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The Rise of Bankruptcy Directors

Law Working Paper N° 593/2021
June 2021

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We thank Kenneth Ayotte, Vincent Buccola, Anthony Casey, Elisabeth de Fontenay, Tobias Keller, Michael Klausner, Adam Levitin, Adriana Robertson, Daniel Sokol, Robert Stark, Robert Tennenbaum and seminar participants at the Bay Area Corporate Law Scholars Workshop, the Bar Ilan University Law Faculty Seminar, the Florida–Michigan–Virginia Virtual Law and Economics Seminar and the University of Toronto Seminar in Law and Economics for helpful comments. We also thank Noy Abramov, Jacob Barrera, Jade Henry Kang, Spencer Kau, Victor Mungary, Julia Staudinger, Or Sternberg, Jonathan Tzuriel, and Sara Zoakei for their excellent research assistance.

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Abstract

In this Article, we use hand-collected data to shed light on a troubling innovation in bankruptcy practice. We show that 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 refer to these directors as "bankruptcy directors" and conduct the first empirical study of their rise as key players in the world of corporate bankruptcy. 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 are part of a small community of repeat private-equity sponsors and law firms. Securing future directorships may require pleasing this clientele at the expense of creditors. Consistent with this prediction, we find that unsecured creditors recover on average 21% less when the company appoints a bankruptcy director. While other explanations are possible, this finding at least 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. We propose that the court regard bankruptcy directors as independent only if all creditors support their appointment, making them accountable to all sides of bankruptcy disputes.

Keywords: Boards of Directors, Chapter 11, Bankruptcy, Corporate Governance, Conflicts of Interest, Board Governance

JEL Classifications: K22, K20, M100, G33, G30, G34

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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, the 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 keep creditors from controlling this litigation, the board appointed as new directors two bankruptcy experts who claimed that, because they had no prior ties to Sycamore or Nine West, they were independent and could handle those claims.[3] The firm's creditors objected. They argued that the new directors still favored Sycamore because it stood behind their appointment, and so they would "hamstring any serious inquiry into [its] misconduct."[4] Nevertheless, the gambit was successful. The bankruptcy 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 important new players in corporate bankruptcies: bankruptcy experts who often join boards of directors on the eve of a bankruptcy filing, whom we call "bankruptcy directors," as important new players in

[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, No. 18–10947, *In re* Nine West Holdings (Bankr. S.D.N.Y. Jan. 1, 2019); Ken Ayotte and Christina Scully, *J. Crew., Nine West and the Complexities of Financial Distress*, working paper (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 it in December 2015 for $371 million. *See id.* at 23.

[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 Claim at 17, No. 18–10947, *In re* Nine West Holdings (Bankr. S.D.N.Y. Oct. 22, 2018) [hereinafter Nine West Standing Motion].

[3] *See* Hearing Transcript at 43, *In re* Nine West Holdings, 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 directors] attended … depositions … but asked just a handful of questions of a single witness … [and] 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, No. 18–10947, *In re* Nine West Holdings (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 20 (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) ("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").

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corporate bankruptcies. Increasingly, large firms prepare to file for Chapter 11 by adding to the board one or two former bankruptcy lawyers, investment bankers, or distressed debt traders.[8] The new directors receive the board's power to make important Chapter 11 decisions and claim in court to be neutral experts that make decisions to benefit the firm and its creditors.[9] The rising prominence of bankruptcy directors has made them controversial. Their proponents tout their expertise and ability to expedite the reorganization and thus protect the company's viability and its employees' jobs.[10] Their opponents retort that they suffer from severe conflicts of interest that harm unsecured creditors.[11]

This Article is the first empirical study of bankruptcy 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 resolve conflicts with creditors.[12] It does so by analyzing a hand-collected sample of the boards of all large firms that filed for Chapter 11 between 2004 and 2019 and that disclosed the identity of their directors to the bankruptcy court.[13]

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[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 (noting that "[independent directors in bankruptcy] … has become the latest cottage industry in the restructuring space").

[9] *See* Regina Stango Kelbon et al., *Appointment of Independent Directors on the Eve of Bankruptcy: Why The Growing Trend?*, 19TH ANN. BANKR. INST. (Apr. 11, 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) (noting that independent directors are helpful in bankruptcy where "speed to exit is paramount").

[11] *See, e.g.*, *"Independent" Directors under Attack*, PETITION (Dec. 12, 2018); Lisa 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; Mark Vandevelde & Sujeet Indap, *Neiman Marcus Director Lambasted by Bankruptcy Judge*, FIN. TIMES (June 1, 2020); American Bankruptcy Institute, *RDW 12 21 2018*, YOUTUBE (Dec. 20, 2018) https://www.youtube.com/watch?v=Ah8RkXYdraI&ab_channel=AmericanBankruptcyInstitute; *The "Weil Bankruptcy Blog Index," CMBS & How Nine West Is the Gift That Keeps on Giving*, PETITION, https://petition.substack.com/p/weilbankruptcyblogindex (last visited Jan. 10, 2021) (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 (2010) (considering creditor conflict); Douglas G. Baird and 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. 747 (2011) (considering the role of unsecured creditors).

[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.

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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.[14] 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 characteristics, the presence of bankruptcy directors is associated with 21% lower recoveries for unsecured creditors. While 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, our finding is concerning because it raises the possibility that bankruptcy directors make decisions that are not value-maximizing.

Next, we examine a potential mechanism through which bankruptcy directors may reduce recoveries for unsecured creditors. We find that the appointment of bankruptcy directors transforms the process of prosecuting self-dealing claims against insiders, as in Nine West. Bankruptcy directors usually join the board in the months leading to the bankruptcy filing and receive the power to make core bankruptcy decisions, such as negotiating the bankruptcy financing. In about half of the cases, they investigate claims against insiders.[15] After the firm files for bankruptcy, the creditors begin their own investigation, but they are racing against the clock as the bankruptcy directors typically negotiate a quick settlement and argue that the court should approve it to save employee jobs.[16]

Finally, we consider potential sources of pro-shareholder bias among bankruptcy directors. In general, shareholders and the board appoint bankruptcy directors without consultation with creditors. They may therefore prefer to facilitate a graceful exit for the shareholders who control the board and who would otherwise be liable to creditors for misconduct. 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 for this service. Bankruptcy directors depend on this clientele for future engagements.

In our data, we observe several individuals appointed to these directorships repeatedly, pointing to a growing professionalization of their role. For example, the two

[14] We identified bankruptcy directors using information from the 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 id.*

[15] *See infra* Table 2.

[16] 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. REG. 651 (2020).

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bankruptcy directors in the Nine West case had collectively served in this role on seven other boards, all with the same law firm.[17] Another example is that of the director at the top of our super-repeaters list. He has served on the boards of at least 96 companies, 31 of which were positions on the board of Chapter 11 debtors on the petition date or within a year thereafter.[18]

We find that the super-repeaters on our list had an average (median) of 17 (13) directorships and that about 44% of these directorships were in companies that went into bankruptcy when the super-repeaters served at the board or up to a year before their appointment.[19] Our data also show that super-repeaters have strong ties to two leading bankruptcy law firms.[20] 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.

Overall, these findings support the claim that bankruptcy directors are a new weapon in the private-equity playbook. They allow sponsors to extract value from portfolio firms in self-dealing transactions and, if a firm fails, appoint bankruptcy directors to handle creditor claims, file for bankruptcy, and force creditors to accept a cheap settlement.[21] If this claim is correct, the ease of handling self-dealing claims in the bankruptcy court *ex post* can fuel more aggressive self-dealing *ex ante*.[22]

Our findings have important policy implications. Bankruptcy law strives to protect both businesses and creditors. Those two goals clash when creditors bring suits that delay the emergence from bankruptcy. While bankruptcy directors aim for speedy resolution of these suits, their independence is questionable because the prospective defendants in these suits appointed them. Moreover, they often seek to bypass the procedure Congress created with the bankruptcy code by claiming to replace the unsecured creditors committee before the bankruptcy court.

We argue that the contribution of bankruptcy directors to streamlining the bankruptcy process should not come the expense of creditors. The bankruptcy court can avoid this cost by treating as independent only bankruptcy directors who earn the support of unsecured creditors. Our sample contains examples of such directors.

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[17] *See* UCC Declaration in Charge of Standing Motion, *supra* note 2, at 116–17, 217.

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

[19] *See id.*

[20] *See infra* Section III.C.5.

[21] *See infra* note 111 and accompanying text (arguing that independent directors are changing incentives for private-equity sponsors, who are will be "encouraged to asset strip").

[22] 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." THE CAESARS PALACE COUP (2021).

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In contrast, bankruptcy directors who do not earn the support of unsecured creditors should not prevent unsecured creditors from investigating and pursuing claims. There is nothing wrong with the board using them as reorganization experts. For example, they can try to resolve financial distress prior to any bankruptcy filing, as happened in some cases in our sample. The trouble arises when bankruptcy directors seek treatment as neutral actors when creditors believe they are really acting on behalf of shareholders.

