself, which they described as akin to "political patronage."[69] Although the receivership judge would select the independent co-receiver, the company would also have a say. Prior to a receivership filing, the investment bankers' lawyers interviewed the potentially presiding federal judge to ascertain not only whether he would be available to entertain the receivership petition, but also to obtain the judge's perspective on proposed insider receivers and who the judge may propose as a co-receiver.[70] If the judge's proposed selection of a co-receiver was unsatisfactory, a different judge could be interviewed.[71] Judges (and indirectly investment bankers' counsel) would repeatedly select the same co-receivers who (like bankruptcy directors) might even have more than one remit at a time.[72]

The repeated appointments were (and in the context bankruptcy

---

[65] Dodd, *supra* note 44, at 1114.

[66] Lubben, *supra* note 2, at 162; Alfred B. Teton, *Reorganization Revised*, 48 YALE L.J. 573, 580 (1939).

[67] Lubben, *supra* note 41, at 1442; *Mismanagement*, *supra* note 60, at 286; Lowenthal, *supra* note 3, at 28; Lowenthal, *supra* note 46, at 116 and 120; Paul D. Cravath, *The Reorganization of Corporations, in Some Legal Phases of Corporate Financing, Reorganization and Regulation*, at 153, 160 (1917) (noting that co-receiver appointments were the regular practice in the Southern District of New York).

[68] *Mismanagement*, *supra* note 60, at 286. Control would remain in the hands of the old régime. Lowenthal, *supra* note 3, at 28.

[69] *Id.*

[70] Lowenthal, *supra* note 46, at 116-17 (noting testimony by a debtor-lawyer that the pre-filing interview was common practice); *see* Harkin v. Brundage, 276 U.S. 36, 55, 7 (1928). ("Circumstances which should have no influence lead the parties in interest to prefer one court to another in the selection of the person to be appointed as receiver, with the hope on behalf of those in charge of the embarrassed corporation that the appointment may fall to one whose conduct will be in sympathy with, rather than antagonistic to, the previous management of the corporation, in the hands of which the embarrassment has arisen.).

[71] Lowenthal, *supra* note 3, at 28.

[72] Lowenthal, *supra* note 46 at 125-26 (describing Judge Wilkerson's (S.D.N.Y) repeated appointment of Mr. Brundage as a co-receiver, including in the case of Harkin v. Brundage, 276 U.S. 36, 42 (1928)).

directors are) concerning and suggest structural bias. Indeed, the use of the term patronage could easily have appeared in Professors Ellias, Kamar, and Kastiel's description of the appointment process for bankruptcy directors.[73] As one commentator described, the co-receiver was:

> a merely formal position; his reputation lent dignity to the receivership, but the scope of his activity was narrowly circumscribed. He had little personal knowledge of the corporation's affairs, and in view of the friendly nature of the proceedings, it is probable that he did not feel bound to conduct an inquiry into any but the most flagrant abuses, for the attendant publicity would have impeded reorganization by destroying the faith of the security-holders.[74]

Consistent with investment bankers' pro-manager bent, the protective committees they controlled often failed to support vigorous investigations because they valued the continuity of management and the investigation cost could easily outstrip the recovery.[75]

In 1933 and 1934, Congress made an initial attempt to codify and reform equity receivership practices, but managers' and investment bankers' control persisted.[76] The debtor could initiate a voluntary proceeding and the debtor's management would remain in possession unless a trustee was appointed.[77] Consistent with the co-receiver model, a corporate officer could be appointed as a trustee, so long as an outside co-trustee was also appointed.[78] The cumulative result was that "the position of the management [was] considerably strengthened."[79] The statute also simplified the

---

[73] Other commentators have applied this descriptor to independent directors who are repeatedly appointed outside of bankruptcy by the same owner. *See* Da Lin, *Beyond Beholden*, 44 J. CORP. L. 515 (2019).

[74] *Mismanagement*, *supra* note 60, at 286.

[75] Roger S. Foster, *Conflicting Ideals for Reorganization*, 44 YALE L.J. 923, 960 n.6 (1935).

[76] Act of June 7, 1934, ch. 424, 48 Stat. 211 (1934); Act of March 3, 1933, ch. 204, 47 Stat. 1474 (1933).

[77] Benjamin Wham, *Chapter X of The Chandler Act: A Study In Reconciliation Of Conflicting Views*, 26 VA. L. REV. 389, 390 (1939); Dodd, *supra* note 44, at 1113.

[78] *Mismanagement*, *supra* note 60, at 286 (if the railroad's operating revenues were less than $1,000,000 per year, the independent trustee was not required.). § 77 c (1).

[79] Joseph L. Weiner, *Corporate Reorganization: Section 77B of the Bankruptcy Act*, 34

restructuring process by discarding the fiction of the foreclosure sale and allowing plan approval by a majority of creditors to bind dissenters.[80] In sum, reorganization became easier, but insiders and investment bankers remained in control.[81] Reformers viewed this as a step backwards further entrenching management and insulating insiders from scrutiny.[82]

B. Origins of Creditor Derivative Standing

As equity receivership practice matured, derivative standing became an option for creditors to take control of discrete causes of action.[83] This was an important development because, as outlined in the previous subsection, management's retention of control in equity receiverships could create conflicts of interest over claims against those same managers.[84] Derivative standing allows a party to step into the estate's (bankruptcy or receivership) shoes and prosecute an action on the estate's behalf.[85]

The right to bring a derivative action, however, was (and still is) subject to the court's common law gatekeeping function.[86] Unless the trustee or receiver consented, a stakeholder is required to obtain court approval for derivative standing.[87] Requiring authorization safeguards against frivolous or duplicative claims.[88] Since the doctrine originated, derivative standing has been "rooted in equity, and not any specific statutory provision."[89]

COLUM. L. REV. 1173, 1194 (1934).

[80] Other "hocus-pocus" eliminated by the Chandler Act's enactment, included the need for the friendly creditor's bill and the necessity of ancillary receiverships. Wham, *supra* note 77, at 390.

[81] *Id.*

[82] Dodd, *supra* note 44, at 1114; Lowenthal, *supra* note 3, at 28 ("The new Act permits a return to the earlier procedure of leaving control of the property, pending its reorganization, exclusively in the old régime."); *see also* Lubben, *supra* note 2, 156 (characterizing the codification of receivership practice as the second high point of flexibility during the equity receivership era).

[83] Derivative standing was recognized as early as 1900. Chatfield v. O'Dwyer, 101 F. 797, 799 (8th Cir. 1900). Creditor derivative standing should not be confused with a traditional shareholder derivative suit. As Professor Bussel explained, "the resemblance is superficial at best." Daniel J. Bussel, *Creditors' Committees As Estate Representatives in Bankruptcy Litigation*, 10 STAN. J.L. BUS. & FIN. 28, 34 (2004).

[84] *See supra* note 66.

[85] *Id.*

[86] *In re* Roadarmour, 177 F. 379, 381 (6th Cir. 1910).

[87] *In re* Eureka Upholstering Co., Inc., 48 F.2d 95, 96 (2d Cir. 1931).

[88] *In re* Roadarmour, 177 F. 379 at 381; *see also* Fred Reuping Leather Co. v. Fort Greene Nat. Bank of Brooklyn, 102 F.2d 372, 373 (3d Cir. 1939).

[89] Lepene & Gordon, *supra* note 15, at 318; *see* Glenny v. Langdon, 98 U.S. 20, 26 (1878) ("[a]uthority for a creditor to bring suit to recover the property or rights of property

Although many of the early cases derived (pun intended) from the estate lacking sufficient funds and a creditor filling the void,[90] some derivative suits resulted from conflicts of interests between the trustee or receiver and the estate.[91] The paucity of conflict of interest opinions may reflect a number of factors: creditor reluctance to pursue suits, deference to co-receivers, fewer viable claims, or some combination.[92] In any event, by the time Congress codified the equity receivership practices, courts widely recognized derivative standing,[93] but reformers continued to press for mandatory appointment of independent trustees.[94]

Critics of equity receiverships obtained a platform for their reform efforts when Congress ordered the SEC to study how reorganizations contributed to the Great Depression.[95] Led by future Supreme Court justices William O. Douglas and Abe Fortas, the SEC produced a voluminous report (verging on an advocacy piece) detailing the perceived shortcomings of equity receivership practice.[96] The SEC's report's upshot was that management and investment bankers thrived at the expense of outside creditors, which exacerbated business instability and diminished creditor recoveries.[97]

C. Chandler Act Reform

The momentum created by the SEC's report manifested as the enactment of Chapters X and XI.[98] The deals that were a perceived bug of

of the bankrupt, under any circumstances, is certainly not given in the Bankruptcy Act [of 1878] ...; but the argument is that it is founded upon the enlarged principles of equity ....").

[90] *In re* Kenny, 269 F. 54, 54 (W.D. Pa. 1920).

[91] *In re* Stern, 144 F. 956, 959 (8th Cir. 1906) (derivative standing allowed for claim objection when trustee had conflict of interest arising from prior representation of creditor).

[92] The availability of derivative suits also likely had a knock-on effect of persuading estate fiduciaries to bring claims against management who might have otherwise been reluctant. *See Mismanagement*, *supra* note 60, at 287 (noting creditor pressure resulted in the bankruptcy court ordering a trustee to bring claims in the Missouri Pacific bankruptcy case).

[93] Bussel, *supra* note 83, at 28 n.1.

[94] *Mismanagement*, *supra* note 60, at 287.

[95] Roe, *supra* note 2, at 195-96.

[96] SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1936-40) [hereinafter SEC Report]; E. Merrick Dodd Jr., *The Securities and Exchange Commission's Reform Program for Bankruptcy Reorganizations*, 38 COLUM. L. REV. 223, 225 (1938).

[97] Roe, *supra* note 2, at 196.

[98] Lubben, *supra* note 2, at 159, 161. Section 77B was also repealed, while Section 77 was amended. *Id.*

equity receiverships were replaced by independent administrative oversight.[99] The new legislation removed control from management and investment bankers and placed it with trustees and technocrats. No more debtors in possession or insider receivers/trustees; outside independent trustees were appointed in all railroad cases and large reorganization cases with administrative agencies (ICC for railroads and the SEC for non-railroads) playing a supervisory role.[100] The bankruptcy judge also enhanced responsibilities, particularly in the confirmation process – "the judge was *not* to defer to the bankruptcy deal."[101] "In essence, insiders were replaced with three experts: the judge, the trustee, and the Securities and Exchange Commission."[102]

Conflict of interest issues were front of mind in making these seismic changes.[103] As one reformer put it:

> One of the sinister features of management control of property in reorganization was the management's ability to forestall any investigation into its past record to determine whether or not any claims existed against the old officers or their associates, and to ascertain generally the management's fitness to be retained in office.[104]

Independent investigations of potential claims against insiders by the SEC and the trustee were viewed as necessary.[105] As the Supreme Court put

---

[99] As two reform champions pronounced: "Chapter X is in every way an improvement upon its predecessors, the equity receivership and the Section 77B proceeding. Its ritual is more complex and impressive, its substance more satisfying, its promise of protection to investors more emphatic." Eugene V. Rostow & Lloyd N. Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334 (1939).

[100] Lubben, *supra* note , at 160, 162. The SEC's review of the reorganization plan was mandatory, Chandler Act, §§ 172-73, 52 Stat. 840. while the ICC's approval of the reorganization plan was required. Bankruptcy Act of 1898, § 77(d).

[101] Roe, *supra* note 2, at 196 (emphasis in text).

[102] Lubben, *supra* note 2, at 163.

[103] The SEC Report suggested that an independent trustee should undertake the investigation with the objective "of disclosing and diligently pursuing corporate assets in the form of claims against directors, officers, their affiliated interests and others who may have misused corporate control for their personal benefit." *SEC Report*, *supra* note 96.

[104] Teton, *supra* note 66, at 580.

[105] The trustee's duties included "examining the debtor's prefiling management team, deciding whether the firm had been mismanaged or whether managers had engaged in fraud, and investigating other financial or operational irregularities" Myron N. Krotinger,

it "a debtor in possession cannot be expected to investigate itself."[106] Consistent with Chapter X's theme of protecting investors through expert oversight, reformers considered these independent investigations far superior to derivative actions.[107] Even in smaller Chapter X cases[108] where a debtor remained in possession, it was intended that an independent examiner would administer the estate's claims, especially those against insiders.[109]

Concurrently with Chapter X, Congress enacted Chapter XI, which established a framework for the reorganization of smaller firms. Among the features that distinguished it from Chapter X were: (i) only unsecured debts could be coercively modified,[110] (ii) the debtor would remain in possession post-petition,[111] and (iii) no investigation into the debtor's financial distress, including mismanagement, was required.[112] The bankruptcy referee would appoint a trustee only under limited circumstances, such as gross mismanagement or rampant self-dealing.[113] An examiner could be appointed to handle discrete functions like an investigation of old management.[114]

Both Chapters X and XI contemplated committees, albeit with differing roles.[115] Reflecting reformers' skepticism of investment bankers' control over creditors' committees, Chapter X Committees were not "official" and as a result, generally served an information dissemination function and did not have standing in the case.[116] In contrast, Chapter XI

Management and Allocation of Voting Power in Corporate Reorganizations, 41 COLUM. L. REV. 646, 651 (1941) (citing Section 167(3) of the Chandler Act).

