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Corporate Governance and Bargaining in the Shadow of Bankruptcy

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CONCURRENT SESSION

2024

Corporate Governance and Bargaining in the Shadow of Bankruptcy

I. Introduction/Background

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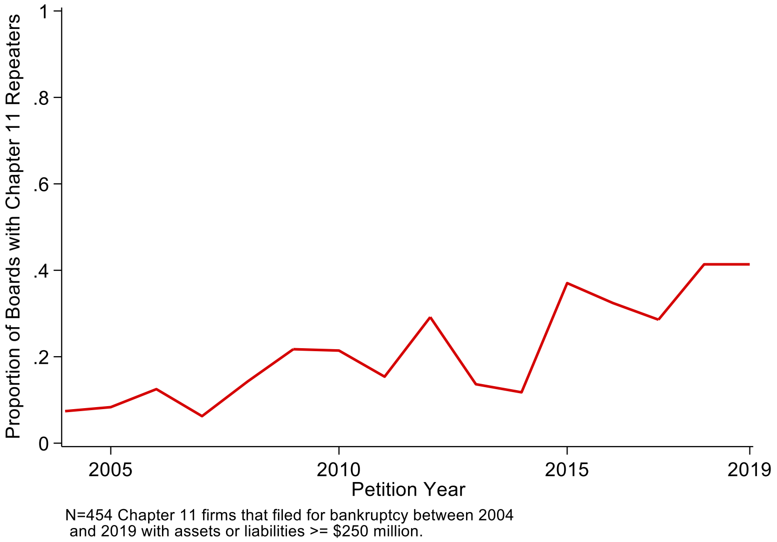
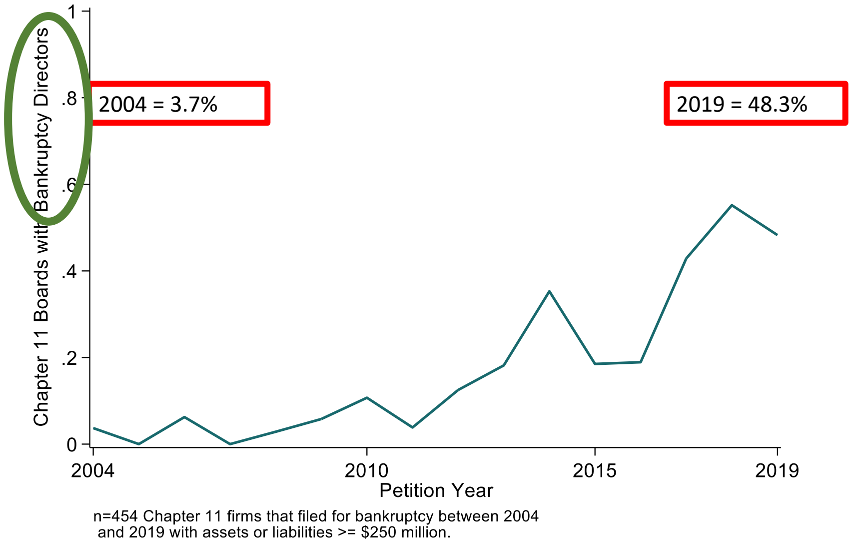
Proportion of Chapter 11 Cases with "Bankruptcy Repeaters" on Board, 2004-2019



Proportion of Chapter 11 Cases Where Board Claims Director Independence, 2004-2019



What did the directors do on the boards?

<u>**Role of Bankruptcy Directors**</u>	
Evaluate Restructuring Proposals, Negotiate With Creditors, Run Sale Process	71%
Investigate Claims Against Pre-Bankruptcy Shareholders	44%
Investigate Claims Against Pre-Bankruptcy Lenders	17%
Investigate Pre-Bankruptcy Shareholders or Creditors	46%

Of N=78 bankruptcy director cases.

III. Real Life Examples

- What not to do – FTX discussion
- What to do – Privately held business example
- Conclusions
- Q & A

Bankruptcy Hardball

Jared A. Ellias* and Robert J. Stark**

On the eve of the financial crisis, a series of Delaware court decisions resulted in a radical change in law: creditors would no longer have the kind of common law protections from opportunism that helped protect their bargains for the better part of two centuries. In this Article, we argue that Delaware's shift materially altered the way large firms approach financial distress, which is now characterized by a level of chaos and rent-seeking unchecked by norms that formerly restrained managerial opportunism. We refer to the new status quo as "bankruptcy hardball." It is now routine for distressed firms to engage in tactics that harm some creditors for the benefit of other stakeholders, often in violation of contractual promises and basic principles of corporate finance. The fundamental problem is that Delaware's change in law was predicated on the faulty assumption that creditors are fully capable of protecting their bargains during periods of distress with contracts and bankruptcy law. Through a series of case studies, we show how the creditor's bargain is often, contrary to that undergirding assumption, an easy target for opportunistic repudiation and, in turn, dashed expectations once distress sets in. We further argue that the Delaware courts paved the way for scorched earth corporate governance. Fortunately, judges can help fix the problem with more rigorous application of existing legal doctrines.

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INTRODUCTION

In late 2017, PetSmart Inc. (PetSmart), one of the world's leading retailers of pet supplies, found itself in deep financial distress.[1] The company's financial troubles originated with an ill-fated leveraged buyout and acquisition that burdened PetSmart with billions of debt in the form of secured bank loans and unsecured bonds.[2] The leveraged buyout and acquisition did not go well. PetSmart's bond debt began trading at steep discounts, suggesting that traders in the bond market viewed the firm as insolvent.[3] The textbook account of corporate governance would suggest that PetSmart's board of directors would respond to this financial distress by seeking to improve the underlying business or, perhaps, by filing for Chapter 11 bankruptcy to maximize the value of the firm for the benefit of creditors, who would collect before PetSmart's shareholders. Instead, PetSmart's board authorized a transaction that seems shocking for a firm in its situation: it took nearly $2 billion out of the reach of creditors, distributing about $900 million to its shareholders, and placing $750 million in a subsidiary that was not obligated to repay its $9 billion in debt.[4]

The PetSmart scenario is emblematic of a paradigm shift in how boards of directors now approach financial distress.[5] For most of American history, boards of directors were counseled to manage distressed firms with an eye towards

1. *See* Eliza Ronalds-Hannon & Lauren Coleman-Lochner, *The Most Expensive Takeover in Retail is Drowning in Debt*, BLOOMBERG (Apr. 25, 2018), https://www.bloomberg.com/news/articles/2018-04-25/yielding-21-in-bond-market-the-no-1-retail-lbo-is-in-trouble/ [https://perma.cc/HA9N-ZPQ8].

2. *See id.*

3. *See id.*

4. *See* Eliza Ronalds-Hannon & Katherine Doherty, *PetSmart Moves Part of Chewy.com Out of Creditors' Reach*, BLOOMBERG (June 4, 2018), https://www.bloomberg.com/news/articles/2018-06-04/petsmart-is-said-to-move-chewy-stake-in-j-crew-style-transfer/ [https://perma.cc/H9UB-3YH2].

5. Reporting in the popular media has also noticed that something has changed, but this Article is the first to describe the entirety of the phenomenon. *See, e.g.*, Soma Biswas, *Deal to Save J. Crew from Bankruptcy Angers High-Yield Debt Investors*, WALL STREET J. (Sept. 21, 2017), https://www.wsj.com/articles/deal-to-save-j-crew-from-bankruptcy-angers-high-yield-debt-investors-1506011065/ [https://perma.cc/YDG6-UXXU] (discussing a transaction that pushed "junior bondholders to the front of the line of creditors, ahead of term-loan holders, who were in a superior position . . ." and increasing fear on the part of debt investors that aggressive interpretations of credit contracts are undermining the debt markets); Sujeet Indap, *Private Equity Firms' Lawyers Get Creative*, FIN. TIMES (Aug. 14, 2017), https://www.ft.com/content/3a42e50e-7e23-11e7-9108-edda0bcbc928/ [https://perma.cc/FYT3-VWS4] ("Every [private equity] firm is adopting more aggressive approaches. Some sponsors will win, some will lose."); Nathan Vardi, *Leon Black's Apollo Global Management Keeps Winning Battles and Outmaneuvering Creditors*, FORBES (Aug. 28, 2014), https://www.forbes.com/sites/nathanvardi/2014/08/28/leon-blacks-apollo-global-management-keeps-winning-battles-and-outmaneuvering-creditors/#5d7c2da2785f/ [https://perma.cc/AS2N-CKAE] (noting that a leading private equity firm is routinely winning battles with creditors, whose claims are legally senior to shareholders). One prominent investment banker described 2018 as being characterized by "the brazen asset stripping [the rerouting of assets away from creditors] that [large firms] have gotten away with – mind boggling!" *See End of the Year Followup*, PETITION (Dec. 19, 2018) (quoting J. Scott Victor), https://petition.substack.com/p/petitions-2018-deal-of-the-year [https://perma.cc/S4CS-Y4Y3].

maximizing firm value for the benefit of creditors.[6] In today's world, by contrast, many firms pursue strategies intended to hurt creditors or, if possible, avoid bankruptcy for the benefit of shareholders. It is quite revealing that, after PetSmart removed nearly $2 billion from the reach of creditors, the trading price of its bonds actually *increased* in value.[7] The bondholders who were still harmed by the transaction likely breathed a sigh of relief because they had feared far worse.[8] Although unthinkable only a few years ago, in today's environment, a distressed firm's redistribution of nearly $2 billion away from its creditors is seen as unexpectedly generous to those same creditors because its private equity owner did not help itself to more.

In this Article, we argue that the norms restraining managers of distressed firms from declaring all-out war on creditors have been fading since the financial crisis.[9] Managers are now playing what we call "bankruptcy hardball" with creditors.[10] To be sure, it is well established that the interests of creditors, managers, and shareholders diverge when a firm becomes distressed.[11] The managers of a distressed firm can use their control to select from a range of options with important distributional ramifications for the firm's stakeholders.[12]

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6. Justice Story pioneered this area of jurisprudence in the early 1800s, first as a district court judge, *see* Wood v. Dummer, 30 F. Cas. 435, 435–40 (C.C.D. Me. 1824) (No 17,944), and then on the Supreme Court, *see* Mumma v. Potomac Co., 33 U.S. 281, 281–87 (1834). In short, his view was that managers of an insolvent firm operate the company as a "trust fund" for the benefit of creditors, and this view became known as the "trust fund doctrine." For a fuller discussion of the evolution of the trust fund doctrine into modern fiduciary duty shifting, see generally Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1332 (2007) (summarizing the transition from trust fund doctrine to duty shifting).

7. *See* Ronalds-Hannon & Doherty, *supra* note 4.

8. *See id.*

9. In another example, the private equity owner of Caesar's, the gaming conglomerate, decided to strip the firm of its best assets to gain bargaining power over creditors should the firm ultimately file for bankruptcy. In an internal presentation, employees of the private equity owner justified the transfer, later found by a court-appointed examiner to be a fraudulent transfer, as "increasing . . . [our] 'war chest' [to fight creditors with] upon a potential restructuring." *See* Final Report of Examiner Richard J. Davis at 343, *In re* Caesars Entm't Operating Co., 561 B.R. 441 (Bankr. N.D. Ill. 2016) (No. 15-01145).

10. The title was inspired by the recent works of Joseph Fishkin & David E. Pozen, *Asymmetric Constitutional Hardball*, 118 COLUM. L. REV. 915 (2018), and Mark Tushnet, *Constitutional Hardball*, 37 J. MARSHALL L. REV. 523 (2004). The behavior we label "bankruptcy hardball" does not necessarily involve a bankruptcy filing, and "bankruptcy hardball" should be thought of as describing a universe of aggressive tactics in debtor-creditor relations. Many of them are not new; what is new, we believe, is the frequency and intensity of the deployment of hardball tactics, partially as a result of legal changes we describe *infra* Part III.B.2–3.

11. *See* David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 923 (2003) (discussing corporate governance in bankruptcy); *see also* Michelle M. Harner et al., *Activist Investors, Distressed Companies, and Value Uncertainty*, 22 AM. BANKR. INST. L. REV. 167 (2014) (discussing Chapter 11 proceedings for alternative funds).

12. *See also* Adam J. Levitin, *The Problematic Case for Incentive Compensation in Bankruptcy*, 156 U. PA. L. REV. 88, 101 (2007) (noting that the biggest corporate governance problem in Chapter 11 is navigating "the uncertainties of valuation and hence of the incentives and identity of the residual owner"). *See generally* Harner et al., *supra* note 11; Lynn M. LoPucki & William C. Whitford, *Corporate Governance in Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993) (discussing management of insolvent companies).

While this moral hazard—which we call *control opportunism*[13]—is well established, what has changed over the past ten years is the level of aggressiveness now observed of otherwise conventional firms.

This change may be attributed, at least in part, to the common law's retreat from its historical role protecting creditors.[14] For most of American history, judges played an important role in policing control opportunism with various common law doctrines providing creditors with remedies if managers went beyond the accepted boundaries of opportunistic behavior.[15] These doctrines did not function to hold managers liable to creditors for any business decision that did not work out.[16] But, by explicitly focusing managerial decision-making on the interests of creditors and by exposing such decision-making to some form—albeit hazy—of potential liability, they likely deterred a kind of swashbuckling recklessness or intentional dereliction of the creditor's bargain.[17]

However, on the eve of the financial crisis, the Delaware courts suddenly changed course.[18] In 2007, the Delaware Supreme Court's *Gheewalla* decision limited the fiduciary duties that managers previously owed to creditors in times of financial distress.[19] This shift had an ideological motivation, as influential critics argued that creditors did not need protection from judges and that fiduciary duties and other equitable remedies were unnecessary to deter control opportunism.[20] After all, such commentators reasoned, the largest creditors—generally banks and bond investors—are well situated to protect themselves.[21] To the extent these sophisticated creditors fear opportunism, they can contract *ex ante* to prevent it, and courts can simply enforce those contracts as it becomes necessary to do so.[22] Further, some judges declared that any opportunistic behavior not identified *ex ante* and banned by "contractual agreements" are ably policed by other safety-valve equitable doctrines and laws, such as "fraud and

13. We believe this Article is the first to use the phrase "control opportunism" as a generic description of the perverse incentives that drive investors and managers to exploit their control over Chapter 11 debtors to extract private benefits, as further explained in Part I. But many of the agency problems and frictions on optimal governance discussed herein have been discussed in other work. *See* Levitin, *supra* note 12.

14. *See infra* Part II.

15. *See infra* notes 83–100 and accompanying text.

16. *See id.*

17. *See infra* notes 87–103 and accompanying text.

18. *See id.*

19. *See infra* notes 87–93 and accompanying text.

20. *See, e.g.*, Hu & Westbrook, *supra* note 6 (arguing that fiduciary duties for creditors are unnecessary); *infra* notes 87–89 and accompanying text.

21. *See, e.g.*, Hu & Westbrook, *supra* note 6; Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 864–68 (2008) (arguing against fiduciary duty protections for sophisticated creditors).

22. *See* Prod. Res. Grp. v. NCT Grp. (Production Resources), 863 A.2d 772, 789 (Del. Ch. 2004).

fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law, and other sources of creditor rights."[23]

In this Article, we argue that *Gheewalla* and its progeny relieved corporate decision-making of important guiding principles, and, in the vacuous space that now exists, remarkable instances of control opportunism are observable and increasingly common place.[24] We believe that this is the consequence of a fundamental misunderstanding of creditors' ability to protect themselves reliably and predictably with contracts and bankruptcy law.[25] First, we argue that there is no perfect contractual solution for this kind of problem because, even where creditors can foresee control opportunism, clever lawyering and the evolving circumstances of financial distress can help managers disable or evade enforcement of even the most skillfully crafted contractual covenants.[26] While the contractarian scholar might retort that creditors simply need to write better contracts, we argue that distress gives rise to a sort of cat-and-mouse game, where contract enforcement often hinges more on practical reality than judicial process, and well-advised debtors and creditors routinely arrive at outcomes inconsistent with *ex ante* contracts.[27] Indeed, as the cases we describe below make clear, debtors can often exploit their circumstances to essentially re-write their covenants while the otherwise counteracting force—the threat of breach of contract litigation—has increasingly less potency as a firm's distress deepens.[28]

Second, we contend that bankruptcy law currently provides far less protection for creditors than presumed by commentators and Delaware precedent.[29] In theory, when firms encounter severe financial trouble, they file for Chapter 11 bankruptcy, and the judge supervises a management team devoted to maximizing the firm's value to provide creditors with the best possible recovery, consistent with contractual terms negotiated pre-bankruptcy.[30] In practice, however, bankruptcy judges balance creditor interests against other policy goals, such as the need for the firm to finance itself post-petition, to

23. *See* N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) (declaring that creditors do not get fiduciary duties, but are rather "afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, [and] bankruptcy law . . . ").

24. *See infra* notes 101–103 and accompanying text.

25. *See infra* notes 105–173 and accompanying text; *see also* Haslund v. Simon Prop. Grp., 378 F.3d 653, 655 (7th Cir. 2004) (Posner, J.) (noting complete contracts are impossible, and contracts can be "shorter and simpler and cheaper" when courts fill gaps and resolve ambiguities in the case of litigation).

26. *See infra* notes 105–173 and accompanying text.

27. *See id.*

28. *See id.*

29. *See, e.g.*, Hu & Westbrook, *supra* note 6, at 1369–78 (arguing bankruptcy provides sufficient protection for creditors, and, therefore, fiduciary duty shifting to creditors should be abolished). *See contra infra* notes 175–261 and accompanying text.

30. *See generally* John A. E. Pottow, *Fiduciary Principles in Bankruptcy and Insolvency*, *in* THE OXFORD HANDBOOK OF FIDUCIARY LAW 205 (Evan J. Criddle et al. eds., 2019).

reorganize, and to protect the jobs of current and future employees.[31] As further explained below, clever debtors and their lawyers understand this and have developed procedural strategies that effectively disable the formal machinery of creditor protection, including related doctrines like the law governing fraudulent transfers.[32] This sort of bankruptcy hardball may help explain why PetSmart's board decided to make such an opportunistic distribution of value: with funds already in hand, the firm's private equity sponsor became better positioned to get more than it might be entitled to at the conclusion of a bankruptcy process or out-of-court restructuring.[33]

This Article proceeds as follows. In Part I, we define the problem of control opportunism. In Part II, we describe the common law's migration away from creditor protection, as well as the ideological underpinnings of that paradigm shift. In Part III, we discuss several case studies that illustrate the current state of affairs. While creditors were successful in thwarting opportunistic behavior in some of the cases we describe, we choose these cases because they illustrate different strategies that managers can use to play bankruptcy hardball, with great costs to creditors.[34]

In Part IV, we argue that Delaware judges and bankruptcy judges could do a great deal to restore order to debtor-creditor relations by subjecting alleged control opportunism to greater scrutiny and by taking a more skeptical view of attempts by managers to disable *ex ante* contracts.[35] Admittedly, *Gheewalla* is not the only force that has reshaped debtor-creditor relations. For example, perpetually favorable debt market conditions in the years after the financial crisis have reduced the bargaining power of debt investors and emboldened managers, and the rise of hedge funds and claims trading has changed the administration of Chapter 11.[36] However, we assert that, *ceteris paribus,* the status quo could be improved if today's standards were applied more rigorously.[37] Judges have the

31. *See, e.g.*, *infra* notes 175–224 and accompanying text.

32. *See infra* notes 220–261 and accompanying text.

33. *See, e.g.*, *In re* Lyondell Chem. Co., 503 B.R. 348, 353 (Bankr. S.D.N.Y. 2014), *abrogated by In re* Tribune Co. Fraudulent Conveyance Litig., 818 F.3d 98 (2d Cir. 2016) (demonstrating the advantage of already having received money even if there is fraudulent transfer risk associated with the conveyance).

34. They also present cases involving at least some degree of arguable control opportunism. Many cases, we suspect, involve less readily observable opportunistic conduct.

35. *See, e.g.*, Henry E. Smith, *Equity as Second-Order Law: The Problem of Opportunism* (Harvard Pub. L., Working Paper No. 15-13, 2015) (arguing that equitable doctrines are needed to constrain opportunism).

36. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648 (2010); Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1686 (2009) (detailing many changes that have altered the bargaining dynamic in Chapter 11, such as the rise of claims trading, the influence of hedge funds, and investors holding credit default swaps). For a discussion of the continuing borrower-friendly credit markets, see Joe Rennison, *In Leveraged Loans*, *Sellers Are Still in Near-Total Control*, FIN. TIMES (Mar. 22, 2019), https://www.ft.com/content/68a67be6-4b58-11e9-8b7f-d49067e0f50d/ [https://perma.cc/445E-ZW76].

37. *See infra* Part IV.

discretion to counteract opportunistic behavior if they choose to do so.[38] Indeed, the credit markets need predictability more than anything else, and today's frenzied world of dashed expectations and chaotic litigation is anything but predictable.[39] To the extent that creditor expectations are not routinely upheld *ex post*, investors will adjust *ex ante* by avoiding certain deal structures—perhaps making efficient financings unreachable in some cases, limiting the supply of capital to businesses.[40]

I.
THE PROBLEM OF CONTROL OPPORTUNISM DURING TIMES OF FINANCIAL DISTRESS

In this Section, we define what we believe is the major friction on optimal governance for distressed firms: control opportunism.[41] After establishing this analytical framework, we explain how management will be tempted to use their control over the firm to extract benefits—either for itself or for its traditional fiduciary constituents, the shareholders—by favoring one group of investors over another.

A. The Classic Twin Agency Problems of Corporate Law

In a healthy corporation, the main agency problems of managers and shareholders are well understood and usually considered to be driven by different problematic incentives.[42] First, managers are said to be tempted by moral hazard to use their control of a healthy firm to extract value that would otherwise go to shareholders, such as by abusing the compensation-setting process to extract undeserved money[43] or by manipulating a sale process to make it easier for

38. *See id.*

39. *See* Clifford J. White III, *Professional Fees, Corporate Governance, Predictability and Transparency in Chapter 11*, 35 AM. BANKR. INS. J. 12 (2016) (discussing the importance of predictability in Chapter 11).

40. Investors often tailor investment contracts with an eye towards minimizing the firm's cost of capital—which can involve allocating control and monitoring rights in a range of arrangements. If creditors cannot trust that their recovery expectations will be held up *ex post*, it may limit the contracting space that investors can use to customize these bargains, reducing the supply of capital on the margin and perhaps even reducing the aggregate amount of economic activity.

41. For a more expansive treatment of all of the ways creditors can be opportunistic, see Jonathan C. Lipson, *Governance in the Breach: Controlling Creditor Opportunism*, 84 S. CAL. L. REV. 1035, 1049–59 (2011). Lipson discusses what he calls "creditor opportunism," a wider category that includes not only abuses of the power of control but also complexities created by creditors owning a wide range of claims against the firm. What we call "control opportunism" is a more limited species of opportunism because it is confined to the temptation creditors have to be opportunistic through obtaining control of the firm, but "control opportunism" is also more expansive because it focuses on the behavior of managers, not creditors.

42. For the seminal article on this topic, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

43. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (discussing executives' control over their pay).

management's preferred owner to buy the company instead of a higher paying bidder.[44]

There is a second agency problem at the heart of corporate governance as well: the agency conflict between shareholders and creditors.[45] Shareholders control a firm by electing the board of directors, which hires the senior officers who actually run the firm.[46] Because managers owe shareholders a fiduciary duty, it is often assumed they are operating the firm on behalf of shareholders.[47] However, the typical firm also usually funds its activities with some amount of debt.[48] This leads to an agency conflict when the firm approaches insolvency because managers may take excessive risks to pursue shareholders' interests.[49] For example, a firm may launch a new product that will either succeed massively or exhaust the firm's remaining assets.[50] To the extent these risks turn out to produce strong returns, the returns mostly inure to the benefit of shareholders.[51] To the extent the risks are unsuccessful, the downside generally falls on creditors who can find themselves holding claims against a firm with diminished value.[52] Creditors recognize this problem and routinely contract to block managers from pursuing excessively risky actions. For example, creditors may require firms to keep a minimum level of money in the bank or insist on creditor approval for major investments that could divert significant amounts of value.[53]

B. The Debt-Equity Conflict in Modern Finance: Control Opportunism and Incentive Conflicts between Holders of Options

The debt-equity conflict becomes even more complicated when its theoretical intuitions are imposed on modern corporate finance. Large conglomerates do not fit the classic paradigm of one corporate borrower, a single creditor, and an individual shareholder.[54] Instead, sizeable firms fund their

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44. *See, e.g.*, LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES (Yakov Amihud ed., 1989) (discussing the debate over management's private interests in deciding the timing and purchaser of leveraged buyouts).

45. *See, e.g.*, Michael C. Jensen & Clifford W. Smith, Jr., *Stockholder, Manager, and Creditor Interests: Applications of Agency Theory*, *in* RECENT ADVANCES IN CORPORATE FINANCE (E. I. Altman & M. G. Subrahmanyam eds., 1985).

46. For a discussion of the history of independent directors, see 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 (2007).

47. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2019).

48. *See, e.g.*, Joshua D. Rauh & Amir Sufi, *Capital Structure and Debt Structure*, 23 REV. FIN. STUD. 4242 (2010).

49. *See* Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118–19 (1979).

50. *See id.*

51. *See id.*

52. *See id.* at 118.

53. *See id.* at 125–46 (describing bond covenants).

54. *See* Rauh & Sufi, *supra* note 48, at 4243.

activities with a combination of secured debt, unsecured debt, and equity.[55] The investors who provide all three forms of capital are contracting to receive different levels of return with different levels of risk.[56] It is clearest to think of modern investors as holding options with different levels of priority against the firm's assets.[57]

Consider a hypothetical firm owned by a private equity sponsor that owes $100 to secured creditors and $50 to unsecured bondholders. In insolvency, all of these investors will be the equivalent of the holders of options.[58] The firm's secured lenders have what they probably think of *ex ante* as a deeply-in-the-money, capped call option to receive a repayment of principal plus an interest payment, as well as the right to receive the first $100 in firm value in insolvency. The firm's unsecured bondholders have the equivalent of a capped option to receive the next $50 in value from $100 until $150. The private equity sponsor has an option to receive all of the value of the firm after the $150 in debt has been paid in full.[59]

Accordingly, for the modern firm, the debt-equity conflict is driven by the firm's financial circumstances and solvency at any given point in time. Imagine our hypothetical firm is considering a business plan that has a 50 percent chance of yielding a total firm value of $200 if it succeeds, and a 50 percent chance of destroying most of the firm's value and leaving only $10 for distribution to creditors if it fails. If the firm is worth $100 today, secured creditors stand in the same position as "creditors" in the classic debt-equity narrative in that they will suffer the downside of the plan's failure, going from a 100 percent payoff to a 10 percent payoff. And while the private equity shareholder remains the ultimate beneficiary of the plan's success, the first $50 inures to the benefit of unsecured creditors. As a result, the classic debt-equity conflict is better understood as a conflict between the holders of "deeply-in-the-money" options versus "out-of-

55. *See id.*

56. *See, e.g.*, C. Edward Dobbs, *Negotiating Points in Second Lien Financing Transactions*, 4 DEPAUL BUS. & COM. L.J. 189 (2006) (discussing the interest of lenders in funding riskier, junior lien loans in exchange for higher returns).

57. *See, e.g.*, ASWATH DAMODARAN, INVESTMENT VALUATION: TOOLS AND TECHNIQUES FOR DETERMINING THE VALUE OF ANY ASSET 611–46 (3d ed. 2012).

58. *See, e.g.*, *id.* The option-pricing framework is useful here because it provides a single framework for thinking about how pre-bankruptcy investors are treated in bankruptcy. In bankruptcy, state law and contract characteristics like security and subordination create a hierarchy between creditors who have a right to receive a pay out if their claim is "in the money." Investors are "in the money" if the firm is worth enough that the investors, with their spot in line, can expect to receive a payout. For example, if a firm is worth $500 as of the Chapter 11 petition date, a senior creditor who is entitled to the first $50 in firm value has a "deeply-in-the-money" option, meaning the firm's value would have to go down by $450—our measure of depth—for that senior creditor to sustain losses. If the firm is instead worth $100, the senior creditor would still be "in the money," but not as deeply in the money as before. A similar senior creditor owed $50 by a firm worth only $50 has an "at-the-money" call option, where the expected payout will be reduced dollar-for-dollar if the firm's value falls.

59. *See generally* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 654 (1973).

the-money" options, where the identity of the option holders will vary based on the underlying facts.[60] One cannot identify the incentives of a particular investor simply by looking at the type of investment contract they used—secured loan versus unsecured loan, for example—without contextualizing the priority created by those contracts within the capital structure as a whole and the firm's value.

When a firm is insolvent, management will enjoy two forms of control over the ultimate payoff the firm's investors receive. The first is over the *substance* of any restructuring. This can involve, for example, migrating value within a conglomerate or away from the firm altogether through distributions to shareholders.[61] These types of transactions are about manipulating how and how much particular stakeholders recover vis-à-vis competitors in the capital structure.[62] There are less overt instances of substantive control including managerial decisions about a firm's new business plan, how much value generally exists for distribution to creditors, and what the reorganized firm's capital structure should look like.[63] An aggressive business plan with optimistic projections of future earnings can support a higher valuation and more debt than a pragmatic plan with more conservative assumptions.[64] The higher the valuation, the more value that management or a bankruptcy judge can deem exists for distribution to creditors or shareholders.[65]

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60. This is not a new way of viewing the debt-equity conflict. Chancellor Allen reflected on a similar hypothetical in the famous footnote 55 of *Credit Lyonnais*. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991). The key intuition in this framework is to recognize the traditional model of debt-equity agency conflict—shareholders want risk, creditors want to liquidate today—is incomplete when mapped onto the complexity of modern finance. For example, unsecured creditors of one firm may have a bias towards liquidation because they are deeply in the money, while unsecured creditors of another firm may have a bias towards taking risks because they are out of the money. One cannot understand the bias of an individual investor simply by looking at the type of investment contract they have; one must look at the broader context of the value of the firm to recognize how those incentives might impact their behavior.

61. For example, the debtor can move value outside of a collateral basket under a secured loan agreement or from one corporate entity to another.

62. An example of this kind of substantive control is the PetSmart fact pattern discussed above, where the board authorized a large dividend to shareholders and otherwise migrated value within the conglomerate away from creditors before restructuring discussions even began. *See supra* notes 2–5 and accompanying text.

63. *See* Jared A. Ellias, *Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?: Evidence from Junior Activist Investing*, 8 J. LEGAL ANALYSIS 493, 494–96 (2016).

64. *See id.*

65. At the end of the bankruptcy case, the judge must apportion the value of the firm based on pre-bankruptcy entitlements to value. As it is impossible to achieve a scientific measurement of the value of an operating business, the typical practice in bankruptcy is to estimate the firm's value via expert evidence or an auction process for all of the firm's assets. When the firm's value is estimated with expert evidence, an investment banker will typically draw on management's business plan to come up with an estimated range of firm value, and the judge will determine whether a plan proponent, relying on such expert evidence, has carried its burden of proof. *See id.*

Second, management controls the *timing* of any decision to restructure its debt by modifying its debt contracts and reorganizing its capital structure.[66] This can mean a consensual out-of-court exchange or a bankruptcy filing.[67] These decisions can also be enormously consequential for investors.[68] A quick bankruptcy filing can benefit senior option holders, who may prefer to exchange their debt for the firm's equity today rather than risk further degradation of firm value.[69] A slow trip through bankruptcy can extend the option of out-of-the-money creditors or shareholders, and give the firm's operations time to improve.[70]

In exercising this discretion, management will be tempted by what we refer to as *control opportunism*: corporate decision-making that favors one group of stakeholders over another and can benefit management financially or in other ways.[71] For example, imagine that there are plausible reasons to think that a troubled firm should delay bankruptcy because its fortunes will improve, and also imagine that, at the same time, there are equally plausible reasons to think a firm should immediately file for bankruptcy because its fortunes will not improve. Neither option is a clear value-maximizing strategy, so the board looks for reasons other than value maximization to select one strategy over the other. Management can align with the senior option holder and file for bankruptcy immediately with a conservative business plan and strategy to exit bankruptcy quickly. In exchange, the senior option holder can reward managers with lucrative post-bankruptcy employment.[72] Alternatively, management can align with junior option holders and delay filing for bankruptcy as long as possible, or file for bankruptcy with an aggressive business plan that keeps junior option holders in the money. Management may choose this path for several different reasons. One is because they traditionally think of themselves as working for the shareholders who appointed them. Another possibility is that management holds

66. *See* Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219, 221–33 (2004).

67. *See generally* William W. Bratton & Adam J. Levitin, *The New Bond Workouts*, 166 U. PA. L. REV. 1597 (2018) (discussing out-of-court debt exchanges exchanges).

68. *See generally* LoPucki & Whitford, *supra* note 12, at 691–719.

69. *See id.*

70. *See id.*

71. Here too, Chancellor Allen's footnote 55 is reflective of what is observed in the real world. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) ("The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors."); *see also* Ellias, *supra* note 63 (describing the moral hazards and perverse incentives managers face).