Our analysis has implications also 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 shows 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.

I. THE TRANSPLANTATION OF INDEPENDENT DIRECTORS INTO BANKRUPTCY LAW

In this Part, we consider how reliance on independent directors has become a staple of corporate law and how it has recently transitioned 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 migrated 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

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

[24] *See* Del. Code tit. 8, § 144(a) (2021).

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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 to supervise management.[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 board and its committees with independent directors.[30] Third, institutional investors with ever-increasing 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 giving boards more deference if they appointed independent directors to vet conflict decisions.[33]

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[25] *See, e.g.*, Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 117–18 (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) [hereinafter Gordon]; Bebchuk & Hamdani, *supra* note 23, at 1281–82.

[27] *See* Gordon, *id.* at 1465; Kobi Kastiel & Yaron Nili, *Captured Boards: The Rise of Super Directors and the Case for a Board Suite*, WIS. L. REV. 19 (2017).

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

[29] *See* Gordon, *supra* note 26, at 1968.

[30] *See* NYSE Listed Company Manual, §§ 303A.01, 303A.04 (2009), 303A.05 (2013), 303A.06 (2009); NASDAQ Stock Mkt. Rules §§ 5605(b)(1), 5605(c)(2), 5605(d)(2), and 5605(e) (2019). *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 few exceptions) that listed-company boards have a majority of independent directors").

[31] *See* Ronald Gilson & Jeffery 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, 894 (2014).

[33] *See, e.g.*, Bebchuk & Hamdani, *supra* note 23, at 1281-82; Gordon, *supra* note 26, at 1490 (both reviewing the role that Delaware courts played in encouraging public companies to give more power to independent directors).

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In corporate freeze-outs, a controlling shareholder acquires the shares of public shareholders and takes the company private.[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 committee is truly independent and 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

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[34] *See, e.g.,* Guhan Subramanian, *Fixing Freeze-outs*, 115 YALE L.J. 2 (2005).

[35] *See, e.g.,* Lucian Arye Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freeze-outs, in Concentrated Corporate Ownership* 247 (Randall K. Morck ed., 2000); Subramanian, *id.* at 32–38.

[36] *See* Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) ("[W]hen a controlling stockholder 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 Communication Systems, Inc., 638 A.2d 1110 (Del. 1994); Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014) [hereinafter *MFW*].

[38] *See* Fernan Restrepo, *Judicial Deference, Procedural Protections, and Deal Outcomes in Freeze-out Transactions: Evidence from the Effect of MFW* (Working Paper, 2020) (finding that special committees were formed in over ninety percent of post-*MFW* freeze-outs).

[39] *See MFW*, *supra* note 37. *See also* Wachtell, Lipton, Rosen & Katz, *Use of Special Committees in Conflict Transactions*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 23, 2019).

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

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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 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]

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[41] *See* Del. Ch. Ct. R. 23.

[42] *See* Aronson v. Lewis, 473 A2d 805, 818 (Del 1984). 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 WL 4040806, at *6 (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, the 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 (Del. Ch. 2013); Sandys v. Pincus, 152 A.3d 124 (Del. Dec. 2016).

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

[44] *See generally* Minor Myers, *The Decision of the Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309 (2009) (discussing special litigation committees).

[45] *See, e.g., In re* Oracle Corp. Deriv. Litig., 824 A.2d 917 (Del. Ch. 2003) ("the 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, 36 DEL. J. CORP. L. 359 (Del. Ch. 2010) ("SLC members are not given the benefit of the doubt as to theirs 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 special litigation committee was independent, acted in good faith, and made a reasonable investigation, and then may apply its own independent business judgement to decide whether to grant the motion. This standard of review is higher than the business judgment rule. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787–89 (Del. 1981).

[47] *See* C.N.V. Krishnan et al., *How Do Legal Standards Matter? An Empirical Study of Special Litigation Committees*, 60 J. CORP. FIN. 101543 (2020) (also finding that, "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").

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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] Years went by and little has changed. 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 they 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.

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 request the judge considers the input of creditors, who are usually

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[48] *See* JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS __ (1989). *See also* Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447 (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. 491 237, 252 (2009) ("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 (2020); Yaron Nili, *Out of Sight, Out of Mind: The Case for Improving Director Independence Disclosure*, 43 J. CORP. L. 35 (2017).

[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.)

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sophisticated investors who can offer independent analysis.[53] Bankruptcy law amplifies creditor voice by allowing the appointment of a committee of unsecured creditors 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 in the course of the bankruptcy process that judges endorse. What has motivated this change?

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 factors.

First, as boards developed a practice of looking to expert directors for major decisions outside bankruptcy, it was 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 if the board worries about lawsuits.

Second, the lawyers who advise financially distressed companies may see independent directors as helpful in persuading the bankruptcy judge to issue orders that allow their client to leave bankruptcy. Since judges are more deferential to independent directors who make decisions that shareholders oppose, these lawyers may have reasoned, they could learn to be more deferential also 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

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[53] *See, e.g.*, Wei Jiang et al., *Hedge Funds and Chapter 11*, 67 J. FIN. 513, 556 (2012); Jared A. Ellias, *Do Activist Investors Constrain Managerial Moral Hazard? Evidence from Junior Activist Investing*, 8 J. LEGAL ANALYSIS 493 (2016); Michelle M. Harner et al., *Activist Investors, Distressed Companies, and Value Uncertainty*, 22 AM. BANKR. INST. L. REV. 167 (2014).

[54] *See* Robert Gayda & Catherine LoTempio, *supra* note 12, at 1 ("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").

[55] *See* Regina Stango Kelbon et al., *Appointment of Independent Directors on the Eve of Bankruptcy: Why The Growing Trend?*, 19TH ANN. BANKR. INST. (Apr. 11, 2014) 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").

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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 increased the space for 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, shareholders' 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 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.

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[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 CAL. 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 L. STUD. 31, 31 (2017); Andrew Winden, *Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures*, 18 COLUM. BUS. L. REV. 852 (2018).

[57] *See, e.g.,* In re Walt Disney Co. Deriv. Litig., 907 A.2d 693, 698 (Del. Ch. 2005) ("The redress for [directors'] failures . . . must come . . . through the action of shareholders . . . and not from this Court"). *See also* Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342, 1351 (D. Nev. 1997) ("One 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 contexts").

[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).

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Creditors cannot influence the election of directors, and so bankruptcy directors lack incentives to advance creditors' interests.

Additionally, unlike corporate law, bankruptcy law already contemplates other representatives of creditors. Importantly, a committee of unsecured creditors acts as a court-appointed fiduciary to maximize firm value while protecting creditor rights.[59] Courts have interpreted this broad authority to permit the committee 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]

By appointing bankruptcy directors, debtor firms and their lawyers seek to use the asserted objectivity of these directors to wrest control of self-dealing claims against shareholders from creditors and the court. This contradicts what Congress envisaged, sidestepping the checks and balances in Chapter 11 and undermining the goals of the bankruptcy process.

Moreover, in Chapter 11 proceedings, creditors are usually sophisticated investors advised by expert lawyers.[61] They can protect their interests. There is no reason to let shareholders' 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 identified in the corporate law context.

First, bankruptcy professionals—lawyers, investment bankers, and bankruptcy directors—form a much smaller community than the corporate governance community.[62] In this environment, it is likely that bankruptcy directors will work with the same professionals on their next engagement. Consistently, the evidence we present below reveals a group of super-repeater directors who have developed a profession of sitting on the board 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 to the board experts 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.

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[59] *See, e.g.,* 11 U.S.C. §§ 1102 (2019); Peter C. Blain & Diane H. O'Gawa, *Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers, and Duties*, 73 MARQ. L. REV. 581, 605-609 (1990).

[60] *See id.*

[61] *See supra* note 53 and accompanying text.

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

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Third, about half of the firms appointing bankruptcy directors are private equity-controlled firms.[63] Private-equity sponsors are repeat players that can appoint individuals at many boards.[64] They can reward a director who has served them well on the board of one bankrupt company by placing her on other boards.[65] Conversely, a bankruptcy director who harms the interests of a private-equity controller will likely lose 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 private-equity sponsors in previous bankruptcies and consider appointing those same directors to the boards of its troubled portfolio firms.

In short, bankruptcy directors can be a challenge for bankruptcy law's structured bargaining process, which Congress intended, as Judge Friendly put it, to "not only be fair but seem fair."[66] As we will discuss, they may well undermine this goal.

II. EXAMPLES

In this Part, we present two case studies of how bankruptcy directors 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 in brief 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.

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[63] *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.

[64] *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").

[65] *See* Lin, *supra* note 23, at 543.

[66] Before the enactment of the modern bankruptcy code, Judge Henry Friendly famously had expressed this sentiment. In re Ira Haupt & Co., 361 F.2d 164, 168 (2d Cir. 1966) (Friendly, J.) ("The conduct of bankruptcy proceedings not only should be right but must seem right").

