NOTE

FIGHTING FIRE WITH FIRE: BANKRUPTCY COMMITTEES IN THE AGE OF HOSTILE RESTRUCTURINGS

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In Chapter 11, litigation against former owners, managers, and financiers can eventually generate proceeds for the bankruptcy estate. These litigation claims have become significant, especially as more bankruptcies involve allegations of wrongdoing on the part of private equity sponsors. For unsecured creditors, who often receive paltry recoveries, litigation claims can be particularly valuable. Unsecured creditors are a diverse group, however, and it can be hard to meaningfully aggregate their preferences over whether and how to pursue litigation. This complicates the role of the Official Committee of Unsecured Creditors, which has a fiduciary duty to general unsecured creditors. The ideal creditor to pursue litigation in bankruptcy would lack liquidity constraints, be able to gather resources and assess risk, and have experience with the bankruptcy process. Although hedge funds fit the bill, this Note shows that they rarely serve on the Official Committee, even if their involvement could benefit all unsecured creditors. A recent case against hedge fund manager Daniel Kamensky that resulted in a prison sentence will only deter them further. I propose that courts should empower hedge funds in limited circumstances involving significant litigation claims by allowing multiple Official Committees,

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with fiduciary duties only to the unsecured creditors on a given committee.

I. INTRODUCTION

Capital market developments over the past two decades have not been kind to unsecured creditors. More secured debt has pushed its way into the corporate capital structure, leaving few assets available for unsecured creditors.[1] In

[1] *See* George Triantis, *Debtor-in-possession Financing in Bankruptcy*, *in* RESEARCH HANDBOOK ON CORPORATE BANKRUPTCY LAW 177, 182 (Barry E. Adler ed., 2020) ("The proportion of asset value covered by liens has grown so that many firms entering into bankruptcy have few if any unencumbered assets."); *see also* Josef S. Athanas, Matthew L. Warren & Emil P. Khatchatourian, *Bankruptcy Needs to Get Its Priorities Straight: A Proposal for Limiting the Leverage of Unsecured Creditors' Committees When Unsecured Creditors Are "Out-of-the-Money"*, 26 AM. BANKR. INST. L. REV. 93, 93 (2018) ("Imagine the typical modem chapter 11 case . . . [t]he debtor's secured loans are secured by substantially all of the debtor's assets, and the total amount of the secured loans . . . exceeds the enterprise value of the debtor when it files.").

addition, over the past several years, managers and equityholders have increasingly resorted to the practice of pulling assets out of distressed firms or layering additional debt onto nearly insolvent corporations.[2] Clever lawyering tactics and judicial decisions that legitimized these tactics have eroded traditional creditor protections.[3] The end result is that large firms often enter Chapter 11 bankruptcy with little to no value left to distribute to unsecured creditors, at least based off of the assets they have in place.[4] All that is left for unsecured creditors in this position is the possibility of pursuing litigation against parties involved in pre-bankruptcy transactions, such as avoidance actions seeking to reverse asset transfers out of the business, or breach of duty actions against directors.[5]

These developments fundamentally alter the role of the Official Committee of Unsecured Creditors (the "Official Committee") in Chapter 11.[6] The Official Committee member becomes more like a litigator and less like a director overseeing the debtor's management, as she would have been if there were assets left to distribute out of the debtor's estate.

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2 *See* Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF L. REV 745, 748 (2020) ("Although unthinkable only a few years ago, in today's environment, a distressed firm's redistribution of nearly $2 billion away from its creditors is seen as unexpectedly generous to those same creditors because its private equity owner did not help itself to more.").

3 *See infra* Section II.D; *see also* Ellias & Stark, *supra* note 2, at 783.

4 *See* Athanas, Warren & Khatchatourian, *supra* note 1, at 95–96 ("Today, in many cases, the Unsecured Creditors' Committee represents out-of-the-money creditors with no continuing interest in the debtor.").

5 *See, e.g.*, John H. Ginsberg, M. Katie Burgess, Daniel R. Czerwonka & Zachary R. Caldwell, *Befuddlement betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts*, 19 AM. BANKR. INST. L. REV. 71, 107 (2011) ("The unsecured creditors' committee can move the court to transfer to the committee the right to bring a fraudulent transfer action, including on grounds that the debtor-in-possession is too conflicted to reliably evaluate the merits of a fraudulent transfer action and to diligently pursue such action if meritorious.").

6 11 U.S.C. § 1102(a) calls for "the United States Trustee [to] appoint a committee of creditors holding unsecured claims" as soon as "practicable after the order for relief under Chapter 11."

This shift in purpose does not change the fact that Official Committees play a meaningful part in distressed debt markets. Not only do they offer other unsecured creditors the chance at a higher recovery through settlements or damage awards, they also police transactions that harm creditors prior to bankruptcy, potentially discouraging those transactions ex ante and benefitting credit markets as a whole.[7] For Official Committee members to be effective enforcers of creditor rights, however, it is important for them to have experience with litigation. Hedge funds, as repeat players in distressed debt markets, legal and financial sophistication, and information-gathering resources, are often good candidates for spearheading bankruptcy litigation.

This Note argues that today's Official Committees are not structurally compatible with the new litigation regime. Using data collected from large Chapter 11 cases filed between 2018 and 2020, I show that Official Committees are dominated by trade creditors.[8] Even though most large Chapter 11 debtors have unsecured financial debt in their capital structures, and financial debt in those cases typically accounts for approximately 80% of unsecured claims,[9] direct holders of financial debt (i.e., hedge funds)[10] make up less than 5% of Official Committee membership.[11] Though public perception of hedge funds is low,[12] they serve an important function in distress markets because they are uniquely positioned to

[7] 11 U.S.C. § 1103.

[8] *See infra* Section II.C.

[9] Author's own calculations. *See infra* Section II.C.

[10] For an investigation of hedge funds' role in distressed debt markets, *see* Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401, 404 (1997); *see also* Wei Jiang, Kai Li & Wei Wang, *Hedge Funds and Chapter 11*, 67 J. FIN. 513, 514 (2012).

[11] *See infra* Table 2.

[12] Jessica Menton, *'Looking Down Their Nose at You': GameStop Frenzy Showed a Fresh Contempt for Hedge Funds. Why Do Americans Hate Them?*, USA TODAY (Feb. 11, 2021), https://www.usatoday.com/story/money/markets/2021/02/11/hedge-funds-gamestop-what-are-hedge-funds-best-hedge-funds/4371758001/ [https://perma.cc/YJZ5-PUJ4].

check perpetrators of aggressive pre-bankruptcy transfers, particularly private equity firms. One of the key deterrents to hedge fund participation in the Official Committee is the fiduciary duty owed by its members to general unsecured creditors and the constraints, including trading restrictions, associated with that duty. These fiduciary duties, which already rest on tenuous historical and economic grounds, make little sense when recoveries take the form of litigation rights over which unsecured creditors differ substantially when it comes to liquidity preferences, risk aversion, information, and non-claim incentives. Deterred from Official Committees, hedge funds and other distressed debt investors turn instead to ad hoc committees that have less access to information, are not automatically entitled to legal fee reimbursement, and are less likely to have standing to pursue avoidance actions related to pre-bankruptcy transactions.

To illustrate the dilemma, consider DebtorCo, a firm worth $900 thousand if liquidated and $1 million if kept operational. Bank A has lent DebtorCo $900 thousand in exchange for a lien on substantially all of DebtorCo's assets. Bank B has lent an additional $400 thousand on an unsecured basis. DebtorCo used to have $400 thousand worth of gold in its basement, but this gold was recently stolen by robbers. DebtorCo filed for bankruptcy, listing $100 thousand worth of unsecured debt owed to its trade creditors in addition to its bank debt. Bank B, wishing to keep its hands clean, then sold its $400 thousand unsecured claim to VigilanteFund at a discount.

In this situation, the incentives of DebtorCo's creditors differ substantially. Bank A will be paid in full no matter what, so it prefers whatever option distributes funds the fastest. The trade creditors prefer to keep DebtorCo operational, since this will preserve their ongoing business relationships with the firm and deliver them a small recovery on their unsecured claims.[13] They would certainly like to have

[13] Assuming the trade creditors and unsecured bank debt holders (now VigilanteFund) have equal priority, then a plan respecting this priority would deliver 20% of the residual $100 thousand worth of firm value to trade creditors and 80% to VigilanteFund, either in the form of cash or equity in the reorganized firm.

the gold back, but they are wary of the costs, risk, and time associated with going after the robbers. VigilanteFund, which has encountered robbers before and has, on several occasions, brought them to justice, is in the best position to decide whether to pursue the stolen gold. Any gold that VigilanteFund recovers will go toward the recoveries of trade creditors as well. In addition, empowering VigilanteFund means that the ex-ante costs of stealing the gold are higher for the robbers.

A real-life example of DebtorCo can be found in the recent bankruptcy of department store operator Neiman Marcus. In 2018, the company transferred approximately $1 billion in shares of MyTheresa, one of its subsidiaries, to a corporation held by its private equity owners.[14] Soon after, hedge fund manager Daniel Kamensky sued Neiman Marcus, alleging that the transaction was a fraudulent conveyance designed to put MyTheresa assets beyond the reach of Neiman Marcus's creditors.[15] This suit was eventually dismissed, but when Neiman Marcus filed for bankruptcy in 2020, Mr. Kamensky joined the Official Committee and persuaded the court to reexamine the issue.[16] Eventually, Neiman Marcus and its Official Committee reached a settlement in which unsecured creditors would receive $10 million in cash and shares of MyTheresa worth up to $275 million.[17]

The story does not end there, however. As part of the settlement, unsecured creditors wanted a cash backstop—the option to receive cash rather than shares—because

[14] *Neiman Marcus v. Marble Ridge Capital: The Story Behind the $1 Billion-Plus Legal Battle*, THE FASHION LAW (Sep. 25, 2020), https://www.thefashionlaw.com/neiman-marcus-v-marble-ridge-capital-the-story-behind-the-1-billion-plus-legal-battle [https://perma.cc/DLT4-LENP].

[15] *Id.*

[16] Transcript of Record at 13, United States v. Kamensky, No. 21-CR-00067 (S.D.N.Y. Feb. 3, 2021), ECF No. 39.

[17] Alan Zimmerman, *Neiman Marcus Reaches Settlement With Creditors Over MyTheresa Claims*, S&P GLOBAL (July 31, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/neiman-marcus-reaches-settlement-with-creditors-over-mytheresa-claims-59695312 [https://perma.cc/QS42-AK4E].

MyTheresa shares were illiquid.[18] Preliminary negotiations had converged on Mr. Kamensky's hedge fund as the provider of this cash backstop, but when he learned that an investment bank had plans to intervene and offer unsecured creditors more cash per share, he pressured the bank to withhold its bid by threatening to use his position on the Official Committee to block their deal.[19] For this interference, Mr. Kamensky was charged with fraud in violation of his fiduciary duties as well as bankruptcy extortion and bribery.[20] He was eventually sentenced to six months in prison, an extreme outcome in light of the history of bankruptcy-related offenses.[21] To be sure, Mr. Kamensky broke the law. But he also played an important role in shining light on Neiman Marcus' own potential misdeeds.