72. *See, e.g.*, Jared A. Ellias, *Regulating Bankruptcy Bonuses*, 92 S. CAL. L. REV. 653, 682 (2019) (discussing the post-bankruptcy employment contract awarded by senior option holders to Citadel Broadcasting's CEO).

a potentially lucrative block of the firm's stock. Lastly, management may simply have little affinity for the firm's lenders.[73]

Moreover, even a manager free of any bias towards any stakeholder has private incentives to run a bankruptcy process geared towards a quick exit and lower creditor recoveries. For example, managers generally want to avoid the scrutiny and expense associated with bankruptcy.[74] If bankruptcy is unavoidable, then they naturally want the company to exit as soon as possible to minimize the delay, inconvenience, and business dislocation that comes with running a firm under bankruptcy court administration.[75] Managers also generally prefer to have as little debt as possible upon emergence from bankruptcy in order to free up future financing capacity and make a return trip to bankruptcy less likely.[76] Further, management is unlikely to benefit from a prolonged bankruptcy process that exhausts restructuring options and fairly adjudicates all creditor claims.

Importantly, control opportunism can have significant real-world consequences. Fear that managers will favor one creditor group over another can upset incentives to invest *ex ante*.[77] Further, the incentives managers have to be strategic and run a speedy bankruptcy process lead many observers to conclude Chapter 11 practice currently favors senior option holders at the expense of junior creditors and shareholders, even without any attempt by management to favor one group over another.[78]

II.
THE MODERN APPROACH OF THE COMMON LAW TO CONTROL OPPORTUNISM

While modern finance has complicated the story of control opportunism, the law has long recognized that managers have distorted incentives when a firm nears insolvency. Historically, courts extended equitable protections that created liability for managers who grossly abused their discretion. In early American history, this equitable protection took the form of the so-called "trust fund doctrine." In modern times, judges used fiduciary duty law to protect creditors.[79]

73. Social psychology has long recognized that people tend to be biased in favor of other people and things they are more familiar with. *See, e.g.*, Robert B. Zajonc, *Attitudinal Effects of Mere Exposure*, 9 J. PERSONALITY & SOC. PSYCHOL. 1 (1968) (showing evidence of the mere exposure effect).

74. *See generally* Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991) (suggesting that managers prioritize avoiding financial trouble, especially bankruptcy).

75. *See id.*

76. *See* Paul M. Goldschmid, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 191 COLUM. BUS. L. REV. 191, 266–67 (2005).

77. *See generally* Barry E. Adler, *Game-Theoretic Bankruptcy Valuation*, 41 J. LEGAL STUD. 209 (2012).

78. *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003); George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19 (2004); Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 KY. L.J. 839 (2005); *see also* Skeel, *supra* note 11, at 923.

79. As this Article focuses on developments since the financial crisis, space constraints prevent us from fully discussing the trust fund doctrine. For good introductions, see Hu & Westbrook, *supra*

In this Section, we briefly summarize the rise and fall of modern fiduciary duties to creditors.

A. *The Emergence of Fiduciary Duties for Creditors in Delaware*

In the early 1980s, corporate debt became more central to corporate finance, as banking deregulation and the rise of junk bonds changed the traditional profile of a typical corporate creditor. Thus, the classic agency problem between debt and equity began to loom larger and larger. The problem of debt grew in importance as junk bonds opened up a new source of junior priority financing, and firms began to finance riskier ventures with debt that might have previously been funded with equity.[80] Junk bonds also financed a wave of leveraged buyouts. Debt as a percentage of firm value increased from about 25 percent of firm value in the 1930s to 65 percent in the early 1990s.[81] Eventually, corporate America began to labor under this unprecedented debt load.

Perhaps in reaction to the rise of debt as well as the need to adjudicate claims arising out of leveraged buyouts, the Delaware Chancery Court expanded the range of scenarios in which boards of directors would need to consider creditor interests.[82] In *Credit Lyonnais,* the court held that the board of a firm "operating in the vicinity of insolvency" owed its fiduciary duty not just to shareholders but also to the "corporate enterprise" as a whole.[83] This shift was

note 6, at 1331–36, and Norwood P. Beveridge, Jr., *Does a Corporation's Board of Directors Owe a Fiduciary Duty to its Creditors?*, 25 ST. MARY'S L.J. 589 (1994). Justice Story's "trust fund doctrine" also aligned with seminal receivership and bankruptcy precedent, including Supreme Court opinions: (i) establishing the absolute priority rule, see *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482, 502 (1913); (ii) imposing strict evidentiary standards before creditors must cede value to shareholders, see *Nat'l Sur. Co. v. Coriell*, 289 U.S. 426, 436–37 (1933); and (iii) condemning control opportunism intended to shift estate value from creditors to shareholders, see *Pepper v. Litton*, 308 U.S. 295, 311–13 (1939). Many of these principles were incorporated into the Bankruptcy Code, see for example 11 U.S.C. § 1129(b)(2) (2018), and continue to shape lender expectations. But, as discussed herein, these principles are increasingly ignored and/or rendered ineffectual in the day-to-day administration of insolvency scenarios and bankruptcy cases.

80. *See* Jeremy I. Bulow et al., *Distinguishing Debt from Equity in the Junk Bond Era*, *in* DEBT, TAXES, AND CORPORATE RESTRUCTURING 135, 144–45 (John B. Shoven & Joel Waldfogel eds., 1990).

81. *See* John R. Graham et al., *A Century of Capital Structure: The Leveraging of Corporate America,* 118 J. FIN. ECON. 658, 659 (2015) (tracing the history of corporate debt).

82. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991); *see also* Dianne F. Coffino & Charles H. Jeanfreau, *Delaware Hits the Brakes: The Effect of* Gheewalla *and* Trenwick *on Creditor Claims*, 17 J. BANKR. L & PRAC. 1 (2008) (describing the shift). Even prior to *Credit Lyonnais*, many courts outside of Delaware held that the fiduciary duties of directors shifted from the corporation's stockholders to its creditors when the corporation was in fact insolvent. *See, e.g.*, Clarkson Co. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981); *see also* FDIC v. Sea Pines Co., 692 F.2d 973, 976–77 (4th Cir. 1982) ("However, when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors."). Note that, even before *Credit Lyonnais* and *Gheewalla*, some Delaware courts had already begun to articulate a view that deprived creditors of equitable protections. *See, e.g.*, Katz v. Oak Indus., 508 A.2d 873, 879 (Del. Ch. 1986) ("The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.").

83. 1991 WL 277613, at *34. Twenty-five years before *Credit Lyonnais*, in 1974, a Delaware court suggested in dicta that a creditor might be able to recover against directors or officers of a

necessary given directors' incentives to put creditors' money at risk while looking out for shareholder interests.[84] The *Credit Lyonnais* opinion, while unpublished, was widely influential in changing the liability calculus of boards of directors. After *Credit Lyonnais*, if the firm was "in the vicinity of insolvency," directors could be held liable to creditors as well as shareholders.[85]

B. *Academic Critique of Equitable Protections and Judicial Movement Away from Fiduciary Duties for Creditors*

The law's evolution toward protecting creditors was not well-received by many academic commentators and Delaware jurists. Academics disputed the fundamental logic of *Credit Lyonnais*.[86] Courts thought they were reducing the costs of contracting by not requiring creditors to anticipate all scenarios where creditor interests could diverge from shareholders. Academic contract theorists, in particular, became increasingly convinced that equitable doctrines aimed to achieve fairness—like those voiding otherwise enforceable contracts—were largely unnecessary and that courts should enforce agreements strictly as written.[87] As Douglas Baird and Robert K. Rasmussen wrote in an influential article in 2006, after first describing the ability of lenders to create and enforce contractual covenants:

> In today's environment, we see little need for judicial doctrines designed to promote investor welfare. For example, courts in recent years have taken more seriously the notion that the board's allegiance should shift to the creditors when the business finds itself in the "zone of insolvency." In the absence of such a shift of priorities, the argument goes, the board may incline too much toward imprudent gambles

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corporation even without a contractual right in the event of "fraud, insolvency, or a violation of a statute . . . ." Harff v. Kerkorian, 324 A.2d 215, 222 (Del. Ch. 1974), *aff'd in part, rev'd in part*, 347 A.2d 133 (Del. 1975).

84. *See Credit Lyonnais*, 1991 WL 277613, at *34; *see also* Myron M. Sheinfeld & Judy Harris Pippitt, *Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case*, 60 BUS. LAW. 79, 88 (2004).

85. *See, e.g.*, Bo Becker & Per Strömberg, *Fiduciary Duties and Equity-Debtholder Conflicts*, 25 REV. FIN. STUD. 1931, 1933, 1937 (2012) (noting that *Credit Lyonnais* was "immediately recognized as an important precedent" and finding empirical evidence that firms altered their capital structure and investment policy in light of the new legal regime).

86. *See, e.g.*, Hu & Westbrook, *supra* note 6, at 1348 ("[D]uty shifting doctrines are flatly inconsistent with the long-held aspirations of the field of corporate governance and they preclude the use of analytical techniques made possible by modern finance."); *see also* Frederick Tung, *Gap Filling in the Zone of Insolvency*, 1 J. BUS. & TECH. L. 1201, 1204 (2007) ("[A]t least for commercial creditors, fiduciary duties that include such creditors are unnecessary . . . .").

87. *See* Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1193 (2003) (arguing that the ability of banks and bondholders to protect themselves and exit bad investments mean that they should be limited to the contractual rights they have negotiated); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 618 (2003) (arguing that commercial parties "want the state to enforce the contracts that they write, not the contracts that a decisionmaker with a concern for fairness would prefer them to have written").

> designed to get them back into the money. Such a shift of fiduciary duties may be unnecessary, however. Lenders, as we have seen, are quite capable of taking care of themselves. Rather than adding ill-defined fiduciary duties to the contracts that they write, a better course may be to ensure that such duties do not impede the exercise of contractual rights for which creditors have bargained.[88]

As academic commentators increasingly argued against fiduciary duty shifting on theoretical grounds, Delaware courts grew less confident that the system they created in *Credit Lyonnais* was administrable or logically coherent.[89] Thus, in *Gheewalla*, the Delaware Supreme Court essentially reversed *Credit Lyonnais* and eliminated the idea that fiduciary duties shift in the "zone of insolvency."[90] The court noted that creditors have many ways to protect themselves, such as contractual covenants, fraudulent transfer law, and the implied covenant of good faith. The court concluded that these protections "render the imposition of an additional, unique layer of protection through direct claims for breach of fiduciary duty unnecessary."[91] *Gheewalla* merely left open the possibility that creditors could bring derivative claims against the board when the firm became insolvent.[92]

In *Quadrant Structured Products Co. v. Vertin*, the Delaware Chancery Court went even further, arguably placing creditors in a worse position in fiduciary duty analysis than prior to *Credit Lyonnais*.[93] In *Quadrant*, the court found that the directors and officers of insolvent firms do not owe a fiduciary duty to creditors.[94] Instead, the directors of an insolvent firm may consider the interests of creditors when assessing their fiduciary duty to the corporation,

88. Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1248 (2006); *see also* Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency,* 1 J. BUS. & TECH. L. 335 (2007) (arguing that firms in the zone of insolvency owe creditors only those rights contracted for and those implied by the covenant of good faith).

89. *See* Trenwick Am. Litig. Tr. v. Ernst & Young, 906 A.2d 168, 170–74 (Del. Ch. 2006) (echoing the reasoning of the Chancery Court that deepening insolvency was only a "catchy term" and not a legitimate cause of action); *see also* Hugh M. McDonald et al., *Lafferty's Orphan: The Abandonment of Deepening Insolvency*, 26 AM. BANKR. INST. J. 56, 56 (2007) ("[D]eepening insolvency—whether articulated as a cause of action or theory of damages—is based on a brittle legal foundation that is quickly eroding away.").

90. *See* Quadrant Structured Prod. Co. v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014) ("In *Gheewalla,* the Delaware Supreme Court discarded the zone [of insolvency]."); *see also* Adam B. Badawi, *Debt Contract Terms and Creditor Control*, 4 J. L. FIN. ACC. 1 (2019) (examining the impact of the *Gheewalla* decision); Charles H. Jeanfreau, *Unexpected Setbacks for Creditors in Chapter 11 Cases*, 2012 ANN. SURVS. BANKR. L. 365, 369 (2012) ("After *Gheewalla,* the ability of creditors of solvent corporations to use the threat of a breach of fiduciary duty lawsuit against directors to increase their leverage in restructuring negotiations was sharply curtailed.").

91. N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 100 (Del. 2007).

92. *See generally* Coffino & Jeanfreau, *supra* note 82.

93. *See* 102 A.3d at 174 (Del. Ch. 2014).

94. *See id.* at 176 (citing Robert J. Stearn, Jr. & Cory D. Kandestin, *Delaware's Solvency Test: What Is It and Does It Make Sense? A Comparison of Solvency Tests Under the Bankruptcy Code and Delaware Law*, 36 DEL. J. CORP. L. 165, 171 (2011)).

which in some cases might justify taking a "less risky" course of action such as an efficient liquidation.[95] But, if the directors, in their business judgment, decide to take "extreme risk," that decision too will be protected by the business judgment rule.[96]

In sum, *Quadrant* confirmed that *Gheewalla* marked a radical shift in the law. Prior to *Gheewalla*, it was largely uncontested that directors needed to focus their efforts on creditor returns during times of insolvency, or face liability.[97] After *Gheewalla*, that is no longer the case. While creditors may still bring derivative claims in limited scenarios such as disloyal wealth transfers,[98] this remaining right represents scant consolation for the loss of the broader protections previously enjoyed under traditional equity jurisprudence.[99]

Juxtaposing the advice lawyers gave to distressed debtors before and after *Gheewalla* and *Quadrant* provides important evidence of the paradigm shift in the approach boards are counseled to take when a firm approaches insolvency. For example, in an article written for clients in 2001, lawyers at a leading law firm wrote that "[w]hen a corporation becomes insolvent, . . . [r]ather than pursuing high-risk strategies for the benefit of shareholders, directors must seek to protect creditors' claims to corporate assets and earnings."[100] After *Quadrant,* a leading law firm wrote in a client alert that directors can now favor some

95. *See id.* at 175 (citing *Production Resources*, 863 A.2d 772 (Del. Ch. 2004), as standing for the proposition that the "zone of insolvency" line of cases should be understood as providing directors a defense if they choose a more conservative course of action instead of "undertak[ing] extreme risk"). In the language of financial economics, an efficient liquidation is a liquidation where the assets are efficiently put to their highest-valued use, typically through sale to its highest valued user. For example, a failed retailer might efficiently liquidate its land to a housing developer that builds apartment buildings. For a deeper discussion of how bankruptcy law reallocates assets toward productive uses, see Shai Bernstein et al., *Asset Allocation in Bankruptcy*, 74 J. FIN. 5 (2019).

96. *See* Quadrant Structured Prod. Co. v. Vertin, 102 A.3d 155, 192 (Del. Ch. 2014) (stating that the creditor plaintiff cannot rebut the business judgment rule merely by arguing that the directors took an excessively risky course of action, so long as it was designed to benefit the corporation as a whole, including creditors).

97. As Sabin Willett notes, the change created by *Gheewalla* was so significant that it likely took lawyers a period of adjustment before they began to advise boards that fiduciary duties no longer ran to creditors. *See* Sabin Willet, Gheewalla *and the Director's Dilemma*, 64 BUS. LAW. 1087, 1088 (2009).

98. *See* Quadrant Structured Prod. Liability Co. v. Vertin, 115 A.2d 535, 544 (Del. Ch. 2015) (noting that the chief function of the creditor derivative suit is to protect a corporation from self-dealing payments and other disloyal wealth transfers).

99. *See* Prod. Res. Grp. v. NCT Grp., 863 A.2d 772, 798 (Del. Ch. 2004) (suggesting that such a scenario could be a situation in which "directors display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor"); *see also* Bryan Anderson, Gheewalla *and Insolvency: Greater Certainty for Directors of Distressed Companies*, 11 U. PA. J. BUS. L. 1031, 1037 (2009) (explaining that dicta in *Production Resources* and *Big Lots* left open the possibility of direct claims by creditors).

100. J. Douglas Bacon & Jennifer A. Love, *When Good Things Happen to Bad People: Practical Aspects of Holding Directors and Managers of Insolvent Corporations Accountable*, 10 J. BANKR. L. & PRAC. 185, 186 (2001).

creditors over others without having to worry about liability.[101] Another leading law firm wrote that *Quadrant* protects directors "adopting a high-risk business strategy that might benefit controlling shareholders when a corporation is insolvent . . . ."[102]

In other words, pre-*Gheewalla,* the advice was stern, directional, and protective of the creditors' bargain. Post-*Quadrant*, the advice is vacuous and provides little directional guidance to the board. Advice focuses instead on the freedom from liability the board now enjoys so long as the board can plausibly justify its actions.

III.
GHEEWALLA'S SHAKY FOUNDATIONS

Without fiduciary duty, creditor protection rests on the idea that creditors are sufficiently protected through contract law, with fraudulent transfer law and bankruptcy law hovering in the background. We consider each of these arguments in turn, using case studies to suggest that each area of law provides far less protection for creditors than the Delaware courts assumed.

A. The Limits of Contractual Solutions to Control Opportunism

The classic argument against equitable protections for creditors is that creditors can protect themselves with contract law.[103] The problem with this argument is that creditors cannot design perfect contractual language *ex ante* to cover all conceivable forms of opportunism. In this Section, we use three case studies to show how management can play bankruptcy hardball to thwart contractual expectations or impose costs that creditors could not have prevented *ex ante*. In our first case study, *Forest Oil*, we show how managers can design transactions to exploit contractual ambiguities. The lesson of this case study is that even creditors who anticipate opportunism can struggle to craft a covenant that good lawyers cannot evade *ex post.* In our second case study, *Cumulus*

101. *See* John L. Reed, *Delaware Court of Chancery Issues Significant Ruling on the Ability of Creditors to Assert Fiduciary Duty Claims Against Directors: Key Takeaways*, DLA PIPER LLP (May 14, 2015), https://www.dlapiper.com/en/us/insights/publications/2015/05/delaware-court--chancery-issues-significant-ruling/ [https://perma.cc/7KN2-MN33] (noting that after *Gheewalla*, directors can favor certain creditors over others without breaching their fiduciary duty and have no obligation to run the business for the protection of creditors); *see also* SULLIVAN & CROMWELL LLP, MORE CLARITY FOR DELAWARE DIRECTORS WHEN CONSIDERING RESTRUCTURING TRANSACTIONS (2015), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Restructuring.pdf/ [https://perma.cc/Y9PR-D6S6] (noting that directors are now protected by the business judgment rule even in insolvency); Marshall S. Huebner & Darren S. Klein, *The Fiduciary Duties of Directors of Troubled Companies*, 34 AM. BANKR. INST. J. 18 (2015).

102. Mark S. Chehi et al., *Delaware Court of Chancery Decision Clarifies Fiduciary Issues in Insolvent Company Context*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (2015), https://www.skadden.com/insights/publications/2015/01/delaware-court-of-chancery-decision-clarifies-fidu/ [https://perma.cc/LK5Q-4HW5].

103. *See supra* notes 83–89 and accompanying text.

Media, we show that managers can reinterpret contractual language for uses and transactions that were probably never anticipated by the lenders that originally extended credit. In the third case study, *Colt Holdings*, we show how control of a corporation can give managers the opportunity to stall a bankruptcy filing and, after filing for bankruptcy, to stall an inevitable restructuring, destroying millions of dollars in value to prolong the private equity owner's option value. This problem is very hard to solve with a contract.

The important lesson of this Section is that, even when creditors expressly recognize a risk, designing a contractual solution is hard—and may, in fact, be impossible given the skill of the lawyers that represent insolvent companies and that the threat of contract-based litigation has decreasing potency as the company's fortunes deteriorate.

1. *Forest Oil: Thwarting the Intent of a Contract with Form-Over-Substance Transaction Engineering*

For an example of how control opportunism can thwart creditors' bargained-for protections, consider Forest Oil Corporation (Forest Oil). In early 2014, Forest Oil was a deeply troubled company.[104] The oil and natural gas firm was buffeted by declining revenue and overwhelming debt, which included borrowings under a reserve-based loan facility and about $800 million in unsecured bonds.[105] In May of 2014, Forest Oil entered a deal that promised to solve its financial trouble: a sale of the firm to Sabine Oil & Gas Company (Sabine).[106] Under the terms of the deal, the combined entity would repay all outstanding debt, and Forest Oil's public stockholders would receive a healthy equity interest in the new enterprise.[107] The transaction was scheduled to close towards the end of 2014.[108]

Importantly, Forest Oil's bondholders had protected themselves with a "change-of-control" covenant in case the firm was sold or underwent a similar fundamental transformation.[109] The bond indentures defined "change-of-control" broadly to include several possibilities, including: (1) when a person or group comes to own more than 50 percent of the total voting power of the company; (2) upon the sale of all or substantially all of the assets of the company; and (3) upon a merger or consolidation with another entity resulting in Forest Oil stockholders no longer holding at least 50 percent voting power.[110] The "change-of-control" covenant thus required the bond debt to be paid off in full if someone

104. *See* Declaration of Michael Magilton at 7, *In re* Sabine Oil & Gas Corp., 547 B.R. 503 (Bankr. S.D.N.Y. 2016) (No. 15-11835).

105. *See id.* at 19–20, 50–52.

106. *Id.* at 13.

107. *See In re Sabine Oil & Gas Corp.,* 547 B.R. at 521.

108. *See id.*

109. *See id.*

110. Complaint ¶¶ 24–57, Wilmington Sav. Fund Soc'y v. Forest Oil Corp., No. 650584/2015 (N.Y. Sup. Ct. Feb. 25, 2015) [hereinafter Wilmington Savings Complaint].

bought Forest Oil.[111] Accordingly, Sabine arranged for the combined firm to borrow $800 million in new bank debt to refinance the outstanding bonds.[112]

However, prior to the closing of the transaction between Forest Oil and Sabine, crude oil prices collapsed and threw the assumptions undergirding the deal into chaos.[113] Sabine found itself with a deal it no longer wanted on the terms it had negotiated.[114] While Sabine had the financial wherewithal to close the deal, the fall in oil prices meant that the combined company would struggle to service the debt that the deal would require.[115] Sabine wanted out.[116] The Forest Oil board initially refused, and for good reason: Forest Oil would not survive on its own, and falling commodity prices were a contractual risk assumed by Sabine and its private equity sponsor.[117] Indeed, by this point, Forest Oil was clearly insolvent, with assets estimated to cover approximately 70 percent of its bond debt.[118] To avoid bankruptcy, Forest Oil needed the deal to somehow close—but on terms Sabine could accept.[119]

To bridge the gap with Sabine, a Forest Oil director suggested an alternative approach.[120] The merger would close as originally planned, but the Forest Oil bonds would not be refinanced.[121] Rather, the bonds would remain outstanding post-closing, but subordinated to $1.65 billion in preexisting Sabine secured debt that would be merged into the combined company.[122] To achieve this outcome, the transaction was re-engineered to avoid triggering a "change-of-control" under the Forest Oil bond indentures.[123] The work-around was simple: instead of buying all of Forest Oil's stock, Sabine's equity sponsor would receive stock with limited control rights.[124]

The re-engineered transaction circumvented the intent of the "change-of-control" covenant. More specifically, the revised transaction would allow Forest Oil stockholders to retain majority voting power in the company, but it would

111. *See In re Sabine Oil & Gas Corp.,* 547 B.R. at 521.

112. *See id.*

113. Crude oil fell from $103 per barrel in July to $55 per barrel by mid-December of 2014. Complaint ¶¶ 51–53, *In re* Sabine Oil & Gas Corp., 547 B.R. 503 (2016) (No. 15-11835) [hereinafter Sabine Oil Complaint].

114. *See In re Sabine Oil & Gas Corp.*, 547 B.R. at 525.

115. *See* Debtors' Objection to the Motions of the Official Committee of Unsecured Creditors, Forest Notes Indenture Trustees, and Bank of New York Mellon Trust Company N.A. for (I) Leave, Standing, and Authority to Commence and Prosecute Certain Claims and Causes of Action on Behalf of the Debtors' Estates And (II) Non-Exclusive Settlement Authority at 4, *In re* Sabine Oil & Gas Corp., 547 B.R. 503 (2016) (No. 15-11835) [hereinafter Sabine Oil Debtors' Objection].

116. *See id.*

117. *See* Sabine Oil Complaint, *supra* note 113, ¶¶ 75–81.

118. *See id.* ¶¶ 120–22.

119. *See id.* ¶¶ 81.

120. *See In re Sabine Oil & Gas Corp.*, 547 B.R. at 526.

121. *See id.* at 525–27.

122. *See id.*

123. *See id.*

124. *See id.* at 525.

leave them with only a 26.5 percent economic interest.[125] First, a Certificate of Amendment authorized Forest Oil to increase the number of its common shares and to create new "Series A Non-Voting Equity-Equivalent Preferred Shares."[126] Sabine then contributed its equity interests in Sabine Oil & Gas Holdings LLC to Forest Oil.[127] In exchange for those equity contributions, Forest Oil granted Sabine shares of Forest Oil stock, representing, in all, approximately a 73.5 percent economic interest in the new company and 40 percent of the total voting power.[128] Because Forest Oil stockholders still retained a 60 percent majority of the voting stock of the company, a "change-of-control" did not occur as dictated by the bond indenture.[129]

By any practical measure, however, a "change-of-control" certainly had occurred. The Forest Oil and Sabine boards approved "technical changes" to the post-closing corporate charter and bylaws. These changes gave Sabine's private equity owner virtual control of the new board of directors that was guaranteed far into the future.[130]

The Forest Oil and Sabine boards reached a solution—but one that came at the expense of bondholders. The modified transaction closed mid-December 2014, without any advance notice to stakeholders.[131] The bond market gasped at the betrayal, and the market value of outstanding Forest Oil bonds dropped from more than $800 million when the merger was announced to less than $370 million. Bondholders found themselves suddenly sitting behind more than $1.6 billion in legacy Sabine secured debt in the combined corporate structure.[132] The Forest Oil bondholders promptly brought suit.[133] Unfortunately, the lawsuit did not go far. A few months after the deal closed, the combined company filed for Chapter 11 relief.[134] The bondholders' lawsuit was stayed by the Chapter 11 filing before the state court could even consider a motion to dismiss. In the end, Forest Oil bondholders recovered less than $16 million, or about 97 percent less than they could have received had their bargained-for covenants been honored.

2. *Cumulus Media: Thwarting the Intent of a Contract with an Implausible Debt Exchange*

For another example of a debtor devising a restructuring transaction that simultaneously satisfies the technical language of a debt contract while standing

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125. *See id.*
126. Sabine Oil Complaint, *supra* note 113, ¶ 97.
127. *See id.* ¶ 98.
128. Declaration of Michael Magilton, *supra* note 104, at 62.
129. *See In re Sabine Oil & Gas Corp.*, 547 B.R. at 526.
130. *See* Wilmington Savings Complaint, *supra* note 110, at 44–46.
131. *See id.* at 41.
132. *See* Christine Idzelis & Laura J. Keller, *Forest Oil Seen Punishing Bondholders with Rarely Used Loophole*, BLOOMBERG (Dec. 17, 2014), https://www.bloomberg.com/news/articles/2014-12-17/forest-oil-seen-punishing-bondholders-with-rarely-used-loophole/ [https://perma.cc/KW82-LQG5].
133. *See* Declaration of Michael Magilton, *supra* note 104, at 26.
134. *See id.* at 1–2.

the spirit of the language on its head, consider Cumulus Media Inc. (Cumulus), one of the country's largest owners of radio stations.[135] Prior to financial distress, Cumulus borrowed $2.4 billion, consisting of a $1.8 billion senior secured term loan and $610 million in unsecured notes.[136] By 2015, Cumulus began struggling and started exploring options to restructure its balance sheet.[137] By the end of 2016, the implied market value of Cumulus was below the amount of the secured debt, suggesting that the unsecured noteholders were completely "out of the money."[138]

Cumulus' term loan credit agreement included standard terms that allowed the company to borrow additional secured debt under a "working capital" revolving line of credit. In general, a revolving line of credit is the corporate equivalent of a personal credit card. A revolving line of credit allows a company to borrow money and then repay it later. Most firms use revolving lines of credit to pay their daily operational needs, including raw material costs, payroll, rent, and utilities. Importantly, the revolving line of credit would be senior in payment priority to Cumulus' term loan. While it may seem strange for term lenders to allow other lenders to have a senior claim, doing so actually protects the term lenders by providing the company the means to manage its business.[139] Revolving loans are generally a safe form of lending for banks, with low interest payments and a low likelihood of not being repaid in full if the firm falls into financial distress.

As is increasingly common among distressed firms, Cumulus reacted to its financial distress by devising an aggressive strategy to "refinance" its debt. In reality, there was no refinancing: Cumulus planned to transform its bondholders into revolving lenders through a sham transaction that created a dubious revolving line of credit. The plan proceeded in three steps. First, Cumulus would

135. *See* Declaration of John F. Abbot in Support of Chapter 11 Petitions and First Day Motions at 3, *In re* Cumulus Media Inc., No. 17-13381 (Bankr. S.D.N.Y. Nov. 30, 2017) [hereinafter Declaration of John F. Abbot].

136. The term loan was secured by a first priority lien on substantially all of Cumulus' assets. *See* Cumulus Complaint Seeking Declaratory Judgment at 2, Cumulus Media Holdings Inc. v. JPMorgan Chase Bank, No. 16-cv-9591 (S.D.N.Y. Mar. 3, 2017), 2017 WL 1367233 [hereinafter Cumulus Complaint].

137. *See* Declaration of John F. Abbot, *supra* note 135, at 18–19 (noting that Cumulus made several large acquisitions, including Citadel Broadcasting in 2011 and then Westwood One in 2013).

138. Cumulus' market value was only about $1.45 billion or, in other words, about $360 million less than the amount due to the secured lenders, rendering the unsecured noteholders completely out of the money. *See* Term Loan Parties' Memorandum of Law in Opposition to Plaintiffs' Motion for Summary Judgment and in Support of Plaintiffs' Motion for Summary Judgment at 5–6, *Cumulus Media Holdings Inc.*, No. 16-cv-9591, 2017 WL 1367233 [hereinafter Cumulus Term Loan Parties' Memo] (reporting that between the third quarter of 2013, when the Term Loans were made, and the third quarter of 2016, Cumulus' earnings fell by nearly 50 percent, from $416 million annually to $212 million).

139. The credit agreement allowed Cumulus to borrow in this way up to $200 million on a senior basis, but that amount could be increased with "incremental" facilities at the discretion of the borrower. By early 2017, Cumulus seemingly had the ability to borrow up to an additional $305 million ahead of the term lenders. *See* Cumulus Term Loan Parties' Memo, *supra* note 138, at 7.

"borrow" the full amount allowed under their revolving line of credit.[140] Second, management would dramatically increase the interest rate (from about 4.25 percent to 14.25 percent) and extend the maturity date of the new debt without needing the permission of anyone other than the revolving lenders.[141] Third, management would give the high interest, senior secured debt to the bondholders in a debt exchange that replaced $610 million in out-of-the-money unsecured debt with $305 million "borrowed" under the revolving line of credit.[142]

In short, the firm would magically transform the bondholders, Cumulus' unsecured creditors, into secured creditors through exploiting the right to obtain a senior credit line for working capital. The firm's shareholders would benefit from this exchange, as it would decrease the firm's overall debt. The firm's term lenders, however, would see their rights against their collateral diluted by $209 million.[143] The term lenders reacted with fury and sued to block the exchange. After extensive litigation, the term lenders convinced a judge to enjoin the plan.[144]

The failed Cumulus proposal was brazen. When the credit agreement was signed, Cumulus had bargained for certain rights that were meant to provide the firm with working capital in the event of financial distress. Presumably, *ex ante,* the lenders who extended the term loan did not anticipate, let alone consciously decide to assume the risk, that Cumulus would use these rights to refinance junior, unsecured bond debt and bootstrap such debt to a senior priority position. Cumulus' strategy was not only based on an implausible reading of the credit agreement but also remarkably inconsistent with the underlying principles of secured lending. While the court eventually blocked Cumulus, the firm still wasted years pursuing dead-end restructuring strategies, incurring unnecessary litigation expense, and suffering unknown opportunity costs.

3. *Colt Holdings: Helpless Creditors in the Face of a Management Team Determined to Extract a Ransom for their Private Equity Sponsor*

In some cases, managers do not need to stand behind an improper reading of a contract to harm creditors. Instead, they can simply delay a restructuring, effectively holding the firm hostage to preserve shareholder option-value. Consider the conduct of Colt Holdings Company (Colt), the manufacturer of

140. *See id.* at 13.

141. *See id.*

142. *See id.*

143. *See id.* at 7–8.

