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The “Restructuring Director”: A Critique and Response

Samuel S. Kohn, Moderator
Dorsey & Whitney LLP

John Castellano
AlixPartners, LLP

Michael J. Epstein
Deloitte Transactions and Business Analytics LLP

William H. Henrich
Getzler Henrich & Associates LLC

Jeremy Matican
Jefferies

Hon. Jil Mazer-Marino
U.S. Bankruptcy Court (E.D.N.Y.)

Oscar N. Pinkas
Greenberg Traurig, LLP

Jennifer L. Rodburg
Fried, Frank, Harris, Shriver & Jacobson LLP

CONCURRENT SESSION

2023

The Restructuring Director: A Critique and Response

Panel 1

Hon. Jil Mazer-Marino

John Castellano

William H. Henrich

Jennifer L. Rodburg

Moderator: Samuel S. Kohn

The Restructuring Director: A Critique and Response

Panel 2

Hon. Jil Mazer-Marino

Michael Epstein

Jeffrey Finger

Oscar Pinkas

Moderator: Samuel S. Kohn

Today’s Topics

I. Purpose of an Independent/Restructuring Director in Distressed Situations and Restructurings

II. Fiduciary Duties of an Independent Director

III. Vignettes and Discussion

IV. Questions

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Vignette 1

Directors of the selling company, Seller Inc., approved a leveraged buyout that caused a substantial increase of debt for the resulting company of the transactions, Troubled Holdings. The purchaser connected to the LBO, Private Equity, became a majority equity holder of Troubled Holdings. Several years later, Troubled Holdings was experiencing significant financial issues and its five-member board, at the suggestion of Private Equity, one of the board members, appointed two independent directors, Hall and Oates, who had extensive experience in restructuring to investigate claims relating to the LBO and to assess potential restructuring alternatives. The board considered two other candidates suggested by Troubled Holdings' GC. Hall practiced as a restructuring partner in a major law firm for three decades. Oates was a financial advisor that had advised Private Equity in two prior workout transactions. Hall and Oates retained their own professionals who do not represent the other board members in any way. They reviewed over 120,000 documents relating to the LBO and the corporate structure for their investigation.

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Vignette 1 (con't)

Less than a year later, Troubled Holdings filed for a Chapter 11. Six months into the Chapter 11, Hall and Oates, who had exclusive authority to approve settlements relating to the Chapter 11, ultimately approved a settlement relating to their LBO investigation whereby the defendants, which include the directors and officers of Seller Inc. and Private Equity, would provide $105 million to be paid to Troubled Holdings for distribution to its creditors in exchange for a release from any litigation involving the LBO transaction, which was part of the chapter 11 plan proposed in the bankruptcy case. The UCC determined that the claims against the defendants may be worth $650 million but needed more time to investigate. It also raised concerns about the independence of Hall and Oates, particularly about their possible bias for Private Equity. Troubled Holdings, on the other hand, had aggressive milestones set by their DIP lender that couldn't allow for the time the UCC would need to thoroughly investigate and bring possible claims beyond a 120-day period after filing.

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Vignette 1 (con't)

The First Day Declaration filed in the Chapter 11 disclosed that (1) Private Equity was both one of the major equity sponsors and an unsecured creditor of the Debtor, and (2) that the Debtor's board appointed Hall and Oates and outlined their extensive restructuring credentials. The Declaration did not provide further details into how Hall and Oates were selected.

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Vignette 2

Little Dog is a wholly-owned subsidiary of Big Dog. A gas explosion in one of Little Dog's refineries occurred and Little Dog now owes billions in environmental liabilities. Plaintiffs asserted veil piercing claims against the parent Big Dog, a multinational oil company, as Little Dog had very little cash and assets. Little Dog's board was comprised of seven members, including one associated with Big Dog, and five of them voted to appoint two independent directors, Bird and Cat, to evaluate historical transactions, corporate interrelationships and course of dealings for a potential settlement between Big Dog and Little Dog. Big Dog, who did not suggest Bird or Cat as nominees for independent directors, voted for their appointment. Bird and Cat hired their own counsel, Vogel LLP, which is Bird's former law firm for decades, and financial advisors to accomplish this task. Vogel LLP subsequently became lead debtor's counsel for Little Dog's Chapter 11.

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Vignette 2 (con't)

In its first day filing, Little Dog announced that it was seeking approval of the settlement with Big Dog for $200 million against billions of dollars in claims. The unsecured claims consisted of billions in environmental liability to governmental agencies and other claimants. The UCC objected to the retention of Debtor's lead counsel on disinterestedness grounds and raised the issue of Bird's relationship with Vogel LLP. It questioned how and when Vogel LLP transitioned from representing Bird and Cat, which negotiated the settlement between Big Dog and Little Dog that forms part of the plan, to representing Little Dog, citing the lack of documentation that Bird and Cat actually controlled major decisions for the Chapter 11.

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Vignette 2 (con't)

In addressing the objection, Vogel LLP stated that the bylaws of Little Dog would be amended to provide that Bird and Cat would (1) have exclusive authority over any claims, transactions, litigations, disputes, arrangements or other matters among Big Dog and Little Dog, including the settlement agreement; and (2) become the sole arbiters of any matter deemed a conflict matter involving the Debtor, Big Dog, and nondebtor affiliates. Before this, Bird and Cat did not have such authority.

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Vignette 3

Family-owned Simpsons, a company in the food industry, was hit with a mass tort lawsuit consisting of thousands of plaintiffs for a defective baby formula product. Many of the plaintiffs sustained significant injuries and some resulted in death of their infants. Within its board of directors, Simpsons assembled and appointed a special committee comprised of three seasoned restructuring and food industry professionals without any prior connection to the owners. The special committee directed Simpsons to file a Chapter 11 after reaching an agreement with the family owners, the Flanders, who will contribute $4 billion into a fund for the mass tort litigation in exchange for releases for the Flanders family against the mass tort litigation.

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Vignette 3 (con't)

The first day motions and declaration did not explain how the special committee was selected and appointed. The filed disclosure statement provided that the special committee had exclusive authority over settlements and any causes of action Simpsons may assert against the Flanders family and shareholders, but did not specify if this authority existed at the time the settlement with the Flanders family was negotiated and approved. A tort plaintiff sought an appointment of an examiner to investigate the independence of the special committee, voicing concerns about the influence of the Flanders family on the special committee' decision to settle and grant releases to them on behalf of Simpsons.


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Questions?

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Law Working Paper N°593/2021
February 2022

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ECGI Working Paper Series in Law

The Rise of Bankruptcy Directors

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Abstract

In this Article, we use hand-collected data to shed light on a troubling development in bankruptcy practice. We show that distressed companies, especially those controlled by private-equity sponsors, often now prepare for a Chapter 11 filing by appointing bankruptcy experts to their boards of directors and giving them the board's power to make key bankruptcy decisions. These directors often seek to wrest control of self-dealing claims against shareholders from creditors. We call these directors "bankruptcy directors" and conduct the first empirical study of their rise as key players in corporate bankruptcies. While these directors claim to be neutral experts that act to maximize value for the benefit of creditors, we argue that they suffer from a structural bias because they often receive their appointment from a small community of repeat private-equity sponsors and law firms. Securing future directorships may require pleasing this clientele at the expense of creditors. Indeed, we find that unsecured creditors recover on average 20% less when the company appoints a bankruptcy director. While other explanations are possible, this finding shifts the burden of proof to those claiming that bankruptcy directors improve the governance of distressed companies. Our policy recommendation, however, does not require a resolution of this controversy: we propose that the court regard bankruptcy directors as independent only if an overwhelming majority of creditors whose claims are at risk supports their appointment, making them accountable to all sides of the bankruptcy dispute.

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

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Jared A. Ellias*
Professor of Law and Bion M. Gregory Chair in Business Law
University of California, Hastings College of Law
200 McAllister Street
San Francisco, CA 94102, United States
phone: + (415) 581 8815
e-mail: elliasjared@uchastings.edu

Ehud Kamar
Professor of Law
Tel Aviv University, The Buchmann Faculty of Law
Ramat Aviv
Tel Aviv 6997801, Israel
phone: +972 3640 7301
e-mail: kamar@tau.ac.il

Kobi Kastiel
Assistant Professor of Law
Tel Aviv University, The Buchmann Faculty of Law
Ramat Aviv
Tel Aviv 6997801, Israel
phone:
e-mail: kastiel@tauex.tau.ac.il

* Corresponding Author

The Rise of Bankruptcy Directors

Jared A. Ellias,[*] Ehud Kamar,[**] and Kobi Kastiel[***]

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In this Article, we use hand-collected data to shed light on a troubling development in bankruptcy practice. We show that distressed companies, especially those controlled by private-equity sponsors, often now prepare for a Chapter 11 filing by appointing bankruptcy experts to their boards of directors and giving them the board's power to make key bankruptcy decisions. These directors often seek to wrest control of self-dealing claims against shareholders from creditors. We call these directors "bankruptcy directors" and conduct the first empirical study of their rise as key players in corporate bankruptcies. While these directors claim to be neutral experts that act to maximize value for the benefit of creditors, we argue that they suffer from a structural bias because they often receive their appointment from a small community of repeat private-equity sponsors and law firms. Securing future directorships may require pleasing this clientele at the expense of creditors. Indeed, we find that unsecured creditors recover on average 20% less when the company appoints a bankruptcy director. While other explanations are possible, this finding shifts the burden of proof to those claiming that bankruptcy directors improve the governance of distressed companies. Our policy recommendation, however, does not require a resolution of this controversy: we propose that the court regard bankruptcy directors as independent only if an overwhelming majority of creditors whose claims are at risk supports their appointment, making them accountable to all sides of the bankruptcy dispute.

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[*] Visiting Professor of Law, Harvard Law School; Bion M. Gregory Chair in Business Law and Professor of Law, University of California, Hastings College of the Law.

[**] Professor of Law, Tel Aviv University, Faculty of Law.

[***] Associate Professor, Tel Aviv University, Faculty of Law; Lecturer on Law, Harvard Law School.

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

To take control of the litigation, the board appointed as new directors two bankruptcy experts who claimed that, because they had no prior ties to Sycamore or Nine West, they were independent and could handle those claims.[3] Once the firm filed for bankruptcy, its creditors objected. They argued that the new directors still favored Sycamore because it stood behind their appointment, and so they would "hamstring any serious inquiry into [its] misconduct."[4] Nevertheless, the gambit was successful. The bankruptcy court allowed the new directors to take control of the litigation.[5] The new directors blocked creditor attempts to file lawsuits on their own[6] and ultimately settled the claims for about $100 million.[7]

The Nine West story illustrates the emergence of important new players in corporate bankruptcies: bankruptcy experts who join boards of directors shortly before or after the

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[1] *See* Notice of Motion of the 2034 Notes Trustee for Entry of an Order Granting Leave, Standing, and Authority to Commence and Prosecute a Certain Claim on Behalf of the NWHI Estate at 15, No. 18–10947, *In re* Nine West Holdings (Bankr. S.D.N.Y. Jan. 1, 2019); Ken Ayotte & Christina Scully, *J. Crew., Nine West and the Complexities of Financial Distress*, YALE L.J.F. 363 (Nov. 10, 2021) (describing some of the transfers in detail). For example, the private-equity sponsor had allegedly purchased the assets of Kurt Geiger for $136 million in April 2014 and sold it in December 2015 for $371 million. *See id.* at 23.

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

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

[4] *See* Nine West Standing Motion, *supra* note 2, at 34 ("[the lawyers for the independent directors] attended … depositions … but asked just a handful of questions of a single witness … [and] chose not to demand and review the Debtors' privileged documents relating to the LBO").

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

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

[7] *See* Nine West Standing Motion, *supra* note 2, at 20 (seeking permission to prosecute claims for "well over $1 billion"); Soma Biswas, *Nine West Settles Potential Lawsuits Against Sycamore Partners*, WALL ST. J. (Oct. 18, 2018) ("Nine West Holdings Inc. unveiled Wednesday an amended restructuring plan that settles potential lawsuits against private-equity owner Sycamore Partners LP for $105 million in cash, far less than the amount the unsecured creditors committee is seeking").

filing of the bankruptcy petition and claim to be independent.[8] The new directors—typically former bankruptcy lawyers, investment bankers, or distressed debt traders—often receive the board's power to make important Chapter 11 decisions or become loud voices in the boardroom shaping the company's bankruptcy strategy.[9] We call them "bankruptcy directors."

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

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

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

[9] *See* Regina Stango Kelbon et al., *Appointment of Independent Directors on the Eve of Bankruptcy: Why The Growing Trend?*, 19TH ANN. BANKR. INST. (Apr. 11, 2014) ("Employing an outside director to exercise independent judgment as to corporate transactions in bankruptcy may not only provide additional guidance to a suffering business, but can make the decision-making process seem right in the eyes of stakeholders and ultimately, the court").

[10] *See* Robert Gayda & Catherine LoTempio, *Independent Director Investigations Can Benefit Creditors*, LAW360 (July 24, 2019) (noting that independent directors are helpful in bankruptcy where "speed to exit is paramount").

[11] *See, e.g., "Independent" Directors under Attack*, PETITION (Dec. 12, 2018); Lisa Abramowicz, *Private Equity Examines Its Distressed Navel*, BLOOMBERG (May 26, 2017), https://www.bloomberg.com/opinion/articles/2017-05-26/payless-shoesource-private-equity-examines-its-distressed-navel; Mark Vandevelde & Sujeet Indap, *Neiman Marcus Director Lambasted by Bankruptcy Judge*, FIN. TIMES (June 1, 2020); American Bankruptcy Institute, *RDW 12 21 2018*, YOUTUBE (Dec. 20, 2018) https://www.youtube.com/watch?v=Ah8RkXYdraI&ab_channel=AmericanBankruptcyInstitute; *The "Weil Bankruptcy Blog Index," CMBS & How Nine West Is the Gift That Keeps on Giving*, PETITION, https://petition.substack.com/p/weilbankruptcyblogindex (last visited Jan. 10, 2021) (calling the Nine West case a "standard episode of 'independent director' nonsense").

[12] *See, e.g.,* Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648 (2010) (considering creditor conflict); Douglas G. Baird and Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 784 (2002); David A. Skeel Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 919 (2003) (considering the role of secured creditors); Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 VAND L. REV. 747 (2011) (considering the role of unsecured creditors). For other articles that, like this Article, criticize recent changes in Chapter 11 practice, see Adam J. Levitin, *Purdue's Poison Pill: The Breakdown of Chapter 11's Checks and Balances*, 100 TEX. L. REV. (forthcoming 2022); Lynn M. LoPucki, *Chapter 11's Descent into Lawlessness*, 96 AM. BANKR. L.J. (forthcoming 2022).

their directors to the bankruptcy court.[13] To our knowledge, it is the largest sample of boards of directors of Chapter 11 firms yet studied.[14]

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

After controlling for firm and bankruptcy characteristics, we find that the recovery rate for unsecured creditors, whose claim is typically most at risk in bankruptcy, is on average 20% lower in the presence of bankruptcy directors. We cannot rule out the possibility that the firms appointing bankruptcy directors are more insolvent and that this explains their negative association with creditor recoveries. Still, this finding at least shifts the burden of proof to those claiming that bankruptcy directors improve the governance of distressed companies to present evidence supporting their view in this emerging debate.

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

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

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

[14] *See* infra note 150 and accompanying text.

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

[16] *See infra* Table 2.

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

of the demand. Bankruptcy directors depend on this clientele for future engagements and may exhibit what we call "auditioning bias."

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

These findings support the claim that bankruptcy directors are a new weapon in the private-equity playbook. In effect, bankruptcy directors assist with shielding self-dealing transactions from judicial intervention. Private-equity sponsors know that if the portfolio firm fails, they could appoint bankruptcy directors to handle creditor claims, file for bankruptcy, and force the creditors to accept a cheap settlement.[20] Importantly, the ease of handling self-dealing claims in the bankruptcy court may fuel more aggressive self-dealing in the future.[21]

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

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

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[18] *See id.*

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

[20] *See infra* note 112 and accompanying text (arguing that independent directors are changing incentives for private-equity sponsors, who are will be "encouraged to asset strip").

[21] As Sujeet Indap and Max Frumes write, "[A leading bankruptcy law firm that advises debtors] developed a reputation for keeping a stable of 'independent' board of director candidates who could parachute in to bless controversial deal making." THE CAESARS PALACE COUP (2021).

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

Some might argue that our solution is impractical or otherwise lacking. We answer these claims. More importantly, our solution is the only way to ensure that bankruptcy directors are truly independent. If it cannot be made to work, bankruptcy law should revert to the way it was before the invention of bankruptcy directors, where federal bankruptcy judges were the only impartial actor in most large Chapter 11 cases. In such a scenario, debtors will be free to hire whomever they want to help them navigate financial distress, but the court will regard these bankruptcy directors as ordinary professionals retained by the debtor: it should weigh their position against the creditors', allow the creditors to conduct their own investigation and sue over the bankruptcy directors' objection, and not approve settlements merely because the bankruptcy directors endorse them.

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

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

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

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[22] *See* Alexander Saeedy, *Elizabeth Warren Floats Expanded Powers for Bankruptcy Creditors Against Private Equity,* WALL ST. J. (Oct. 20, 2021).

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

I. The Transplantation of Independent Directors into Bankruptcy Law

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

A. Independent Directors in Corporate Law

1. The Rise of Independent Directors in Corporate Law

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

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

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

[25] *See, e.g.,* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 117–18 (2004) (explaining the common rationale for the business judgment rule which suggests that business experts may know business better than judges).

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

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

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

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

their board and its committees with independent directors.[30] Third, institutional investors with ever-increasing shareholdings emphasized board independence.[31] Last, corporate managers embraced board independence to avoid intrusive regulation and preserve their autonomy.[32]

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

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

Reliance on these committees to vet freeze-outs has become the norm.[38] To qualify for deferential review, Delaware courts require that the controlling shareholder meet a number of conditions designed to enhance the committee's effectiveness and mimic the

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[30] *See* NYSE Listed Company Manual, §§ 303A.01, 303A.04 (2009), 303A.05 (2013), 303A.06 (2009); NASDAQ Stock Mkt. Rules §§ 5605(b)(1), 5605(c)(2), 5605(d)(2), and 5605(e) (2019). *See also Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2187, 2194 (2004) ("The revised listing standards of both the NYSE [New York Stock Exchange] and NASDAQ . . . require (with few exceptions) that listed-company boards have a majority of independent directors").

[31] *See* Ronald Gilson & Jeffery Gordon, *Board 3.0—An Introduction*, 74 BUS. LAW. 351, 356 (2019).

[32] *See, e.g.,* Gordon, *supra* note 26, at 1523–26; Urska Velikonja, *The Political Economy of Board Independence*, 92 N.C. L. REV. 855, 894 (2014).

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

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

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

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

[37] *See* Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110 (Del. 1994); Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014) [hereinafter *MFW*].

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

dynamics of an arm's-length bargain. The courts examine whether committee is truly independent and disinterested, whether it had a sufficiently broad mandate from the board (including the power to reject the transaction), whether it received independent financial and legal advice, whether it negotiated diligently and with no outside influence, and whether it possessed all material information.[39]

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

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

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

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

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

[42] *See* Aronson v. Lewis, 473 A2d 805, 818 (Del 1984). Delaware court held that for plaintiffs to establish the futility of making a demand on the board to sue the controller, it is not enough to charge that a director was nominated by or elected at the behest of the controlling shareholder. *See id.* *See also* Friedman v. Dolan, No. 9425, 2015 WL 4040806, at *6 (Del. Ch. June 30, 2015) (stating that "[t]he mere fact that one [director] was appointed by a controller" does not suffice to overcome the presumption of her independence); Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1051 (Del. 2004) (holding that 94% voting power was not enough to create reasonable doubt of independence). However, in two recent cases, the Delaware courts expressed concerns about directors operating in a highly networked community, such as the Silicon Valley community, noting that this may undermine their independence. *See* In re Trados Inc. S'holder Litig., 73 A.3d 17 (Del. Ch. 2013); Sandys v. Pincus, 152 A.3d 124 (Del. Dec. 2016).

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

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

[45] *See, e.g., In re* Oracle Corp. Deriv. Litig., 824 A.2d 917 (Del. Ch. 2003) ("the SLC has the burden of establishing its own independence by a yardstick that must be "like Caesar's wife"—"above reproach"). *See also* London v. Tyrrell (Del. Ch. Mar. 11, 2010) ("SLC members are not given the benefit of the doubt as to theirs impartiality and objectivity. They, rather than plaintiffs, bear the burden of proving that there is no material question of fact about their independence. The composition of an SLC must be such that it fully convinces the Court that the SLC can act with integrity and objectivity, because the situation is typically one in which the board as a whole is incapable of impartially considering the merits of the suit").

