A Better Guard for the Henhouse: Should Creditors' Committees Control Estate Litigation?

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Introduction

In October 2021, Senator Elizabeth Warren and several cosponsors introduced a revised version of the Stop Wall Street Looting Act.[1] First introduced in 2019, the proposed legislation targets a range of perceived abuses by private equity firms ranging from the carried interest tax "loophole" to the lack of risk-retention requirements for securitized debt.[2] Among several new proposals to stop the "looting" of portfolio companies is one of particular interest to bankruptcy practitioners: giving unsecured creditors' committees the exclusive right to bring or settle certain lawsuits in bankruptcy.

Senator Warren's proposed bill marks the latest turn in a long-running debate about whether creditors' committees should control litigation for bankruptcy estates.[3] Under the current Bankruptcy Code, when a corporation is a debtor-in-possession in a Chapter 11 reorganization, the corporation's board of directors maintains the authority to make decisions on the corporation's behalf. This includes decisions about whether to prosecute litigation claims.[4] If a creditors' committee wants to take over litigation where the bankrupt corporation's board has declined to bring claims, it normally must persuade the bankruptcy court that the debtor's refusal to pursue that litigation is unjustifiable. But the bill's proponents argue that this arrangement favors corporate insiders[5]

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1. Alexander Saeedy, *Elizabeth Warren Floats Expanded Powers for Bankruptcy Creditors Against Private Equity*, WALL ST. J. (Oct. 20, 2021), https://www.wsj.com/articles/elizabeth-warren-floats-expanded-powers-for-bankruptcy-creditors-against-private-equity-11634750237 [https://perma.cc/5FH3-MJT6].

2. *Warren, Baldwin, Brown, Pocan, Jayapal, Colleagues Reintroduce Bold Legislation to Fundamentally Reform the Private Equity Industry*, ELIZABETH WARREN (Oct. 20, 2021), https://www.warren.senate.gov/newsroom/press-releases/warren-baldwin-brown-pocan-jayapal-colleagues-reintroduce-bold-legislation-to-fundamentally-reform-the-private-equity-industry [https://perma.cc/A8CW-HU8V].

3. For articles advocating for creditors' committees to prosecute derivative claims, see, for example, Daniel J. Bussel, *Creditors' Committees as Estate Representatives in Bankruptcy Litigation*, 10 STAN. J. L. BUS. & FIN. 28, 30-31 (2004). For articles taking the contrary view, see, for example, Keith Sharfman, *Derivative Suits in Bankruptcy*, 10 STAN. J. L. BUS. & FIN. 1, 3 (2004).

4. Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. (forthcoming 2022) (manuscript at 3), https://ssrn.com/abstract=3866669 [https://perma.cc/M5RQ-GPKE].

5. As explained below, the term "insiders" is defined broadly in the proposed legislation. We use the term generally to refer to officers, directors, or controlling stockholders.

and shortchanges creditors. As the conventional wisdom goes, the debtor's board and management cannot properly fulfill the fiduciary duty of remedying fraudulent transfers that they made. Giving the board and management control over bankruptcy litigation thus presents "the proverbial problem of the fox guarding the henhouse."[6] And as discussed below, proponents of the legislation also suggest that the prevailing practice of appointing allegedly independent directors does not fully solve the problem, as even those directors have inherent conflicts of interest that make them poorly suited to pursue actions against company insiders. The bill purports to remedy these issues by empowering the creditors' committee, rather than the debtor's board, to manage such litigation.

This article summarizes the current law on creditor control of estate litigation, explores the arguments for the proposed legislation, discusses its limitations, and suggests possible alternatives.

Derivative Standing for Creditors

The bankruptcy trustee generally has the right to prosecute claims on behalf of the debtor's estate, including "avoidance" actions to unwind fraudulent or preferential transfers made by the debtor.[7] In practice, a trustee is usually not appointed in a Chapter 11 reorganization. Instead, the debtor-in-possession continues to operate its business during the bankruptcy proceeding and performs the trustee's functions.[8] Section 1107(a) of the Bankruptcy Code provides that, with certain exceptions, the "debtor in possession shall have all the rights . . . and shall perform all the functions and duties . . . of a trustee serving in a case under this chapter."[9]

Pursuant to section 1107(a), the debtor's board and management typically make litigation decisions ranging from how much time and effort to spend on investigating claims to what the opening offer in a settlement negotiation should be. Often, a corporation will appoint independent directors with bankruptcy experience prior to a Chapter 11 filing.[10] These independent directors are typically asked to evaluate the merits of claims and review prior transactions. Independent directors' recommendations carry weight with the bankruptcy courts, who often defer to their conclusions.[11] The appointment of independent directors is based on the premise that they will be neutral experts who will impartially and skillfully assess what claims the estate should bring against the company's insiders.