144. *See id.* at 9. Most importantly, a provision in the credit agreement blocked Cumulus from taking actions that "materially and adversely" affected the interest of the term lenders. *See* Cumulus Complaint, *supra* note 136, at Exhibit A § 4.25 ("Cumulus Term Loan Agreement"). The amendment to the credit agreement was the removal of the financial ratio that allowed the firm to incur incremental secured debt as part of the debt exchange. The Term Lenders also argued that the credit agreement allowed the refinancing of the senior notes through the transaction Cumulus sought to effectuate. *Id.* § 8.8(j); *see* Transcript of Proceedings at 90, *Cumulus Media Holdings Inc.*, No. 16-cv-9591, 2017 WL 1367233 [hereinafter Cumulus Transcript with Ruling].

iconic "Colt" firearms. Colt endured a prolonged period of financial distress primarily because its private equity sponsor starved it for cash and left it unable to invest in improving its business. Management then tried to use Chapter 11 to protect the private equity firm's investment while denying creditors their rightful recovery, in violation of foundational legal principles.[145] This strategy did not work, and the case ended in predictable fashion but only after the legal and other administrative expenses consumed the money that the company might have otherwise used to modernize its operations.

We include this case study because it further illustrates the limits of contract law as a serviceable protection for creditors. The sort of opportunistic conduct employed here—stalling, ignoring creditors in negotiations, and pursuing deals that were in the best interests of a deeply out-of-the-money shareholder while the firm deteriorated—seems virtually impossible to protect against via contractual covenants.[146] Even though creditors were able to eventually prevail in litigation, there is no remedy at law to make them whole.

Much of Colt's debt originated from a leveraged buyout led by a private equity firm.[147] For years, Colt's equity sponsor exploited its ownership position to drain Colt of cash, and, as a result, little of the company's cash flow was reinvested in the business. Between 2002 and 2014, the business distributed \$241.3 million to the private equity sponsor.[148] These transfers left Colt without

145. *See* Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1459 (1990) (discussing the priority that creditors have over shareholders).

146. It is possible to try to wrest control of a firm with an involuntary bankruptcy filing. *See*, *e.g.*, *In re* Caesars Entm't Operating Co., No. 15-10047 (KG), 2015 WL 495259, at *1 (Bankr. D. Del. Feb. 2, 2015) (discussing the Caesar's involuntary bankruptcy filing). But, in general, involuntary bankruptcies are very rare because lenders fear being held liable for damaging the business. *See, e.g.*, David S. Kennedy et al., *The Involuntary Bankruptcy Process: A Study of the Relevant Statutory and Procedural Provisions and Related Matters*, 31 U. MEM. L. REV. 1, 51 (2000) (discussing the potential liability of petitioning creditors for damages if an involuntary petition is found to be in bad faith).

147. *See* Disclosure Statement for Debtors' Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code at 14, *In re* Colt Holding Co., No. 15-11296-LSS (Bankr. D. Del. Nov. 10, 2015) [hereinafter Colt's Disclosure Statement] (describing the 2013 merger with New Colt Holding Corp., a privately-held manufacturing affiliate of Colt Holdings Company).

148. *See* Colt Def. Inc., Registration Statement (Form S-1), at 21, 84 (June 3, 2005) (reporting that Colt Defense paid \$36.4 million in distributions between 2002 and 2004 and reporting fees paid to its equity sponsor pursuant to a management agreement); Colt Defense LLC (Form S-4, Amendment No. 2), at 79, F-25 (Mar. 21, 2011) (reporting that Colt Defense paid \$166 million in distributions between 2007 and 2010 and describing a "financial advisory agreement" with its equity sponsor); Colt Defense LLC, Annual Report (Form 10-K), at 63, 82 (Feb. 22, 2012); Colt Defense LLC, Annual Report (Form 10-K), at 90 (Mar. 25, 2013) (reporting that Colt Defense paid \$21.2 million in distributions between 2010 and 2012); Colt Defense LLC, Annual Report (Form 10-K/A), at 39, 86-87 (Sept. 12, 2014) (noting a decrease in cash distribution to members from \$12.9 million in 2011 to \$3.3 million in 2012 and describing a "consulting agreement" with its equity sponsor). Additionally, the company passed on all of its tax attributes to its owner. *See* Keith A. Maib's Declaration in Support of the Debtors' Chapter 11 Petitions and First Day Pleadings, *In re* Colt Holding Co., No. 15-11296-LSS (Bankr. D. Del. June 15, 2015) [hereinafter Maib Declaration].

the ability to keep up with its peers when it came to manufacturing automation and other research and development investments.

In the fall of 2014, Colt's capital structure included three forms of funded debt: (1) a secured revolving loan; (2) a secured term loan in the principal amount of $48 million; and (3) unsecured senior notes in the principal amount of $246 million.[149] The unsecured notes were then trading at a low price because of the market perception that Colt would have difficulty satisfying, among other obligations, an interest payment due on November 15.[150] Anticipating a restructuring, the company's noteholders organized and reached out to the company, offering "fresh capital on better terms than presently available" in the marketplace.[151] The company did not immediately respond to the offer; instead, it refinanced its existing secured debt in a transaction that only gave it enough additional capital to make the November interest payment.[152]

Two months later, Colt exchanged its senior secured revolving line of credit with a $33 million term loan.[153] The new term loan did not increase Colt's liquidity and, by comparison to its prior borrowing arrangement, imposed higher capital costs and tightened covenants.[154] The noteholders again wrote to Colt, "respectfully urg[ing] the Board to change course, and start working towards a more consensual and value-accretive resolution."[155] Colt's written reply was terse and, again, dismissive.[156]

On April 1, 2015, Colt filed a notice with the U.S. Securities and Exchange Commission (SEC) indicating that it would not be making its required securities filings on time. [157] The filing said that Colt is "unable to provide an expected date" for resuming SEC compliance.[158] And on April 14, 2015, Colt made an aggressive offer to its noteholders, offering to give them junior secured claims if

149. *See* Colt Defense LLC, Quarterly Report for Sept. 28, 2014 (Form 10-Q/A), at 23–45 (Dec. 2, 2014).

150. *See Colt Defense Bondholder Group Advised by Brown Rudnick, GLC, Awaits Numbers*, REORG-RESEARCH (Nov. 19, 2014), https://platform.beta.reorg-research.com/v3/#/items/intel/1934?item_id=7545/.

151. *See* Declaration of Abraham T. Han in Support of the Objection and Supplemental Objection of the Ad Hoc Consortium of Holders of 8.75 percent Colt Defense LLC and Colt Finance Corp LLC Senior Notes Due 2017 to the Debtors Motion for Interim DIP Loan Approval at Exhibit H, *In re* Colt Holding Co., No. 15-11296-LSS (Bankr. D. Del. June 19, 2015) [hereinafter Han Declaration].

152. *See* Supplemental Objection of Ad Hoc Consortium of Holders of Senior Notes to Debtors' DIP Motion ¶ 20, *In re* Colt Holding Co., No. 15-11296-LSS (Bankr. D. Del. June 19, 2015) [hereinafter Supplemental Objection to Colt's Debtors' DIP Motion]; Colt Defense LLC, Current Report (Form 8-K) (Nov. 17, 2014) (disclosing Colt Defense's entry into new $70 million senior secured term loan facility on November 17, 2014, days after receiving the letter from the noteholders).

153. *See* Colt Defense LLC, Current Report (Form 8-K) (Feb. 9, 2015) (describing Colt Defense's entry into a credit agreement with Cortland Capital Market Services).

154. *See id.*; Supplemental Objection to Colt's Debtors' DIP Motion, *supra* note 152, ¶ 23.

155. *See* Han Declaration, *supra* note 151, at Exhibit P.

156. *See* Supplemental Objection to Colt's Debtors' DIP Motion, *supra* note 152, ¶ 25.

157. In particular, Colt announced that it would not be timely filing its 2014 10-K statement. *See* Colt Defense LLC, Notification of Late Filing (Form 12b-25) (Apr. 1, 2015).

158. *See id.*

they would reduce the amount they were owed by 70 percent.[159] Notably, the firm's private equity owner was not offering to take any losses of its own under the proposal.[160] The offer also contained a disclosure intended to threaten the noteholders: the private equity sponsor also owned the building that housed Colt's only manufacturing facility; the private equity sponsor leased that facility to Colt; and the lease was about to expire.[161] The disclosure went on to say that Colt's equity sponsor had the power to deny lease renewal and cause great harm to the business, implying that the private equity owner could evict Colt if the exchange offer that would allow them to maintain their investment failed.[162] Notwithstanding the eviction threat, the exchange offer was soundly rejected by the noteholders.[163]

The noteholders then made a counteroffer that would give Colt new cash, but at a price: the equity sponsor would have to give up its ownership of the company.[164] The proposal was rejected out of hand.[165] When asked if the company would support *any* plan that transferred ownership from the equity sponsor to noteholders, one company representative allegedly responded: "Hell no!"[166] The only alternative to the debt exchange was, as allegedly stated by the same representative, "litigat[ion]."[167]

On June 14, 2015, Colt filed for Chapter 11 relief in Delaware.[168] The bankruptcy filing kicked off intense litigation, as noteholders successfully fought the equity sponsor's attempt to remain in control of the firm.[169] In the end,

159. The offer contained other problematic terms. Under the exchange offer, old notes would be exchanged for new "third-lien" secured notes reflecting a 70 percent principal reduction; the new indenture would be stripped of "substantially all" protective covenants contained in the existing indenture; and all default enforcement rights would be vested in the term loan lenders, via an onerous intercreditor agreement that rendered the noteholders silenced third-lien lenders. *See* Supplemental Objection to Colt's Debtors' DIP Motion, *supra* note 152, ¶ 28; Colt Defense LLC, *supra* note 158, at Exhibit T3E.1.

160. *See* Colt Defense LLC, *supra* note 157, at Exhibit T3E.1.

161. *See* Supplemental Objection to Colt's Debtors' DIP Motion, *supra* note 152, at 45.

162. *Id.* at 45–46.

163. *See* Maib Declaration, *supra* note 148, ¶ 22 (stating that the noteholders informed the Company that "there was absolutely no interest in the Company's Prepackaged Plan").

164. In particular, the noteholders offered to: (1) refinance the first-lien term loan on a junior-lien basis with attractive terms; (2) elevate the second-lien term loan to a first-lien position; (3) provide an incremental $20 million in availability, also on a junior-lien basis, to help Colt with, among other things, modernizing operations; and (4) convert the notes to equity, reducing the firm's debt load. *See* Han Declaration, *supra* note 151, Exhibit R.

165. *See id.* ¶ 41.

166. *See id.* ¶ 43.

167. *See id.* ¶ 41.

168. *See* Chapter 11 Voluntary Petition, *In re* Colt Holding Co., No. 15-11296-LSS (Bankr. D. Del. June 14, 2015).

169. The equity sponsor's scheme proceeded in two parts. With its bankruptcy petition, Colt filed a motion for approval of an accelerated Section 363 sale process, with the equity sponsor as the proposed "Stalking Horse" bidder. *See* Debtors' Motion, Pursuant to 11 U.S.C. §§ 105, 363, and 365, and Fed. R. Bankr. P. 2002, 6004, 6006, 9008 and 9014, for Entry of (A) an Order (I) Approving Bid Procedures in Connection with the Sale of Substantially All of the Debtors' Assets Free and Clear of Liens, Claims,

noteholders were forced to cede about 20 percent of the firm's post-bankruptcy equity to the pre-bankruptcy equity sponsor, given its ownership of Colt's factory, but they otherwise became the owners of the firm.[170]

In certain respects, the restructuring outcome was consistent with what one might have expected. The firm entered Chapter 11 and exited with less debt and owned by its pre-bankruptcy creditors. But management's attempts to save the equity sponsor's investment meant that the outcome came at a tremendous cost: the firm's financial condition deteriorated significantly because management insisted on delaying the restructuring to provide the equity sponsor with more bargaining power. In fact, the money that Colt borrowed in the bankruptcy, which could have been spent modernizing its business, was instead spent covering costs of bankruptcy and continuing operating *status quo*. Indeed, the post-petition professional costs of the debtor's lawyers alone amounted to more than $14.5 million.[171] Colt never received the financing needed for long overdue R&D and automation, and left bankruptcy without improving its competitive position.[172] While contract law can do many things for creditors, it cannot protect against a management team determined to stall and delay bankruptcy and a bona fide restructuring to the point that the firm itself is damaged.

B. The Limits of Relying on Bankruptcy Law to Protect Investors

Bankruptcy law is often cited as a body of law that protects creditors.[173] But bankruptcy law has multiple policy goals, some of which, especially

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Encumbrances, and Other Interests, (II) Approving Procedures Related to the Assumption and Assignment of Executory Contracts and Unexpired Leases in Connection with Such Sale, (III) Approving the Form and Manner of Notice Thereof, (IV) Scheduling the Hearing to Consider Approval of Such Sale, and (V) Granting Certain Related Relief; and (B) an Order Approving the Sale of Substantially All of the Debtors' Assets ¶ 13, *In re Colt Holding Co.*, No. 15-11296-LSS. Second, Colt filed a motion seeking to approve a debtor-in-possession financing from its pre-petition first lien lender, which required the firm to close on the Section 363 sale within 60 days. *See* Motion to Approve Debtor In Possession Financing, *In re Colt Holding Co.*, No. 15-11296-LSS.

170. The global settlement had many moving pieces: (1) the DIP loan was "rolled" into a new first lien term loan; (2) the second lien debt was rolled into a new second lien term loan; (3) incremental liquidity ($50 million) was raised by rights offering to noteholders (supplying $45 million) and the equity sponsor (supplying $5 million); (4) the lease on the manufacturing facility was extended; and (5) equity was divided between noteholders (83.25 percent) and the equity sponsor (16.75 percent). *See* Debtors' Motion for Entry of an Order Authorizing the Debtors to Enter into and Perform Under the Restructuring Support Agreement, *In re Colt Holding Co.*, No. 15-11296-LSS.

171. *See* Omnibus Order Awarding Final Allowance of Compensation for Services Rendered and for Reimbursement of Expenses at Exhibit A, *In re Colt Holding Co.*, No. 15-11296-LSS.

172. One of the peculiar aspects of this story is that Colt's board was not dominated by self-interested employees of the equity sponsor and close affiliates. In fact, the board majority was comprised of two military generals, two union representatives, and a retired restructuring lawyer *See* Maib Declaration, *supra* note 148, ¶ 48. It is entirely possible that this otherwise disinterested board hewed closely to *Gheewalla* and its progeny, using the maturing lease to justify taking actions like proposing restructuring transactions that would leave control in the hands of the equity sponsor while denying the noteholders the benefit of their bargain.

173. *See generally In re* Schwartz-Tallard, 803 F.3d 1095, 1100 (9th Cir. 2015) (noting that bankruptcy law protects the interests of creditors as a whole).

protecting corporations and their employees, can loom larger for judges than the need to give pre-bankruptcy creditors the benefit of their bargain. The need to protect the firm loomed particularly large after the financial crisis shook the economy to the core, creating a body of precedent that has further eroded creditor rights. The cases below all involve extreme facts, but they also involve managers playing bankruptcy hardball in defiance of the bargained-for protections of creditors and equitable principles.

In the first case study, *General Growth Properties*, we show how *ex ante* contractual arrangements often yield to other bankruptcy policy goals, such as protecting jobs and promoting reorganization. In the second case study, *American Safety Razor*, we show how these other policy priorities can create space for opportunism such as, in that case, a potentially rigged auction process. The *Lyondell* example shows how a well-advised management team's deft understanding of bankruptcy policy priorities and procedural rules can rob creditors of rights they would have had outside of bankruptcy.

1. *General Growth Properties: How the Creditor Bargain May Yield to Other Bankruptcy Policy Goals*

General Growth Properties (GGP), one of the largest owners and operators of shopping centers in the country, historically financed its commercial real estate at the project level, borrowing for each venture against the particular assets being developed.[174] Such loans generally had terms of three to seven years, thus the company's "business plan was based on the premise it would be able to refinance the debt" whenever circumstances required.[175]

To this end, GGP and its lenders set up a very specific lending structure, with the goal of achieving "asset isolation"—the separation of a high-quality real estate asset from the rest of the conglomerate.[176] To simplify things, the typical "bankruptcy-remote" structure was as follows. A wholly-owned GGP subsidiary entity owned specific real estate assets, financed with loans. A representative example was Stonestown Shopping Center L.P., which owned a mall in San Francisco, CA.[177] In order to protect their collateral interests, the lenders required GGP to separate the San Francisco mall from the rest of the conglomerate, which GGP agreed to do in exchange for lower interest rates.[178] Importantly, each subsidiary board had to consist of a majority of "independent managers" who

174. *See In re* Gen. Growth Props., 409 B.R. 43, 53–54 (Bankr. S.D.N.Y. 2009).

175. *See id.* at 53.

176. *See* Motion of ING Clarion Capital Loan Services LLC, Pursuant to 11 U.S.C. § 1112(b) to Dismiss the Cases of Bakersfield Mall LLC; Rasccap Realty, Ltd.; Visalia Mall, L.P.; GGP-Tucson Mall L.L.C; Lancaster Trust; Ho Retail Properties II Limited Partnership; RS Properties Inc.; Stonestown Shopping Center L.P.; and Fashion Place, LLC at 2, 9, *In re* Gen. Growth Props., 409 B.R. 43 (No. 09-11977-alg) [hereinafter ING Clarion Motion].

177. *See id.* at 9.

178. *See id.* at 1.

essentially represented the lender's interests.[179] As the law requires the board of each subsidiary to separately approve its bankruptcy filing, this structure was designed to ensure that the conglomerate could not drag the isolated asset into a larger GGP bankruptcy and thereby help fund the reorganization of other parts of the conglomerate.[180] The lender sought this protection to avoid being delayed for repayment or having its rights prejudiced as assets were diverted to fund affiliate bankruptcies.[181]

In the wake of the financial crisis, GGP was unable to refinance its debt and the firm's financial distress worsened.[182] The management team's reaction was unprecedented. They took steps to unwind the "asset isolation" structure, force each subsidiary to file for bankruptcy, and thereby keep the conglomerate together—and the company's senior managers in their jobs.[183] The steps taken were dramatic. At approximately 2:00 a.m. on April 16, 2009, GGP's managers fired the independent directors at each subsidiary via email and, once control was fully established, initiated the collective bankruptcy proceedings.[184] The bankruptcy filings and the violation of the "asset isolation" structure immediately roiled the credit markets.[185]

GGP's various project lenders now found themselves in exactly the situation they had contractually sought to avoid.[186] They asked the bankruptcy court to dismiss the subsidiary bankruptcy petitions as bad faith filings.[187] They also alleged that management's actions had violated their particular obligor

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179. *See* Motion of FRM Funding Company, Inc. Pursuant to 11 U.S.C. § 1112(b), to Dismiss the Chapter 11 Case of Fox River Shopping Center, LLC at 6–7, *In re Gen. Growth Props.*, 409 B.R. 43 (No. 09-11977-alg) [hereinafter FRM Motion] (noting the "independent managers" were generally required to be appointed by a nationally recognized company that provides professional independent directors, managers and trustees).

180. *See id.* at 7 (noting a typical operating agreement (the equivalent to the corporate charter) had a provision requiring the independent directors to consider the interests of the subsidiary and its creditors in deciding whether to file for bankruptcy. This structure was designed to get around the unenforceability of a contract that directly restricts a corporation's ability to file for bankruptcy).

181. *See id.* at 15.

182. *See In re Gen. Growth Props.*, 409 B.R. at 53 (describing how the 2008 crisis in commercial mortgage-backed securities markets impaired the company's ability to refinance its debt). At the time of its bankruptcy filing, the accounting value of GGP's assets was nearly $30 billion supporting more than $27 billion in liabilities. *Id.* at 48.

183. *See* ING Clarion Motion, *supra* note 176, at 2–3.

184. *See id.*

185. General Growth Properties, Inc. *Decision Notes Weaknesses of Securitization Special Purpose Entities*, O'MELVENY & MYERS LLP (Aug. 13, 2009), https://www.omm.com/resources/alerts-and-publications/publications/general-growth-properties-inc-decision-notes-weaknesses-of-securitization-special-purpose-entities/ [https://perma.cc/YY4X-WWFK] ("This decision should serve as a cautionary tale for those involved in structuring SPE and CMBS transactions.").

186. *Id.* (explaining that "the debtors subject to the motions to dismiss were structured to be SPEs so that project-level entities would be bankruptcy-remote," but "[t]he SPE structures failed to keep the project-level entities out of bankruptcy").

187. *In re Gen. Growth Props.*, 409 B.R. at 47 ("The primary ground on which dismissal is sought is that the Subject Debtors' cases were filed in bad faith.").

firm's fiduciary duties.[188] The bankruptcy judge recognized that the "asset isolation" structure had been set up to "create impediments to a bankruptcy filing."[189] However, given that the subsidiaries were solvent—hence the need for their assets to fund the bankruptcy—the court found that the only fiduciary duty that the subsidiary boards owed was to their shareholders, and the shareholder was in each case the parent corporation that needed their assets to reorganize.[190] Similarly, the court found that the dead-of-night dismissal of the independent directors did not constitute bad faith, given that the subsidiaries' organizational documents allowed GGP to do so.[191]

This scenario illustrates how, in bankruptcy, larger business goals and practical necessity can overwhelm the creditor bargain. The GGP structure reflected clear risk allocation: the project lenders agreed to provide capital at more attractive rates than was otherwise available in the market, in exchange for particular "asset isolation" protections. That bargain was not honored, the lenders pleaded with the bankruptcy court to enforce their deal, and the bankruptcy court was unmoved. Unlike the other case studies discussed in this Article, GGP's case did not involve a salacious form of control opportunism, and its facts were highly unusual. But, the case outcome reflects a lesson of far greater reach: the bankruptcy court is, by nature, a hospitable forum for debtors, and the process intends to follow management's lead, at least at inception. Generally speaking, in this tug of war, the individual creditor bargain does not have equal footing with the debtor's larger restructuring goals.

2. *American Safety Razor: How Management's Control Over the Case Narrative Further Enables Opportunism*

The bankruptcy of American Safety Razor LLC (ASR) also provides lessons on how the bankruptcy process can be exploited to thwart the creditor bargain. As we describe below, management's guiding interest as the firm fell into insolvency may have been preserving their own jobs. The firm's managers appear to have silently advanced an opportunistic agenda, which they almost succeeded in doing. While the stealthy maneuvering was exposed and disabled, it took an unusual and unlikely constellation of circumstances for that to happen. The story provides a useful example of how a management team can spin a narrative to profit at the expense of creditors: the need to exit bankruptcy

188. *See id.* at 63 (noting that the Operating Agreements of the project lenders provide that Independent Managers owe a "fiduciary duty of loyalty and care" when performing their duties under the agreement).

189. *See id.* at 63–64.

190. *Id.* at 64 (finding that Delaware law "provides that the directors of a solvent corporation are authorized—indeed, required—to consider the interests of the shareholders in exercising their fiduciary duties" and finding that the managers did not breach their fiduciary duties by "voting to file based on the interests of the Group").

191. *Id.* at 68.

immediately to avoid the firm's value melting away, an immediate auction required for financing, and manipulation of said auction.

ASR was in the business of manufacturing disposable wet-shave razors for personal consumption.[192] ASR was a major player in the "private label" razor business, manufacturing razors that stores would sell under their own brand.[193] In late 2009, ASR appeared to be more than able to weather the financial crisis and pay the interest and principal on approximately $240 million in first lien secured debt and $175 million in second lien secured debt.[194] However, in late 2009, ASR learned that its largest customer would be discontinuing the business relationship, thereby throwing the firm into turmoil and triggering defaults under the firm's first and second lien debt contracts.[195]

The firm soon entered pre-bankruptcy negotiations with ad hoc committees of first and second lien lenders.[196] As the "junior" option-holder, the ad hoc committee of second lien lenders had strong incentives to make sure that management did not collude with senior lenders to disadvantage their claims. The second lien lenders soon engaged Goldman Sachs to try to refinance the first lien debt.[197] Shortly thereafter, Goldman Sachs issued a letter stating that it was "highly confident" that it could arrange and syndicate "$300 million" in new debt capital for the company, which would be more than enough to repay the first lien lenders, leaving the second lien lenders as the firm's new owners.[198] Nevertheless, the letter warned that, in order to realize this expectation, Goldman Sachs would require "reasonable time to market the Financing with the assistance of management of the Company."[199] Instead, a few weeks later—while the refinancing process was still underway—ASR filed for Chapter 11 relief in Delaware.[200]

It quickly became clear why ASR had filed for Chapter 11 so suddenly: it had another plan in mind, one that offered particular benefits for the company's management team. With the Chapter 11 petition, ASR immediately sought permission to sell all of its assets to the first lien lenders after a quick auction

192. *See* Affidavit of J. Andrew Bolt, Executive Vice President and Chief Financial Officer of American Safety Razor Company, LLC and Blade Acquisition Company, and Vice President and Authorized Officer of the Other Debtors, in Support of First Day Motions at 4, 6, *In re* Am. Safety Razor Co., No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter First Day Affidavit].

193. *See id.* at 6 (noting that ASR products are "primarily sold under a retailer's store brand").

194. *See id.* at 9.

195. *See id.* at 11.

196. *See id.* at 14–15.

197. *See id.* at 16–17.

198. Energizer Holdings, Inc.'s Objection to Second Lien Lenders' Application for Allowance of an Administrative Claim at Exhibit A ¶ 8, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. June 23, 2011) [hereinafter Energizer's Objection].

199. *Id.*

200. *See* Objection of Blackrock Kelso Capital Corp. and GSO/Blackstone Debt Funds Management LLC, as Collateral Manager, to Debtors' Motions for Orders Approving: (1) Proposed Post-Petition Financing, and (2) Terms of the Debtors' Retention of Lazard Middle Market LLC at 4, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. June 23, 2011).

process.[201] The auction used a framework in which the first lien lenders were the stalking horse bidders with a "credit bid," where the first lien lenders would not pay any money at all. Instead, they would simply waive their claim against the debtor. This meant that any superior bid would need to be made in cash and higher than the $240 million in first lien debt. As part of their credit bid, the first lien lenders promised to assume the employment agreements of management, guaranteeing them continued employment or lucrative severance.[202]

In considering the motion, the bankruptcy judge confronted a decision environment where the debtor had decisively tilted in their favor.[203] She found herself confronted by a management team that claimed that the sale was needed to preserve the company's approximately 1,700 employees.[204] Time was of the essence, management said, because the firm's major selling season ended in October—meaning the firm, which filed for bankruptcy at the very end of July, needed to emerge in a matter of weeks in order to have a viable business.[205] In effect, management claimed to have waited so long to file for bankruptcy that the judge had no alternative but to approve the financing and sale motions.[206] If the judge forced management to explore alternatives, she might put 1,700 people[207] out of jobs in the midst of the most difficult job market in decades.[208] The second lien lenders would likely be of little help, as they were bound by an intercreditor agreement that prohibited them from objecting to any asset sale supported by the first lien lenders.[209]

201. *See* Debtors' Motion Pursuant to Sections 105(a), 363 and 365 of the Bankruptcy Code and Bankruptcy Rules 2002, 6004, 6006, for Entry of an Order (A) Approving the Sale of Substantially All of the Debtors' Assets Free and Clear of Encumbrances and (B) Authorizing the Assumption and Assignment of Certain Executory Contracts and Unexpired Leases at 19–20, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter ASR Debtors' Sale Motion].

202. *See id.* at 10–11; *id.* at Exhibit B, Part 2 § 7.16 (providing twelve-month employment guarantees to existing employees along with "substantially comparable bonuses"); *see also* Transcript of Proceedings from September 28, 2010 at 139:5–14:4, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. Oct. 1, 2010) (noting Energizer bid expressly carves out similar employment protections and Energizer marked up the first lien lenders' purchase agreement to reserve right to terminate employees).

203. To support the sale motion and the credit bid, the debtor also sought permission to borrow $25 million in post-petition financing from the first lien lenders. *See* ASR Debtors' Motion Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364, and 507 (I) Authorizing Debtors (A) To Obtain Postpetition Financing and (B) To Utilize Cash Collateral; (II) Granting Liens and Providing Super-Priority Administrative Expense Status; (III) Granting Adequate Protection to Prepetition Secured Parties; and (IV) Scheduling a Final Hearing at 1, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter ASR DIP Motion].

204. *See generally* ASR First Day Affidavit, *supra* note 192 (emphasizing the need to leave bankruptcy quickly to keep the firm from collapsing during its key selling seasons).

205. *See id.* at 18.

206. *See generally id.* (emphasizing that time is of essence).

207. *See id.* at 8.

208. *See* ASR DIP Motion, *supra* note 203.

209. Transcript of Proceedings from 9/30/2010 at 94–95, *In re* Am. Safety Razor Co., No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter ASR 9/30 Transcript].

Management then set about designing an auction process that gave them full control over the process. Every bidder was required to sign a confidentiality agreement in order to bid, which gave the company the ability to hide the identity of bidders as well as terms offered.[210] A month after bidding had begun, a news service suddenly reported that Energizer Holdings, Inc. (Energizer) had extended a $300 to $325 million cash bid for the company as part of the bankruptcy auction process.[211] This was news to the second lien lenders: their committee did not receive notice from ASR that Energizer had submitted a bid, and Energizer was contractually prohibited by ASR to relay that information to the second lien committee.[212] But, to ASR, this was not news at all: ASR had rejected Energizer's bid out of hand.[213] ASR would later argue in court that its decision was justified because Energizer's bid was fraught with antitrust risk, an important reason to prefer the first lien lenders' otherwise lower credit bid.[214] They would also deny the second lien lenders' allegations that ASR's stated antitrust concern was mere façade, that the real motivation behind rejecting the bid was ASR's understanding that Energizer, which intended to merge ASR into its Schick subsidiary, simply would not want ASR's historical management team.[215]

The second lien lenders promptly filed an aggressive objection to the sale motion, ignoring any restraints under the intercreditor agreement and commencing fierce litigation.[216] Management responded with charges of bad faith and tried to stop both the second lien lenders and Energizer from appearing in bankruptcy court, threatening to seek damages from the second lien lenders for breach of their intercreditor agreement and Energizer for breach of the non-disclosure agreement.[217] Nevertheless, during the court proceeding, the second lien lenders introduced evidence and presented expert witness testimony to support its contention that Energizer's bid was much higher than the first lien lenders' bid, that there was no meaningful antitrust risk, and, more to the point, that management was abusing its position of control.[218] The court found that ASR had, in fact, acted inappropriately by ejecting Energizer from the bidding

210. *See* Transcript of Proceedings from 9/29/2010 at 77–86, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. Oct. 5, 2010) [hereinafter ASR 9/29 Transcript].

211. *See* Energizer's Objection, *supra* note 198, at Exhibit A ¶ 19.

212. *See id.*

213. *See id.* at Exhibit A ¶ 20.

214. *See* ASR 9/29 Transcript, *supra* note 210, at 18–20.

215. *See* ASR 9/30 Transcript, *supra* note 209, at 18.

216. *See* Objection of the Second-Lien Lenders to the Debtors' Sale Motion, and Emergency Cross-Motion Requesting: (I) Authority to Commence an Investigation of the Debtors' Auction Process Pursuant to Bankruptcy Rule 2004; (II) Appointment of an Examiner; and/or (III) Appointment of a Chapter II Trustee at 1, *In re* Am. Safety Razor Co., No. 10-12351 (Bankr. D. Del. July 28, 2010) [hereinafter Objection to ASR's Sales Motion].

217. *See* ASR 9/30 Transcript, *supra* note 209, at 25, 50.

218. *See* 9/29 Transcript, *supra* note 210, at 74–92.

process and, as a remedy, continued the sale hearing for eight days to afford Energizer the opportunity to finalize its offer for the company.[219]

At the subsequent hearing, Energizer presented a final bid that offered to repay the first lien debt in full, assume all administrative and unsecured claims, and provide $57 million—about a 31 percent cash distribution—for the second lien lenders.[220] Remarkably, ASR and the first lien lenders continued their strenuous opposition to the Energizer bid, which the bankruptcy court overruled.[221] Energizer's "hostile" bid closed a few weeks later, no antitrust problems materialized, and members of management were terminated soon thereafter.[222]

This story seemingly has a happy ending: control opportunism was thwarted and value did ultimately flow in a manner seemingly consistent with the pre-petition bargain. But, that was as much dumb luck as anything else. It took a news service reporting a bid that was otherwise hidden by confidentiality agreement, as well as a group of sufficiently angry second lien lenders who not only had the courage of their convictions but also the patience and willingness to fund a fight on such hostile terrain. When the news of Energizer's bid leaked, ASR immediately threatened a fierce battle in all directions. Many potential bidders and creditors would have simply moved on, deterred by the rhetoric and a seemingly rigged process. As such, the lesson of the case is not so much found in the ultimate case outcome; rather, it is found in observing how management can employ Machiavellian strategies behind the scenes that, with any luck, will forever remain hidden. Moreover, there can be no assurance that the second lien lenders did, in fact, receive the true inherent value of their bargain. There was, after all, no real auction process, Energizer or other potential bidders spurned by the process might have been willing to pay more,[223] and the significant fees charged by ASR's lawyers were ultimately borne by the second lien lenders.

3. *Lyondell: How Debtors and Lenders Can Take Advantage of Rules of Bankruptcy Law to Neuter Fraudulent Transfer Claims*

In addition to contract and bankruptcy law, the *Gheewalla* court also cited fraudulent transfer law as rendering equitable protections for creditors unnecessary. Fraudulent transfer law provides creditors a cause of action when

219. *See* 9/30 Transcript, *supra* note 209, at 37–41.