[106] Sec. & Exch. Comm'n v. Am. Trailer Rentals Co., 379 U.S. 594, 617 (1965).

[107] Krotinger, *supra* note 105, at 653 n.38.

[108] Cases with less than $250,000 of liabilities. [add cite]

[109] Section 216(13) of the Chandler Act; Krotinger, *supra* note 105, at 654. Records of examiner action are sparse. Professor Bussel has suggested this likely reflects the abundance of gatekeepers for larger cases, which presumably could better support the additional fees. Daniel J. Bussel*, A Third Way: Examiners As Inquisitors*, 90 AM. BANKR. L.J. 59, 77 (2016).

[110] *In re* Peoples Loan & Inv. Co., 410 F.2d 851, 856 (8th Cir. 1969); *see* Sec. & Exch. Comm'n v. U.S. Realty & Imp. Co., 310 U.S. 434, 456 (1940) (Chapter X, as opposed to Chapter XI, could permit "some re-arrangement of [the debtor's] capital structure").

[111] Chandler Act § 342.

[112] *See* H.R. Rep. No. 95-595, at 233 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6182 ("[F]or a small business there was felt to be no need for a trustee to investigate the affairs of the debtor....").

[113] *In re* Pioneer Warehouse Corp., 2 B.R. 1, 14 (Bankr. E.D.N.Y.).

[114] Wham, *supra* note 77, at 393 (citing Chandler Act § 168).

[115] Michelle M. Harner, *The Search for an Unbiased Fiduciary in Corporate Reorganizations,* 86 NOTRE DAME L. REV. 469, 483 (2011).

[116] *Id.* at 481-83 (detailing reformers' criticisms of protective committees and the resulting limitations in Chapter X). George J. Walsh, *The Creation, Rights, Duties and Compensation of Creditors' Committees Under Chapters X and XI of the Bankruptcy Act*, 40 BROOK. L. REV. 35, 40 (1973). They could informally wield significant power by

Committees possessed standing and provided the primary oversight of the debtor's conduct and the plan process.[117] This role was consistent with debtor's power to modify unsecured creditors' rights.[118] Committees and individual creditors could bring derivative suits under the same common law standard that applied prior to the enactment of Chapters X and XI.[119]

Debtors' management recognized their control rights (and jobs) would be eliminated by a Chapter X filing and they naturally attempted to shoehorn their firms into Chapter XI or delayed the bankruptcy filing as long as possible.[120] The Supreme Court provided a (likely unintended) assist by recognizing a malleable "needs to be served" standard for whether cases should be filed under Chapter X or Chapter XI.[121] Seizing the opening, increasingly large debtors squeezed into Chapter XI.[122]

While champions of Chapter X initially characterized it as "reorganization in the grand manner[,]"[123] by the 1970s it was considered a grand failure.[124] Management resisted filing for bankruptcy until it was too

---

successfully soliciting proxies from bondholders and then voting them en mass. Daniel J. Bussel, *Coalition-Building Through Bankruptcy Creditors'Committees*, 43 U.C.L.A. L. REV. 1547, 1562 (1996) (describing *Woods v. City National Bank & Trust Co*., 312 U.S. 262 (1941)).

[117] Harner, *supra* note 115, at 483. In spite of this gatekeeper role, commentators suggested that "[u]nder Chapter XI of the pre-Code law, creditors' committees played a very limited role." Peter C. Blain & Diane Harrison, *Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers, and Duties*, 73 MARQ. L. REV. 581, 623 (1990).

[118] Yet because the appointment of Committees was discretionary and required self-organization they were the "exception rather than the rule." Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 995, 1000 (1993).

[119] *E.g.*, Dallas Cabana, Inc. v. Hyatt Corp., 441 F.2d 865, 868 & n.10 (5th Cir. 1971)(listing cases).

[120] House Comm. on the Judiciary, Bankruptcy Law Revision, H.R. Rep. No. 595, 95th Cong., 1st Sess. 222, 233-34 (1977).

[121] David A. Skeel, Jr., *Welcome Back, SEC*?, 18 AM. BANKR. INST. L. REV. 573, 589 n.11 (2010)(citing General Stores Corp. v. Shlensky, 350 U.S. 462, 466 (1956)).

[122] Skeel, *supra* note 121, at 589 n. 11. Even amidst allegations of self-dealing, management of Chapter XI debtors could attempt to retain control by agreeing to a bankruptcy court-supervised investigation in lieu of the appointment of a trustee. *In re* Am. Guar. Corp., 221 F. Supp. 961, 967 (D.R.I. 1963). The bankruptcy court would appoint special counsel to undertake the investigation. *In re* Am. Guar. Corp., 246 F. Supp. 322, 325 (D.R.I. 1965).

[123] Rostow & Cutler, *supra* note 99, at 1334.

[124] Perhaps the best evidence of Chapter X's failures is the indirect rewriting of Chapter X through the comprehensive revision of the Bankruptcy Rules in the 1970s. Lubben, *supra* note 2, at 166. Congress's enactment of the one-off Regional Rail Reorganization Act of 1973 to resolve the financial distress of Northeastern railroads was a similar indictment of

late, while the automatic trustee appointment removed management's expertise just when it needed it most.[125] Case outcomes were predictably poor.[126] Critics categorized the delay and costs associated with agency oversight and reporting as another cause of Chapter X's failure.[127] The stage was set for a reversion to flexibility.

D. The Bankruptcy Code

In 1978, Congress enacted the Bankruptcy Code, which consolidated the corporate reorganization chapters into the new Chapter 11.[128] Flexibility returned as Chapter 11 retained the DIP construct used in Chapter XI and jettisoned Chapter X's mandatory appointment of trustees and agency reports.[129] Committees and examiners (in large cases) were intended to provide oversight and a counterweight to management control.[130]

Chapter 11 debtors usually remain in possession because "[a]ppointing a trustee in a Chapter 11 case is an extraordinary remedy, and there is a corresponding strong presumption that the debtor should be permitted to remain in possession."[131] A chapter 11 trustee is only appointed when cause exists, which could be based on management misfeasance or malfeasance, but not case size (a repudiation of the default reason under Chapter X).[132] Trustee appointments remain rare.[133] The prevailing wisdom is that the costs outweigh the benefits because the learning curve for the trustee to operate the business is too steep and the expense (including the statutorily-set trustee compensation) are too high.[134]

Section 77. *Id.* at 169.

[125] Butler, *et. al.*, *supra* note 27, at 340.

[126] Dan J. Schulman, *Business Reorganizations Under Proposed Senate Bill 540*, 3 J. BANKR. L. & PRAC. 265, 269 & n.21 (1994) (citing 124 CONG. REC. S17, 419 (daily ed. Oct. 6, 1978)) (noting that Chapter X reorganizations were successful only 21% of time). This statistic is particularly troubling as Section 363 Sales were not employed.

[127] "Just about everyone other than the SEC thought that removing the SEC from bankruptcy … was a great idea." Skeel, *supra* note 121, at 576.

[128] Lubben, *supra* note 2, at 171; Bussel, *supra* at note 109, 78.

[129] Lubben, *supra* note 2, at 171.

[130] Barry L. Zaretsky, *Trustees and Examiners in Chapter 11*, 44 S.C. L. REV. 907, 944 (1993).

[131] Off. Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel*. Cybergenics Corp. v. Chinery, 330 F.3d 548, 577 (3d Cir. 2003)(internal citations and quotations omitted).

[132] 11 U.S.C. § 1104(a)(1).

[133] Jeffery A. Deller, *Examining the Examiner: Waiver of the Attorney-Client Privilege and the Outer Limits of an Examiner's Powers in Bankruptcy*, 43 DUQ. L. REV. 187, 188 (2005).

[134] *See* Off. Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics

In large cases, Congress intended examiners to investigate management wrongdoing.[135] Examiners generally have exercised the DIP's statutory duty to investigate its financial condition and file a report.[136] Although the Bankruptcy Code authorizes an examiner to perform any other duties of the DIP, the authority of an examiner to act on its investigation and bring an action against insiders has split courts.[137] Sensitive to cost considerations, parties rarely request examiners.[138]

Committees play a similar, if adversarial, role because they must be responsive to their constituents (the unsecured creditors).[139] The Committee's primary tasks include investigating the debtor's financial condition, its acts, its conduct, and its management as well as evaluating significant transactions proposed by the debtor such as DIP financing or a sale of substantially all the debtor's assets (a "363 Sale"[140]).[141] Contrasting an examiner's independent investigation, a committee conducts its investigations and negotiations for the benefit of general unsecured creditors, often to the detriment of other stakeholders.[142] Unlike examiners, Committees are appointed in most large cases.[143] Absent a chapter 11 trustee or examiner appointment, the Committee usually takes a leading role in investigating insider misconduct claims.

The return of the DIP concept heralded the increasing importance of derivative standing as debtors remained unwilling to bring claims against their current officers and directors or other insiders.[144] The relative

---

Corp. v. Chinery, 330 F.3d 548 at 577; Klee & Shaffer, *supra* note 118, at 1045, 1049.

[135] 11 U.S.C. § 1104(c). 124 CONG. REC. S17403-34 daily ed., Oct. 6, 1978 (statement of Senator DeConcini).

[136] Bussel, *supra* note 109, at 80.

[137] Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp.(*In re* W.R. Grace & Co.), 285 B.R. 148, 156-57 (Bankr. D. Del. 2002)(finding that authorizing an examiner has standing to act as a party is not appropriate but listing other precedent that so authorized).

[138] Lipson, *supra* note 28, at 4 (an examiner appointment was requested in only 15% of a sample of large 576 chapter 11 public entity cases between 1991 and 2007).

[139] Bussel*, supra* note 109 at 77.

[140] Named after the operative provision of the Bankruptcy Code, 11 U.S.C. § 363.

[141] 11 U.S.C. § 1103(c)(2).

[142] Bussel*, supra* note 109 at 77.

[143] Stephen J. Lubben, *The Types of Chapter 11 Cases*, 84 AM. BANKR. L.J. 233, 242 (2010). To encourage the formation and active role of Committees, Congress required that the fees and expenses of the Committee's court-approved professionals be paid by the chapter 11 estate. Christopher S. Sontchi & Bruce Grohsgal, *Should the Appointment of an Unsecured Creditors' Committee Be Made Optional in Chapter 11?*, AM. BANKR. INST. J., 12 (Nov. 2019).

[144] *E.g.*, *In re* Monsour Med. Ctr., 5 B.R. 715, 716 (Bankr. W.D. Pa. 1980); *In re* Chem. Separations Corp., 32 B.R. 816, 819 (Bankr. E.D. Tenn. 1983).

popularity of derivative standing compared to chapter 11 trustee appointments is the product of the view that derivative standing is a compromise when appointing a trustee to administer the entire case would be "too harsh," but viable claims exist.[145] The Committee is usually the party that requests derivative standing to prosecute claims on behalf of the debtors' estate.[146]

E. Entire Fairness Enters the Scene

Conflicts of interest are not confined to claims against insiders, they can arise in any business transaction between the estate and an insider. Often, the most important transactions in a bankruptcy case are DIP financings and 363 Sales as they can predetermine the case trajectory and dispose of substantially all the debtor's assets outside of the plan confirmation process.[147] When high-stakes proposed transactions involve both the estate and insiders, courts commonly scrutinize them under the heightened standard known as entire fairness, not the baseline business justification standard.[148]

Proposed transactions between a debtor and outsiders are subject to the business justification standard.[149] The standard is derived from the business judgment rule: "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[150] The inquiry only requires the debtor to show a "good business reason" for the transaction.[151] Because courts are generally unwilling to

---

[145] *Monsour*, 5 B.R. 715, at 718; *see* Off. Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel*. Cybergenics Corp. v. Chinery, 330 F.3d 548, 577 (3d Cir. 2003)("we believe that appointing a trustee is too drastic a step to constitute a serious alternative to allowing derivative suits by creditors' committees").