6. Off. Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel*. Cybergenics Corp. v. Chinery, 330 F.3d 548, 573 (3d Cir. 2003) (en banc).

7. 11 U.S.C. §§ 544, 547(b), 548 (2018).

8. UNITED STATES COURTS, *Chapter 11 – Bankruptcy Basics*, https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics [https://perma.cc/ZQT7-V464].

9. 11 U.S.C. § 1107(a) (2018).

10. Ellias et al., *supra* note 4.

11. *See* Saeedy, *supra* note 1.

By comparison, the official committee of unsecured creditors (UCC) is appointed by the United States Trustee.[12] It comprises several creditors (at least three and rarely more than seven) that hold unsecured claims against the estate. The committee members are fiduciaries who represent the interests of all unsecured creditors, although they cannot necessarily bind other creditors.[13] The UCC investigates the debtor's conduct and financial affairs, helps formulate a Chapter 11 plan, and may also request the appointment of a trustee or examiner to take over the debtor's duties.[14] Importantly, the UCC hires its own counsel and advisors subject to the bankruptcy court's approval, and those professionals' fees are paid by the debtor's estate.[15]

Unsecured creditors, however, have limited options if they object to a debtor board's litigation decisions. Although the UCC has the "right to be heard" on any issue in the bankruptcy case,[16] it does not, as a matter of right, have standing to prosecute claims on behalf of the estate. That rule follows the fundamental corporate law principle that creditors, unlike shareholders, cannot bring derivative suits on behalf of the firm.[17] In bankruptcy, however, unsecured creditors have an effective ownership interest in the debtor, so an insolvent corporation can owe a fiduciary duty to its creditors.[18] Despite there being no statutory provision explicitly allowing creditors to seek derivative standing, most circuit courts of appeals (including the Second, Third, Fifth, Sixth, Seventh, Eighth, and Ninth Circuits) have held that creditors or the UCC may enjoy derivative standing if the bankruptcy court approves.[19]

Yet the bar for unsecured creditors to obtain derivative standing is high. A creditor is often required to show that the estate has a colorable claim and that the debtor-in-possession "unjustifiably" refused to bring suit on its own.[20] Because that test effectively requires the court to decide whether the overall benefits of the proposed claim outweigh its costs, debtors usually have strong arguments against bringing derivative suits. For example, debtors can often

12. 11 U.S.C. § 1102(a) (2018).

13. *See In re* Kensington Int'l Ltd., 368 F.3d 289, 315 (3d Cir. 2004) ("[W]hile the Committee had a duty to represent the collective interests of the unsecured creditors, it did not have the authority to bind each individual creditor.").

14. 11 U.S.C. § 1103(c) (2018).

15. 11 U.S.C. § 1103(a) (2018); OFF. OF THE U.S. TRUSTEE – REGION 11, *Information Sheet, Official Committee of Unsecured Creditors*, U.S. DEP'T. OF JUST., https://www.justice.gov/ust-regions-r11/file/ch11_creditor_cmte_infosheet_madison.pdf/download [https://perma.cc/A5RY-Z8ZX].

16. 11 U.S.C. § 1109(b) (2018).

17. Sharfman, *supra* note 3, at 1. In rare cases, a committee of equity security holders can be appointed, and they may be granted derivative standing to pursue claims on behalf of the debtors. This situation is rare because shareholder interests are rarely "in the money" and are typically wiped out in a reorganization. *Cf*. *In re* Adelphia Commc'ns Corp., 544 F.3d 420, 425-26 n.3 (2d Cir. 2008).