Given that hedge funds already account for a small fraction of Official Committee membership and Mr. Kamensky's sentence is certainly not an incentive to participate, bankruptcy courts face a problem. Unsecured creditors who have a lot to contribute by way of litigation sophistication are less capable than other unsecured creditors of taking action. One solution to this power imbalance is for the U.S. Trustee to appoint multiple Official Committees of Unsecured Creditors—one consisting of financial debt holders, one consisting of creditors with a special interest in ongoing operations of the firm, and potentially others when necessary. These Official Committees would only owe fiduciary duties to the subset of unsecured creditors that they represent. This solution is not too different from the status quo, in which financial debt holders form their own ad hoc committees, except that it would not arbitrarily disenfranchise hedge

[18] Transcript of Record, *supra* note 16, at 10–11.

[19] Transcript of Record at 15, United States v. Kamensky, No. 21-CR-00067 (S.D.N.Y. Feb. 3, 2021), ECF No. 15.

[20] *Id.*

[21] Among the offenses listed in the prosecution's complaint against Mr. Kamensky were violations of Title 18, United States Code, Sections 152(6) and 2, extortion and bribery in connection with bankruptcy. According to the Sentencing Commission's database, sentences have been given for this charge only twice, and both received terms of probation. *See* Transcript of Record, *supra* note 16, at 20.

funds relative to other unsecured creditors. In addition, designating an Official Committee of financial debt holders would grant hedge funds seeking avoidance or other litigation access to information about the debtor and improve their chances of being granted standing to pursue those claims. Sometimes, it takes a vulture to attack a vulture.

Section II of this Note provides background information on the Official Committee including its historical origins, its functions according to the Bankruptcy Code (the "Code"), and its new role given the current bankruptcy environment. This section also presents basic summary statistics on Official Committee membership from 2018 to 2020. Section III explores problems with the modern-day Official Committee, including the uneasy case for fiduciary duties, the arbitrary distinction between official and ad hoc committees, and the shifting place of unsecured creditors in the capital structure. Section IV explores the multiple Official Committees solution and Section V concludes.

II. BACKGROUND ON THE OFFICIAL COMMITTEE

To assess whether the Official Committee model is functioning properly, one needs to first understand its roles and responsibilities. The modern-day Official Committee is an amalgamation of two different types of earlier bankruptcy committees. This section reviews the history of the Official Committee and its fiduciary duties. It then compares the theoretical to the practical role of the Official Committee in recent bankruptcy cases and presents summary statistics on membership from 2018 to 2020. It concludes by discussing recent trends in the distress market, set in motion by private equity firms, that have elevated hostilities between bankruptcy players.

A. Legal History

Before 1978, corporate bankruptcies were governed by Chapters X or XI of the Bankruptcy Act of 1898, both of which went into effect after the passage of the Chandler Act of

1938.[22] Chapter X was generally designed for large corporate debtors and involved several oversight bodies including a trustee, the SEC, and the bankruptcy court.[23] Under Chapter X, the firm could restructure all of its debt and equity.[24] Chapter XI, on the other hand, was designed for smaller debtors. Under Chapter XI, only unsecured classes of debt could be restructured, and therefore bankruptcy itself was a simpler process involving plan formulation by the debtor subject to unsecured creditor majority approval.[25] There was no need for the involvement of other claimants or oversight bodies aside from the court.

Creditors' committees under Chapter X were informal but powerful. While there were a number of differences between these committees and the Official Committee model today,[26] two are particularly important: they were designed to represent a uniform group of debtholders, and they often had the power to vote the proxies of the debtholders they represented. In this respect, the role of the Chapter X creditors' committee member was similar in spirit to that of an indenture trustee, and in fact, these committees were often comprised of indenture trustees and other financial advisors.[27]

The creditors' committees in these cases were also very different from Chapter XI committees. The Chandler Act recognized a committee of unsecured creditors that could be formed at the initial meeting of creditors with the purpose of being the "spokesman" for unsecured creditors.[28] This committee had no formal powers, although the debtor was instructed to deliver notice of certain events to the committee

[22] Pub. L. No. 75-696, 52 Stat. 840 (1938) (repealed 1978) (formerly codified as amended at 11 U.S.C. §§ 1–1103 (1976)).

[23] *See* Daniel J. Bussel, *Coalition-Building Through Bankruptcy Creditors' Committees*, 43 U.C.L.A. L. REV. 1547, 1557–58 (1996).

[24] *See id.* at 1558.

[25] *See id.*

[26] *See id.* at 1560.

[27] *See* Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 995, 1015 (1993).

[28] H.R. REP. NO. 595, 95th Cong., 1st Sess. 249 (1977).

if one existed, and it was understood that the committee might play a supervisory role.[29] Unlike today's Official Committee, however, the Chapter XI committee was elected by other unsecured creditors and the language around committee formation was less strict.[30]

The Bankruptcy Code derives the Official Committee model directly from Chapter XI, not Chapter X, but with a few changes.[31] Concerned that representation of all unsecured classes was inadequate, Congress shifted from an election model to appointment by the U.S. Trustee.[32] In order to enhance monitoring incentives, the Code improved the Official Committee's position with respect to the reimbursement of fees and expenses.[33] In other respects, however, the Official Committee remained the same.

Fiduciary duties under the Code arose in a somewhat unsystematic fashion. Chapter XI committees, on which the Code's Official Committees are modeled, had no fiduciary obligations.[34] Unofficial Chapter X committees often owed fiduciary duties to the creditors they represented, but this was

29 Chandler Act, Pub. L. No. 75-696, 52 Stat. 840, 908, 911 (1938).

30 *Compare* Chandler Act, *id.* at 909 (1938) ("[t]he creditors *may* appoint a committee") *with* 11 U.S.C. § 1102(a) ("the United States trustee *shall* appoint a committee") (emphasis added).

31 H.R. DOC. NO. 137, 93d Cong., 1st Sess. 218 (1973) ("Subdivision (a) establishes an 'official' committee to represent creditors in any Chapter VII case; it is derived from § 338 of the present Act. Adequate, independent representation of creditors is especially important in a case where a disinterested trustee is not appointed."). Chapter VII under draft legislation from 1973 eventually became Chapter 11 under the Bankruptcy Code when it was enacted in 1978. Rob H. Kamery, *A Historical Review of the 1979 Bankruptcy Code*, 7 PROC. OF THE ACAD. OF LEGAL, ETHICAL, AND REGUL. ISSUES 7, 7 (2003). Section 338 of the Chandler Act was contained within Chapter XI. *Id.* at 909.

32 H.R. REP. NO. 595 at 249 ("Committee members are often selected by key creditors and credit associations which have a close connection with the debtor or counsel for the debtor.").

33 *Id.* at 249 (explaining that, according to the old model, "reimbursement of expense incurred by the committee (legal and accounting primarily) will not be allowed unless a plan is confirmed. This often results in no investigation of the business or only a cursory one.").

34 *Id.* at 250.

because proxy solicitations for plan votes were allowed under Chapter X and members of Chapter X committees often owed multiple and conflicting duties to other claimants.[35] While Congress explicitly recognized that a fiduciary duty existed in Chapter X and not Chapter XI, it declined the opportunity to insert a fiduciary duty into the sections of the Code concerning Official Committees.[36]

Where Congress refused to act, courts stepped in. The first known case under the Code to mention fiduciary duties of the Official Committee was *Penn-Dixie*.[37] The issue at hand in that case concerned a statutorily-appointed equityholders' committee, not a creditors' committee, comprised of the debtor's two largest shareholders. The court ended up disqualifying one of the members because it had employed a managing director who also played a significant role in the management of the debtor. In doing so, the court stated that

35 The seminal case for Chapter X committees was *Woods*. *See* Woods v. City Nat'l Bank & Trust Co., 312 U.S. 262 (1941). This case involved a committee representing the interests of first mortgage bondholders consisting of the indenture trustee for the bondholders, as well as several underwriters of the bonds. *See* Bussel, *supra* note 24, at 1562. Even though the committee had no statutory powers, it controlled the votes of roughly half of the bondholders through a proxy solicitation. *Id.* Unfortunately for those bondholders, the committee was absurdly conflicted: the underwriters on the committee had already been found in violation of securities laws for those very bonds, the indenture trustee was also the indenture trustee for the bonds of the firm's competitors, and counsel for the committee was also counsel for the indenture trustee. *Id*. In another Chapter X case, *Realty Associates*, a bondholders' committee consisted of members who happened to also be directors of the debtor. *In re* Realty Associates Securities Corp., 56 F. Supp. 1008, 1009 (E.D.N.Y. 1944), *aff'd* 156 F.2d 480 (2d Cir. 1946). On a motion to disqualify those directors from serving on the committee, the court stated that "[a] bondholders (creditors) committee is a fiduciary for all bondholders and as such owes undivided loyalty and allegiance to the bondholders, and to them alone." *Id*. In both *Woods* and *Realty Associates*, the committee was an unofficial group representing a uniform set of claimants and the issue at hand was not whether the committee members violated their duties in some way, but whether a representative with a clear conflict of interest arising from a preexisting fiduciary obligation to a competing group was fit to serve on the committee in the first place.

36 H.R. DOC. NO. 93-137 at 218–19.

37 *In re* Penn-Dixie Industries, Inc., 9 B.R. 941 (S.D.NY. 1981).

"the fiduciary duties and responsibilities assumed by creditors' committee members, likewise apply to equity security committee members."[38] The court cited, as authority, a pre-Code edition of Collier on Bankruptcy[39] and a guide to the Bankruptcy Reform Act of 1979 that was published in the same year that it was enacted.[40] Although it recognized that Chapter X committees were "comparatively informal," the court went on to state that "[n]otwithstanding this, the conflict of interest principles developed thereunder provide sound precedent under the Bankruptcy Code."[41] Nonetheless, later cases directly addressing the fiduciary duties of creditors' committees overlap significantly with the language of *Penn-Dixie*.[42]

B. Traditional Functions of the Official Committee

In theory, the Official Committee may carry out a number of functions reflecting the numerous frictions inherent to the bankruptcy process. Certain creditors invariably find it too costly to obtain information or transact in ways that will maximize the value of their claims. In some cases, the creditor group as a whole may lack the bargaining position needed to prevent insiders from siphoning away value. Even if insiders are somehow kept in check, secured creditors and equityholders, to the extent that they are not the residual claimants to firm value, may be incentivized to make inefficient decisions about the continuation of the firm. And, notwithstanding the two-thirds voting rule, small groups of creditors can take advantage of coordination problems that will hold up the process for all parties.

[38] *Id.* at 944.

[39] *Id.* (citing 6 COLLIER ON BANKRUPTCY (James Wm. Moore & Lawrence P. King eds., 14th ed. 1976)).

[40] *Id.* (citing HARVEY R. MILLER & MICHAEL L. COOK, A PRACTICAL GUIDE TO THE BANKRUPTCY REFORM ACT (1979)).

[41] *Id.* at 944 n.8.

[42] The leading case on fiduciary duties of the Official Committee is *Johns-Manville*, and it cites to the same edition of Collier and guide to the Bankruptcy Reform Act as in *Penn-Dixie. In re* Johns-Manville Corp., 26 B.R. 919, 924–25 (Bankr. S.D.N.Y. 1983).

While Official Committees have the ability to address many of these frictions, their membership will dictate, in part, their precise functions. For example, an Official Committee that consists mostly of hedge funds could stand up to powerful coalitions of lenders or private equity firms on either side of the capital structure but may have a difficult time convincing trade creditors that they are trustworthy stewards of information. On the other hand, an Official Committee comprised of tort claimants might be successful coalition-builders but might not be experienced enough to monitor the debtor in a way that completely eliminates rent extraction by insiders.