[146] *See* Lepene & Gordon, *supra* note 10 at 337.

[147] Jonathan C. Lipson, *The Secret Life of Priority: Corporate Reorganization After Jevic*, 93 WASH. L. REV. 631, 697 (2018); George W. Kuney, *Hijacking Chapter 11,* 21 EMORY BANKR. DEV. J. 19 (2004).

[148] Another option that has rarely been used is to appoint an examiner to supervise and negotiate a transaction that involves potential insider counterparties. *See* Carragher, *supra* note 10, at 52, 53 (describing *Fontainebleau Las Vegas Holdings* case where sale-facilitating examiner was appointed). Although the results of the sale process in the *Fontainebleau Las Vegas Holdings* were applauded, *see id.*, compensation of the examiner presented problems as the district court found that it could not be based on the 11 U.S.C. § 506(c) surcharge right. *In re* Fontainebleau Las Vegas Holdings, LLC, 434 B.R. 716, 755 (S.D. Fla. 2010).

[149] *E.g.*, *In re* Bos. Generating, LLC, 440 B.R. 302, 321 (Bankr. S.D.N.Y. 2010).

[150] Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (*In re* Integrated Res., Inc.), 147 B.R. 650, 656 (S.D.N.Y. 1992).

[151] *In re* Iridium Operating LLC, 478 F.3d 452, 466 (2d Cir.2007); Parker v. Motors Liquidation Co. (*In re* Motors Liquidation Co.), 430 B.R. 65, 83 (S.D.N.Y.2010) ("The overriding consideration for approval of a Section 363 sale is whether a 'good business

second-guess management's decisions, this standard is very deferential.[152]

In contrast, proposed transactions with insider counterparties are generally subject to the entire fairness standard.[153] The traditional rationale for this heightened scrutiny is that "they are rife with the possibility of abuse."[154] Rather than establish a new common law standard, bankruptcy courts ported the Delaware corporate law standard for entire fairness into bankruptcy law.[155] It generally requires that (i) a fair procedural process be undertaken prior to proposing the transaction for approval and (ii) the substantive transaction itself must be on fair terms.[156] When the entire fairness standard is triggered, the default deference to the debtor's corporate decisioning evaporates and the debtor must prove to the court that the deal and the price are both fair.[157] Put another way, "when [the debtor] can be trusted, judicial review is unnecessary and perhaps harmful, but when [the debtor] cannot be trusted, judicial review becomes necessary."[158] As part of their core remit, Committees will often pressure the court to apply the entire fairness standard to proposed 363 Sales and DIP financings involving insider counterparties.[159]

Having discussed the general statutory and common law framework for corporate governance under the Bankruptcy Code, we now turn to the evolution of case control rights. The development of bankruptcy directors reflects the newest era, Sponsor control.

---

reason' has been articulated.").

[152] Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 117-24 (2004) (explaining the underpinning for the business judgment rule).

[153] *See* Carragher, *supra* note 10.

[154] C & J Clark Am., Inc. v. Carol Ruth, Inc. (*In re* Wingspread Corp.), 92 B.R. 87, 93 (Bankr. S.D.N.Y. 1988).

[155] *See In re* Transcare Corp., No. 16-10407 (SMB), 2020 WL 8021060, at *17 (Bankr. S.D.N.Y. July 6, 2020).

[156] Bernard S. Sharfman, *The Importance of the Business Judgment Rule*, 14 N.Y.U. J.L. & BUS. 27, 41 (2017) (describing factors considered for fair dealing and fair price).

[157] *In re* Innkeepers USA Tr., 442 B.R. 227, 231 (Bankr. S.D.N.Y. 2010).

[158] Julian Velasco, *Shareholder Ownership and Primacy*, 2010 U. ILL. L. REV. 897, 955 (2010).

[159] *In re* Latam Airlines Grp. S.A., 620 B.R. 722, 771 (Bankr. S.D.N.Y. 2020). A rich literature exists considering the composition, impact and usefulness of Committees. *See, e.g.*, Melissa B. Jacoby, *Unbundling Business Bankruptcy Law*, 101 N.C. L. Rev. 1703 (2023); Jared A. Ellias, Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?: Evidence from Junior Activist Investing, 8 J. Legal Analysis 493 (2016); Wei Jiang, Kai Li, and Wei Wang, *Hedge Funds and Chapter 11*, 67 J. OF FIN. 513 (Apr. 2012); Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 VAND. L. REV. 749, 751 (2011).

F. Bankruptcy's Three Modern Control Eras

The Bankruptcy Code era can be divided into three eras of control: first management control, then lender control, and now Sponsor control. Although exceptions exist, these historical pathologies are well-recognized and provide a useful paradigm for understanding the development of bankruptcy practices.

i. Management Control

The first decade following the 1978 enactment of the Bankruptcy Code was the golden age of management control and lengthy reorganization attempts. Large debtors usually had minimal secured debt and relied upon unsecured bonds for debt financing.[160] Cash is king in bankruptcy, and control over the cash often equates to control over the bankruptcy case. Because debtors could either use their unsecured cash or encumber unsecured assets to obtain financing, debtors' management typically retained control over the bankruptcy case.[161] Creditors were impotent.[162] The result was lengthy cases where management prioritized reorganizing the debtor over a more rapid sale.[163] The extended case duration served management's ends, namely through continued employment and the option value of a return to equity, while "playing with creditors' money."[164] Committee derivative standing provided one of the few handbrakes on management authority when viable insider claims existed.[165] Nonetheless, the perceived leverage imbalance between debtors and creditors caused some commentators to call for a reversion to a mandatory trustee or examiner system echoing the Chandler Act.[166]

---

[160] Skeel, *supra* note 12 *see* Elisabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 J. CORP. L. 725, 737 (2014).

[161] Skeel, *supra* note 1212.

[162] *Id.*

[163] Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1045-46 (1992).

[164] *Id.* (summarizing literature concluding that managers generally prefer reorganization to liquidation because it allows them to keep their jobs and "effect wealth transfers from creditors (and perhaps other stakeholders) to equity holders[,]" which usually include management).

[165] *See supra* note 144.

[166] Jerome R. Kerkman, *The Debtor in Full Control: A Case for Adoption of the Trustee System*, 70 MARQ. L. REV. 159, 197 (1987).

ii. Lender Control

The locus of control shifted in the 1990s.[167] Lenders' ability to constrain debtors' use of cash grew as debtors' greater reliance on secured debt upset the prior bargaining equilibrium. Increasing prevalence of blanket loans and second liens meant few, if any, assets were unencumbered while cash was commonly subject to lenders' liens.[168] This combination, together with the Bankruptcy Code's rules for obtaining new credit, constrained debtors' options.[169] Lenders employed their leverage pre-petition to displace management with chief restructuring officers ("CROs"), while also weaponizing DIP financing to force debtors to follow lenders' preferred case trajectories.

CROs emerged in the early 2000s to enable lenders' control of the bankruptcy process from pre-filing through confirmation. When lenders lost faith in management due to misfeasance or malfeasance, they did not request appointment of chapter 11 trustees.[170] Instead, they pressed for the appointment of CROs as a lender-friendly alternative.[171] Like a chapter 11 trustee, CROs' duties are often comprehensive and they commonly function as a chief executive officer.[172] Creditors champion CROs due to their greater sophistication and restructuring experience compared to chapter 11 trustees.[173] Of course, the debtor will not willingly appoint a CRO, but a lender often conditions future financing or waiver of covenant defaults on a CRO appointment.[174] Left without other options, debtors agree to lenders'

---

[167] Jonathan C. Lipson, *Bargaining Bankrupt: A Relational Theory of Contract in Bankruptcy*, 6 HARV. BUS. L. REV. 239, 277 (2016).

[168] *See* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 523 (2009) (noting that for 97% of public firm filers in 2001, secured creditors held blanket liens on substantially all the debtor's assets); *see also* David Skeel, *Bankruptcy's Identity Crisis*, 171 U. PA. L. REV. 2097, 2107 (2023)(describing proliferation of second liens); Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L. J. 648, 676 (2010); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STANFORD L. REV. 673, 696 (2003).

[169] Barry Adler, *A Reassessment of Bankruptcy Reorganization After Chrysler and General Motors*, 18 AM. BANKR. INST. L. REV. 305, 313 (2010).

[170] *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1247 (2006).

[171] James H.M. Sprayregen *et al.*, *Chapter 11: Not Perfect, But Better Than The Alternatives*, 14 J. BANKR. L. & PRAC., 6 (Dec. 2005).

[172] A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875, 918 (2009); *see In re* Advanced Contracting Sols., LLC, 582 B.R. 285, 296 (Bankr. S.D.N.Y. 2018) (CRO oversaw bankruptcy case, including DIP financing and sale process).

[173] Sprayregen *et al.*, *supra* note 171, at 6.

[174] Baird & Rasmussen, *supra* note 170, at 1233.

requests.[175] Reflecting the maturation of the age of lender control, CROs went from non-existent in the mid-1990s to being appointed in approximately 30% of the largest cases from 1997 to 2007.[176] CRO appointments remain common.[177]

Critics highlight how CROs strengthen lender control at the expense of other stakeholders.[178] Because the lender usually engineers the CRO's appointment, it would be natural for the CRO to prefer the lender's interests. After all, he or she has the lender to thank for the position. The CRO will also want to be appointed in future cases involving the lender. As Professors Baird and Rasmussen put it, "[t]he CRO may be compensated by the company, but her interests are aligned with the lenders."[179] Due to this alleged structural lender-bias, some academics supported restrictions on the appointment of CROs,[180] but no meaningful reform occurred.

The Bankruptcy Code's scheme for DIP financing further strengthens pre-petition blanket secured lenders' leverage and constrains the market for DIP financing. When no unencumbered assets exist, the only realistic option for obtaining DIP financing is to grant a priming lien.[181] Finding and persuading a new lender to extend credit while also providing the required adequate protection to the current secured lender is challenging because the obvious option for adequate protection, a lien on unencumbered assets, is by definition unavailable.[182] In contrast, a current first lien secured lender can waive the issue of priming, when it is the DIP lender.[183] Due to this bargaining leverage, plus its superior knowledge of the debtor, the pre-

---

[175] Lenders may be reluctant to identify exactly who the CRO should be for fear of lender liability claims based on their taking control of the debtor. However, they will still have the final say via a veto power over the debtor's selection. *Id*. at 1233 n.73.

[176] Dickerson, *supra* note 172, at 921.

[177] *E.g.*, *In re* Urb. Commons 2 W. LLC, 648 B.R. 530, 536 (Bankr. S.D.N.Y. 2023)); *In re* K.G. IM, LLC, 620 B.R. 469 (Bankr. S.D.N.Y. 2020).

[178] *E.g.*, *Id.* at 917. *But see* Baird & Rasmussen, *supra* note 170, at 1233.

[179] *Id*. at 1234.

[180] Dickerson, *supra* note 172, at 919. *But see* Baird & Rasmussen, *supra* note 170, at 1245. (suggesting that the ability to obtain appointment of a CRO balances the power of management and "may create an environment in which the market for corporate control can once again operate effectively").

[181] David Skeel, *Pandemic Hope for Chapter 11 Financing*, 131 YALE L.J. FORUM 315, 326 (2021).

[182] *E.g.*, *In re* Desert Fire Protection v. Fontainebleau Las Vegas Holdings, LLC (*In re* Fontainebleau Las Vegas Holdings, LLC), 434 B.R. 716, 754 (S.D. Fla. 2010); Frederick Tung, *Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis*, 37 YALE J. ON REG. 651, 707 n.45 (2020).

[183] KeyBank Nat'l Ass'n v. Franklin Advisers, Inc., 616 B.R. 14, 25 (Bankr. S.D.N.Y. 2020); Baird & Rasmussen , *supra* note 170, at 1238.

petition secured lender is usually the proposed DIP lender.[184]

Without the ability to offer additional assets as collateral, debtors were left with few options to provide consideration to a DIP lender besides exorbitant financial terms and case control.[185] Professors Ayotte and Ellias have characterized the case control aspects of DIP financing as "a process sale" where the debtor effectively "sells" control of the bankruptcy case to the DIP lender as consideration for providing the DIP loan.[186] Core elements of the process sale are the negative covenants and milestones lenders bargain for in DIP financing documentation.[187] At bottom, they restrict the debtor's operational autonomy.[188] Negative covenants preclude certain material decisions (like asset dispositions, capital expenditures, and changes in management, control, or ownership) absent consent of the lender.[189] Milestones force the debtor to meet the lender's preferred timeline by setting deadlines for key achievements in the bankruptcy case like sales or plan confirmation.[190] Lenders use covenants and milestones to enforce their control because tripping a covenant or failing to achieve a milestone "entitl[es] the lender to relief from the stay and the ability to immediately realize upon its security, begin assessing default interest rates and penalty fees, and terminate any further financing."[191]

Lender control also altered the Committee's leverage. Truncated deadlines for the Committee to challenge secured lenders' liens (the debtor often waives the right to contest liens as part of the DIP order) commonly

---

[184] Tung, *supra* note 182, at 658 (pre-petition lenders provided 75% of DIP financings in sample).