[46] Under Delaware law, the court first inquires whether the special litigation committee was independent, acted in good faith, and made a reasonable investigation, and then may apply its own independent business judgement to decide whether to grant the motion. This standard of review is higher than the business judgment rule. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787–89 (Del. 1981).

"in states with the lowest level of judicial review outcomes are more likely to be favorable for defendants."[47]

2. Reasons to Doubt Independent Directors in Corporate Law

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

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

B. The Rise of Independent Bankruptcy Directors

Until recently, corporate law's infatuation with independent directors has had no parallel in bankruptcy law. As Congress designed bankruptcy law, the role of the board in

[47] *See* C.N.V. Krishnan et al., *How Do Legal Standards Matter? An Empirical Study of Special Litigation Committees*, 60 J. CORP. FIN. 101543 (2020) (also finding that, "an SLC report recommending case dismissal in Delaware court in the post-Oracle period is significantly and negatively associated with the probability of a case dismissal. Thus, the change in the legal standard appears to have made the Delaware courts more skeptical of SLC recommendations calling for case dismissals").

[48] *See* JAY W. LORSCH, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS __ (1989). *See also* Usha Rodrigues, *The Fetishization of Independence,* 33 J. CORP. L. 447 (2008).

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

[50] *See* Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 153 (2010) ("[T]he psychological research with respect to structural bias is particularly relevant in the context of boards, highlighting the degree to which such bias undermines directors' ability to be critical of their fellow directors"). *Cf.* Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 491 237, 252 (2009) ("Directors, even those defined as independent, are members of the board of directors and, so the theory goes, are likely to be biased in favor of other directors").

[51] *See* Yaron Nili, *The Fallacy of Director Independence* 2020 WIS. L. REV. 491 (2020); Yaron Nili, *Out of Sight, Out of Mind: The Case for Improving Director Independence Disclosure*, 43 J. CORP. L. 35 (2017).

vetting conflict transactions is only to propose actions for the judge's approval.[52] In deciding whether to grant a board request the judge considers the input of creditors, who are usually sophisticated investors who can offer independent analysis.[53] Bankruptcy law amplifies creditor voice by allowing the appointment of a UCC that acts as a check on the board.[54]

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

1. Factors Contributing to the Growing Popularity of Bankruptcy Directors

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

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

Second, the lawyers who advise financially distressed companies may see independent directors as helpful in persuading the bankruptcy judge to issue orders that allow their client to leave bankruptcy. Since state court judges are more deferential to independent directors who make decisions that shareholders oppose, these lawyers may have reasoned, bankruptcy judges would also be more deferential to independent directors who make decisions that creditors oppose.[55]

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

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

[54] *See* Robert Gayda & Catherine LoTempio, *supra* note 12, at 1 ("Some commentators view these "internal" investigations as infringing on the role of unsecured creditors' committees, which had historically reviewed and analyzed prepetition conduct of a debtor and the debtor's management/ownership for potential causes of action").

[55] *See* Regina Stango Kelbon et al., *Appointment of Independent Directors on the Eve of Bankruptcy: Why The Growing Trend?*, 19TH ANN. BANKR. INST. (Apr. 11, 2014) 17 ("Employing an outside director to exercise independent judgment as to corporate transactions in bankruptcy may not only provide additional

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

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

2. *Reasons to Doubt the Independence of Bankruptcy Directors*

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

Outside bankruptcy, shareholders' power to elect directors aligns directors with shareholders. In fact, courts have relied on shareholders' ability to displace directors as a reason for deferring to directors.[57] Recent evidence supports this view, showing that the number of directors who fail to receive shareholder support is on the rise, meaning that

guidance to a suffering business, but can make the decision-making process seem right in the eyes of stakeholders and ultimately, the court").

[56] John Coates finds that clients of larger law firms with more takeover experience adopt more defenses in charters of firms conducting an initial public offering. *See* John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1304 (2001). Other studies find that large law firms are responsible for the adoption of exclusive forum-selection provisions, and that three Silicon Valley law firms drive the use of certain dual-class structures. *See* Roberta Romano & Sarath Sanga, *The Private Ordering Solution to Multiforum Shareholder Litigation*, J. EMPIRICAL L. STUD. 31, 31 (2017); Andrew Winden, *Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures*, 18 COLUM. BUS. L. REV. 852 (2018).

[57] *See, e.g.,* In re Walt Disney Co. Deriv. Litig., 907 A.2d 693, 698 (Del. Ch. 2005) ("The redress for [directors'] failures . . . must come . . . through the action of shareholders . . . and not from this Court"). *See also* Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342, 1351 (D. Nev. 1997) ("One of the justifications for the business judgment rule's insulation of directors from liability . . . is that unhappy shareholders can always vote the directors out of office" (internal quotation marks omitted) (quoting Shoen v. AMERCO, 885 F. Supp. 1332, 1340 (D. Nev. 1994)); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) ("[T]he Rights Plan will not have a severe impact upon proxy contexts").

shareholders use their votes.[58] These disciplinary mechanisms do not exist in bankruptcy. Creditors cannot influence the election of directors, and so bankruptcy directors lack incentives to advance creditors' interests.

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

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

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

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

First, bankruptcy professionals—lawyers, investment bankers, and bankruptcy directors—form a much smaller community than the corporate governance community generally.[63] In this environment, it is likely that bankruptcy directors will work with the same professionals on their next engagement. Indeed, the evidence we present below reveals a group of super-repeater directors who have developed a profession of sitting on the board of bankrupt companies.

Second, financial distress is an extraordinary event in the life of a corporation that can justify the appointment of specialized directors. It provides a natural setting for adding experts to the board to vet conflict transactions without raising suspicion. In contrast, outside

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

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

[60] *See id.*

[61] *See, e.g.,* Wei Jiang et al., *Hedge Funds and Chapter 11*, 67 J. FIN. 513 (2012).

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

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

bankruptcy, firms are limited in their ability to appoint new directors to investigate a potential derivative claim or negotiate a freeze-out.

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

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

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

II. EXAMPLES

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

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

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

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

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

A. Neiman Marcus

In 2017, the private-equity sponsors of retailer Neiman Marcus ("Neiman") searched for a way to protect their investment in the struggling retailer.[68] They focused on MyTheresa, a Neiman subsidiary that sold luxury goods online.[69] The private-equity sponsors consulted the investment bank Lazard Limited ("Lazard"), that recommended "moving certain assets with strategic value, such as the MyTheresa business [away from creditors]"[70] This, according to Lazard, would "allow[] the accrual of future MyTheresa value appreciation" for the private-equity sponsors only, leaving creditors with no claim against what most observers considered the firm's most valuable asset.[71] Lazard anticipated that the transfer could be subject to "challenges from creditors"[72] over "fraudulent conveyance / fiduciary duty considerations"[73] and offered its help in dealing with such "complexities."[74]

In 2018, the idea became a reality through a series of stock dividends that transferred control of MyTheresa to Neiman's private-equity-owned parent, beyond the reach of the creditors of Neiman's $6 billion debt.[75] The transfer caused the value of the debt to collapse,

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[68] *See* Declaration of Mark Weinsten, Chief Restructuring Officer, of Neiman Marcus Group LTD LLC, In Support of the Debtors' Chapter 11 Petitions and First Day Motions at 2, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. July 30, 2019); Preliminary Report of the Official Committee of Unsecured Creditors Regarding the Bankruptcy Estates' Litigation Claims Against Neiman Marcus Group, Inc., The Equity Sponsors and Directors of Neiman Marcus Group, Inc., and Other Parties at 25, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. July 30, 2019) [hereinafter UCC Report] (describing capital structure post-LBO).

[69] *See* Ex. Neiman Marcus Discussion Material, Lazard Presentation at 2, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. July 30, 2019) [hereinafter Lazard Presentation]. *See* UCC Report, *supra* note 25, at 30 ("In an email dated June 15, 2016, Ares (Rachel Lee) stated that 'we had talked a few weeks ago about separating the MyTheresa asset' and asked Proskauer Rose LLP '[i]f we wanted to 'dividend' the stock of MyTheresa to existing NMG shareholders, could we do that and what are the implications?'").

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

[71] *Id.* at 19 ("Dividending the MyTheresa business out of the loan group using Restricted Payment basket capacity would allow the accrual of future MyTheresa value appreciation to the Sponsors"). This sort of scheming by private-equity sponsors has become typical in the 2010s, who often greet financial distress by engaging in transactions that shift value to shareholders and away from creditors. *See generally* Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CAL. L. REV. 745 (2020). The Financial Times would later report that creditor anger over the transaction and "private equity aggression … struck a chord with many in the distressed debt market." *See* Sujeet Indap & Mark Vandevelde, *Neiman Marcus: How a Creditor's Crusade against Private Equity Power Went Wrong*, FIN. TIMES (Oct. 3, 2020).

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

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

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

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

spurring threats and negotiations between the creditors and Neiman.[76] A few months later, the private-equity sponsors agreed to return some of MyTheresa's assets to creditors in exchange for a two-year extension of the debt's maturity date and other credit support.[77]

However, this did not solve Neiman's problems, which the COVID-19 pandemic made worse,[78] and in May 2020, the company filed for bankruptcy.[79] Before the filing, the company agreed with its private-equity sponsors and most of its creditors on a plan that would reduce debt by $4 billion.[80] Neiman intended to seek a court order discharging the private-equity sponsors from liability over the MyTheresa transfer.[81]

In planning its bankruptcy filing, Neiman took steps to hobble the ability of the UCC to pursue the MyTheresa claims. First, the terms of the bankruptcy financing required the company to leave bankruptcy in 120 days, limiting the time the UCC could investigate and litigate, and constraining the UCC's investigation budget.[82] Second, a month prior to the

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

[77] *See generally* Neiman Marcus Grp., Current Report (Form 8–K) (Mar. 1, 2019). As part of the exchange, the company's secured creditors received a partial payment and agreed to extend the maturity date of the loan by two years. *See id.* at 26. The secured term lenders received a pay-down of $550 million of approximately $2.8 billion in debt. *See id.* They also received additional collateral, which was an important part of the deal. *See* UCC Report, *supra* note 25, at 49. The company's unsecured creditors exchanged their debt for a mixture of new secured debt, supported by a lien on MyTheresa's assets, and MyTheresa preferred stock. *See* Neiman Marcus Grp., Current Report (Form 8–K) (Mar. 1, 2019) at 29. In many ways, the transfer was a challenge to creditors: Should they negotiate to get part (or all) of the assets back or should they litigate? The creditors appear to have chosen to settle for the return of some of MyTheresa, which would not preclude them from filing a lawsuit if the company later filed for bankruptcy. One dissident creditor tried to bring the lawsuit on its own, but lacking standing to do so without the support of a larger number of creditors. *See* Order Granting Defendant's Plea to the Jurisdiction and Alternatively, Special Exceptions, Marble Ridge Capital v. Neiman Marcus, No. 18–18371 (Bankr. Tex. Mar. 19, 2019).

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

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

[80] *See id*. at 5. Companies filing for Chapter 11 bankruptcy typically arrive with ready Restructuring Support Agreements ("RSAs") tied to bankruptcy financing arrangements, as was the case for Neiman. *See* Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale*, 39 YALE J. REG. (forthcoming 2022); Anthony J. Casey, Frederick Tung & Katherine Waldock, *Restructuring Support Agreements: An Empirical Analysis* (Working Paper, 2021) (on file with authors). For more on RSAs, see generally Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593 (2017); Edward J. Janger & Adam J. Levitin, *Badges of Opportunism: Principles for Policing Restructuring Support Agreements*, 13 BROOK. J. CORP. FIN. & COM. L. 169, 169 (2018).

[81] *See* Marble Ridge Capital LP and Marble Ridge Master Fund LP's Statement in Response to the Declaration of Mark Weinsten and Limited Objection to Debtors' Emergency Motion for Postpetition Financing at 17, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. July 30, 2019).

[82] For governance through DIP lending, see generally Ayotte & Ellias, *supra note* 55*;* George G. *Triantis*, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. Rev. 901, 901 (1993);

bankruptcy filing, the private-equity sponsors appointed two new directors: former bankruptcy lawyer Marc Beilinson and former distressed debt trader Scott Vogel.[83] The two received the board's power to handle conflicts between the Neiman and its private-equity sponsors**,** including the MyTheresa transfer.[84] Each of these bankruptcy directors received a \$250,000 flat fee plus \$500 an hour.[85]

Immediately after the bankruptcy filing, a creditor filed a motion to appoint an independent examiner to investigate the MyTheresa transfer, claiming that the bankruptcy directors would favor the private-equity sponsors and senior creditors.[86] The creditor also asked to bar the bankruptcy directors from investigating the MyTheresa transaction.[87]

On the witness stand, Beilinson stumbled.[88] He could not provide satisfying answers to questions from the bench about the investigation he oversaw,[89] and his answers revealed

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Barry E. Adler et al., *Value Destruction in the New Era of Chapter 11*, 29(2) J.L. ECON. & ORG. 461 (2013); Elizabeth Warren and Jay L. Westbrook, *Secured Party in Possession*, 22 AM. BANKR. INST. J. 12, 12 (2003); Kenneth Ayotte and David A. Skeel, *Bankruptcy Law as a Liquidity Provider,* 80 U. CHI. L. REV. 1557 (2013).

[83] *See In re* Innkeepers USA Trust at 62, 226, No. 10–13800 (Bankr. S.D.N.Y. Sept. 1, 2010) [hereinafter Beilinson Testimony]. Specifically, the private-equity sponsors appointed Beilinson and Vogel as "independent managers" at an intermediate holding company, NMG LTD LLC. The control of the ultimate parent remained in the hands of the board appointed by the private-equity sponsors. *See* Neiman Marcus Trial, *supra* note 59, at 34.

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

[85] *See id.* at 38.

[86] Marble Ridge Capital LP and Marble Ridge Master Fund LP's Expedited Motion, Pursuant to Bankruptcy Code Sections 105(a), 1104(c), 1106(b), and 1107(a) and Federal Rule of Bankruptcy Procedure 2007, For Entry of an Order Appointing an Examiner with Duties to Prosecute, *In re* Neiman Marcus (Bankr. S.D. Tex. Mar. 15, 2020) [hereinafter Marble Ridge Examiner Motion]. The bankruptcy code provides creditors the ability to seek the appointment of an examiner as an independent fiduciary to investigate potential wrongdoing. *See generally* Jonathan C. Lipson, *Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies*, 84 AM. BANKR. L.J. 1 (2010). Neiman Marcus argued that there was no need for an examiner investigation since the UCC and the bankruptcy directors were already investigating the transaction. *See* Neiman Marcus Trial, *supra* note 59, at 41.

[87] *See* Marble Ridge Examiner Motion, *supra* note 86, at 128 ("For all of the reasons, Your Honor, we're not in a position to trust that we're going to get a good faith, independent examination report that does anything other than say, in order to get out of bankruptcy fast and given the fact that the unsecured creditors aren't entitled to any distribution because we got to satisfy all of the claims of the senior creditors -- too bad. Sorry. We know that's the result we're more than likely to get").

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

[89] Under questioning from the judge, Beilinson identified as one of the issues whether the MyTheresa dividend was an intentional fraudulent conveyance, but when asked what mattered for this determination, he gave an answer that the judge described as "completely wrong". *See* Neiman Marcus Trial, *supra* note 59, at 108. Beilinson testified that what mattered as whether "the recovery or the unwinding would benefit or not benefit the bankruptcy estate, and whether it should impact the currently negotiated RSA, which has substantial amount of the debt structure supporting it." *See id.* at 108–09. In reality, intentional fraudulent transfer claims require investigating evidence that the transfer of value was with an "actual intent" to defraud, hinder, or delay creditors. *See* 11 U.S.C. § 365. *See generally* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985).

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

Three weeks later, Beilinson resigned and Vogel remained the sole bankruptcy director.[94] Vogel's own résumé raised questions for creditors, as he was a former employee of a lender that extended a loan to Neiman in the bankruptcy with conditions that made the prosecution of fraudulent-transfer claims against the private-equity sponsors more difficult.[95]

The UCC began investigating the transaction and quickly concluded that the claims were valuable.[96] It then filed a motion informing the court of this conclusion. The motion suggested that if the claims did not settle, the UCC should preserve them for prosecution after

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[90] The judge then asked him for specific examples of what he had done in the past 30 days on the investigation and Beilinson responded by saying he and Vogel had "spoken with Counsel," that "document requests have gone out" and "[they had] accumulated 3,000 documents." *See* Neiman Marcus Trial, *supra* note 59, at 109.

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

[92] *See* Neiman Marcus Trial, *supra* note 59, at 188. A news report at the time referred to the "extraordinary" exchange as "blistering criticism". *See* Vandevelde & Indap, *supra* note 12. Another observer later noted that the case was too important for shenanigans" such as "independent directors doing the bidding of a private-equity sponsor (and/or themselves)". *See Our "Matter of the Year"*, PETITION, https://petition.substack.com/p/our-matter-of-the-year (last visited Jan. 17, 2021).

[93] The judge was willing to grant only a cursory investigation of whether the bankruptcy directors were doing their job, which would not have been very useful to the creditor as it would not be hard for the directors to prove they were not wholly absentee. *See* Neiman Marcus Trial, *supra* note 59, at 196.

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

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

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

the bankruptcy case ended.[97] A few days later, the UCC indicated it was ready to make the results of its six-week investigation public.[98]

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

On July 24, the UCC released the preliminary results of its investigation.[101] The report concluded that the transaction constituted a constructive fraudulent transfer and likely also an intentional fraudulent transfer.[102] It added that these claims would merit release only in return for an amount close to their estimated value of the transferred assets, about $1 billion.[103]

However, six days later, Neiman announced that Vogel had negotiated with the private-equity sponsors a much smaller settlement.[104] The settlement included a package of

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

[98] *See* Motion of the Official Committee of Unsecured Creditors to file Under Seal as Necessary (1) Preliminary Report of the Official Committee of Unsecured Creditors Regarding the Bankruptcy Estates; Litigation Claims Against Neiman Marcus Group, Inc., the Equity Sponsors and Directors of Neiman Marcus Group, Inc., and Other Parties and Appendix Thereto and (II) Initial Expert Report of the Michel-Shaked Group and Executive Summary Thereof, No. 20–32519, *In re* Neiman Marcus (Bankr. S.D. Tex. July 17, 2020). Prior to the UCC report becoming public, the private-equity sponsors filed a "counter report" with their own analysis of the strength of the claims against them. *See generally* Counter-Report of Ares Mgmt., *supra* note 32.

[99] *See Neiman Marcus: Neiman Disinterested Manager Says Viable Fraudulent Conveyance Claims Tied to MyTheresa Transfer Exist; Ares Has Agreed to Requested 'Number' in Settlement Talks; UCC Has Had No Direct Talks with Ares*, REORG (July 23, 2020), https://reorg.com/neiman-manager-viable-fraudulent-conveyance-claims/ [hereinafter Viable Fraudulent Conveyance Claims]. *See also* Hr'g Trial at 5, *In re* Neiman Marcus Grp., No. 20–32519 (Bankr. S.D. Tex. July 23, 2020) [hereinafter Neiman Marcus Hearing].

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

[101] The investigation had taken place in the 51 days between the filing of the report and the UCC's retention of counsel. While the investigation involved the review of more than 800,000 pages of documents and 8 depositions, it clearly was only at a preliminary stage and could have expanded to cover a wider range of witnesses. *See* UCC Report, *supra* note 25, at 22.

[102] *Id.* at 66.

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

[104] *See* Notice of Filing of Disclosure Statement for the Debtors' First Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code at 65, *In re* Neiman Marcus LTD LLC, No. 20–32519 (Bankr. S.D. Tex. July 30, 2020).

cash and stock that, using the UCC's estimate of MyTheresa's value, would be worth $172 million.[105]

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

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

More broadly, he offered a grim assessment of the effect of bankruptcy directors on creditor recovery and thus on the message to private-equity sponsors:

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

Without changes, he said, bankruptcy directors would turn the system of governance designed by Congress into a "sham."[113] He urged the judge to scrutinize the conflicts of bankruptcy directors in future cases by scrutinizing "their relationship with the law firms, what is their relationship with the sponsors, and what is the true independence. And that's

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

[106] *See id.* at 2.

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

[108] *Id.* at 29.

[109] *Id.* at 29.

[110] *Id.* at 30.

[111] *Id*. at 30.

[112] *Id.* at 34.