The Code directly or indirectly addresses several Official Committee functions. Section 1102(b)(3) stipulates in part (A) that it "shall provide access to information" *to* unsecured creditors, and in part (B) that it shall collect information *from* unsecured creditors.[43] Reducing information costs between the debtor and general unsecured creditors is therefore a crucial responsibility of the Official Committee. Section 1103(c) gives the Official Committee several monitoring powers, including the right to investigate the debtor's operations and to request the appointment of a trustee or examiner under Section 1104.[44] Going a step beyond informing and monitoring, Section 1103(c) also suggests that the Official Committee has a degree of control at least over plan formulation, providing that it may "consult with" the debtor "concerning the administration of the case"[45] and "participate in the formulation of a plan[.]"[46] The extent to which the Official Committee may control the plan, however, is unclear. Finally, while there is no mention of its role offsetting biases of other claimants, the acknowledgement in Section 1102(a)(1) that additional official committees consisting of equityholders (or even other creditors) may be appointed "as the United States Trustee deems appropriate"

43 11 U.S.C. § 1102(b)(3).
44 *Id.* at § 1103(c)(2)–(4).
45 *Id.* at § 1103(c)(1).
46 *Id.* at § 1103(c)(3).

is a tacit recognition that unsecured creditors are not necessarily the residual claimants to firm value in all bankruptcy cases.[47]

C. Summary Statistics on Recent Official Committees

The Code sends a clear message about the Official Committee's composition: it "shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee."[48] Time and conflicts of interest have chipped away at this mandate, however.[49] In practice, the U.S. Trustee exercises "wide latitude in appointing creditors to a committee."[50] Perhaps because of this latitude, the Official Committee has evolved over time.[51]

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[47] *Id*. at § 1102(a)(1).

[48] *Id*. at § 1102(b)(1).

[49] Typically, the U.S. Trustee selects from among the list of largest creditors submitted at the outset of the case. *See* Ayer et al*., What Every Unsecured Creditor Should Know About Chapter 11*, AM. BANKR. JOURNAL, 5 (2004). This does not mean, however, that the members are necessarily the seven largest creditors.

[50] Carl A. Eklund & Lynn W. Roberts, *The Problem with Creditors' Committees in Chapter 11: How to Manage the Inherent Conflicts without Loss of Function*, 5 AM. BANKR. INST. L. REV. 129 (1997).

[51] Professor Bussel conducted a study of bankruptcy filings in the Central District of California from 1986 to 1991. Bussel, *supra* note 24. Of the 13 large cases in his sample in which the Official Committee played a significant role, six involved substantial litigation over committee membership, and he selected three to analyze through case studies. In *Maxicare*, through two separate official committees (one of trade creditors and one of bondholders), the U.S. Trustee roughly mimicked the unsecured capital structure of the firm, although banks were shut out. *In re* Family Health Servs., Inc., No. SA 89-01549-JW (Bankr. C.D. Cal. June 9, 1989). In *Leisuretech*, despite the fact that trade creditors made up only 5% of the unsecured capital structure, they were awarded five seats on an eleven-member committee. *In re* Leisure Technology, Inc., Case No. LA 91-73557-WL (Bankr. C.D. Cal. filed Apr. 26, 1991) In *Smith International*, the U.S. Trustee announced that any of the top twenty largest general unsecured and trade creditors would be allowed to serve on the committee if they wished—the committee ended up with nineteen members, including the

To understand the composition of Official Committees in recent bankruptcies, I begin with the set of non-financial Chapter 11 cases in the UCLA-LoPucki Bankruptcy Research Database filed between 2018 and 2020.[52] This dataset includes all large U.S. bankruptcies filed since 1980, where a company is considered large if it was either publicly traded prior to filing or had at least $100 million in assets in 1980 dollars (approximately $314 million in 2020 dollars). I excluded firms in the financial or real estate industries as well as firms with foreign incorporation forms.[53] I also excluded prepackaged bankruptcy cases without Official Committees.[54] This brings the final sample down to sixty-eight cases.

Table 1 presents summary statistics on basic formational outcomes.[55] I considered Official Committees only, i.e., those formed by the U.S. Trustee, and not *ad hoc* committees. In 91% of cases, the U.S. Trustee was able to form an official committee of unsecured creditors. One case consisted only of

debtor's main competitor and patent litigation adversary. *In re* Smith Int'l, Inc., No. LA 86-03947-TD (Bankr. C.D. Cal. filed Mar. 7, 1986)

[52] UCLA-LOPUCKI BANKRUPTCY RESEARCH DATABASE, https://lopucki.law.ufl.edu/index.php [https://perma.cc/8PGM-RE6R] (last visited Feb. 16, 2023).

[53] Financial firms incur debt for fundamentally different reasons than non-financial firms, and real estate firms are less likely to have an Official Committee because there are usually too few unsecured creditors willing to serve.

[54] In prepackaged cases, the plan formulation and voting processes take place prior to bankruptcy. As a result, courts waive the requirements in Section 1102 for these cases. Occasionally, however, the plan will fall through in bankruptcy court and the debtor reenters negotiations. The U.S. Trustee may form Official Committees in these types of cases. Dennis F. Dunne, Dennis C. O'Donnell & Nelly Almeida, *Pre-Packaged Chapter 11 in the United States: An Overview*, GLOB. RESTRUCTURING REV. (Dec. 11, 2019), https://globalrestructuringreview.com/guide/the-art-of-the-pre-pack/edition-1/article/pre-packaged-chapter-11-in-the-united-states-overview [https://perma.cc/CAQ3-H2YT].

[55] Official Committee formation data are collected from reports submitted by the U.S. Trustee's office. This report is typically entitled "Notice of Appointment of Creditors' Committee." It typically contains the list of unsecured creditors appointed to the Official Committee, their names and the names of the entities they represent, and their addresses.

an equityholders' committee. There was no Official Committee in the remainder of cases, 7% of the sample. Of the cases in which no Official Committee was formed, three provided an explanation for its omission (not enough unsecured creditors were willing to serve on the Official Committee), while two provided no explanation. The formation failure rate was highest in the Southern District of Texas, which accounted for 38% of the sample but 80% of cases without an Official Committee.

Table 1: Committee Formation

Committee Outcome (Official Only)	Fraction of Cases (N = 68)
Unsecured Creditors Committee Formed	91.2%
Equity Committee Only	1.5%
No Committee	7.4%

In no instance did the actual Official Committee consist of representatives of the seven largest claims as listed on Official Form 204, the list provided by the debtor of unsecured creditors holding the largest claims.[56] There are several potential reasons why this may be the case. There are certain types of contingent unsecured creditors, such as the Pension Benefit Guaranty Corporation or landlords, whose claims are not reported because the debtor has not yet decided whether to take certain actions such as terminating a pension plan or rejecting a lease. Unsecured creditors may also prefer to free ride rather than to expend the effort and incur the litigation risk associated with Official Committee service. In addition, the U.S. Trustee has the discretion to pass over unsecured creditors with significant conflicts of interest, and may choose to form an Official Committee of any size. The average Official

[56] This list is typically consolidated across all of the debtor's entities. In most cases, the debtor provides a list of the top thirty unsecured creditors, although some debtors provide more. *Instructions: For Bankruptcy Forms for Non-Individuals*, U.S. BANKR. CT. (Dec. 2015, rev. Mar. 2019), https://www.uscourts.gov/sites/default/files/instructions-non-individuals-2015.pdf [https://perma.cc/9SDS-9R7C].

Committee in the sample consists of 6.2 members, although membership ranges from two to nine.

I then categorized each of the 385 Official Committee members in the sample using a multi-step process. First, I categorized members who are typically not listed on Official Form 204 but have distinguishable names, such as "Pension Benefit Guaranty Corporation."[57] I also label members who self-categorize in their titles, such as "John Doe, Litigation Plaintiff." For the remaining creditors, I cross-checked their names against the names listed on Official Form 204. This form also typically provides information on the category of unsecured creditor listed, although these categories are self-reported by the debtor. Therefore, in the following step, I standardized categories into ten final groupings, listed in Table 2.[58] In the final step, I imputed categories to those Official Committee members who remain unclassified.[59]

57 These categories consist of the Pension Benefit Guaranty Corporation, pension funds, landlords, unions, and hedge funds. Pension funds contain the terms "pension" or "profit sharing plan" in their titles. There are several repeat landlords in the sample, e.g., Simon Property Group. Unions are also identifiable by name, e.g., AFL-CIO. Distress funds, in this round, contain at least one of the following terms: "fund," "capital," "trading," "investments," "securities," or "asset management." I then use broad-based web searches to verify that these firms are not other types of financial institutions, such as mutual funds or financial service providers. If they are, they are categorized under *Other Finance*.

58 For example, I categorized under *Trade* any unsecured creditor that is described by the as "trade payable" or "vendor." A complete list of categories, including the standardization step, is on file with author. A total of 1.6% of members remain uncategorized.

59 For unclassified financial institutions, I assign themed to the category of *Indenture Trustee* if they are one of the six most common trustee firms in the sample: Wilmington, U.S. Bank, UMB Bank, BOKF, BNY Mellon, and Delaware Trust. For other unclassified firms, I use broad-based web searches to verify that they are not financial institutions and then classify them as trade creditors. 18.4% of trade creditors are imputed. One explanation for why these creditors had to be imputed is that their firms have a dedicated bankruptcy Official Committee representative, but they did not hold claims large enough to make it to the Official Form 204 in a particular case. For example, AT&T and Baker Hughes each appear on the Official Committee in multiple cases, but are absent from Official Form 204 in at least one case.

Individuals, for example, are rarely named on Official Form 204. Because they may be litigation plaintiffs, current or former employees, or even lenders in some capacity, I assign unclassified individuals to their own category.

Table 2: Official Committee Members Categorized

All Cases (n = 62)			Cases with Financial Debt (n = 42)		
[1] Category	**[2] % Members (Total)**	**[3] % Cases (At Least 1)**	**[4] Category**	**[5] % Members (Total)**	**[6] % Cases (At Least 1)**
Trade	53.5	91.9	Trade	49.0	90.5
Indent. Trustee	13.0	61.3	Indent. Trustee	18.6	88.1
Landlord	8.8	29.0	Landlord	6.1	23.8
Individual	6.5	25.8	Individual	7.2	28.6
PBGC	4.4	27.4	PBGC	4.2	26.2
Hedge fund	3.6	14.5	Hedge fund	4.9	19.0
Union	2.9	17.7	Union	2.7	16.7
Other Finance	2.1	12.9	Other Finance	2.3	14.3
Litigation	2.1	11.3	Litigation	3.0	16.7
Pension Fund	1.6	9.7	Pension Fund	1.1	7.1

Columns 1 through 3 of Table 2 include data on all firms in the sample, while Columns 4 through 6 include data only on firms with nonzero financial unsecured debt. Among cases with financial unsecured debt, the median (mean) fraction of financial unsecured debt relative to all unsecured debt is 83% (77%).[60] The table presents summary statistics on Official Committee members by category in terms of both the percentage of all Official Committee members accounted for by each category (Columns 2 and 5) as well as the percentage of bankruptcy cases with Official Committees that contain at least one member of that category (Columns 3 and 6). As the table indicates, trade creditors are by far the dominant Official Committee members, accounting for 54% of total

60 Financial debt consists of bonds of any form.

membership across all cases and appearing in 92% of all cases in the sample with Official Committees. Column 2 indicates that indenture trustees, who represent bondholders, are a distant second, accounting for 13% of total membership. Landlords, who are not traditionally conceived of as unsecured creditors due to the executory nature of most real property leases, account for a surprising 9% of Official Committee membership. This may be explained by the COVID-19 pandemic and the "Retail Apocalypse" causing firms to enter Chapter 11 with higher levels of past-due rent. Continuing down Column 2, although individuals account for 7% of Official Committee members, this group is most likely a blend of employees and litigation claimants, so it is difficult to precisely identify their precise economic interests. The remaining categories each account for less than 5% of total members across all cases in Column 2, as well as case with financial debt in Column 5.