220. *See generally* Notice of Filing of Energizer Holdings, Inc's Revised Bid at Exhibit A, B, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. July 28, 2010).

221. Hilary Russ, *Energizer Wins American Safety Razor With $301M Bids*, LAW360 (Oct. 8, 2010), https://www.law360.com/articles/200242/energizer-wins-american-safety-razor-with-301m-bid/ [https://perma.cc/2E3P-MRPQ].

222. *See id.*

223. Energizer had signaled it was to continue to participate in bidding, but they never had any reason to raise their bid. *See generally* Notice of Energizer Holdings, Inc.'s Continued Interest to Participate in Sale Process and to Consummate Transaction, *In re Am. Safety Razor Co.*, No. 10-12351 (Bankr. D. Del. July 28, 2010).

firms intentionally or constructively strip the firm of assets to the detriment of existing creditors. As an initial matter, the case law consistently shows weaknesses in fraudulent transfer theory as a creditor remedy.[224] But, more to the point, bankruptcy law provides managers with a toolkit to neuter fraudulent transfer claims. In addition to the now standard method of using bankruptcy financing to handcuff management's discretion, management also has the ability to settle fraudulent transfer claims without the permission of the creditor who suffered the loss as a result of the conveyance. This is due to an anomaly in corporate law. While creditors can bring fraudulent transfer claims on their own outside of bankruptcy, inside Chapter 11 the debtor-in-possession (DIP) can control all property of the estate, including fraudulent transfer claims.[225] Courts have held that this control includes the right to settle those claims, even if the true plaintiff-creditor who was harmed by the conveyance opposes the settlement on the grounds that it is far too low.[226]

In other words, managers can use bankruptcy law to strip creditors of rights they would have had outside of bankruptcy. The basic problem with the prosecution of fraudulent transfer claims in bankruptcy is that a debtor in bankruptcy is controlled by a management team that seeks to ensure the quickest bankruptcy and the brightest future for the debtor—goals that often conflict with a fulsome prosecution of fraudulent transfer remedies. In some asset-stripping transactions, the defendants in a fraudulent transfer are also the party providing post-bankruptcy financing to the debtor. This means leverage over management and, in certain situations, the ability to choke the procedural rights of unsecured creditors. While the debtor's actions are subject to court review, the legal standards invariably require the judge to consider the best interest of the debtor's other constituencies, such as current and future employees and managers. This particular fragility opens the door for control opportunism, as reflected in the Chapter 11 case of *Lyondell Bassell*.

In December 2007, chemical giant Bassell AF S.C.A. acquired Lyondell AF S.C.A. (Lyondell) in a textbook leveraged buyout (LBO) funded with $21 billion in new secured borrowings from a group of investors (the LBO Lenders)

224. Consider the Tribune LBO fraudulent transfer litigation. The LBO took place in 2007 and the Chapter 11 filing occurred in 2008. Fraudulent transfer litigation was initiated in 2011. In a July 2018 Wall Street Journal article, which referred to the LBO litigation as a "classic of the [] genre," Judge Kevin Carey was quoted as saying "it doesn't sound like we are very close [to the end of the litigation]." *See* Peg Brickley, *Judge Pushes Settlement Talks in Tribune LBO Court Fight*, WALL STREET J. (Jul. 10, 2018), https://www.wsj.com/articles/judge-pushes-settlement-talks-in-tribune-lbo-court-fight-1531257092/ [https://perma.cc/JZ5A-HCTY]. If a "classic of the genre" is alive eight and a half years (and counting) and still nowhere near the end, it hardly can be seen as a reliable buttress for the creditor's bargain.

225. *See* Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 572 (3d Cir. 2003) (discussing the need to allow creditors to bring the fraudulent transfer claims that otherwise are controlled by the Chapter 11 debtor as derivative actions).

226. *See In re* Adelphia Commc'ns Corp., 368 B.R. 140, 271–72 (Bankr. S.D.N.Y. 2007).

heaped on top of the firm's already extant $3.1 billion in unsecured debt.[227] The combined firm competed in a cyclical, investment-heavy petrochemical industry, and the heavy debt burden left the firm vulnerable to weakening in its core business.[228] Merely twelve weeks after closing the transaction, Lyondell began to run out of cash.[229] As the Great Recession ravaged the economy, Lyondell collapsed into bankruptcy in January 2009. This put Lyondell's $3.1 billion in prior unsecured bonds in a desperate position, sitting behind $21 billion in secured debt owed to LBO Lenders.[230] Given that the LBO cash went to the historical shareholders, but the debtors remained liable on transaction-related secured debt, the LBO transaction thus had the effect of stripping Lyondell of substantial value.[231]

These facts would seem to lend themselves to a textbook fraudulent transfer claim, with pre-LBO unsecured creditors hoping to avoid liens transferred to the secured lenders and the $12.5 billion paid to old Lyondell shareholders.[232] LBO Lenders would, however, be able to exploit bargaining power to secure from management a release of their fraudulent transfer exposure for a relatively small amount—all with the blessing of the bankruptcy judge.

Like most large firms, Lyondell's management team began bankruptcy by seeking a DIP loan to fund the bankruptcy case.[233] Lyondell, like most firms in the modern era of secured credit,[234] arrived in bankruptcy with liens fully encumbering all of its assets—in this case, the liens of the lenders that funded the LBO. In practice, lenders seldom agree to fund reorganizations without obtaining a priming lien,[235] which generally requires the consent of the existing

227. *See In re* Lyondell Chem. Co., 503 B.R. 348, 353 (Bankr. S.D.N.Y. 2014), *as corrected* (Jan. 16, 2014), *abrogated by In re* Tribune Co. Fraudulent Conveyance Litig., 818 F.3d 98 (2d Cir. 2016).

228. *See* Complaint at 3, *In re Lyondell Chem. Co.*, 503 B.R. 348 (No. 09-10023).

229. *See* Corrected Objection of the Official Committee of Unsecured Creditors to Debtors' Motion to Approve Settlement Agreement with Financing Party Defendants in Committee Litigation at 90, *In re Lyondell Chem. Co.*, 503 B.R. 348 (No. 09-10023) [hereinafter *Lyondell* UCC Settlement Objection].

230. *See In re Lyondell Chem. Co.*, 503 B.R. at 353 (describing pre-LBO debt).

231. *See* Weisfelner v. Blavatnik, 543 B.R. 428, 433 (Bankr. S.D.N.Y. 2016).

232. *See In re Lyondell Chem. Co.*, 503 B.R. at 355 (describing pre-LBO debt).

233. *See* Motion for an Order (I) Authorizing Debtors (A) To Obtain Post-Petition Financing Pursuant to 11 U.S.C. §§ 105, 361, 362, 364(c)(1), 364(c)(2), 364(c)(3), 364(d)(1), and 364(e), (B) To Utilize Cash Collateral Pursuant to 11 U.S.C. § 363 and (C) To Purchase Certain Assets Pursuant to 11 U.S.C. § 363, (II) Granting Adequate Protection to Pre-Petition Secured Parties Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364 and (III) Scheduling Final Hearing Pursuant to Bankruptcy Rules 4001(b) and (c) at 2, *In re Lyondell Chem. Co.*, 503 B.R. 348 (No. 09-10023) [hereinafter *Lyondell* DIP Motion].

234. *See* Barry E. Adler et al., *Value Destruction in the New Era of Chapter 11*, 29 J. L. ECON. & ORG. 461, 462 (2012).

235. A priming lien is a lien that is senior to all existing liens. In practice, the lenders who make DIP Loans want to protect their investment with a priming lien and in practice that often requires the consent of the existing lienholder (typically, a bank) as the existing lienholder can litigate to block the loan, which can scare off other lenders. For a general discussion of DIP lending that elaborates on this framework, see George G. Triantis, *Debtor-in-Possession Financing*, *in* RESEARCH HANDBOOK ON CORPORATE BANKRUPTCY LAW (Barry E. Adler ed., forthcoming June 2020).

lienholder. This effective veto right means that the existing senior secured lender is the only plausible DIP lender because they can veto any other loan.[236]

In this case, the senior secured lenders exploited their right to provide DIP financing to defend preemptively their liens against fraudulent transfer claims and acquire what the pre-LBO unsecured creditors would later condemn as "near total influence over the management of the[] bankruptcy cases."[237] The lenders grew their influence through attaching seven conditions to the DIP financing. First, they limited the Official Committee of Unsecured Creditors' (the "Official Committee") lien investigation budget to $250,000, a paltry sum in comparison to the more than $20 million that would ultimately be spent. Second, they allotted that committee about four months to investigate the facts surrounding the LBO.[238] Third, they required Lyondell to exit bankruptcy within ten months—a herculean task for one of the largest corporate failures in history in the midst of historic financial dislocation.[239] Fourth, they sought and obtained new collateral for $3.25 billion of the existing secured debt: the proceeds of avoidance actions. Fifth, they demanded a variety of additional contractual covenants, which had the effect of giving them control over management, especially including the right to recommend a change in management.[240] Sixth, the debtors agreed to pay the litigation costs of the bank defendants in any fraudulent transfer action.[241] Seventh, the debtor agreed to waive their right to prosecute the fraudulent transfer actions on behalf of the estate, leaving the official committee to do so with a very limited budget.[242]

Combined, these provisions of the DIP order dramatically weakened the ability of pre-LBO unsecured creditors to prosecute fraudulent transfer claims. The bankruptcy code expects the Official Committee to prosecute these actions on their behalf, but the Official Committee would have almost no time to marshal evidence for the most persuasive complaint, and their professionals would not get paid for their work associated with doing so once the $250,000 budget was exhausted. Moreover, the fraudulent transfer claims would need to be resolved for the firm to exit bankruptcy, and the lenders provided a very short runway for that to happen.

Thus, the LBO Lenders could exploit the debtors' need to obtain financing to fortify their ability to defend against fraudulent transfer liability. In evaluating requests to finance the case, the judge must find, among other things, that: (1) the proposed financing is an exercise of sound business judgment; (2) the

236. *See, e.g.*, B. Espen Eckbo et al., *Rent Extraction by Super-Priority Lenders* at Table 3 (Tuck Sch. of Bus., Working Paper No. 3384389, 2019) (showing that 70 percent of DIP loans are from pre-petition lenders in a sample of Chapter 11 debtors that filed for bankruptcy between 2002 and 2014).

237. *See Lyondell* UCC Settlement Objection, *supra* note 229, at 7.

238. *See id.* at 10–11.

239. *See id.* at 7.

240. *See id.* at 7–8.

241. *See id.* at 8.

242. *See id.*

financing is in the best interests of the estate and its creditors; (3) the financing is necessary to preserve the estate's assets; (4) the loan's terms were fair; and (5) the financing was negotiated in good faith.[243] Of these factors, only the second considers the interests of unsecured creditors directly, and the judge was allowed to, as he did, find that the restrictions on the Official Committee's ability to prosecute the fraudulent transfer actions were reasonable products of management's business judgment and desire to secure DIP financing.[244] After all, management represented to the court that the failure to approve the financing "would likely result in liquidation, severe employee dislocation and crippling losses for vendors and customers."[245] It is not surprising that avoiding that liquidation was more important to the judge than protecting pre-LBO unsecured creditors.

To be sure, the bankruptcy judge did provide the Official Committee with some bargaining power. The court granted the Official Committee permission to prosecute the claims, which was granted on an accelerated schedule that Lyondell's management demanded to ensure the firm could exit Chapter 11 expeditiously.[246] The parties agreed to conclude discovery and conduct a bench trial in a few months on the extremely complicated, fact-intensive, fraudulent transfer issues.

However, bankruptcy law gave the debtor's management team the power to settle the claim without the input of the Official Committee.[247] That power would ultimately undermine the Official Committee's ability to litigate.

Lyondell's management team took several steps that had the effect of reducing the ability of the Official Committee to procure a favorable settlement. First, prior to the hearing on the Official Committee's motion to prosecute the fraudulent transfer claims, the debtors asserted that, even though the Official Committee had the right to prosecute the claims, they believed they had the power to settle them since the causes of action ultimately belonged to the bankruptcy estate.[248] In other words, the Official Committee, representing the class of aggrieved pre-bankruptcy creditors, could see the claims settled by a party whose major motivation was to exit bankruptcy. In a private email, the lead lawyer for the debtors assured a major secured lender that he would deploy the right to settle the claim when "[our] leverage [is] greatest."[249]

243. *See In re* Roeben, 294 B.R. 840, 845 (Bankr. E.D. Ark. 2003).

244. *See* Transcript of the Motion for Entry of an Order Authorizing the Debtors to Enter into the 8th Amendment to their Debtor-in-Possession Loan Agreement to (A) Increase the Amount of the Commitment Thereunder Until the Funding Date of the Proposed Sale Transaction and (B) Extend the Maturity Date at 743, *In re* TerreStar Networks Inc., 457 B.R. 254 (Bankr. S.D.N.Y. 2011) (No. 10-15446).

245. *See Lyondell* DIP Motion, *supra* note 233, at 6.

246. *See Lyondell* UCC Settlement Objection, *supra* note 229, at 24.

247. *See In re* Adelphia Commc'ns Corp., 544 F.3d 420, 424 (2d Cir. 2008).

248. *See Lyondell* UCC Settlement Objection, *supra* note 229, at 25.

249. *See id.*

Management also effectively granted the LBO banks the ability to "hold-up" a $22 billion restructuring by making them the provider of exit financing. Obviously, the LBO defendants refused to prosecute any fraudulent transfer claims by any plan of reorganization they were funding, which meant the claims had to be settled for the firm to leave bankruptcy.[250] As the Official Committee's lawyers built their case for trial, management's lawyers monitored all depositions but refused to meet with the Official Committee's lawyers to understand their view of the strength of the claims.[251]

The debtors then shocked the Official Committee by announcing that they had settled the fraudulent transfer claims for $300 million, which the official committee saw as a "lowball settlement" that paid unsecured creditors a fraction of the $3.2 billion they were owed.[252] Notably, the debtors never asserted that they settled the claims for "as much as possible,"[253] but rather that the settlement would "permit the reorganization to proceed" while "ensuring the unsecured creditors a very fair recovery."[254] They accused the unsecured creditors, who strenuously opposed the settlement, of "gambling with the future of LyondellBassell and nearly 16,000 jobs as well."[255] Perhaps telegraphing how he would rule, at the hearing when the settlement was initially announced, the bankruptcy judge reaffirmed that "[the bankruptcy court's] highest responsibility is to ensure that our patient doesn't die on the operating table."[256]

Because of the permissive common law tests whose key is "reasonableness" of the debtor's proposal to settle claims in bankruptcy, the debtors could obtain judicial approval merely by showing it was reasonable given the various risks and uncertainties associated with the litigation. Further, the caselaw expressly allowed management to "consider the good of the entire enterprise" in proposing a settlement, not just the unsecured creditors.[257] As part of the judge's reasonableness analysis, he was required to consider "the complexity, expense and likely duration of [the] litigation" as well as the balance to the firm itself in being able to exit bankruptcy in a prompt manner.[258] In support of the settlement, management asserted that "only the [prosecution of fraudulent transfer claims] stand[] between the company and [leaving bankruptcy]; only the [prosecution of fraudulent transfer claims] poses the threat of liquidation."[259] Under the pressure of the debtors' settlement motion, the

250. *See id.* at 27.
251. *See id.* at 29.
252. *See id.* at 26, 70–71.
253. *See id.* at 61.
254. Debtors' Memorandum of Law in Support of Motion to Approve Settlement with Financing Party Defendants in Committee Litigation at 3, *In re* Lyondell Chemical Co., 503 B.R. 348 (Bankr. S.D.N.Y. 2014) (No. 09-10023) [hereinafter *Lyondell* Debtors' Memo].
255. *See id.* at 2.
256. *See Lyondell* UCC Settlement Objection, *supra* note 229, at 63.
257. *In re* Adelphia Commc'ns Corp., 327 B.R. 143, 165 (Bankr. S.D.N.Y. 2005).
258. *See Lyondell* Debtors' Memo, *supra* note 254, at 53.
259. *See id.* at 60–61.

committee settled the claims for an additional $150 million, agreeing to release the LBO lenders from any additional liability.[260]

In conclusion, the story of Lyondell shows how procedural machinations and a determined management team can cripple the prosecution of a potentially valuable fraudulent transfer claim. Lyondell engaged in a risky leveraged buyout that stripped the firm of assets, leaving its pre-bankruptcy unsecured creditors buried under $20 billion in debt that put it into bankruptcy barely a year later. When the Official Committee attempted to prosecute those claims on behalf of unsecured creditors, the committee members found themselves given mere months to build a case that would normally take years because of the bargaining power the lenders had over management through the DIP motion. When they prepared to try the claims to the judge, they found the claims settled out from under them by management, who did not pretend they had sought "the highest possible settlement," but rather a settlement that would protect the company and its employees—a factor that mattered to the judge. Under the pressure of that standard, the Official Committee was forced to settle the claim for about 15 percent of what they might have obtained had they won in court.

IV.
ADJUDICATING CONTROL OPPORTUNISM IN THE NEW ERA OF GOVERNANCE OF DISTRESSED FIRMS

As the case studies above suggest, debtor-creditor relations have declined in the years following *Gheewalla*. Well-established norms and patterns of behavior have been upset and broken, and basic standards of comity have devolved. This is to the overall detriment of the credit markets because lenders need to have predictable recovery expectations in order to provide *ex ante* credit.

However, we believe that judges can do better without returning to a world of fiduciary duty shifting. Non-bankruptcy judges, including state court judges and federal judges, and bankruptcy judges each have a role to play in restoring predictability and order to distressed governance. Importantly, the changes we describe below are entirely under the control of judges and would not require significant legislation or major shifts in the law. They would simply have judges view managers of distressed firms with a practiced skepticism, recognizing that control opportunism might influence whatever it is management is trying to do.

State court and federal judges adjudicating contract disputes should consider whether management's proposed course of action is a reasonable, good-faith display of business judgment that promises to maximize the value of the firm. Even in the absence of an explicit duty that shifts to creditors, many commentators and courts believe that managers continue to owe their fiduciary

260. *See* Joint Amended and Revised Motion of the Debtors and the Official Committee of Unsecured Creditors to Approve Revised Settlement Agreement with Financing Party Defendants in Committee Litigation at 8, *In re* Lyondell Chemical Co., 503 B.R. 348 (Bankr. S.D.N.Y. 2014) (No. 09-10023).

duty in the first instance to the firm, not to shareholders directly.[261] For an example of how this could work, consider the lawsuit filed by Cumulus' Term Lenders. They sued asserting contract claims to block what they saw as a misuse of the revolving loan provision in the loan contract. While the court considered this as a contract case, it is easy to imagine how a fiduciary duty analysis could be grafted on top of it in a way that is consistent with *Gheewalla* and *Quadrant*.

For example, the court could have considered the level of analysis that management undertook in connection with the exchange offer, as courts often do in investigating fiduciary duty claims and the applicability of the business judgment rule.[262] Did Forest Oil's board really think that the reconstituted merger with Sabine, heaping on all that legacy Sabine secured debt, would maximize the value of the firm and benefit the corporation as a whole? In performing this analysis, courts should attach highly limited value to the notion that avoiding bankruptcy benefits the corporation. Did PetSmart's board really think that a dividend to its private equity sponsor would help a distressed firm already struggling under the weight of billions of dollars of debt?

For fiduciary duty analysis in bankruptcy courts, Forest Oil offers an illustrative example.[263] The court summarily dismissed the fiduciary claims as being inconsistent with the law after *Gheewalla* and *Quadrant*. But what if the court had instead believed that the management re-engineered the deal to purportedly evade the change of control covenant? Surely, this kind of conduct should, and could, raise judicial eyebrows. The judicial tendency, since *Gheewalla*, has been encouraging to debtors intending to evade contractual covenants to do things they had previously promised not to do. Maybe those *ex ante* promises should be taken more seriously in subsequent litigation.

Importantly, we believe that management would be restrained if they knew they would be forced to justify their conduct under a judiciary inquiry with more bite. While a more aggressive application of the business judgment rule would not eliminate control opportunism, it would likely deter the most egregious cases.

Additionally, fraudulent transfer litigation has been devalued as an insolvency remedy. This kind of action currently takes a very long time to litigate. While some of this reflects the state of affairs in the judiciary generally, courts should be mindful of litigation duration in scheduling hearings and ruling on fraudulent transfer motions. The slow-moving trains of justice have broader consequences than denying justice to a particular plaintiff. It emboldens the

261. *See* Quadrant Structured Prods. v. Vertin, 115 A.3d 535, 547 (Del. Ch. 2015). Note that a substantial number of courts and commentators believe that fiduciary duties run directly to shareholders, not to the corporation in the first instance. *See generally* Andrew S. Gold, *Dynamic Fiduciary Duties*, 34 CARDOZO L. REV. 491 (2012) (discussing how it is unclear whether fiduciary duties are owed to the corporation or the shareholders in the first instance.) As Gold points out, the standard formulation is to say "duties are owed to both shareholders and the corporation," which incorrectly suggests that the interests of the corporation and the shareholders never conflict. *Id.* at 493.

262. The seminal case in this area is Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

263. *See In re* Sabine Oil & Gas Corp., 547 B.R. 503 (Bankr. S.D.N.Y. 2016).

entire private equity industry to extract excessive dividends from portfolio firms, knowing that it might take more than a decade to litigate the fraudulent transfer action, by which time every employee currently at the private equity firm will be gone.

Similarly, we believe that bankruptcy judges need to be more assertive in the face of demands from management that certain liquidation is the only alternative to a course of action that benefits one stakeholder over another.[264] There is no reason to think that DIP financing would really dry up if bankruptcy judges announced they would not allow DIP financings to limit the investigative rights of unsecured creditors over purported fraudulent transactions. Similarly, there is limited empirical evidence supporting the view that firms need to emerge from Chapter 11 so quickly that there is not enough time to fully investigate an important fraudulent transfer claim.

Bankruptcy judges should also be wary of procedural mechanisms like sale motions and motions to settle claims that strip unsecured creditors of due process rights. Information should be widely shared, and managers should never have the right to conceal the existence of "higher and better" bids. If the official committee of unsecured creditors receives permission to bring a cause of action, for example, the court should be loath to allow management the right to settle it over the official committee's objection.

Bankruptcy judges should also consider whether fraudulent transfer law needs to operate more aggressively, mindful of *Gheewalla* and the spate of opportunism since the financial crisis. For example, courts could consider whether technical aspects of fraudulent transfer law—such as the "collapsing doctrine"—should be applied in a more plaintiff-friendly way.[265] Courts should also be skeptical of efforts to inoculate leveraged buyouts from challenges, such as round-trip transactions, that lack economic substance. To be sure, nothing we have described are major reforms, but they could create a significantly different boardroom decision-making environment for distressed firms.

CONCLUSION

In this Article, we argued that the common law's journey away from creditor protection was driven by the mistaken belief that creditors could protect themselves using contract and bankruptcy law. As the case studies above show, opportunistic managers are difficult to restrain with contracts even when the risk

264. Others have expressed this sentiment as well. *See, e.g.*, Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014) (pointing out the problems with expedited sales of assets in bankruptcy proceedings).

265. The collapsing doctrine is a common law analysis that allows a court to view several transactions as an integrated whole, which can expand the range of avoidable transactions in the common situation where a leveraged transaction has several steps and the firm only become insolvent by some measures at the last step. By "collapsing" the several steps into one, the entire transaction can be avoided as a fraudulent transfer. *See In re* Route 70 & Massachusetts, L.L.C., No. 09-14771(RG), 2011 WL 1883856, at *1 (Bankr. D.N.J. May 17, 2011).

of opportunism is identified and contracted for *ex ante.* The lawyers who represent large firms are simply too skilled in the perpetual cat-and-mouse game not to find loopholes and ways around even the best contractual language. Moreover, bankruptcy judges consider many policy goals, outside of creditor protection—like preserving firm value and maximizing employment—and these other goals often win when they compete with a creditor's argument that management committed some pre-bankruptcy harm to creditors.

However, as we outlined in Part IV, judges can do much more to help. A more aggressive application of the business judgment standard will force boards to think harder about their actions and do more to justify them. An adverse decision constraining control opportunism would likely go quite a way to chill this type of aggressive opportunism. Just as judges created the current system of distressed governance, so too can they recreate it.

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

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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.

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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/weilbankruptcyblogindex [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.

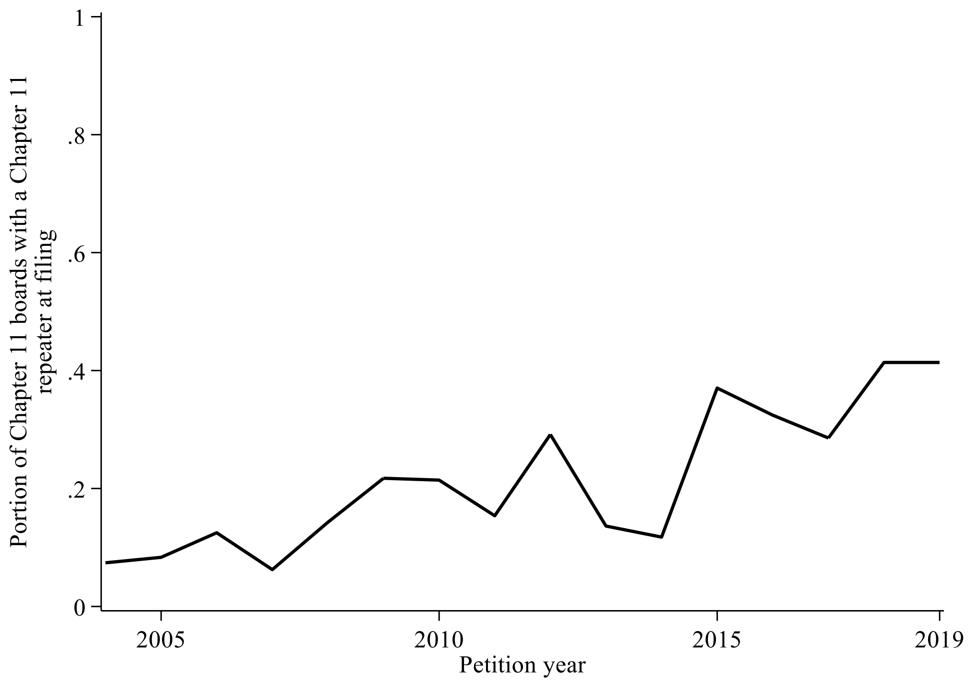
44 BUS. LAW. 103, 103 (1988).

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.

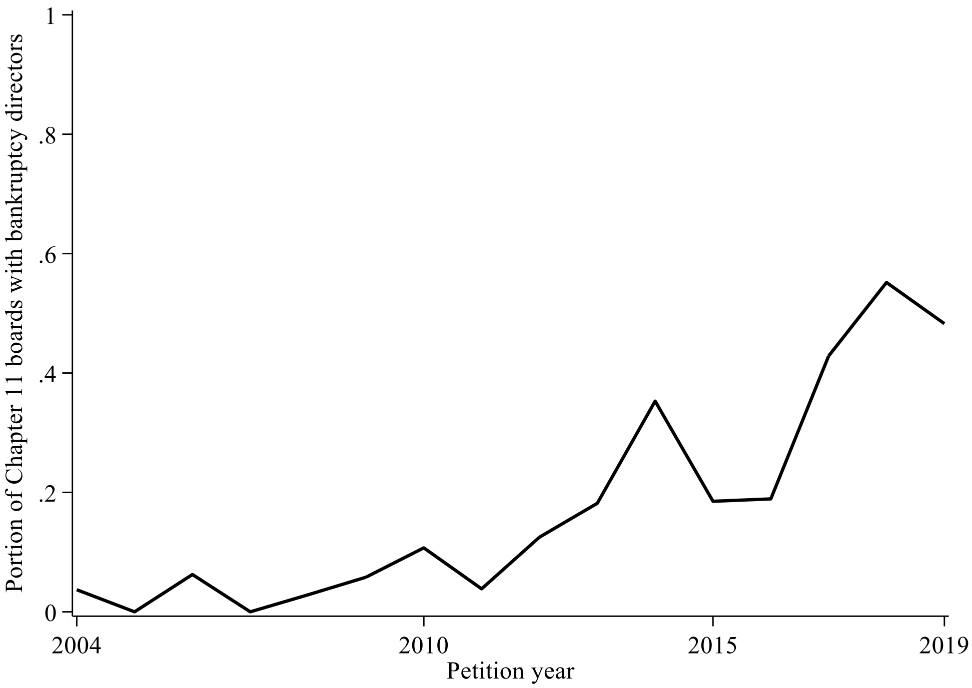
155. We ran a series of three searches. First, we searched for mentions of "disinterested" or "independent." We then searched a block of text that was [–50 words, +150 words] around the search word to see if it included the word "Manager" or "Director." To ensure we did not miss anything, we also searched 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).

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	Chapter 11
FTX TRADING LTD., *et al.*,[1]	Case No. 22-11068 (JTD)
Debtors.	(Jointly Administered)

NOTICE OF FILING FIRST INTERIM REPORT OF JOHN J. RAY III TO THE INDEPENDENT DIRECTORS ON CONTROL FAILURES AT THE FTX EXCHANGES

PLEASE TAKE NOTICE that, on November 11, 2022 and November 14, 2022, the above-captioned debtors and debtors-in-possession (collectively, the "Debtors"), filed voluntary petitions for relief under Chapter 11 of Title 11 of the United States Code, 11 U.S.C. §§ 101, *et seq*. in the United States Bankruptcy Court for the District of Delaware (the "Court").

PLEASE TAKE FURTHER NOTICE that the Debtors hereby file the *First Interim Report of John J. Ray III to the Independent Directors on Control Failures at the FTX Exchanges* (the "First Interim Report"), attached hereto as **Exhibit A**.

PLEASE TAKE FURTHER NOTICE that copies of the First Interim Report and other pleadings filed in the above-captioned Chapter 11 Cases may be obtained free of charge from the website maintained by the Debtors' noticing and claims agent at https://restructuring.ra.kroll.com/FTX/. You may also obtain copies from the Court's website at www.deb.uscourts.gov for a fee.

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[1] The last four digits of FTX Trading Ltd.'s and Alameda Research LLC's tax identification number are 3288 and 4063 respectively. Due to the large number of debtor entities in these Chapter 11 Cases, a complete list of the Debtors and the last four digits of their federal tax identification numbers is not provided herein. A complete list of such information may be obtained on the website of the Debtors' claims and noticing agent at https://cases.ra.kroll.com/FTX.

Dated: April 9, 2023
Wilmington, Delaware

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Exhibit A

FIRST INTERIM REPORT OF JOHN J. RAY III TO THE INDEPENDENT DIRECTORS ON CONTROL FAILURES AT THE FTX EXCHANGES

April 9, 2023

TABLE OF CONTENTS

I. Introduction

FTX Trading Ltd. ("FTX.com" and, together with its U.S. counterpart, FTX.US, the "FTX exchanges") was among the world's largest cryptocurrency exchanges, where millions of customers bought, sold and traded crypto assets. The FTX exchanges gained international prominence for their popularity among users, their high-profile acquisitions and celebrity endorsements, and the public image of Sam Bankman-Fried, their co-founder and CEO, as a philanthropist who worked to enhance standards, disclosure, oversight, and customer protection in the crypto industry.[1] On November 11, 2022, however, capping a stunning collapse that began just nine days earlier with the revelation of financial weakness at their affiliated trading firm, Alameda Research LLC ("Alameda"), the FTX exchanges and certain entities under common ownership (the "FTX Group")[2] filed for bankruptcy (the "Chapter 11 Cases"). Within weeks, Bankman-Fried was charged with perpetrating a multibillion-dollar fraud through the FTX Group with at least three senior insiders, who have pleaded guilty in connection with the scheme.

When the Chapter 11 Cases were first filed, the Debtors[3] identified five core objectives: (1) implementation of controls, (2) asset protection and recovery, (3) transparency and investigation, (4) efficiency and coordination with any non-U.S. proceedings and

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[1] *See* David Yaffe-Bellany, *A Crypto Emperor's Vision: No Pants, His Rules*, N.Y. TIMES, May 14, 2022, https://www.nytimes.com/2022/05/14/business/sam-bankman-fried-ftx-crypto.html?.

[2] The "FTX Group" refers to FTX Trading Ltd., West Realm Shires Services Inc., d/b/a FTX.US, Alameda Research LLC, and their directly and indirectly owned subsidiaries.

[3] The Debtors comprise the approximately one hundred entities associated with the FTX Group listed at https://restructuring.ra.kroll.com/FTX.

(5) maximization of value.[4] It is in furtherance of these core objectives, particularly transparency, that this first interim report is issued. The Debtors plan to issue supplemental reports which describe the cause and effect of the pre-petition events which lead up to the Chapter 11 Cases.

In working to achieve their objectives, the Debtors have had to overcome unusual obstacles due to the FTX Group's lack of appropriate record keeping and controls in critical areas, including, among others, management and governance, finance and accounting, as well as digital asset management, information security and cybersecurity. Normally, in a bankruptcy involving a business of the size and complexity of the FTX Group, particularly a business that handles customer and investor funds, there are readily identifiable records, data sources, and processes that can be used to identify and safeguard assets of the estate. Not so with the FTX Group.