[185] DIP lenders obtain above-market returns. As Professor Tung has highlighted, the interest rates for DIP loans are similar to those for non-investment grade and highly speculative bonds, while DIP loans are much less likely to default. Tung, *supra* note 182, at 686.

[186] Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale*, 39 YALE J. ON REG. 1, 4 (2021).

[187] *Id.* at 11-14.

[188] *See* Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 154 (2005) ("leverage has enabled DIP lenders to impose increasingly severe covenants and conditions on the debtor and its activities"); Kuney, *supra* note 147at 56 (suggesting "overall effect" of negative covenants is to give "the DIP lender almost complete control over the debtor's reorganization").

[189] Negative covenants "are a well-known mechanism for controlling financial agency problems" that arise from a firm's insolvency and the shift to creditors as the fulcrum security holders who "enjoy the marginal gains and bear the marginal losses of firm actions." George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 910-11 (1993); *see* Kuney, *supra* note 147, at 53-56 (listing common examples of negative covenants).

[190] Tung, *supra* note 182, at 672.

[191] Kuney, *supra* note 188, at 56.

appear in DIP financing documentation.[192] Because lenders' blanket liens encumber the debtors' cash, the lender can attempt to curtail the Committee's power by bargaining for a covenant limiting the budget for investigating the secured lenders' liens and any claims against the lender.[193] Supporters of limiting Committee investigation budgets suggest that they should reflect the economics of the underlying bankruptcy case. Why should the Committee be able to spend the secured lender's collateral when "there is no distributable value of the bankrupt debtor beyond the secured debt to pay administrative expenses and priority claims, much less unsecured claims"?[194] We will return to this theme when discussing the proposals for administering bankruptcy directors.

iii. Sponsor Control

Lender control may be receding, however, as Sponsors and other powerful insiders attempt to seize primacy or collude with select lenders.[195] In both the eras of management control and lender control, public companies were the paradigmatic large corporate debtors. Portfolio companies have replaced them.[196] The shift in the identity of the archetypical debtor does not necessarily alter the control paradigm. However, the ownership and corporate governance makeup of Sponsors and their portfolio companies shifts negotiating dynamics.[197] Using their sophistication and management control, Sponsors can build on the gains by lenders in the prior era.[198]

Sponsors enjoy a tight rein on management and unified equity ownership. Although a private equity fund may have many investors, the investors are not direct owners of the portfolio companies.[199] The investors'

---

[192] *In re* Caesars Entm't Operating Co., 561 B.R. 457, 464 (Bankr. N.D. Ill. 2016) (explaining how Committee challenge deadlines operate).

[193] Kuney, *supra* note147, at 67. Because the lender has a lien on debtor's cash collateral, any amounts to be used by to pay a Committee's professionals must be carved-out of the collateral to ensure payment. Thus, if the lender only authorizes a limited budget, it may constrict the ability of the Committee to perform a thorough investigation and litigate the associated issues. *Id*. at 67-68 (advocating for reasonable Committee budgets). *But c.f.* Athanas *et al*., *supra* note 30, at 105, 112 (suggesting that budgets and carve-outs do not constrain Committee professionals because chapter 11 plan confirmation requires payment of all administrative expense claims in full, regardless of any carve-out).

[194] *Id.* at 104.

[195] Samir D. Parikh, *Financial Disequilibrium*, 171 U. PA. L. REV. (Forthcoming 2023);

[196] Mayra Rodriguez Valladares, *Over Half of Rated Company Defaulters Are Owned by Private Equity Firms*, FORBES.COM (July 16, 2020).

[197] *See infra* notes 200-203.

[198] *See infra* note 204; Robert W. Miller, *Loan-to-Own 2.0* (on file with author).

[199] Elisabeth de Fontenay, *Private Equity's Governance Advantage: A Requiem*, 99 B.U. L. REV. 1095, 1103 (2019).

money (along with debt financing) funds the purchase of portfolio companies, but the Sponsor is the sole equity owner of each portfolio company.[200] The portfolio company's board is dominated by insiders whose careers depend on the Sponsor.[201] Management and equity have the same goal, the Sponsor's success. They can act decisively because Sponsors avoid the collective action and agency problems endemic to public company equity holders.[202] Sponsors can also draw upon deep financial and operational resources.[203] Due to these characteristics, a Sponsor is well-placed to negotiate toe-to-toe with lenders while also dominating the portfolio companies' management to orchestrate the bankruptcy case for its benefit.[204]

In contrast, a public company's management has less institutional motivation to support equity.[205] Public company boards are largely populated by independent directors who have other full-time jobs.[206] Put another way, they are not beholden to equity holders like the insider directors of a portfolio company. Moreover, they do not, and realistically cannot, have a "particular allegiance" to the ever-changing body of equity holders.[207]

The differing incentives for independent and insider directors also manifest in the types of transactions and strategies they are prepared to authorize. Reputational and litigation risk may constrain independent directors' willingness to pursue transactions that could anger lenders.[208] In

---

[200] Sung Eun Kim, *Typology of Public-Private Equity*, 44 FLA. ST. U.L. REV. 1435, 1442 (2017). This is usually accomplished through a leveraged buyout of the prior equity holders.

[201] "Private equity firms generally staff the board of a portfolio company with the lead principals responsible for the investment, and they intentionally tie these principals' compensation closely to the portfolio company's success." Fontenay, *supra* note 199, at 1103. "One board member will be, in effect, the lead director, who will drive the PE firm's engagement with the portco. This person will have substantial personal financial gain/loss on the line, not only from portco-specific payoffs in an IPO or private exit but also in terms of his/her career within the PE firm." Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0: An Introduction*, 74 BUS. LAW. 349, 357 (2019). These smaller boards "meet more frequently than public-company boards [and] managers viewed as underperforming are quickly replaced." Elisabeth de Fontenay, *The Myth of the Ideal Investor*, 41 SEATTLE U.L. REV. 425, 442 (2018).

[202] Diane Lourdes Dick, *Grassroots Shareholder Activism in Large Commercial Bankruptcies*, 40 J. CORP. L. 1, 8 (2014) ("tend to be widely dispersed and possess divergent economic interests").

[203] Buccola, *supra* note 11, at 22.

[204] *Id.*

[205] For background on the rise of independent directors, consider Yaron Nili, *The Fallacy of Director Independence*, 2020 WIS. L. REV. 491, 497 (2020).

[206] Or they are full-time directors splitting between director positions at different firms. *Id.* at 504.

[207] Buccolla, *supra* note 11.

[208] *Id.*

contrast, a portfolio company's board may approve hardball tactics against lenders because the board is beholden to its Sponsor and may be less worried about tarnishing its reputations.[209] A Sponsor can also trust management to run the bankruptcy case for its benefit.[210] Whatever plan is proposed is more likely to support the Sponsor's interests.

II. Bankruptcy Directors

This section will first examine the controversial role of bankruptcy directors in corporate governance and why they have proliferated. The case study of *Cengage Learning* is illustrative. Afterward, it will summarize the proposals for handling what cleansing effect bankruptcy directors should provide. Lastly, it will evaluate each of the proposals.

A. Cengage Learning – An Exemplar Bankruptcy Director Case

The *Cengage Learning* case shows how the appointment of bankruptcy directors can facilitate a Sponsor's control over conflicted claims or transactions. Thompson Learning was a leading provider of educational management solutions and course materials. Apax Partners, L.P. ("Apax") a private equity firm, acquired Thompson Learning for $7.75 billion and renamed it Cengage Learning ("Cengage").[211] Apax structured the acquisition as a leveraged buyout with $5.6 billion funded through new debt financing and the remainder covered by Apax's equity contributions.[212] Due to headwinds created by the digital transition of course materials and the increased interest payments associated with the new debt financing, Cengage's financial performance deteriorated and it became clear that the value of the firm was less than the value of the first lien debt.[213] Thus, the first lien holders were the fulcrum security (*i.e.,* the tranche of debt or equity in the company's capital structure that is not entirely "out of the money"[214]) and would own the reorganized equity following a chapter 11 reorganization. In contrast, Apax's equity stake would be eliminated because equity holders

---

[209] *Id.* at 36.

[210] *See* Miller, *supra* note 198.

[211] Declaration of Dean D. Durbin, Chief Financial Officer, in Support of Chapter 11 Petitions and First Day Motions, *In re* Cengage Learning, Inc., Docket No. 1:13-bk-44106 (Bankr. E.D.N.Y. Jul 02, 2013) [Dkt Entry No. 15].

[212] *Id.*

[213] *Id.*

[214] Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians at the Gate?*, 89 WASH. U. L. REV. 155, 161 (2011).

generally receive no distributions unless creditors are paid in full.[215] Recognizing that a bankruptcy case was likely and that Apax would eventually lose control if they did not obtain a higher priority position in the capital structure, Apax purchased over $1 billion of Cengage's debt at a discount.[216] At the same time, Cengage also repurchased some of its own debt on the open market.[217] The repurchases benefited Apax by increasing Apax's pro-rata share of Cengage's remaining debt, which gave Apax greater leverage during a bankruptcy case and increased the chances that Apax could control the fulcrum security. The repurchases were controversial because Cengage could have used that money to fund operations and the repurchases may have triggered adverse tax consequences for Cengage.[218] Based on its control over Cengage's repurchase decisions, viable claims could have existed against Apax for a breach of fiduciary duty.[219]

Let's consider a counterfactual scenario where no bankruptcy directors were appointed. An internal investigation of debt purchases would be conflicted because Apax would be on both sides of the investigation (through its control of Cengage's equity and its status as the potential defendant). After Cengage filed for bankruptcy, a Committee would conduct the investigation and evaluate whether to seek derivative standing to bring claims on behalf of Cengage against Apax. That is not what transpired.

Cengage hired a bankruptcy director with restructuring experience to evaluate the company's restructuring options and investigate the debt repurchases and whether viable claims existed against Apax.[220] Once Cengage filed for bankruptcy, the Committee swiftly filed a motion to suspend the bankruptcy director's investigation because his findings could undermine or even preempt the Committee's own nascent investigation.[221] The Committee's fears were well-founded as the bankruptcy director concluded that no viable claims against Apax existed prior to the bankruptcy

---

[215] This is the absolute priority rule codified in 11 U.S.C. § 1129(b)(2)(B).

[216] Motion of the Official Committee of Unsecured Creditors for an Order Terminating or, in the Alternative, Suspending the Debtors' Prepetition Investigation into Certain Conduct of Apax Partners, L.P. and its Affiliates *In re* Cengage Learning, Inc., Docket No. 1:13-bk-44106 (Bankr. E.D.N.Y. Jul 26, 2013) [Dkt Entry No. 164] (hereinafter Cengage Committee Motion).

[217] *Id.*

[218] *Id.*

[219] *Id.*

[220] Declaration of Richard D. Feintuch in Support of Debtors' Objection to Motion of the Official Committee of Unsecured Creditors For an Order Terminating or, in the Alternative, Suspending the Debtors' Prepetition Investigation into Certain Conduct of Apax Partners, L.P. and its Affiliates, *In re* Cengage Learning, Inc. (Bankr. E.D.N.Y. July 30, 2013) [Dkt Entry No. 181] (hereinafter Feintuch Declaration).

[221] Cengage Committee Motion.

court ruling on the Committee's suspension request.[222] Eventually, the Committee, Apax, and the other holders of Cengage's first lien debt agreed to a settlement that resulted in a consensual plan confirmation process.[223]

Proponents of bankruptcy directors will highlight this result; the bankruptcy director was appointed and the end result was a confirmed consensual chapter 11 plan. Yet, this same result may have occurred if the Committee could have undertaken its investigation without the parallel one by the bankruptcy director. Indeed, unsecured creditors may have fared better as bankruptcy directors are generally associated with lower creditor recoveries.[224] Moreover, the process undertaken to appoint the bankruptcy director was opaque.[225]

B. Bankruptcy Directors' Proliferation and Controversy

The popularity of bankruptcy directors stems from demand-side and supply-side factors as well as their efficacy. The frequency of viable claims against Sponsors plus Sponsors' willingness to participate in 363 Sales and DIP financings involving their portfolio companies drives their interest in evading the traditional protections applied to conflicts.[226] Bankruptcy directors can solve this common problem by insulating what would otherwise be conflicted corporate decisions.[227] Because Sponsors select them from the pool of candidates, bankruptcy directors may be motivated to serve Sponsors' interests to obtain future engagements.[228] Non-bankruptcy scholarship evaluating independent directors' connections supports this conclusion.[229] It is bankruptcy directors' close connection to Sponsors and their interests that distinguishes bankruptcy directors from CROs.[230] Indeed, these connections and repeated engagements, as well as lower recoveries for creditors, spawned the criticism of bankruptcy directors.