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A. Neiman Marcus

In 2017, the private-equity sponsors of retailer Neiman Marcus ("Neiman") searched for a way to protect their investment in the struggling retailer.[67] They focused on MyTheresa, a Neiman subsidiary that sold luxury goods online.[68] The private-equity sponsors consulted the investment bank Lazard Limited ("Lazard"), who recommended "moving certain assets with strategic value, such as the MyTheresa business [away from creditors]"[69] 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.[70] Lazard anticipated that the transfer could be subject to "challenges from creditors"[71] over "fraudulent conveyance / fiduciary duty considerations"[72] and offered its help in dealing with such "complexities."[73]

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, beyond the reach of the creditors of Neiman's $6 billion debt.[74] The transfer caused the value of the debt to collapse,

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[67] *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., No. 20–35219 (Bankr. S.D. Tex. July 30, 2019); 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, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. July 30, 2019) [hereinafter UCC Report] (describing capital structure post-LBO).

[68] *See* Ex. Neiman Marcus Discussion Material, Lazard Presentation at 2, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. July 30, 2019) [hereinafter Lazard Presentation]. *See* UCC Report, *supra* note 25, 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?'").

[69] *See* Lazard Presentation, *supra* note 31, at 1

[70] *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 by private-equity sponsors has become typical in the 2010s, 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 CAL. L. REV. 745 (2020). The Financial Times would later report that Marble Ridge's "crusade over 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).

[71] *See* Lazard Presentation, *supra* note 31, at 1.

[72] *See id.* at 10. *See also* UCC Report, *supra* note 25, at 80.

[73] *See* Lazard Presentation, *supra* note 31, at 1.

[74] *See* UCC Report, *supra* note 25, at 34; George Ticknor et al., *Neiman Marcus Capitalizes on Weak Covenant Package to Transfer Valuable Assets Beyond the Reach of Certain Creditors* 1–2, LOCKE LORD (Oct. 18, 2018), https://www.lockelord.com/-/. The private equity owners would later justify the moves as making it easier to manage MyTheresa without the weight of the Neiman Marcus' debt weighing down the online retailer in negotiations with vendors. *See* Counter-Report of Ares Mgmt., *supra* note 32, at 12.

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spurring threats and negotiations between the creditors and Neiman.[75] 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.[76]

However, this did not solve Neiman's problems, which the COVID-19 pandemic made worse,[77] and in May 2020, the company filed for bankruptcy.[78] 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 billion.[79] Neiman intended to seek a court order discharging the private-equity sponsors from liability over the MyTheresa transfer.[80]

In planning its bankruptcy filing, Neiman took steps to hobble the ability of the court-appointed official committee of unsecured creditors (the "UCC") to pursue the MyTheresa claims. First, the terms of the bankruptcy financing required the company to leave bankruptcy in 120 days, limiting the time the UCC could investigate and litigate, and

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[75] *See* Soma Biswas, *Neiman Marcus Bondholder Criticizes Transfer of Valuable Online Business*, WALL ST. J. (Sept. 21, 2018).

[76] *See generally* Neiman Marcus Grp., 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.* at 26. 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 25, 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., Current Report (Form 8–K) (Mar. 1, 2019) at 29. 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 lacking standing to do so without the support of a larger number of creditors. *See* Order Granting Defendant's Plea to the Jurisdiction and Alternatively, Special Exceptions, Marble Ridge Capital v. Neiman Marcus, No. 18–18371 (Bankr. Tex. Mar. 19, 2019).

[77] *See* Declaration of Mark Weinstein, Chief Restructuring Officer, of Neiman Marcus Grp. Ltd LLC, In Support of the Debtors' Chapter 11 Petitions and First Day Motions, at 3–4, *In re* Neiman Marcus Grp. LTD LLC, No. 20–23519 (Bankr. S.D. Tex. May 7, 2020).

[78] 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.

[79] *See id*. at 5. 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* (UC Hastings Law, Working Paper No. 382) (2021); Anthony J. Casey, Frederick Tung & Katherine Waldock, *Restructuring Support Agreements: An Empirical Analysis* (2010) (unpublished 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).

[80] *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., No. 20–35219 (Bankr. S.D. Tex. July 30, 2019).

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constraining the UCC's investigation budget.[81] 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.[82] The two received the board's power to handle conflicts between the Neiman and its private-equity sponsors**,** including the MyTheresa transfer.[83] Each of these bankruptcy directors received a $250,000 flat fee plus $500 an hour.[84]

Immediately after the bankruptcy filing, a creditor filed a motion to appoint an independent examiner to investigate the MyTheresa transfer, claiming that the bankruptcy directors would favor the private-equity sponsors and senior creditors.[85] The creditor also asked to bar the bankruptcy directors from investigating the MyTheresa transaction. [86]

On the witness stand, Beilinson stumbled.[87] He could not provide satisfying answers to questions from the bench about the investigation he oversaw,[88] and his answers revealed

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[81] For governance through DIP lending, see generally Ayotte & Ellias, *supra note* 55*;* George G. *Triantis*, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. Rev. 901, 901 (1993); Barry E. Adler et al., *Value Destruction in the New Era of Chapter 11*, 29(2) J.L. ECON. & ORG. 461 (2013); Elizabeth Warren and Jay L. Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 12, 12 (2003); Kenneth Ayotte and David A. Skeel, *Bankruptcy Law as a Liquidity Provider,* 80 U. CHI. L. REV. 1557 (2013).

[82] *See In re* Innkeepers USA Trust at 62, 226, No. 10–13800 (Bankr. S.D.N.Y. Sept. 1, 2010) [hereinafter Beilinson Testimony]. 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* Neiman Marcus Trial, *supra* note 59, at 34.

[83] *See* Beilinson Testimony, *supra* note 60, at 62, 226.

[84] *See id.* at 38.

[85] 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 (Bankr. S.D. Tex. Mar. 15, 2020) [hereinafter Marble Ridge Examiner Motion]. The bankruptcy code provides creditors 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* (Univ. of Wis. Legal Studies, Working Paper No. 1136). Neiman Marcus argued that there was simply no need for an examiner investigation since the UCC and the bankruptcy directors were already investigating the transaction. *See* Neiman Marcus Trial, *supra* note 59, at 41.

[86] *See id.* at 128 ("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").

[87] *See generally* Neiman Marcus Trial, *supra* note 59.

[88] 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* Neiman Marcus Trial, *supra* note 59, at 108. 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

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that it had not gone very far.[89] 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."[90] In an extraordinary exchange, the judge warned Neiman "I do not want to see a fiduciary to this estate ever appear in front of me ever again unprepared, uneducated, and borderline incompetent."[91] 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.[92]

Three weeks later, Beilinson resigned and Vogel remained the sole bankruptcy director.[93] Vogel's own résumé raised questions for creditors, as he was a former employee of a lender who 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.[94]

The UCC began investigating the transaction and quickly concluded that the claims were valuable.[95] It then filed a motion informing the court of this conclusion. The motion suggested that if the claims did not settle, the UCC should preserve them for prosecution after

amount of the debt structure supporting it." *See id.* at 108–09. 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* 11 U.S.C. § 365. *See generally* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985).

[89] The judge then asked him for specific examples of what he had done in the past 30 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 3,000 documents." *See* Neiman Marcus Trial, *supra* note 59, at 109.

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

[91] *See* Neiman Marcus Trial, *supra* note 59, at 188. A news report at the time referred to the "extraordinary" exchange as "blistering criticism". *See* Vandevelde & Indap, *supra* note 12. 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, https://petition.substack.com/p/our-matter-of-the-year (last visited Jan. 17, 2021).

[92] 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 59, at 196.

[93] Anna Zwettler, *Marc Beilinson Resigns as Board Member of Neiman Marcus*, FASHION UNITED (June 22, 2020), https://au.fashionunited.com/news/people/marc-beilinson-resigns-as-board-member-of-neiman-marcus/2020062212659. *See also* Neiman Marcus Trial, *supra* note 59, at 159 ("you didn't hear anything about Mr. Vogel, and you didn't hear any challenges to his independence").

[94] *See* Marble Ridge Examiner Motion, *supra* note 64, at 10.

[95] *See* Court Precludes Neiman UCC From Attaching Competing Plan, DS to Forthcoming Exclusivity Termination Motion; Committee 'Not Convinced at All' MyTheresa Transaction, Releases-Related Dispute Will Settle, REORG (June 22, 2020), https://reorg.com/ucc-neiman-sponsors-file-dueling-reports/.

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the bankruptcy case ended.[96] A few days later, the UCC indicated it was ready to make the results of its six-week investigation public.[97]

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.[98] In response, the UCC's lawyers said they had played no role in these negotiations and expressed concern that the settlement amount would be too low.[99]

On July 24, the UCC released the preliminary results of its investigation.[100] The report concluded that the transaction constituted a constructive fraudulent transfer and likely also an intentional fraudulent transfer.[101] 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.[102]

However, six days later, Neiman announced that Vogel had negotiated with the private-equity sponsors a much smaller settlement.[103] The settlement included a package of

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[96] *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, No. 32519, *In re* Neiman Marcus (Bankr. S.D. Tex. July 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*.