Upon assuming control, the Debtors found a pervasive lack of records and other evidence at the FTX Group of where or how fiat currency and digital assets could be found or accessed, and extensive commingling of assets. This required the Debtors to start from scratch, in many cases, simply to identify the assets and liabilities of the estate, much less to protect and recover the assets to maximize the estate's value. This challenge was magnified by the fact that the Debtors took over amidst a massive cyberattack, itself a product of the FTX Group's lack of controls, that drained approximately $432 million worth of assets on the date of the bankruptcy

[4] First Day Declaration of John Ray III, Dkt 24 ("First Day Declaration") ¶ 6. *See also* Presentation to the Official Committee of Unsecured Creditors, Dkt 507 at 7; Presentation to the Official Committee of Unsecured Creditors, Dkt 792 (describing efforts to assess exchange shortfalls); Presentation to the Official Committee of Unsecured Creditors, Dkt 1101 (describing statement of financial affairs).

petition (the "November 2022 Breach"),[5] and threatened far larger losses absent measures the Debtors immediately implemented to secure the computing environment.

Despite the public image it sought to create of a responsible business, the FTX Group was tightly controlled by a small group of individuals who showed little interest in instituting an appropriate oversight or control framework. These individuals stifled dissent, commingled and misused corporate and customer funds, lied to third parties about their business, joked internally about their tendency to lose track of millions of dollars in assets, and thereby caused the FTX Group to collapse as swiftly as it had grown. In this regard, while the FTX Group's failure is novel in the unprecedented scale of harm it caused in a nascent industry, many of its root causes are familiar: hubris, incompetence, and greed.

This first interim report provides a high-level overview of certain of the FTX Group's control failures in the areas of (i) management and governance, (ii) finance and accounting, and (iii) digital asset management, information security and cybersecurity. The report does not address all control failures in these or other areas. The Debtors continue to learn new information daily as their work progresses and expect to report additional findings in due course.

II. Background

The following is a brief description of the FTX Group entities most relevant to this interim report.

A. Alameda

Founded in 2017 by Bankman-Fried and Gary Wang, Alameda operated as a "crypto hedge fund" that traded and speculated in crypto assets and related loans and securities

[5] All crypto asset values set forth in this report are as of the petition date, November 11, 2022.

for the account of its owners, Bankman-Fried (90%) and Wang (10%).[6] Alameda also offered over-the-counter trading services and made and managed other debt and equity investments. Beginning in October 2021, Caroline Ellison acted variously as CEO and co-CEO of Alameda, which was organized in the State of Delaware.

B. FTX.com

Founded in 2019 by Bankman-Fried and Wang, FTX.com was a digital asset trading platform and exchange that was organized in Antigua and represented as being off-limits to U.S. users.[7] FTX.com was operated, at the most senior level, by Bankman-Fried, Wang, and Nishad Singh, who had worked at Alameda and joined FTX.com soon after it was launched. By November 2022, FTX.com had more than seven million registered users around the world.

C. FTX.US

Founded in January 2020 by Bankman-Fried, Wang, and Singh, FTX.US was an exchange for spot trading in digital assets and tokens in the United States. The FTX.US platform was organized in the State of Delaware. By November 2022, FTX.US had over one million U.S. users.[8]

III. Scope of Review

A. Retention of Advisers

In connection with the Chapter 11 Cases and related matters, the Debtors have retained a number of advisers, including:[9]

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6 First Day Declaration ¶ 22.

7 *See id.* ¶ 33.

8 *Id.* ¶ 21.

9 This summary is limited to the advisers, and the work these advisers are performing, on the control failures that are relevant to this interim report. As noted in the Debtors' Chapter 11 filings, some of these advisers have additional responsibilities, and the Debtors have retained additional advisers beyond those listed here to assist with other important matters of the estate.

- **Legal:** The Debtors retained Sullivan & Cromwell LLP as lead counsel to assist in the filing and prosecution of the Chapter 11 Cases, investigating potential causes of action and avenues of recovery for the Debtors' estate, and responding to requests from government authorities, among other matters. The Debtors also retained Quinn Emanuel Urquhart & Sullivan LLP as Special Counsel to assist the Debtors and the Board in litigating bankruptcy-related matters against third parties, and investigating and prosecuting certain claims, including asset recovery actions.

- **Restructuring, asset identification and forensic accounting:** The Debtors retained Alvarez & Marsal North America, LLC ("A&M") as their restructuring adviser to assist in identifying, quantifying, and securing liquid and crypto assets, investments, and other property of the Debtors' estate, as well as development of ongoing business plans and supporting the overall restructuring process. The Debtors also retained AlixPartners LLP ("AlixPartners") to assist in tracing and analyzing financial and accounting data, including trading activity and FTX Group internal transfers, and re-constructing historical financial statements for each Debtor entity.

- **Cybersecurity, computer engineering, and cryptography:** The Debtors retained Sygnia, Inc. ("Sygnia") to secure their computing environment following the November 2022 Breach; to identify and secure the Debtors' remaining digital assets; to investigate the November 2022 Breach; and to perform technical and forensic analysis in support of the Debtors' other ongoing work to recover assets.

- **Blockchain analytics:** The Debtors retained TRM Labs, Inc. ("TRM") and Chainalysis Inc. ("Chainalysis") to engage in blockchain analysis to assist A&M and Sygnia in identifying crypto assets of the Debtors, and to monitor crypto assets stolen in the November 2022 Breach, including in order to work with law enforcement and other third parties to attempt to freeze and recover the stolen assets.

Identifying and recovering assets of the Debtors' estate, and identifying potential claims of the estate, requires extensive coordination among these advisers, particularly given the FTX Group's lack of adequate record keeping and extensive commingling of assets.

B. Data Collection

To date, the Debtors have reviewed over one million documents collected from Debtor entities around the world, including communications (*e.g.*, Slack, Signal, email) and other documents (*e.g.*, Excel spreadsheets, Google Drive documents). The Debtors have also been engaged in substantial analysis of FTX Group customer transaction data, which is housed in databases that are over one petabyte (*i.e.*, 1000 terabytes) in size. The Debtors' review of relevant documents and customer transaction data remains ongoing.

The Debtors have also reviewed and analyzed the FTX Group's available financial records. These include QuickBooks, which certain entities in the FTX Group used as their general ledgers; certain bank statements; financial statements; tax returns; promissory notes evidencing intercompany loans; spreadsheets recording real estate transactions, political and charitable contributions, and venture investments; and Slack channels devoted to expense reimbursements and related matters.

Finally, the Debtors have analyzed a small set of laptops and other electronic devices of certain employees of the FTX Group, and continue to collect such devices. The set of electronic devices in the Debtors' possession does not include those known to have belonged to Bankman-Fried and other key insiders that are currently in the possession of the Bahamian Joint Provisional Liquidators ("JPLs") and are the subject of ongoing discussion between the Debtors and the JPLs.

C. Witnesses

To date, the Debtors have conducted interviews of 19 employees of the FTX Group, and received substantial information through counsel for five others. These include interviews of employees who worked in Policy and Regulatory Strategy, Information Technology, Controllers, Administration, Legal, Compliance, and Data Science and Engineering, among others. The Debtors continue to identify, interview, and collect information from potentially relevant witnesses.

While Singh, Wang, and Ellison have pleaded guilty pursuant to cooperation agreements with the Justice Department, it is generally not feasible for the Debtors to interview them on key subjects until after the ongoing criminal prosecution of Bankman-Fried has concluded. Wang has provided discrete assistance to the Debtors' financial and technical advisors.

IV. Review of Control Failures

The FTX Group's control failures created an environment in which a handful of employees had, among them, virtually limitless power to direct transfers of fiat currency and crypto assets and to hire and fire employees, with no effective oversight or controls to act as checks on how they exercised those powers. These employees, particularly Bankman-Fried, deprioritized or rejected advice to improve the FTX Group's control framework, exposing the exchanges to grave harm from both external bad actors and their own misconduct.

A. Lack of Management and Governance Controls

The FTX Group lacked appropriate management, governance, and organizational structure. As a result, a primary objective of the Debtors has been to institute an appropriate governance framework from the outset of the bankruptcy.

1. FTX Group Management and Governance

The management and governance of the FTX Group was largely limited to Bankman-Fried, Singh, and Wang. Among them, Bankman-Fried was viewed as having the final voice in all significant decisions, and Singh and Wang largely deferred to him.[10] These three individuals, not long out of college and with no experience in risk management or running a business, controlled nearly every significant aspect of the FTX Group. With isolated exceptions, including for FTX.US Derivatives ("LedgerX"), a non-Debtor entity it acquired in late 2021, FTX Japan, a Debtor acquired in 2022, and Embed Clearing LLC, a non-Debtor acquired in 2022, the FTX Group lacked independent or experienced finance, accounting, human resources, information security, or cybersecurity personnel or leadership, and lacked any internal audit function whatsoever. Board oversight, moreover, was also effectively non-existent.

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[10] *See, e.g.*, *SEC* v. *Caroline Ellison et al.*, 22-cv-10794 (S.D.N.Y. Dec. 21, 2022), Compl. ¶¶ 21, 25, 45(b), 45(c), 46, 67, 96, Dkt 1; *SEC* v. *Nishad Singh*, 23-cv-01691 (S.D.N.Y. Feb. 28, 2023), Compl. ¶¶ 8, 9, 32, 34, 40, 50-51, 67, 90, 100, Dkt 1.

Most major decision-making and authority sat with Bankman-Fried, Singh, and Wang, and numerous significant responsibilities were not delegated to other executives or managers even where such individuals had been hired. Commenting on Wang's and Singh's control over the FTX Group's technology development and architecture, an FTX Group executive stated that "if Nishad [Singh] got hit by a bus, the whole company would be done. Same issue with Gary [Wang]."

Efforts to clarify corporate responsibilities and enhance compliance were not welcome and resulted in backlash. For example, the President of FTX.US resigned following a protracted disagreement with Bankman-Fried and Singh over the lack of appropriate delegation of authority, formal management structure, and key hires at FTX.US; after raising these issues directly with them, his bonus was drastically reduced and senior internal counsel instructed him to apologize to Bankman-Fried for raising the concerns, which he refused to do. Similarly, less than three months after being hired, and shortly after learning about Alameda's use of a North Dimension bank account to send money to customers of the FTX exchanges, a lawyer within the FTX Group was summarily terminated after expressing concerns about Alameda's lack of corporate controls, capable leadership, and risk management.

Echoing its lack of appropriate management and governance structure, the FTX Group lacked an appropriate organizational structure. Rather than having an ultimate parent company able to serve as a central point for decision-making that could also direct and control its subsidiaries, the FTX Group was organized as a web of parallel corporate chains with various owners and interests, all under the ultimate control of Bankman-Fried.

The FTX Group's lack of management and governance controls also manifested in the absence of any comprehensive organizational chart of the FTX Group entities prior to the end of 2021, and the lack of any tracking of intercompany relationships and ownership of particular entities. At the time of the bankruptcy filing, the FTX Group did not even have current and complete lists of who its employees were.

2. Debtors' Management and Governance

A primary objective of the Debtors was to institute an appropriate management, governance, and structural framework at the outset of the bankruptcy. To do so, the Debtors arranged the conduct of the Chapter 11 Cases into four groups of businesses, or "Silos," for organizational purposes: (a) Debtor West Realm Shires Inc. and its Debtor and non-Debtor subsidiaries (the "WRS Silo"), which includes the businesses known as FTX.US, LedgerX, FTX.US Derivatives, FTX.US Capital Markets, and Embed Clearing, among other businesses; (b) Debtor Alameda Research LLC and its Debtor subsidiaries (the "Alameda Silo"); (c) Debtor Clifton Bay Investments LLC, Debtor Clifton Bay Investments Ltd., Debtor Island Bay Ventures Inc. and Debtor FTX Ventures Ltd. (the "Ventures Silo"); and (d) Debtor FTX Trading Ltd. and its Debtor and non-Debtor subsidiaries (the "Dotcom Silo"), including the exchanges doing business as "FTX.com" and similar exchanges in non-U.S. jurisdictions. The Debtors then moved expeditiously to build a Board of Directors that, for the first time, would provide independent oversight of the disparate corporate chains that constituted the FTX Group.

As previously set forth in filings in the Chapter 11 Cases, the Debtors appointed a board of directors (the "Board") consisting of five directors with respective silo responsibilities.[11] These directors were wholly independent from the FTX Group, and have a wealth of experience in complicated restructuring matters well suited to the Debtors' present

[11] First Day Declaration ¶¶ 46-47.

circumstances.[12] The Board meets effectively on a weekly or more frequent basis on matters of common interest of the Silo directors, including the objectives set forth above.[13]

The Debtors appointed John J. Ray III as their Chief Executive Officer, Mary Cilia as their Chief Financial Officer, Kathryn Schultea as their Chief Administrative Officer, and Raj Perubhatla as their Chief Information Officer. These officers each have extensive experience in providing crisis management services, including work relating to complex financial and operational restructurings, to distressed and under-performing companies. Collectively, these executives have over 125 years of experience, including at senior management levels of public companies.

B. Lack of Financial and Accounting Controls

At its peak, the FTX Group operated in 250 jurisdictions, controlled tens of billions of dollars of assets across its various companies, engaged in as many as 26 million transactions per day, and had millions of users. Despite these asset levels and transaction volumes, the FTX Group lacked fundamental financial and accounting controls. Reconstruction of the Debtors' balance sheets is an ongoing, bottom-up exercise that continues to require significant effort by professionals.

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[12] *Id.* The Director of the WRS Silo is Mitchell I. Sonkin, a Senior Advisor to MBIA Insurance Corporation. The Director of the Alameda Silo is Matthew R. Rosenberg, a Partner at Lincoln Park Advisors. The Director of the Ventures Silo is Rishi Jain, a Managing Director and Co-Head of the Western Region of Accordion. The Director of the Dotcom Silo, and the Lead Independent Director, is the Honorable Joseph J. Farnan, who served for almost three decades as a United States District Judge for the District of Delaware.

[13] At this phase in the Chapter 11 Cases, the Debtors are focused on asset recovery and maximization of value for all stakeholders through the eventual reorganization or sale of the Debtors' complex array of businesses, investments and property around the world. The Debtors believe that all Silos benefit from this central administration process and full visibility of the assets being obtained, and the various sales processes being run, with all Silo Directors participating in the relevant decision-making processes in order to flag any inter-Silo issues early. At a later stage in the Chapter 11 Cases, when the Debtors' assets have been appropriately marshaled and secured, the Board and Debtors will turn their focus to distributional matters. The Board has also implemented appropriate procedures for the resolution of any conflicts of interest among the Silos and if necessary as the case progresses, any Silo may engage independent counsel in connection with the resolution of intercompany claims which, as the Debtors have previously noted, are likely to be complex but are still in the process of being assessed.

1. Lack of Key Personnel, Departments and Policies

The FTX Group did not have personnel who were experienced and knowledgeable enough to account accurately for assets and liabilities, understand and hedge against risk, or compile and validate financial reports. Key executive functions, including those of Chief Financial Officer, Chief Risk Officer, Global Controller and Chief Internal Auditor, were missing at some or all critical entities. Nor did the FTX Group have any dedicated financial risk, audit, or treasury departments. Although certain of the FTX Group entities nominally employed individuals responsible for accounting at those entities, in many instances, those individuals lacked the requisite expertise and had little or no internal staff. As a general matter, policies and procedures relating to accounting, financial reporting, treasury management, and risk management did not exist, were incomplete, or were highly generic and not appropriate for a firm handling substantial financial assets.

Indeed, in late December 2020, when the FTX Group learned, in connection with exploring a potential direct listing on NASDAQ, that FTX.US would have to be audited, and that this audit would include a review of policies and procedures, senior FTX Group personnel scrambled to cobble together purported policies that could be shown to auditors. In requesting the assistance of certain employees in quickly writing policies, FTX Group management informed them that because the "auditors [would] spend time in understanding and reviewing [FTX] internal processes," internal controls would have to be documented. FTX Group management asked employees "well-versed with" "parts of the [work]flow" to provide first drafts of policies and procedures in a mere 24 hours. It is unclear to what extent the resulting policies—which were prepared by editing off-the-shelf precedents provided by the FTX Group's outside accountants—reflected the reality of the FTX Group's business, but they were never formally promulgated, and no employees were ever trained on them.

The FTX Group principally relied on a small outside accounting firm to perform almost all of its basic accounting functions. Although the outside accountants' public profile is limited, it appears to have a small number of employees and no specialized knowledge relating to cryptocurrencies or international financial markets. There is no evidence that the FTX Group ever performed an evaluation of whether its outside accountants were appropriate for their role given the scale and complexity of the FTX Group's business, or whether they possessed sufficient expertise to account for the wide array of products in which the FTX Group transacted.

2. Lack of Appropriate Accounting Systems

Companies with operations as large and complex as those of the FTX Group normally employ either an advanced off-the-shelf Enterprise Resource Planning ("ERP")[14] system (*e.g.*, Oracle Fusion Cloud ERP, SAP S/4HANA Cloud) or a sophisticated proprietary system tailored to the accounting needs of the business such as, for a crypto exchange or trading business, a system tailored to the crypto assets in which the business transacted. Any appropriate accounting system should be capable of handling large volumes of data to accurately record, process, and report financial statement information (balance sheet/income statement) as well as operational information (actual versus budgeted spending), and to store key supporting materials. To minimize the risk of data integrity errors and the need for manual processing of transactions, data should flow automatically into the accounting system from core systems of the business, with transactions recorded based on appropriate accounting criteria and logic. None of the FTX Group companies employed such an accounting system.

Fifty-six entities within the FTX Group did not produce financial statements of any kind. Thirty-five FTX Group entities used QuickBooks as their accounting system and

[14] An ERP system is a type of software system that helps an organization automate and manage core business processes for optimal performance. ERP software coordinates the flow of data among a company's business processes, streamlining operations across the enterprise.

relied on a hodgepodge of Google documents, Slack communications, shared drives, and Excel spreadsheets and other non-enterprise solutions to manage their assets and liabilities. QuickBooks is an accounting software package designed for small and mid-sized businesses, new businesses, and freelancers.[15] QuickBooks was not designed to address the needs of a large and complex business like that of the FTX Group, which handled billions of dollars of securities, fiat currency, and cryptocurrency transactions across multiple continents and platforms.

As a result of the FTX Group's poor controls, and the inherent limitations of QuickBooks software for use in a large and complex business, the FTX Group did not employ QuickBooks in a manner that would allow it to maintain accurate financial records. For example, QuickBooks did not interface directly with the FTX Group's core systems. Data had to be transported from the FTX Group systems into QuickBooks manually, generally by outside accountants who did not have access to the source data to validate that they had completely and accurately transferred the data into QuickBooks. Furthermore, because they processed large volumes of data only manually, a great deal of transaction detail (*e.g.*, the purpose of a transaction) was either populated *en masse*, or omitted entirely. Substantial accounts and positions went untracked in QuickBooks. Digital asset transactions were tracked in QuickBooks using the generic entry "investments in cryptocurrency," but detailed recordkeeping reflecting what those cryptocurrency investments actually consisted of did not exist in QuickBooks, making reconciliation with other data sources extremely challenging or impossible. Approximately 80,000 transactions were simply left as unprocessed accounting entries in catch-all QuickBooks accounts titled "Ask My Accountant." Further complicating matters,

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15 *See* INTUIT QUICKBOOKS, https://quickbooks.intuit.com/ (last visited Apr. 4, 2023).

QuickBooks entries were often made months after transactions occurred, rendering impossible real-time financial reporting and risk management.

Alameda often had difficulty understanding what its positions were, let alone hedging or accounting for them. For the vast majority of assets, Alameda's recordkeeping was so poor that it is difficult to determine how positions were marked. A June 2022 "Portfolio summary" purporting to model cryptocurrency positions held by Alameda stated, with respect to valuation inputs for certain tokens, that Alameda personnel should "come up with some numbers? idk." In an internal communication, Bankman-Fried described Alameda as "hilariously beyond any threshold of any auditor being able to even get partially through an audit," adding:

> Alameda is unauditable. I don't mean this in the sense of "a major accounting firm will have reservations about auditing it"; I mean this in the sense of "*we* are only able to ballpark what its balances are, let alone something like a comprehensive transaction history." We sometimes find $50m of assets lying around that we lost track of; such is life.

Bankman-Fried's statements evidence the challenges a competent audit firm would have had to overcome to audit Alameda's business.

3. Inadequate Reporting and Documentation

A large number of FTX Group entities did not close financial reporting periods on a timely basis, and back-end checks to identify and correct material errors (*e.g.*, secondary review of transactions over a certain size, reconciliations of bank accounts, cryptocurrency wallets transactions, and other off-exchange positions) did not occur. These and other deficiencies resulted in numerous, often substantial, positions either not being recorded or being recorded in vague or inaccurate ways.

Key accounting reports necessary to understand the FTX Group's assets and liabilities, such as statements of cash flows, statements of equity, intercompany and related party transaction matrices, and schedules of customer entitlements, did not exist or were not prepared regularly. Important treasury reports, such as reports on daily liquidity, daily settlement, funding mismatches, concentration risk, and liability profiles, did not exist or were not prepared regularly. Copies of key documentation—including executed loan agreements, intercompany agreements, acquisition and investment documents, bank and brokerage account statements, and contract and account information of all types—were incomplete, inaccurate, contradictory, or missing entirely. Thousands of deposit checks were collected from the FTX Group's offices, some stale-dated for months, due to the failure of personnel to deposit checks in the ordinary course; instead, deposit checks collected like junk mail. As discussed in greater detail below, the FTX Group did not maintain reliable lists of bank or trading accounts, cryptocurrency wallets, or authorized signatories. The Debtors have had to construct this historical data from scratch and make sense of the numerous resulting discrepancies, anomalies, and undocumented positions.

Although the FTX Group consisted of many, separate entities, transfers of funds among those entities were not properly documented, rendering tracing of funds extremely challenging. To make matters worse, Slack, Signal, and other informal methods of communication were frequently used to document approvals. Signal and Telegram were at times utilized in communications with both internal and external parties with "disappearing messages" enabled, rendering any historical review impossible. Expenses and invoices of the FTX Group were submitted on Slack and were approved by "emoji." These informal, ephemeral messaging systems were used to procure approvals for transfers in the tens of millions of dollars, leaving only informal records of such transfers, or no records at all.

Numerous loans were executed between former insiders and Alameda without contemporaneous documentation, and funds were disbursed pursuant to those purported loans with no clear record of their purpose. In one instance, an insider entered into an agreement to purchase a piece of real estate. The funds used to purchase that property, however, were wired directly from Alameda and FTX Digital Markets Ltd. ("FTX DM"), a Bahamas-based entity which was owned by, and had obtained the funds from, FTX Trading Ltd. Only four months after the real estate purchase had closed did the employee enter into a promissory note with Alameda in which he undertook to repay the funds used to purchase the property. Other insiders received purported loans from Alameda for which no promissory notes exist.

4. Trading Records from Other Exchanges

While the FTX Group maintained over a thousand accounts on external digital asset trading platforms in jurisdictions around the world, many of which held significant assets at various points in time, it had no comprehensive, centralized source of information reflecting the purpose of these accounts, or the credentials to access them. Many of these accounts were opened using names and email addresses that were not obviously linked to any of the FTX Group entities. Other accounts were opened using pseudonymous email addresses, in the names of shell companies created for these purposes, or in the names of individuals (including individuals with no direct connection to the FTX Group).

The Debtors have been working to identify and access these external accounts in order to secure the Debtors' assets and extract historical trading data. Obtaining such access has required significant document review, interviews with current and former employees, and engagement with the external platforms. In many instances, accounts belonging to the Debtors have been seized, locked, or frozen, requiring further coordination with the platforms and foreign government agencies to provide adequate proof of ownership and authorization to access the accounts.

5. Intercompany Transactions

The FTX Group did not observe any discernable corporate formalities when it came to intercompany transactions. Assets and liabilities were routinely shuffled among the FTX Group entities and insiders without proper process or documentation. Alameda routinely provided funding for corporate expenditures (*e.g.*, paying salaries and other business expenses) whether for Alameda, for various other Debtors, or for FTX DM, and for venture investments or acquisitions whether for Alameda or for various other Debtors. Alameda also transferred funds to insiders to fund personal investments, political contributions, and other expenditures—some of which were nominally "papered" as personal loans with below-market interest rates and a balloon payment due years in the future.

Intercompany and insider transfers were often recorded on the QuickBooks general ledgers in a manner that was inconsistent with the apparent purpose of the transfers. For example, an Alameda bank account transferred tens of millions of dollars to a personal bank account of Bankman-Fried in 2021 and 2022. Although the transfers were documented in promissory notes as loans from Alameda to Bankman-Fried, they were recorded on the general ledger as "Investment in Subsidiaries: Investments-Cryptocurrency." The Debtors have identified examples of intercompany transactions that do not balance to each other (*i.e.*, where the amounts "due to" and "due from" do not balance across the relevant entities). North Dimension, a shell company owned by Alameda, frequently recorded cash transfers to Alameda accounts in the general ledger with the description "interco transfer reflecting bank wire," without otherwise stating the purpose or substance of the transaction.

In addition to these inconsistencies, many intercompany transactions recorded in the QuickBooks general ledgers involved digital assets, but critical records regarding which digital assets were transferred, and at what values they were transferred, were not maintained in

QuickBooks. Multiple intercompany transactions were recorded in QuickBooks by grouping many transactions together in summary batch entries without sufficient information to identify or properly account for the underlying transactions. Compounding the issue, these batch entries were then recorded under generalized account names in QuickBooks such as "investments in cryptocurrency," as described above. The cumulative impact is that these intercompany transactions as recorded in QuickBooks are difficult to reconcile with underlying documentation, and have required substantial additional investigation to understand and properly account for.

6. Extraordinary Privileges Granted to Alameda

Alameda was a customer of FTX.com, trading for its own account as well as engaging in market-making activities, and, in that capacity, it was granted extraordinary privileges by the FTX Group.[16] As detailed below, the FTX Group configured the codebase of FTX.com and associated customer databases to grant Alameda an effectively limitless ability to trade and withdraw assets from the exchange regardless of the size of Alameda's account balance, and to exempt Alameda from the auto-liquidation process that applied to other customers. Any number of different controls routinely implemented by financial institutions and exchanges in established financial markets would be expected to have prevented, detected, and escalated these secret privileges to personnel in control functions with sufficient independence and authority to address the issue.[17]

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[16] FTX Group granted the same privileges to Alameda on FTX.US. Because the Debtors' investigation is ongoing as to whether or to what extent Alameda made use of these privileges on FTX.US, this discussion focuses on FTX.com.

[17] For instance, at a financial institution, these privileges would be expected to be identified by the finance department, as part of balance activity reports and margin balance monitoring; the market risk department, via VAR calculations and funding risk metrics; and the accounting department, through reconciliations of account-level balances against independently calculated aggregate exchange balances; and by having compliance, information technology, risk management, and finance departments that are segregated and independent from traders and other front-line business personnel.

The FTX Group not only failed to disclose these privileges to its customers or the public, but affirmatively misrepresented Alameda's privileged status relative to that of other customers. On July 31, 2019—the same day Singh altered the codebase to allow Alameda to withdraw apparently unlimited amounts of crypto assets from FTX.com, and a week after he altered it to effectively exempt Alameda from auto-liquidation—Bankman-Fried claimed on Twitter that Alameda's account was "just like everyone else's and "Alameda's incentive is just for FTX to do as well as possible."[18] As recently as September 2022, in interviews with reporters, Bankman-Fried claimed that Alameda was a "wholly separate entity" and Ellison claimed that Alameda was "arm's-length and [did not] get any different treatment from other market makers."[19]

a. FTX customers and auto-liquidation processes

In general, there were two types of customers on FTX.com: retail customers and market makers (*i.e.*, liquidity providers that stand ready to buy or sell to satisfy market demand). As to both types of customers, the exchange implemented automatic liquidation processes such that if the customer's account balance fell below a certain threshold, then the customer's existing positions on the exchange would be liquidated (*i.e.*, sold off) until the account balance became net-positive again.

For retail customers, the auto-liquidation process was triggered if the customer's account balance approached zero. Market-makers and certain other preferred customers were

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18 Sam Bankman-Fried, Twitter (July 31, 2019), *at* https://twitter.com/bitshine_/status/1156665108174651392?ref_src=twsrc%5Etfw%7Ctwcamp%5Etweetembed%7Ctwterm%5E1156696100729806849%7Ctwgr%5E4bccfdc775938ec4496be7f2a64f95301cbc3e7b%7Ctwcon%5Es2_&ref_url=https%3A%2F%2Fwww.forbes.com%2Fadvisor%2Finvesting%2Fcryptocurrency%2Fwhat-happened-to-ftx%2F (responding to a Twitter user's question about how Bankman-Fried would "resolve the conflict of interest of running [his] own derivative exchange, AND actively trading against the market at the same time").

19 Annie Massa, Anna Irrera, and Hannah Miller, *Quant Shop with Ties to FTX Powers Bankman-Fried's Crypto Empire*, BLOOMBERG NEWS (Sept. 14, 2022).

provided lines of credit in amounts that varied by customer up to a maximum of $150 million; for those customers, the auto-liquidation process would be triggered if the account became negative and approached the pre-set borrowing limit.

Apart from auto-liquidation processes that prevented customers from trading on the exchange if their balance went below a given threshold, through the operation of its code, FTX.com did not allow customers—except, as set forth below, Alameda—to withdraw assets from the exchange in excess of the amount of their net-positive account balance.

b. Alameda's privileges

Contrary to the public claims of FTX Group management, the FTX Group exempted Alameda from the automatic processes set forth above in multiple ways. Specifically, one of the privileges secretly granted to Alameda, executed through a setting known as "*borrow*," permitted Alameda alone to trade on FTX.com effectively without regard to the size of its overall negative position. *Borrow* was a field in the customer account settings within the FTX.com exchange's customer databases that contained a value for each customer representing how much the customer could "borrow"—*i.e.*, whether and to what extent the customer's account balance could become net-negative without triggering trade restrictions or the FTX.com exchange's auto-liquidation processes. As of the petition date, on FTX.com:

- Most retail customers had a *borrow* value of zero;
- Certain preferred customers and market makers had a *borrow* value greater than zero and in amounts up to $150 million;

- Alameda alone had a *borrow* value set to $65 billion.[20]

The second and third privileges secretly granted to Alameda, known as "*can_withdraw_below_borrow*," and "*allow_negative*," provided Alameda the unique ability to withdraw an unlimited amount of crypto assets from FTX.com even when its account balance was net-negative. Singh added these features to the codebase of the FTX.com exchange on July 23, 2019 and July 31, 2019, respectively. It appears that Alameda's *can_withdraw_below_borrow* privilege was quickly supplanted by the addition to the codebase of *allow_negative*, which operated in essentially the same manner and controlled in the event of conflict with the settings for *can_withdraw_below_borrow*.[21]

Allow_negative referred to a field in the FTX.com exchange's customer databases that, if set to "true" for a particular customer, (i) allowed the customer to *withdraw* an unlimited amount of crypto assets from the FTX.com exchange while having a net-negative account balance (as opposed to merely "borrow") and (ii) exempted the customer from the FTX.com exchange's automatic liquidation processes. As of the petition date, Alameda was the only customer on FTX.com for which *allow_negative* was set to "true." When taken together, Alameda's $65 billion *borrow* and *allow_negative* settings gave it the unique ability to trade and

[20] Due to the FTX Group's failure to maintain appropriate database logs, it is not possible to determine precisely when these particular *borrow* values for Alameda were configured, or by whom. In interviews, one FTX Group employee recalled that, in approximately the summer of 2022, he discovered a configuration that gave Alameda a line of credit in a very large amount, and raised the issue with Singh, who responded that he would reduce the amount to $1 billion (an amount that would still be approximately seven times larger than that of any customer or market maker on the exchange). Due to the lack of database logs, it is unclear what Alameda's *borrow* value was set to at the time, or to what extent Singh made any change to reduce it. Nonetheless, database records reflect that as of the petition date, Alameda's *borrow* limit was set to $65 billion.

[21] While it appears that *can_withdraw_below_borrow* was thus rendered obsolete by Singh's addition of *allow_negative*, the Debtors currently understand that the *borrow* privilege granted to Alameda continued to remain relevant because Alameda would still need a net-positive account balance (after accounting for the specified *borrow* value) in order to actually trade on the exchange.

withdraw virtually unlimited assets, regardless of the size of its account balance and without risk of its positions being liquidated.

The Debtors' investigation of extraordinary privileges granted to Alameda remains ongoing.

C. Lack of Digital Asset Management, Information Security & Cybersecurity Controls

The Debtors identified extensive deficiencies in the FTX Group's controls with respect to digital asset management, information security, and cybersecurity. These deficiencies were particularly surprising given that the FTX Group's business and reputation depended on safeguarding crypto assets. As a result of these control failures, the FTX Group exposed crypto assets under its control to a grave risk of loss, misuse, and compromise, and lacked a reasonable ability to prevent, detect, respond to, or recover from a significant cybersecurity incident, including the November 2022 Breach.