18. *See In re* STN Enters., 779 F.2d 901, 904 (2d Cir. 1985); *see also* Sara Ann Brown, *D&O Fiduciary Duties During Insolvency*, AM. BAR. ASS'N (Aug. 30, 2018), https://www.americanbar.org/groups/litigation/committees/business-torts-unfair-competition/practice/2018/d-and-o-fiduciary-duties-during-insolvency [https://perma.cc/T929-NCZZ]

19. *See In re* Racing Servs., Inc., 540 F.3d 892, 898 (8th Cir. 2008) (collecting cases). *But see In re* Baltimore Emergency Servs. II, Corp., 432 F.3d 557, 561 (4th Cir. 2005) (questioning whether the Bankruptcy Code permits derivative standing for creditors).

20. *STN*, 779 F.2d at 905.

persuasively argue that extended litigation outweighs the potential for recovery, or that a quick settlement would facilitate the speedy administration of the estate and serve the best interest of all stakeholders.[21] Further, the bankruptcy court often gives deference to the debtor's judgment "pursuant to the business judgment rule."[22] Indeed, some courts have commented that granting derivative standing is "the exception rather than the rule."[23]

Alternatively, a creditor or creditors' committee can acquire standing with the consent of the debtor or bankruptcy trustee. Like the test for suits by single creditors, suits by committees require the bankruptcy court to find that such suits are "in the best interest of the bankruptcy estate" and would be " 'necessary and beneficial' to the fair and efficient resolution of the bankruptcy proceedings."[24] For obvious reasons, this situation is uncommon. The debtor often has its own reasons for not pursuing a lawsuit and would prefer to keep the power to make strategic litigation decisions for itself. But even in this scenario, the keys to the litigation are not handed to the creditor automatically; the bankruptcy court still has discretion to "check any potential for abuse."[25]

The upshot is that under current law, creditors and creditor committees can acquire standing to pursue avoidance actions on behalf of the estate. But to acquire standing, they need the approval of the bankruptcy court, which must "carefully scrutinize the request and satisfy itself that derivative standing is proper under the circumstances."[26]

21. *See Racing Services*, 540 F.3d at 901 (the bankruptcy court must perform a "cost-benefit analysis" and consider "[the] probabilities of legal success and financial recovery in event of success; (2) the creditor's proposed fee arrangement; and (3) the anticipated delay and expense to the bankruptcy estate that the initiation and continuation of litigation will likely produce") (internal citations and quotation marks omitted).

22. Off. Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel*. Cybergenics Corp. v. Chinery, 330 F.3d 548, 575 (3d Cir. 2003) (en banc).

23. *In re* Rosenblum, 545 B.R. 846, 863 (Bankr. E.D. Pa. 2016); *see also Baltimore Emergency Services*, 432 F.3d at 562.

24. *In re* Commodore Int'l, Ltd., 262 F.3d 96, 100 (2d Cir. 2001); *see also Racing Services*, 540 F.3d at 902.

25. *Racing Services*, 540 F.3d at 902.

26. *Id*. at 903.

Table 1: Relevant Players

Entity	Typical Constituent Entities	Selected By	Powers
Debtor-in-Possession	Board of Directors (including independent bankruptcy directors)	Shareholders (controlling shareholders such as private equity sponsors may play significant role)	Manage corporations' activities, including the prosecution and settlement of claims in bankruptcy
Unsecured Creditors' Committee	Three to seven creditors holding unsecured claims	The U.S. Trustee (office of the DOJ, not to be confused with a Chapter 11 trustee)	Investigate claims; review debtors' finances; negotiate reorganization plan; may seek derivative standing to pursue litigation claims
Chapter 11 Trustee	One person, usually supported by law firm or other staff	Bankruptcy Court	Replace debtor-in-possession
Examiner	One person, usually supported by law firm or other staff	Bankruptcy Court	Evaluate independence of directors and/or merits of potential claims; scope of powers to be determined by bankruptcy court

The Perceived Need for Reform

Critics of the current approach argue that it fails to appropriately police corporate insiders and maximize value for the estate and its creditors. The proposed Stop Wall Street Looting Act seeks to address this concern. Specifically, the proposed legislation would add a new subsection (c) to Section 1107 of the Bankruptcy Code that would read as follows:

> (c) Notwithstanding subsection (a), if a debtor in possession is serving in a case under this title, a committee of creditors appointed under section 1102 of this title shall have the exclusive right of a trustee serving in a case under this chapter to bring or settle on behalf of the estate—
>
> (1) an action under section 544, 547, 548, or 553 to avoid a transfer made or obligation incurred by the debtor in connection with a change of control transaction, as defined in section 3 of the Stop Wall Street Looting Act; or
>
> (2) an action against an insider, a former insider, or an agent or aider and abettor of an insider or former insider.[27]