[97] *See* Motion of the Official Committee of Unsecured Creditors to file Under Seal as Necessary (1) 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 and Appendix Thereto and (II) Initial Expert Report of the Michel-Shaked Group and Executive Summary Thereof, No. 20–32519, *In re* Neiman Marcus (Bankr. S.D. Tex. July 17, 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 32.

[98] *See Neiman Marcus: 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/ [hereinafter Viable Fraudulent Conveyance Claims]. *See also* Hr'g Trial at 5, *In re* Neiman Marcus Grp., No. 20–32519 (Bankr. S.D. Tex. July 23, 2020) [hereinafter Neiman Marcus Hearing].

[99] *See* Viable Fraudulent Conveyance Claims, *supra* note 80.

[100] The investigation had taken place in the 51 days between the filing of the report and the official committee's retention of counsel. While the investigation involved the review of more than 800,000 pages of documents and 8 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 25, at 22.

[101] *Id.* at 66.

[102] *See* UCC Report, *supra* note 25, at 13.

[103] *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 65, *In re* Neiman Marcus LTD LLC, No. 20–32519 (Bankr. S.D. Tex. July 30, 2020).

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cash and stock that, using the UCC's estimate of MyTheresa's value, would be worth $172 million.[104]

While the UCC accepted the deal given the economy's fragility and Neiman's need to reorganize quickly,[105] it expressed concerns about the role that the bankruptcy director had played in the process.[106] The UCC's lead lawyer stated that Vogel sabotaged the UCC's litigation process.[107] 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."[108]

He 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."[109] He explained that "counter[ing 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."[110]

More broadly, he offered a grim assessment of the effect of bankruptcy 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.[111]

Without changes, he said, bankruptcy directors would turn the system of governance designed by Congress into a "sham."[112] He urged the judge to scrutinize the conflicts of bankruptcy directors in future cases by scrutinizing "their relationship with the law firms, what is their relationship with the sponsors, and what is the true independence. And that's

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[104] *See* Statement on Behalf of Scott Vogel, *supra* note 21.

[105] *See id.* at 2.

[106] *See* Neiman Marcus Settlement Transcript, *supra* note 59, at 19–20.

[107] *Id.* at 29.

[108] *Id.* at 29.

[109] *Id.* at 30.

[110] *Id*. at 30.

[111] *Id.* at 34.

[112] *Id.* at 36. Ultimately, Marble Ridge had to close after its founder tried 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); Sujeet Indap & Mark Vandevelde, *Hedge Fund Manager Admits 'Grave Mistake' in Neiman Marcus Battle*, FIN. TIMES (Aug. 20, 2020).

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not just the [bankruptcy director, it's also] their counsel."[113] In the case at bar, he noted, the law firm for the bankruptcy directors had previously represented the private-equity sponsors.[114]

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.[115]

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 sponsored argued, a sale process a year earlier had failed to produce a buyer willing to pay more than $500 million for MyTheresa.[116] 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 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 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.[117] Following the buyout, Payless conducted a series of transactions with its private-equity sponsors, including a distribution of $350 million in dividends.[118]

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[113] *See* Neiman Marcus Settlement Transcript, *supra* note 59, at 35.

[114] *See id.* at 37. When Willkie joined, it asked the two independent directors for permission to continue to work with the sponsors, and received this permission. *See id.*

[115] *See* David Carnevali & Sujeet Indap, *German Online Retailer MyTheresa Valued at $2.2bn in US Listing*, FIN. TIMES (January 20, 2021).

[116] *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 5, 23, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. July 30, 2020) [hereinafter Counter-Report of Ares Mgmt.]. 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.

[117] In 2012, a private equity group led by Golden Gate Capital and Blum Capital took over Payless Holdings LLC ("Payless"), 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); *Payless UCC Objects to 'Placeholder' DS and Fast-Track Plan Process*, REORG (May 25, 2017).

[118] Notice of Filing of Disclosure Statement for the Debtors' Fourth Amended Joint Plan of Reorganization of Payless Holdings LLC and Debtor Affiliates Pursuant to Chapter 11 of the Bankruptcy Code,

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A few years later, in April 2017, Payless filed for bankruptcy in the Eastern District of Missouri. 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.[119] Payless described Cremens as a seasoned independent director with vast business and restructuring experience.[120] Cremens joined the board at the suggestion of the debtors' lead law firm, Kirkland & Ellis LLP[121] ("Kirkland") and immediately began investigating the claims against the private-equity sponsors.[122] He also hired Munger Tolles & Olson LLP ("Munger") to represent him in the Chapter 11 case.[123] As is often the case with bankruptcy directors, his bankruptcy experience raised questions about the extent to which he was truly objective. Cremens had extensive ties to Kirkland[124] and Munger and had recently worked

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Ex. 1 at 23–4, No. 17–42267–695, *In re* Payless Holdings LLC (Bankr. E.D. Mo. June 23, 2017) (Docket No. 1259) [hereinafter Payless Disclosure].

[119] Payless Disclosure, *supra* note 118, Ex. 1 at 23–24.

[120] *Id.*

[121] *See* Transcript of Hearing Re: Debtor's Motion for Entry of an Order (I) Approving the Adequacy of the Disclosure Statement; (II) Fixing Dates and Deadlines Related to the Confirmation of the Plan; (III) Approving Certain Procedures for Soliciting and Tabulating the Votes on, and for Objecting to, the Plain; (IV) Approving the procedures Related to the Rights Offering and Authoring the Retention of Financial Balloting Group LLC in Connection Therewith; and (V) Approving the Manner and Form of the Various Natives and Documents Relating Thereto (Docket No. 377) at 46, *In re* Payless Holdings LLC, No. 17–42267 (Bankr. E.D. Mo. July 5, 2017) [hereinafter Payless Hearing].

[122] Payless Disclosure, *supra* note 118, Ex. 1 at 23–24.

[123] 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 in Possession Effective Nunc Pro Tunc to the Petition Date at 6, *In re* Patriot Coal Corporation, No. 15–32450 (Bankr. E.D. Va. May 20, 2015) [hereinafter Kirkland Employment Application); Payless Hearing, *supra* note 115, at 46.

[124] 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 177, 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 (Docket No. 660), Ex. B at 16–17, No. 14–10979, *In re* Energy Holdings Corp. (Bankr. D. Del. July 21, 2018).

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as bankruptcy director with both firms.[125] He also had ties to one of the private-equity owners.[126]

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."[127] 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 days, limiting the ability of unsecured creditors to investigate the claims.[128] By attempting to keep the unsecured creditors from hiring professionals, Cremens undermined their ability to proceed quickly.[129]

Cremens ran an investigation that was, in the eyes of unsecured creditors, deeply flawed and superficial. On the one hand, he and his lawyers reviewed hundreds of documents and interviewed 12 witnesses.[130] On the other, he failed to obtain tolling agreements from the private-equity sponsors for claims that could have expired during the time of the investigation[131] 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

[125] *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 (Docket No. 2367), at 1–2, No. 18–31274, *In re* iHeartMedia, Inc. (Bankr. S.D. Tex. Jan. 7, 2019).

[126] 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 (Docket No. 1023), at 13–14 No. 17–42267, *In re* Payless Holdings, LLC (Bankr. E.D. Mo. June 12, 2017) [hereinafter Payless UCC Objection] (noting that Cremens "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"). Cremens had also worked on other cases alongside Kirkland, as had his lawyers at Munger. *See id.* at 13–14.

[127] *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 3, No. 17–42267–659, *In re* Payless Holding LLC (Bankr. E.D. Mo. May 24, 2017).

[128] *Id.* at 7.

[129] *See* Tracy Rucinski, *Payless to try Fending off Creditors Probe of Owners with Own Review*, REUTERS (May 25, 2017), https://www.reuters.com/article/us-payless-bankruptcy-pprivateequity/payless-to-try-fending-off-creditor-probe-of-owners-with-own-review-idUSKBN18L27K.

[130] Payless Hearing, *supra* note 115, at 47.

[131] *Id.* at 52–53.

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the strength of the claims.[132] Both of these actions raised questions as to how serious Cremens was about litigating the claim. Unsecured creditors would later characterize Cremens' effort as an attempt to "sweep the [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."[133]

Cremens' lawyers would later explain 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 resolve the issues rather than polarize the case by coming out strongly one way or another.[134]

This response infuriated the lawyers for the unsecured creditors, who argued that Cremens misconceived his role.[135] Moreover, Cremens had tried to block the unsecured creditors from hiring a financial advisor because he was "conducting an investigation."[136] The unsecured creditors called this as an effort to "usurp [their] role in conduct[ing] this kind of investigation."[137]

The unsecured creditors continued to prepare to prosecute the claims, but their backs were against the wall because this seemingly interfered 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

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[132] *Id.* at 47–49 ("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").

[133] *Id.* at 48.

[134] *Id.* at 66.