Sponsors' business models make them obvious targets for

[222] Feintuch Declaration.

[223] *See* Court Confirms Cengage Learning's Plan of Reorganization, *available at*, https://www.cengage.com/restructuring/pdfs/Conf_Press_Release_FINAL_3-13-14.pdf

[224] *See infra* note 255 and text accompanying.

[225] *See* Feintuch Declaration (failing to describe appointment process and the bankruptcy director's connections to Apax).

[226] *See infra* notes 236-240.

[227] *See infra* notes 241-244.

[228] *See infra* notes 245-247.

[229] *See infra* notes 248**Error! Bookmark not defined.**-250.

[230] *See infra* notes 251-254 and text accompanying.

investigations of conflicted claims and transactions.[231] One of Sponsors' primary source of returns are performance fees derived from dividends and management fees.[232] When a portfolio company issues dividends or pays rich management fees unsupported by services rendered (basically disguised dividends) while it is insolvent, strong claims for avoidance of these payment as fraudulent transfers exist.[233] As illustrated by the *Cengage* example, Sponsors may also attempt to control a subsequent bankruptcy or restructuring by obtaining an influential creditor position through purchasing their portfolio company's debt while also causing the portfolio company to redeem debt.[234] Claims against the board and the Sponsor for breaches of fiduciary duty related to any of these types of transactions may also arise.[235]

The settlement of these claims against a Sponsor cannot be undertaken by the debtor's board without triggering the entire fairness standard due to their conflict of interest.[236] Management is obviously conflicted concerning any claims against itself, while the board of directors' close relationship with the Sponsor establishes a conflict of interest.[237] Once a bankruptcy is filed, a Committee will often press for derivative standing.[238]

Sponsors' unified holdings, together with their greater sophistication and funding, make Sponsors much more likely than public company equity holders to act as a DIP lender and the stalking horse bidder for the debtor's assets.[239] A Sponsor may (either directly or indirectly through an affiliated credit fund) provide DIP financing to its portfolio company, paving the way

---

[231] Buccola, *supra* note11, at 5.

[232] Elisabeth de Fontenay & Yaron Nili, *Side Letter Governance*, 100 WASH. U. L. REV. 907, 925-26 (2023).

[233] Katherine Waldock, *Fighting Fire with Fire: Bankruptcy Committees in the Age of Hostile Restructurings*, 2022 COLUM. BUS. L. REV. 1097, 1119 (2022).

[234] *See supra* Section II.A.

[235] Youngman v. Yucaipa Am. All. Fund I (*In re* ASHINC Corp.), 629 B.R. 154 (Bankr. D. Del. 2021). These claims may not be viable when the entity has waived claims for breaches of fiduciary duties. See, e.g., *In re* Optim Energy, LLC, Case No. 14–10262 (BLS) 2014 WL 1924908, at *6 (Bankr. D. Del. May 13, 2014)(finding that an operating agreement of an LLC organized under Delaware law can effectively waive fiduciary duties).

[236] *See* Ellias, *et al., supra* note 19, at 1085.

[237] Buccola, *supra* note 11**Error! Bookmark not defined.**, at 22.

[238] *See* Robert K. Rasmussen, *Temporal Priority*, 20 BERKELEY BUS. L.J. 53, 80 (2023)(nothing Committee's strong incentives to investigate transactions between portfolio companies and Sponsors).

[239] A restructuring support agreement may link the 363 Sale process with the DIP financing. *See* Edward J. Janger & Adam J. Levitin, *Badges of Opportunism: Principles for Policing Restructuring Support Agreements*, 13 BROOK. J. CORP. FIN. & COM. L. 169, 184 (2018), which may maximize the value of the bankruptcy estate at the expense of bankruptcy priorities. Kenneth Ayotte & Alex Zhicheng Huang, *Standardizing and Unbundling the Sub Rosa DIP Loan*, 39 EMORY BANKR. DEV. J. 523, 525-26 (2023).

for a credit bid for its portfolio company's assets. Thus, the Sponsor could wear three different hats: sole equity holder (with strong control of management), proposed DIP lender, and proposed stalking horse for a 363 Sale.[240] However, Sponsor may be concerned that its insider status as an equity holder in the debtor will trigger the entire fairness standard for approval of a 363 Sale or DIP financing.

One way to fit the conflicted DIP financing, 363 Sale, or settlement of claims within the more deferential business justification framework is to change the identity of the debtor's corporate representative. If an independent party negotiates on behalf of the debtor with a proposed insider, then there is no conflict of interest presented by an insider on both sides of the transaction.[241] The appointment of a bankruptcy director accomplishes this trick.[242] The Sponsor uses its control of the board of the soon-to-be debtor portfolio company to obtain appointment of the bankruptcy director. The bankruptcy director then handles any transactions, negotiations, or investigations involving the Sponsor. Because the bankruptcy director is not a debtor employee, and is therefore "independent," any proposed transactions with the Sponsor no longer involve an insider negotiating on behalf of the debtor. The transaction could therefore be subject to the business justification standard, rather than the entire fairness standard.[243] Even when the appointment of bankruptcy directors does not trigger the business justification standard, their actions provide useful optics that are helpful in obtaining court approval.[244]

The close connections between bankruptcy directors and the Sponsors who orchestrate their retention suggests that bankruptcy directors should rationally prefer Sponsors' interests over creditors'. Bankruptcy directors may exhibit "auditioning bias" and favor the Sponsor's interest in an attempt to obtain future directorships.[245] The short-term nature of these positions and limited pool of clients (*i.e.*, Sponsors and other powerful insiders) elevates

---

[240] *See infra* note 322 and text accompanying.

[241] Michael R. Handler & Arthur J. Steinberg, *The Role of Independent Directors in Mitigating Liability Arising From Restructuring Decisions*, REV. OF BANKING AND FIN. SERVS. (Nov. 2022).

[242] Ellias *et al.*, *supra* note 1, at 1097.

[243] *See In re* Sears Holdings Corporation, Case No. 18-23538 (Bankr. S.D.N.Y. Feb. 8, 2019) [Dkt Entry No. 2507] (applying business judgment rule standard to sale to insiders negotiated by independent directors and overruling objections by Committee, among others).

[244] *E.g.*, *In re* Latam Airlines Grp. S.A., 620 B.R. 722, 775 & 778-79 (Bankr. S.D.N.Y. 2020); *see In re* Collab9, LLC, 631 B.R. 255, 260 (Bankr. C.D. Cal. 2021) (detailing independent director's extensive involvement in sale process and court's prior approval of sale).

[245] *Id.*

the risk of pro-Sponsor behavior.[246] The existence of what Professors Ellias, Kamar, and Kastiel call "super-repeaters" (bankruptcy directors who are serve outsized number of times) in their recent empirical study is consistent with these concerns.[247]

The criticism of bankruptcy directors' bias parallels the concerns voiced against horizonal directors outside of bankruptcy.[248] Horizontal directors, who serve full-time on multiple boards within the same industry may possess an auditioning bias as "alienating one management team could more readily lead to a negative reputation within the industry."[249] Patronage concerns are not limited to bankruptcy directors as independent directors who are recurrently appointed by the same controlling shareholder may appease the shareholder in the expectation of securing future engagements.[250] Super-repeaters reflect a mix of both patronage and horizontal directors as they are closely connected with a small group of clients (Sponsors) and law firms in a single industry (distressed companies).

Indeed, it is this direct patronage that differentiates bankruptcy directors from CROs.[251] Lenders are unlikely to expressly demand the hiring of a specific person as the CRO because exercising direct control of the debtor can create the risk of lender liability.[252] The Sponsor inherently possesses the risk the lender does not want to undertake; it has direct control of management.[253] As a result, Sponsors are more willing to select the specific bankruptcy director to sit on the board of its portfolio company debtor. Thus, auditioning bias concerns are stronger for bankruptcy directors. Other stakeholders may be more willing to accept CROs as their efforts may maximize enterprise value as a whole.[254] Put a different way, the spillover effects of a successful CRO may advantage non-lender creditors, while the impact of a successful bankruptcy director will lower the recovery for non-Sponsor stakeholders.

Lower recoveries for general unsecured creditors are exactly what Professors Ellias, Kamar, and Kastiel found to be correlated with the

---

[246] *Id.* at 1088.
[247] *Id.* at 1111.
[248] *E.g.*, Yaron Nili, *Board Gatekeepers*, 72 EMORY L.J. 91 (2022); Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 473 (2008).
[249] Yaron Nili, *Horizontal Directors*, 114 NW. U. L. REV. 1179, 1232–33 (2020).
[250] Da Lin, *supra* note 73, at 531; Lucian A. Bebchuk & Assaf Hamdani, Independent Directors and Controlling Shareholders, 165 U. PA. L. REV. 1271, 1274 (2017).
[251] *But see* Melissa B. Jacoby, *Fake and Real People in Bankruptcy,* 39 EMORY BANKR. DEV. J. 497, 510 (2023) (equating CROs and bankruptcy directors).
[252] Baird & Rasmussen, *supra* note 170, at 1235-36.
[253] *See* supra note 200-201 and text accompanying.
[254] *Id.* at 1235.

appointment of bankruptcy directors.[255] Although the authors admit that other uncontrolled factors may be causal, one commonsense narrative is that cases involving bankruptcy directors allow insiders to retain more value at the expense of general unsecured creditors.[256]

III. Proposed Reforms

Having previously garnered little commentary, bankruptcy directors are now hotly debated. Once the initial draft of Professors Ellias, Kamar, and Kastiel's findings and suggested reforms became public, Senator Elizabeth Warren responded by proposing the *Stop Wall Street Looting Act*. In the wake of publication, Messrs. Ellis and Yeh provided further proposals for reform. Meanwhile, disclosure-focused proposals also surfaced. First, Messrs. Rosen, Brownstein, and Gross and later former-Judge Jones, who voiced his support from the bench in the case of *In re Mountaineer Express Oil Co*. This section will summarize and evaluate each proposal through the lens of control rights and the historical treatment of conflicted claims and transactions in bankruptcy.

A. Ellias, Kamar, and Kastiel's Proposal

Professors Ellias, Kamar, and Kastiel suggest treating the bankruptcy directors as neutral actors with the powers of independent directors only when they are "overwhelmingly supported" by relevant stakeholders.[257] No new legislation would be needed; bankruptcy judges would adopt a protocol where the debtor would present the bankruptcy directors and solicit stakeholders' votes.[258] Absent sufficient approval from the stakeholders whose claims are at risk (usually the unsecured creditors represented by the Committee, but it may include the secured creditors when appropriate), bankruptcy directors would be considered professionals retained by the debtor.[259] The court "'should weigh their position against creditors', allow creditors to conduct their own investigation and sue, and not approve proposed settlements merely because the bankruptcy directors endorse

[255] Ellias *et. al*., *supra* note 19, at 1088 (finding that after controlling for firm and bankruptcy characteristics, 20% lower in the presence of bankruptcy directors).

[256] *Id*. at 1122.

[257] *Id.* at 1131. The authors are most concerned about releases in favor of or settlements of claims against Sponsors, but their basic concerns apply to other transactions involving Sponsors.

[258] *Id.* at 1130.

[259] *Id.*

them."[260]

Professor Ellias, Kamar, and Kastiel's proposal reflects financial stakeholders' primacy, but operationalizing the protocol will be challenging. Outside of bankruptcy, public-company shareholders are generally the sole focus of reform proposals to improve the process for selecting independent directors.[261] Bankruptcy muddies the waters. A bankrupt company is usually insolvent, which means that fulcrum security holders should control litigation, or at least have a voice in evaluating claims or transactions that directly affect their distribution.[262] Any incremental change to distributions caused by the bankruptcy directors' decision concerning conflicted claim or transaction will impact their distributions. The fulcrum security, however, may fluctuate between creditor (or even equity holder) constituencies during the pendency of the bankruptcy case. This is particularly true when the debtor's valuation is commodity-dependent and the value of the underlying commodity fluctuates wildly, such as oil or cryptocurrency.[263] Disallowance of major claims or subordination of liens can similarly alter the position of the fulcrum security. Yet, the claim reconciliation and lien evaluation process usually occur much later in the case.[264] The authors recognized that the unsecured creditors are not always the fulcrum security and, in some cases, a secured creditor may be the appropriate party (or among the appropriate parties) to vote on whether to consider the bankruptcy directors legally independent.[265] What should be done when the fulcrum security moves after the vote? The judicial discretion creates judgment calls for the court that may, in hindsight appear mistaken.