Collectively, Official Committee members representing bondholders account for roughly 20% of total membership across all cases and 25% in cases with financial debt.[61] Not all bondholder representatives are created equal, however. Hedge funds are the only category in which the institution's managers, and possibly the Official Committee members themselves, may have committed their own capital to the investment and therefore hold bonds of the debtor directly.[62] Although other bondholder representatives are also financial professionals, they differ from hedge funds in that they do not typically pursue active control strategies or seek tranches of

[61] I assume that indenture trustees, pension funds, hedge funds, mutual funds, and banks primarily hold bond debt as opposed to other forms of unsecured claims. There may be discrepancies in this estimate arising from, for example, trade debt purchases by hedge funds or direct unsecured loans by banks to debtors.

[62] Arpit Gupta & Kunal Sachdeva, *Skin or Skim? Inside Investment and Hedge Fund Performance* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26113, 2019).

the capital structure where they can maximize returns.[63] Hedge funds may therefore perceive that indenture trustees are improperly incentivized or lack the requisite skills to truly maximize the recoveries on their bonds. For example, a hedge fund Official Committee member in the bankruptcy of Fibermark, Inc. was said to have exhibited a "lack of respect"[64] for the indenture trustee on the Official Committee when he emailed another member, complaining that the trustee had "absolutely no skin in the game."[65] Despite what may be described as the enhanced incentives of hedge funds to pursue the highest possible recoveries to unsecured creditors, they account for less than 4% of the total Official Committee membership and appear on it in fewer than 15% of all cases. Excluding cases without financial unsecured debt, hedge funds still account for less than 5% of Official Committee membership and appear in less than 20% of all cases, despite the fact that the unsecured debt of the median firm in this subset consists of 83% financial debt.

D. The New Acrimonious Landscape

For as long as it has existed, bankruptcy has been a difficult phase in the corporate life cycle. Secured lenders are pitted against equityholders, with the Official Committee in the middle, in negotiations about the valuation of the bankrupt firm. Since the mid-2010s, however, the mood has become markedly more acrimonious, owing mainly to a new set of strategies that distress market participants have been pursuing prior to bankruptcy. Academics have described these

[63] *See* Jiang et al., *supra* note 10; *see also* Jongha Lim, *The Role of Activist Hedge Funds in Financially Distressed Firms,* 50 J. FIN. & QUANTITATIVE ANALYSIS 1321 (2015).

[64] Report of Harvey R. Miller as Examiner at 51, *In re* FiberMark, Inc.*,* 349 B.R. 385 (Bankr. D. Vt. 2006).

[65] *Id.* at 52.

strategies as "aggressive maneuvers",[66] "aggressive tactics",[67] and "hostile restructurings."[68]

It is a widely held belief that private equity firms, also referred to as "sponsors," are responsible for this mood change.[69] While traditional equityholders have had a limited set of tools to retain value in bankruptcy due in large part to the absolute priority rule that looms as the alternative to non-consensual reorganization in Chapter 11, resourceful private equity firms have built up an arsenal of new weapons. These include paying themselves management fees,[70] selecting favorable board members prior to bankruptcy,[71] and what are now colloquially referred to as "drop down" and "uptier" transactions, discussed below. Private equity firms also continue to engage in leveraged buyouts (LBOs), in existence since the early 1980s,[72] which layer significant amounts of debt on top of unsecured credit in the capital structure.

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66 Robert K. Rasmussen & Michael Simkovic, *Bounties for Errors: Market Testing Contracts*, 10 HARV. BUS. L. REV. 117, 122 (2020).

67 Kenneth Ayotte & Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 YALE L. J. 363, 372 (2021).

68 Diane L. Dick, *Hostile Restructurings*, 96 WASH L. REV. 1333, 1333 (2021).

69 *See* Douglas G. Baird, Anthony J. Casey & Randal C. Picker, *The Bankruptcy Partition*, 166 U. PENN. L. REV. (2018); Irina Fox, *Protecting All Corporate Stakeholders: Fraudulent Transfer Law as a Check on Corporate Distributions*, 44 DEL. J. CORP. L. 81 (2020); Mitchell Mengden, *The Development of Collateral Stripping by Distressed Borrowers*, 15 CAP. MKTS. L. J. (2020).

70 *See* Brian Pollack, *It's Complicated: A Guide to Private Equity Fees*, EVERCORE WEALTH MGMT. & TR. CO (July 21, 2016), https://www.evercorewealthandtrust.com/its-complicated-a-guide-to-private-equity-fees/ [https://perma.cc/D3X3-9NMS].

71 *See* Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. (forthcoming).

72 Himani Singh, *Evolution of Leveraged Buyouts: A New Era or Back to Square One?*, N.Y.U. J.L.B. ONLINE (Jan. 18, 2020), https://www.nyujlb.org/single-post/2020/01/18/evolving-of-leveraged-buyouts-a-new-era-or-back-to-square-one#:~:text=The%20first%20LBO%20wave%20started,an%20essential%20source%20of%20financing [https://perma.cc/DD8C-YHCJ].

Drop down and uptier transactions, sometimes referred to together as "liability management transactions," involve strategies that are familiar to bond market participants but are relatively new to loan markets.[73] In a drop down transaction, "borrowers create structurally senior debt by moving assets outside an existing collateral package, often using unrestricted subsidiaries."[74] In a simplified sense, managers take advantage of weaknesses in loan documents to shift assets, that are seemingly pledged as collateral to one set of lenders, into subsidiaries beyond the reach of those lenders, giving rise to the possibility that financiers may provide new loans against those same assets.[75] Drop down transactions harm existing secured lenders but also affect unsecured creditors. Value for unsecured creditors is left over when the amount of the original loan exceeds the value of the collateral. In addition, the overall class of unsecured claims is diluted when drop down transactions leave previously secured lenders only partially secured. In uptier transactions, "borrowers create contractually senior debt by mixing and matching the priority of claims within the existing credit and collateral package."[76] In essence, they elevate the priority of majority lenders at the expense of, and without the consent of, minority lenders within an existing lending syndicate. When these transactions involve new financing, they may harm unsecured creditors for the same reasons that drop down transactions harm unsecured creditors.

Equityholders may also shift value away from unsecured creditors in the pre-bankruptcy period by paying themselves dividends. Unlike more complicated drop down and uptier transactions, dividend payments by distressed firms are more blatant violations of fraudulent transfer and illegal dividend law. Also, they can be and easily are prohibited by restrictive

73 *Liability Management Transactions*, LSTA (Sept. 30, 2020), https://www.lsta.org/news-resources/liability-management-transactions [https://perma.cc/X5LS-2L5M].

74 *Id.*

75 *See* Ayotte & Scully, *supra* note 67, at 368 (providing a summary of the "trap door" loan terms that gave rise to this transaction in J.Crew).

76 *See Liability Management Transactions*, *supra* note 73.

covenants in loan agreements, and so they are less likely to take place.[77] Private equity sponsors may push the envelope on pre-bankruptcy self-dealing by paying themselves established cash flows in the form of consulting fees rather than dividend payments.[78] Still, "[t]hat spigot is turned off in the event of a bankruptcy" due to the increased likelihood that these payments will be construed as fraudulent transfers.[79]

Perhaps the most powerful but speculative challenge to private equity firms is the threat of litigation over LBOs. If an LBO involves so much new debt that it leaves the new firm effectively insolvent, junior creditors can also use fraudulent transfer law to challenge the transaction.[80] Even though LBOs and LBO-related litigation in bankruptcy are not new, the standards as they relate to fraudulent transfer law are still evolving[81] and private equity firms have showed no sign of stopping.[82]

Creditors can combat these transactions in and out of bankruptcy by using doctrines of fraudulent transfer or directorial duties, but they have not been entirely successful in doing so. The owners of J. Crew succeeded, for example, in defending their infamous drop down transaction in court.[83]

[77] *See* William W. Bratton, *Bond and Loan Covenants, Theory and Practice*, 11 CAP. MKTS. L. J. 461, 467–68 (2016).

[78] *See* Ellias et al., *supra* note 71, at 16.

[79] *See* Buccola, *supra* note **Error! Bookmark not defined.**, at 6.

[80] *See infra* Section III.C (providing an overview of fraudulent transfer law).

[81] *See* Fox, *supra* note 69, at 106–08; *see also* Mark Douglas & Charles Oellermann, *Another New York District Court Widens the Bankruptcy Code's Securities Contract Safe Harbor,* JDSUPRA (Jan. 28, 2022), https://www.jdsupra.com/legalnews/another-new-york-district-court-widens-4517034 [https://perma.cc/8QC7-X4E8].

[82] Olivia Raimonde, *Leveraged Buyout Boom is Seen Flooding Loan Markets for Months*, BLOOMBERG (Jan. 3, 2022, 10:43 A.M.), https://www.bloomberg.com/news/articles/2022-01-03/leveraged-buyout-boom-is-seen-flooding-loan-markets-for-months [https://perma.cc/VTP3-2SFF].

[83] *See, e.g.*, Daphne Howland, *J.Crew Prevails in Debt-Swap Ruling*, RETAIL DIVE (Apr. 27, 2018), https://www.retaildive.com/news/j-crew-prevails-in-debt-swap-ruling/522322 [https://perma.cc/X7LZ-ZHGY].

More broadly, courts have given managers more leeway[84] and financial institutions heightened forms of protection[85] when it comes to pre-bankruptcy transactions. And, for puzzling reasons, loan terms have not fully adjusted to protect creditors from liability management transactions.[86] This leaves ex-post enforcement, largely through Official Committees in bankruptcy, as an important tool for ensuring that these transactions do not do too much damage to capital markets. Fortunately, in bankruptcies with few unencumbered assets from which unsecured creditors can seek a distribution, the sole function of the Official Committee may be to pursue litigation against private equity firms.

III. PROBLEMS WITH EXISTING NORMS OF THE OFFICIAL COMMITTEE

The composition and responsibilities of standard Official Committees today are not consistent with the notion that the primary source of value available for unsecured creditors are litigation rights. This Section characterizes this problem and splits it into three subparts. First, the division of the estate's assets into property over which the debtor has possession and contingent litigation rights has implications for the role of unsecured creditors according to the residual claims theory. Second, the diversity of unsecured creditors suggests that members of the Official Committee should not owe fiduciary duties to the broad class of general unsecured creditors, at

84 *See infra* Section III.C.

85 *See* Douglas & Oellermann, *supra* note 81.

86 *See, e.g.*, Scott Greenberg et al., *Recent Developments in Distressed Lender-Side Representations,* JONES DAY (2019), https://www.jonesday.com/files/Uploads/Documents/CLE%20Academy/Jones%20Day%20MCLE%202019/REVISED%20WEB%20ONLY%20-%20Session%203.4%20-%20Coming%20Full%20Circle%20-%20Preparing%20for%20Distressed%20Transactions.pdf [https://perma.cc/X34K-9QZA] ("Following the J.Crew drop down transaction, lenders have attempted to negotiate provisions into credit documents restricting the ability to transfer material assets to unrestricted subsidiaries (so-called 'J.Crew Blocker' provisions). These provisions have not yet gained widespread traction[.]").

least not when most of the value at stake is in litigation rights. Finally, the distribution of unsecured creditors among ad hoc groups and the Official Committee can undermine the deterrent effect that unsecured creditors' avoidance actions can have on private equity firms considering aggressive or coercive transactions.