[135] *Id*. at 80.

[136] 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 (Docket No. 643), at 4, No. 17–42267 (Bankr. E.D. Mo. May 24, 2017).

[137] Payless Hearing, *supra* note 115, at 45.

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that [claims should be brought against the private-equity sponsors]."[138] The private-equity sponsors retorted that the creditor claims were weak[139] and that the unsecured creditors' plan to litigate the claims "threaten[ed] the feasibility of any successful plan for Payless' reorganization."[140] 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.[141]

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.[142] The unsecured creditors had seen this coming, noting earlier in a court hearing that:

> [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 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 . . . what we're seeing is a concerted effort to sweep these claims under the rug for the benefit of insiders: the sponsors and the directors.[143]

Following 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

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[138] *See* Rucinski, *supra* note 132, at 2.

[139] *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, No. 17–42267, *In re* Payless Holdings, LLC. (Bankr. E.D. Mo. July 13, 2017).

[140] *Id.* at 12.

[141] *See* Payless Hearing, *supra* note 115, at 50–1.

[142] *See* Fourth Amended Joint Plan of Reorganization of Payless Holdings LLC and its Debtor Affiliates Pursuant to Chapter 11 of the Bankruptcy Code (Docket No. 1256) at 23, No. 17–42267, *In re* Payless Holdings LLC (Bankr. E.D. Mo. June 23, 2017).

[143] *See* Payless Hearing, *supra* note 115, at 51.

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boards during the sample period. We then examine the role that bankruptcy directors played in the sample cases.

We find 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 21% lower recoveries for unsecured creditors. This finding raises the possibility that bankruptcy 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 at 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 project, we had to build a large dataset of directors of Chapter 11 firms because no commercial dataset contains this information. We began with Next Generation Research's list of Chapter 11 debtors that filed for bankruptcy between January 1, 2004 and December 31, 2019.[144] Our initial list of the debtors consisted of 770 firms with more than $250 million in assets or liabilities on their bankruptcy petition.

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).[145] 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.[146] Second, we

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[144] 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 (2009); Jared A. Ellias, *What Drives Bankruptcy Forum Shopping? Evidence from Market Data*, 47 J. LEGAL STUD. 119 (2018); Wei Jiang et al., *Hedge Funds and Chapter 11*, 67 J. FIN. 513 (2012). Court dockets are available on the federal court website for bankruptcy filings starting 2004.

[145] 11 U.S.C. § 521(a)(B)(iii).

[146] 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

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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 the names and roles of all board members.[147]

Of the 528 firms with SOFAs listing their board members, we were able to obtain disclosure statements for 454 firms.[148] 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.[149]

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.[150] Finally, we added firm characteristics from CompuStat and bankruptcy information from Next Generation Research to all 454 firms.

B. Changes in Chapter 11 Boards Over Time

We begin our analysis by examining how boards' bankruptcy expertise on the petition date has changed. Our proxy for bankruptcy expertise is whether a director on a Chapter 11 board had been on 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%

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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, No. 12–13347, *In re* K–V Pharmaceutical Company (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.

[147] *See, e.g.*, Glenn W. Merrick, *The Chapter 11 Disclosure Statement in a Strategic Environment*, 44 BUS. LAW. 103 (1988).

[148] 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.

[149] *See* Radhakrishnan Gopalan et al., *It's Not So Bad: Director Bankruptcy Experience and Corporate Risk-Taking*, J. FIN. ECON. (forthcoming 2021) (studying 356 firms that filed for bankruptcy between 1994 and 2013); Megan Rainville, *Bankruptcy and Director Reputation*, FIN. MGMT. ASSOC. (Oct. 2019), http://www.fmaconferences.org/NewOrleans/Papers/Bankruptcy_and_Director_Reputation_012019.pdf (last visited Oct. 30, 2020) (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 (1990) (studying 61 firms that filed for bankruptcy between 1979 and 1985).

[150] 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 22 firms with two SIC codes in CompuStat.

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between 2014 and 2019, and 41.3% in 2019. This reveals a transformation in bankruptcy expertise, with boards becoming more Chapter 11-savvy in the course of the 2000s.

[Figure 1]

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 Part, 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 represented 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 meet general independence criteria.[151] 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.[152] 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

[151] Bankruptcy commentators and practitioners usually refer to these directors "independent directors." *See, e.g.*, Kelbon et al., *supra* note 9. We use the term "bankruptcy director" to capture the unique aspects of serving as a purported independent director in Chapter 11 proceedings. As we discuss below, this service raises particular concerns.

[152] 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 where the text block appeared to discuss the independence of a director or a subcommittee 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.

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> 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.[153]

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.[154]

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]

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

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

[154] *See* Disclosure Statement for the Fourth Amended Joint Chapter 11 Plan of Cobalt International Energy, Inc. and its Debtor Affiliates at 52, No. 17–36706 (Bankr. S.D. Tex. Mar. 8, 2018).

[155] A number of public firms in our sample have a controlling private owner, a structure especially common in the energy industry.

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[Table 1]

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%).[156] 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 the current appointment (40% versus 19%).[157] As we will discuss, the biographies of bankruptcy directors reveal that many more of them have experience in restructuring beyond what this measure captures.

Table 1 does not reveal that bankruptcy directors are associated with significantly shorter average duration of bankruptcy proceedings (about 333 days versus about 362 days) or with 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.[158] They do so in two ways, as statements by one bankruptcy director in the Gymboree Corporation bankruptcy in 2017 illustrate.

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[156] *See* Tom Corrigan et al., *The Power Players that Dominate Chapter 11 Bankruptcy*, WALL ST. J. (May 24, 2019).

[157] We use BoardEx data to identify the directors' entire biography, including Chapter 11 boards outside of our sample period.

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

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The first way is to claim that a board decision in the bankruptcy process (like financing terms[159] or an auction plan[160]) deserves deference because the bankruptcy directors who made it are independent. In the Gymboree case, for example, the bankruptcy director explained that had no prior material relationship with the firm or with its private-equity sponsor.[161] 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.[162]

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 and expertise and the investigation he had led to urge the court to overrule creditor objections.[163]

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.[164] 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 the debtors in the remaining cases did not state that the bankruptcy directors *did not* do these things. In unreported results we find that,

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[159] *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 (discussing the BCBG bankruptcy case).

[160] *See* LBI Plan Objection, *supra* note 157, at 7 (alleging that the bankruptcy directors deliberately ran the auction so to produce a "low-ball valuation").

[161] *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, No. 17–32986, *In re* The Gymboree Corp. (Bankr. E.D. Va. Sept. 2, 2017) [hereinafter Gymboree Winograd Declaration].

[162] *See* Gymboree Winograd Declaration, *supra* note 160, at 2–3.

[163] *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 23, No. 17–22045, *In re* rue21, Inc. (Bankr. W.D. Pa. Aug. 28, 2017). The director first noted his expertise (*see id.* at 2), his independence (*see id.* at 3), the work he had done to investigate claims against insiders (*see id*. at 36), and his conclusion that legal claims against insiders should be released (*see id.* at 6). He then rejected creditors' objections to his conclusion (*see id.* at 7) and asked the judge to defer to his business judgment (*see id.* at 8).

[164] In unreported results, we find that for the 42 sample cases with detailed information on director join dates, the average bankruptcy director joined the board seven months prior to the petition date.

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when firms identify their bankruptcy directors by name, the mean and the median of the number of bankruptcy directors per firm are two, and the maximum is five.

[Table 2]

Next, we use regression analysis to learn more about differences between cases with bankruptcy directors and cases without them. As Table 1 showed, 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 recoveries. 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. 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 assets, firm liabilities, industry distress in the year before the bankruptcy filing, and value-weighted public stock return in the firm's industry over the bankruptcy period. It shows that bankruptcy directors are associated with 21% lower creditor recoveries.[165]

[Table 3]

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 underlying difficulty explains the low recoveries. While we control for each firm's assets and liabilities as proxies for its ability to pay creditors, these are historical accounting numbers, not current market values. Our regressions thus only imperfectly account for the underlying difficulty of each bankruptcy.

Moreover, a bankruptcy could be difficult for reasons unrelated to the firm's ability to pay. For example, there could be intercreditor disputes or regulatory issues. We do not systematically 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. However, to the extent bankruptcy directors then conclude the case without all of that value returning to the bankruptcy estate, they do cause the low recoveries. This would be consistent with our finding that bankruptcy directors investigate claims against insiders in 46% of their engagements.

[165] In unreported regressions, we also examine the same specifications using a two-limit Tobit model with qualitatively similar results.

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At the very least, our findings explain why bankruptcy directors are controversial: firms that hire them end up paying on average up to 21% less to unsecured creditors than other firms. The difference is even starker when focusing on the firms whose bankruptcy directors investigate claims against insiders. In those firms, unsecured creditors fare on average as much as 43% worse than in other firms. These differences are highly statistically significant and visible to bankruptcy lawyers and investors active in Chapter 11 cases. In our view, they at least shift the burden of proof to those claiming that bankruptcy directors *do not* favor the shareholders who hire them.