[113] *Id.* at 36. A postscript to this story is that the creditor who sought the appointment of the examiner had to close his hedge fund after trying to deter an investment bank from making a competing bid for MyTheresa stock in violation of his fiduciary duty as a member of the UCC. *See* Andrew Scurria & Alexander Gladstone, *Hedge Fund Marble Ridge to Close After Scathing Neiman Report*, WALL ST. J. (Aug. 21, 2020); Sujeet Indap & Mark Vandevelde, *Hedge Fund Manager Admits 'Grave Mistake' in Neiman Marcus Battle*, FIN. TIMES (Aug. 20, 2020).

not just the [bankruptcy directors, it is also] their counsel."[114] In the case at bar, he noted, the law firm for the bankruptcy directors had previously represented the private-equity sponsors.[115]

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

Was the $172 million settlement fair given the information available at that time? After all, the UCC did agree to it. Moreover, as the private-equity sponsored argued, a sale process a year earlier had failed to produce a buyer willing to pay more than $500 million for MyTheresa.[117] There will always be questions when the economy changes and assets fluctuate in value after a bankruptcy process. But these unanswerable questions would be less pressing if the UCC had itself negotiated the settlement, without the bankruptcy directors looming in the background.

B. Payless Holdings

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

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

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

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

[117] *See* Counter-Report of Ares Management Corp. and Canada Pension Plan Investment Board in Response to Preliminary Report of the Official Committee of Unsecured Creditors at 5, 23, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. July 30, 2020) [hereinafter Counter-Report of Ares Mgmt.]. Most importantly, they already returned part of MyTheresa, which meant that they could argue the amount they had actually received was less than $1 billion, perhaps $500 million or even less.

[118] In 2012, a private equity group led by Golden Gate Capital and Blum Capital took over Payless Holdings LLC ("Payless"), a retail company specializing in selling low-priced footwear, in a $2 billion acquisition and became the owner of 98.5% of the company's equity. *See* Neil Irwin, *How Private Equity Buried Payless*, N.Y. TIMES (Jan. 31, 2020); *Payless UCC Objects to 'Placeholder' DS and Fast-Track Plan Process*, REORG (May 25, 2017).

[119] Notice of Filing of Disclosure Statement for the Debtors' Fourth Amended Joint Plan of Reorganization of Payless Holdings LLC and Debtor Affiliates Pursuant to Chapter 11 of the Bankruptcy Code, Ex. 1 at 23–4, No. 17–42267–695, *In re* Payless Holdings LLC (Bankr. E.D. Mo. June 23, 2017) (Docket No. 1259) [hereinafter Payless Disclosure].

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

Prior to filing for bankruptcy, Payless appointed Charles H. Cremens to its board.[120] Payless described Cremens as a seasoned independent director with vast business and restructuring experience.[121] Cremens joined the board at the suggestion of the debtors' lead law firm, Kirkland & Ellis LLP[122] ("Kirkland") and immediately began investigating the claims against the private-equity sponsors.[123] He also hired Munger Tolles & Olson LLP ("Munger") to represent him in the Chapter 11 case.[124] As is often the case with bankruptcy directors, his bankruptcy experience raised questions about the extent to which he was truly objective. Cremens had extensive ties to Kirkland[125] and Munger and had recently worked as bankruptcy director with both firms.[126] He also had ties to one of the private-equity owners.[127]

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

[121] *Id.*

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

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

[124] Debtors' Application for Entry of an Order Authorizing the Retention and Employment of Kirkland & Ellis LLP and Kirkland and Ellis International LLP as Attorneys for the Debtors and Debtors in Possession Effective Nunc Pro Tunc to the Petition Date at 6, *In re* Patriot Coal Corporation, No. 15–32450 (Bankr. E.D. Va. May 20, 2015) [hereinafter Kirkland Employment Application); Payless Hearing, *supra* note 115, at 46.

[125] Cremens had worked at other companies represented in bankruptcy by Kirkland. "Three of the Debtors' current directors—Eugene I. Davis, Charles H. Cremens, and Timothy J. Bernlohr—currently serve, and have served in the past, as officers and directors of certain of K&E's clients or affiliates from time to time." *See* Kirkland Employment Application, *supra* note 177, at 1–13, Ex. B 18–19. Cremens also served as a disinterested director of Energy Future Intermediate Holding, a private-equity-owned power company that filed for bankruptcy in 2017 with Kirkland as its lawyers. *See* Debtors' Application for Entry of an Order Authorizing the Retention and Employment of Kirkland & Ellis LLP as Attorneys for the Debtors and Debtors in Possession Effective Nunc Pro Tunc to the Petition Date (Docket No. 660), Ex. B at 16–17, No. 14–10979, *In re* Energy Holdings Corp. (Bankr. D. Del. July 21, 2018).

[126] *See* Declaration of Charles H. Cremens in Support of Confirmation of the Modified Fifth Amended Joint Chapter 11 Plan of Reorganization of iHeartMedia, Inc. and its Debtor Affiliates Pursuant to Chapter 11 of the Bankruptcy Code (Docket No. 2367), at 1–2, No. 18–31274, *In re* iHeartMedia, Inc. (Bankr. S.D. Tex. Jan. 7, 2019).

[127] Objection of the Official Committee of Unsecured Creditors to Debtors' Motion for Entry of an Order (I) Approving the Adequacy of the Debtors' First Amended Disclosure Statement (Docket No. 1023), at

After filing for Chapter 11, Cremens fought to limit the ability of the unsecured creditors to investigate the dividend payout. When the unsecured creditors sought to hire their own financial advisor to study the strength of the claims, Cremens objected, claiming that he was in the midst of such an investigation and that any effort by the unsecured creditors to study the potential causes of action would be "duplicative."[128] He also claimed that he wanted to meet the conditions of the debtor's bankruptcy financing which, as in the Neiman Marcus case, required exit from Chapter 11 within ninety days, limiting the ability of unsecured creditors to investigate the claims.[129] By attempting to keep the unsecured creditors from hiring professionals, Cremens undermined their ability to proceed quickly.[130]

Cremens ran an investigation that was, in the eyes of unsecured creditors, flawed and superficial. On the one hand, he and his lawyers reviewed hundreds of documents and interviewed 12 witnesses.[131] On the other, he failed to obtain tolling agreements from the private-equity sponsors for claims that could have expired during the time of the investigation[132] and declined to hire his own solvency expert to determine whether Payless was solvent at the time of the dividends. This was the most critical question for determining the strength of the claims.[133] Both of these actions raised questions as to how serious Cremens was about litigating the claim. Unsecured creditors would later characterize Cremens' effort as an attempt to "sweep the [claims against the private-equity sponsor] under

13–14 No. 17–42267, *In re* Payless Holdings, LLC (Bankr. E.D. Mo. June 12, 2017) [hereinafter Payless UCC Objection] (noting that Cremens "served on the boards of Aspect Software and/or Bluestem Group with at least three managing directors of Golden Gate Capital, (ii) Aspect Software is owned in part by Angel Island Capital, an affiliate of Golden Gate Capital that currently holds part of the Debtors' term loan debt, (iii) Cremens was on the board of Conexant Systems, which was acquired by an affiliate of Golden Gate Capital, and (iv) Cremens was on the board of Tactical Holdings, which is a portfolio company of Golden Gate Capital"). Cremens had also worked on other cases alongside Kirkland, as had his lawyers at Munger. *See id.* at 13–14.

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

129 *Id.* at 7.

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

131 Payless Hearing, *supra* note 115, at 47.

132 *Id.* at 52–53.

133 *Id.* at 47–49 ("So now you have Mr. Cremens and Munger Tolles & Olson reporting to him, beginning their investigation in January, basically five, six months ago. They describe in the disclosure statement what was done: we looked at 500 documents, we talked to twelve people. Interesting what they didn't do, which was hire—as the committee did—hire a valuation expert to go look at the 2012 LBO, the 2013 dividend recap, the 2014 dividend recap. Because the fraudulent transfer claims—potential claims that arise out of those transactions all turn on the issue of whether or not Payless was insolvent at the time or was left insolvent after it made these dividend payments to their shareholders, Golden Gate and Blum. So, without really taking a hard look at the insolvency issue, I'm not sure how the independent director is going to reach a conclusion that we can all trust and count on").

the rug, to do a cursory examination, to talk to a few people . . . and come up with a conclusion."[134]

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

> [A]s the case has developed, the independent director, knowing that the committee and other parties were looking into these issues, believed that it was in the best interests of these estates to not disclose a position over these issues, but rather to allow the committee and others to complete their examination, so he could act—if you will—as a mediator, and help to resolve the issues rather than polarize the case by coming out strongly one way or another.[135]

This response infuriated the lawyers for the unsecured creditors, who argued that Cremens misunderstood his role.[136] Moreover, Cremens tried to block the unsecured creditors from hiring a financial advisor because he was "conducting an investigation."[137] The unsecured creditors called this as an effort to "usurp [their] role in conduct[ing] this kind of investigation."[138]

The unsecured creditors continued to prepare to prosecute the claims, but their backs were against the wall because their investigation appeared to be at odds with the goal of saving the company. The unsecured creditors announced that they had "accomplished in six weeks what Mr. Cremens has apparently been unable, or unwilling to do in six months—reach a conclusion that [claims should be brought against the private-equity sponsors]."[139] The private-equity sponsors retorted that the claims were weak[140] and that the unsecured creditors' plan to litigate the claims "threaten[ed] the feasibility of any successful plan for Payless' reorganization."[141] The unsecured creditors called this a "false narrative" and "fake

[134] *Id.* at 48.

[135] *Id.* at 66.

[136] *Id*. at 80.

[137] Response of Debtors to Application of the Official Committee of Unsecured Creditors for Entry of an Order Authorizing Retention of Back Bay Management Corporation And its Division, The Michel-Shaked Group, as Expert Consultant and Dr. Israel Shaked as Expert Witness Nunc Pro Tunc (Docket No. 643), at 4, No. 17–42267 (Bankr. E.D. Mo. May 24, 2017).

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

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

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

[141] *Id.* at 12.

news" and pointed out that there should not be a conflict between recovering property from the sponsors and reorganizing the firm: they could litigate the claims after bankruptcy.[142]

However, the unsecured creditors' bargaining power collapsed as the clock continued to run on the debtors' short timeline, perhaps contributing to their decision to accept a settlement of $21 million for claims of $350 million.[143] The unsecured creditors had seen this coming, noting earlier in a court hearing that:

> [W]hat we're terribly afraid of, Your Honor, given the conduct thus far, is that we'll get a late-breaking bulletin on the eve of confirmation, hey, we've decided that there are some claims here, but you know what, it's too inconvenient to bring them; it's too late. We're at confirmation; we're going to get out of bankruptcy. Let's declare victory. We're going to reorganize Payless; we're going to save jobs; we're going to save stores, et cetera, et cetera. But these claims, they're going to fall by the wayside . . . what we're seeing is a concerted effort to sweep these claims under the rug for the benefit of insiders: the sponsors and the directors.[144]

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

III. EMPIRICAL ANALYSIS

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

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

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[142] *See* Payless Hearing, *supra* note 115, at 50–51.

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

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

claim is typically the most at risk in bankruptcy.[145] This finding raises the possibility that bankruptcy directors make decisions that are not value maximizing.

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

A. Data

For this study, we had to build a large dataset of directors of Chapter 11 firms because no commercial dataset contains this information. We began with Next Generation Research's list of Chapter 11 debtors that filed for bankruptcy between January 1, 2004 and December 31, 2019.[146] Our initial list of the debtors consisted of 770 firms with more than $250 million in assets or liabilities on their bankruptcy petition.

We then looked in each court docket for two documents. First, we required the firm to have filed with the bankruptcy court a Statement of Financial Affairs (SOFA).[147] Chapter 11 firms must list all current and former officers and directors in this document and firms that did not comply with this requirement did not meet the sample criteria.[148] Second, we

[145] Bankruptcy law is generally recognized as a process designed to serve unsecured creditors, whose claims are seen at most at risk in Chapter 11 cases. *See, e.g.,* Charles W. Mooney, *The (Il)Legitimacy of Bankruptcies for the Benefit of Secured* Creditors, 2015 U. ILL. L. REV. 675, 753 ("Bankruptcy has traditionally been a collective proceeding with the goal of enhancing recoveries for unsecured creditors beyond those that state court remedies could provide to the creditors as a body"). Existing research focuses on unsecured creditor recoveries when examining the determinants of successful bankruptcy proceedings. *See, e.g.,* Elizabeth Tashjian et al., *An empirical Analysis of Prepackaged Bankruptcies,* 40 J. FIN. ECON. 135 (1996) (finding that unsecured creditor recoveries are higher in prepackaged bankruptcies); Viral V. Archarya et al., *Does Industry-wide Distress Affect Defaulted Firms? Evidence from Creditor Recoveries,* 85 REV. FIN. STUD. 787 (2007) (noting that the conditions of bankruptcy appear to affect senior unsecured debt); Andrew A. Wood, *The Decline of Unsecured Creditor and Shareholder Recoveries in Large Public Company Bankruptcies*, 85 AM. BANKR. L.J. 429 (2011); Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 WASH. U. L.Q. 1341 (2004). A similarly voluminous literature in financial economics examines bondholder recoveries. *See, e.g.,* Rainer Jankowitsch, Florian Nagler & Mart G. Subrahmayam, *The Determinants of Recovery Rates in the US Corporate Bond Market,* 114 J. FIN. ECON. 155 (2014).

[146] This list often serves for empirical research. *See, e.g.,* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511 (2009); Jared A. Ellias, *What Drives Bankruptcy Forum Shopping? Evidence from Market Data*, 47 J. LEGAL STUD. 119 (2018); Wei Jiang et al., *Hedge Funds and Chapter 11*, 67 J. FIN. 513 (2012). Court dockets are available on the federal court website for bankruptcy filings starting 2004.

[147] 11 U.S.C. § 521(a)(B)(iii).

[148] For example, the SOFA filed by K–V Pharmaceutical Company contains the following entry: "If the debtor is a corporation, list all officers and directors of the corporation, and each stockholder who directly

required the firm to have filed with the bankruptcy court a disclosure statement. As part of the creditor voting on the bankruptcy plan, Chapter 11 firms must summarize in this document important developments before and during the proceeding and draw attention to facts relevant for the consideration of either the judge or voting creditors.[149]

Of the 528 firms with SOFAs listing their board members, we were able to obtain disclosure statements for 454 firms.[150] The SOFAs identified 2,549 individuals who served on the boards of these firms on the petition date, including 78 who sat on two boards and 12 who sat on more than two boards. To our knowledge, this is by far the largest sample of Chapter 11 directors ever studied.[151]

Next, we hand-matched each individual with BoardEx's dataset of corporate directors to obtain director characteristics and employment history before the sample period. We were able to match 2,009 individuals from 454 boards in our sample.[152] Finally, we added firm characteristics from CompuStat and bankruptcy information from Next Generation Research to all 454 firms.

B. Changes in Chapter 11 Boards Over Time

We begin our analysis by examining how boards' bankruptcy expertise on the petition date has changed. Our proxy for bankruptcy expertise is whether a director on a Chapter 11 board had been on a director on a prior Chapter 11 board on the petition date or up to a year thereafter. We find that the likelihood that Chapter 11 boards have at least one director with Chapter 11 experience ("Chapter 11 repeater") is 15.4% between 2004 and 2010, 33.5%

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or indirectly owns, controls, or holds 5 percent or more of the voting or equity securities of the corporation." *See* Statement of Financial Affairs at 19, No. 12–13347, *In re* K–V Pharmaceutical Company (Bankr. S.D.N.Y. Sept. 17, 2012). The firms that ignored this requirement tend to have either had quick sales or were prepackaged bankruptcy filers that ignored the SOFA requirement during their brief stay in bankruptcy.

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

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

[151] *See* Radhakrishnan Gopalan et al., *It's Not So Bad: Director Bankruptcy Experience and Corporate Risk-Taking,* J. FIN. ECON. (forthcoming 2021) (studying 356 firms that filed for bankruptcy between 1994 and 2013); Megan Rainville, *Bankruptcy and Director Reputation*, FIN. MGMT. ASSOC. (Oct. 2019), http://www.fmaconferences.org/NewOrleans/Papers/Bankruptcy_and_Director_Reputation_012019.pdf (last visited Oct. 30, 2020) (studying 142 firms with 1,089 directors that filed for bankruptcy between 2003 and 2013); Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders*, 27 J. FIN. ECON. 355 (1990) (studying 61 firms that filed for bankruptcy between 1979 and 1985).

[152] We matched the BoardEx directors with CompuStat firm characteristics using the WRDS BoardEx CRSP CompuStat Company linking table. For BoardEx companies with multiple potential matches in the BoardEx data, we took the lowest scoring match, which indicates the best match according to WRDS' methodology. In specifications that involve four-digit SIC codes, we omitted 22 firms with two SIC codes in CompuStat.

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

[Figure 1]

C. What Bankruptcy Directors Do

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

1. The Rise of Bankruptcy Directors

We focus on directors presented to the bankruptcy judge as independent. With some exceptions, we find that Chapter 11 firms label their directors as independent only if they receive board power in connection with the bankruptcy, and not merely meet general independence criteria.[153] Accordingly, we call these directors "bankruptcy directors." We require them to be independent directors who are not currently working as firm officers, including as chief restructuring officers.

First, we ran a series of searches that was roughly equivalent to searching all disclosure statements for mentions of the terms "independent director," "independent directors," "disinterested director," or "disinterested directors." After eliminating false positives, we identified 78 disclosure statements that discussed the presence of a bankruptcy director.[154] For example, in the Nine West bankruptcy, the disclosure statement provided:

> As the Debtors worked on this business turnaround, in mid-2017 the Debtors also commenced negotiations with their creditors regarding a comprehensive restructuring of their debt obligations. In connection therewith, the Debtors engaged two independent directors in August 2017,

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

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

> who, in turn, directed the Debtors to hire an independent counsel and financial advisor to act at the direction of the independent directors. These directors took an active role in overseeing restructuring negotiations and in reviewing potential claims and causes of action related to the [leveraged buyout] . . . and other potential conflict matters between the Debtors and their private equity owners.[155]

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

> Kirkland conferred with the independent and disinterested directors of the Board about the investigation on multiple occasions. After completing its work concerning those potential claims, Kirkland presented the results of the investigation and bases therefor three times to the independent and disinterested directors before the independent and disinterested directors voted regarding those claims.[156]

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

[Figure 2]

2. The Characteristics of Firms and Bankruptcies with Bankruptcy Directors

Table 1 compares firms with bankruptcy directors to other firms. Firms with bankruptcy directors are significantly more likely to have private-equity sponsors (45% versus 30%) and somewhat less likely to have publicly traded shares (31% versus 42%).[157] In unreported results, we find that the percentage of Chapter 11 firms with private-equity ownership is stable over time. The growing percentage of bankruptcy directors thus reflects a change in how firms, including those with private-equity sponsors, prepare for bankruptcy, not a change in the percentage of private equity portfolio firms among Chapter 11 filers.

[Table 1]

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

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

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

There are additional differences worth noting. Firms with bankruptcy directors are significantly more likely to engage one of the two leading debtor-side bankruptcy law firms, Kirkland (32% versus 16%) and Weil Gotshal & Manges LLP ("Weil") (15% versus 6%).[158] Firms with bankruptcy directors are also significantly more likely to sign a restructuring support agreement, a document outlining a proposed Chapter 11 plan (58% versus 38%). The sample disclosure statements suggest that the bankruptcy directors are often the ones negotiating this document. Finally, boards with bankruptcy directors are significantly more likely to have a director who is a lawyer (53% versus 38%) and a director who was on the board of another Chapter 11 firm prior to the current appointment (40% versus 19%).[159] As we will discuss, the biographies of bankruptcy directors reveal that many more of them have experience in restructuring beyond what this measure captures.

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

3. *The Role of Bankruptcy Directors*

Debtors typically tout their bankruptcy directors to win judicial deference.[160] They do so in two ways, as statements by one bankruptcy director in the Gymboree Corporation bankruptcy in 2017 illustrate.

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

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

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

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

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

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

its private-equity sponsor.[163] The second way is to claim that the board decision deserves deference because the bankruptcy directors who made it are restructuring experts. In the Gymboree case, for example, the bankruptcy director noted his experience in Chapter 11 cases and his background in investment banking.[164]

The strategy is to convince the bankruptcy court that the combination of independence and expertise means that the court should view the bankruptcy directors' conclusions as those of a neutral expert, almost as it views decisions of a court-appointed trustee. For example, in the rue21 bankruptcy in 2017, a bankruptcy director cited his independence and expertise and the investigation he had led to urge the court to overrule creditor objections.[165]

We read each disclosure statement to learn about the tasks that bankruptcy directors perform. Table 2 summarizes our findings. It shows that bankruptcy directors led the restructuring process in 71% of their engagements and investigated claims against insiders (shareholders or lenders) in 46% of their engagements. They joined the board before the bankruptcy filing in 84% of their engagements.[166] They hired their own legal or financial advisors in 49% of their engagements. These numbers are lower bounds for the role that bankruptcy directors played in the sample cases, as the debtors in the remaining cases did not state that the bankruptcy directors *did not* do these things. In unreported results we find that, when firms identify their bankruptcy directors by name, the mean and the median of the number of bankruptcy directors per firm are two, and the maximum is five.