1. Lack of Key Personnel, Departments, and Policies

While the FTX Group employed software developers and a single dedicated IT professional, it had no dedicated personnel in cybersecurity, a specialized discipline that generally acts as a "check" to mitigate risks posed by business pressure for technology to operate as fast and easily as possible. The FTX Group had no independent Chief Information Security Officer, no employee with appropriate training or experience tasked with fulfilling the responsibilities of such a role, and no established processes for assessing cyber risk, implementing security controls, or responding to cyber incidents in real time. Instead, its security was largely managed by Singh and Wang, neither of whom had the training or experience to handle the FTX Group's cybersecurity needs, and both of whom had responsibilities for the speed, efficiency, and continuing development of the FTX Group's technology, which are business needs that generally run counter to those of security and thus are not appropriately managed by the same personnel. In short, as with critical controls in other areas, the FTX Group grossly deprioritized and ignored cybersecurity controls, a remarkable fact given that, in essence, the FTX Group's entire business—its assets, infrastructure, and intellectual property—consisted of computer code and technology.

2. Crypto Asset Management and Security

A critical responsibility of a crypto exchange, as with any business that holds funds provided by others, is to safeguard crypto assets from loss, misuse, misappropriation, or theft by insiders or unauthorized third parties. Crypto exchanges face unique security challenges in this regard, which only heightens their need to focus adequate time, resources, and expertise on fulfilling this core responsibility.

a. Crypto wallets and storage

Crypto assets are held in a crypto wallet, which consists of (i) a public key that serves as the asset owner's identifier on the blockchain ledger, and (ii) a private key that is required to access the user's crypto holdings, authorize transactions, and exercise ownership over a blockchain asset. A crypto wallet can either be a "cold" wallet (*i.e.*, an offline storage unit[22]) or a "hot" wallet (*i.e.*, a storage unit that is connected to the internet). Crypto assets held in hot wallets are at a higher risk of compromise because hot wallets are internet-connected, rendering their private keys vulnerable to hacking, malware, and other cybersecurity threats. Compounding the risk, blockchain transactions are generally irreversible and anonymous, making unauthorized transfers particularly challenging, if not impossible, to recover. For these reasons, it is axiomatic in the crypto industry that a private key should be kept confidential,

[22] Assets maintained in cold wallets are typically kept in a physically secured location and accessed only by authorized personnel on a need-to-access basis, a method known as "cold storage."

including by being generated and stored in a secure and encrypted manner,[23] and used exclusively by the owner. Relatedly, businesses that control private keys need detailed access control policies such that the keys may only be accessed by authorized parties or systems.

The FTX Group stored the private keys to its crypto assets in its cloud computing environment, which included over one thousand servers and related system architecture, services, and databases that it leased from Amazon Web Services (the "AWS account"). AWS's cloud computing platform offers businesses a range of infrastructure-as-a-service (IaaS), platform-as-a-service (PaaS), and software-as-a-service (SaaS) capabilities, and through it, like other businesses, the FTX Group customized, configured, and controlled its own cloud environment.

b. Lack of security controls to protect crypto assets

The FTX Group failed to implement basic, widely accepted security controls to protect crypto assets. Each failure was egregious in the context of a business entrusted with customer transactions, and any one of the controls may have prevented the loss in the November 2022 Breach. Taken together, the failures were further magnified, since each control failure exacerbated the risk posed by the others.

First, the FTX Group kept virtually all crypto assets in hot wallets, which are far more susceptible to hacking, theft, misappropriation, and inadvertent loss than cold wallets because hot wallets are internet-connected. Prudently-operated crypto exchanges keep the vast majority of crypto assets in cold wallets, which are not connected to the internet, and maintain in hot wallets only the limited amount necessary for daily operation, trading, and anticipated

[23] Encryption is the process by which readable data is converted to an unreadable form to prevent unauthorized parties from viewing or using it. Plaintext, by contrast, refers to data that is unencrypted and, therefore, can be viewed or used without requiring a key or other decryption device.

customer withdrawals.[24] Relatedly, prudently-operated crypto exchanges implement strict processes and controls to minimize the security risks (for example, the risk of hacking, theft or loss) inherent in the transfer of crypto assets between hot and cold wallets.

The FTX Group undoubtedly recognized how a prudent crypto exchange should operate, because when asked by third parties to describe the extent to which it used cold storage, it lied. For example, in 2019, Bankman-Fried falsely responded to a customer question on Twitter by providing assurance that "[we use the] standard hot wallet/cold wallet setup."[25] In 2022, the FTX Group responded to questions posed by certain advisers and counterparties about its use of cold storage as follows:

> FTX uses a best practice hot wallet and cold wallet standard solution for the custody of virtual assets. The firm aims to maintain sufficient virtual assets in the hot wallet to cover two days of trading activities, which means only a small proportion of assets held are exposed to the internet, the remaining assets are stored offline in air gapped encrypted laptops, which are geographically distributed. The 2-day trading figure is continuously monitored and if the hot wallet exceeds this amount, it will overflow into the cold wallet. If the figure drops below the 2-day trading figure, the hot wallet will be topped up from the cold wallet.

These representations were false. None of FTX.com, FTX.US, or Alameda had a system in place to monitor or move to cold wallets crypto assets in excess of the amount needed to cover two days of trading activity, and they did not use offline, air-gapped, encrypted, and geographically distributed laptops to secure crypto assets.

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[24] Although there is currently no regulation in the United States that requires exchanges to use cold wallets to store customer assets, other regulatory authorities have imposed such requirements. For instance, regulation in Japan mandates that "Crypto Asset Exchange Service Providers" keep at least 95% of users' crypto assets in a device that is always disconnected from the internet. *See* Article 63-11(2) Payment Services Act in connection with Article 27(2) Cabinet Order on Crypto Asset Exchanges. Offline storage of information is also a standard security practice and control for organizations outlined in the U.S. National Institute of Standards and Technology ("NIST")'s Special Publication 800-53 under System and Communications Protection SC-28(2).

[25] Sam Bankman-Fried, (@SBF_FTX), Twitter (Aug. 16, 2019, 5:00 AM), https://twitter.com/SBF_FTX/status/1162288084634836993.

FTX Group employees openly acknowledged uncertainty about FTX Group's use of cold storage, and that regulators and users appeared to receive different information on the subject. In Slack communications in October 2022, an FTX Group employee relayed an internal communication that "it's ab[ou]t 70% cold and 30% hot," and that he had been instructed that this information was not to be shared with regulators unless it was specifically requested. Another FTX Group employee responded that if the question was being posed by "non-regulators," then "we say 10% in hot wallet, and 90% in cold wallet."

In fact, neither of these assertions about cold storage use was true. Outside of Japan, where required by regulation to use cold storage, the FTX Group made little use of cold storage. The Debtors have identified evidence that an individual associated with LedgerX, a non-Debtor entity, recommended to FTX Group management that FTX.US secure crypto assets in cold storage using a system similar to that employed by LedgerX, but no such system was put in place prior to the bankruptcy.

Second, the FTX Group failed to employ multi-signature capabilities or Multi-Party Computation ("MPC") controls (together, "multi-signature/MPC controls") that are widely used throughout the crypto industry to protect crypto assets. These controls require the cooperation of multiple individuals using unique keys or key fragments to effectuate a transaction.[26] As a result, the controls significantly reduce the risk of fraud, theft, misuse, or errors either by any single individual or in the event any single individual's key or key fragment is compromised. These controls are widely understood to be crucial for crypto exchanges to ensure that unauthorized transactions do not occur, for many reasons: exchanges are regularly

[26] "Multi-signature" refers to the requirement that two or more authorized individuals provide unique keys or credentials to perform sensitive or critical operations, such as engaging in a high-value transfer of crypto assets. MPC controls generate multiple private keys required to digitally sign transactions, thus providing multi-signature capabilities to crypto assets that do not natively support multi-signature. Because MPCs utilize cryptographic methods, multiple parties can act to effect a single transaction without revealing their private keys to each other.

targeted by hackers; exchanges custody assets provided by others, heightening the need for security; exchanges engage in a high volume of transactions, increasing the likelihood that errors will occur; and, as noted above, compounding all of these issues, crypto assets may be difficult or impossible to recover once they have been transferred.

While a single-key mechanism may not be inappropriate for wallets holding a relatively small amount of assets, such as those held by many retail customers, there is no question that a crypto exchange should employ multi-signature/MPC controls and cold storage solutions for—at a minimum—the central wallets that hold the majority of the crypto assets of the exchange. Nonetheless, neither the FTX exchanges nor Alameda utilized them to protect crypto assets. In the few instances in which the FTX Group even attempted to employ these controls, it misapplied them: for each wallet, the FTX Group stored together, in one place, all three private keys required to authorize a transfer such that any individual who had access to one had access to all the keys required to transfer the contents of the wallet, thus defeating the purpose of the controls.

Third, the FTX Group failed to manage or implement any appropriate system to attempt to manage private keys. As noted above, because crypto assets in a hot wallet may be misappropriated by anyone with access to the private key for that wallet, private keys must be maintained in a highly-secure manner. For crypto exchanges, controls to protect and manage keys are of paramount importance because customers who transfer crypto assets from their own wallets to the exchange's wallet must relinquish control over the security of their assets to the exchange. Exchanges and other crypto businesses rely on a variety of methods of secure key storage and management that are generally not difficult to implement, and they rely on detailed access control and management policies such that the keys may only be accessed by authorized parties or systems critical to the operation of the associated wallets.[27] Businesses also regularly retain the services of third-party crypto custodians to secure their crypto assets and minimize the risk of maintaining their own private keys.

Despite the well-understood risks, private keys and seed phrases[28] used by FTX.com, FTX.US, and Alameda were stored in various locations throughout the FTX Group's computing environment in a disorganized fashion, using a variety of insecure methods and without any uniform or documented procedure. Among other examples:

- The Debtors identified private keys to over $100 million in Ethereum assets stored in plain text and without encryption on an FTX Group server.
- The Debtors identified private keys, as well as credentials to third-party exchanges, that enabled access to tens of millions of dollars in crypto assets that were stored in plain text and without encryption across multiple servers from which they could be accessed by many other servers and users in many locations.
- Single-signature-based private keys to billions of dollars in crypto assets were stored in AWS Secrets Manager (a cloud-based tool used to manage sensitive information), and/or a password vault (a tool for secure storage of passwords), neither of which is designed to meet the needs of secure-key storage; any of the many FTX Group employees who had access to AWS Secrets Manager or the password vault could access certain of the keys and unilaterally transfer the corresponding assets.[29]
- Alameda also lacked appropriate documentation as to the description or usage of private keys. For example, a key for $600 million dollars' worth of crypto assets was titled with four non-descriptive words, and stored with no information about what the key was for, or who might have relevant information about it. The Debtors identified other keys to millions of dollars in crypto assets that were simply titled "use this" or "do not use," with no further context.

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[27] Examples of these methods include encryption, as well as the use of commercially available products such as hardware wallets, hardware security modules ("HSMs"), and MPC protocols. A hardware wallet stores a user's private keys in a secure hardware device that resembles a USB drive. Crypto transactions can be made by plugging the hardware wallet into a computer or other device. An HSM is a physical computing device that protects, manages, and stores secrets, such as cryptographic keys.

[28] A seed phrase (also known as a recovery phrase or mnemonic seed) is a series of words generated by a crypto wallet that allows a user to recover all the crypto assets associated with that wallet.

[29] In the infrequent instances in which the FTX Group stored private keys in encrypted form, it stored the decryption key in AWS Secrets Manager and not in a protected form, such as HSM. As a result, the decryption keys could easily be retrieved by an unauthorized actor, thereby dramatically reducing the value of encryption.

- Many FTX Group private keys were stored without appropriate backup procedures such that if the key was lost, the associated crypto assets would likely be permanently lost.
- Because the FTX Group lacked adequate records of private keys, there was a significant risk that crypto assets would be lost simply because no one knew how to locate or access them. As described below, through painstaking analysis by experts, the Debtors have recovered to date over a billion dollars' worth of crypto assets as to which few or no records existed.
- Because the FTX Group failed to maintain appropriate records of access to private keys, employees or others could potentially copy those keys to their own electronic devices and transfer the associated crypto assets without detection.

Fourth, the FTX Group failed to appropriately implement controls to manage "wallet nodes," which are software programs that operate on servers running the software of the blockchain network and help to implement and propagate transactions and maintain the security and integrity of the blockchain. A wallet node that holds private keys for a specific wallet is responsible for managing that wallet's assets and communicating with the blockchain network to process transactions. As a result, the security of the associated wallet's assets depends in large part on the security of the server on which the node is running.

Crypto exchanges typically use trusted wallet nodes to broadcast transactions and query the blockchain to reconcile exchange ledger data with blockchain data. The FTX exchanges and Alameda maintained servers that ran wallet nodes for blockchains, including Bitcoin, Litecoin, and Dogecoin, among others; these nodes acted as hot wallets that held hundreds of millions of dollars' worth of assets. Virtually all FTX.com Bitcoin assets, for example, were held in a single Bitcoin Core wallet node.

Despite the obvious importance of securing its wallet nodes, the FTX Group's security controls for its wallet nodes were grossly deficient. For example, the passwords for encrypting the private keys of wallet nodes were stored in plain text, committed to the code repository (where they could be viewed by many and were vulnerable to compromise), and reused across different wallet nodes such that if one were compromised, every other node with the same password could be compromised as well. Furthermore, wallet node servers were not securely segregated from connected servers such that anyone who compromised the FTX Group's computing environment could potentially compromise its wallet nodes.

3. Identity and Access Management

The FTX Group failed to implement in an appropriate fashion even the most widely accepted controls relating to Identity and Access Management ("IAM")—often the first line of defense in preventing an unauthorized system compromise. IAM refers to the policies, technologies, and procedures used to manage digital identities and control access to computer systems. Typically, IAM controls involve user authentication, authorization, and permissions management to ensure that only authorized individuals or systems are granted access to resources, while preventing unauthorized access and enforcing security policies. In the context of a cryptocurrency exchange, IAM controls are essential for protecting the confidentiality, integrity, and availability of crypto assets.

The FTX Group's IAM controls were insufficient in at least three respects:

First, the FTX Group failed to adhere to the basic security principle of "least privilege," by which users and systems are given access to the minimum needed to perform their duties or functions and nothing more.[30] By limiting access in this way, the impact of a security breach or an unintentional action involving any particular user or system is also necessarily limited. Among notable examples of the FTX Group's failures in this respect, over a dozen people had direct or indirect access to the FTX.com and FTX.US central omnibus wallets, which

[30] The Committee on National Security Systems defines "least privilege" as "[t]he principle that a security architecture should be designed so that each entity is granted the minimum system resources and authorizations that the entity needs to perform its function." Committee on National Security Systems (CNSS) Glossary, CNSSI No. 4009-2015, (Apr. 6, 2015).

held billions of dollars in crypto assets, and dozens of other users were granted access to other types of FTX exchange and Alameda wallets. Only a small number of these individuals needed access to these wallets to perform their duties.

Second, the FTX Group failed to effectively enforce the use of multi-factor authentication ("MFA") among its own personnel and corporate infrastructure, increasing the risk that key account credentials would be compromised and critical assets would thereby be vulnerable to unauthorized access. MFA is a basic security mechanism that requires users to provide two or more methods of authentication (for example, a password and one-time passcode sent to a cell phone or email previously associated with the user) to verify their identity and gain access to a system or account. MFA is a widely used and simple technique to mitigate the risks created by password weaknesses and theft, and businesses commonly require MFA to access any corporate systems, and particularly systems holding sensitive data.

The FTX Group did not enforce the use of MFA in connection with two of its most critical corporate services—Google Workspace, its primary tool for email and document storage and collaboration, and 1Password, its password-management program. The deficiency is ironic given that the FTX Group recommended that customers use MFA on their own accounts,[31] and Bankman-Fried, via Twitter, publicly stressed the importance of "2FA [Two-factor authentication]," a form of MFA, for crypto security:

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[31] *See* FTX.US Security Features, (Sept. 25, 2021) [http://web.archive.org/web/20210925211745/https:/help.ftx.us/hc/en-us/articles/4408447825815-FTX-US-Security-Features]; FTX.US Security Features, (Aug. 14, 2022) [http://web.archive.org/web/20220814000906/https:/help.ftx.us/hc/en-us/articles/4408447825815-FTX-US-Security-Features]; FTX Security Features, (Sept. 21, 2021) [http://web.archive.org/web/20210921181611/https:/help.ftx.com/hc/en-us/articles/360044838051-FTX-Security-Features-]; FTX Security Features, (July 1, 2022) [http://web.archive.org/web/20220701085013/https:/help.ftx.com/hc/en-us/articles/360044838051-FTX-Security-Features-].

> Daily reminder: use 2FA! 90% of crypto security is making sure you've done the basics.[32]

While he correctly characterized MFA as one of "the basics" in securing crypto assets, the FTX Group did not enforce it in the essential areas described above. And in an important instance in which FTX Group did use MFA—for a corporate email account that handled significant administrative matters—FTX Group management arranged to bypass the MFA requirement.

Third, the FTX Group generally did not use Single Sign-On ("SSO"),[33] an authentication scheme used by companies worldwide to manage user access centrally, enabling users to adopt a single strong password to use across multiple applications, thus reducing the risk of unauthorized access and other harms. Without SSO, among other problems, the FTX Group could not effectively manage or revoke user access, enforce MFA, revoke user access, or prevent users from having many user accounts for different services with separate passwords, which increased the likelihood of compromise.

4. Cloud and Infrastructure Security

The FTX Group also failed to implement appropriate controls with respect to cloud and infrastructure security—that is, controls to protect its cloud services, networks, servers, and "user endpoints" such as desktops and laptops. These controls were crucial for the FTX Group, which essentially "lived" in the cloud, where the exchanges operated and the FTX

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[32] Sam Bankman-Fried, (@SBF_FTX), TWITTER (Sept. 12, 2019, 4:11 AM), https://twitter.com/SBF_FTX/status/1172060173604515840.

[33] SSO enables users to authenticate their identity once in order to continually gain access to multiple applications and services without having to re-enter login credentials.

Group stored the majority of its assets. The FTX Group's management of its cloud and infrastructure security deviated from standard corporate practices in several respects.

First, the FTX Group generally shared computer infrastructure and IT services among FTX.com, FTX.US, and Alameda, and in doing so, departed from the fundamental security principle of segmentation, whereby business entities and computing environments are separated to minimize the impact of a breach, and exercise greater control over who can access particular systems. Among many examples, the FTX exchanges and Alameda used a single, shared AWS account, meaning that a compromise of that AWS account would expose all three entities' assets to misuse or theft.[34]

Second, while crypto exchanges are notoriously targeted by hackers, the FTX Group had poor or, in some cases, no "visibility" controls to detect and respond to cybersecurity threats. As widely understood across industries, and emphasized by the U.S. government in public advisories, appropriate visibility controls generally include the creation and collection of logs that record and reflect activity within the computing environment, and systems to alert

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[34] Other significant examples of the FTX Group's segmentation failures that increased the risk of harm from an information security problem or compromise include hosting FTX.com and Alameda in the same collaboration platform, Google Workspace, and employing the same password vault tenant, 1Password, for both FTX.com and FTX.US. The FTX Group appears to have recognized the deficiency, because as of the petition date, FTX.US had begun a process of migrating to its own dedicated AWS account; because it did not complete that work, its assets remained within the shared account such that FTX.US lost approximately $139 million of its crypto assets during the November 2022 Breach. In these ways, the FTX Group departed from best practices, which call for segregation and separation of an organization's infrastructure and networks in order to effectively mitigate the risk of, and impact from, unauthorized access to the organization's environment. *See, e.g.*, U.S. CYBERSECURITY & INFRASTRUCTURE SECURITY AGENCY, *Securing Network Infrastructure Devices*, at https://www.cisa.gov/news-events/news/securing-network-infrastructure-devices (noting that "[s]ecurity architects must consider the overall infrastructure layout, including segmentation and segregation" because "[a] securely segregated network can contain malicious occurrences, reducing the impact from intruders in the event that they have gained a foothold somewhere inside the network").

designated personnel to suspicious activity.[35] The FTX Group failed by any measure to maintain such appropriate controls.

Among many examples of its control deficiencies in this area, the FTX Group did not have any mechanism to identify promptly if someone accessed the private keys of central exchange wallets holding hundreds of millions or billions of dollars in crypto assets, and it did not fully enable even the basic features offered by AWS to assist with cyber threat detection and response.[36] In fact, due to the lack of such controls, the FTX Group did not learn of the November 2022 Breach until the Debtors' restructuring advisor alerted employees after observing, via Twitter and other public sources, that suspicious transfers appeared to have occurred from FTX Group crypto wallets. The FTX Group similarly failed to institute any basic mechanism to be alerted to any "root" login to its AWS account, the cloud computing environment where it operated the FTX exchanges and stored keys to billions of dollars in crypto assets, even though such access would provide virtually complete access to the environment.

Third, the FTX Group did not implement controls sufficient to protect its network endpoints, such as laptops and desktops, from potential security threats. The FTX Group had no commonly used technical controls to ensure that employees used their corporate laptops, leaving employees free to use personal devices devoid of corporate security controls. The FTX Group also lacked any endpoint protection tool to monitor cloud-hosted servers for threats, and several

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[35] *See, e.g.*, U.S. CYBERSECURITY & INFRASTRUCTURE SECURITY AGENCY, *Weak Security Controls and Practices Routinely Exploited for Initial Access* (last revised Dec. 8, 2022), at https://www.cisa.gov/news-events/cybersecurity-advisories/aa22-137a (noting that "[l]og files play a key role in detecting attacks and dealing with incidents[,]" that "implementing robust log collection and retention" provides organizations with "sufficient information to investigate incidents and detect threat actor behavior," and that effective log management calls for setting up "notifications of suspicious login attempts based on an analysis of log files").

[36] For example, Amazon GuardDuty, an AWS feature that supports threat detection, was not enabled at all on FTX.com, and across the entities, VPC flow logs that can capture IP traffic information were only enabled to log the rejected traffic (and only in some networks)—they were not enabled to log the permitted traffic at all. The lack of these and other logs complicated the Debtors' investigation of the November 2022 Breach.

of its critical services did not have the latest security updates installed. For example, to manage inbound internet traffic on a key server, the FTX Group used a version of software that was nearly four years out of date, leaving the server exposed to known vulnerabilities that had been addressed in updated versions of the software. This practice flouted industry standards by which software flaws and vulnerabilities should be remediated in a timely manner.[37]

Fourth, the FTX Group had no comprehensive record from which it could even identify critical assets and services, including employee workstations, software application servers, business data, and third-party cloud and other services it relied upon, leaving it with little to no visibility into what it needed to secure, let alone how to best secure it.[38] Indeed, to understand and gain necessary access to the full scope of services that the FTX Group used, the Debtors had to analyze financial records such as bills paid to vendors, and search through employees' email and chat messages. Although the FTX Group's designated IT professional began creating an inventory of electronic devices issued to employees, and stressed to Singh (who was supposedly in charge of the FTX's Group's cybersecurity) the importance for security purposes of having Singh and other FTX Group senior management identify in the inventory the electronic devices they were using, neither Singh nor other senior management provided the requested information.

5. Application and Code Security

The FTX Group did not implement controls sufficient to protect sensitive data relating to its applications, including its application code, from vulnerabilities and attacks. While essential in any context, securing such data was particularly critical for the FTX Group, which

[37] *See* NIST Special Publication 800-53 Revision 5: SI-2: Flaw Remediation.

[38] The NIST identifies the development and maintenance of an inventory of information systems (including hardware, software, and firmware) that are owned, leased, or operated by an organization as a standard security practice and control. *See* NIST Special Publication 800-53 Revision 5: PM-5: Information System Inventory.

used multiple applications with access to sensitive data and assets, including customer data, financial data, and crypto wallets. In managing its application and code security, the FTX Group departed from standard practices in several ways.

First, while it is widely recognized that sensitive data should be protected through encryption and appropriate access controls,[39] the FTX Group failed to adopt these basic controls to secure its "application secrets," that is, the highly sensitive data such as passwords, API keys,[40] and private keys used by its applications. Protecting these secrets is paramount because they are frequently the target of malicious actors who may use them to gain access to additional data and assets. With respect to the FTX Group, access to such secrets could enable someone to make transfers of billions of dollars' worth of crypto assets from hot wallets or third-party crypto exchanges. Nonetheless, among many examples of its deficient controls in this area, the FTX Group simply stored certain secrets—including the private keys and seeds to Alameda's crypto wallets—in unencrypted files to which numerous employees had access, and kept hundreds of other secrets—including passwords for crypto wallet nodes, API keys for crypto exchanges, and credentials for sensitive email accounts—in source code repositories from which they were widely accessible.[41]

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39 *See* NIST Special Publication 800-53 Revision 5: SC-28: Protection of Information at Rest.

40 Application Programming Interface, or "API," keys are credentials used to authenticate to third-party services, including, for example, other crypto exchanges.

41 While a senior developer subsequently deleted a file containing these secrets from the repository, the developer did not remove the file from the code history in the repository, contrary to the recommended practice of GitHub, where the repository was maintained. As a result, the file continued to remain exposed to anyone who accessed the code repository.

Second, the FTX Group failed to adopt certain standard controls in order to ensure the integrity of its code.[42] For example, there was no effective process for securely introducing, updating, or patching software, and no procedures, such as scanning, to continually ensure the integrity of the code running on FTX Group servers. Thus, among many other harms, the FTX Group was highly vulnerable to software "supply chain" attacks in which malicious actors insert vulnerabilities into third-party software in order to compromise any organization that uses the software.[43] Furthermore, with only minimal code review and testing procedures in place, and no focus on continuous security testing, the FTX Group did not review, test, or otherwise deploy its code in a manner that sufficiently ensured that it was functioning as expected and free of vulnerabilities that might be leveraged by malicious actors.

6. Debtors' Work to Identify and Secure Crypto Assets in the Computing Environment

As a result of FTX Group's lack of appropriate documentation and recordkeeping, the Debtors had to undertake significant efforts to identify, access, and secure crypto assets from the FTX Group's computing environment. The lack of records was particularly challenging because cryptocurrency keys are simply strings of alphanumeric characters that may otherwise be indiscernible in a computing environment. The Debtors' challenge was compounded by the

42 *See, e.g.,* NIST Special Publication 800-53 Revision 5: SA-12: Supply Chain Protection ("Verify the integrity of code obtained from external sources before it is deployed on the system"); NIST Special Publication 800-53 Revision 5: SA-11: Developer Security Testing and Evaluation ("Require developers to test their code for security vulnerabilities before it is deployed into production"); NIST Special Publication 800-53 Revision 5: SA-3: System Development Life Cycle ("Incorporate security requirements into the system development life cycle and ensure that security is addressed in all stages of the life cycle").

43 The most prominent example of a software supply chain attack is the 2020 SolarWinds attack, in which Russian state-sponsored actors compromised SolarWinds software, used widely throughout the U.S. public and private sectors, in order to gain access to the networks of government agencies and companies that downloaded the software.

enormous time pressure that they faced due to a confluence of circumstances that resulted from other FTX Group control failures described above:

- The Debtors took over responsibility for a computing environment that had been compromised. A malicious actor had just drained approximately $432 million worth of crypto assets in hours; the FTX Group did not have the controls to detect the compromise, much less to stop it; and due to the FTX Group's deficient controls to secure crypto assets, the Debtors faced the threat that billions of dollars of additional assets could be lost at any moment.

- Compounding the challenge, and reflecting additional FTX Group control deficiencies, the Debtors' cybersecurity experts found that the FTX Group had no written plans, processes, or procedures that explained the architecture or operation of its computing environment or storage of crypto assets.

- Even as they raced to secure the environment in these challenging circumstances, the Debtors separately faced the risk that individuals in possession of private keys to crypto assets could unilaterally transfer those assets. In other words, securing the environment would not be enough: until the crypto assets were transferred to cold storage, they could be taken by anyone who had the private keys. Indeed, the day after the November 2022 Breach, without the Debtors' authorization, and at the direction of Bahamian authorities, Bankman-Fried and/or Wang used private keys they had in their possession to transfer hundreds of millions of dollars' worth of FTT, SRM, MAPS and other tokens out of Debtor wallets and into cold wallets in Bahamian custody.[44]

- Compounding all of these challenges, and as the Debtors worked to identify and access crypto assets with no "map" to guide them, the Debtors had to engineer technological pathways to transfer many types of assets they identified to cold storage because the FTX Group had never engaged in the computer engineering necessary to make those transfers possible.

The Debtors' work to identify and secure these crypto assets required the combined efforts of experts in computer engineering, cryptography, blockchain technology, cybersecurity, IT architecture, and cloud computing. Examples of the work that was undertaken to identify crypto assets in the environment—ultimately, to date, over a billion dollars' worth of crypto assets as to which few or no records existed—include the following:

[44] Due to price declines, illiquidity, and other issues, these tokens are currently worth a small fraction of the amount of their estimated worth at the time of transfer.

- Experts developed novel code to identify crypto assets and keys that were stored in over a thousand servers and IT resources that constituted the FTX Group computing environment. Millions of these keys had no labelling or description that reflected their nature or use, requiring further analysis and blockchain analytics. Through this work, the Debtors recovered hundreds of millions of dollars' worth of crypto assets not reflected in any recordkeeping system of the FTX Group.

- Experts identified and recovered crypto wallets used for the FTX Group's extensive trading operations, and developed scanning tools and dedicated software to identify Alameda's DeFi portfolio[45] as to which few centralized records have been identified. Using these tools, the Debtors have identified tens of millions of dollars' worth of crypto assets that are in the process of being recovered.

- Experts learned that the FTX exchanges had experienced difficulty with the accuracy of code that the FTX Group had engineered to identify and transfer assets from over 10 million wallets of exchange customers into omnibus accounts. Surmising that crypto assets could still remain scattered among the wallets due to the inaccuracy of that code, experts developed code that would automatically both identify any crypto assets across blockchains that remained among the more than 10 million wallets, and then automatically transfer those assets to cold storage. Through the operation of this code alone, the Debtors have identified and secured over $140 million in crypto assets of the estate.

V. Conclusion

The FTX Group's profound control failures placed its crypto assets and funds at risk from the outset. They also complicated the Debtors' recovery efforts, although the Debtors have made and continue to make substantial progress in that regard. To date, through the work described above, the Debtors have recovered and secured in cold storage over $1.4 billion in digital assets, and have identified an additional $1.7 billion in digital assets that they are in the process of recovering. The Debtors will continue to provide updates on their ongoing recovery efforts and investigation.

[45] A Decentralized Finance (DeFi) portfolio encompasses a range of investments, holdings, and trading positions in blockchain-based financial applications that operate in a decentralized, peer-to-peer manner, rather than relying on centralized exchanges, brokerage firms, or banks.

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE**

In re: FTX TRADING LTD., *et al.*,[1] Debtors.	Chapter 11 Case No. 22-11068 (JTD) (Jointly Administered)

NOTICE OF FILING SECOND INTERIM REPORT OF JOHN J. RAY III TO THE INDEPENDENT DIRECTORS: THE COMMINGLING AND MISUSE OF CUSTOMER DEPOSITS AT FTX.COM

PLEASE TAKE NOTICE that, on April 9, 2023, FTX Trading, Ltd. and its affiliated debtors and debtors-in-possession (collectively, the "Debtors"), filed the *First Interim Report of John J. Ray III to the Independent Directors on Control Failures at the FTX Exchanges* [D.I. 1242-1] with the United States Bankruptcy Court for the District of Delaware (the "Court").

PLEASE TAKE FURTHER NOTICE that the Debtors hereby file the *Second Interim Report of John J. Ray III to the Independent Directors: The Commingling and Misuse of Customer Deposits at FTX.com* (the "Second Interim Report"), attached hereto as **Exhibit A**.

PLEASE TAKE FURTHER NOTICE that copies of the Second Interim Report and other pleadings filed in the above-captioned chapter 11 cases may be obtained free of charge from the website maintained by the Debtors' noticing and claims agent at https://restructuring.ra.kroll.com/FTX/. You may also obtain copies from the Court's website at www.deb.uscourts.gov for a fee.

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1 The last four digits of FTX Trading Ltd.'s and Alameda Research LLC's tax identification number are 3288 and 4063 respectively. Due to the large number of debtor entities in these Chapter 11 Cases, a complete list of the Debtors and the last four digits of their federal tax identification numbers is not provided herein. A complete list of such information may be obtained on the website of the Debtors' claims and noticing agent at https://cases.ra.kroll.com/FTX. The principal place of business of Debtor Emergent Fidelity Technologies Ltd is Unit 3B, Bryson's Commercial Complex, Friars Hill Road, St. John's, Antigua and Barbuda.