Requiring a voting process reminiscent of plan solicitation creates complications at the outset bankruptcy case without increasing meaningful participation. The beginning of the case is chaotic. Unsecured creditors are

---

[260] *Id.* at 1131.

[261] *Id.* at 70-71.

[262] Dan Keating, *Good Intentions, Bad Economics: Retiree Insurance Benefits in Bankruptcy*, 43 VAND. L. REV. 161, 190 n.159 (1990) ("The 'residual' claimants in any Chapter 11 case will be those whose claims are at the margin--that is, those claimants who stand to win or lose depending on the fortunes of the firm.").

[263] Diane Lourdes Dick, *The Bearish Bankruptcy*, 52 GA. L. REV. 437, 448 (2018). (describing commodity focused bankruptcy cases as "bearish bankruptcies"); *Objection of the Official Committee of Unsecured Creditors to Debtors' Emergency Motion to Obtain Post-Petition Debtor-In-Possession Financing*, p. 2, *In re* Core Scientific, Inc., Case No. 22-90341, (Bankr. S.D. Tex. Jan. 26, 2023) [Dkt Entry No. 363] (asserting that 36% increase in price of bitcoin in less than a month had drastically changed valuation of the debtors' assets).

[264] *See infra* note 192 and text accompanying; *In re* Eagle-Picher Indus., Inc., 189 B.R. 681 (Bankr. S.D. Ohio 1995), as amended (Dec. 14, 1995)(court valued claims as part of confirmation process).

[265] Ellias *et. al.*, *supra* note 19, at 1131.

only represented by the Committee once it is appointed, which often occurs shortly before the second-day hearing (often slightly less than 1 month after the petition date).[266] This timing is problematic because major transactions like DIP financing or 363 Sales can be finally approved at a second-day hearing.[267] A bankruptcy director may oversee these transactions where the Sponsor or other insider is a counterparty. Thus, the election would often need to be conducted prior to the second-day hearing to determine whether the bankruptcy director should have cleansing effect. Without a Committee's support, unsophisticated creditors would likely have little ability to determine the impact of the bankruptcy director and whether they should support appointment.[268] It is instructive to consider that a Committee often disseminates its view and recommendations on a proposed plan of reorganization through letters included with court-approved disclosure statements as part of the plan solicitation process.[269] Using a similar process for a bankruptcy director election would likely be impossible due to timing of the Committee's formation. Moreover, the sophisticated parties who could cast an educated vote would also be able to participate using a less complicated procedure, such as the one proposed by this article.[270]

Even if a Committee could provide timely guidance, it would not be a panacea. Given the short window for its members and professionals to evaluate the proposed bankruptcy director prior to the election, the Committee would reflexively resist the bankruptcy directors as the down-side risk of false-positive support would be too high. Moreover, the Committee would also be naturally resistant to the bankruptcy director encroaching on

---

[266] For example, in White Stallion Energy, LLC, the Committee was formed on December 11, 2020; the Committee retained counsel on December 13, 2020, and counsel filed an objection to the DIP financing motion on December 17, 2020. *See* Objection of the Official Committee of Unsecured Creditors to Debtors' Motion for Interim and Final Orders (I) Authorizing the Debtors to (A) Obtain Postpetition Financing and (B) Utilize Cash Collateral, (II) Granting Adequate Protection to Prepetition Secured Parties, (III) Modifying Automatic Stay, (IV) Scheduling a Final Hearing, and (V) Granting Related Relief, *In re* White Stallion Energy, LLC, Case No. 20-13037 (Bankr. D. Del. Dec. 17, 2020), [Dkt Entry No. 128].

[267] *In re* Toys "R" US, Inc., 642 B.R. 727, 737 (Bankr. E.D. Va. 2022)(describing DIP financing approved on a final basis).

[268] The Committee's duty to provide information and guidance to its constituents can be very significant burden, but Congress's decision to include it in the 2005 amendment to 11 U.S.C. § 1102 illustrates its importance. Anupama Yerramalli, *Deciphering the Statutory Language of 11 U.S.C. Section 1102(b)(3): Information Disclosure Requirements Imposed Upon Creditors' Committees*, 15 AM. BANKR. INST. L. REV. 361, 362 (2007).

[269] *E.g., In re* Mirant Corp., 334 B.R. 787, 791 (Bankr. N.D. Tex. 2005)(committee letters included as part of plan solicitation).

[270] Rosen et al., *supra* note 1.

its traditional oversight remit, particularly derivative standing. In sum, the Committee is unlikely to provide an informed, objective perspective on whether a bankruptcy director should be approved.

B. Senator Warren's Proposal

Senator Warren is even more direct in her criticism: the subtitle for the relevant provision of her proposed legislation is the *elimination of sham independent directors*.[271] The Committee would be the sole party with standing to bring or settle a claim against an insider, former insider, or associated aider and abettor.[272] The Committee would also be explicitly empowered to examine any potential directors' conflicts of interest.[273] Although Senator Warren's suggested fix is helpfully simple, it is both underinclusive and too inflexible.

Her proposed amendment would not cover bankruptcy directors' cleansing effect on conflicted transactions like DIP financings and 363 sales, only claims against insiders.[274] Reflecting their sophistication, deep pockets, and strong motivation, Sponsors often act as DIP lenders and stalking horse purchasers.[275] Even more troubling (at least presumably from Senator Warren's perspective), a 363 Sale to a Sponsor that includes avoidance actions or other claims owned by the debtors, would function as a release and

---

[271] Stop Wall Street Looting Act, S. 3022, 117th Cong. § 202(e) (2021) (emphasis added).

[272] *Id.*

[273] *Id.*

[274] Ellias, *supra* note 19, at 1136.

[275] *See, e.g.*, *Debtors' Emergency Motion for Entry of Interim and Final Orders, Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364, 503, 506, 507, and 552, (I) Authorizing the Debtors to (A) Obtain Senior Secured Superpriority Postpetition Financing and (B) Use Cash Collateral, (II) Granting Liens and Superpriority Administrative Expense Claims, (III) Providing Adequate Protection to Prepetition Secured Parties, (IV) Scheduling a Final Hearing, and (V) Granting Related Relief, In re* Instant Brands Acquisition Holdings Inc., Case No. 23-9716 (DRJ) [Dkt Entry No. 31] (private equity sponsor is proposed DIP lender); *Debtors' Motion Pursuant to Sections 105, 363 And 365 Of The Bankruptcy Code: (I) For Entry of Interim and Final Orders (A) Approving Sale Timeline, Bidding Procedures and the Form and Manner of Notice Thereof, and (B) Approving the Debtors' Entry Into the Stalking Horse APA; (II) For Entry of a Final Order Approving the Debtors' (A) Sale of All or Substantially All of the Debtors' Assets Free and Clear of All Encumbrances Other Than Assumed Liabilities and (B) Assumption and Assignment of Certain Executory Contracts and Unexpired Leases to the Winning Bidder; and (III) Granting Related Relief*, *In re* FB Debt Financing Guarantor, LLC, Case No. 23-10025 (KBO) [Dkt Entry No. 32] (seeking approval of stalking horse purchaser partially owned by insider Sponsor, which included sale of avoidance actions against Sponsor).

allow the Sponsor to escape scrutiny under her legislation.[276] The legislation completely ignores Sponsors' ability to use bankruptcy directors to evade the entire fairness standard.

Warren's suggestion would eliminate judicial oversight of derivative standing – a significant change to the treatment of conflicted claims that does not reflect the usual identity of fulcrum security holders. The proposed legislation abolishes the bankruptcy judge's traditional gatekeeping role, even though the need for gatekeeping has recently grown more acute. The bankruptcy judge historically weeded out uncolorable claims, but the proposed legislation might establish "a new status quo where the [Committee] routinely brings avoidance claims and claims against insiders, whether or not those claims have any merit."[277] The debtor's capital structures or changes in valuation should also be considered.[278] What if the Committee's constituents are out-of-the-money or avoidance actions have been encumbered pursuant to DIP financing?[279] Neither is an uncommon situation as fulcrum securities have moved higher in the capital structure.[280] Yet, the proposal would suggest the identity of the fulcrum security holders is irrelevant even when the recoveries of the Committee's constituents are not on the line.[281] Appointment of a Committee is already mandatory regardless of the debtors' capital structure or valuation.[282] Making Committees' power to litigate insider claims similarly mandatory would upset the historical balance of power in a similar (if opposite) way to the rise of bankruptcy directors.

---

[276] Courts have generally found that avoidance actions may be sold by the estate. *In re* Simply Essentials, LLC, 78 F.4th 1006, 1011 (8th Cir. 2023); *In re* Murray Metallurgical Coal Holdings, LLC, 623 B.R. 444, 504–19 (Bankr. S.D. Ohio 2021).

[277] Ellis & Yeh, *supra* note 20, at 9.

[278] *In re* Adelphia Commc'ns Corp., 371 B.R. 660, 672 (S.D.N.Y. 2007) (affirming bankruptcy court's withdrawal of equity committee's derivative standing because it was "beyond rational dispute that the holders of the Equity interests are out of the money"); Athanas *et al*., *supra* note 30, at 104.

[279] *Id.*.

[280] *See infra* note 282

[281] Tactical restructurings – administrative debt hurdle satisfied but not the secured debt hurdle is not. Indeed, As we saw with the era of management control, playing with other people's money creates perverse incentives.

[282] This rule reflects the prevailing reality at the time of the Bankruptcy Code's enactment that unsecured creditors were the fulcrum security – they benefited from any marginal gains and bore the costs. Blanket liens are the status quo and general unsecured creditors are commonly out of the money. *See* Skeel, *supra* note 168 at 2107. Some commentators have suggested that greater flexibility in deciding to not appoint a Committee should be considered. Sontchi & Grohsgal, *supra* note 143, at 12, 75.

C. Ellis and Yeh Proposal

Messrs. Ellis and Yeh prefer a return to greater independent and administrative oversight. They suggest giving the bankruptcy court, rather than the debtors, the power to appoint bankruptcy directors.[283] They also support using the tools already at hand: appoint examiners and chapter 11 trustees more frequently.[284] Recognizing stakeholders' general reluctance to request the appointment of chapter 11 trustees in the context of discrete claims or transactions, they propose clarifying the Bankruptcy Code to allow the appointment of limited-purpose trustees who can investigate and litigate conflicted claims.[285]

The suggestion of a bankruptcy judge appointing independent directors echoes the appointments of independent co-receivers by judges overseeing equity receiverships.[286] The venue and judge-shopping of the equity receivership era remains a fixture of chapter 11 practice.[287] Once a stable group of potential bankruptcy directors is recognized from prior appointments, it is easy to imagine the identity of bankruptcy directors being another data point used by debtors, lenders, and Sponsors in selecting their ideal venue. More cynically, judges might also use their selection of bankruptcy directors as an opportunity to compete for large cases.[288]

Whether it is the judicial appointment of bankruptcy directors, examiners, or limited-purpose chapter 11 trustees, Ellis and Yeh's suggestions share a weakness, they are not supported by the creditors whose money is on the line. Creditors have been reluctant to seek appointment of independent fiduciaries to handle discrete transactions or claims.[289] This is likely because they want to have a say (directly or indirectly) in the resolution of the claims or transactions.[290] In the whole-firm context, they prefer a CRO-appointment. For discrete transactions or claims, they would rather take direct action or have the Committee obtain derivative standing/object to

---

[283] Ellis & Yeh, *supra* note 20, at 10.

[284] *Id.* at 10-12.

[285] *Id.* at 11-12. Courts are currently split over the authority to authorize a limited-purpose chapter 11 trustee. *See id.* at 12 n.63.

[286] *See supra* notes 67-73 and text accompany.

[287] *Compare* Foster, *supra* note 75, at 928 and Lowenthal, *supra* note 3, at 27 *with* Adam J. Levitin, *Judge Shopping in Chapter 11 Bankruptcy*, 2023 U. ILL. L. REV. 351, 415 (2023).

[288] For those who subscribe the narrative of bankruptcy courts competing for large cases, *see, e.g.,* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (2006).