[Table 2]

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

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

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

[165] *See* Declaration of Neal Goldman in Support of Debtors' Reply to Limited Objection of the Official Committee of Unsecured Creditors to the Debtors' First Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code at 23, No. 17–22045, *In re* rue21, Inc. (Bankr. W.D. Pa. Aug. 28, 2017). The director first noted his expertise (*see id.* at 2), his independence (*see id.* at 3), the work he had done to investigate claims against insiders (*see id.* at 36), and his conclusion that legal claims against insiders should be released (*see id.* at 6). He then rejected creditors' objections to his conclusion (*see id.* at 7) and asked the judge to defer to his business judgment (*see id.* at 8).

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

Table 3 presents the results of such a regression.[167] Specifically, it presents the estimates of an ordinary-least-squares regression examining the relation between unsecured creditor recoveries and the presence of bankruptcy directors while controlling for firm financial and bankruptcy characteristics. It shows that, with full control variables, bankruptcy directors are associated with roughly 20% lower creditor recoveries.[168]

[Table 3]

To be sure, this association does not prove that the bankruptcy directors cause the lower recoveries. One could always argue that firms appoint bankruptcy directors when facing difficult bankruptcies and that this explains the low recoveries. While we use standard financial controls, including the ratio of debt to assets, the ratio of secured debt to total debt,[169] and indicators for private equity ownership and for prepackaged bankruptcy filings, these controls likely capture only part of the story of each Chapter 11 case.

Moreover, a bankruptcy could be difficult for reasons unrelated to the firm's ability to pay. For example, there could be inter-creditor disputes or regulatory issues. We do not observe these factors and cannot control for them. If firms appoint bankruptcy directors

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

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

[169] In unreported results, we observe that unsecured creditor recoveries first decrease, and then increase, in the ratio of secured debt to all debt. Accordingly, Columns 2 through 5 of Table 3 include both the ratio of secured debt to total debt (the "untransformed ratio") and that ratio squared. In Columns 2 and 3, the coefficient of the untransformed ratio is statistically significant and negative while, in Columns 2−4, the coefficient of the squared ratio is statistically significant and positive. This curvilinear relationship may reflect a common Chapter 11 tactic: when unsecured debt is small relative to total debt, the firm may choose to pay the unsecured debt in full rather than deal with a litigious UCC. For example, in the 2019 bankruptcy of sample firm Hexion Holdings, the firm paid unsecured creditors (trade debt, pension debt, environmental claims) all of their claims, while only paying junior secured creditors about 25% of their claims and paying senior creditors about 87% of their claims. In that case, the unsecured debt represented a less than 20% of total debt and the firm needed to pay the unsecured debt in full for business reasons. The results are qualitatively similar without the squared term and the statistical significance of the bankruptcy directors indicator variable does not depend on including the squared term.

precisely when these factors are present, we might wrongly attribute the low recoveries to these directors instead of to the firm's underlying circumstances.

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

At the very least, our findings explain why bankruptcy directors are controversial: all else being equal, firms that hire them end up paying on average 20% less to unsecured creditors than other firms.[170] These differences are statistically significant and likely visible to bankruptcy lawyers and investors active in Chapter 11 cases, who may associate bankruptcy directors with relatively lower creditor recoveries. In our view, these findings at least shift the burden of proof to those claiming that bankruptcy directors improve bankruptcy outcomes.

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

4. *The Biographies of Bankruptcy Directors*

To learn more about the backgrounds of bankruptcy directors, we collected biographical characteristics for the 86 named bankruptcy directors in our sample from information in the disclosure statements and supplemented those data with Internet research.[171]

Table 4 summarizes our findings. 48% of the named bankruptcy directors in our sample are bankruptcy experts. Table 1 above showed that 83% of the boards appointing bankruptcy directors report having a director with bankruptcy expertise. This means that firms often pair a Chapter 11 expert with a non-Chapter 11 expert as their bankruptcy

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

[171] Of 78 disclosure statements in our sample that mentioned bankruptcy directors, 57 identified 119 bankruptcy directors by name, leading to our sample of 86 unique names holding those 119 directorships. *See supra* note 154 and the accompanying text. Other disclosure statements mentioned bankruptcy directors active in the bankruptcy without identifying them by name.

directors. Table 4 further shows that the named bankruptcy directors are more likely to be former investment bankers (41%) than lawyers (19%), although a small number of bankruptcy directors were both.

[Table 4]

A subset of individuals within this group of 86 named bankruptcy directors hold many directorships, including in bankrupt companies. We call them "super repeaters." As one of them noted in a court hearing, they "specialize in going on the boards of companies that are emerging from bankruptcy or going into bankruptcy."[172]

To study the super repeaters, we dived deeper into the background of the most active bankruptcy directors. First, we identified the individuals named as bankruptcy directors in more than one disclosure statement. To this list we added individuals who appeared at least three times in our broader sample of 2,895 unique petition-date directors. After eliminating duplicates, we constructed an initial list of twenty directors.[173]

We then obtained from BoardEx information on the background and additional independent directorships of these directors.[174] We reviewed each directorship and eliminated duplicates or directorships for which we do not have service dates.[175] Finally, we identified which additional directorships were in companies that went into bankruptcy during our sample period by matching the list of additional directorships from BoardEx with Next Generation Research's list of Chapter 11 firms. BoardEx does not always provide data on directorship dates. However, when those data were available, we also examined whether the director was on the board of the company on the day of its bankruptcy filing or joined within a year after the bankruptcy filing.[176] After eliminating directors who had only one confirmed directorship of bankrupt companies, a list of 15 directors remained.

These directors have developed a profession of sitting on boards of bankrupt companies. Leading the list is a director, who has sat on 96 boards, for which we were able

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

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

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

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

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

to find the dates of his service, and confirmed that in 31 of these cases he served on boards of companies at the time of their bankruptcy filing or within a year thereafter.[177]

Overall, we find that the 15 super-repeaters on our list had 252 independent directorships, with an average of 17 directorships and a median of 13 directorships per director. Of these 252 directorships for which we have service dates, we find that, in 44% of the cases, the super-repeaters sat on the board at the time of their bankruptcy filing or within a year thereafter.[178]

Finally, we looked at the law firms that represented the bankrupt companies. As we will discuss below, the evidence suggests that these law firms exert significant influence over the selection of bankruptcy directors. Our data show that two law firms, Kirkland and Weil, have a particularly strong connection to super-repeaters. This is unsurprising, as Kirkland and Weil are the two preeminent law firms specializing in the representation of distressed companies.[179]

In 76 cases, we were able to find information on the identity of law firms that represented bankrupt companies with at least one super-repeater on the board. Kirkland represented the bankrupt firm in 33% of these cases, and Weil represented it in 14% of these cases.

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

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

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

[179] *See* Corrigan et al., *supra* note 158.

5. The Selection of Bankruptcy Directors

While firms do not systematically disclose how they select their bankruptcy directors, when they do, they usually describe the appointment as made by shareholders, often on the advice of the debtor's bankruptcy lawyers.[180] For example, Neiman Marcus's lawyers recruited the firm's bankruptcy directors after an employee of the private-equity sponsor reached out to them.[181]

To be sure, the ultimate decision to appoint a specific person to a directorship belongs to a firm's shareholders, and the law firms merely play an advisory role.[182] Nevertheless, the role of the debtor's law firm in advising on the candidate raises concerns because a handful of law firms dominate the market for representing companies on their journeys through Chapter 11. As Table 5 shows, Kirkland and Weil command a particularly large share of this market.[183] One bankruptcy director noted in a court hearing that prior history with the dominant law firms is hard to avoid, as Kirkland has a "90 to 80 percent market share in debtor cases."[184] While that number is exaggerated, the potential for a handful of law firms to influence appointment of these directorships can create what we call "auditioning bias." We discuss this in detail next.

[Table 5]

IV. Policy Implications

In this Part, we consider the policy implications of our analysis. First, we argue that judges should defer to the business judgment of bankruptcy directors only after verifying their neutrality. Second, we claim that bankruptcy directors cannot be neutral if shareholders alone select them, or if they have the support of only some of the creditor classes. We thus

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

181 *See* Neiman Marcus Trial, *supra* note 59, at 54. The employee of the private-equity firm who recruited Beilinson had worked with him on a prior Chapter 11 case. *See id.* The employee asked Beilinson if he was available for an "undisclosed assignment," and two lawyers from Kirkland subsequently called to clarify the engagement. *See id.* at 54–55.

182 As one super-repeater bankruptcy director noted, "Kirkland doesn't decide who goes on the board of directors of companies, owners do." *See* Rue21 Transcript, *supra* note 165, at 46.

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

184 *See* Rue21 Transcript, *supra* note 165, at 36.

propose that bankruptcy judges hold a hearing at the beginning of the bankruptcy process to present prospective or existing bankruptcy directors, their credentials, and their potential conflicts of interest. If these individuals then win overwhelming creditor support, the bankruptcy judge should treat them as independent. Otherwise, the judge should regard them without any type of special judicial deference. We further explain why our proposal will not discourage the use of bankruptcy directors or erode the benefits they can bring, such as adding expertise to the boardroom, streamlining the bankruptcy proceedings and blocking frivolous litigation. We close by considering the recent proposal of Senator Elizabeth Warren, which would accomplish through federal legislation the same goals of restoring the balance of power between debtors and creditors.

A. The Case against Deferring to Bankruptcy Directors in Conflicts with Creditors

The creation of the new role of bankruptcy directors in the past decade is the work of entrepreneurial bankruptcy lawyers and restructuring professionals. They have cleverly blended corporate law's deference to independent directors with bankruptcy law's faith in neutral trustees.[185]

It is easy to see how this innovation might appeal to bankruptcy judges.[186] Chapter 11 cases are contentious and require the bankruptcy judge to navigate the proceedings while understanding the firm's business less well than the parties.[187] A neutral expert could assist the court in this task, smooth the path to settlement and counteract the problems associated with leaving a self-interested board in control.[188] In theory, neutral bankruptcy directors could give the judge some of the benefits of a court-appointed trustee without the judge having to appoint one.[189]

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

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

[187] Conflict between creditors is one of the defining aspects of modern bankruptcy practice. *See, e.g.,* Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648 (2010). The judge's distance from the business often leaves her reliant on the creditors and the debtor to help her understand the facts. *See* Jared A. Ellias, *Regulating Bankruptcy Bonuses*, 92 S. CAL. L. REV. 653 (2019) (discussing the difficulty that judges have evaluating business decisions).

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

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

However, bankruptcy directors are not necessarily neutral. Shareholders usually appoint them on the advice of their lawyers.[190] It is reasonable to assume that they would be hard-pressed to do disappoint those who chose them for this lucrative engagement. Moreover, a bankruptcy directorship is a short-term engagement that creates incentives to treat it as an audition for the next engagements. The dependence on future engagements strengthens bankruptcy directors' desire to be helpful to shareholders and their lawyers. A bias in favor of shareholders can result in cheap settlements of claims against shareholders and in restructurings that let shareholders retain more equity. A bias in favor of lawyers can result in quick settlements to make the lawyers look good at the expense of creditors.[191] In short, shareholders' control of the appointment of bankruptcy directors undermines their independence.

These conflicts become worse when the controlling shareholder and its lawyers are repeat players in the bankruptcy arena, who can influence future nominations to the position of bankruptcy directors.[192] Those connections among bankruptcy directors, a group of private-equity funds and law firms are key to understanding the environment in which bankruptcy directors operate. To become a bankruptcy director one must work with the leading law firms and private-equity firms in the bankruptcy practice.

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

B. Enhancing Creditor Voice and Investigative Power

In this Section, we argue that enhancing the voice of creditors can cure the structural bias of bankruptcy directors. Creditors in Chapter 11 proceedings are usually sophisticated investors with expert lawyers. There is no reason to let shareholders' appointees prevent creditors from representing themselves in matters on which creditors and shareholders disagree. Doing so sidesteps the checks and balances built into Chapter 11.[193]

Bankruptcy law requires a public hearing to ensure that professionals retained for the proceedings have no conflicts.[194] Both debtor lawyers and UCC lawyers undergo this

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

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

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

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

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

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

The solution is to involve creditors in the selection of bankruptcy directors. In some cases, this is already taking place.[197]

Accordingly, we urge bankruptcy judges to use their broad discretion to implement a new procedure that is likely to solve many of the problems we have identified.[198] They should hold a hearing early in the bankruptcy process, in which the debtor will present any bankruptcy directors it appointed or plans to appoint and the creditors will express their opinion. The court will then treat the bankruptcy directors as neutral actors only if an overwhelming majority of creditors whose claims are at risk support the appointment. The expression "creditors whose claims are at risk" typically means the unsecured creditors and the UCC representing them. However, depending on the facts, the judge may also include in this category any other creditors whose rights are subject to modification, including some secured creditors. As for the standard of "overwhelming support," it should be a qualitative equivalent of the two-thirds majority needed to approve a reorganization plan.[199]

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

[196] As the judge in the Neiman bankruptcy noted, there is no Chapter 11 vehicle to look at the conflicts of bankruptcy directors—no "application hire these folks" and no "pleading or contested matter for me to look at the independence of an independent director." *See* Neiman Marcus Settlement Transcript, *supra* note 59, at 35.

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

[198] *See* 11 U.S.C. § 105 (2019). Creditors can already investigate potential conflicts of interest by seeking the appointment of an examiner under 11 U.S.C. § 1104 (2019) or seeking discovery under Federal Rule of Bankruptcy Procedure 2004. However, bankruptcy judges are reluctant to appoint examiners, partly due to the costs and the delay that such an appointment entails. *See generally* Jonathan Lipson, *Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies*, 84 AM. BANKR. L.J. 1 (2010). Moreover, our proposal offers at least three advantages. First, it ensures that the examination of potential conflicts of interest takes place at the beginning of the bankruptcy process. Second, it empowers bankruptcy directors who received creditor support as they conduct investigations and negotiations. Third, it encourages firms to ensure that their bankruptcy-director picks can withstand scrutiny.

[199] *See* 11 U.S.C. § 1126 (2019).

Absent such support, the court should regard the bankruptcy directors as ordinary professionals retained by the debtor: it should weigh their position against creditors',[200] allow creditors to conduct their own investigation and sue,[201] and not approve proposed settlements merely because the bankruptcy directors endorse them. Dissenting creditors should be able to present their own analysis using both time and estate funds, as Congress envisioned. This approach reclaims judicial discretion, rather than limits it: when the judge concludes that the bankruptcy director is not neutral, the judge has wide discretion how to dispose of the case, as she traditionally would.

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

Creditors will likely need information on the bankruptcy directors to form its opinion. Bankruptcy judges could rule what information request is reasonable to create standardization and predictability. Importantly, however, disclosure cannot substitute for creditor support. Requiring disclosure without giving creditors power over the selection of bankruptcy directors will not cure bankruptcy directors' structural bias.[202]

Requiring bipartisan support to ensure director neutrality is an old idea. In the corporate-law context, Lucian Bebchuk and Assaf Hamdani proposed to let public investors appoint or at least substantially influence the appointment of independent directors who vet decisions in which the interests of public investors and the controlling shareholder diverge.[203] The American Stock Exchange used to require issuers with a dual-class share structure to

[200] Bankruptcy directors resemble special litigation committees that boards sometimes form to handle shareholder derivative suits. In Section I.B, we noted important differences between the two institutions that make bankruptcy directors more controversial. However, under Delaware law, even when a court finds that a special litigation committee was independent, acted in good faith and made a reasonable investigation, it may reject the committee's recommendations based on the court's own business judgement. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787–89 (Del. 1981). Consistently, a recent empirical study finds that Delaware courts are skeptical of recommendations by special litigation committees calling for case dismissals. *See* C.N.V. Krishnan et al., *How Do Legal Standards Matter? An Empirical Study of Special Litigation Committees*, 60 J. CORP. FIN. 101543 (2020).

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

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

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

adopt this mechanism to protect the holders of the low-voting shares.[204] A similar requirement exists for listed controlled companies in the United Kingdom,[205] Italy,[206] and Israel.[207] Using this approach to make bankruptcy directors accountable also to creditors will protect creditors while preserving bankruptcy directors' ability to streamline the bankruptcy process.

C. Objections

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

1. Expertise

A common argument for using bankruptcy directors is that their expertise enhances board deliberations and improves the bankruptcy process.[208] In an unreported regression

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

[205] In 2014, the United Kingdom's Financial Conduct Authority adopted new listing rules, which requires subjecting the election or reelection of independent directors in controlled companies to approval by both a majority of shareholders and a majority of minority shareholders. *See* Fin. Conduct Auth., Listing Rules (Listing Regime Enhancements) Instrument 2014, FCA 2014/33, at 12, https://www.handbook.fca.org.uk/instrument/2014/FCA_2014_33.pdf.

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

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

[208] For studies finding that directors with related-industry expertise contribute positively to firm performance, see David Larcker & Brian Tayan, *The First Outside Director* (Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance No. CGRP–83, 2020). *See also* Felix von Meyerinck et al., *Is Director Industry Experience Valuable?*, 45 FIN. MGMT. 207 (2016) (finding significantly higher announcement returns upon appointments of experienced versus inexperienced directors). For a study finding that private-equity-backed firms navigate Chapter 11 more smoothly than other firms do, see Edith S. Hotchkiss et al., *Private Equity and the Resolution of Financial Distress*, 10 REV. CORP. FIN. STUD. 694 (2021).

controlling for other determinants of litigiousness, we find no evidence of such an advantage: there is no apparent relation between the presence of bankruptcy directors and the number of objections filed in court. Given that sophisticated attorneys advise all of the firms in our sample, the benefits of expertise that bankruptcy directors might bring beyond what the lawyers do are questionable.[209]

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

Our two case studies illustrate this point. Marc Beilinson, a bankruptcy director in the Neiman case, had served on fifteen boards, about half of them of bankrupt companies. He clearly had significant experience. However, when he took the witness stand, he was unable to answer questions about the investigation he oversaw and his answers revealed it had not gone very far.[210]

Similarly, when Payless appointed Charles Cremens as bankruptcy director, it described him as having vast restructuring experience, which was true.[211] Nevertheless, he conducted a flawed investigation in the eyes of unsecured creditors: he failed to obtain tolling agreements from the private-equity sponsors for claims that could expire during his investigation, and declined to hire an expert to determine whether Payless had been solvent when it paid dividends. This was the most critical question for the creditors' claims.[212] Yet it is clear from his own representations that he did not see his role to be zealously prosecuting the self-dealing claims.

Finally, there are ways to bring bankruptcy expertise to the board while protecting creditors. As we suggest above, creditors should have a say on the identity of the bankruptcy directors.[213] This will allow the appointment of professional directors who do not owe their appointment only to shareholders. Shareholders could also appoint to the board bankruptcy experts who do not win creditor support, but the court should not treat these directors as independent. Alternatively, boards can acquire bankruptcy expertise by hiring legal and financial advisors rather than appointing new directors.

2. *Speed and Practicality*

Another argument for the use of bankruptcy directors is that they streamline the bankruptcy process. Here too, we find no evidence of such an advantage: the duration of

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

[210] *See supra* notes 88–90.

[211] *See supra* notes 120–121.

[212] *See supra* notes 133 and accompanying text.

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

bankruptcy proceedings in the presence of bankruptcy directors is similar to its duration in their absence both on average and in an unreported regression controlling for other factors that may affect the duration of bankruptcy.[214]

Even if such an advantage existed, it would not alter the calculus. Emerging from bankruptcy quickly at the expense of creditor recoveries undermines an important bankruptcy policy goal.[215] Bankruptcy directors could achieve speedy results by undercutting rights of creditors and by deflating claims against the shareholders who appointed them. Our finding of lower creditor recoveries in the presence of bankruptcy directors is consistent with this prediction. And the two case studies we presented above illustrate the dynamics. In both of them, the bankruptcy directors prevented unsecured creditors from conducting their own investigation and quickly settled fraudulent transfer claims.[216]

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

Objectors might also claim that our solution is impractical because creditors will never support debtors' picks for bankruptcy directors. However, we see no reason to assume that this will be the case. Creditors may well oppose some of the current selections for bankruptcy directors, as no one asked for their opinion when making these selections. But both the selections and creditor views about them will likely be different once debtors know that their selections must receive creditor support. And one can imagine compromise slates of bankruptcy directors appointed to represent diverse creditor constituencies.

More importantly, our solution is the only way to ensure that the bankruptcy process retains the appearance of fairness. If it cannot be made to work, bankruptcy law should revert to the way it was before the invention of bankruptcy directors, where federal bankruptcy judges were the impartial actor in most large Chapter 11 cases whose credibility was key to winning public and creditor acceptance of the legitimacy of the proceeding.[217]

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[214] *See supra* Table 1.

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

[216] *See supra* notes 88–117, 132–134 and accompanying text.