Dated: June 26, 2023
Wilmington, Delaware

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Exhibit A

SECOND INTERIM REPORT OF JOHN J. RAY III TO THE INDEPENDENT DIRECTORS: THE COMMINGLING AND MISUSE OF CUSTOMER DEPOSITS AT FTX.COM

June 26, 2023

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I. Introduction

The rise of the global digital asset industry has created novel opportunities and challenges for consumers, businesses, financial markets, regulators, and others. Rapid advances in blockchain technology have made decentralized finance and digital asset transactions not only possible, but widely accessible and inexpensive for consumers. At the same time, the industry has grappled with challenges common to all businesses that handle financial assets, which can be used to facilitate criminal activity, can be stolen by hackers and, as the FTX Group's collapse has revealed, can be misappropriated by those who have promised to protect them.[1]

The FTX Group portrayed itself as the vanguard of customer protection efforts in the crypto industry. Its co-founder and CEO, Sam Bankman-Fried, claimed to support federal legislation to safeguard consumers' digital assets, and touted the FTX exchanges' purported procedures to protect fiat currency and crypto deposits, including in testimony he provided to the U.S. Senate. In 2021, the FTX Group released, and urged Congress to read, its "key principles" for regulation of the crypto industry, which included the primary goals of "ensuring customer and investor protection, promoting market integrity, preventing financial crimes, and ensuring overall system safety and soundness."[2] In an accompanying press release, Bankman-Fried declared "the protection of investors and the public as a top priority" for the FTX exchanges.

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[1] The "FTX Group" refers to FTX Trading Ltd., West Realm Shires Services Inc., d/b/a FTX.US, Alameda Research LLC, and their directly and indirectly owned subsidiaries. "The Debtors" comprise the approximately one hundred entities associated with the FTX Group listed at https://restructuring.ra.kroll.com/FTX.

[2] FTX International, *FTX Issues Key Principles for Market Regulation of Crypto-Trading Platforms*, PR NEWSWIRE (Dec. 3, 2021), https://www.prnewswire.com/news-releases/ftx-issues-key-principles-for-market-regulation-of-crypto-trading-platforms-301437175.html; FTX US, *FTX's Key Principles for Market Regulation of Crypto-Trading Platforms* (Dec. 3, 2021), https://www.ftxpolicy.com/posts/ftx-key-principles; *Examining Digital Assets - Risks, Regulation, and Innovation: Hearing before the. S. Comm. on Agric., Nutrition and Forestry*,

The image that the FTX Group sought to portray as the customer-focused leader of the digital age was a mirage. In fact, as set forth in this report, from the inception of the FTX.com exchange, the FTX Group commingled customer deposits and corporate funds, and misused them with abandon. Bankman-Fried, along with FTX.com's co-founder, Gary Wang, and Director of Engineering, Nishad Singh (the "FTX Senior Executives"), and others at their direction, used commingled customer and corporate funds for speculative trading, venture investments, and the purchase of luxury properties, as well as for political and other donations designed to enhance their own power and influence.

The FTX Senior Executives did not commingle and misuse customer deposits by accident. Commingling and misuse occurred at their direction, and by their design. Bankman-Fried, with the assistance of a senior FTX Group attorney ("Attorney-1") and others, lied to banks and auditors, executed false documents, and moved the FTX Group from jurisdiction to jurisdiction, taking flight from the United States to Hong Kong to the Bahamas, in a continual effort to enable and avoid detection of their wrongdoing. In doing so, they showed little of the concern for customers that they publicly professed.

Based on the Debtors' current analysis, as of the petition date, approximately $8.7 billion in customer-deposited assets was misappropriated from the FTX.com exchange, the vast majority of which was in the form of cash and stablecoin.[3] The Debtors' ongoing work to trace and recover assets, and maximize recoveries for stakeholders, has been complicated by the

117th Cong. (2022) (testimony of Sam Bankman-Fried), https://www.agriculture.senate.gov/imo/media/doc/Testimony_Bankman-Fried_0209202211.pdf

[3] The FTX exchanges did not distinguish or differentiate between cash and stablecoin held in customer accounts, but treated them collectively as "e-money." As a result of this lack of recordkeeping, the Debtors are unable to provide a breakdown of the cash and stablecoin in a customer account.

extensive commingling and misuse of funds that occurred there. Notwithstanding extensive work by experts in forensic accounting, asset tracing and recovery, and blockchain analytics, among other areas, it is extremely challenging to trace substantial assets of the Debtors to any particular source of funding, or to differentiate between the FTX Group's operating funds and deposits made by its customers.

Like the First Interim Report, this second interim report is issued in furtherance of the Debtors' stated objectives for the bankruptcy, including transparency.[4] In issuing it, the Debtors intend to provide transparency both about facts they have uncovered about the operation of FTX.com, and important issues they are navigating as they seek to maximize recoveries. Also like the First Interim Report, this report reflects the Debtors' current understanding based on their analysis to date. It is important to recognize that this analysis is ongoing, incomplete and subject to change. The Debtors will continue to provide reporting on their analysis and findings as their work progresses.

II. The FTX Group's Representations about the Protection of Customer Deposits

The FTX Group touted a commitment to protecting customer deposits from misuse or misallocation, and publicly championed legislative and regulatory efforts to protect crypto industry customers. Through its website, social media, and in statements and submissions to Congress, regulators and other third parties, the FTX Group represented that it maintained a

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[4] These goals are: (1) implementation of controls, (2) asset protection and recovery, (3) transparency and investigation, (4) efficiency and coordination with any non-U.S. proceedings and (5) maximization of value. First Day Declaration of John Ray III, Dkt. 24 ("First Day Declaration") ¶ 6; *see also* First Interim Report of John J. Ray III to the Independent Directors on Control Failures at the FTX Exchanges, April 9, 2023, *available at* https://restructuring.ra.kroll.com/FTX/Home- DownloadPDF?id1=MTQ5MDc2OQ%3D%3D&id2=0, ("First Interim Report") at 1-2.

strict separation of customer and corporate funds, including by maintaining customer funds in omnibus bank accounts "for the benefit of" ("FBO") FTX exchange customers. At all times, with the exception of isolated jurisdictions, the FTX Group's representations in this regard were false.[5]

A. Background on the Separation of Customer and Corporate Funds

In claiming that it separated customer and corporate funds, the FTX Group represented that it was engaging in a practice common in many industries that is designed to protect customers.[6] Separation avoids the commingling of customer funds with the proprietary assets or working capital of the company holding those funds, and enables the ready identification of customer funds and reliable recordkeeping with respect to them. This separation mitigates the risk that the company might misuse customer funds for its own purposes, and facilitates the return of customer funds if the company holding them experiences financial distress.

The designation of a bank account as "FBO" signifies that assets in the account are maintained separately from those of the entity that maintains the account (*e.g.*, the account holder), for the benefit of a specific beneficiary (*e.g.*, customers). Generally speaking, an FBO

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5 In accordance with regulations in Japan, Cyprus, and Singapore, the FTX Group did segregate customer funds in those jurisdictions. Unless otherwise noted, the findings in this report do not include these jurisdictions, and the report does not address FTX.US, as to which the Debtors' investigation remains ongoing.

6 Apart from common practice, companies in certain industries are subject to regulatory requirements concerning the separation and/or protection of customer assets. *See, e.g.*, 17 C.F.R. § 240.15c3-3(b)(1), (e) (2023) (applicable to broker-dealers); 17 C.F.R. § 275.206(4)-2 (2023) (applicable to investment advisers); 17 C.F.R. § 1.20(a),(e) and (f) (2023) (applicable to futures commission merchants with respect to futures customers); 12 C.F.R. § 9.13(b) (applicable to national banks engaged in fiduciary activities). While depository institutions generally are not required to segregate funds underpinning ordinary customer deposits, they are subject to a host of capital, liquidity and other legal and regulatory requirements that are designed to protect depositors from losses.

account holder does not have full control over the funds in the account, although it functions as a custodian for the account and can direct the account's cash movements. The widely used "FBO" designation serves to clarify the ownership and purpose of the account, ensuring that the funds in the account are used as intended and providing transparency about the identity of the ultimate beneficiaries of the account.

B. Statements to U.S. Officials, the Public and Other Third Parties

The FTX Group represented to U.S. officials, the public and other third parties that it separated and protected exchange customer deposits, and it positioned itself as a vocal advocate of regulation requiring other crypto companies to do the same.

On February 9, 2022, Bankman-Fried testified before a committee of the U.S. Senate in a hearing entitled "Examining Digital Assets - Risks, Regulation, and Innovation." In written testimony submitted for his appearance, Bankman-Fried touted the FTX Group's recent publication of *FTX's Key Principles for Ensuring Investor Protections on Digital-Asset Platforms* ("Key Principles").[7] According to Bankman-Fried:

> We identified the most important components of an investor-protection regime . . . and how FTX offers those protections today . . . These components include:
>
> - maintaining adequate liquid resources to ensure the platform can return the customer's assets upon request;
> - ensuring the environment where customer assets are custodied, including digital wallets, [is] kept secure;
> - ensuring appropriate bookkeeping or ledgering of assets and disclosures to protect against misuse or misallocation of customer assets;
> - ensuring appropriate management of risks including market, credit/counterparty, and operational risks; and

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7 *Examining Digital Assets - Risks, Regulation, and Innovation: Hearing Before the S. Comm. on Agric., Nutrition and Forestry,* 117th Cong. (2022) (testimony of Sam Bankman-Fried), https://www.agriculture.senate.gov/imo/media/doc/Testimony_Bankman-Fried_0209202211.pdf.

- avoiding or managing conflicts of interest.[8]

The *Key Principles* further represented that:

> FTX has policies and procedures for its platforms today that. . . maintain[] liquid assets for customer withdrawals, including a sufficient balance of digital assets funded by the company for its non-U.S. platform. The resources are funded to provide sufficient cover against user losses under certain events and extreme scenarios in order to, among other purposes, ensure a customer without losses can redeem its assets from the platform on demand.
>
> FTX regularly reconciles customers' trading balances against cash and digital assets held by FTX. Additionally, as a general principle FTX segregates customer assets from its own assets across our platforms . . . .[9]

The *Key Principles* were attached as an exhibit to Bankman-Fried's written testimony. The FTX Group also published the *Key Principles* on the websites of the FTX exchanges, and provided them to the White House, the House of Representatives' Financial Services Committee, the Department of the Treasury, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Consumer Financial Protection Bureau, and the New York State Department of Financial Services.[10]

Bankman-Fried also used social media to portray himself as a champion for the protection of customer assets in the crypto industry. On August 9, 2021, he tweeted "as always,

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8 *Id.* at 11-12.

9 *Id.* at 31-31, 34.

10 *FTX's Key Principles for Ensuring Investor Protections on Digital-Asset Platforms*, FTX US (Mar. 10, 2022), http://web.archive.org/web/20221114012002/https://www.ftxpolicy.com/posts/investor-protections; *Digital Assets and the Future of Finance: Understanding the Challenges and Benefits of Financial Innovation in the United States: Hearing Before the H. Comm. on Fin. Serv.*, 117th Cong. (2021) (testimony of Sam Bankman-Fried), https://democrats-financialservices.house.gov/uploadedfiles/hhrg-117-ba00-wstate-bankman-frieds-20211208.pdf.

our users' funds and safety come first. We will always allow withdrawals. . . ,"[11] and on June 27, 2022, he tweeted: "Backstopping customer assets should always be primary. Everything else is secondary." On November 7, 2022—months after discussing internally that over $8 billion in fiat currency alone was missing from the FTX exchanges, and four days before the FTX Group filed its bankruptcy petition—Bankman-Fried tweeted that "[w]e have a long history of safeguarding client assets, and that remains true today."[12]

As set forth below, all of the statements referenced above from the FTX Group's *Key Principles*, and Bankman-Fried's Senate testimony and social media posts, were false.

III. The Commingling of Customer Deposits

Like many companies in the crypto industry, FTX Trading Ltd. had difficulty establishing banking relationships. U.S. banks, which were essential for conducting U.S. dollar transactions, generally were either unwilling to provide services to crypto businesses, or required applicants to undergo enhanced due diligence and register as a money services business ("MSB"), with associated regulatory requirements that FTX Trading Ltd. sought to avoid. As Bankman-Fried acknowledged in an interview in 2021:

> Especially in 2017, if you named your company like "We Do Cryptocurrency Bitcoin Arbitrage Multinational Stuff," no one's going to give you a bank account. . . . [T]hey're just going to be like . . . we've been warned about companies with this name. You know, you're going to have to go through the

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[11] @SBF_FTX, Twitter (June 27, 2022, 1:29 PM), https://twitter.com/SBF_FTX/status/1541473744119631872; @SBF_FTX, Twitter (August 9, 2022, 2:49 AM), https://twitter.com/SBF_FTX/status/1424623866790379522.

[12] The Tweet has since been deleted from Bankman-Fried's Twitter account. *See* Helen Partz, *FTX founder Sam Bankman-Fried removes 'assets are fine' from twitter*, COINTELEGRAPH (Nov. 9, 2022), https://cointelegraph.com/news/ftx-founder-sam-bankman-fried-removes-assets-are-fine-flood-from-twitter.

> enhanced [due diligence] process. And I don't want to bother with that right now; it's almost lunchtime. . . . But everyone wants to serve a research institute.[13]

To evade banks' restrictions, at the direction of the FTX Senior Executives, FTX Group funneled customer deposits and withdrawals in fiat currency through bank accounts of Alameda Research Ltd. ("Alameda") and other affiliates, and made misrepresentations to banks about the purpose for which it was using the accounts. At the same time, also at the FTX Senior Executives' direction, the FTX Group used those accounts for many other purposes, commingling and misusing vast sums of customer and corporate funds in the process. Simply put, as a former Alameda employee explained to the Debtors, the FTX Group made no meaningful distinction between customer funds and Alameda funds.

Because the commingling and misuse of FTX.com customer deposits occurred for several years, it is extraordinarily challenging to trace the source of funding for particular FTX Group transactions, or to differentiate between FTX Group operating funds and FTX.com customer deposits. This section describes some of the Debtors' ongoing analysis to attempt to trace the sources and uses of customer funds, focusing primarily on several U.S. dollar-denominated accounts that the FTX Group used to receive customer deposits and fund customer withdrawals, including accounts in the names of Alameda Research Ltd. ("Alameda-4456" and "Alameda-4605"), North Dimension, Inc. ("North Dimension-8738" and "North Dimension-8746"), and FTX Digital Markets Ltd. ("FTX DM") ("FTX DM-2564" and "FTX DM-2549") (collectively, the "Primary Deposit Accounts").[14] These accounts were at all times controlled

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13 Real Vision Finance, *Building an Arbitrage Infrastructure for Traders*, FULL EPISODE with Sam Bankman-Fried, CEO of FTX, YOUTUBE (June 2, 2021), https://www.youtube.com/watch?v=YLCnGXawUj0.

14 The accounts described here and throughout this report refer to the last four digits of the relevant entities' account number for simplicity.

directly or indirectly by Bankman-Fried, although other FTX Group employees, at times, also controlled them.

At the outset, it is important to emphasize that the FTX Group, at the FTX Senior Executives' direction, used many bank accounts besides the Primary Deposit Accounts to receive customer deposits and fund customer withdrawals. These include, for example, accounts in the names of FTX DM ("FTX DM-7814" and "FTX DM-3799"), and FTX Trading Ltd. ("FTX Trading-1596," "FTX Trading-6659," and "FTX Trading-9964(S)")[15] which the FTX Group labeled internally as FBO accounts, as well as other accounts in the names of Alameda Research Ltd. ("Alameda 9485(S)") and FTX Trading Ltd. ("FTX Trading-9018"); customer and corporate funds were commingled in all of these accounts and used for corporate expenditures and the benefit of Bankman-Fried, Singh and other senior employees operating the FTX exchanges, including in the examples discussed in Section V of this report. Second, the FTX Group also regularly transferred funds from the Primary Deposit Accounts to other bank accounts that did not receive customer deposits directly, but that it designated internally as FBO accounts. Corporate and customer funds from these accounts were similarly commingled and misused in the same fashion. Finally, the Primary Deposit Accounts received many transfers from other FTX Group accounts, many of which themselves held commingled funds as a result of the FTX Group's regular practice of transferring funds among its accounts.

[15] Account numbers with the (S) designation represent accounts on a bank platform which allowed for instantaneous transfers of funds to other accounts on the same platform.

A. The Primary Deposit Accounts

1. Alameda

By the time FTX.com launched in April 2019, Alameda had been engaged in trading for more than a year and had established accounts with certain U.S. banks for dollar-denominated transactions. Rather than establishing new bank accounts in the name of FTX Trading Ltd., the FTX Group instead used Alameda's existing bank accounts to receive customer deposits and fund customer withdrawals for the FTX.com exchange. Between at least November 16, 2019 and August 30, 2020, wire instructions provided to FTX.com customers for the purpose of making fiat currency deposits were printed on Alameda letterhead, and instructed FTX.com customers to send funds to one of more than a dozen different Alameda bank accounts, depending on the specific fiat currency at issue. These included Alameda-4456, one of the Primary Deposit Accounts, which was initially the FTX Group's designated account for customers' U.S. dollar deposits.

As a result, from the inception of FTX.com, Alameda's bank accounts received substantial funds from FTX.com customers. For 2020 alone, for example, the Debtors have already confirmed that Alameda-4456 received over $250 million in deposits from customers directly, over $250 million from Alameda's trading counterparties, and over $4 billion from other Alameda accounts that were funded, in part, by customer deposits. Analysis of the source of funds in this and other accounts is ongoing.

2. North Dimension

During 2020, certain of Alameda's banks raised questions about Alameda's wire activity, and certain banks began rejecting wires to or from Alameda. For example, in May 2020, a representative of a bank where Alameda maintained an account that received customer deposits wrote to Alameda that he "noticed references to 'FTX,' a related company that offers crypto derivatives exchange services and is also owned by Samuel Bankman-Fried." Given this observation, the representative asked whether the account would "be[] used to settle trades for their derivatives exchange platform (FTX Trading)?"

Rather than tell the truth to the bank—*i.e.*, that it not only intended to, but had in fact been using the Alameda account for FTX.com customer transactions for nearly a year—the FTX Group lied. Specifically, at the direction of a senior FTX Group executive, an Alameda employee falsely responded that "customers occasionally confuse FTX and Alameda" but that "all incoming/outgoing wires are to settle trades with Alameda Research."

Thereafter, in an effort to avoid scrutiny, the FTX Group incorporated a new, wholly owned entity called North Dimension Inc. ("North Dimension"). North Dimension's purpose was to enable the FTX Group to obtain bank accounts through which it could operate the FTX.com exchange. To obtain the accounts, as set forth in Section IV.A, at the direction of a senior FTX Group attorney, Attorney-1, the FTX Group falsely represented to a bank that North Dimension was a crypto trading firm with substantial operations, when in fact North Dimension was a shell company with no operations. Beginning in April 2021, the FTX Group opened North Dimension-8738 and -8746, two of the Primary Deposit Accounts, and began instructing FTX.com customers to wire funds to them.[16]

By at least September 2021, however, certain customers' banks had begun questioning, and sometimes rejected, wires to or from the North Dimension accounts. An internal document created by the FTX Group in November 2021 listed the "known banks that

[16] Notwithstanding these instructions, some customers continued to send their deposits to Alameda bank accounts, which continued to accept them.

don't want to work with us," and identified numerous banks that had rejected wires to or from North Dimension accounts, Alameda accounts, or both.

As with the Primary Deposit Accounts in the name of Alameda, the FTX Senior Executives allowed customer and non-customer funds to be commingled in the North Dimension accounts. While analysis is ongoing as to a substantial portion of the balances, by December 31, 2021, the North Dimension accounts had received at least $1 billion in customer deposits, as well as funds transferred from various other FTX Group accounts (many of which themselves held commingled funds) totaling at least $2 billion. Also like the Primary Deposit Accounts in the name of Alameda, the FTX Group used the North Dimension accounts both to fund customer withdrawals and to fund corporate and other expenditures at the direction, and for the benefit, of the FTX Senior Executives, including in the examples set forth in Section V.

3. FTX Digital Markets

While Bankman-Fried claimed publicly to welcome regulation of the crypto industry, in late 2020, when Hong Kong announced plans to regulate crypto exchanges,[17] Bankman-Fried and the other FTX Senior Executives immediately sought to leave the jurisdiction. With assistance from Attorney-1, the FTX Senior Executives sought to move to a country in which they faced less regulatory risk. As Ellison described it in October 2021, the

[17] *Hong Kong wants cryptocurrency trading platforms to be regulated*, Reuters (Nov. 2, 2020), https://www.reuters.com/article/crypto-currencies-hongkong-regulator-idUSKBN27J07U.

FTX Group moved to the Bahamas because, with respect to its regulatory environment, the Bahamas was "friendly" and "cutting back on red tape."[18]

In moving to the Bahamas, where they incorporated FTX DM in July 2021, the FTX Senior Executives sought to minimize any substantive change to or scrutiny of their business. Thus, for example, on behalf of the FTX Group, in July 2021, Attorney-1 offered a former Bahamian government official, acting as an attorney, a $1 million "bonus" to procure a necessary business license for FTX DM within ten weeks. The attorney obtained the license less than six weeks later.

Thereafter, FTX DM sought to open bank accounts in the U.S. in its name. Despite the fact that FTX DM had no contractual relationship with FTX customers with respect to custody of fiat currency or the payment of fee revenue, FTX DM claimed in its account opening application that it intended to open both a "[c]ustodial" bank account to process FTX exchange customer funds, and an operating account that would be funded "from the parent company and also internal transfers from the [c]ustodial account (fees from customers)." The bank opened the FTX DM accounts in December 2021.[19] After that date, the FTX Group appears to have used the FTX DM accounts, like other accounts, on a commingled basis for many purposes, including the cycling of money to and from customers to meet withdrawal requests when necessary and various investments, donations and expenditures. With respect to

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18 Andrew R. Chow, *After FTX Implosion, Bahamian Tech Entrepreneurs Try to Pick Up the Pieces*, Time (March 30, 2023), https://time.com/6266711/ftx-bahamas-crypto/.

19 While the FTX Group began processing most wires through the FTX DM accounts after this time, it continued to accept certain customer deposits in the North Dimension and Alameda accounts as well.

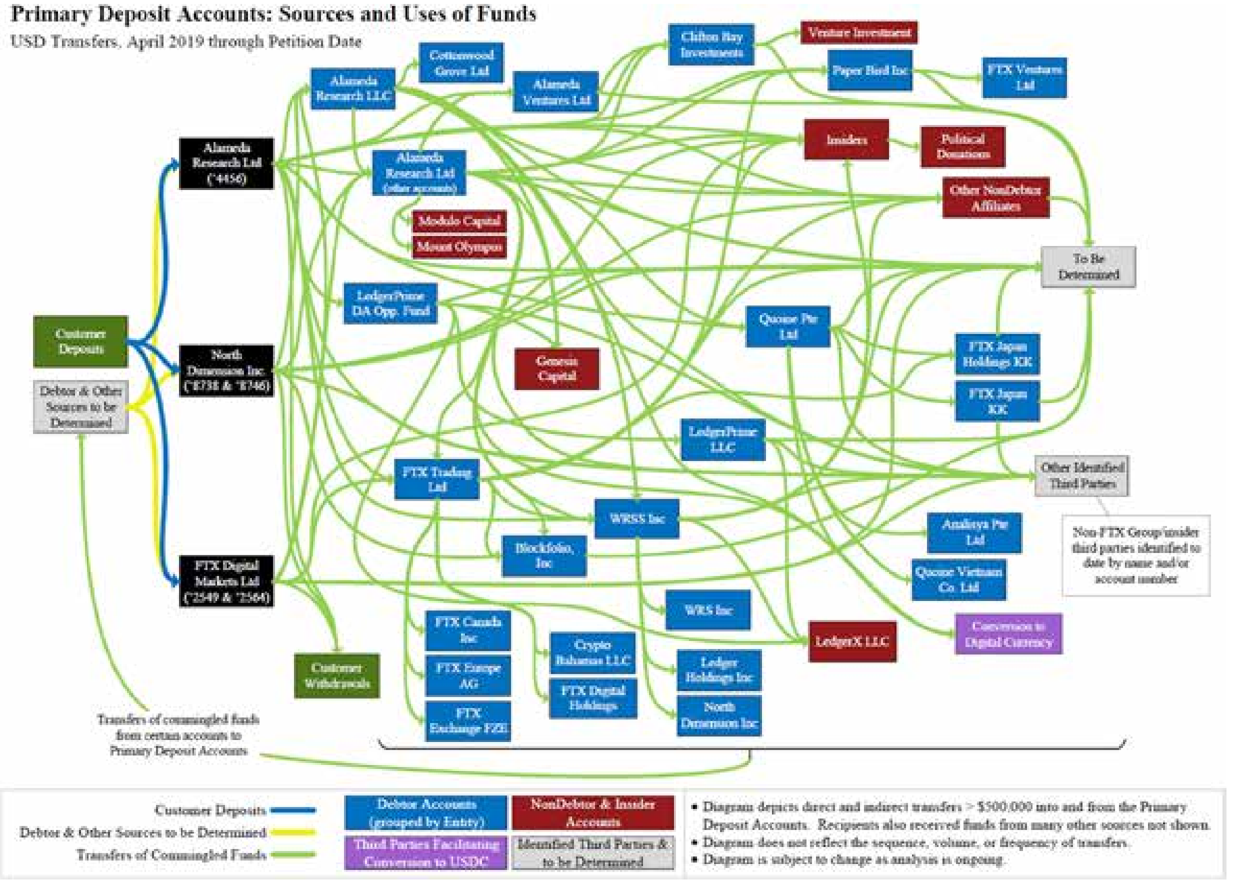
customer withdrawals, the FTX Group appears to have used the FTX DM accounts in part as a pass-through vehicle to funnel at least $5.4 billion in customer deposits to FTX Trading Ltd.

B. Commingling of Funds from the Primary Deposit Accounts

Figure 1 below is a diagram reflecting the Debtors' analysis to date of the flow of funds into and out of the Primary Deposit Accounts from the inception of the FTX.com exchange in April 2019 through November 11, 2022, the date of the FTX Group's bankruptcy petition. The diagram illustrates the sources of funding of the Primary Deposit Accounts, including FTX.com customers; the outflows from the Primary Deposit Accounts, including to FTX Group entities; and the further outflows from those FTX Group entities to other Debtors and non-Debtors. In other words, the diagram illustrates where FTX.com customer deposits into the Primary Deposit Accounts were sent, as identified to date.

Of note, besides the Primary Deposit Accounts, many other Debtor accounts depicted in the diagram received deposits directly from FTX.com exchange customers. Any entity that received transfers of less than $500,000 in total is not depicted, and the diagram does not otherwise depict the size or relative size of the transfers, as substantial analysis is ongoing in this area. It should be noted, however, that given the FTX Group's lack of appropriate recordkeeping, the fungible nature of cash, the lack of detail in certain bank account records, and other issues, it may not ultimately be possible to trace all the sources and uses of funds for FTX Group bank accounts. Certain FTX Group expenditures that the Debtors have been able to trace in part to customer funds are set forth in Section V.

Figure 1


Primary Deposit Accounts: Sources and Uses of Funds
USD Transfers, April 2019 through Petition Date
Customer Deposits
Debtor & Other Sources to be Determined
Alameda Research Ltd ('4456)
North Dimension Inc ('8738 & '8746)
FTX Digital Markets Ltd ('2549 & '2564)
Alameda Research LLC
Cottonwood Grove Ltd
Alameda Ventures Ltd
Clifton Bay Investments
Venture Investment
Paper Bird Inc
FTX Ventures Ltd
Insiders
Political Donations
Alameda Research Ltd (other accounts)
Other NonDebtor Affiliates
Modulo Capital
Mount Olympus
To Be Determined
LedgerPrime DA Opp. Fund
Quoine Pte Ltd
Genesis Capital
FTX Japan Holdings KK
FTX Japan KK
LedgerPrime LLC
FTX Trading Ltd
Other Identified Third Parties
WRSS Inc
Blockfolio, Inc
Analisya Pte Ltd
Quoine Vietnam Co. Ltd
Non-FTX Group/insider third parties identified to date by name and/or account number
WRS Inc
LedgerX LLC
Conversion to Digital Currency
FTX Canada Inc
FTX Europe AG
FTX Exchange FZE
Crypto Bahamas LLC
FTX Digital Holdings
Ledger Holdings Inc
North Dimension Inc
Customer Withdrawals
Transfers of commingled funds from certain accounts to Primary Deposit Accounts
Customer Deposits
Debtor & Other Sources to be Determined
Transfers of Commingled Funds
Debtor Accounts (grouped by Entity)
NonDebtor & Insider Accounts
Third Parties Facilitating Conversion to USDC
Identified Third Parties & to be Determined
• Diagram depicts direct and indirect transfers > $500,000 into and from the Primary Deposit Accounts. Recipients also received funds from many other sources not shown.
• Diagram does not reflect the sequence, volume, or frequency of transfers.
• Diagram is subject to change as analysis is ongoing.

C. Lack of Commitment in Terms of Service to Protect Customer Deposits

Notably, while the FTX Group claimed publicly that it protected and separated customer deposits, FTX Trading Ltd. made no such representation in its Terms of Service Agreement ("Terms of Service") with customers. In fact, the Terms of Service were silent on what FTX Trading Ltd. would do with customer fiat currency, and made no claim that the company would segregate, custody, secure or otherwise protect it. Given the extensive commingling of customer deposits from the inception of the FTX.com exchange, this discrepancy between the FTX Group's public and contractual commitments is telling.

The FTX Group knew how to create a contractual agreement to separate and protect customer deposits when it suited the FTX Group to do so. In its terms of service with customers in Japan, for example, one of the few jurisdictions in which exchange customer deposits were actually protected and separated, FTX Japan Co. Ltd. represented that fiat currency deposits were held in "a segregated user management trust" that was "managed separately from the Company's money. . . ." By contrast, and even though they were occasionally revised, the Terms of Service never stated that FTX Trading Ltd. separated and protected customer fiat currency deposits. Instead, in the isolated instances in which a customer inquired directly on the subject, employees lied. For example, in June 2022, when a potential customer inquired, after reviewing the Terms of Service, "how and where client assets. . . fiat/e-money balances" were maintained, "e.g. omnibus FBO account, in FTX partner bank etc, legal ownership?," a senior employee of FTX Trading Ltd. responded, consistent with Bankman-Fried's Senate testimony that FTX custodied customer assets, that "[f]iat is held in FBO omnibus accounts." As set forth above, with only limited exceptions, that response was false.

D. Falsity of Claim to Reconcile Trading Balances

The FTX Group lied in its *Key Principles* that it "regularly reconcile[d] customers' trading balances" against funds held by the exchanges.[20] In fact, the Debtors have identified no evidence that the FTX Group performed any meaningful reconciliation prior to making this claim on its website and in materials provided to Congress, federal agencies, and other third parties.

At times, the FTX Senior Executives, with Caroline Ellison and certain other employees, estimated their growing liabilities in internal communications. By August 2022, the FTX Senior Executives and Ellison privately estimated that the FTX.com exchange owed customers over $8 billion in fiat currency that it did not have. They did not disclose the shortfall, but at that time, for the first time, they created a sham customer account on FTX.com to reflect the hidden fiat currency liability. To minimize the risk of scrutiny, the FTX Senior Executives and Ellison referred to this sham account only as "our Korean friend's account." The account reflected that their "Korean friend" owed the FTX.com exchange $8.9 billion.

IV. The Role of Attorney-1 in Facilitating the Commingling of Customer Deposits

A senior FTX Group attorney, Attorney-1, actively facilitated and covered up the FTX Group's commingling of customer and corporate funds. Attorney-1 caused and allowed

[20] *FTX's Key Principles for Ensuring Investor Protections on Digital-Asset Platforms*, FTX US (Mar. 10, 2022), http://web.archive.org/web/20221114012002/https://www.ftxpolicy.com/posts/investor-protections.

false information to be conveyed to customers, banks, auditors, investors, and other third parties, including as set forth in the following examples.

A. False Statements to a U.S. Bank

As discussed above, after U.S. banks started rejecting wires involving customers to and from certain Alameda bank accounts, the FTX Group lied to a U.S. bank ("Bank-1") to induce it to open new accounts in the name of North Dimension, which the FTX Group falsely claimed was a crypto trading firm. In fact, the FTX Senior Executives, Attorney-1 and other senior FTX Group employees secretly intended to use, and did use, the North Dimension accounts to receive customer deposits and fund customer withdrawals for FTX.com. Attorney-1 and Bankman-Fried played leading roles in carrying out this deception.

Specifically, Attorney-1 instructed an FTX Group employee to copy and paste into the application for North Dimension's bank accounts the information that Alameda had previously submitted on its own applications to open its bank accounts. The employee did so, and as a result, the application submitted to Bank-1 falsely represented that North Dimension "operates a cryptocurrency trading business." In response to a due diligence questionnaire that Bank-1 required as part of the application process for trading businesses, the FTX Group further falsely described North Dimension as a proprietary and OTC trading firm with 2,000 counterparties and average monthly trading volume of $10 million. Bankman-Fried signed and certified that this response to the bank's questionnaire was correct and complete to the best of his knowledge and belief.

In fact, as Attorney-1 and Bankman-Fried well knew, the information provided to Bank-1 about North Dimension was false. Unlike Alameda, which was a crypto trading and market-making firm with employees, operations and trading activity, North Dimension had no business operations or employees. Attorney-1, who had assisted in incorporating North

Dimension, was also identified to Bank-1 in a false and misleading fashion as North Dimension's General Counsel and Chief Compliance Officer.