The bill makes no mistake about its motivations by including the above language under a section entitled "elimination of sham independent directors."[28] The section-by-section summary on Senator Warren's website further explains that "[l]itigation claims brought against company insiders must be brought by . . . the creditor committee rather than the debtor-in-possession who often put sham 'independent' directors on boards."[29]

The bill's proponents argue that the debtor's board cannot be trusted to avoid transfers "that it itself made," as that "would amount to reputational self-immolation."[30] Appointing "independent" directors to evaluate the transaction, they contend, still does not fully address the conflict of interest. Indeed, supporters of the bill allege that these "independent" directors are not truly independent, but are instead installed to bless fraudulent transfers and protect the entrenched interests of the board and management.

Legislative skepticism of independent directors has scholarly support. One forthcoming publication estimates that unsecured creditors recover on average 21% less when the company appoints independent directors prior to its bankruptcy filing.[31] The authors argue this is in part because the allegedly "independent directors" are part of a small community of repeat players whom law firms and private-equity sponsors choose again and again to serve on distressed companies' boards. Typically, shareholders appoint these bankruptcy directors based on their lawyers' advice, though the process can be heavily driven by a controlling shareholder such as an equity sponsor.[32] To increase their

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27. Stop Wall Street Looting Act, S. 3022, 117th Cong. § 202(e) (2021).

28. *Id*.

29. Section by Section Analysis – Stop Wall Street Looting Act at 2, ELIZABETH WARREN, https://www.warren.senate.gov/download/the-stop-wall-street-looting-act-of-2021-section-by-section-final [https://perma.cc/MP7F-K2LC].

30. Off. Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel*. Cybergenics Corp. v. Chinery, 330 F.3d 548, 573 (3d Cir. 2003) (en banc).

31. Ellias et al., *supra* note 4, at 1.

32. *Id*. at 35-36 (noting the example of Neiman Marcus's bankruptcy lawyers recruiting the firm's bankruptcy directors after an employee of the private equity sponsor reached out to them).

chances of being rehired in the future, those directors are "predisposed to favor those who chose them for this lucrative engagement."[33] This "structural bias," the authors argue, can lead to inadequate investigations and rushed negotiations, resulting in lower recovery for junior creditors.[34]

This concern is not purely academic. In recent years, the independence and qualifications of independent directors have often come under attack. For example, in the Neiman Marcus bankruptcy, two independent directors were appointed to investigate potential fraud involving the debtor's private-equity sponsors' decision to transfer Neiman's valuable MyTheresa business out of the reach of creditors. One director, Marc Beilinson, testified at a hearing about an unsecured bondholder's motion to appoint an examiner to investigate the MyTheresa transaction. Although the bankruptcy judge ultimately declined to appoint an examiner, he harshly criticized Beilinson's testimony as "unprepared, uneducated, and borderline incompetent" and warned the attorneys against ever appointing a similar fiduciary again.[35] A month later, Beilinson resigned.[36] The remaining independent director negotiated a settlement with the private equity sponsors estimated to be worth around $172 million. Although the UCC accepted the deal, it expressed dissatisfaction with the result and accused the remaining director of making a low-ball settlement offer.[37]

Unintended Consequences and Limitations of the Proposed Legislation

The proposed legislation seeks to address a serious and real problem. But its solution comes with unintended consequences that may undermine rather than promote creditors' interests. We discuss several of these issues below.

First, as drafted, the legislation is overly broad. It applies not just to claims against current and former insiders, but also the company's consultants and contractors, as well as all their agents, affiliates, and relatives.[38] Because virtually any claim against insiders will belong to the UCC, and because "insiders" are defined broadly,[39] creative UCC counsel could claim exclusive standing over a large swath of actions involving individual defendants and pre-petition transactions.[40] The implicit assumption is that UCCs will wield these newfound

33. *Id*. at 37.

34. Soma Biswas & Alexander Gladstone, *Some Independent Directors of Bankruptcy Firms Show Bias, Study Says*, WALL ST. J. (July 23, 2021), https://www.wsj.com/articles/some-independent-directors-of-bankrupt-firms-show-bias-study-says-11627032600 [https://perma.cc/26AZ-N88F].