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.[166]

Table 4 summarizes our findings. 48% of the named bankruptcy directors in our sample are bankruptcy experts. Table 1 above showed 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.

[Table 4]

A subset of individuals within this group of 86 named bankruptcy directors hold many directorships, including in bankrupt companies. We call them "super repeaters." As one of

[166] 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 152 and the accompanying text. Other disclosure statements mentioned independent directors active in the bankruptcy without identifying them by name.

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them noted in a court hearing, they "specialize in going on the boards of companies that are emerging from bankruptcy or going into bankruptcy."[167]

To study the super repeaters, we dived deeper into the background of the most active bankruptcy directors. First, we identified the individuals who named as bankruptcy directors more than once in the disclosure statements. 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 twenty directors.[168]

We then obtained from BoardEx information on the background and additional independent directorships of these directors.[169] We reviewed each directorship and eliminated duplicates or directorships for which we do not have service dates.[170] 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 Next Generation Research's list of Chapter 11 firms. BoardEx does not always provide data on directorship dates. However, when those 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.[171] After eliminating directors who had only one confirmed directorship of bankrupt companies, a list of 15 directors remained. Table 5 summarizes our findings.

[Table 5]

Table 5 shows super-repeaters. They have developed a profession of sitting on boards of bankrupt companies. Leading the list is Gene Davis, who has sat on 96 boards, for which we were able to find the dates of his service, and confirmed that in 31 of these cases he served on boards of companies at the time of their bankruptcy filing or within a year thereafter.[172]

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[167] *See* Certification of Transcript (Docket No. 1059) at 46, No. 17–22045, *In re* rue21, Inc. (Bankr. W.D. Va. Sept. 1, 2017) [hereinafter Rue21 Transcript].

[168] 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.

[169] If an individual also serves as an officer in the company, we exclude that directorship from our list.

[170] Occasionally, BoardEx includes multiple entries associated with the same directorship. For example, 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.

[171] Due to data limitation we are unable to confirm that 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.

[172] In addition to his bankruptcy work, Davis also had a career as an activist investor nominee to boards of firms not in bankruptcy. *See, e.g.,* RBC Capital Markets, 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, Davis testified that he was not sure how many boards he was

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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 board at the time of their bankruptcy filing or within a year thereafter.[173]

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.[174]

In 76 cases, we were able to find information on the identity of law 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 we 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.[175] For example, Neiman Marcus's lawyers

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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 Davis 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.

[173] Our data is 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.

[174] *See* Tom Corrigan et al., *supra* note 156.

[175] *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, No. 18–23538, *In re* Sears Holdings Corp. (Bankr. S.D.N.Y. Feb. 1,

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recruited the firm's bankruptcy directors after an employee of the private-equity sponsor reached out to them.[176]

To be sure, 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.[177] 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 6 shows, Kirkland and Weil command a particularly large share of this market.[178] One bankruptcy director noted in a court hearing that prior history with the dominant law firms is hard to miss, as Kirkland has a "90 to 80 percent market share in debtor cases."[179] While that number is exaggerated, the 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 6]

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. We thus propose treating as independent only individuals who win creditor support at the beginning of the bankruptcy proceedings. Finally, we 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.

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.

[176] *See* Neiman Marcus Trial, *supra* note 59, 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.

[177] 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 165, at 46.

[178] 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 director with prior Chapter 11 experience, 32% of debtors with a bankruptcy director, and 44% of the debtors in which a bankruptcy director investigated claims against insiders.

[179] *See* Rue21 Transcript, *supra* note 165, at 36.

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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.[180]

It is easy to see how this innovation might appeal to bankruptcy judges.[181] Chapter 11 cases are contentious and require the bankruptcy judge to navigate the proceedings while understanding the firm's business less well than the parties.[182] 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.[183] In theory, neutral bankruptcy directors could give the judge some of the benefits of a court-appointed trustee without the judge having to appoint one.[184]

However, bankruptcy directors are not neutral experts. Shareholders appoint them on the advice of their lawyers.[185] They are naturally predisposed to favor 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 bankruptcy directors' 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

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[180] *See infra* Part I.B.

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

[182] Conflict between creditors is one of the defining aspects of modern bankruptcy practice. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648 (2010). 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 (2019) (discussing the difficulty that judges have evaluating business decisions).

[183] The distortions caused by allocating control of Chapter 11 to shareholders occupy 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 (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).

[184] 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*, ILL. L. REV. 571, 573 (2015).

[185] *See supra* Section III.C.5.

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look good at the expense of creditors.[186] In short, shareholders' control of the appointment of bankruptcy directors undermines their independence.

[Figure 3]

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.[187] Figure 3 depicts part of the social networks of the eight busiest bankruptcy directors. It shows that all of these directors relate to each other and to a group of private-equity funds and law firms. Those connections 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 unsecured 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 themselves in matters on which creditors and shareholders disagree. Doing so sidesteps the checks and balances built into Chapter 11.[188]

Bankruptcy law requires a public hearing to ensure that professionals retained for the proceedings have no conflicts.[189] Both debtor lawyers and UCC lawyers undergo this

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

[187] 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 expressed in two recent cases 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.

[188] *See infra* Section I.B.

[189] *See* 11 USC 327(a).

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vetting.[190] Can a similar procedure ensure the neutrality of bankruptcy directors?[191] 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 will not want to disappoint them and jeopardize future engagements. This structural bias will remain as long as shareholders and their lawyers alone control the selection of bankruptcy directors.

The solution is for bankruptcy courts and distressed firms to involve creditors in the selection of bankruptcy directors. In some cases, this is already happening.[192] The appointment of specialist directors with the support of creditors raises fewer concerns, although disputes can still arise when there is disagreement among creditors on the appointment.

We suggest that bankruptcy judges adopt a practice of holding a hearing, early in the bankruptcy process, in which the debtor firm will present any bankruptcy directors it appointed or plans to appoint. The creditors will then express their views about the appointment. If the creditors support the appointment, the court will treat the bankruptcy directors as neutral actors. If the creditors are of different minds, the court will regard the bankruptcy director as partisan in areas of creditor disagreement. Judges could look to evidence that creditors supported a director in a prior bankruptcy in the same way they look to whether a different court accepted an expert's testimony as credible.

If the creditors whose views the court deems important oppose the appointment, the court will treat the bankruptcy directors as representing the debtor: it will consider their position when making judicial decisions, but will weigh it against creditors' position.[193]

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[190] *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 interests of the unsecured creditors' committee's counsel).

[191] As the judge in the Neiman bankruptcy noted, there is no Chapter 11 vehicle to look at the conflicts of bankruptcy directors—no "application hire these 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 59, at 35.

[192] 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. We believe that the level of creditor support needed to accept a bankruptcy director as a neutral expert should be overwhelming support from all levels of creditors.

[193] Bankruptcy directors resemble special litigation committees 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 special litigation committee 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 finds that Delaware courts are skeptical of recommendations by special litigation committees calling for case dismissals. *See* C.N.V.

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When this happens, the court should generally let the UCC conduct its own investigation of claims against insiders and will consider its recommendations.[194] Importantly, the court should not conclude that a proposed settlement is fair only because the bankruptcy directors endorse it without additional evidence of fairness. Dissenting creditors should be able to present their own analysis of the facts, which will require both time and estate funds—as Congress envisioned.

We realize that allowing creditors to conduct a parallel investigation when they oppose the bankruptcy directors can delay the proceedings. We will address this concern in Part IV.C below. In any event, debtors wishing to expedite the process could seek creditors' blessing of the selection of bankruptcy directors in advance. Similarly, bankruptcy directors could gather evidence pre-petition to immediately turn over to creditors for their own analysis. Streamlining the bankruptcy process should not come at creditors' expense.

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.[195] 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.[196] A similar requirement exists for listed controlled companies in the United Kingdom,[197] Italy,[198] and

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Krishnan et al., *How Do Legal Standards Matter? An Empirical Study of Special Litigation Committees*, 60 J. CORP. FIN. 101543 (2020).

[194] Derivative standing for creditors is a matter of bankruptcy common law, and some judges and circuits have not embraced the concept, or fully embraced it in all situations. *Compare* Official 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 (Bankr. N.D. Tex. 2009).

[195] *See* Bebchuk & Hamdani, *supra* note 23, at 1304–11.

[196] *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).

[197] In 2014, the United Kingdom's Financial Conduct Authority adopted new listing rules, which requires 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., Listing Rules (Listing Regime Enhancements) Instrument 2014, FCA 2014/33, at 12, https://www.handbook.fca.org.uk/instrument/2014/FCA_2014_33.pdf.

[198] 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).

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Israel.[199] Using this approach to make bankruptcy directors accountable also to creditors will protect creditors while preserving these 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 explanations are possible, we do not find evidence in our data that supports them.

1. Expertise

A common argument for using bankruptcy directors is that their expertise enhances board deliberations and improves the bankruptcy process.[200] 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 dubious.[201]

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 unsecured creditors do especially well in a lawsuit.