Although Attorney-1, Bankman-Fried and others also knew that they intended to use a North Dimension account to process customer deposits and withdrawals for the FTX exchanges, that information was not disclosed on the application to open the account. Further, in response to Bank-1's question in the application, "Is the business a money services business (MSB)?" the FTX Group falsely responded "No." But as Attorney-1 well knew, the FTX Group intended to use the North Dimension account to receive and pay funds to customers, and thus was acting as a money services business.

Attorney-1 also knowingly directed others to create a false and misleading corporate register of members and managers to be provided to Bank-1 in connection with the North Dimension application. Specifically, after Bank-1 asked for a copy of the register, Attorney-1 directed a law firm to create a register. Attorney-1 provided the law firm with the names of the individuals to be identified as members or managers of North Dimension. The register of members was subsequently provided to Bank-1 in order to give North Dimension, a purely shell company, a false air of legitimacy.

B. Retaliation against an Employee Who Raised Concerns about Commingling

After a less senior attorney at the FTX Group discovered and raised concerns that North Dimension accounts were being used to fund FTX exchange customer withdrawals, Attorney-1 fired the attorney, who had been hired less than three months earlier.

Specifically, in early 2022, an FTX Group attorney observed a lack of internal documentation and recordkeeping regarding the FTX Group's corporate organization and intercompany relationships. In the course of investigating, the attorney learned that Alameda owned North Dimension, and that the FTX Group was using North Dimension accounts to fund

FTX exchange customers' withdrawals. The attorney began asking questions about this practice, as he understood that Alameda was a proprietary trading firm that was not involved in handling exchange customer funds, and that it did not have a license to act as a money services business.

Attorney-1 responded by calling the attorney and asking him to meet in person the same day, a Saturday. When the attorney arrived to the meeting as requested, Attorney-1 fired him. The attorney confronted Attorney-1 about the serious operational and control deficiencies he had identified in his short time at the FTX Group. The attorney also expressed disbelief that Attorney-1 had never told him that Alameda had issues with respect to acting as an unlicensed money services business. Attorney-1 provided no substantive response to any of these points.

Days later, the now-terminated attorney emailed Attorney-1 to say he was "still reeling from being summarily fired on Saturday after raising the concerns we discussed." He nonetheless urged Attorney-1 to address "the most pressing issues" facing the company, including with the assistance of an outside law firm, and noted that doing so would require Attorney-1 to tell the law firm "the whole truth." There is no evidence that Attorney-1 raised these matters with anyone outside the FTX Group.

This incident occurred just weeks after Bankman-Fried provided false information to a U.S. Senate committee that the FTX exchanges secured assets deposited by customers, ensured sufficient liquid resources to meet customer withdrawal requests, and maintained appropriate recordkeeping and disclosures to protect against misuse or misallocation of assets. The Debtors have identified on Attorney-1's hard drive a final copy of the false written testimony that Bankman-Fried provided to Congress.

C. Creation of the Sham Payment Agent Agreement

With the participation of Bankman-Fried, Attorney-1 also created and directed the creation of sham agreements that purported to legitimize certain improper transfers and arrangements of the FTX Group, and that facilitated the FTX Group's commingling and misuse of assets and other misconduct. As an example, from January to April 2021, Attorney-1 conceived of, drafted and backdated—by nearly two years—a sham intercompany agreement for the sole purpose of providing it to an external auditor that had been retained to prepare an audited financial statement of FTX Trading Ltd. in connection with a contemplated initial public offering ("IPO") of the company.

As described above, from the inception of FTX.com in April 2019 until the end of August 2020, exchange customers were directed to send fiat deposits to Alameda bank accounts, which continued to receive customer deposits even after that time. Then, in January 2021 as FTX prepared for an audit, Attorney-1 asked an outside law firm to prepare a "cash management" agreement that could provide an "explanation" for why Alameda held "FTX cash . . . for the benefit of the FTX customers." Attorney-1's statement that Alameda held cash "for the benefit" of FTX customers was false to the extent it suggested that Alameda secured, segregated, or otherwise allowed only customers to direct the spending of cash that customers deposited for credit to their FTX exchange accounts.

Attorney-1 also directed that the agreement state that "FTX gets first dibs on Alameda's cash," an apparent attempt to paper over the fact that—as Attorney-1 was aware—there were no existing limitations on Alameda's ability to spend FTX exchange customers' cash for its own purposes. In accordance with Attorney-1's directions, the draft agreement the law firm subsequently provided stated that Alameda provided "cash management" services for FTX Trading Ltd., and that assets of FTX Trading Ltd. held by Alameda pursuant to the agreement would be deemed a loan to Alameda.

After receiving the draft agreement, Attorney-1 took no steps to finalize or implement it. Instead, beginning in March 2021, Attorney-1 prepared his own version of the sham agreement that did not reflect any loan to Alameda. Pursuant to Attorney-1's version, a draft of which he initially titled "Intercompany Treasury Management and Subordination Agreement" and the final draft of which he titled "Payment Agent Agreement," Alameda provided mere "payment services" pursuant to which it would "complete payments . . . as directed by FTX from time to time," and receive assets from FTX "to be held and/or transferred . . . as quickly as commercially possible." In reality, as Attorney-1 well knew, Alameda never transferred and had no intention of transferring customer deposits to FTX "as quickly as commercially possible" or, in fact, at all.

In addition to being false in substance, the Payment Agent Agreement also appears to have been significantly backdated. While metadata reflects that Attorney-1 created the Payment Agent Agreement on April 12, 2021, and that the executed version was last modified on April 16, 2021, the agreement purports to have an "Effective Date" of June 1, 2019—nearly two years earlier. This effective date appears only once in the agreement, in typewritten form on the signature page, which Bankman-Fried signed on behalf of both Alameda and FTX Trading. Notably, while Bankman-Fried regularly executed agreements electronically using DocuSign, which electronically records the date and time of execution, Bankman-Fried signed the sham Payment Agent Agreement using a wet signature.[21] On the same signature page, a footer reads, "Intercompany Treasury Management and Subordination Agreement," a

[21] An earlier draft of the sham agreement that Attorney-1 created, which, according to the metadata, Bankman-Fried edited, purported to require Alameda to warrant that it "maintain[ed] total assets in cryptocurrency and/or cash in one or more accounts held on FTX in an amount that net of all liabilities is valued at least 1.5 times the balance owed" to FTX Trading Ltd. under the agreement. This provision was not included in the executed Payment Agent Agreement.

relic of the first draft of the sham agreement that Attorney-1 created in March 2021—nearly two years after Bankman-Fried supposedly signed it.

Bankman-Fried and the FTX Group also used the sham Payment Agent Agreement to support their claim to the outside auditor that fiat currency of FTX.com customers did not need to be recorded in FTX Trading Ltd.'s audited financials. FTX Trading Ltd. informed its auditor that, pursuant to the agreement, Alameda "provides cash management services to FTX." A member of FTX Trading Ltd.'s external accounting team who was closely involved in the audit explained in an e-mail to the FTX Group's external counsel working on the IPO that pursuant to this "cash management agreement," Alameda "manages the fiat aspects for customers." She explained, because "we have been using Alameda as our payment processor, we have not recorded the customer fiat nor their crypto balances on our books as an asset or liability."

After Attorney-1 caused the outside auditor to be provided with the Payment Agent Agreement, the outside auditor prepared an audited financial statement of FTX Trading Ltd. that inaccurately and misleadingly characterized FTX Trading Ltd.'s relationship with Alameda, and did not record any fiat currency of FTX.com customers. While the IPO was not ultimately consummated, the FTX Group proceeded to share the false and misleading audited financials with potential investors in connection with its $400 million Series C financing that closed in January 2022.

V. Use of Commingled Funds for the FTX Group's Own Expenditures

Following substantial forensic analysis, which remains ongoing, the Debtors have been able to identify certain transactions that appear clearly to have been funded in part with commingled customer deposits. These include political and "charitable" donations, venture investments and acquisitions, and the purchase of luxury real estate for senior FTX Group employees in the Bahamas, as described below. Certain of the transactions were funded directly from the Primary Deposit Accounts. Others were funded from accounts that had received funds from the Primary Deposit Accounts, including FTX Trading Ltd.-9018(S) ("FTX Trading-9018(S)"), FTX Trading-9964(S), and Alameda-9485(S), several of which also received customer deposits directly and/or were labeled internally as "FBO."

A. Political Donations

Bankman-Fried, Singh and another FTX Group insider made more than $100 million in political donations funded through purported "loans" from the FTX Group. Singh has pleaded guilty to conspiring to make unlawful political contributions and defraud the Federal Elections Commission ("FEC"), and Bankman-Fried has been charged with the same crime. The funds they and the other FTX Group insider used to make these political donations were often transferred from FTX Group bank accounts that included commingled customer and corporate funds.

For example, during the period April 2022 through June 2022, one FTX Group executive received wire transfers totaling at least $26 million from North Dimension-8738, a Primary Deposit Account. During the three months preceding these transfers, this Primary Deposit Account received at least $360 million in customer deposits, as well as $330 million in deposits from other FTX Group accounts, many of which had previously received customer funds. Based on the Debtors' analysis of bank and public records, upon receiving the commingled funds from this Primary Deposit Account, the executive used them to make at least $12.7 million in political contributions.

As another example, on November 19, 2021, Singh made a $500,000 contribution to a Political Action Committee ("PAC") called People for Progressive Governance, which was formed by the president of Bankman-Fried's super PAC, Protect our Future. Singh made this political contribution using funds he received from Alameda-4456, a Primary Deposit Account. Specifically, on November 17, 2021, the Alameda-4456 account transferred $1 million to Singh's personal bank account. Two days later, Singh transferred $500,000 from his personal bank account to the PAC.

While transfers to these FTX Group executives for political contributions were sometimes described as "loans" in the FTX Group's QuickBooks general ledger, the evidence identified by the Debtors indicates the transfers were "loans" in name only. The Debtors have identified virtually no loan agreements or similar documentation, and as to the little purported documentation that exists (for a single, small "loan") there is no evidence it was ever intended to be repaid. The Debtors have identified no evidence that the relevant executives paid any interest on the supposed "loans" at any time, or repaid any of the more than $100 million they "borrowed" for political contributions.

Many recipients of these political contributions have either returned the funds to the Debtors or turned them to over to the U.S. Department of Justice.

B. "Charitable" Donations

Bankman-Fried and other FTX Group executives also frequently made donations to individuals and nonprofit organizations from Primary Deposit Accounts that held commingled funds. In February 2021, Bankman-Fried announced the establishment of the FTX Foundation (a/k/a FTX Philanthropy), which would make grants for a range of purportedly altruistic endeavors.[22] The FTX Group committed publicly to contribute at least "1% of FTX's revenue

[22] FTX FOUNDATION,https://web.archive.org/web/20220809135211/https://ftxfoundation.org/.

from fees" to the FTX Foundation.[23] In fact, under the direction and control of Bankman-Fried, the FTX Foundation was financed in part with commingled customer funds.

The FTX Foundation grants were funded via transfers from a variety of bank accounts, including North Dimension-8738 and Alameda-4456 (Primary Deposit Accounts), as well as Alameda-4464 and FTX Trading-9018, all of which contained commingled customer and corporate funds. The FTX Foundation used these funds to make grants to individuals and nonprofits.

In addition to receiving transfers of commingled funds, the FTX Foundation also regularly directed the payment of "grants" directly from FTX Group bank accounts that held commingled customer and corporate funds. For example, on May 19, 2022, the FTX Foundation authorized a $300,000 grant to an individual to "[w]rite a book about how to figure out what humans' utility function is (are)," and transferred the funds to this individual from North Dimension-8738, a Primary Deposit Account. On June 30, 2022, the FTX Foundation funded a $400,000 grant to an entity that posted animated videos on YouTube related to "rationalist and [Effective Altruism] material," again causing the funds to be wired directly from North Dimension-8738, a Primary Deposit Account.

Bankman-Fried and other FTX Group executives also directed commingled funds to Guarding Against Pandemics, Inc. ("GAP"), and related entities. GAP, a tax-exempt entity with the stated mission of mitigating global pandemic-related risks, worked closely with Guarding Against Pandemics PAC, a political action committee run by Bankman-Fried's younger brother. The Debtors have to date identified more than $20 million that the FTX Group

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23 FTX, *The FTX Foundation for Charitable Giving*, MEDIUM (Feb. 8, 2021), https://ftx.medium.com/the-ftx-foundation-for-charitable-giving-5ae53178dce.

wired to GAP and affiliated entities from an Alameda Research Ltd. account that held commingled customer funds that it received from Alameda-4456, a Primary Deposit Account.

C. Venture Investments and Acquisitions

The FTX Senior Executives also used commingled customer funds to finance venture investments and acquisitions. For example, with growing concern that the close relationship between Alameda and the FTX exchanges was drawing unwanted attention, Bankman-Fried decided to invest in a new cryptocurrency hedge fund, Modulo Capital, Inc. ("Modulo"), which was started by two of his associates. Between June and November 2022, at the direction of Bankman-Fried, the FTX Group transferred approximately $450 million to Modulo.[24] The funds were transferred from Alameda-9485, which in turn received funds from (among other FTX Group accounts) FTX Trading-9964(S),[25] an account that, although designated internally as "corporate," had in fact received customer deposits between January and November 2022. On May 19, 2022, at Bankman-Fried's direction, the FTX Group transferred an additional $25 million to Modulo from another account that had received transfers of commingled funds from North Dimension-8738 and Alameda-4605, both Primary Deposit Accounts.

In early May 2023, as part of a resolution with the Debtors, Modulo returned approximately $407 million to the Debtors and also released its claims as to $56 million in assets held on the FTX.com exchange, which together represented approximately 98% of the funds the FTX Group had transferred to Modulo.

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[24] $25 million was sent directly to Modulo Capital, Inc. The remainder was sent to Modulo Capital Alpha Fund LP.

[25] On November 1, 2022, Modulo wired $200,000,000 to Alameda-9485(S), purportedly to return a wire that Alameda had mistakenly sent Modulo earlier.

D. Luxury Real Estate in the Bahamas

As has been widely reported, at the direction of Bankman-Fried and other FTX executives, the FTX Group spent over $243 million on real estate in the Bahamas, including multi-million dollar luxury properties for FTX Group employees and their friends and family. The FTX Group funded these real estate purchases from accounts that held commingled customer and corporate funds.

The FTX Group purchased most of this real estate through a subsidiary, FTX Property Holdings Ltd., which was incorporated in the Bahamas in July 2021 at the request of Attorney-1.[26] Because FTX Property Holdings did not have its own bank account, however, FTX DM funded the purchases using its operating account in the Bahamas ("FTX DM-0275").[27] Figure 2 below shows the FTX Group bank accounts that contributed funding for the real estate purchases by FTX Property Holdings. Although the precise flow of funds differed slightly from one purchase to the next,[28] commingled funds from FTX Trading-9018 were ultimately transferred to FTX DM-0275, from which they were used to purchase the properties.

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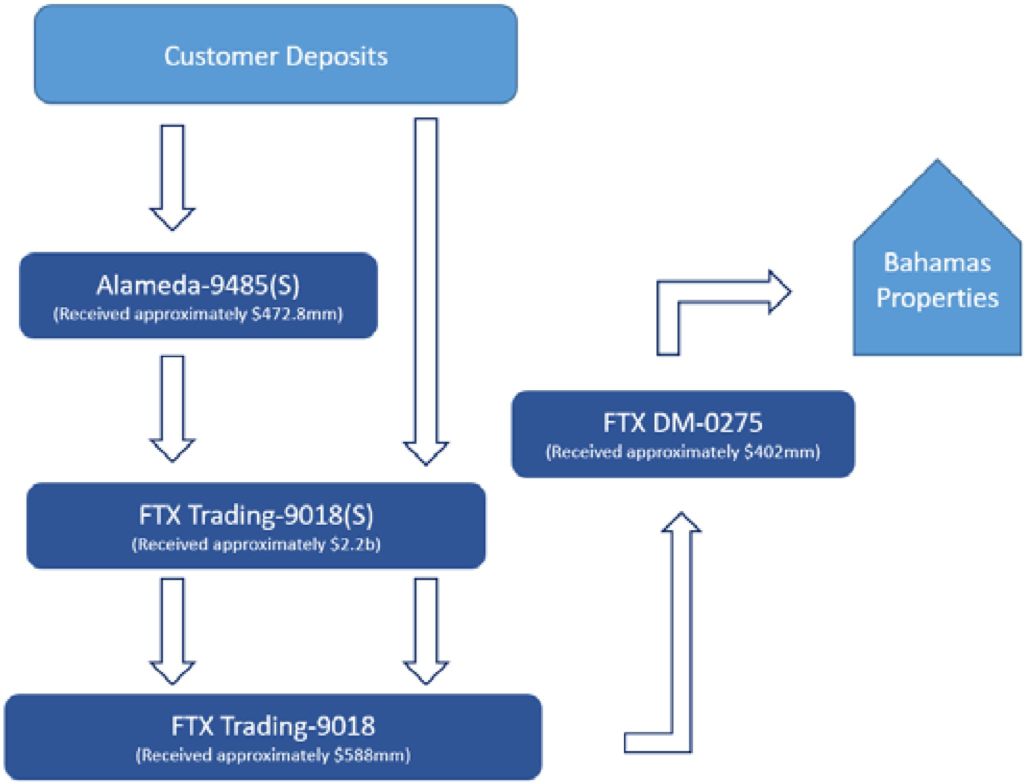
26 At least three properties were purchased in May or June 2021 for FTX Group insiders before FTX DM and FTX Property Holdings were incorporated.

27 Several of the properties were purchased in Bahamian Dollars, rather than U.S. Dollars. For these, FTX DM transferred funds from a U.S. dollar-denominated account, FTX DM-0275, to a Bahamian dollar-denominated account ("FTX DM-0150"), to pay for those properties.

28 In the case of the three properties that were purchased in May or June 2021 prior to the incorporation of FTX DM and FTX Property Holdings, an FTX Trading Ltd. account ("FTX Trading-8563") funded the real estate purchases. In the case of one purchase in September 2021, Alameda-4456 funded the deposit on the property, while the balance of the purchase price was funded by FTX Trading-9018 transferring funds to FTX DM-0275.

Figure 2



During the period May through October 2021, Alameda-9485(S) received at least $472.8 million in customer funds. Thereafter, between October 2021 and January 2022, Alameda-9485(S) transferred a total of approximately $2.2 billion of commingled funds to FTX Trading-9018(S), an account that also received deposits directly from customers during at least the period October 2021 through March 2022. In turn, from October 2021 through January 2022, FTX Trading-9018(S) transferred approximately $588 million of commingled funds to FTX Trading-9018.

Finally, FTX Trading-9018 made the following six transfers of commingled funds to FTX DM-0275, which totaled approximately $402,000,000, and constituted substantially all funds in the account:

- $2 million on or around September 22, 2021;
- $50 million on or around October 6, 2021;
- $50 million on or around October 28, 2021;
- $100 million on or around December 29, 2021;
- $150 million on or around March 17, 2022;
- $50 million on or around August 9, 2022.

Using these commingled funds, at the direction of Bankman-Fried and other senior executives, the FTX Group purchased more than 30 properties, including a $30,000,000 six bedroom, 11,500 square foot penthouse in the Albany resort community in the Bahamas in January 2022. The property, known as the Orchid Penthouse, was home to Bankman-Fried, Singh, Wang, Ellison and others prior to the FTX Group's collapse. In addition, also at the direction of Bankman-Fried and other senior executives, the FTX Group used these commingled funds to purchase the properties described in Appendix A to this report.

VI. Total Losses to Customers

As noted above, the FTX Senior Executives and Ellison informally tracked the size of FTX.com's undisclosed, fiat currency liability to customers that resulted from the extensive commingling and misuse of FTX.com customer deposits. While their estimate in August 2022 of a cash liability of $8.9 billion, which they reflected in the sham "Korean friend" account, has made headlines, in fact, their estimate was even higher at times. In March 2022, for example, Ellison estimated in private notes that FTX.com had a cash deficit alone of over $10 billion. As to assets on the exchange, as discussed in the First Interim Report, through modifications that Singh made to the exchanges' codebase in 2019, the FTX Senior Executives separately allowed Alameda to borrow on FTX.com effectively without limit, and with no risk of auto-liquidation, no matter how negative its net positions were.

On May 12, 2022, Bankman-Fried testified before a committee of the U.S. House of Representatives in a hearing entitled, "Changing Market Roles: The FTX Proposal and Trends in New Clearinghouse Models." During his testimony, Bankman-Fried referenced the "LME nickel fiasco," a then-recent incident in which an investor with an $8 billion short position in nickel went into default, causing harm to counterparties who were exposed to the investor's credit risk.[29] According to Bankman-Fried, FTX.com customers would not face such harms due to the exchanges' superior risk-management system, which prevented customers from becoming exposed to risk in the event of another party's default. In providing this testimony, Bankman-Fried failed to disclose that Alameda, the crypto fund he owned with Wang, was uniquely exempt from the system's operation. Bankman-Fried failed to disclose that he had directed and facilitated the commingling of billions of dollars of FTX.com customer deposits in Alameda and other bank accounts that he owned and controlled. And Bankman-Fried failed to disclose that, as of the time he testified, he had directed and facilitated the misuse of commingled funds from those bank accounts in an amount far larger than what was lost by the nickel trader.

[29] *Changing Market Roles: The FTX Proposal and Trends in New Clearinghouse Models: Hearing before the H.R. Comm. on Agric.*, 117th Cong. (2022) (testimony of Sam Bankman-Fried), https://www.congress.gov/event/117th-congress/house-event/LC69154/text?s=1&r=3; FTX, *Risk Management: Avoiding the Next "LME Nickel" Market Incident* (Apr. 12, 2022), http://web.archive.org/web/20230201060359/https://www.ftxpolicy.com/posts/risk-management.

Based on the Debtors' ongoing analysis, as of the petition date, the FTX.com exchange owed customers approximately $8.7 billion. The vast majority of the deficit—over $6.4 billion—was in the form of fiat currency and stablecoin that had been misappropriated.[30]

Despite the ongoing challenges created by the commingling of customer deposits and corporate assets, and other mismanagement of the FTX Group, the Debtors continue to make substantial progress in their ongoing efforts to identify, secure and recover assets for the estate. To date, the Debtors have recovered approximately $7 billion in liquid assets, and they anticipate additional recoveries. The Debtors will continue to provide updates on their ongoing recovery efforts and investigation as their work progresses.

[30] This figure excludes Alameda's balances on the FTX US, Japan, Singapore, and Cyprus local exchanges.

Appendix A:
Bahamas Properties Purchased by the FTX Group Using Commingled Customer Funds

Property	Approximate Purchase Price	Approximate Closing Date
Residential Properties		
Albany Charles Unit 3A	US$7,235,000	11/30/2021
Albany Charles Unit 4B	US$7,000,000	4/29/2022
Old Fort Bay Lot A	US$16,400,000	4/7/2022
Sandyports Lots 15 & 16	B$1,920,000 (B$1,391,000 and B$529,000)	12/31/2021
One Cable Beach Unit 209	B$950,000	6/30/2021
One Cable Beach Unit 112	US$1,371,871	6/14/2021
One Cable Beach Unit 311	US$2,000,000	6/3/2021
Turnberry Lot #39	B$880,000	1/25/2022
Albany Charles Unit 3B	US$6,750,000	3/31/2022
Albany Charles Unit 4A	US$7,500,000	12/3/2021
Albany Charles Unit 5A	US$10,250,000	11/10/2022
Albany Cube Unit 1B	US$3,310,886.79	11/9/2021
Albany Gemini Unit 1D	US$4,750,000	6/9/2022
Albany Honeycomb Unit 2A	US$7,000,000	1/18/2022
Albany Honeycomb Unit 2C	US$5,500,000	8/2/2022
Albany Honeycomb Unit 3E	US$6,250,000	4/11/2022
Albany Orchid Unit 1A	US$5,500,000	9/13/2022
Albany Orchid Unit 3B	US$7,311,320.75	11/19/2021
Albany Orchid Penthouse	US$30,000,000	1/18/2022
Albany Tetris Unit D2	US$8,900,000	12/30/2021
Albany Tetris Unit 2E	US$7,850,000	5/30/2022
Albany Tetris Unit 3D	US$7,478,873.24	12/30/2021
Albany Lot 44	US$11,000,000	2/16/2022
Ocean Terraces	US$17,500,000	3/8/2022
One Cable Beach Unit 207	US$1,540,000	7/15/2022
One Cable Beach Unit 309	US$1,395,000	7/18/2022
One Cable Beach Unit 603	US$975,000	8/11/2022
One Cable Beach Unit G12	US$1,295,000	7/15/2022
Old Fort Bay Lots 5A & 5B	B$9,000,000	5/19/2022
Commercial Properties		
Bayside Estates – Pictet	US$4,500,000	2/3/2022
Blake Road	B$875,000	6/15/2022
Pineapple House	B$1,800,000	7/22/2022
Veridian Corporate Center Units 18, 24, 25, 26, 27, 30	US$8,550,000	12/30/2021
Veridian Corporate Center Unit 23	US$2,290,000	4/8/2022
Veridian Corporate Center Units 2-22, 28 and 29	B$14,500,000	9/29/2022

Faculty

Elisabeth O. da Silva, CPA, CFF is a partner in the Business Advisory practice of DGC in Boston and has nearly 30 years of experience conducting white-collar investigations and providing litigation consulting and expert-witness services in the context of complex commercial litigation for a wide variety of companies, ranging from small, privately owned businesses to large, multinational publicly traded entities. Ms. da Silva has directed numerous international high-profile investigations involving complex accounting rules, alleged accounting malfeasance, asset misappropriation/concealment, and a variety of other accounting, auditing and financial matters. She frequently assists companies and their counsel with the analysis/quantification of alleged white-collar crimes, as well as presentations to regulatory and prosecutorial offices. Ms. da Silva has served as the financial advisor for both debtors' and creditors' committees in unprecedented bankruptcy matters, including municipalities and energy businesses. She has performed extensive and complex analysis of solvency as well avoidance actions and preference claims. Ms. da Silva has testified as an accounting or damages expert at trial, arbitration and deposition for privately owned and publicly traded entities, as well as on behalf of the Securities and Exchange Commission. She also serves as an arbitrator in commercial disputes and is an active member of the American Arbitration Association's roster of arbitrators. Ms. da Silva advises legal counsel, management, shareholders and boards of directors on accounting and auditing, financial, valuation and internal control matters in the context of internal investigations, shareholder disputes, post-acquisition and net working capital disputes, business and contract disputes, accountants' liability, bankruptcy and restructuring, and enforcement or regulatory issues. Prior to joining DGC, she co-founded and operated a boutique litigation consulting firm after 14 years at EY, where her career began. Ms. da Silva has published numerous articles and participated in webinars on a variety of topics. She serves on the Joint Trial Board of the American Institute of Certified Public Accountants, is co-chair of the Litigation Support and Business Valuation Committee of the Massachusetts Society of Certified Public Accountants, a public member of the Massachusetts Board of Bar Overseers, and a member of ABI, the Women in White Collar Defense Association and the Turnaround Management Association. She also serves on the Roster of Arbitrators of the American Arbitration Association. Ms. da Silva received her B.B.A. from the University of Massachusetts at Amherst.

Prof. Jared A. Ellias is the Scott C. Collins Professor of Law at Harvard Law School in Cambridge, Mass., and he writes and teaches about corporate bankruptcy law and the governance of large firms more generally. His current research focuses on the governance of large bankrupt firms and the role played by activist investors and the effect of bankruptcy filings on firms, and his research interests include corporate bankruptcy, corporate governance, contract law, empirical methods in social science and law, and economics. Prof. Ellias has served as a teaching fellow and lecturer at Stanford Law School, a visiting associate professor at Boston University School of Law, the Bion M. Gregory Chair in Business Law at the University of California, Hastings College of the Law, and the William Nelson Cromwell Visiting Professor of Law at Harvard Law School. He joined the Harvard Law Faculty in July 2022. Prof. Ellias's research on corporate bankruptcy topics has been published or is forthcoming in leading peer-reviewed law and social science journals (such as the *Journal of Legal Studies*, the *Journal of Legal Analysis* and the *Journal of Empirical Legal Studies*), as well as in leading student-edited law reviews (such as the *California Law Review*, the *Southern California Law Review*, the *Yale Journal on Regulation* and the *Columbia Law Review Sidebar*). He has presented papers at a large number of academic conferences, such as at the annual meeting of the American Law and Economics Association and the Conference on Empirical Legal Studies, and at faculty workshops at leading law schools. Prof. Ellias's work has been selected twice for the Stanford/Yale/Harvard junior faculty forum and for presentation at the Weil, Gotshal & Manges Roundtable at Yale Law School. One of his articles was designated by *Corporate Practice Commentator* as one of the Top 10 Corporate and Securities Laws Articles of 2020. Prof. Ellias has presented research at a wide variety of bankruptcy lawyer conferences and events, and he is widely quoted in the press, including by the *New York Times*, the *Wall Street Journal*, the *Washington Post*, the *Financial Times*, Bloomberg News and the *San Francisco Chronicle*, among many other media venues. In 2020, he was honored as one of ABI's "40 Under 40. Prof. Ellias frequently advises state and federal lawmakers on bankruptcy-related issues, and he has testified on corporate bankruptcy issues before the California State Senate and presented research at a wide variety of bankruptcy law conferences and events. He advised the California State Senate on the 2019 bankruptcy of the Pacific Gas & Electric Co., one of the top 10 largest industrial bankruptcies of all time, which touched on many core issues of interest to the State of California. Prior to joining the Harvard faculty, Prof. Ellias was the founding faculty director of the Center for Business Law at UC Hastings. He received the UC Hastings Foundation Faculty Award for Faculty Scholarship, the highest research award given by UC Hastings to faculty. Before entering academia, Prof. Ellias was an associate in private practice at Brown Rudnick LLP in New York, where he represented financial institutions and ad hoc and statutory creditor committees in corporate restructuring transactions, both in and out of bankruptcy court. He received his A.B. in 2005 from the University of Michigan and his J.D. in 2008 from Columbia Law School.

Michael J. Epstein is the global special situations leader for Deloitte Transactions and Business Analytics LLP's restructuring practice in Boston. He is an accomplished strategic leader and global operations professional with more than 30 years of professional services (including over a decade at the Big Four), boutique consultancy and industry experience helping businesses navigate through periods of uncertainty and change in all industries. Mr. Epstein has advised senior executives from small privately held family businesses to large corporate settings through significant periods of transformation, both financial and operational, optimizing liquidity performance, changing the negotiating leverage dynamic in corporate ecosystems, and building consensus in stakeholder dynamics. He has experience as a CEO, CRO, board representative and a board member of private and nonprofit organizations alike. His board appointments have included mid-market media and technology companies (CFS Group, MC Communications, Medical Media Holdings), as well as nonprofit education and trade association organizations, including Audit Committee appointment at each. On numerous occasions, Mr. Epstein also has held fiduciary positions and has led or advised corporations, their management teams and their boards as small as $5M in revenue to as large as $3B in debt. A frequent industry panelist and an author of articles regarding corporate governance and stakeholder communications, Mr. Epstein started his career in banking and after business school began his consulting journey. He later segued to become U.S. CEO of a startup technology business for six years. While growing the startup, he presided over the build-out of financial applications for specialty finance and developed a data center to support early remote client management, with nearly $1 billion in outstanding loans being managed. He also joined the board of directors and assisted in executing the IPO in the U.K. in 2004. Mr. Epstein received his B.S. from Tufts University and his M.B.A. from The Wharton School at the University of Pennsylvania.

Lisa M. Kresge is co-managing partner of Brennan Scungio & Kresge LLP in Providence, R.I., haivng joined the firm in 2011 from the Boston office of Brown Rudnick. With a focus on commercial finance, she represents businesses and financial institutions — including banks, credit unions and mortgage-servicers — in both transactional work and commercial litigation. Ms. Kresge handles corporate restructuring and creditors' rights matters, representing secured creditors, trade claimants and other parties-in-interest in chapter 7 and chapter 11 bankruptcy and receivership cases in jurisdictions across the U.S. She routinely counsels commercial lenders and borrowers in connection with secured and unsecured credit facilities, asset-based financing, loan workouts, commercial and residential foreclosures, and other lending and business transactions. Ms. Kresge is a frequent writer and speaker on bankruptcy, receivership and foreclosure law topics. A court-appointed receiver for the Rhode Island Superior Court, she is a member of the Association of Commercial Finance Attorneys, the Business Section of the American Bar Association and the International Women's Insolvency & Restructuring Confederation. She also was elected to the board of the Rhode Island Women's Bar Association in 2018 and is currently the vice president of that organization and serves as co-chair of the board of the New England chapter of the International Women's Insolvency & Restructuring Confederation. She was recognized in 2023 for Excellence in Law by *Rhode Island Monthly* in the practice area of Bankruptcy & Workout. Ms. Kresge received her undergraduate degree *cum laude* in 1996 from American University and her J.D. in 1999 from Boston University School of Law.