35. *Neiman Marcus Loses Independent Director, Withdraws Perella Retention Request*, DEBTWIRE (June 19, 2020), https://www.debtwire.com/intelligence/view/intelcms-x44nfm [https://perma.cc/MB7K-9MQZ].

36. *Id*.

37. Ellias et al., *supra* note 4, at 20.

38. Stop Wall Street Looting Act, S. 3022, 117th Cong. § 3(11) (2021).

39. *Id*.

40. In addition, the bill also gives UCCs control over avoidance claims involving "change in control" transactions, which are broadly defined to include transactions that give persons acquiring voting securities in the corporation the "ability to direct the actions of that corporation." *Id*. at 10. It is unclear

litigation powers judiciously. But the UCC is not an inherently neutral party and may not always serve the interests of all stakeholders. Unsecured creditors are often willing to risk extended litigation at a chance for a payoff, because their recoveries are often limited—frequently mere cents on the dollar—and they stand to capture a large portion of litigation awards.

By contrast, the debtor, its employees, and other stakeholders often have a stronger interest in a speedy and efficient reorganization.[41] In deciding whether to bring a claim, the proper cost-benefit analysis is not simply a matter of comparing attorneys' fees against the potential recovery. One must also consider the demands on managerial time, the delays to the restructuring, and the impacts on the debtor's relations with lenders, suppliers, customers, and employees.[42] Debtors are cognizant of these variables. Creditors, however, are poorly situated to understand such concerns as they are not involved in the day-to-day management of the debtor and have less incentive to take such concerns into account.

Further, the UCC's individual members may not adequately represent the interests of all unsecured creditors. Just like the independent directors, these UCC members could be bought off by the debtor with incentives such as offers to settle their own individual claims based on facts unique to those claims.[43] Some UCC members may also lack the sophistication necessary to adequately control estate litigation; for example, UCC members may be foreign trade creditors who are unfamiliar with U.S. bankruptcy laws and unable to effectively evaluate the strength of litigation claims. And the UCC's strategy is often influenced in large part by its attorneys, who have their own interest in pursuing aggressive litigation that generates more fees. This problem is especially acute because the UCC is playing with house money. Because the UCC can have its legal fees paid by the estate, the UCC has little motivation to make cost-efficient litigation choices. Even more troubling is the added incentive for unscrupulous creditors to jockey for a position on the UCC for the purpose of extorting value from the estate for themselves.[44] While we do not suggest that unscrupulous behavior among UCC members is widespread, the unique incentives and conflicts affecting the UCC raise doubts about whether it is always the best entity to litigate estate claims.

how courts would interpret the "ability to direct" a corporation's actions; for example, a transaction that gives an equity owner even one board seat may qualify.

41. Sharfman, *supra* note 3¸ at 16.

42. *Id*. at n.82.

43. *Cf*. *In re* Gibson Grp., Inc., 66 F.3d 1436, 1441 (6th Cir. 1995) ("A debtor-in-possession often acts under the influence of conflicts of interest and may be tempted to use its discretion [involving avoidance actions] as a sword to favor certain creditors over others.").

44. *Cf*. Complaint, SEC v. Kamensky, No. 1:20-cv-07193 (S.D.N.Y. 2020) (alleging that distressed debt investor used position on the UCC so his fund could buy securities at a lower price), https://www.sec.gov/litigation/complaints/2020/comp-pr2020-203.pdf [https://perma.cc/EG3J-T4B7]; Jonathan Stempel, *New York Hedge Fund Founder Kamensky Sentenced to Prison in Neiman Marcus Fraud*, REUTERS (May 7, 2021), https://www.reuters.com/world/us/new-york-hedge-fund-founder-kamensky-sentenced-prison-neiman-marcus-fraud-2021-05-07 [https://perma.cc/HZK3-7CKQ].

The proposed legislation thus risks creating a new status quo where the UCC routinely brings avoidance claims and claims against insiders, whether or not those claims have any merit. Some academic research already shows that derivative suits "frequently result in awards only large enough to pay the litigants' legal bills," and do not maximize value for the company.[45] As the Third Circuit explained, this concern is alleviated under the current approach "by the need to obtain bankruptcy court approval."[46] The court must perform its own analysis of the costs and benefits of pursuing the litigation, to "assure itself that there is a sufficient likelihood of success to justify the anticipated delay and expense to the bankruptcy estate."[47] Yet the proposed bill (which says the UCC "*shall* have the *exclusive* right"),[48] appears to strip the courts of that discretion, meaning that a UCC could pursue claims no matter how low the likely recovery or how high the costs.