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 of bankrupt companies. He clearly had significant experience. However, when he took the witness stand, he was

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[199] 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* Companies Law, 5759–1999, §§ 239, 245 (as amended).

[200] For studies finding that directors with related-industry expertise contribute positively to firm performance, see David Larcker & Brian Tayan, *The First Outside Director* (Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance No. CGRP–83, 2020). *See also* Felix von Meyerinck et al., *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 et al., *Private Equity and the Resolution of Financial Distress* (ECGI Fin. Working Paper No. 331, 2012).

[201] 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.

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unable to answer questions about the investigation he oversaw and his answers revealed it had not gone very far.[202]

Similarly, when Payless appointed Charles Cremens as bankruptcy director, it described him as having vast restructuring experience.[203] 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 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.[204] 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 identity of the bankruptcy directors.[205] This will allow the appointment of professional directors who do not owe their appointment only to shareholders. Courts will still need to be mindful when evaluating the actions of directors supported only by some creditors in resolving disputes between creditors. When creditors do not have such a say, shareholders should still be allowed to choose their board members and to hire experts if they would like, but the decisions of such directors should not be regarded by the bankruptcy judge with any special status. Alternatively, boards can acquire bankruptcy expertise by hiring legal and financial advisors rather than appointing new directors. This has been the standard practice for the entirety of the modern bankruptcy system.

2. Speed

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 bankruptcy duration.[206]

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.[207] Bankruptcy directors could achieve speedy results by undercutting rights of

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[202] *See supra* notes 87–89.

[203] *See supra* notes 119–120.

[204] *See supra* notes 132 and accompanying text.

[205] *See supra* Section IV.B.

[206] *See supra* Table 1.

[207] *See* Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014)

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creditors and by deflating claims against the shareholders who appointed them. Our finding of significantly lower creditor recoveries in the presence of bankruptcy directors is consistent with this prediction. The two case studies we presented above illustrate the dynamics. In both of them, the bankruptcy directors prevented unsecured creditors from conducting their own investigation and quickly settled fraudulent transfer claims.[208]

3. Avoiding Meritless Litigation

Finally, one could argue that unsecured creditors might pursue meritless claims in the hopes of extracting a holdup-value settlement.[209] In theory, bankruptcy directors could prevent this by analyzing claims and settling them with minimal delay to the firm's emergence from bankruptcy.[210] 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.

CONCLUSION

In this Article, we studied 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 appointment to shareholders. They therefore 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 self-dealing claims against shareholders, 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

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[208] *See supra* notes 87–116, 131–133 and accompanying text.

[209] 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, *Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?*, 8 J. LEGAL ANALYSIS 493, 498 (2016). 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 (2020); Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930 (2006). *See also* Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235 (2013).

[210] *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).

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directors do not favor the shareholders who hire them. Our policy recommendation, however, does not require a resolution of this controversy. We propose that the court regard bankruptcy directors as independent only if the creditors support their appointment, making them equally dependent on both sides to the dispute.

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Figure 1. The Proportion of Chapter 11 Boards with a Chapter 11 Repeater.

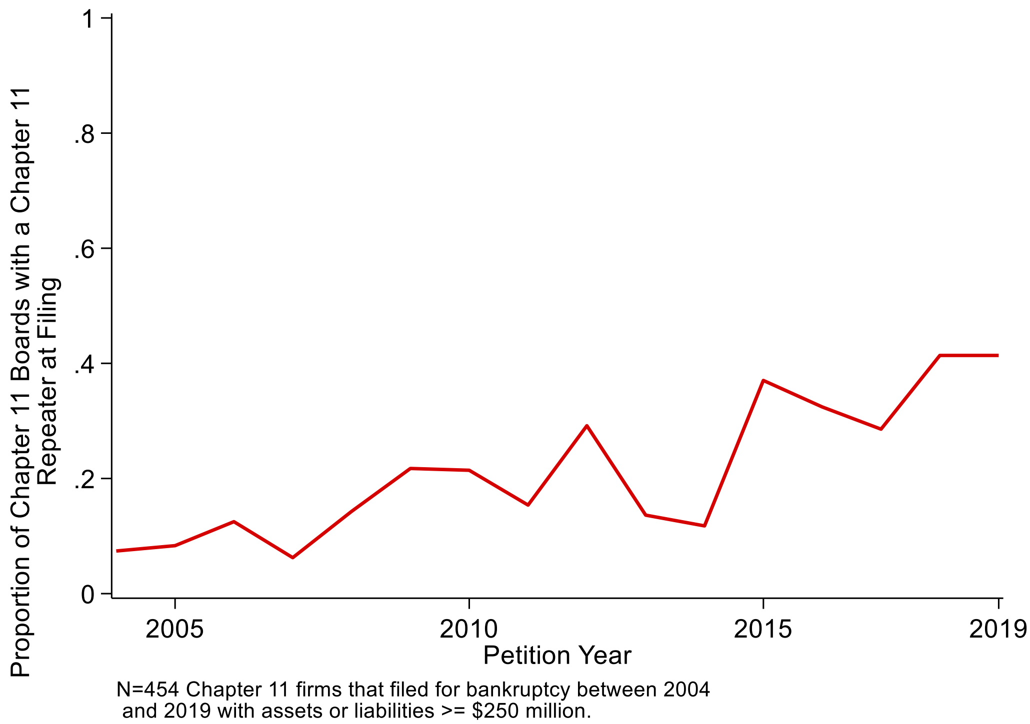

Figure 1 shows the portion of Chapter 11 petitions filed by boards with a director who was previously a director of another firm when that other firm filed for Chapter 11 bankruptcy ("Chapter 11 Repeater"). Director work history (including history before the sample period) is from BoardEx, with the director work history supplemented by the information from our court document data gathering.

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Figure 2. The Proportion of Chapter 11 Firms with Bankruptcy Directors

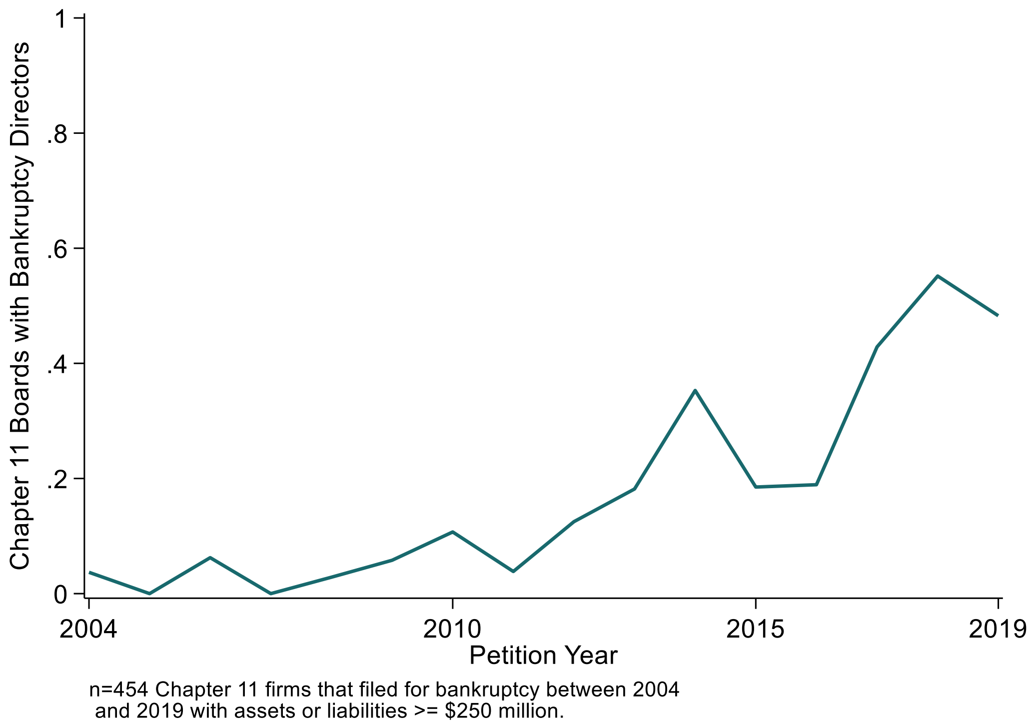

Figure 2 shows the proportion of Chapter 11 firms in each of the sample years that represented to the bankruptcy court that some of its directors were independent or disinterested. We term these directors "bankruptcy directors" because this allows them to play an active role in the bankruptcy process.