A. Unsecured Creditors as Residual Claimants

The identity and capital structure position of the residual claimant, the class of claimholders entitled to residual value the firm generates beyond its fixed obligations, is important for corporate governance both in and out of bankruptcy. For healthy firms, equityholders are the residual claimants, but as firms enter into distress and there is little value to distribute to equityholders, their claims become option-like. As firms enter into insolvency, equityholders become out of the money and residual claim status passes to junior creditors, i.e., unsecured creditors. For firms that are deeply insolvent, it is possible that even unsecured creditors will become out of the money, meaning that asset values cannot even cover the amount of secured debt in the capital structure. Control and monitoring rights should, according to basic theory, be allocated to residual claimants, whose incentives are best aligned with firm value maximization.[87] Those rights should not be allocated to claimholders who are out of the money and incentivized to take too many risks; nor should they be allocated to claimholders who are overly secure and incentivized to take too little risk.

This simplified analysis does not take into account the fact that firm assets may be in the form of speculative, contingent litigation rights. Consider the gold from the hypothetical in Section I. Once it is stolen, it is no longer an asset within the possession of the firm. State and, in some cases, bankruptcy

[87] *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AMER. ECON. REV. 777, 782 (1972); *see also* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 306 (1983).

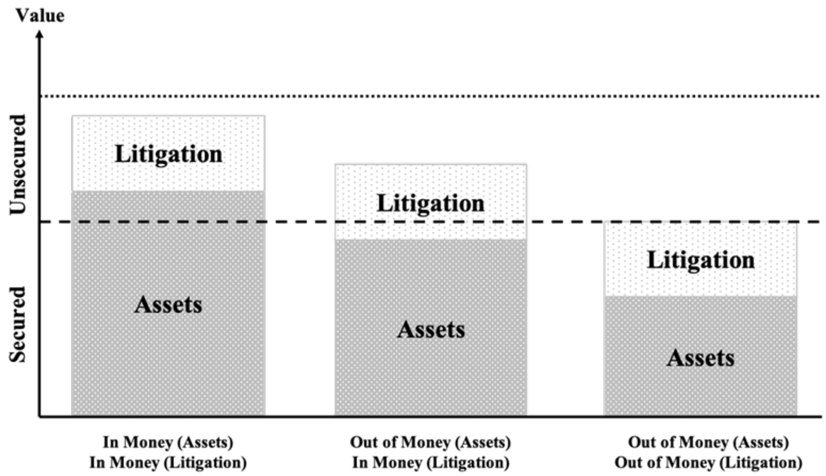
law[88] dictates who is entitled to the proceeds of litigation by or on behalf of claimants of the firm, i.e., who is entitled to pursue the robbers, which itself is worth the expected amount that will be recovered multiplied by the probability that it will be recovered. It does not follow, however, that a claimholder with a litigation right ought to have the same control and monitoring rights which, in theory, should flow to residual claimants.

Figure 1 depicts the interaction of traditional residual claim theory with two types of assets: those that the firm possesses (denoted, simply, "Assets") and litigation rights (denoted "Litigation"). It shows residual claim status for insolvent firms only, as asset values are always less than the sum of secured and unsecured debt. Value is on the y-axis, and the dashed line indicates how much secured debt is in the capital structure, while the space between the dotted line and dashed line indicates how much unsecured debt is in the capital structure. The x-axis depicts the asset structures of three different types of firms based on the residual claim status of unsecured creditors, firms in which unsecured creditors are: (i) in the money with respect to both possessed and litigation-right assets (left); (ii) out of the money with respect to possessed assets but in the money with respect to litigation assets (center); and (iii) out of the money with respect to both possessed and litigation-right assets (right).[89]

[88] Fraudulent transfer law, for example, exists both within state statutes and the Bankruptcy Code. *See* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985).

[89] In theory, unsecured creditors could be in the money with respect to possessed assets and out of the money with respect to litigation-right assets. This would happen if, for example, assets specifically pledged as collateral to secured lenders were conveyed out of the firm, but the firm possessed other assets that were unencumbered by liens. For reasons discussed in Section I, this scenario is unlikely.

Figure 1: Residual Claims in Insolvency with Two Asset Forms



In a way, the central issue of this paper is the distinction between the firm on the left and the firm in the center. When a firm is in the money with respect to both existing assets and litigation rights, the Official Committee has a meaningful role to play in both the governance of the firm as well as the investigation of avoidance actions. When a firm is out of the money with respect to assets possessed by the firm but in the money with respect to litigation rights, the sole focus of the Official Committee should be on maximizing the value derived from those litigation rights. Empirical evidence suggests that the median large Chapter 11 debtor is in the middle category or close to the middle category. According to S&P Global, for large corporations that filed for bankruptcy between 2008 and 2021, unsubordinated unsecured creditors experienced recoveries in the 0% to 10% range in 45% of cases, while subordinated unsecured creditors experienced recoveries in the 0% to 10% range in 70% of cases.[90] These data are

90 Kenny K. Tang et al., *Recovering From COVID-19: Why the Timing of Bankruptcy and Emergence Matters For Debt Recovery*, S&P GLOB. COMMENTS fig.6 (Feb. 7, 2022, 2:58 PM), https://www.spglobal.com/ratings/en/research/articles/220207-recovering-

collected from Chapter 11 plans and disclosure statements, which means that they incorporate expected recoveries from litigation.

This is not the model of the Official Committee suggested by the Code, however. The functions of the Official Committee, according to Sections 1102 and 1103, are to provide information to other unsecured creditors, monitor the debtor, and participate in formulation of the Plan.[91] Although the Official Committee is also tasked with investigation, it is only into the "acts, conduct, assets, liabilities, and financial condition of the debtor, [and] the operation of the debtor's business"[92] and not into the avoidance actions described elsewhere in the Code.[93]

There is, of course, the possibility that unsecured creditors are entirely out of the money with respect to both existing assets and litigation rights. This could be the case if the expected value of litigation rights is very small, or if an action equivalent to a conveyance took place when virtually all of the assets of the firm were already encumbered by liens. In this situation, the Official Committee runs the risk of violating the absolute priority rule by taking any action that either depletes resources of the estate or results in a distribution to unsecured creditors.[94] Unsecured creditors can only be out of the money with respect to litigation rights worth a strictly positive amount, however, if one views a secured creditor as a creditor with a lien on the debtor's assets before bankruptcy. Under Section 506(b) of the Code, a secured claim is only allowed to the extent that it "is secured by property the value of which . . . is greater than the amount of such claim."[95] In essence, it splits an undersecured claim into a perfectly secured claim and an unsecured claim. If the court ignores property under a litigation dispute for the purposes of Section 506(b), or places

from-covid-19-why-the-timing-of-bankruptcy-and-emergence-matters-for-debt-recovery-12253538.

91 *See supra* Section II.B.

92 11 U.S.C. § 1103(c)(2).

93 *See id.* §§ 544(b), 548.

94 *See* Athanas et al., *supra* note 1, at 99.

95 11 U.S.C. § 506(b).

a low probability on its recovery, then the litigation rights still technically belong to unsecured creditors.[96]

B. The Fiduciary Duty

One of the central tenets of fiduciary theory is that a fiduciary can only serve one principal. As Harlan Fiske Stone explained, "the fiduciary principle, the precept as old as holy writ, [is] that 'a man cannot serve two [principals].'"[97] It is too hard for a fiduciary to have a clear objective in the presence of multiple principals. Faced with conflicting objectives, a fiduciary may be exposed to liability for potentially violating her duty no matter which decision she makes. As discussed in Section II.D, unsecured creditor groups are extremely diverse, calling the suitability of fiduciary duties into question in this context.[98] Although it is straightforward that unsecured creditors prefer higher recovery rates to lower recovery rates in the same way shareholders prefer greater profits to lesser profits, there are several dimensions along which their preferences differ.[99]

Certain unsecured creditors are well known for their preference, or in some circumstances bias, for maintaining the debtor's going-concern operations. Trade creditors famously prefer continuation as a going concern because there is value in their repeated interactions with the debtor.[100] Employees

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[96] One exception to this is if the undersecured creditors make a Section 1111(b) election, in which the full claim amount may still be treated as secured. *Id.* § 1111(b).

[97] Harlan F. Stone, The Public Influence of the Bar, Address at the Dedication of the Law Quadrangle, University of Michigan (June 15, 1934), *in* 48 HARV. L. REV. 1, 8 (1934).

[98] *See* Kurt F. Gwynne, *Intra-Committee Conflicts, Multiple Creditors' Committees, Altering Committee Membership and Other Alternatives for Ensuring Adequate Representation Under Section 1102 of the Bankruptcy Code*, 14 AM. BANKR. INST. L. REV. 109, 109 (2006).

[99] Several papers have highlighted the inherent contradiction of the fiduciary duty as applied to members of the Committee. *See, e.g.*, Klee & Shaffer, *supra* note 27; Bussel, *supra* note 24; Eklund & Roberts, *supra* note 50.

[100] *See, e.g.,* Eklund & Roberts, *supra* note 50, at 142 n.93 (internal citations omitted); *see also* Klee & Shaffer, *supra* note 27, at 1028.

and the unions that represent them prefer continuation for similar reasons. The Pension Benefit Guaranty Corporation (PBGC), which guarantees a minimum payout to defined benefit pension holders, may also prefer continuation of the debtor. Since bankrupt firms have discretion over whether or not to retain or terminate defined benefit pension plans,[101] the PBGC prefers continuation as it allows for the possibility that certain pension plans will not be terminated. When it comes to other unsecured creditors, however, the argument that they prefer reorganization is weaker, all else being equal. While there may have been cases involving "bust-up" strategies in the early days of the Code, outright liquidations are rare in modern-day bankruptcies.[102] Instead, hedge funds and other types of sophisticated investors may have a higher tolerance for divesting what they perceive as underperforming parts of the business or allowing a greater fraction of storefronts to close. Landlords are the one unsecured constituency that may possess a clear liquidation bias, at least when they believe they can replace the debtor with more lucrative tenants.

Unsecured creditors also have strong and varying preferences over liquidity. Hedge funds, which usually operate by locking up investors for a certain period of time,[103] are more likely to tolerate at least short-term illiquidity. Other bondholders and large landlords, to the extent that they have deep pockets, may also be indifferent to short-term illiquidity. On the other hand, smaller trade creditors and litigation claimants may prefer recoveries in the form of cash rather than illiquid stock or litigation rights. In fact,

[101] Mark G. Douglas, *Second Circuit Ruling Makes Pension Plan Termination in Bankruptcy More Expensive*, JONES DAY INSIGHTS (Jul. 2009), https://www.jonesday.com/en/insights/2009/07/second-circuit-ruling-makes-pension-plan-termination-in-bankruptcy-more-expensive.

[102] *See* Katherine P. Waldock, A Typology of U.S. Corporate Bankruptcy (Jan. 2020) (unpublished manuscript) (on file with the Columbia Business Law Review).