[289] *See supra* notes 133 and 138 and text accompanying; Jacoby, *supra* note 251, at 509 (creditors perceive trustees as contrary to their interests.

[290] Lipson, *supra* note 28, at 54.

the conflicted transaction on entire fairness grounds.[291] The proof is in creditors' actions; they don't want a return of a mandatory trustee model of the Chandler Act and they don't request the "mandatory" appointment of examiners established by the Bankruptcy Code.[292] Given this lack of demand, further expansion of appointed fiduciaries appears unwarranted.

D. The Disclosure-Focused Proposals

Messrs. Rosen, Brownstein, and Gross responded to the criticism of bankruptcy directors by suggesting comprehensive disclosures of the relevant connections.[293] Examples include other boards where the bankruptcy director serves, connections to the insiders in the case, and connections to the debtor's law firm.[294] They assert that these disclosures are sufficient to allow creditors to evaluate bankruptcy directors, but they ignore the appointment process, including the alternative candidates (if any) and how the Sponsor made its decision. They also fail to identify the applicable legal standard for approval and who would bear the burden of satisfying the standard.

Former Judge David Jones's proposal in the *Mountaineer Express Oil Co.* case picks up the torch and expounds a potential procedure for treating bankruptcy directors. In the *Mountaineer Express Oil Co.* case, conflicts between the two majority owners and the debtors existed due to potential claims against the majority owners and their non-debtor entities.[295] The majority owners appointed two bankruptcy directors to join them on the board three days before the petition date.[296] The bankruptcy directors were delegated authority to act on behalf of the debtors when conflicts with the majority owners arose.[297] Early in the case, the debtors moved for approval of the appointment of the bankruptcy directors.[298] The statutory basis for the motion was primarily Section 363(b) of the Bankruptcy Code, which allows the court to authorize a debtor's use of property outside of the ordinary course

---

[291] *Id.*

[292] Some of the few times it is used, it is "for gamesmanship, not enlightenment." Lipson, *supra* note 28, at 6.

[293] Rosen et al. supra note 1.

[294] *Id.*

[295] *Debtors' Motion for Entry of Order (I) Ratifying the Appointment of Independent Directors Effective as of the Petition Date; and (II) Authorizing the Payment of Director Fees*, *In re* Mountain Express Oil Co., 23-90147 (DRJ) [Dkt Entry No. 283] [hereinafter Mountain Express Bankruptcy Director Motion].

[296] *Id.*

[297] *See id.*

[298] *Id.*

of business.[299] The standard for approval was the very deferential business justification standard that applies to non-conflicted transactions.[300] The Committee and the United States Trustee objected in part because they did not believe the motion was necessary or appropriate as the bankruptcy directors had been appointed pre-petition.[301]

At the hearing, Judge Jones was clearly cognizant of academics', politicians', and practitioners' criticism of bankruptcy directors, but viewed disclosure as the answer.[302] He first lauded the debtors for filing the motion because it provided a vehicle to make the bankruptcy director appointment process more transparent and allowed parties to evaluate the appointment's propriety. This was

> exactly what debtors should be doing …. so that there is transparency and clarity to the process, so there is no question who these folks are and how they came to be, and obviously they are subject to reasonable inquiry prior to a hearing if that's the case and it just puts everything out front and I really, really like that.[303]

He characterized the motion as "such a good idea for the process because I think that anytime we can take something that is a mystery to the non-bankruptcy world and make it more transparent and easy to access, easy to understand, easier to criticize, easier to debate… I think that is a good thing."[304] The court generally granted the motion and approved the retention of the bankruptcy directors.[305]

Disclosure is undoubtedly important, but it does not cure the apparent

---

[299] Mountain Express Bankruptcy Director Motion.

[300] *Id.*

[301] *See* United States Trustee's Objection to Debtors' Motion for Entry of Order (I) Ratifying the Appointment of Independent Directors Effective as of the Petition Date; and (II) Authorizing the Payment of Director Fees, *In re* Mountain Express Oil Co., 23-90147 (DRJ)(Bankr. S.D. Tex. May 5, 2023) [Dkt Entry No. 370].

[302] Mountain Express Bankruptcy Director Motion.

[303] Hearing Audio for Mountain Express Bankruptcy Director Motion, *In re* Mountain Express Oil Co., 23-90147 (DRJ) [Dkt Entry No. 460]. 15:20-15:41

[304] *Id.* at 47:28-58.

[305] *Order (I) Ratifying the Appointment of Independent Directors Effective as of the Petition Date; and (II) Authorizing the Payment of Director Fees*, *In re* Mountain Express Oil Co., 23-90147 (DRJ) [Dkt Entry No. 459] [hereinafter Mountain Express Bankruptcy Director Order].

structural bias and empirical findings favoring shareholders who arrange bankruptcy directors' appointments.[306] This is particularly true because the extremely deferential business justification standard generally applies to a debtor's proposed use of property outside of the ordinary course, including management retention matters.[307] Given that many bankruptcy directors have prior experience with restructurings and bankruptcy cases, their competency is unlikely to be questioned and the standard for approval will likely be easily met.[308] Ironically, it is this experience, or more precisely the repeated reappointments that is problematic. The correlation between bankruptcy directors and lower creditor recoveries merits protections beyond adequate disclosure and approval based on an extremely deferential standard.

IV. Entire Fairness

This Article suggests another option - apply the entire fairness standard to determine whether bankruptcy directors should be classified as neutral actors. This proposal has similarities to the creditor-voting proposal, but it evades the valuation and timing problems. It also borrows from the disclosure-focused proposals, but it reflects the structural concerns surrounding bankruptcy directors by placing a much heavier burden on the debtor to prove that they should have cleansing effect. A case study of the recent *Performance Power Sports Group* case and a further discussion of the *Mountain Express* case animate the proposal.

Maximizing participation in the process for evaluating the cleansing effect of bankruptcy directors is paramount. Trying to cabin the proceeding to the moving target of a fulcrum security is unrealistic. Section 1109 of the Bankruptcy Code grants any creditor or equity holder standing to object to a motion, including any use of property outside the ordinary course of business.[309] Thus, all parties can be heard on a motion to approve the cleansing effect of bankruptcy directors. Although the United States Trustee should participate, financial stakeholders should be central. At bottom, it is their financial interests that can be prejudiced by conflicted transactions and

---

[306] Ellias *et. al.*, *supra* note 119, at 1130.

[307] *E.g.*, *In re* Nine W. Holdings, Inc., 588 B.R. 678, 686 (Bankr. S.D.N.Y. 2018)(applying business justification standard under 11 U.S.C. § 363(b) to retention and compensation of officers and listing substantially similar cases). Professional retentions and compensation are generally covered by other provisions of the Bankruptcy Code. *E.g.*, 11 U.S.C. § 327, 328, and 330.

[308] Horror stories of incompetence have been profiled, however. Two of the most notorious involved one director. *See In re* Innkeepers USA Tr., 442 B.R. 227, 231-32 (Bankr. S.D.N.Y. 2010); Ellias *et. al.*, *supra* note 19, at 1102.

[309] 11 U.S.C. § 1109(b).

settlements of insider claims. As shown by their historical reluctance to support examiners and chapter 11 trustees (and even further back, the problems of Chapter X), financial stakeholders naturally prefer to retain control. Any protocol for evaluating the impact of bankruptcy director retention should respect this reality.

The debtor would need to show both fair process and fair terms for a bankruptcy director to cleanse the debtor's proposed decisioning. Given the evidence generated by Professors Ellias, Kamar, and Kastiel, the process and the result are both extremely important. Put a different way, debtors should use a process that does not trigger the structural bias concerns.[310]

Outside of the bankruptcy context, recent scholarship has suggested both increasing and standardizing the amount of disclosure made to support the retention of proposed independent directors.[311] Among the relevant recommendation are (i) disclosure of all information the company considered in declaring the person "independent," (ii) SEC establishment of a non-exclusive list of information that the company should obtain from the proposed board member, and (iii) verification of the board's independence determination by an independent professional.[312]

Mapping these recommendations onto the bankruptcy director context, the United States Trustee could establish a standardized non-exclusive questionnaire.[313] Messrs. Rosen, Brownstein, and Gross's list provides a solid starting place.[314] The data, along with all other material considered by the debtor, would then be disclosed as part of the retention motion. Heightened disclosure would help transparentize an opaque process.[315] With the initial questionnaire as a preliminary marker, discovery propounded by the Committee, secured creditors, or even the United States Trustee could illuminate the process used to select the bankruptcy director

---

[310] *C.f.* Skeel, *supra* note 168, at 2125 (noting control by a party that is more disinterested than the current model of bankruptcy directors may "reduce the perception, and possibly the reality, of insider control in bankruptcy").

[311] Yaron Nili, *Out of Sight, Out of Mind: The Case for Improving Director Independence Disclosure,* 43 J. CORP. L. 35, 62 (2017).

[312] *Id.* at 70-72.

[313] Although it has been subject to criticism, the longevity of the United States Trustee's "Jay Alix Protocol" for retention of CROs and their firms illustrates that the United States Trustee can play an informal role in the process. Timothy W. Brink & James R. Irving, *Emerging Trends and Lingering Criticisms: A CRO Retention Update,* AM. BANKR. INST. J., September 2013, at 18, 18, 88 (describing Jay Alix protocol and its adoption). Consistent with the goal of allowing financial stakeholders to decide whether the bankruptcy directors should be considered independent, stakeholders, the United States Trustee should not have an outsized role.

[314] *See supra* note 294.

[315] This is similarly true outside of bankruptcy. *See* Nili, *supra* note 311.

and whether the proposed person was an appropriate choice. In the end, the debtor would have the burden of satisfying both requirements of entire fairness. The adversarial nature of the motion process, plus the bankruptcy court's consideration of whether the process and terms are fair, would provide independent verification.[316]

The result of the entire fairness inquiry would determine the standard for evaluating the independent director's decisions, not his or her retention. If the debtor satisfies both procedural and substantive fairness, then the bankruptcy director will be categorized as a neutral actor and the business justification standard will apply to his or her decisions.[317] The Court could still allow a Committee to evaluate the bankruptcy director's decisions, but they would be given deference. The recent case of *Performance Powersports Group* illustrates this dynamic within the context of the Sponsor control era.

Performance Powersports Group Holdings, Inc. ("PPG") and its affiliates sell dirt bikes, go-karts, ATVs, and golf carts throughout the United States. Less than two years before their bankruptcy filing, Kinderhook Industries, LLC ("Kinderhook"), a Sponsor, consummated a leveraged buyout of PPG's equity holders for a total purchase price of $112 million.[318] As part of the transaction, PPG became a portfolio company of Kinderhook, who was the sole equity holder and held multiple board seats.[319] PPG's financial distress stemmed from supply chain disruptions and a vendor dispute. Shortly before their bankruptcy filing, PPG appointed a bankruptcy director who was delegated authority to review and act when a conflict of interest arose between PPG and Kinderhook.[320] The bankruptcy director undertook an investigation into claims against Kinderhook and concluded

[316] This is a distinction from the retention of independent directors outside of bankruptcy where their independence is generally only tested in *ex post* when the propriety of a transaction is tested in litigation. Nili, *supra* note 311, at 62.

[317] *See* James M. Peck, et al., *The Importance of Being Truly Independent*, AM. BANKR. INST. J., January 2018, at 40.

[318] Declaration of Ken Vanden Berg in Support of Debtors' Chapter 11 Petitions and First Day Motions and Applications, *In re* Performance Powersports Group Investor, LLC, Case 23-10047, (Bankr. D. Del. Jan. 16, 2023) [Dkt Entry No. 16] [hereinafter Vanden Berg Declaration].

[319] Omnibus Objection of The Official Committee of Unsecured Creditors to the Debtors' (I) Motion for Entry of Interim and Final Orders Authorizing the Debtors to Obtain Postpetition Financing and (II) Motion for Entry of Order Approving Bidding Procedures for Sale of Substantially All of the Debtors' Assets, *In re* Performance Powersports Group Investor, LLC, Case 23-10047, (Bankr. D. Del. Feb. 20, 2023) [Dkt Entry No. 152] [hereinafter PPG Committee Objection].