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

3. Avoiding Meritless Litigation

Finally, one could argue that unsecured creditors might pursue meritless claims in the hopes of extracting a holdup-value settlement.[218] In theory, bankruptcy directors could prevent this by analyzing claims and settling them with minimal delay to the firm's emergence from bankruptcy.[219] In our view, however, this argument is not persuasive. The traditional tools of litigation management—motions to dismiss and summary judgment hearings—address this concern. Bankruptcy judges are experts in identifying meritless claims and can reduce the bargaining power of litigants with weak claims. There is no need to allow bankruptcy directors to preclude unsecured creditors from getting their day in court.

D. Senator Warren's Proposal for Federal Legislation

In October 2021, after the publication of a draft of this Article, Senator Elizabeth Warren introduced draft legislation to curb the ability of bankruptcy directors to undermine creditor rights.[220] The proposed legislation has two components. First, it would give exclusive power to the UCC to prosecute and settle claims against insiders.[221] Second, it would provide the UCC the power to demand a court hearing to examine potential conflicts of interest of any director.[222]

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

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[218] One of us has found no empirical support for the view that creditors prosecute meritless lawsuits in pursuit of holdup-value settlements. *See* Jared A. Ellias, *Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?*, 8 J. LEGAL ANALYSIS 493, 498 (2016). Nevertheless, the perception that they do is a powerful narrative in bankruptcy practice. *See, e.g.,* Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709 (2020); Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930 (2006).

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

[220] *See supra* note 22 and accompanying text.

[221] *See* Stop Wall Street Looting Act, S. 3022, 117th Congress § 202(e) (2021).

[222] *See id.* at § 202(d).

CONCLUSION

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

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

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

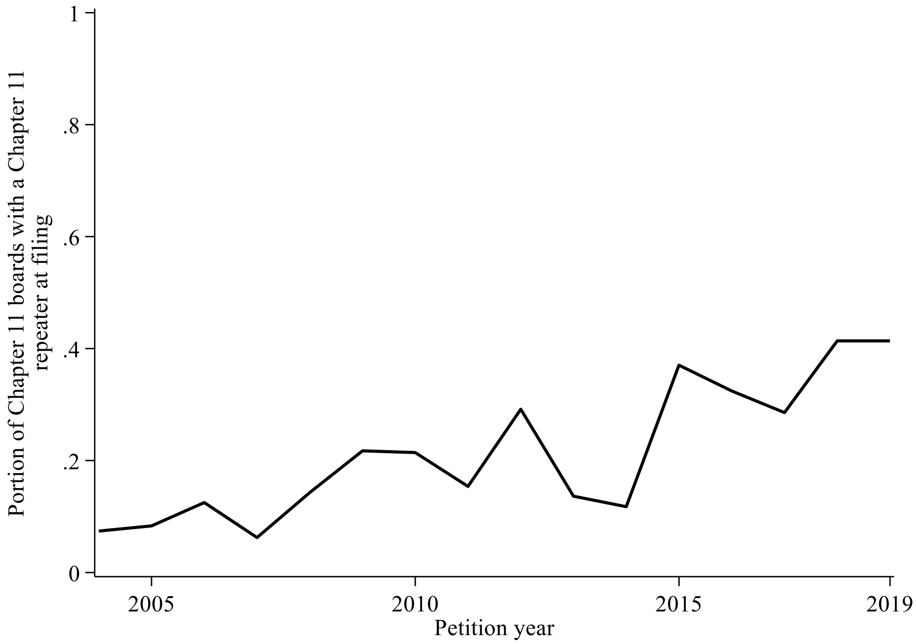

Figure 1 shows the portion of 454 boards of firms with assets or liabilities of $250 million or more that filed for Chapter 11 bankruptcy between 2004 and 2019 with a director who had previously been on the board of another firm when it filed for Chapter 11 bankruptcy (*Chapter 11 repeater*). Director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

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

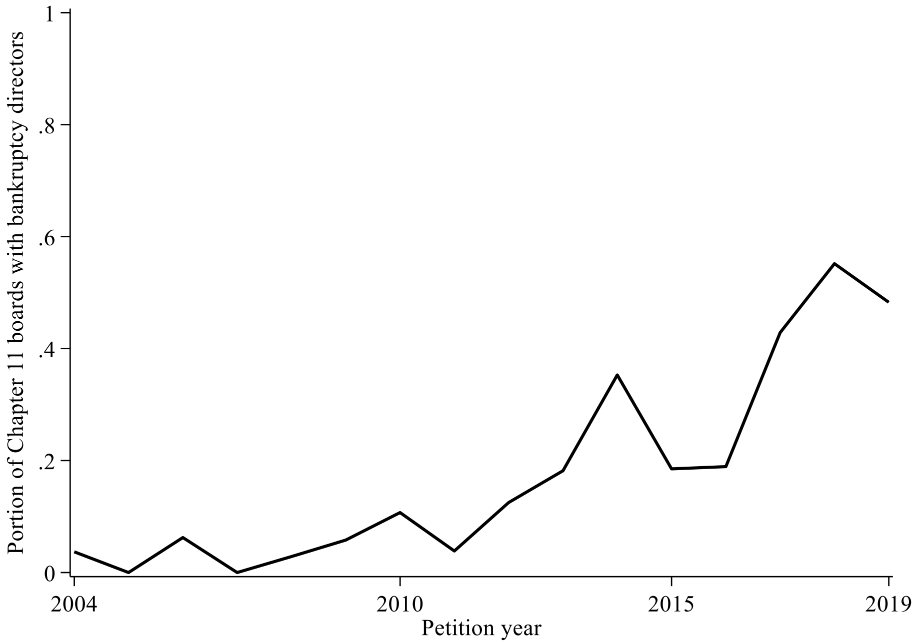

Figure 2 shows the portion of Chapter 11 firms that represented to the bankruptcy court that some of their directors were independent or disinterested. The sample includes 454 firms with assets or liabilities of $250 million or more that filed for Chapter 11 bankruptcy between 2004 and 2019.

Table 1. Characteristics of Firms, Bankruptcies, and Boards

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

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

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

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

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

Table 3. Determinants of the Percentage of Unsecured Debt Paid

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

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

Table 4. Characteristics of Named Bankruptcy Directors

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

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

Table 5. Law Firms' Share of Cases

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

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

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THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

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THE ROLE OF INDEPENDENT DIRECTORS IN MITIGATING LIABILITY ARISING FROM RESTRUCTURING DECISIONS

In this article the authors begin by discussing the law relevant to board decision-making when a corporation is in distress, the fiduciary duties of directors, and the important role of the independent director in the bankruptcy process. They then turn to detailed discussions of the recent D&O litigation challenging restructuring decisions in the Toys "R" Us and SportCo Holdings chapter 11 plans. They conclude with steps boards can take to mitigate the risk of liability in connection with negotiating and approving restructuring transactions.

By Michael R. Handler and Arthur J. Steinberg *

Corporate restructurings usually have one thing in common — rarely are *all* the stakeholders happy with the result. This is particularly true in a bankruptcy proceeding involving significant creditor loss. Moreover, in a bankruptcy proceeding where the debtor's tangible assets are encumbered by liens, it is likely that unsecured creditors' only hope for recovery is from litigation claims constituting property of the debtor's estate ("estate causes of action") which are typically unencumbered. A frequently asserted estate cause of action involves a transfer of assets from the debtor to insiders for less fair market value or no consideration. In that scenario, the commentary on distressed company governance focuses on the role of the independent director in reducing liability for these types of claims. In contrast, recent litigation against the board of directors ("Board") brought by trustees formed by the *Toys "R" Us* and *SportCo Holdings* chapter 11 plans highlights a different fact pattern arising from decisions made by those Boards with respect to the structure and terms of the restructuring itself. This article describes the law relevant to Board decision-making when a corporation is in distress, the relevant D&O litigation arising in *Toys R Us* and *SportCo Holdings*, and concludes with steps Boards can take to mitigate the risk of liability in connection with negotiating and approving restructuring and restructuring-related transactions.

BACKGROUND: DISTRESSED COMPANY GOVERNANCE AND APPLICABLE LAW

The internal affairs doctrine provides that "the law of the state where a corporation is incorporated governs issues relating to the internal affairs of a corporation, which include issues relating to a corporations' directors' and officers' fiduciary duties."[1] The *primary* fiduciary duties of directors and officers are the duty of care and the duty of loyalty. The duty of care obligates every corporate director and officer to discharge duties to the corporation with the same diligence, care, and skill which ordinary prudent persons exercise in their personal affairs. Under Delaware law, directors owe a

[1] *In re Hydrogen, L.L.C.*, 431 B.R. 337, 346 (Bankr. S.D.N.Y. 2010).

* *MICHAEL R. HANDLER and ARTHUR J. STEINBERG are partners in King & Spalding LLP's New York City office. Their e-mail addresses are mhandler@kslaw.com and asteinberg@kslaw.com.*

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fiduciary duty to the company and its equity holders.[2] This means they must exercise their business judgment in the best interests of the corporation for the benefit of its shareholder owners.[3] In the *SportCo* and *Toys "R" Us* chapter 11 cases (discussed below), the relevant debtor corporate entities were governed by Delaware law.

Under Delaware law, when a corporation is insolvent, the Board's fiduciary duties shift such that they must also take into consideration the interests of the corporation's creditors, "as the residual beneficiaries of any increase in value."[4] "The corporation's insolvency makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value."[5] Note that "[t]he stockholders remain residual claimants, but they can benefit from increases in the corporation's value only after the more senior claims of the corporation's creditors have been satisfied."[6] Although directors of an insolvent corporation must take into consideration the interests of creditors in connection with maximizing the value of the enterprise, the substantive duties are still owed to the corporation and not the creditors themselves. Practically speaking, this means that the Board of an insolvent corporation may still pursue "value maximizing strategies" on the riskier end of the spectrum if it still would otherwise satisfy the business judgment standard.[7]

Both outside and inside of bankruptcy, the standard of review as to whether a director and/or officer took corporate action consistent with his or her fiduciary duties depends on whether the corporate fiduciaries were economically interested in the transaction being reviewed (i.e., free from conflict). The most deferential standard of review is the "business judgment rule" under which there "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."[8] The business judgment rule "shields corporate decision-makers and their decisions from judicial second-guessing when the following elements are present: '(1) a business decision, (2) disinterestedness, (3) due care, (4) good faith, and (5) according to some courts and commentators, no abuse of discretion or waste of corporate assets.'"[9] Courts apply a "heightened scrutiny" test in assessing the bona fides of a transaction among a debtor and an insider of the debtor. "In applying heightened scrutiny, courts are concerned with the integrity and entire fairness of the transaction at issue, typically examining whether the process and price of a proposed transaction not only appear fair but are fair, and whether fiduciary duties were properly taken into consideration."[10] Where "heightened scrutiny" is applied, the "independence" and "disinterestedness" of the independent and disinterested director(s) authorizing the debtor to proceed with the proposed transaction, as well as the process the independent director(s) employed to evaluate the transaction, are critical factors in the post-decision scrutiny of the transaction.

In order to ensure that Board decision making will be evaluated under a "business judgment" standard and otherwise mitigate the risk of allegations of self-dealing

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[2] *See, e.g.*, *Quadrant Structured Prods. Co.. Ltd. v. Vertin*, 102 A.3d 155, 184 (Del. Ch. 2014) ("A transfer of value from a solvent subsidiary to the holder of 100% of the equity cannot give rise to a fiduciary wrong."); *Official Comm. of Unsecured Creditors v. Meltzer*, 589 B.R. 6, 27 (D. Me. 2018) ("Remember that it is acceptable, even required, for the directors of a solvent wholly-owned subsidiary to serve its parent's interests.").

[3] *Prod. Res. Gp., L.L.C. v. NCT Gp., Inc.*, 863 A.2d 772, 790 (Del. Ch. 2004) ("Having complied with all legal obligations owed to the firm's creditors, the board would . . . ordinarily be free to take economic risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value.").

[4] *Quadrant*, 102 A.3d at 184.

[5] *Id.* at 172.

[6] *Id.* (internal citations omitted).

[7] *Id.* at 187.

[8] *See, e.g., In re Latam Airlines Group S.A.*, 620 B.R. 722, 768 (Bankr. S.D.N.Y. 2020).

[9] *Id.* (emphasis added).

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

and/or a compromised decision-making, one of the first action items on the checklist of any sophisticated Board is ensuring there is at least one "independent" director sitting on the Board.[11] Appointment of an independent director is especially important if a bankruptcy filing is imminent, as all non-ordinary course transactions (e.g., asset sales, new employee compensation programs or modifications thereto, new financing arrangements or modifications thereto), especially transactions with "insiders" and other related parties, will be scrutinized by creditors and, in some cases, a chapter 11 trustee or examiner.

The role of the independent director on the Board of a distressed company prior to bankruptcy will vary based on facts and circumstances. At a minimum, the independent director will typically take the lead in making recommendations with respect to related party/insider transactions. In connection with preparing for a chapter 11 filing, the independent director may also take the lead on overseeing and communicating with restructuring advisors, negotiating with funded debt creditors on relevant prepetition agreements (such as debtor-in-possession financing and a restructuring support agreement), and crafting a communications strategy with employees, vendors, and customers related to the chapter 11 filing. The use of an independent director and/or special committee of the Board alone does not automatically protect the Board from a higher degree of scrutiny. The independent director and/or special committee must have actual bargaining power without interference and the real ability to decide whether to accept or reject the terms of an offer.[12]

In a chapter 11 bankruptcy case, the debtor automatically assumes an additional identity as the "debtor in possession."[13] A debtor will remain a debtor in possession until the debtor's plan of reorganization is confirmed and goes effective, the debtor's case is dismissed or converted to chapter 7, or a chapter 11 trustee is appointed. The appointment or election of a trustee occurs only in a small number of cases. Generally, the debtor, as "debtor in possession," operates the business and performs many of the same functions that a trustee would perform.[14] In addition to an independent director, the appointment of a chief restructuring officer may also protect against the appointment of a trustee or examiner. The concept of allowing the debtor to remain in possession is "premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee."[15]

RECENT CHAPTER 11 LITIGATION CHALLENGING RESTRUCTURING DECISIONS

Ongoing litigation arising from the Toys "R" Us" and SportCo Holdings chapter 11 cases brought by litigation trustees acting on behalf of unsecured creditors against directors relating to restructuring-related decisions underscore the importance of (1) the involvement of independent directors in analyzing and making restructuring decisions on behalf of the Board and (2) developing a robust record of critical and independent analysis in support of such decisions.

SportCo Holdings

In June of 2019, SportCo Holdings, Inc. and various affiliates (collectively, "SportCo") filed for chapter 11 in the Delaware Bankruptcy Court. SportCo was a marketer and distributor of hunting and fishing products and accessories that faced various financial and operational challenges, which were compounded by SportCo's acquisition of the assets of competitor AcuSport Corporation. The chapter 11 filing was preceded by, among other thing, an unsuccessful going concern sale process and, as discussed below, a failed out-of-court restructuring negotiation between SportCo and the holders of its Term Loan Debt (defined below).[16]

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[11] The term "independent director" does not have a firmly established definition in the context of state and bankruptcy law, but in substance, it is a director with no material relationship (personal or financial) with the corporation. American College of Bankruptcy Program, Oct. 5, 2021, "Independent Directors,CROs and Examiners: Managing Conflicts in Multi-Debtor Chapter 11 Mega-Cases."

[12] *See, e.g., Rabkin v. Olin Corp*., No. 7547, 1990 WL 47648, at *861-62 (Del. Ch. Apr. 17, 1990), aff'd 586 A.2d 1202 (Del. 1990); *In re First Boston, Inc. S'holder Litig*., No. 10338, 1990 Del. Ch. LEXIS 74 (June 7, 1990).

[13] 11 U.S.C. § 1101.

[14] 11 U.S.C. § 1107(a).

[15] *Wolf v. Weinstein*, 372 U.S. 633, 651 (1963) ("[S]o long as the Debtor remains in possession, it is clear that the corporation bears essentially the same fiduciary obligation to the creditors as does the trustee . . . .").

[16] All background information related to SportCo was pulled from the Declaration of Bradley P Johnson in Support of the Debtors' Chapter 11 Petitions and First Day Pleadings, *In re: SportCo Holdings, Inc., et al.,* No. 19-11299-JKS, 2021 WL 482513, (Bankr. Del. June 10, 2019), ECF No. 9, or the Debtors' Second Amended Combined Disclosure Statement and Joint Chapter 11 Plan of Liquidation, *In re: SportCo Holdings, Inc., et al.,* No. 19-11299-JKS, 2021 WL 482513, (Bankr. Del. Oct. 14, 2021), ECF No. 394, unless otherwise noted.

SportCo was majority owned by private equity firm Wellspring Capital Partners, and minority owned by investment firms Prospect Capital Corporation, Summit Partners Credit Fund, L.P. and certain members of the senior management team. As of the petition date, the funded indebtedness consisted of (1) approximately $23 million of first lien, asset based revolving credit facility debt ("ABL Debt") and (2) $230 million second lien term loan facility debt ("Term Loan Debt"; together with the ABL Debt, the "Secured Funded Debt"). In addition to the Secured Funded Debt, the debtors had approximately $41 million of unsecured debt comprised mostly of professional services, trade, and employee severance claims. The chapter 11 cases were funded by a roll up ABL debtor-in-possession facility from the existing ABL lenders. The chapter 11 cases were "free-fall" cases, as there was no restructuring support agreement with any of the holders of the Secured Funded Debt, nor was there a stalking horse agreement providing for the sale of substantially all of SportCo's assets.

Ultimately, following the liquidation of SportCo's assets in the chapter 11 cases, the ABL Debt and DIP Debt were repaid in full, approximately 14% of the Term Loan Debt was repaid, and unsecured claims and the deficiency Term Loan Debt claims (i.e., the remaining portion of the debt remaining after the collateral was sold and the proceeds applied in accordance with the secured claim waterfall) shared in the proceeds of estate causes of action assigned to a litigation trustee. In November of 2019, SportCo's plan of liquidation was confirmed, and in April of 2020, the litigation trustee filed a complaint against certain Wellspring Capital entities and certain of the former directors and officers asserting various causes of action against them.[17]

The claims asserted by the litigation trustee included claims against certain directors and officers for breach of their fiduciary duties of care and loyalty for rejecting an out-of-court restructuring proposal because it did not contain releases and indemnification for the directors and officers of SportCo. The complaint stated that the D&O Defendants, all of whom were employees of Wellspring or SportCo and not independent, engaged in discussions with the holders of Term Loan Debt regarding a potential restructuring before the bankruptcy filing.[18] The trustee's complaint asserted that "[t]he D&O Defendants, refused at the last minute, to execute any debt restructuring agreement premised on an out-of-court balance sheet restructuring that did not include a broad release and indemnification language in favor of the D&O Defendants and Wellspring Capital because they, and not the debtors' creditors, stood to receive substantial value if the debtors' debt restructuring agreement included [those] provisions."[19] The complaint further asserted that in insisting on such provisions, the D&O Defendants "placed their own self-interests above those of their fiduciaries — specifically, the debtors — and permitted the debtors to breach their loan covenants instead of entering into a restructuring agreement that did not provide the D&O Defendants or Wellspring Capital with the releases and the benefit of indemnification." [20]

In dismissing the trustee's breach of the duty of care claim, the bankruptcy court found that "the Complaint does not allege facts that would support the conclusion that the D&O Defendants failed to inform themselves adequately in rejecting the proposed out of court restructuring or that such action amount[ed] to gross negligence."[21] However, the bankruptcy court denied the D&O Defendants' request to dismiss the breach of the duty of loyalty claim, rejecting the D&O Defendants' argument that the "individual releases would not have been a 'private interest' because the benefit would have been shared with restructured SportCo . . . [by] sav[ing] the post-restructuring company the expense of indemnifying the D&O Defendants in connection with any litigation that would arise following a change of control in connection with a restructuring."[22] Instead, the bankruptcy court found that "the extent to which individual releases might have benefitted SportCo is a partly factual question because it involves the nature and extent of the D&O Defendants' entitlements to indemnification and other matters this Court cannot now resolve."[23]

Toys "R" Us

Ongoing litigation arising from the Toys "R" Us bankruptcy cases also highlights the risk of breach of fiduciary duty litigation against directors and officers in connection with restructuring decisions that arguably result in suboptimal outcomes for junior creditors,

[17] Complaint, *Ronald Friedman v. Wellspring Capital Management, et al.* (In re: SportCo Holdings, Inc., et al.), No. 20-50554-JKS (Bankr. Del. Apr. 2, 2020), ECF No. 1.

[18] *Id.* at ¶¶ 129-134.

[19] *Id.* at ¶ 166.

[20] *Id.* at ¶ 168.

[21] *In re Sportco Holdings, Inc.*, 2021 WL 4823513 (Del. Bankr. Oct. 14, 2021), at *10.