[103] Kevin P. Scanlan, Darina F. Delappe & David Yanvarashvili, *Hedge Fund Liquidity Management Considerations*, KRAMER LEVIN PRIV. FUNDS BLOG (Jan. 25, 2021), https://www.kramerlevin.com/en/perspectives-search/hedge-fund-liquidity-management-considerations.html [https://perma.cc/K5PM-X8BR].

situations in which financial firms are willing to provide liquidity to these groups (for a discount) and also serve on the Official Committee are precisely when thorny fiduciary issues may arise.

Differences in risk aversion may also affect unsecured creditors' preferences in bankruptcy. Risk aversion matters to a certain extent when recoveries to unsecured creditors are in the form of equity, but it matters a great deal more when recoveries are in the form of litigation rights. Pursuing avoidance actions as a form of recovery means that unsecured creditors may face negative recoveries, if individual creditors finance professional fees out of their own pockets, or recoveries greater than 100%, if other claimholders forgo their right to receive distributions out of any surplus arising from a successful outcome. Leaving aside the value of their claims, wealthier individuals are more likely to be tolerant of risk.[104] Hedge funds and direct bondholders are therefore more likely to be risk-tolerant than employees, litigation claimants, and smaller trade creditors.

Mathematically, it is impossible to maximize objectives along multiple dimensions unless those dimensions are monotonic transformations of one another.[105] There are other practical difficulties with serving the interests of multiple principals. A fiduciary is supposed to promote the financial interests of those she represents, but it can be difficult to draw a line between what does and does not count as a financial interest. If a trade creditor is also a competitor of the debtor, should an Official Committee member consider liquidation so that the trade creditor can benefit from a concentrated market share? No, and case law indicates that judges are wary of competitors acquiring too much control over the debtor precisely because of these motives.[106] And yet there does not seem to be any problem with a trade creditor's having a

[104] Daniel Paravasini, Veronica Rappoport & Enrichetta Ravina, *Risk Aversion and Wealth: Evidence from Person-to-Person Lending Portfolios*, 63 MGMT. SCI. 279 (2017).

[105] Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective*, 22 J. APPLIED CORP. FIN. 32, 34 (2010).

[106] *See, e.g.*, Klee & Shaffer, *supra* note 27, at 1018.

financial interest in continuation as a going concern so that it can profit from future interactions.

Despite the theoretical arguments against owing fiduciary duties to multiple principals, recent developments in corporate governance have moved in that direction.[107] In 2019, for example, 181 CEOs who were members of the Business Roundtable made a commitment to leading "their companies for the benefit of all stakeholders—customers, employees, suppliers, communities, and shareholders."[108] Prior to that, the "Friedman Doctrine," or the notion that corporate boards and executives owe duties solely to shareholders, had prevailed among business leaders.[109] In addition, public benefit corporations, or firms with a legal mission to pursue social objectives in addition to shareholder wealth maximization, have become increasingly popular.[110] Perhaps the most salient indicator of multiple stakeholder capitalism is the corporate movement toward incorporating environmental, social, and governance (ESG) factors into the decisionmaking process, a trend that altered the corporate fabric from the boardroom to Capitol Hill.[111]

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107 There is a deep academic literature on this subject. *See, e.g.*, Jill E. Fisch & Steven D. Solomon, *Should Corporations Have a Purpose?*, 99 TEX. L. REV. 1309 (2020); Dorothy S. Lund, *Corporate Finance for Social Good*, 121 COLUM. L. REV. 1617 (2021).

108 *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'*, BUS. ROUNDTABLE (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans [https://perma.cc/D5G3-PRTR].

109 Colin Mayer, Leo E. Strine & Jaap Winter, *50 Years Later, Milton Friedman's Shareholder Doctrine is Dead,* FORTUNE (Sept. 13, 2020, 5:00 AM), https://fortune.com/2020/09/13/milton-friedman-anniversary-business-purpose [https://perma.cc/7YHK-PXL6].

110 Christopher Marquis, *Public Benefit Corporations Flourish in the Public Markets*, FORBES (June 14, 2021), https://www.forbes.com/sites/christophermarquis/2021/06/14/public-benefit-corporations-flourish-in-the-public-markets/. . .sh=fb158c5233d4 [https://perma.cc/WH4N-VHVC].

111 Tara Giunta et al., *ESG Disclosure Gains Momentum as Bill Passes House of Representatives*, PAUL HASTINGS (June 21, 2021), https://www.paulhastings.com/insights/international-regulatory-

The multiple principals issue also exists elsewhere within the bankruptcy context. In 1991, the Delaware Chancery Court held in *Credit Lyonnais* that directors of companies in the "vicinity of insolvency" owe duties to creditors as well as shareholders.[112] The economic rationale behind *Credit Lyonnais* duties is similar to the rationale behind the existence of creditors' committees: as a firm approaches and enters into insolvency, creditors rather than equityholders become the residual claimants to firm value and their preferences, therefore, are better aligned with firm value maximization.[113] Although the Delaware Supreme Court walked back *Credit Lyonnais* in *Gheewalla*, a later decision holding that directors only owe derivative duties to creditors when the firm is actually insolvent, the multiple principals issue still exists for directors of insolvent firms and some jurisdictions outside Delaware have more expansive about the "zone of insolvency."[114]

Official Committees are not the same as corporate boards, however. Shareholders are still central to the optimization problems of directors and officers serving for-profit corporations. While corporate objectives may now be subject to a number of internal constraints—e.g., commitments to pay a living wage or reduce carbon emissions by a certain percentage per year—shareholder wealth maximization is still central to the equation.[115] After all, corporate boards in

enforcement/esg-disclosure-gaining-momentum-as-bill-passes-the-house-of-representatives [https://perma.cc/ZLQ3-S3YA].

112 Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. No. 12150, 1991 WL 277613, at *34 (Del. Ch. 1991).

113 *See* Alchian & Demsetz, *supra* note 87.

114 N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007). *See also* Joan MacLeod Heminway, *Shareholder Wealth Maximization as a Function of Statutes, Decisional Law, and Organic Documents*, 74 WASH. & LEE L. REV. 939, 954 (2017).

115 Larry Fink, *Larry Fink's 2022 Letter to CEOs: The Power of Capitalism*, BLACKROCK (Jan. 17, 2022) https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter [https://perma.cc/NXQ3-CBEB] ("It is through effective stakeholder capitalism that capital is efficiently allocated, companies achieve durable

the United States are still elected by shareholders. For the Official Committee, however, there is no default principal other than the general unsecured creditor. To the extent that no representative general unsecured creditor exists, there is a vacuum in place of a singular objective such as profit maximization. One could adopt a majority rule by claim amount, in which case the median Official Committee would seek to maximize bondholder wealth according to the statistics in Section II.D. The drafters of the Code explicitly rejected Official Committee selection by vote, however.[116] The representative unsecured creditor could also be the average trade creditor, which would at least be consistent with the recent history of its membership. Trade creditors make up less than 30% of unsecured debt in the median case (less than 17% in cases with unsecured financial debt),[117] however, and are motivated by factors external to their unsecured claims.

The choice set of the Official Committee is also significantly smaller than that of corporate officials. Except in situations involving the merger or acquisition of an entire business, corporate managers are faced with a continuum of strategic and financial decisions. If a corporation pursues a decision that favors one constituency over another, such as building a new oil well that is expected to be profitable, it can balance out this conflict by making another decision, such as purchasing carbon offsets. Official Committees, on the other hand, are often faced with a small number of binary choices, e.g., whether to pursue a fraudulent conveyance claim against a private equity sponsor. The Official Committee will either pursue or not pursue litigation, and unsecured creditors who are unsatisfied with the decision may not have other avenues to pursue. When options are limited, it is harder to compromise in a way that satisfies multiple principals with conflicting objectives.

profitability, and value is created and sustained over the long-term. Make no mistake, the fair pursuit of profit is still what animates markets[.]").

116 H.R. REP. NO. 595, 95th Cong., 1st Sess. 104 (1977).

117 *See supra* Table 2.

Fiduciary duties, therefore, are a poor theoretical fit with Official Committees. Unsecured creditors are too diverse and have significantly different preferences over continuation, liquidity, and risk. These differences immediately put Official Committee members, who are not compensated for their service, in an impossible situation whereby any decision they make will violate a duty to some subset of unsecured creditors. Even though the multiple stakeholder model has recently gained traction in everyday corporate governance matters, Official Committees differ from boards of directors in the sense that there is no principled constituent that represents the baseline stakeholder among various types of unsecured creditors, and the limited number of choices Official Committee members can make often renders an all-or-nothing solution that satisfies one group at the expense of another.

C. Official vs. Ad Hoc Committees

Official Committees are not the only committees that are part of bankruptcy proceedings. Any group of claimants, within any class, can form an ad hoc group or committee. It is common for unsecured creditors, even in cases with Official Committees, to form ad hoc groups if enough similarly situated creditors are unsatisfied with representation by the Official Committee. Using data described in Section II.D, I found that ad hoc committees of unsecured creditors form in 50% of all cases and 69% of cases with financial unsecured claims.[118] Of the cases identified with at least one ad hoc committee of unsecured creditors, 84% included a noteholders' committee. In this subsection, I describe the powers and privileges of Official Committees relative to these ad hoc committees of unsecured creditors.

[118] To carry out this analysis, I ran docket keyword searches for all entries containing the terms "committee," "group," or "ad hoc." I then categorized entries by hand, excluding all official committees (of unsecured creditors or otherwise) and committees consisting of equityholders and secured lenders or first lien holders. I only classified a committee as an ad hoc unsecured creditor committee if I could identify the nature of the claims of its participants. In four instances, I classified junior lien holders' committees as ad hoc unsecured creditors' committees.

To the extent that it can be beneficial both to general unsecured creditors and credit markets for sophisticated investors to challenge pre-bankruptcy transactions that are detrimental to the debtor's estate, it is important for those investors to be able to bring actions in the first place. It is not an easy task to pursue avoidance litigation in bankruptcy, which typically unfolds through adversary proceedings. As discussed below, a creditor must first establish derivative standing. Litigation to undo transactions of the type that have been recently pursued by private equity firms often involves fraudulent transfer law,[119] which is "especially complex, because the trustee can proceed under the federal Bankruptcy Code or under state law."[120] For a creditor to prevail on a fraudulent transfer claim, she must show that: (1) the transferor had fraudulent intent, or (2) the transfer was for less than reasonably equivalent value and the debtor either (a) would have been left with unreasonably small capital or (b) intended to incur debts beyond its ability to pay.[121] The legal doctrine in this area is "thorny and fact-intensive."[122] Creditors may also assert claims for breach of fiduciary duties, although this tool has been blunted following *Gheewalla*, at least in Delaware.[123] Broadly speaking, it takes experience and time to pursue avoidance litigation in bankruptcy, and sophisticated creditors are more likely than unsophisticated creditors to possess this experience and even commence

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119 *See* Dick, *supra* note 68, at 1371; *see also* Buccola, *supra* note **Error! Bookmark not defined.**, at 7.

120 David Burns, *5 Common Types of Adversary Proceedings*, DAVE BURNS L. OFF., LLC (Aug. 1, 2019), https://www.daveburnslaw.com/bankruptcy/2019/08/01/adversary-proceedings-in-bankruptcy-cases/ [https://perma.cc/TZQ7-LBR9].