[320] Declaration of Peter Kravitz in Support of DIP Motion and Sale Motion, *In re* Performance Powersports Group Investor, LLC, Case 23-10047, (Bankr. D. Del. Mar. 22, 2023) [Dkt Entry No. 253] [hereinafter Kravitz Declaration].

that no viable claims existed.[321]

As a paradigmatic example of Sponsor control, Kinderhook played three "separate" roles in the bankruptcy case – equity holder, proposed lender, and proposed purchaser. As part of their first-day pleadings, PPG sought approval of DIP financing provided by a Kinderhook affiliate and bid procedures that proposed another Kinderhook affiliate as the stalking horse purchaser.[322] Among the proposed consideration Kinderhook would receive for providing the DIP financing was a release of claims against it and its affiliates.[323] Cognizant of the conflicts created by Kinderhook's equity position, PPG's board delegated authority to the bankruptcy director to negotiate the DIP financing and sale process on behalf of PPG.[324]

An unhappy vendor, the Committee, and the United States Trustee objected to the bid procedures and the DIP financing.[325] Judge Silverstein approved the bid procedures with only minor changes, but she adjourned the DIP motion (including the proposed release) to set up a combined hearing on the approval of the 363 Sale and allow the Committee to investigate any claims against Kinderhook. When no other purchaser bid on the debtors' assets, PPG cancelled the auction and sought approval of the 363 Sale to Kinderhook. Kinderhook, however, made it clear that it would only close if it obtained the release in the proposed DIP financing. By that time, the Committee had finished a parallel investigation into claims against Kinderhook and similarly concluded that no valid claims existed.[326]

Judge Silverstein approved both the DIP financing motion and 363 Sale motion in an oral ruling.[327] She emphasized the extensive and uncontradicted evidentiary record that the DIP financing and 363 Sale were the best deals available to the debtor's estate following extensive marketing processes (including a pre-petition sales process).[328] Her ruling tracked the entire fairness inquiry by finding that "based on all this evidence, the sale

---

[321] *Id.*

[322] Vanden Berg Declaration. Although it was not the senior lender, Kinderhook avoided a priming fight as the senior lenders agreed to consensual use of cash collateral; the new funding was provided on a junior basis.

[323] As originally proposed, the DIP financing included a release of any related individual, but the release was subsequently narrowed to only include the Sponsor and affiliates.

[324] Kravitz Declaration.

[325] The Committee's initial objection to the 363 Sale sought to apply the heightened/entire fairness standard notwithstanding the independent status of the bankruptcy director. PPG Committee Objection.

[326] Hearing Audio, *In re* Performance Powersports Group Investor, LLC, Case 23-10047, (Bankr. D. Del. Feb. 20, 2023) [Dkt Entry No. 262] at 1:54:01-1:54:46.

[327] *See id.*

[328] *Id.*

process was fair, the notice was appropriate, the sale price is a fair price, and I see no collusion, no evidence of insider influence."[329] The importance of the bankruptcy director was obvious given her repeated reference to his involvement in negotiations.[330] She concluded that "regardless of what standard I look at, whether it be business judgment, the intermediate standard, or the entirely fair standard, I find that the evidence supports the sale."[331] Thus, she did not opine whether the business judgment rule or the entire fairness standard applied, but the presence of the bankruptcy director and his role in negotiating the 363 Sale and the DIP financing were crucial.[332]

Absent statutory change, one of a Committee's core functions is to investigate conflicted transactions and insider wrongdoing.[333] To balance this authority with a bankruptcy director appointment that satisfies entire fairness, one could envision a bankruptcy judge following Judge Silverstein's playbook of allowing the Committee to conduct its own investigation, but still giving deference to the debtor while requiring a strong evidentiary basis to support the bankruptcy director's decisioning.

Failure to satisfy either procedural or substantive fairness will mean that any decision by the independent director would be equivalent to one by the debtor. The bankruptcy director will not be fired, but he or she will not cleanse the debtor's decisioning.[334] If a transaction is at issue, it would be subject to the entire fairness standard. If a claim against an insider is under consideration, then derivative standing (subject to court approval) would be appropriate.

What about the fact that bankruptcy directors are usually retained pre-petition? Bankruptcy directors' pre-bankruptcy decisions should be evaluated like any other director's and should not be ratified or specially insulated. Indeed, the most controversial aspect of the *Mountain Express* bankruptcy directors' retention motion was the request to ratify pre-petition actions by the bankruptcy directors.[335] Judge Jones appropriately refused to approve this request.[336]

A protocol for evaluating the cleansing effect of bankruptcy directors is imperative. Not only would it help mitigate substantive gamesmanship like ratification of pre-petition actions, but it would also narrow the scope for

---

[329] *Id.* at 2:00:11-2:00:55.
[330] [add cites]
[331] *Id.* at 2:01:03-2:01:17.
[332] *Id.* at 1:51:19-1:52:18 & 1:55:27-1:58:01.
[333] *See supra* note 141 and text accompanying.
[334] This perspective parallels Professors Ellias, Kamar, and Kastiel's. Jared A. Ellias et. al., *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. 1083, 1131 (2022).
[335] Mountain Express UST Objection.
[336] *See* Mountain Express Bankruptcy Director Order.

procedural disputes. Although a default practice may emerge, it will likely require extensive and expensive litigation.[337] A court-developed protocol, like the one proposed by this article, would short-circuit the value-destroying development process.

Conclusion

Whether it is focused on the outset of the case[338] or its conclusion,[339] criticism of modern bankruptcy strategies is commonplace. There is a person or persons behind these decisions exercising control rights. Often, the decisions with the highest stakes are made by bankruptcy directors. Bankruptcy directors' relationships with patrons reflect the current era of Sponsor control and parallels the co-receivers of the equity receivership era. Just because Sponsors can control the debtor for their benefit, does not mean they normatively should. Bankruptcy courts should adopt a process to allow stakeholders to evaluate the propriety of bankruptcy directors' appointments. The bankruptcy system's credibility depends on it. It may be tempting to further strengthen Committees or facilitate more examiner and trustee appointments. On the one hand, we should remember that no private actor, even a Committee, "has the incentive to maximize the value of the business across all states of the world."[340] On the other hand, interested parties have shown little interest in court-appointed fiduciaries. Lessons from prior treatments of control rights in bankruptcy should not be forgotten and any reform should focus on stakeholders' interests and realigning control rights with the fulcrum security holders.

---

[337] This is particularly true because disputes over involving bankruptcy directors often settle prior to any definitive ruling. *See supra* note 223. Indeed, bankruptcy practice inherent settlement predilection is well-documented. *E.g.*, Daniel J. Bussel, *A Third Way: Examiners As Inquisitors*, 90 AM. BANKR. L.J. 59, 119 (2016); Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 633, 678-91 (2009).

[338] *See* Ayotte & Huang, *supra* note 239 (criticizing DIP financing that establishes reorganization payoffs at the outset of the case); Levitin, *supra* note 287(criticizing venue and judge shopping in bankruptcy).

[339] *See* Ralph Brubaker, *Mandatory Aggregation of Mass Tort Litigation in Bankruptcy*, 131 YALE L.J. Forum 960 (2022)(criticizing non-debtor releases in chapter 11 plans); Robert Miller, *Equitable Mootness: Ignorance Is Bliss and Unconstitutional*, 107 KY. L.J. 269, 292-93 (2019)(criticizing equitable mootness).

[340] Baird & Rasmussen, *supra* note 170, at 1243.

Faculty

Jason D. Angelo is counsel with Reed Smith LLP's Financial Industry Group in Wilmington, Del., where he practices in the areas of restructuring, insolvency and commercial litigation, including related appellate work. His diverse practice includes advising a variety of constituents in complex business reorganizations and insolvency matters, including debtors, secured creditors, creditor committees, equityholders, parties to preference and fraudulent-transfer disputes, and other key stakeholders. He also has experience representing and advising indenture trustees and other fiduciaries in the corporate trust space. Mr. Angelo has been recognized as a "Rising Star" in the restructuring and insolvency community by the *IFLR1000* (2022-23), was selected as part of the"NextGen" Program (2021) sponsored by the American College of Bankruptcy and the National Conference of Bankruptcy Judges, and participated in the 2022 Pathfinder Program with the Leadership Counsel on Legal Diversity. Upon graduating from law school, Mr. Angelo clerked for Hon. Marie P. Simonelli of the New Jersey Superior Court—Appellate Division. He currently serves on the Delaware State Bar Association's DE&I Steering Committee, is a member of the board of directors of the Philadelphia LGBTQ+ Bar Association, and previously chaired the Delaware State Bar Association's LGBTQ+ Committee for a number years. He also has been a Co-Chair of Reed Smith's Global LGBTQ+ Business Inclusion Group, PRISM, since 2019, and he was an inaugural member of the Diverse Alumni of Seton Hall (DASH) Committee. Mr. Angelo volunteers with the Delaware Office of the Child Advocate, Delaware Volunteer Legal Services and the ACLU of Delaware. He received his undergraduate degree in 2010 cum laude from the University of Delaware and his J.D. cum laude in 2013 from Seton Hall University School of Law, where he served as editor-in-chief of the *Seton Hall Legislative Journal* and won Seton Hall's Congressman Peter W. Rodino, Jr. Award for Leadership, Service, and Humanitarianism.

L. Katherine Good is a partner with Potter Anderson & Corroon LLP in Wilmington, Del., and coheads its bankruptcy team. She focuses her practice on corporate restructuring, bankruptcy and creditors' rights. Ms. Good regularly represents debtors, secured lenders, committees, asset-purchasers, liquidation trusts and other parties in chapter 11 cases, as well as foreign representatives and other parties in chapter 15 ancillary proceedings. She regularly litigates in bankruptcy court as well as in appeals before federal district courts and courts of appeals. Ms. Good has represented companies in successful out-of-court restructurings and pre-packaged and pre-arranged bankruptcy cases. In addition, she has experience with substantive nonconsolidation opinions for structured finance transactions. Ms. Good received her B.A. from the University of North Carolina at Chapel Hill and her J.D. from Emory University School of Law.

Zachary J. Javorsky is an associate in Richards, Layton & Finger, P.A.'s Bankruptcy & Corporate Restructuring department in Wilmington, Del., where his practice focuses on corporate bankruptcy, bankruptcy litigation, corporate restructuring and other insolvency matters. He received his undergraduate degree from Pennsylvania State University and his J.D. *magna cum laude* from Penn State Dickinson Law.

Hon. Karen B. Owens is a U.S. Bankruptcy Judge for the District of Delaware in Wilmington. Prior to her appointment, she was a director in the Bankruptcy and Insolvency group of Ashby & Geddes, P.A., where she maintained a diverse practice, representing corporate debtors, estate professionals, various secured and unsecured creditor constituencies, and other interested parties in reorganization and liquidation proceedings and bankruptcy-related litigation. Prior to joining Ashby & Geddes, Judge Owens started her career at Skadden, Arps, Slate, Meagher & Flom as a corporate restructuring associate, and later went on to clerk for Hon. Brendan Linehan Shannon of the U.S. Bankruptcy Court for the District of Delaware. She is an adjunct professor in the Bankruptcy L.L.M. Program at St. John's University School of Law in New York, co-president of the Delaware Bankruptcy American Inn of Court, a member of the board of directors of the Philadelphia/Wilmington Chapter of the Turnaround Management Association, and a member of the International Women's Insolvency & Restructuring Confederation. Judge Owens received her Bachelor's degree from Pennsylvania State University, where she was Phi Beta Kappa, and her J.D. *summa cum laude* from American University's Washington College of Law, where she served as an associate managing editor for the *American University Law Review* and as legal intern to Hon. Stephen S. Mitchell of the U.S. Bankruptcy Court for the Eastern District of Virginia.

Hon. Christopher S. Sontchi is an international judge of the Singapore International Commercial Court and is the former Chief Judge of the U.S. Bankruptcy Court for the District of Delaware in Wilmington, where he served for 16 years. He also is the sole member of Sontchi, LLC, where he conducts mediations and arbitrations, provides expert services, and serves as an independent fiduciary. Judge Sontchi is a frequent speaker in the U.S. and abroad on issues relating to corporate reorganizations, having made over 100 appearances. He also is a Lecturer in Law at the University of Chicago Law School and has taught restructuring to international judges with the World Bank Group, most recently in the People's Republic of China. Judge Sontchi is a member of the Singapore International Arbitration Centre, International Insolvency Institute, Judicial Insolvency Network, National Conference of Bankruptcy Judges, ABI and INSOL International. He recently was inducted into the American College of Bankruptcy. In addition, he is a member of the International Advisory Council of the Singapore Global Restructuring Initiative and the Founders' Committee for the University of Chicago Law School's Center on Law and Finance. Justice Sontchi has testified before Congress on the safe harbors for financial contracts. He has also published articles on creditors' committees, valuation, asset sales and safe harbors. Following law school, Judge Sontchi clerked for Hon. Joseph T. Walsh in the Delaware Supreme Court. He received his B.A. Phi Beta Kappa with distinction in political science from the University of North Carolina at Chapel Hill and his J.D. from the University of Chicago Law School.