[22] *Id.*

[23] *Id.* The docket in the adversary proceeding suggests that the parties are in mediation with respect to the breach of the duty of loyalty claim that survived the defendants' motion to dismiss.

particularly with the benefit of hindsight.[24] Like the SportCo chapter 11 cases, the Toys "R" Us bankruptcy cases were "free-fall" cases and, like in SportCo, the unsecured creditor claimants' recovery was significantly impaired and in large part limited to proceeds from estate causes of action. At a very high level, the Toys "R" Us enterprise consisted of three different (but at times, overlapping) debtor and accompanying creditor groups: (1) Toys "R" Us Inc. and certain direct and indirect subsidiaries (collectively, but excluding the Toys Delaware Debtors (as defined below), the "TRU Debtors"), which constituted the U.S business and included indirect ownership of the Toys "R" Us trademarks and other intellectual property (which were held by Toys "R" Us - Delaware Inc. and certain of its direct and indirect subsidiaries (collectively, the "Toys Delaware Debtors")); (2) Propco I and Propco II (the "Propco Debtors"), consisting of owned real estate that was leased to affiliates; and (3) TRU Taj LLC and certain direct and indirect subsidiaries (collectively, the "Taj Debtors"; together with the TRU Debtors, the Toys Delaware Debtors, and the Propco Debtors, the "Toys Debtors") consisting of the international subsidiaries. Combined, the Toys Debtors had in excess of $5 billion of funded debt obligations. The TRU Debtors and Taj Debtors chapter 11 cases were filed on September 18, 2017. Two independent directors were appointed to the TRU Board on September 13, 2017 for the purpose of taking control of decisions for which the other directors would have conflicts of interest. Note that the chapter 11 filings were precipitous, and in large part due to news reports that Toys "R" Us had engaged restructuring advisors and was considering restructuring options, which caused suppliers to begin to pull trade credit and withhold products amid generally tighter liquidity conditions and right before the holiday inventory build.

As part of the Toys Delaware Debtors and TRU Debtors respective chapter 11 plans, certain general, unsecured, and administrative expense creditors of the Toys Delaware Debtors and TRU Debtors received as part of their recovery interests in a litigation trust (the "TRU Creditor Litigation Trust"), which was formed to prosecute estate causes of action against the TRU Debtors' directors and officers. On March 12, 2020, the TRU Creditor Litigation Trust filed a complaint against certain TRU D&Os (the "TRU D&O Defendants") alleging various claims, including breach of fiduciary duty of care and loyalty claims relating to the TRU Board's decision to incur $3.1 billion of debtor-in-possession financing to fund a plan process premised on the Toys Debtors emerging from bankruptcy as a going concern rather than a "structured wind-down."[25] The crux of the complaint asserted that the Board's decision to pursue a going concern restructuring process was an "irrational" gamble that was driven by the TRU D&O Defendants' personal interests rather than based on an informed analysis to pursue a path forward that would "maximize the value of the enterprise for TRU's creditors."[26]

The TRU Creditor Litigation Trust also asserted breach of fiduciary duty claims against the TRU D&O Defendants for (1) authorizing pre-petition retention payments to company executives before the commencement of the Bankruptcy Proceeding[27] and (2) authorizing the payment of advisory fees to TRU's private equity shareholders from the fourth quarter of 2014 through the first quarter of 2017.[28] In addition to breach of fiduciary claims, the TRU Creditor Litigation Trust asserted claims for intentional or negligent misrepresentation, fraudulent concealment, or negligence on behalf of vendors based on allegations that the TRU D&O Defendants induced trade vendors to ship goods and provide services to TRU on credit after the commencement of the bankruptcy cases, the Defendants misrepresented facts concerning TRU's ability to make payments for those goods and services.[29]

The complaint further asserted that the Board and TRU's outside advisors were dominated by the TRU CEO director, whose desire to continue earning his $3.75 million salary and other perks, earn a $2.8 million retention bonus, as well protect the equity interests of Bain, KKR and Vornado (who he was allegedly beholden to), resulted in him dominating the Board and TRU's outside advisors to pursue a strategy that kept

[24] All background information related to Toys "R" Us was pulled from the Declaration of David A. Brandon, Chairman of the Board and Chief Executive Officer of Toys "R" US, Inc., In Support of Chapter 11 Petitions and First Day Motions, *In re: Toys "R" Us, Inc., et. al.*, No. 17-34665-KLP (Bankr. E.D. Va. Sept. 19, 2017), ECF No. 20, or the Second Amended Disclosure Statement for the Joint Chapter 11 Plan of the TAJ Debtors and the TRU Inc. Debtors, , *In re: Toys "R" Us, Inc., et. al.*, No. 17-34665-KLP (Bankr. E.D. Va. Sept. 6, 2018), ECF No. 4552 unless otherwise noted.

[25] The complaint was amended twice. All citations refer to the Second Amended Complaint filed on April 30, 2021 in the United States Bankruptcy Court for the Eastern District of Virginia under the case caption, *TRU Creditor Litigation Trust v. Brandon, et. al. (In re: Toys "R" Us, Inc., et. al.),* Case No. 17-34665-KLP.

[26] *Id.* at ¶ 171.

[27] *Id.* at ¶¶ 75-89.

[28] *Id.* at ¶¶ 45-55.

[29] *Id.* at ¶¶ 90-118.

TRU alive as long as possible.[30] The complaint alleged that as a result of such domination, the Board did not request advice from its advisors on a wind-down strategy or any other alternative to a large-scale DIP financing, and that failure to do so was a "particularly egregious" abdication of the duty of care "because the DIP financing path was not a plausible strategy and would almost certainly result in the liquidation of TRU anyway, after destroying value and depriving unsecured creditors of access to hundreds of millions of dollars of unencumbered assets to at least partially satisfy their claims."[31]

The TRU D&O Defendants filed a motion to dismiss the complaint and, rather than rule on the motion to dismiss, the bankruptcy court treated the motion as a motion for summary judgment.[32] In their motion for summary judgment, the TRU D&O Defendants made various arguments in support of dismissal of the breach of duty of care and loyalty claims relating to the TRU Board's decision to incur the DIP financing and pursue a going concern restructuring, including that DIP financing related claims are barred by the "law of the case" doctrine as a result of the final DIP order's determination that the DIP financing was "fair and reasonable" and "reflect[ed] the [Debtors'] exercise of prudent business judgment consistent with their fiduciary duties."[33] The defendants also argued that because the official committee of unsecured creditors supported the DIP financing, the trust, which represented the same constituency, should be estopped from "advanc[ing] the opposite argument."[34] In its opposition brief, the TRU Creditor Litigation Trust contended that the bankruptcy court's October 2017 order finding that the DIP financing was "'necessary and vital" to preserve Toys' going-concern value is not "law of the case" because the confirmation order bars the application of any preclusion doctrine and expressly preserves the trust's claims against officers and directors, and that the claims are not precluded because the bankruptcy court approved the DIP orders based on "false and misleading information" furnished by the debtors and their advisors.[35]

On June 27, 2022, the U.S. Bankruptcy Court for the Eastern District of Virginia entered an order and memorandum opinion granting the TRU D&O Defendants' motion for summary judgment to dismiss the cause of action for breach of fiduciary duty for authorizing DIP financing, but denying the motion for summary judgment to dismiss with respect to other breach of fiduciary causes of action and the vendor inducement-related claims for intentional or negligent misrepresentation, fraudulent concealment, or negligence.[36] With respect to the breach of fiduciary duty for authorizing DIP financing claim, the bankruptcy court found that the final DIP order's findings that the DIP financing was "necessary and vital to the preservation and maintenance of the going concern values of the DIP Loan Parties and to a successful reorganization" and that the terms were "fair and reasonable, reflect the DIP Loan Parties' exercise of prudent business judgment consistent with their fiduciary duties and constitute reasonably equivalent value and fair consideration" were binding findings under the "law of the case doctrine."[37] In applying the "law of the case doctrine," the bankruptcy court explained that the TRU Creditor Litigation Trust offered "no 'new evidence' that, in the view of the bankruptcy court, was not available through discovery and that could have been offered prior to entry of the Final DIP Order."[38]

With respect to the other claims against the TRU D&O Defendants, the bankruptcy court found that the plaintiffs had submitted sufficient evidence such that there was a genuine dispute and trial issuable of fact with respect to the allegations underlying such claims. Notably, with respect to the breach of fiduciary duty claim for approving retention bonuses to 117 TRU executives, the bankruptcy court found that TRU Creditor Litigation Trust "documented extensive evidence and supporting case law" in support of its argument that, among other things, the "Defendants were not disinterested, failed to consider material

[30] *Id.* at ¶¶ 180-192.

[31] *Id.*

[32] Order, *TRU Creditor Litigation Trust v. Brandon, et. al. (In re: Toys "R" Us, Inc., et. al.),* No. 17-34665-KLP (Bankr. E.D. Va. Sept. 30, 2020), ECF No. 65.

[33] Defendant's Motion and Memorandum of Law for Summary Judgement, *TRU Creditor Litigation Trust v. Brandon, et. al. (In re: Toys "R" Us, Inc., et. al.),* No. 20-03038-KLP (Bankr. E.D. Va. Dec. 13, 2021) ECF No. 315 at pg. 5-8.¶.

[34] *Id.* at pg. 7.

[35] Trust's Opposition to Defendants' Motion for Summary Judgment, *TRU Creditor Litigation Trust v. Brandon, et. al. (In re: Toys "R" Us, Inc., et. al.),* No. 20-03038-KLP (Bankr. E.D. Va. Jan. 18, 2022), ECF No. 343 at pg. 79-81; 85-86.

[36] TRU Creditor Litig. Tr. v. Brandon, et al. (In re Toys "R" Us, Inc.), Ch. 11 Case No. 17-34665-KLP, Adv. Pro. No. 20-03038-KLP, slip op. (Bankr. E.D. Va. June 27, 2022).

[37] *Id.* at pg. 6-7.

[38] *Id.* at pg. 19.

information reasonably available to them, failed to consider reasonable alternatives, and abdicated decision-making process to Defendant Brandon, the CEO of Tru, who was the recipient of the largest bonus."[39]

CONCLUSION: THE ROLE OF INDEPENDENT DIRECTORS IN MITIGATING D&O LIABILITY RISK

Toys "R" Us and SportCo underscore the risk of litigation against directors and officers in connection with their restructuring-related decisions when their corporations ultimately file for chapter 11, and the unsecured creditor recovery (without resort to estate causes of action) is minimal. When developing a governance strategy for a distressed company, the Board and its advisors must consider the "worst case" restructuring outcome and how the directors' and officers' decisions may be viewed in hindsight by creditors that suffer losses as a result of decisions made or approved by the Board. Although litigation may be an inevitability as a result of a business-driver restructuring outcome, decisions related to Board processes in assessing restructuring options and negotiating with creditors and other key stakeholders, will help develop a record to insulate the Board from ultimate liability (and could prevent litigation itself from being brought in the first place or significantly reduce the perceived merits and settlement value of such litigation).

Indeed, the breach of duty of loyalty claim in *SportCo* may have been dismissed if an experienced independent director was on the Board (as opposed to no independent director, as was the case there). Ideally, that independent director would have had (1) "actual bargaining power without interference and the real ability to decide whether to accept or reject the terms of an offer" and (2) sufficient resources to undertake a robust analysis demonstrating a thorough assessment of downside risks.[40] The SportCo bankruptcy court found that the litigation trustee pled facts sufficient to show that releases and indemnification were restructuring terms constituting private interests of the very directors negotiating the restructuring on behalf of SportCo. The result may have been different if the SportCo Board would have been further insulated by forming a special committee consisting of one or more independent directors vested with the exclusive authority to negotiate and approve the terms of a restructuring transaction.

In contrast to the SportCo Board, there were two independent directors on the TRU Board. Although authority to enter into the DIP financing and negotiate the terms of a restructuring was not vested exclusively with the independent directors, the decision to obtain DIP financing and pursue a going concern restructuring were not "interested transactions" for the non-independent directors approving the relevant transactions. Yet, the TRU Creditor Litigation Trust still alleged that the Board was compromised by the insider CEO, and that his economic self-interest drove the TRU Board's restructuring strategy. Although the cause of action for breach of fiduciary duty for authorizing DIP financing was dismissed on the grounds that it was precluded by the final DIP order findings, the TRU Creditor Litigation Trust's lawsuit underscores the potential exposure director and officers face as a result of bankruptcy liability management decisions if their decisions are not unilaterally made by disinterested independent directors (or otherwise subsequently blessed by bankruptcy court order). Absent exclusive decision-making authority by the independent director, the corporate governance record should ideally show that the independent director is leading the decision-making process, including overseeing analysis from outside professional advisors. In addition, the summary judgment denial for the tort causes of action in respect of vendors allegedly being induced to provide credit based on misrepresentations underscores the risks that directors and officers face when dealing with trade creditors in the lead up to a bankruptcy filing. Finally, SportCo and Toys "R" Us are cautionary tales. The litigation posture of the Board in both of these cases would have been vastly improved with a properly inserted, and the timely appointment of, an independent director or special committee of the Board. ■

[39] *Id.* at pg. 21.

[40] *See, e.g.*, *Rabkin*, 1990 WL 47648, at *861-62, aff'd 586 A.2d at 1202. For example, in connection with the Purdue Pharmacy chapter 11 cases, prior to filing for bankruptcy, Purdue Pharma's governance documents were amended to "irrevocably grant[] an independent Special Committee of the Board of Directors exclusive authority over the prosecution, defense, and settlement of any causes of action Purdue Pharma may assert against its shareholders, as well as members of the Sackler Families and their affiliates." See Debtors' Amended Disclosure Statement, *In re Purdue Pharma L.P.*, 19-23649-RDD (Bankr. S.D.N.Y. May 26, 2021), ECF No. 2937, at 68.

Independent Director Investigations Can Benefit Creditors

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Summary

Independent directors are increasingly appointed to conduct investigations of distressed companies traditionally conducted by unsecured creditors' committees. While this sets up friction between the directors and the committees, there are advantages that can also benefit unsecured creditors, as seen in three recent cases, say Robert Gayda and Catherine LoTempio of Seward & Kissel.

Article

Investigations conducted by independent directors[1] of distressed companies have become common in recent years. Some commentators view these "internal" investigations as infringing on the role of unsecured creditors' committees, which had historically reviewed and analyzed prepetition conduct of a debtor and the debtor's management/ownership for potential causes of action. Undoubtedly, there is often friction between independent directors and creditors' committees regarding the investigation (and related settlements).

However, there are advantages to independent director investigations, particularly in the current bankruptcy environment, where speed to exit is paramount. These advantages can also serve to benefit unsecured creditors. This article reviews some of the advantages independent director investigations may provide and surveys several recent cases where independent directors investigated prepetition conduct, including the dynamics between constituencies and the ultimate results.

Potential Advantages of Independent Director Investigations

A company considering bankruptcy will often appoint new members, unaffiliated with the company and its prior management, to its board of directors in the months leading up to its bankruptcy petition. Such independent directors often are highly experienced restructuring professionals. While independent directors serve alongside the other members of the board, they may also be directly delegated (often through the appointment to a special committee) the responsibility of investigating and potentially prosecuting or settling claims against the company's insiders, sponsors and/or affiliates relating to certain transactions that occurred prior to the bankruptcy filing.

There are certain practical advantages to independent director investigations. As newly appointed members of a board with significant restructuring expertise, independent directors are generally well positioned to investigate claims.

Independent directors often hire their own legal and financial advisers to assist with the investigation. Once appointed, independent directors can immediately commence their investigation, in many instances prior to the company's bankruptcy filing and the appointment of a creditors' committee. Independent directors, as an extension of the debtor, may also obtain early access to many key parties and documents through informal means, without being limited by privilege concerns or the need for court intervention.

In addition, it is possible that a special committee of independent directors, acting on behalf of a debtor, would have standing to prosecute certain causes of action where creditors might not.[2]

These advantages can help expedite an investigation and thus a bankruptcy case, resulting in reduced cost and increased certainty, which, among other things, may encourage additional investment from parties of interest that might lead to a successful case. Creditors' committees can shadow an in-progress investigation, and benefit from information already collected, while retaining the right to act if not satisfied with the process or the pace at which it is being conducted.

A Survey of Recent Cases

The significant number of bankruptcy cases in recent years that involve independent director investigations exhibit their prevalence and utility. The following cases are just three examples of such cases (there are several major cases involving independents pending), which illustrate some of the case dynamics created and the ultimate results achieved.[3]

Shopko

The disinterested directors of Specialty Retail Shops Holding Corp., or "Shopko," were appointed to the board of directors in December 2017. On Nov. 26, 2018, the board authorized the formation of a special committee comprised of the independent directors, which commenced an investigation of, among other things, certain dividends to Shopko's equity owners, including Sun Capital Partners Inc. Shopko and its affiliates filed for bankruptcy in Nebraska on Jan. 16, 2019, and filed a disclosure statement and plan of reorganization, which contained standard releases.

The special committee supported the approval of the disclosure statement, provided that any proposed plan releases remained subject to their active investigation. After the Feb. 28, 2019, approval of the disclosure statement, disputes arose between the debtors and the creditors' committee regarding the investigation. On March 13, the creditors' committee filed a motion for standing to prosecute claims that were the subject of the special committee investigation, arguing that the debtors unjustifiably refused to bring such claims, and that the debtors were "hopelessly conflicted."

The hearing on this motion, as well as the confirmation hearing, were adjourned several times as the parties negotiated. On April 26, 2019, the creditors' committee filed a motion to convert the Chapter 11 cases to Chapter 7, arguing that the cases were administratively insolvent and that a Chapter 7 trustee would be better situated to bring claims against insiders, and a hearing was set for May 28.

On May 1, the cases shifted course as the special committee announced that it had reached a settlement with Sun Capital, whereby Sun Capital would pay $15 million to satisfy the insider claims. The creditors' committee filed a motion to compel discovery regarding its reasonableness. On May 21, 2019, the parties, including the creditors' committee and the debtors, filed a notice indicating that they had reached a global settlement, which increased the settlement amount to $15.5 million and included other substantive changes to the plan. The plan was ultimately confirmed on June 7, 2019, although confirmation was denied once.[4]

Mission Coal

In September 2018, Mission Coal Company LLC appointed two independent members to its board of directors. On Oct. 14, 2018, Mission Coal and certain affiliates filed for bankruptcy in the U.S. District Court for the Northern District of Alabama. Thereafter, in late October 2018, the independent directors began investigating Mission Coal's prepetition activity, including payments made to sponsors, affiliated entities and third parties, and loans made to insiders and affiliated parties.

The unsecured creditors' committee concurrently conducted its own investigation of estate causes of action. To coordinate and streamline the investigations, the parties agreed to a discovery stipulation, which was filed on Nov. 15, 2018. Pursuant to the stipulation, the parties agreed to share copies of any document productions received and to permit both parties' attendance at all interviews conducted or depositions taken.

On Jan. 2, 2019, the debtors filed a plan of reorganization and an accompanying disclosure statement. At that time, the independent directors' investigation remained ongoing and the releases contained in the plan were made subject to the conclusion of the investigation. The independent directors completed their investigation in late February 2019 and began negotiating the resolution of potential estate claims. Around the same time, the unsecured creditors' committee filed a motion for standing to prosecute and settle certain causes of action on behalf of the debtors' estates, including claims for recovery of alleged transfers from the debtors of approximately $76.15 million.

On March 27, 2019, the independent directors announced a settlement of estate claims with certain current and former equity owners of the debtors and their affiliated nondebtor entities. The settlement provided for, among other things, $15 million in cash, the assumption by certain of the settling parties of up to $12 million in liabilities, a $1 million note payable to the debtors, and waiver of certain deficiency claims. The proposed settlement was incorporated into an amended plan filed on March 30, 2019. Given the settlement, the debtors also opposed the unsecured creditors' committee's standing motion.

A hearing on confirmation of the plan began on April 3, 2019, with the unsecured creditors' committee objecting to the plan. After four days of hearings on confirmation, the debtors announced a settlement requiring the unsecured creditors' committee to support the plan, provided that, among other things, certain of the settlement proceeds would be earmarked for unsecured creditors. The settlement with the unsecured creditors' committee was incorporated into a further amended plan, which was confirmed by the Bankruptcy Court on April 15, 2019.

Nine West

In August 2017, the board of directors of Nine West Holdings Inc. and certain of its affiliates appointed two independent members. In October 2017 the independent directors began investigating causes of action related to Nine West's 2014 going-private transaction and related purchase of certain businesses from Nine West by equity sponsor-affiliated entities. On April 6, 2018, Nine West and certain affiliates filed for bankruptcy in the U.S. District Court for the Southern District of New York. The independent directors' investigation continued after the bankruptcy filing, while the unsecured creditors' committee pursued a parallel investigation.

On June 18, 2018, the debtors and the unsecured creditors' committee agreed to a "standstill agreement" that provided, among other things, that the debtors would not seek to settle any estate claims under investigation until the expiration of a standstill period, which was originally set to expire on Aug. 14, 2018, but was subsequently extended until Sept. 13, 2018.