121 UNIF. FRAUDULENT TRANSFER ACT § 4(a) (UNIF. L. COMM'N 1984). As of 2020, twenty-one states had adopted the revised Uniform Voidable Transactions Act, which has broadly similar language to the Uniform Fraudulent Transfer Act. Mark G. Douglas, *Uniform Voidable Transactions Act Adopted in New York*, JONES DAY INSIGHTS (Apr. 2020), https://www.jonesday.com/en/insights/2020/04/uniform-voidable-transactions-act-adopted-in-new-y [https://perma.cc/3JXF-BARJ].

122 Dick, *supra* note 68, at 1371.

123 *See supra* Section III.B; *see also* Ellias & Stark, *supra* note 2, at 760.

investigations into possible causes of action before the bankruptcy has even begun.

Although the Code does not contain any explicit provisions relating to the derivative standing of creditors, most bankruptcy courts grant creditors standing in certain circumstances.[124] This standing is often referred to as "STN standing"[125] after *STN Enterprises*,[126] a case in which the Second Circuit inferred derivative standing from provisions in the Code relating to the rights of Official Committees to be "heard on any issue"[127] and perform services "as are in the interest of those represented."[128] Although a court need not "undertake a mini-trial"[129] to confer standing to a group of creditors, "a requirement for some kind of merits inquiry necessarily must be implied, as it is impossible to determine whether a litigation is in the best interest of an estate without at least some consideration of the possibilities of success."[130] Usually, courts grant approval to bring derivative actions to the Official Committee, rather than to ad hoc committees or individual creditors.[131]

The Code also confers other privileges to the Official Committee that are not necessarily enjoyed by ad hoc committees. The Official Committee is tasked with providing information to other unsecured creditors and investigating

124 Doron P. Kenter, *Still Standing After All This Time: STN Enterprises Affords Derivative Standing to Creditors' Committees to Bring Actions on Behalf of the Estate*, WEIL RESTRUCTURING BLOG (Feb. 23, 2012), https://restructuring.weil.com/throwback-thursday/still-standing-after-all-this-time-stn-enterprises-affords-derivative-standing-to-creditors-committees-to-bring-actions-on-behalf-of-the-estate/ [https://perma.cc/V2XB-RHT5].

125 *See, e.g.,* Adelphia Commc'n Corp., 371 B.R. 660, 668 (Bankr. S.D.N.Y. 2007).

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

127 11 U.S.C. § 1109(a).

128 *Id.* § 1103(c)(5).

129 *In re* STN Enters., 779 F.2d at 905.

130 *In re* Adelphia Commc'n Corp., 330 B.R. 364, 376 (Bankr. S.D.N.Y. 2005).

131 *See, e.g.*, Kenter, *supra* note 124.

the debtor, implying access to confidential information.[132] The Official Committee also has a right to counsel whose fees are paid for by the estate.[133] Ad hoc committees may also petition the court for payment of counsel fees, but they must show that they were incurred in connection with a "substantial contribution" to the case.[134] Similarly, Official Committees are entitled to payment of their expenses out of the assets of the estate.[135] It is typical for the court, when requested, to carve out funds for the Official Committee to finance investigations into potential causes of action.[136] To the extent that these funds are carved out of assets pledged as collateral, ad hoc committees face an uphill battle in convincing the court to let them pursue the same sorts of investigations.

Because judges have significant discretion over the distribution of rights and privileges between official and ad hoc committees, it is difficult to pin down the precise power differential between the two groups. Some judges may defer to ad hoc committees, especially if they control nearly all of the general unsecured class by claim amount. In other cases, the inability of unsecured creditors to serve on the Official Committee results in their complete disenfranchisement. For example, in *Longview Power*, the ad hoc committee alleged that "each attempt [at formation] has been frustrated as certain unsecured creditors otherwise prepared to serve on the Creditors' Committee have been paid in full pursuant to earlier orders authorizing payment of prepetition claims . . . As a result . . . unsecured creditors have had no seat at the table."[137]

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132 *See supra* Section II.B.

133 U.S. DEP'T OF JUST., CIVIL RESOURCE MANUAL § 48 (1996).

134 11 U.S.C. § 503(b)(3)(D).

135 *Id.* § 503(b)(3)(F).

136 *See, e.g.*, Athanas et al., *supra* note 1, at 93–94.

137 Objection of the Ad Hoc Group of Unsecured Creditors to the Debtor's Disclosure Statement at 2, *In re* Longview Power, LLC, et al., No. 13-BK-12211 (Bankr. D. Del. Dec. 11, 2013), ECF No. 574.

IV. EVALUATING SOLUTIONS

A. Multiple Official Committees

In order to make sure that unsecured creditors that are experienced in adversary litigation are not deterred from Official Committee membership, courts should allow parties to form multiple Official Committees. Section 1102 of the Code calls upon the U.S. Trustee to "appoint a committee of creditors holding unsecured claims and *may appoint additional committees of creditors* or of equity security holders as [it] deems appropriate."[138] The statute explicitly recognizes that the U.S. Trustee may form official committees of equityholders but does not limit additional committees of creditors to secured creditors, indicating that the drafters contemplated multiple Official Committees of unsecured creditors. As discussed below, there is precedent for forming multiple Official Committees in Chapter 11 cases.

The Code does not state that represented claimants under Section 1102 must be general unsecured creditors, only that Official Committee members are accountable to creditors who "hold claims of the kind represented by that committee."[139] This means that the U.S. Trustee can create multiple classes of unsecured creditors, at least for coalitional purposes, and that each Official Committee would only owe a fiduciary duty to their representees. In theory, unsecured creditors would be represented by the Official Committee most aligned with their own preferences over continuation, liquidity, and risk. In practice, the U.S. Trustee would have to divide represented creditors along observable lines such as claim type, e.g., noteholders versus all other unsecured creditors. This is not functionally that different from the dual system of ad hoc noteholders' committees and Official Committees that exists

[138] 11 U.S.C. § 1102(a)(1) (emphasis added). 11 U.S.C. § 1102(a)(4) describes circumstances under which the U.S. Trustee can alter Official Committee membership but does not detract from the statutory language of 11 U.S.C. § 1102(a)(1).

[139] *Id.* § 1102(b)(3)(A)(1).

today, except that members of an Official Noteholders' Committee would owe fiduciary duties to all noteholders. This would also facilitate "Chinese Wall" agreements that allow hedge funds to trade, subject to disclosure and conflict of interest limitations, while serving on the Official Committee.[140]

Having multiple Official Committees could solve several problems. First, because their incentives would be more closely aligned with those of other noteholders, sophisticated investors would be less likely to shy away from membership. In turn, hedge funds on the Official Noteholders' Committee (or its equivalent) would monitor each other's behavior, reducing the threat of fiduciary breach. In addition, when unsecured creditors are in the money with respect to both existing firm assets and significant litigation rights, Official Committees could separately specialize in governance and avoidance actions. Finally, there would be less of an opportunity for counsel capture because there would be two sets of Official Committee counsels. Of course, this system runs the risk of conflict between the two Official Committees, but this conflict already exists between Official Committees and ad hoc unsecured creditors' committees. With multiple Official Committees, rather than letting the Code and the deterrent effects of fiduciary duties arbitrarily enfranchise one committee and not the other, judges could decide for themselves based on residual claimant status and the merits of the actions sought by each group.

This solution could also have other applied benefits such as drawing unsecured creditors into pre-bankruptcy negotiations. Since 2010, approximately half of all large bankruptcies have involved a restructuring support

140 *See, e.g.*, Matt Porcelli, *Bankrupting the Inside Job: Alternatives to the Washington Mutual Approach to Policing Creditor Committee Insider Trading*, 9 N.Y.U. J.L. & BUS. 295, 306 (2012); *see also* Thomas C. Pearson, *When Hedge Funds Betray a Creditor Committee's Fiduciary Role: New Twists on Insider Trading in the International Financial Markets*, 28 REV. BANKING & FIN. L. 165, 188–89 (2008).

agreement (RSA), most of which are executed pre-petition.[141] RSAs almost never involve parties other than the debtor, secured lenders, bondholders, and private equity firms.[142] Knowing that they will have leverage on an Official Committee during bankruptcy, hedge funds involved in pre-bankruptcy negotiations will have more leverage to bargain on behalf of unsecured creditors. This same knowledge might also encourage RSA parties to include noteholders in pre-bankruptcy negotiations, since noteholders will have significant blocking positions once the bankruptcy commences. Relatedly, noteholders would be less willing to sign off on releasing other parties from liability, anticipating that the expected value of those releases are higher if they can pursue litigation as members of an Official Committee.[143]

One of the primary obstacles to the formation of multiple Official Committees is a decision from the Bankruptcy Court for the Southern District of New York in *Enron*.[144] In that case, ad hoc committees of energy merchants as well as subsidiary noteholders were separately concerned about their abilities to pursue claims against Enron and sought status as independent Official Committees, apart from the one already appointed, with duties solely to their classes of claims.[145] Judge Gonzales denied their motions for separate Official

[141] Anthony J. Casey, Frederick Tung & Katherine P. Waldock, Restructuring Support Agreements: An Empirical Analysis (Jan. 2022) (unpublished manuscript) (on file with the Columbia Business Law Review).

[142] *Id.* at 13. The share of RSAs involving bondholders has fallen in the past several years.

[143] Non-consensual third-party releases in bankruptcy are highly controversial and have recently attracted Congressional attention. *See, e.g.,* Michael J. Cohen, Michael A. Rosenthal & Matthew J. Williams, *Congressional Committees Propose Changes to Bankruptcy Code Prohibiting Non-Consensual Releases of Third Parties and Limiting Other Important Bankruptcy Tools*, GIBSON DUNN (Aug. 2, 2021), https://www.gibsondunn.com/congressional-committees-propose-changes-to-bankruptcy-code-prohibiting-non-consensual-releases-of-third-parties-and-limiting-other-important-bankruptcy-tools [https://perma.cc/6HJK-U7EM].

[144] *In re* Enron Corp., 279 B.R. 671 (Bankr. S.D.N.Y. June 21, 2002).

[145] *Id.* at 692–93.

Committee status, stating that neither group had "met their burden of proving that the Creditors' Committee cannot adequately represent them and express their views."[146] As evidence for adequate representation, Judge Gonzalez cited the existence of competent counsel for both ad hoc committees and the fact that "their voices have been heard and have provided an impetus to several actions taken in these cases."[147] He noted that both types of creditors had multiple representatives on the Official Committee.[148]

If anything, *Enron* reinforces, rather than undermines, the argument for multiple Official Committees. It simply puts structure on a test for appointment: lack of adequate representation on the Official Committee.[149] If a group of unsecured creditors wishing to avoid a fraudulent conveyance in a bankruptcy case with virtually no other unencumbered assets were to approach a judge today and request separate Official Committee status because the existing one was not willing to pursue action, and none of the claims that those creditors held were represented on the Official Committee, they would have a strong case for misrepresentation under *Enron*. As further support, bankruptcy cases before and after *Enron* have included multiple Official Committees, although they are admittedly rare.[150]

Nor does this Note suggest that *Enron* should have come out any differently. Both ad hoc committees wanted to pursue litigation claims against the debtor, both had representatives on the Official Committee, and the Official Committee was in the process of taking action. Sometimes, small groups of

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146 *Id.* at 694.

147 *Id.* at 693.

148 *Id.*

149 An earlier case, *Public Service Company of NH*, had established the adequate representation test. *In re* Pub. Serv. Co., 89 B.R. 1014 (Bankr. D.N.H. 1988).