Nor would the proposal necessarily eliminate duplicative creditor litigation. While the bill would give the UCC the exclusive right to bring derivative suits for the estate, creative lawyers for other creditors can always attempt to repackage those claims as "direct" ones they can bring in their own right. Courts have at times struggled with distinguishing between "direct" and "derivative" claims.[49] and whether a given claim is "on behalf of the estate" (as defined by the proposed bill) could also generate collateral litigation. For example, it is not entirely clear that the UCC would control only those claims brought in the name of the estate if courts are persuaded that causes of action for the estate's benefit are "on behalf of the estate" as well. And there is also the potential for additional litigation delays, for individual creditors could also sue the UCC's members for breach of their fiduciary duty.[50]

Finally, the bill may also create significant chilling effects on the market for distressed assets. Faced with the high risk of fraudulent transfer lawsuits, potential lenders and purchasers could be disincentivized to do business with financially distressed firms. Thus, a distressed company may shy away from, or be unable to complete, a value-maximizing sale of its assets.[51] Without a lifeline from lenders and buyers, a distressed company may need to liquidate rather than reorganize. Liquidation, in turn, threatens to destroy the company's value and requires termination of its employees. The proposed bill thus not only affects the

45. Off. Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel*. Cybergenics Corp. v. Chinery, 330 F.3d 548, 574 (3d Cir. 2003) (en banc) (citing Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON & ORG. 55 (1991) and Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991)).

46. *Id*. at 575.

47. *In re* STN Enters., 779 F.2d 901, 906 (2d Cir. 1985).

48. Stop Wall Street Looting Act, S. 3022, 117th Cong. § 202(e) (2021).

49. *See* Brookfield Asset Mgmt., Inc. v. Rosson, 261 A.3d 1251, 1263 & n.42 (Del. 2011) (collecting examples of how "[c]lassification of a particular claim as derivative or direct can be difficult").

50. *In re* Rickel & Assocs., Inc., 320 B.R. 513, 514 (Bankr. S.D.N.Y. 2005).

51. Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 13 (2000) ("The possibility of being targeted . . . by various administrative claimants could make secured creditors less willing to provide postpetition financing.").

law firms and parties involved in the litigation, but could also inflict significant costs on other stakeholders.

Potential Alternatives

Proponents of the legislation should be mindful of the pitfalls discussed above and consider ways to minimize their effects. One option is to narrow the scope of the existing bill, such as limiting the definition of "insider." For example, the bill could give UCCs a more limited power to sue only private equity sponsors, rather than all company insiders. Another simple change is to establish a default rule permitting UCCs to prosecute certain bankruptcy actions, while retaining discretion for the bankruptcy court to turn the litigation over to the debtor or the trustee.

Some critics may argue that giving UCCs any presumption of standing to litigate claims is too radical of a fix and would "throw out the baby with the bathwater." If that is the case, Congress could consider less seismic changes that focus on ensuring the independence of a debtor's directors. For example, Congress could require additional disclosures for directors in the bankruptcy context.[52] Congress could also require additional processes (such as a hearing) for selecting independent directors, similar to the current process used to select professionals and advisors for the debtor and the UCC. Moreover, bankruptcy courts and debtors can directly involve creditors in the selection of directors. One proposal would require bankruptcy judges to hold a hearing early in the bankruptcy process to appoint independent directors, where the UCC and other creditors have an opportunity to express their views.[53] Only directors with the support of creditors would be deemed neutral and independent. An even more disruptive version of these proposals would give the bankruptcy court, rather than the debtor, the power to appoint independent directors.

The simplest and most powerful solution, however, may be to employ the powers bankruptcy courts already have. The Bankruptcy Code already provides two critical tools to investigate and pursue claims without relying on conflicted debtors-in-possession. First, bankruptcy courts can already appoint neutral examiners to scrutinize the independence of directors and the merits of the underlying claims.[54] Using examiners more frequently could help clarify for stakeholders and the court whether estate claims are truly worth bringing. In fact, there are strong reasons to think that appointing an examiner is mandatory in large corporate bankruptcies. Section 1104 of the Bankruptcy Code states that the bankruptcy court "shall" appoint an examiner where (i) "the appointment is in the interests of creditors, any equity security holders, and other interests of the

52. Kenneth A. Rosen and Philip J. Gross, *Avoiding Independent Director Challenges In Ch. 11 Litigation*, LOWENSTEIN SANDLER, LLP (July 13, 2021), https://www.lowenstein.com/news-insights/publications/articles/avoiding-independent-director-challenges-in-ch-11-litigation-rosen-brownstein-gross [https://perma.cc/8ZUP-7EKG].