In turn, the unsecured creditors' committee agreed not to file a motion seeking derivative standing to pursue estate causes of action during the standstill period. The goal of the standstill agreement was to allow the parties to continue their respective investigations and pursue negotiations around the settlement of any related claims.

After the expiration of the standstill period, on Oct. 4, 2018, the unsecured creditors' committee filed a motion seeking standing to pursue estate causes of action. Subsequently, on Oct. 17, 2018, the debtors filed a plan of reorganization incorporating a settlement of the claims subject to the independent director investigation for $105 million in settlement proceeds to be distributed to unsecured creditors. Anticipating a dispute, the bankruptcy judge ordered the parties into mediation.

While a global resolution was not achieved in mediation, the debtors and the unsecured creditors' committee agreed to terms of a revised plan that provided for, among other things, the creation of a litigation trust, an additional $10 million cash contribution with respect to the settlement, and changes to the distribution of the settlement proceeds. Certain unsecured creditors, however, continued to seek standing to pursue estate causes of action and objected to the debtors' amended plan.

Ultimately, the debtors announced a global resolution on Feb. 8, 2019, providing for further changes to the allocation of settlement proceeds, as well as an additional settlement contribution of $5 million, resulting in aggregate proceeds of $120 million under the settlement. The debtors' plan incorporating the global settlement was confirmed on Feb. 25, 2019.

Conclusion

Independent director investigations are likely to remain prevalent in the restructuring landscape. While it is difficult to determine exactly what drove the result in any given case, there are certainly some practical advantages to independent investigations. Where required, these investigations can help a case progress, which can result in tangible benefits to the bankruptcy estate, including unsecured creditors.

Even though a creditors' committee may view the use of an independent investigation as usurping its role, creditors' committees retain traditional remedies (standing motions, etc.) and will employ them irrespective of the appointment of independent directors. The cases above highlight this push and pull between constituencies. Like any other restructuring tool, restructuring professionals must acknowledge the trend, and consider the utility of these investigations on a case by case basis.

Robert J. Gayda is a partner and Catherine V. LoTempio is an associate at Seward & Kissel LLP.

[1] This article refers only to investigations conducted by independent "directors" of corporations. This reference, however, is also intended to include independent "managers," which would be appointed to govern limited liability companies.

[2] CML V, LLC v. Bax, 6 A.3d 238, 242 (Del. Ch. 2010) (holding that under the plain language of the Delaware LLC statute, creditors of an insolvent LLC are denied standing to bring derivative actions on behalf of the company), aff'd 28 A.3d 1037 (Del. 2011); see also Official Comm. of Unsecured Creditors of HH Liquidation, LLC v. Comvest Grp. Holdings, LLC (In re HH Liquidation, LLC), 590 B.R. 211, 283 (Bankr. D. Del. 2018) (citing Bax).

[3] The summaries included in this article are based solely on publicly available information.

[4] An individual creditor has filed a notice of appeal with respect to confirmation (mainly related to the treatment of professional fee claims).

ARTICLE: The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices

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Author: Jeffrey N. Gordon*

* Alfred W. Bressler Professor of Law, Albert E. Cinelli Enterprise Professor of Law, Columbia Law School; Research Associate, European Corporate Governance Institute (jgordon@law.columbia.edu). For research assistance, many thanks to Ben Dickson, Nicolas Diefenbacher, Elysse Folk, Matt Jennejohn, Gary Li, Michael Horwitz, Adam Nelson, Jon Olsen, Jacob Oslick, Jason Sussman, and Benjamin Whetsell. For discussion and comments on prior drafts, many thanks to workshop participants at Columbia, Fordham, Georgetown, Stanford, and Virginia, and the American Association of Law Schools January 2007 Business Associations Section meeting, and to Bill Bratton, Jack Coffee, Larry Cunningham, Rob Daines, Deborah DeMott, Mel Eisenberg, Jill Fisch, Ron Gilson, Zohar Goshen, and Don Langevoort.

Highlight

Between 1950 and 2005, the composition of large public company boards dramatically shifted towards independent directors, from approximately 20% independents to 75% independents. The standards for independence also became increasingly rigorous over the period. The available empirical evidence provides no convincing explanation for this change. This Article explains the trend in terms of two interrelated developments in U.S. political economy: first, the shift to shareholder value as the primary corporate objective; second, the greater informativeness of stock market prices. The overriding effect is to commit the firm to a shareholder wealth maximizing strategy as best measured by stock price performance. In this environment, independent directors are more valuable than insiders. They are less committed to management and its vision. Instead, they look to outside performance signals and are less captured by the internal perspective, which, as stock prices become more informative, becomes less valuable. More controversially, independent directors may supply a useful friction in the operation of control markets. Independent directors can also be more readily mobilized by legal standards to help provide the public goods of more accurate disclosure (which improves stock price informativeness) and better compliance with law. In the United States, independent directors have become a complementary institution to an economy of firms directed to maximize shareholder value. Thus, the rise of independent directors and the associated corporate governance paradigm should be evaluated in terms of this overall conception of how to maximize social welfare.

Text

[*1468]

Introduction

"Independent directors" - that is the answer, but what is the question?

The now-conventional understanding of boards of directors in the diffusely held firm is that they reduce the agency costs associated with the separation of ownership and control. Elected by shareholders, directors are supposed to "monitor" the managers in view of shareholder interests. Who should serve on the board of a large public firm? Circa 1950, the answer was, as a normative and positive matter, that boards should consist of the firm's senior officers, some outsiders with deep connections with the firm (such as its banker or its senior outside lawyer), and a few directors who were nominally independent but handpicked by the CEO. Circa 2006, the answer is "independent directors," whose independence is buttressed by a range of rule-based and structural mechanisms. Inside directors are a dwindling fraction; the senior outside lawyer on the board is virtually an extinct species.

The move to independent directors, which began as a "good governance" exhortation, has become in some respects a mandatory element of corporate law. For controversial transactions, the Delaware courts condition their application of the lenient "business judgment rule" to board action undertaken by independent directors. [1] The New York Stock Exchange requires most listed companies to have boards with a majority of independent directors [2] and audit and compensation committees comprised solely of independent directors. [3] The NASD requires that conflict transactions be approved by committees consisting solely of independent directors. [4] Post-Enron federal legislation requires public companies to have an audit committee comprised solely of independent directors. [5] But why has the move to independent directors been so pronounced?

One of the apparent puzzles in the empirical corporate governance literature is the lack of correlation between the presence of independent directors and the firm's economic performance. Various studies have searched in vain for an economically significant effect on the overall performance of the firm. Some would deny there is a puzzle: theory would predict that firms will select the board structure that enhances the chance for survival and success; if competitive market pressure eliminates out-of-equilibrium patterns of corporate governance, the remaining diversity is functional. Others would note that corporate governance in the United States is already quite good, and thus marginal improvements in a particular corporate governance mechanism would expectedly have a small, perhaps negligible, effect.

[*1469] The claim of this Article is that the rise of independent directors in the diffusely held public firm is not driven only by the need to address the managerial agency problem at any particular firm. "Independent directors" is the answer to a different question: how do we govern firms so as to increase social welfare (as proxied by maximization of shareholder value across the general market)? This maximization of shareholder value may produce institutions that are suboptimal for particular firms but optimal for an economy of such firms. Independent directors as developed in the U.S. context solve three different problems: First, they enhance the fidelity of managers to shareholder objectives, as opposed to managerial interests or stakeholder interests. Second, they enhance the reliability of the firm's public disclosure, which makes stock market prices a more reliable signal for capital allocation and for the monitoring of managers at other firms as well as their own. Third, and more controversially, they provide a mechanism that binds the responsiveness of firms to stock market signals but in a bounded way. The turn to independent directors serves a view that stock market signals are the most reliable measure of firm performance and the best guide to allocation of capital in the economy, but that a "visible hand," namely, the independent board, is needed to balance the tendency of markets to overshoot.

This Article develops this general theme through an account of the changing function of the board over the past fifty years, from the post-World War II era to the present. During this period, the board's principal role shifted from the "advising board" to the "monitoring board," and director independence became correspondingly critical. Although other factors are at work, there were two main drivers of the monitoring model and genuine director independence.

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1 See infra text accompanying note 54.

2 Unless the company has a 50% shareholder. See infra text accompanying note 51.

3 See infra text accompanying notes 102, 107.

4 See infra note 115.

5 See infra text accompanying note 102.

First, the corporate purpose evolved from stakeholder concerns that were an important element of 1950s managerialism to unalloyed shareholder wealth maximization in the 1990s and 2000s. Inside directors or affiliated outside directors were seen as conflicted in their capacity to insist on the primacy of shareholder interests; the expectations of director independence became increasingly stringent.

Second, fundamental changes in the information environment reworked the ratio of the firm's reliance on private information to its reliance on information impounded in prevailing stock market prices. Over the period, the central planning capabilities of the large public firm became suspect. Instead, a Hayekian spirit, embodied in the efficient capital market hypothesis, became predominant. [6] The belief that markets "knew" more than the managers of any **[*1470]** particular firm became increasingly credible as regulators and quasi-public standard setters required increasingly deep disclosure and this information was impounded in increasingly informative stock prices. The optimal boundaries of the firm changed as external capital markets advanced relative to internal capital markets in the allocation of capital. The richer public information environment changed the role of directors. Special access to private information became less important. Independent directors could use increasingly informative market prices to advise the CEO on strategy and evaluate its execution, as well as take advantage of the increasingly well-informed opinions of securities analysts. Independents had positional advantages over inside directors, who were more likely to overvalue the firm's planning and capital allocation capabilities. In the trade-off between advising and monitoring, the monitoring of managers in light of market signals became more valuable. The reliability of the firm's public disclosures became more important. Indeed, by the end of the period, boards came to have a particular role in assuring that the firm provided accurate information to the market.

Thus, fidelity to shareholder value and to the utility of stock market signals found unity in the reliance on stock price maximization as the measure of managerial success. From a social point of view, maximizing shareholder value may be desirable if fidelity to the shareholder residual (as opposed to balancing among multiple claimants) leads to maximization of the social surplus. This is the shareholder primacy argument. Independently, maximizing shareholder value may be socially desirable if stock prices are so informative that following their signals leads to the best resource allocation. This is the market efficiency argument.

Over the period, boards eventually undertook measures that assured management's responsiveness to stock market signals, in particular through the use of stock-related compensation and retention decisions based on stock market performance. But there was an additional twist in the board's intermediation between managers and markets: the board, acting through the independent directors, came to have power to limit the potency of stock market signals in the takeover market. There was skepticism as to whether markets were perfect, even at the height of the prestige of the efficient capital market hypothesis. After the 1987 stock market crash, economists developed increasingly more persuasive accounts of how stock market prices - even though, on average, the best estimate of intrinsic value - could deviate for a substantial time period from economic fundamentals. The board gained power under state law to hinder the operation of the takeover market, i.e., to weigh the reliability of the market price as a measure of shareholder value at a particular time. The problem is this: given the imperfection of market prices, what is the **[*1471]** optimal degree of responsiveness to price changes, not just for any particular firm but across the entire economy? Investors may optimally adjust portfolios of liquid financial assets on one time line; managers may optimally adjust internal investment decisions over real assets on another. In light of potentially negative systematic effects from quick responses in the takeover market to imperfect market signals, it may be optimal to have a firm-

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[6] See F. A. Hayek, The Use of Knowledge in Society, 35 Am. Econ. Rev. 519 (1945). Hayek addresses the problem of the society's central planner, but his extolling of the superiority of the market in coordinating and guiding behavior becomes the ultimately successful critique of the planning capacities of the large firm heralded in books such as John Kenneth Galbraith, The New Industrial State (4th ed. 1985):

The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form, but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.

Hayek, supra, at 519.

specific institution that could slow the pace of control market activity to test the market for price reversals. The "visible hand" of the well-functioning board could, in theory, serve this function.

Independent directors have a comparative advantage for these different tasks. They are less dependent on the CEO and more sensitive to external assessments of their performance as directors; they are less wedded to inside accounts of the firm's prospects and less worried about the disclosure of potentially competitively sensitive information. They also have credibility in the "checking" of market signals against intrinsic measures of the firm's prospects. In other words, genuinely independent directors might create significant value in the allocation of resources, not just in their firm but more generally as other firms are forced to adapt to the best performers. Thus, one of the hallmarks of the period was the development of various mechanisms of director independence aimed at producing directors who were independent in fact.

This emphasis on the critical role of independent directors as an efficiency-justified strategy for importing stock market signals into the firm's (and the economy's) decisionmaking will strike some as a radical interpretation of the history. I make no claim that the various actors have been fully aware of the implications of each step - much may have happened through inadvertence, and the role of independent directors could have been otherwise - but this is the end point of this non-teleological process.

This Article proceeds as follows. Part I reviews the overall trend of board composition of large U.S. public companies since 1950. On the basis of data assembled from a number of different sources, the fraction of independent directors for large public firms has shifted from approximately 20% in the 1950s to approximately 75% by the mid-2000s. Part I also reviews the strengthening of various mechanisms of director independence that enhanced the independence-in-fact of directors over the period. Part II surveys the empirical studies that fail to find significant economic effects from this pronounced move toward director independence and concludes that the studies are looking in the wrong place. The studies look at board composition differences across firms. Yet if the main advantage of independent directors is to help commit firms throughout the economy to a shareholder wealth maximization strategy, then systematic effects will swamp cross-sectional variation. [7] Part III non-exhaustively canvasses the 1950-2005 period to explore **[*1472]** one important driver in changing board composition: the shift toward shareholder wealth maximization as the dominant corporate purpose. Director independence became linked to the monitoring of managerial performance in order to serve shareholder ends. Part III also traces a complementary development: managers who once vigorously resisted board independence as a limitation to their autonomy came to champion the independent board as a buffer from the hostile takeover and as a substitute for greater government intervention in the wake of scandals.

Part IV non-exhaustively canvasses the 1950-2005 period to explore another driver of the change in board composition: the increasing informativeness and value of stock market signals. Informativeness was enhanced by increased disclosure resulting from regulatory initiatives by the Securities and Exchange Commission and the quasi-public accounting standards setting authorities. New information processing technology and increasing investments in securities analysis helped make prices more informative as well. It's not that the disclosure system changed to accommodate a demand for independent directors. Rather, as stock prices became more informative, the concern about the independents' potential debility - their lack of a well-informed view about the firm - subsided. Indeed, an increasingly important element of the independent board's monitoring role came to be the appropriate use of market signals in executive compensation contracts and in CEO termination decisions. Additionally, directors came to have an increasingly important function in assuring the accuracy of the firm's financial disclosure, i.e., "controls monitoring."

Part V concludes with the suggestion that the rise of independent directors, at least in the United States, is tied to a new corporate governance paradigm that looks to the stock price as the measure of most things. Maximizing the stock price serves two normative ends: promoting the interests of shareholders and making use of the information

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[7] This generalizes the argument made regarding hostile takeovers: that ultimately their benefits (costs) are not adequately reckoned by summing bidder and acquirer gains (losses), but rather in the systematic effects from a robust market in corporate control.

impounded by the market to allocate capital efficiently. In this time of increased shareholder activism, one important question is whether the enhanced independence of directors will create a space for a public firm to resist stock market pressure in the pursuit of currently disfavored business strategies (and whether this would be desirable) or whether the very pressures that give rise to director independence will in the end swamp this possibility.

I. Changing Board Composition, 1950-2005: The Rise of Independent Directors and Director Independence

One of the most important empirical developments in U.S. corporate governance over the past half century has been the shift in board composition **[*1473]** away from insiders (and affiliated directors) toward independent directors. This trend is consistent throughout the period and accelerates in the post-1970 subperiod. This Part describes the trend, looking at a number of studies that use different samples of firms and that apply somewhat different definitions of "independence." In addition to the numerical shift, the independence-in-fact of directors has been buttressed in the post-1970 period by a series of rule-based and structural mechanisms. In its own way, the effort to create independence-in-fact is as striking as the numerical shift.

A. Changing Board Composition, 1950-2005

No single study traces the rise of independent directors over the 1950-2005 period. The study that best captures the changing board composition over the period is Lehn, Patro and Zhao's paper reporting the insider-outsider breakdown for all publicly traded U.S. firms that survived from 1935 through 2000, namely eighty-one predominantly large firms. [8] Lehn et al. find a consistent decline in the average percentage of insiders over the 1950-2000 period, from approximately 50% to approximately 15%, with accelerating change after 1970. [9] The available data, however, apparently do not readily **[*1474]**

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[8] Kenneth Lehn et al., Determinants of the Size and Structure of Corporate Boards: 1935-2000 (Nov. 2003) (unpublished manuscript), available at http://ssrn.com/abstract=470675. They describe their sample as all firms in the Center for Research on Security Prices (CRSP) database which survive over the period and for which data are also available in the Moody's Industrial Manual. Id. (manuscript at 12). The sample of course imperfectly represents the universe of firms existing at any point in time and tilts toward the largest firms. Id. Interestingly, the fraction of insiders monotonically increases over the 1935-1950 period, from approximately 45% to 50%. Id. (manuscript at 36 tbl.1 panel C) (presenting descriptive statistics of sample firms with five-year frequency). The abovementioned survivorship bias in the sample suggests an adaptive quality in the shift away from insiders and toward independent directors in the post-1950 period.

[9] This table, drawn from the Lehn et al. data, describes the shift over the period. Percent change is based on my own calculations.

Percentage of Inside Directors, 1950-2000

Year

Mean

Decade-to-decade percent change

1950

49%

n/a

1955

47%

1960

43%

-12%

Figure 1. Board Composition, 1950-2005

[SEE FIGURE 1 IN ORIGINAL]

permit a further breakdown of the "outside" directors into "affiliated" and "independent" directors over the entire period. Other studies, typically cross-sectional in nature, examine proxy filings to classify directors. The earliest such study was in 1970. [10] The Securities and Exchange Commission (SEC) did a detailed survey covering 1977-

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1965

42%

1970

41%

-5%

1975

39%

1980

33%

-20%

1985

30%

1990

26%

-21%

1995

21%

2000

16%

-38%

1978, [11] the academic studies began in 1985, and the Investor Responsibility Research Center began its database for approximately 1500 public firms in 1996. [12]

I have put together these studies to construct a "time series" showing the board composition trend over the 1950-2005 period, [13] which is depicted **[*1475]**

Figure 2. Changing Proportion of Inside and Independent Directors, 1950-2005

[SEE FIGURE 2 IN ORIGINAL]

graphically in Figures 1 and 2. [14] These figures show a steady increase in the representation of independent directors on the board, from approximately 20% in 1950 to approximately 75% in 2005. This is a powerful change in board composition that calls out for an explanation.

The limitations of this demonstration are obvious: I have used cross-sectional studies to reclassify the Lehn et al. category of "outsiders" into the more useful "affiliated" and "independent" categories, assuming in particular that the 1970 breakdown of outsiders is applicable to the 1950-1970 period for which there are no earlier cross-sectional studies. (In light of the history discussed below, it is likely that this overstates the fraction of independents on pre-1970 boards, which thus understates the change over the period.) Also, the various studies used different samples and undoubtedly applied different criteria in coding proxy disclosure about directors into the relevant classifications. These classification decisions would have been influenced by whether the researcher was trying to assess whether non-insiders augmented the corporation's capacities (thus referring to affiliated directors as "instrumental" directors) [15] or enhanced monitoring (calling affiliated directors "grey" **[*1476]** directors). [16] Notwithstanding the inevitable noise, the overall trend that emerges is quite striking, as reflected by Figure 1 and by the fitted curves of Figure 2.

There has been an additional trend in the latter part of the period toward what Bhagat and Black call "supermajority" independent boards. [17] As recently as 1989, boards with only one or two insiders were unheard of. In a Korn/Ferry 1989 survey of large public companies, 67.5% reported three insiders and 32.5% reported four insiders. [18] By 2003, the pattern was strikingly different: 65% reported two or fewer insiders; 35% reported three insiders; none reported more than three insiders. [19] By 2004, under the influence of Sarbanes-Oxley and the stock exchange

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[10] Ephraim P. Smith, Interlocking Directorates Among the "Fortune 500,' 3 Antitrust L. & Econ. Rev., Summer 1970, at 47, 48 (assessing board composition as sidelight to director interlocks).

[11] S. Comm. on Banking, Housing, and Urban Affairs, 96th Cong., SEC Staff Report on Corporate Accountability 590-98, 598 tbl.2 (Comm. Print 1980) [hereinafter SEC Staff Report] (surveying 1200 major firms drawn from NYSE, Amex, Nasdaq, and OTC/regional exchanges in 1978-79). The SEC study led to a rule proposal, subsequently withdrawn, that would have required precise categorization of the outside directors.