150 *See, e.g.*, *In re* Family Health Servs., Inc., 101 B.R. 618, 619 (Bankr. C.D. Cal. 1989) (featuring a Bondholders Committee); *see also In re* PG&E Corp., 603 B.R. 471 (Bankr. N.D.Cal. 2019) (featuring both an Official Committee of Tort Creditors as well as a general Official Committee of Unsecured Creditors).

creditors seek derivative standing to pursue litigation on their own, which undermines the best interests of the estate if other creditors are also willing and able to pursue those claims. The solution proposed herein simply urges courts to be open to multiple Official Committee formation when one group of unsecured creditors with minimal or no representation on the Official Committee wishes to pursue potentially valuable rights of action and it is prevented from doing so by the opposition of other unsecured creditors. At the end of the day, judges should have discretion, just as they have discretion over granting standing, approving settlements, and disbanding Official Committees that overreach or face insurmountable conflicts.[151] This opens up possibilities not only for the litigation-related scenarios described in this paper, but other circumstances in which there are sharp differences between major constituencies of unsecured creditors, such as in mass torts bankruptcies.

B. The Continued Need for Fiduciary Duties

A tempting policy solution is to eliminate the fiduciary duty owed by Official Committee members altogether. As discussed in Section III.B, the divergent interests of unsecured creditors make it nearly impossible to honor the fiduciary duty in certain situations. Because of this, the case law and norms around the Official Committee's fiduciary duties have become muddled and members are entitled to immunity for acting out of self-interest in a number of situations.[152] Especially where certain specialized unsecured creditors can be valuable as members of the Official Committee, fiduciary duties that deter membership can be harmful to general unsecured creditors and even broader credit markets. As noted by Professor Bussel, "[t]he fiduciary shoe cobbled by Justice Douglas for the old-style protective

[151] Norman N. Kinel & Philip J. Gross, *Does a Bankruptcy Court Have the Authority to Disband an Official Committee?*, 253 N.Y.L.J., no. 105, 2015, at 1.

[152] *See* Klee & Shaffer, *supra* note 27, at 1054–56.

committee simply does not fit our newfangled statutory committee."[153]

Despite arguments against the imposition of a fiduciary duty on Official Committee members, however, it is the primary mechanism that prevents creditors from taking advantage of their positions to benefit themselves at the expense of other unsecured creditors. Whether or not courts curtail the privileges of Official Committees in response to their present roles as litigants, their members still have rights to confidential information and privileged positions at the bargaining table. Hedge funds in particular, while valuable sources of expertise, may use Official Committee membership opportunistically. Hedge fund managers themselves owe fiduciary duties to their funds.[154] They exist in a competitive environment, relying on observable success to build their reputations and support future rounds of financing.[155]

One way that hedge funds may disrupt a fair bankruptcy process is by engaging in "outsider" trading, i.e., opportunistic trading by non-insiders with access to privileged information.[156] Because of fiduciary obligations and the confidential status of the information they receive, Official Committee members become constructive insiders and therefore adopt the same disclose-or-abstain duties owed by traditional corporate insiders.[157] Although the duty to refrain from trading is made explicit by the U.S. Trustee during the Official Committee formation process, fiduciary duties serve as an additional deterrent to investors looking to purchase unsecured claims in order to gain a seat on the Official Committee and use

153 Bussel, *supra* note 24, at 1565.

154 *See, e.g.*, ZACHARY G. NEWMAN & JONATHAN M. PROMAN, I'VE BEEN SUED FOR WHAT?—FIDUCIARY DUTY CLAIMS AGAINST HEDGE FUND MANAGERS AND HOW TO AVOID THEM (2013).

155 C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296, 296–97 (2016).

156 For articles specifically on insider trading and Official Committees in bankruptcy, *see supra* note 140.

157 Porcelli, *supra* note 140, at 305–06.

confidential information to trade in other portions of the capital structure.[158]

Hedge funds can also use their positions on the Official Committee to promote plan distributions that benefit other classes in which they hold claims. For example, an undersecured lender with an unsecured deficiency claim[159] may view Official Committee membership as an opportunity to persuade unsecured creditors that the debtor's true valuation is low, thereby putting most of the new equity under the plan in the hands of secured lenders. Although it is acceptable for members of a class to vote in a way that primarily benefits a different class, the fiduciary duty bars Official Committee members from advancing the interests of other classes in which they are cross-holders to the extent that they conflict with the interests of general unsecured creditors.[160] Still, this sort of behavior was perceived as a threat in the early days of the Code.[161] Since then, Congress passed Federal Rules of Bankruptcy Procedure Section 2019(b)(1), which requires Official Committee members to disclose all "disclosable economic interests,"[162] including those that could be affected by the outcome of the bankruptcy.[163] In addition, the U.S.

[158] Creditors wishing to serve as fiduciaries on any official committee are advised that they may not purchase, sell or otherwise trade in or transfer claims against the Debtor while they are committee members absent an order of the Court. "By submitting the enclosed Questionnaire and accepting membership on an official committee of creditors, you agree to this prohibition." *See* Off. of the U.S. Tr., *Questionnaire for Official Committee of Unsecured Creditors*, U.S. DEP'T OF JUST. https://www.justice.gov/ust-regions-r04/file/ch11_credcomsoli_greenbelt.pdf/download [https://perma.cc/MYL5-KX3L].

[159] According to the Code, an undersecured claim is bifurcated into a secured claim up to the amount of the available collateral and an unsecured deficiency claim for the residual. *See* 11 U.S.C. § 506(a)(1).

[160] *See In re* Figter Ltd., 118 F.3d 635 (9th Cir. 1997).

[161] *See, e.g.*, *In re* Johns-Manville Corp., 26 B.R. 919, 925 (Bankr. S.D.N.Y. 1983).

[162] *See* FED. R. BANKR. P. 2019(a)(1).

[163] *See* FED. R. BANKR. P. 2019(b)(1).

Trustee requires periodic certification of claims[164] and typically refrains from appointing creditors with significant conflicts of interest arising from cross-holdings.

As exemplified by the case of Mr. Kamensky, described in the Introduction, bankruptcy parties can also interfere with the restructuring process by limiting participation in auctions to which they are current or prospective bidders.[165] In his case, even though the court had not yet set up a formal auction for the cash backstop offer, Mr. Kamensky made clear to a rival investment bank that he did not want them to offer unsecured creditors more cash per share (essentially precluding a higher bid than his).[166] As general unsecured creditors increasingly receive Chapter 11 plan distributions in the form of litigation rights, this problem will continue to worsen, especially if smaller investors are willing to cash out at steep discounts due to liquidity constraints.[167]

Even though this Note has assumed, so far, that hedge funds will pursue litigation more aggressively than other unsecured creditors, this may not always be the case. Repeated interactions are valuable to financial market participants, and a hedge fund that frequently does business with a private equity firm—for example, as a participant in a syndicate of non-bank lenders financing an LBO—may not find it in its long-term best interests to sue that firm even if the lawsuit would maximize the fund's bankruptcy-specific

164 *See* Off. of the U.S. Tr., *Official Committee of Unsecured Creditors Information Sheet*, U.S. DEP'T OF JUST. https://www.justice.gov/ust-regions-r08/file/ch11creditor_information_sheet.pdf/download [https://perma.cc/W6N2-4KZN].

165 *See supra* Part I.

166 Sealed Complaint, U.S. v. Daniel Kamensky, No. 21-CR-00067, at 1–2 (S.D.N.Y. Feb. 3, 2021), ECF No. 1.

167 Another example of a one-sided cash backstop offer was in the bankruptcy of Century 21. In that case, unsecured creditors received litigation claims relating to how much insurers would have to pay to the estate and, in order to convert them into liquid claims, sold them to Century 21's owners without an auction. *In re* Cortlandt Liquidating LLC, No. 20-BK-12097, BL Docket No. 324 (Bankr. S.D.N.Y. Sept. 10, 2020).

claims.[168] Fiduciary duties, therefore, prevent hedge funds in such position from taking advantage of Official Committee membership to *block* otherwise valuable litigation against private equity sponsors.

If the Official Committee's fiduciary duties remain in place, there should at least be clearer standards for evaluating a fiduciary breach. For example, if an Official Committee member expends effort pursuing two different types of recoveries, one of which benefits unsecured creditors by $20 million and one of which harms unsecured creditors by $10 million, has she breached her fiduciary duty? What if both outcomes are still uncertain? Courts have shown willingness to provide immunity to Official Committee members in certain situations,[169] suggesting that they may also be willing to take a cost-benefit approach and assess contributions to the Official Committee on net. Relatedly, when evaluating a potential fiduciary breach, courts could attempt to estimate the marginal contribution of an Official Committee member to the general unsecured class relative to the net benefit derived by that member from serving on the Official Committee. If both the former is positive and the latter is zero, this would be a case against finding fiduciary breach.[170] Official Committee members would not be deterred, therefore, from engaging in certain costly activities because they would be assured that attempts to break even would not constitute violations of their fiduciary duties.

168 *See, e.g.*, Victoria Ivashina & Anna Kovner, *The Private Equity Advantage: Leveraged Buyout Firms and Relationship Banking*, 24 REV. FIN. STUDIES 2462, 2495 (2011).

169 *See* Klee & Shaffer, *supra* note 27, at 1054–55.

170 For example, consider an Official Committee member who is the sole champion of a breach-of-duties suit against former directors. This litigation ends up generating a recovery of $10 million for the class of unsecured creditors. The Official Committee member promoting the suit incurred personal expenses of $1 million associated with the litigation but recouped this expense by positioning itself as the sole cash backstop offeror to unsecured creditors with a liquidation preference. In this situation, the Official Committee member will have benefitted unsecured creditors by $10 million but will have personally benefitted, above and beyond recoveries on unsecured claims she already owned, by $0.

V. CONCLUSION

Recently, many large Chapter 11 debtors have entered bankruptcy in possession of almost no assets that could be of value to unsecured creditors, since all of the firm's assets had already been pledged to secured lenders. At the same time, private equity sponsors have engaged in aggressive pre-bankruptcy transactions that have left debtors with even fewer assets. In situations like these, the only substantial recourse for unsecured creditors is to use litigation, often against those same private equity sponsors, in the hopes of freeing up sources of value by undoing some of the transactions that took place prior to filing. This position, as a litigant, is not compatible, however, with the standard functions of the Official Committee. If its primary role is to pursue fraudulent transfer or breach-of-duty actions, the Official Committee would be better staffed with litigation experts than governance providers. Using data from recent cases, I show that hedge funds are disproportionately underrepresented on Official Committees. I argue that in today's environment, fiduciary duties to a diverse group of unsecured creditors do not make sense and could deter hedge funds and other professionals from providing value to Official Committees through their litigation expertise.

One solution is to encourage courts to allow the formation of multiple Official Committees focused separately on litigation and traditional governance roles. Based on the rough positions of unsecured creditors in the capital structure, which experienced judges can estimate, the court can apportion rights across these Official Committees. Importantly, each group would only owe fiduciary duties to unsecured creditors with similar claims and, as a result, hedge funds would not be deterred from participation. Relative to the current system of coexisting Official and ad hoc committees, this proposal removes arbitrary constraints on the participation of hedge funds as unsecured creditors while preserving certain protections of fiduciary duties. Viewed as an ex-post solution to coercive liability management transactions, this system may confer positive spillovers on credit markets by deterring bad behavior by private equity firms. This should not be the only deterrent, however. Researchers should continue to investigate what else can be done to prevent abusive drop down and uptier transactions and understand why lenders have been slow to adjust contractual terms to protect themselves.