53. Ellias et al., *supra* note 4, at 39.

54. 11 U.S.C. § 1104(c) (2018).

estate," or (ii) "the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000."[55] Some bankruptcy courts, however, believe that, despite Section 1104's text, they still have discretion to not appoint an examiner.[56] Congress could respond by clarifying when appointing an examiner is mandatory. In many cases, a mandatory examiner may be preferable to a claim-wielding UCC, because an examiner will not share the conflicts that may affect UCC members. And provided that the bankruptcy court and relevant stakeholders try to avoid duplicative investigation, the appointment of an examiner should not result in a net increase in professional fees.

Second, courts still have the power to replace the debtor-in-possession with a trustee under Section 1104 of the Bankruptcy Code.[57] Installing a trustee requires a showing of cause, such as "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management," or "if such appointment is in the interests of creditors."[58] Section 1104 also broadly allows appointment of a trustee for "similar cause,"[59] which has been read to include conflicts of interest.[60] In practice, because the Code favors letting debtors-in-possession continue to manage the estate, courts have set the bar for appointing a trustee "very high" and reserved that remedy for truly "extraordinary" cases.[61] As commentators have pointed out, however, the sort of management misconduct that justifies derivative claims should in theory provide cause for appointing a trustee as well.[62] Some courts have therefore appointed trustees for the limited purpose of pursuing estate claims, though other courts have held that they lack authority to make such appointments.[63] Congress could resolve such ambiguity by statutorily authorizing bankruptcy courts to appoint trustees for the limited purpose of investigating or pursuing estate claims when the current board or management is conflicted. Such a fix would encourage bankruptcy courts to

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55. *Id*.

56. *See, e.g.*, *In re* Residential Capital, LLC, 474 B.R. 112, 116, 121 (Bankr. S.D.N.Y. 2012) ("While section 1104(c) expresses a Congressional preference for appointment of an independent examiner to conduct a necessary investigation, the facts and circumstances of the case may permit a bankruptcy court to deny the request for appointment of an examiner even in cases with more than $5 million in fixed debts.").

57. 11 U.S.C. § 1104(a) (2018).

58. *Id*.

59. *Id*.

60. *See, e.g., In re* Ancona, No. 14-10532, 2016 WL 7868696, at *9 (Bankr. S.D.N.Y. Nov. 30, 2016) (collecting cases).

61. *In re* Bayou Grp., LLC, 564 F.3d 541, 546 (2d Cir. 2009) (collecting authorities); *see also In re* G-I Holdings, Inc., 385 F.3d 313, 319 (3d Cir. 2004) (discussing the "heavy 'presumption' " against appointing trustees).

62. *See* Kelli A. Alces, *Enforcing Corporate Fiduciary Duties in Bankruptcy*, 56 U. KAN. L. REV. 83, 87, 127 (2007).

63. *See id*. at 87 & n.18; *In re* Intercat, Inc., 247 B.R. 911, 925 (Bankr. S.D. Ga. 2000) (appointing trustee for limited purpose, including pursuing estate claims against insiders); *In re* Celeritas Techs., LLC, 446 B.R. 514, 521 (Bankr. D. Kan. 2011) (similar). *But see In re* W.R. Grace & Co., 285 B.R. 148, 157 (Bankr. D. Del. 2002) (holding that bankruptcy courts lack power to appointed "limited purpose" trustees).

focus more on alleged conflicts, including those afflicting independent directors, and give less deference to the debtors' recommendation.

Conclusion

The problem of a debtor-in-possession abandoning valuable claims against insiders, and thus failing to maximize value for an estate, is a real and relevant concern. Senator Warren's proposal to have official creditors' committees prosecute these claims addresses one aspect of the problem. Yet it may cause unintended effects that ultimately harm creditors and other stakeholders. Those evaluating the merits of the proposed legislation should consider these issues, as well as alternatives that may better address the underlying problem in a more tailored way.