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Figure 3. The Professional Network of Super Repeaters

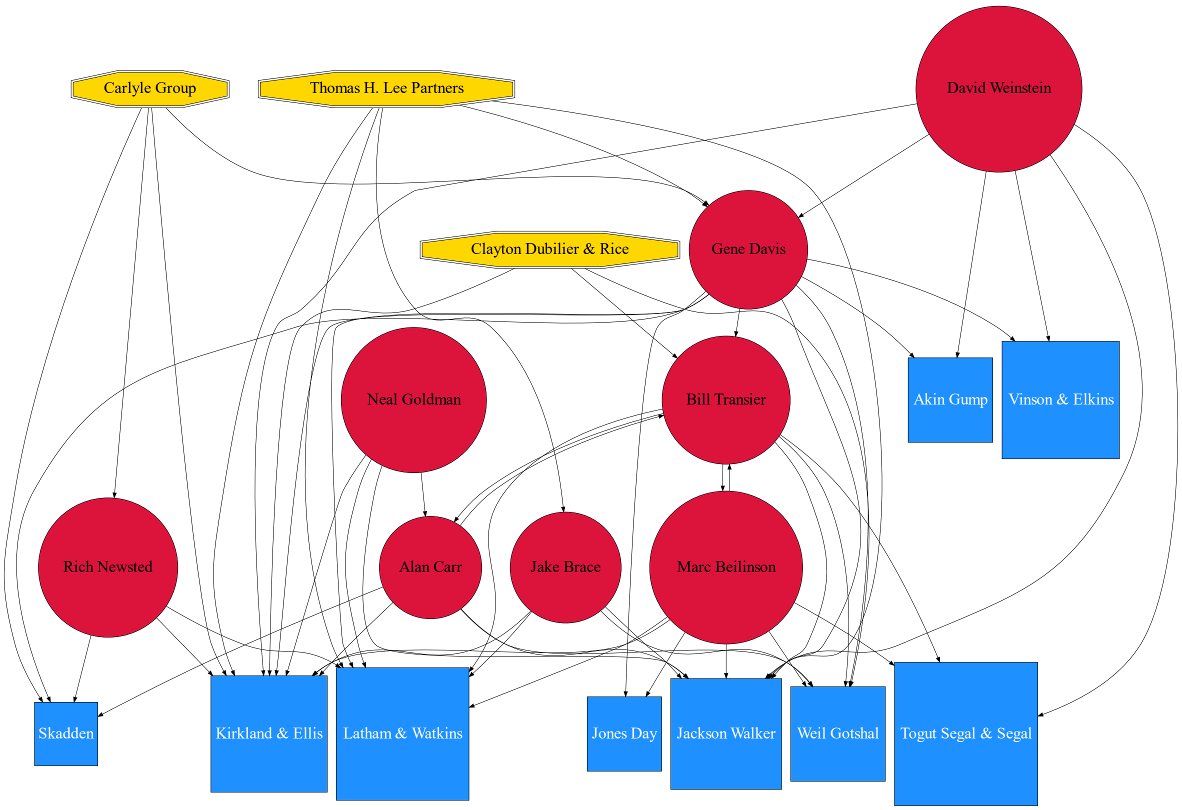

Figure 3 shows a partial professional network of the eight most commonly appointed bankruptcy directors, whom we call super-repeaters, and connections to law firms and private-equity firms involved in those same director-engagements. The circles are directors, the squares are law firms and the octagons are private-equity firms.

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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)	2,928.85	5,673.52	2,373.37	5,287.25	555.48	–0.83
Liabilities (in millions)	3,566.58	7,261.92	2,664.85	5,969.52	901.74	–1.11
Private equity ownership (1/0)	0.45	0.50	0.30	0.46	0.15**	–2.50
Family business or individual investor ownership (1/0)	0.17	0.38	0.10	0.31	0.06	–1.59
Controlling shareholder, including private equity and family/individual ownership (1/0)	0.62	0.49	0.41	0.49	0.21***	–3.41
Publicly traded equity (1/0)	0.31	0.46	0.42	0.49	–0.12*	1.89
Bankruptcy Characteristics						
Prepackaged (1/0)	0.12	0.32	0.11	0.32	0.00	–0.09
Delaware venue (1/0)	0.45	0.50	0.42	0.49	0.03	–0.51
SDNY venue (1/0)	0.29	0.46	0.24	0.43	0.06	–1.03
SDTX venue (1/0)	0.10	0.31	0.07	0.25	0.03	–1.02
EDVA venue (1/0)	0.03	0.16	0.02	0.14	0.00	–0.24
Debtor counsel is Kirkland (1/0)	0.32	0.47	0.16	0.37	0.16***	–3.28
Debtor counsel is Weil (1/0)	0.15	0.36	0.06	0.23	0.10***	–3.06
Restructuring Support Agreement (1/0)	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
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 (1/0)	0.53	0.50	0.38	0.49	0.14**	–2.34
Board includes a director with Chapter 11 board experience (1/0)	0.40	0.49	0.19	0.39	0.21***	–4.01

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 Statement of Financial Affair 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

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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 to the Board (N=57)	
Experience in restructuring or distressed companies	0.81
Lawyer	0.42
Investment banker	0.61
Distressed debt trader	0.21

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

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Table 3. Determinants of Payouts to Unsecured Creditors

	(1) Unsecured Creditor Payout %	(2) Unsecured Creditor Payout %	(3) Unsecured Creditor Payout %	(4) Unsecured Creditor Payout %	(5) Unsecured Creditor Payout %	(6) Unsecured Creditor Payout %
Bankruptcy director appointed	–0.09* (0.05)	–0.11** (0.05)	–0.21** (0.10)			
Bankruptcy director investigated insiders				–0.15** (0.06)	–0.16*** (0.06)	–0.43*** (0.16)
Log(assets)		0.05 (0.04)	0.05 (0.06)		0.05 (0.04)	0.04 (0.06)
Log(liabilities)		–0.06 (0.04)	–0.03 (0.06)		–0.05 (0.04)	–0.01 (0.06)
Industry distress before bankruptcy			–0.14 (0.10)			–0.15 (0.10)
Industry return over bankruptcy period			0.01 (0.02)			0.01 (0.02)
Constant	0.37*** (0.02)	0.54 (0.37)	–0.05 (0.75)	0.37*** (0.02)	0.49 (0.37)	–0.28 (0.75)
Observations	342	297	178	342	297	178
R-squared	0.01	0.02	0.32	0.01	0.02	0.34
Year fixed effects	No	No	Yes	No	No	Yes
Industry fixed effects	No	No	Yes	No	No	Yes

Table 3 shows ordinary least squares regression models 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, indicated 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%. In columns (1) through (3), the independent variable of interest is an indicator that equals one if the firm indicated it had appointed a bankruptcy director to manage the restructuring process, and zero otherwise. In columns (4) through (6), the independent variable of interest is an indicator that equals one if the firm indicated it had asked a bankruptcy director to investigate claims against insiders, and zero otherwise. Industry distress is an indicator that equals one if, in the year prior to the Chapter 11 filing, the weighted return of publicly traded firms in the firm's industry was –30% or less.[211] Industry return over the bankruptcy period is the weighted average of publicly traded firms in the firm's industry between the day the firm filed for bankruptcy and the day it exited from bankruptcy through an auction or confirmation of a plan of reorganization. Industry fixed effects are Fama–French 48. Robust standard errors are in parentheses. *** p<0.01, ** p<0.05, * p<0.1.

[211] This is a modified version of the methodology of Tim C. Kopler & Sheridan Titman, *Financial Distress and Corporate Performance*, 49 J. FIN. 1015 (1994). We include industry distress as a control variable because poor industry conditions can also explain low creditor recoveries.

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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

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. Robust standard errors are in parentheses. *** $p<0.01$, ** $p<0.05$, * $p<0.1$

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Table 5. Super Repeaters

Name	Independent Directorships (with dates)	Directorships during bankruptcy
Gene Davis	96	31 (32%)
Rich Newsted	17	9 (53%)
Bill Transier	19	12 (63%)
Fredric Brace	15	5 (33%)
Alan Carr	14	4 (29%)
David Weinstein	14	9 (64%)
Marc Beilinson	13	6 (46%)
Neal Goldman	13	6 (46%)
Harvey Tepner	10	3 (30%)
Jon Foster	12	5 (42%)
Patrick Bartels Jr.	7	5 (71%)
Alan Miller	7	6 (86%)
Tony Johnson	6	3 (50%)
Tom Hudgins	5	4 (80%)
Steve Winograd	4	3 (75%)

Table 5 summarizes the names of the super repeaters (column 1), the number of company boards on which each super repeater served as an independent director, after eliminating duplications and companies for which we do not have service dates (column 2), and the number of companies on which each super repeater served on the day of their bankruptcy filing or joined within a year after the bankruptcy filing (column 3).

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Table 6. Law Firms' Share of Cases

Law Firm	% of Cases	% of Boards With Directors with Prior Chapter 11 Experience	% of Boards with Bankruptcy Directors	% of Boards with Bankruptcy Directors Who Conducted an Investigation
Kirkland	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	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	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	0.02	0.01	0.00	0.00
Jackson Walker LLP	0.02	0.06	0.05	0.08
Cole Schotz Meisel Forman & Leonard	0.02	0.01	0.01	0.00
Greenberg Traurig LLP	0.02	0.00	0.03	0.03

Table 6 summarizes the market shares of the 19 law firms advising the most debtors in our sample.

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