[12] See Institutional Shareholder Servs. (ISS), Board Practices/Board Pay 2006, at 1 (2006) (describing database compilation). (The Investor Responsibility Research Center was acquired by ISS in 2005.)

[13] See infra Appendix Table 1. Perhaps the right metaphor is to think of these figures as "snapshots on a string."

[14] Figure 1 shows the assembled data in five-year increments. Figure 2 shows all data points and trend lines graphed using the Excel polynomial-fitting command.

[15] E.g., Barry D. Baysinger & Henry N. Butler, Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition, 1 J.L. Econ. & Org. 101, 110 (1985).

[16] E.g., Benjamin E. Hermalin & Michael S. Weisbach, The Determinants of Board Composition, 19 RAND J. Econ. 589, 591 (1988).

[17] Sanjai Bhagat & Bernard Black, The Non-Correlation Between Board Independence and Long-Term Firm Performance, 27 J. Corp. L. 231, 239 (2002).

[18] Korn/Ferry Int'l, Board of Directors Sixteenth Annual Study 1989, at 15, 25 (1989) (Diefenbacher calculations based on survey data). The largest firms reported four insiders on average. Id. at 15.

listing rules, the shift was virtually complete: 91% reported two or fewer insiders; 9% reported three insiders. [20] Large public firms have moved to a pattern of one, perhaps two, inside directors and an increasing number of independent directors. Some academics and practitioners have characterized the emerging pattern as the cynosure of corporate governance because of its maximum control of managerial agency costs. [21]

[*1477]

B. Mechanisms of Enhanced Director Independence, 1950-2005

The preceding section described the long-term numerical trend away from inside directors and toward independents. Nominally independent directors can of course be passive, ineffectual, and otherwise be found in management's pocket, as famously described in Myles Mace's 1971 book. [22] In 1989, nearly two decades later, Jay W. Lorsch and Elizabeth MacIver argued that the independent director was still more likely to be a "pawn" than a "potentate." [23] Nevertheless, one of the striking elements of the 1950-2005 period was the development of various mechanisms to create and enhance the independence of directors. The genesis of many of these mechanisms was the 1970s wave of corporate governance reform, which tried to establish preconditions for the monitoring board. Indeed, "independent director" entered the corporate governance lexicon only in the 1970s as the kind of director capable of fulfilling the monitoring role. Until then, the board was divided into "inside" and "outside" directors. [24] Further developments favoring director independence occurred in the 1990s as part of the post-hostile bid settlement among institutional investors, managers, and boards. [25] The last wave, post-2002, was spurred by the Enron, WorldCom, and other board failures, which led to new efforts to strengthen director independence in light of the board's additional role of controls monitoring as well as performance monitoring.

Analytically, these mechanisms of director independence can be broken down into four categories: (1) tightening the standards and rules of disqualifying relationships; (2) increasing negative and positive sanctions, such as legal

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[19] Korn/Ferry Int'l, 30th Annual Board of Directors Study 2003, at 8-9 (2003); Korn/Ferry Int'l, 30th Annual Study Supplement 12 (2004) (reporting 2002-2003 proxy data and Diefenbacher calculations).

[20] Korn/Ferry Int'l, 31st Annual Board of Directors Study 2004, at 10 (2004) (reporting 2003-2004 proxy data and Diefenbacher calculations); see also Bus. Roundtable, Business Roundtable Corporate Governance Survey: Key Findings (2006), available at http://www.businessroundtable.org/publications/publication.aspx?qs=2AC6BF807822B0F1AD34484 (reporting that 85% of its approximately 160 members expect to have a board in 2006 consisting of at least 80% independent directors, 98% expect that their boards will be at least 60% independent, and 42% expect an entirely independent board); Shearman & Sterling LLP, Trends in the Corporate Governance Practices of the 100 Largest US Public Companies 4 (2005), available at http://www.shearman.com/cg survey05/ (reporting that independent directors comprised 75% or more of the board of eighty-one of the top 100 companies in 2004 and 2005 and that the CEO was the only non-independent director of thirty-seven of the top 100 companies in 2005).

[21] See, e.g., Michael C. Jensen, The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems, 48 J. Fin. 831, 865 (1993); Martin Lipton & Jay W. Lorsch, A Modest Proposal for Improved Corporate Governance, 48 Bus. Law. 59, 67-68 (1992) (recommending a board size of eight or nine directors, comprised of at least two independent directors for every one insider or affiliate, and arguing that "five or six independent directors, who are carefully selected, should provide the breadth of perspective and diversity required").

[22] Myles L. Mace, Directors: Myth and Reality 108 (1971); see also Laura Lin, The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence, 90 NW. U. L. REV. 898, 898-903, 912-17 (1996) (discussing the "managerial hegemony" theory which asserts that management controls the board regardless of its composition).

[23] Jay W. Lorsch with Elizabeth MacIver, Pawns or Potentates: The Reality of America's Corporate Boards (1989).

[24] Professor Mitchell argues that the principal role of the pre-1970s outside director was to provide cover for conflict transactions entered into by insiders and to provide a liability shield for insiders in other respects. He also suggests that this function still continues. See Lawrence E. Mitchell, The Trouble with Boards (Sept. 9, 2005) (unpublished manuscript, on file with author).

[25] See infra text accompanying notes 103-06, 256-58.

liability for fiduciary duty breach, reputational sanctions, and stock-based compensation; (3) development of intra-board structures, such as task-specific committees and designation of a "lead director"; and (4) reducing CEO influence in director selection and retention by, for example, the creation of a nominating committee staffed solely by independent directors. Without being Panglossian, it does seem that the accumulating effects of changes in each of these mechanisms, as well as the accumulating cultural shift fostered by the **[*1478]** successive reform efforts, should have increased the independence-in-fact of directors over the period.

1. Relationship standards and rules

A straightforward way to strengthen director independence is to select candidates who have no ongoing (or even prior) relationship with the corporation other than as a director. Over the 1950-2005 period the relationship measure of independence tightened considerably. Initially the relationship test focused narrowly on the director's employment status. Those who were not current officers were, by definition, outsiders, [26] including non-executive directors who had what would be regarded today as a disqualifying material relationship - such as employment with a supplier or a customer, or with the firm's investment bank or law firm. [27] This consensus was reflected by the 1962 New York Stock Exchange statement that accepted a description of an outside director as simply one who is non-management. [28]

Standards tightened considerably in the wake of the 1970s corporate governance crisis, which for the first time produced a concerted demand for "independent" directors. The well-publicized business failures of the period led to increasing acceptance of the "monitoring model" of the board, which required independent directors. [29] The contemporaneous revelations of widespread corporate bribery and illegal campaign contributions at home and **[*1479]** abroad, so-called "questionable payments," spurred the SEC to insist on independent directors in the settlement of various enforcement actions. [30]

The unresolved question was what exactly constituted "independence" - how should one deal with economic interests and personal ties that would potentially undercut independence. Federal regulatory guidance, stock exchange listing standards, state fiduciary law, and "best practice" pronouncements have all played a role in line-drawing.

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[26] Stanley C. Vance, Functional Control and Corporate Performance in Large-Scale Industrial Enterprise (1955) (unpublished manuscript) (described in Stanley C. Vance, Corporate Governance: Assessing Corporate Performance by Boardroom Attributes, 6 J. Bus. Res. 203, 204-05 (1978)).

[27] See, e.g., CONFERENCE BD., CORPORATE DIRECTORSHIP PRACTICES 17 (1959) (describing "officers of creditor banks and insurance companies or of financial institutions that regularly serve the company, and the corporate counsel" as outsiders).

[28] N.Y. STOCK EXCH., THE CORPORATE DIRECTOR AND THE INVESTING PUBLIC 7, 19-20 (1962); see also STANLEY C. VANCE, BOARDS OF DIRECTORS: STRUCTURE AND PERFORMANCE 5 (1964) (defining outsiders as those who "have no significant personal holdings in the company even though they are associated with banks, brokerage firms, insurance companies, and other investment companies; . . . are executives of other organizations; or . . . are primarily public figures"). This was a view apparently held by academics as well. See Jeffrey Pfeffer, Size and Composition of Corporate Boards of Directors: The Organization and Its Environment, 17 ADMIN. SCI. Q. 218, 219 n.6 (1972) ("Inside directors are directors who are currently involved in the management of the organization and, in some definitions, former executives as well. . . . Outside directors do not have a direct management relationship with the organization."). See generally JEREMY BACON <AMP> JAMES K. BROWN, CONFERENCE BD., CORPORATE DIRECTORSHIP PRACTICES: ROLE, SELECTION AND LEGAL STATUS OF THE BOARD (1975) (classifying non-officer directors as "outside" even though they are chosen by management).

[29] See infra notes 207-14 and accompanying text. The "monitoring model" was promoted most notably by Melvin A. Eisenberg, The Structure of the Corporation: A Legal Analysis 162-70 (1976).

[30] See, e.g., Arthur F. Mathews, Recent Trends in SEC Requested Ancillary Relief in SEC Level Injunctive Actions, 31 Bus. Law. 1323, 1326-28, 1334-35 (1976). The SEC also insisted on other corporate governance measures, such as the creation of audit committees and special committees. For a contemporaneous skeptical account of the effectiveness of these corporate governance elements in particular consent decrees, see Lewis D. Solomon, Restructuring the Corporate Board of Directors: Fond Hope - Faint Promise?, 76 Mich. L. Rev. 581 (1978).

The 1978 Corporate Director's Guidebook, an influential product of mainstream corporate lawyers, drew a two-level distinction: first distinguishing between "management" and "non-management" directors, and then between affiliated and non-affiliated non-management directors. [31] A former officer or employee was to be regarded as a managerial director. A director with other economic or personal ties "which could be viewed as interfering with the exercise of independent judgment" was an affiliated non-managerial director - for example, "commercial bankers, investment bankers, attorneys, and others who supply services or goods to the corporation." [32]

In 1978, the SEC went so far as to propose proxy disclosure that would categorize outside directors as "affiliated" or "independent, with the obvious intention of using disclosure to obtain Chairman Harold Williams' objective of boards staffed principally, if not entirely, by independent directors. [33] In response to corporate objections, it rapidly withdrew the proposal, [34] lamely explaining that "the ability to exercise independent judgment is not solely dependent upon the label attached to a particular director." [35] On the NYSE front, its 1977 audit committee listing standard, which required staffing by "directors independent of management," split the difference: it permitted **[*1480]** directors from organizations with "customary commercial, industrial, banking, or underwriting relationships with the company" to serve on an audit committee unless the board found that such relationships "would interfere with the exercise of independent judgment as a committee member." [36] That definition remained intact until 1999, when the criterion of audit committee independence was significantly tightened in response to the prodding of the Blue Ribbon Committee on Improving Audit Committee Effectiveness. Audit committees were required to consist of at least three "independent directors," and the "customary" economic relationships of the 1977 were now off limits for committee members. [37]

Another federal regulatory tightening of the "independence" standard came through the 1996 IRS criteria for "outside" directors who could approve performance-based remuneration that was excepted from the $ 1 million deductibility cap on executive compensation established by *section 162(m) of the Internal Revenue Code*. [38] Those criteria disqualified a former officer of the corporation and a director who receives remuneration from the corporation "either directly or indirectly, in any capacity other than as a director." [39] The criteria also place stringent

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[31] ABA Comm. on Corporate Laws, Corporate Director's Guidebook, 33 BUS. LAW. 1591, 1619-20 (1978).

[32] Id. at 1620.

[33] Proposed Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 14,970, 15 SEC Docket 291 (July 18, 1978); see Harold M. Williams, Corporate Accountability, in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 513 (Donald E. Schwartz ed., 1979).

[34] Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 15,384, Investment Company Act Release No. 10,510, 16 SEC Docket 348 (Dec. 6, 1978).

[35] SEC Staff Report, supra note 11, at 469. A survey of the 1978-1979 proxy season undertaken in connection with the proposal revealed that nearly 30% of "outside" directors were in fact "affiliated" and thus not "independent." See id. at 598 tbl.2 (surveying 1200 major firms drawn from the NYSE, Amex, Nasdaq, and OTC/regional exchanges).

[36] NYSE, Inc., Listed Company Manual §303 & supp. (1983) (embodying Proposed Rule Change by Self-Regulatory Organizations, *42 Fed. Reg. 8737* (Feb. 11, 1977), and Order Approving Proposed Rule Change, ***42 Fed. Reg. 14,793*** (Mar. 16, 1977)).

[37] See April Klein, Likely Effects of Stock Exchange Governance Proposals and Sarbanes-Oxley on Corporate Boards and Financial Reporting, 17 Acct. Horizons 343, 346 & tbl.1 (2003); NYSE, Inc., NYSE Corporate Accountability and Listing Standards Committee 6 n.2, 7 n.3 (2002).

[38] *26 U.S.C. §162*(m) (2007). The code provision was added as part of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §13211, ***107 Stat. 312,*** which became effective as of January 1, 1994. The provision required the setting of performance goals by a compensation committee "which is compromised solely of 2 or more outside directors." *26 U.S.C. § 162*(m)(4)(C)(i) (2007). The compensation committee then needs to "certify that the performance goals and any other materials terms were in fact satisfied." Id. §162(m)(4)(C)(iii).

limits on the extent to which the director could have an ownership interest in or be employed by an entity that received payments from the corporation. [40] In turn, the IRS regulations influenced the SEC's 1996 rules specifying independent director approval of certain stock-related transactions as a condition of exemption from the short-swing profit recapture provisions of section 16(b) of the 1934 Securities Exchange Act. [41] The definition of a "non-employee director" with such approval power followed the substance of the IRS regulation. [42] The tests of economic distance for director **[*1481]** independence established by these two important federal regulatory agencies were important benchmarks. [43]

State courts grappling with the right of shareholders (as opposed to the board) to maintain derivative litigation alleging corporate wrongdoing were another important source of heightened standards of director independence midway in the period. The "questionable payments" scandal of the 1970s led to a spate of shareholder derivative suits. Corporations sought to take control of the actions to avoid their potentially disruptive effects and to eliminate alleged "strike suits." In the important decision of Zapata Corp. v. Maldonado, [44] the Delaware Supreme Court held that even for a "demand-excused" derivative action, a "special committee" constituted of independent directors could nevertheless obtain dismissal of the action if it demonstrated this was in the best interests of the corporation. In its dismissal request, the special committee had the burden of demonstrating its independence. This, of course, increased the demand for directors with minimal prior connection to the corporation and its management, and helped ratchet up the independence standard. Moreover, the standards developed in derivative litigation in the 1970s and early 1980s also set criteria for the bona fides of directors who needed judicial sanction for their approval of target defensive measures in the face of a hostile bid. [45]

Throughout the 1980s and 1990s, various panels and "blue ribbon" committees developed somewhat influential "best practice" guidelines for relationship tests. The most important exposition, the American Law Institute's ("ALI's") 1992 Principles of Corporate Governance, recommended that the board of a public corporation "should have a majority of directors who are free of any significant relationship with the corporation's senior executives." [46] "Significant relationship" was defined in a way to disqualify many affiliated directors, both through categorical exclusions relating to the firm's principal outside law firm or investment bank, and through attention to customer/supplier relationships crossing a relatively low ($ 200,000) economic materiality threshold. [47] The Principles of Corporate Governance also called for the firm's nominating committee to engage in a more

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[39] *Treas. Reg. §1.162-27(e)(3)(i)* (1995).

[40] The regulations include a $ 60,000 "de minimis" exception for payments to an entity where the director is a minority owner or employee." Id. §1.162-27(e)(3)(ii)-(iii).

[41] Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 37,260, Investment Company Act Release No. 21,997, 62 SEC Docket 138 (May 31, 1996).

[42] *17 C.F.R. §240.16b-3(b)(3) (2007)*. This regulation also includes a quantitatively similar de minimis exception for consulting arrangements.

[43] Additionally, as part of its 1992 executive compensation disclosure rules, the SEC established similar independence standards. The standards were not mandatory for compensation committee members; rather, disclosure was required of directors who did not meet the standards. See Executive Compensation Disclosure, Securities Act Release No. 6962, Exchange Act Release No. 31,327, Investment Company Act Release No. 19,032, 52 SEC Docket 1961 (Oct. 16, 1992) (currently reflected in Regulation S-K Item 402(j)).

[44] *430 A.2d 779 (Del. 1981);* see also *Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979).*

[45] See cases cited infra note 49.

[46] Am. Law Inst., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §3A.01 (1994) [hereinafter ALI PRINCIPLES] (as adopted and promulgated in 1992); see also NAT'l ASS<APOS>N OF CORPORATE DIRS., REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM 9-10 (1996).

[47] ALI PRINCIPLES, supra note 46, §1.34.

individualized review of factors that **[*1482]** could undermine the independence of particular directors. [48] The ALI project had influence beginning in 1982 with its tentative first draft, whose "significant relationship" test was similar to the final version. [49]

Ultimately, the Enron corporate reform wave at the end of the period worked a sea change. [50] Seeking to avoid corporate governance legislation, the NYSE in 2002 initiated a significant revision of its board composition standards. A majority of directors were required to be independent, and stringent independence criteria applied to all such directors, not just audit committee members. [51] Under prodding from institutional investors, issuers, and the SEC, the NYSE revised the proposals over a yearlong period, adding and subtracting stringency. The 2004 version (as further refined) contains a **[*1483]** general standard requiring an affirmative board determination that a purportedly independent director has "no material relationship with the listed company" (including "as a partner, shareholder or officer of an organization that has a relationship with the company"). [52] It also has a series of carefully defined exclusions and safe harbors that cover in detail the effect of prior employment, familial ties, consulting relationships, and charitable ties. And, of course, the SEC, exercising regulatory authority under

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48 Id. §3A.01 cmt. d.

49 See Stephen M. Bainbridge, Independent Directors and the ALI Corporate Governance Project, *61 Geo. Wash. L. Rev. 1034, 1035 n.6 (1993).* Many claimed - with good reason - that reliance on nominal markers of independence was superficial, arguing that psychological and social fellow-feeling among the class of people chosen as directors creates a "structural bias" that undercuts true independence. See, e.g., Eisenberg, supra note 29, at 146; James D. Cox & Donald E. Schwartz, The Business Judgment Rule in the Context of Termination of Derivative Suits by Independent Committees, *61 N.C. L. Rev. 541, 542-43 (1983)* (describing structural bias as "a predisposition toward the defendant because the members who serve on the special litigation committee have a common cultural bond with the defendants on whom they are passing judgment"). Whatever its reality, the "structural bias" objection to director independence has been rejected by most courts in most instances where independence-in-fact has been challenged. See, e.g., *Beam v. Stewart, 845 A.2d 1040, 1050-52 (Del. 2004); Aronson v. Lewis, 473 A.2d 805, 815 n.8 (Del. 1984).* But cf. *Miller v. Register & Tribune Syndicate, Inc., 336 N.W.2d 709, 716 (Iowa 1983)* (noting that potential for structural bias leads to greater judicial scrutiny). Courts seemed to take "disinterestedness" plus nominal independence, as defined by then-applicable criteria, as sufficient for the purpose. E.g., *Beam, 845 A.2d at 1050* (holding that "allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence"). There might be some disagreement between the Delaware Supreme Court and the Delaware Chancery Court, which has examined independence more searchingly. See *In re Oracle Corp., 824 A.2d 917, 939-42 (Del. Ch. 2003)* (deciding that professors did not satisfy independence standards for special committee and adopting a contextual approach); *Orman v. Cullman, 794 A.2d 5, 25 n.50 (Del. Ch. 2003)* (explaining that independence turns on whether a director's decision is "controlled by another," such as from domination "through close personal or familial relationship or though force of will," or if the director is "beholden" to the controller because of that party's unilateral power to decide whether the director will receive a significant enough benefit). See generally Julian Velasco, Structural Bias and the Need for Substantive Review, *82 Wash. U. L.Q. 821 (2004)* (exploring the courts' response to structural bias and proposing a standard of review of the substantive merits of directors' decisions).

50 See Stephen M. Bainbridge, A Critique of the NYSE's Director Independence Listing Standards (UCLA Sch. of Law Research Paper Series, Paper No. 02-15, 2002), available at *http://ssrn.com/abstract=317121*.

51 NYSE, Inc., Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors, August 1, 2002 (2002), available at *http://www.nyse.com/pdfs/corp* gov pro b.pdf. The majority independent directors requirement does not apply to a company with a 50% shareholder, though the independent audit committee requirement does. Id.

52 See NYSE, Inc., Listed Company Manual §303A.02 (2007); see also NYSE, Inc., NYSE Listed Company Manual Section 303A Corporate Governance Listing Standards Frequently Asked Questions (Feb. 13, 2004), available at *http://www.nyse.com/pdfs/section303Afaqs.pdf*.

Sarbanes-Oxley, specified minimum conditions in 2003 for director independence for directors who serve on the audit committee. [53]

2. External sanctions and rewards

A different mechanism for director independence focuses on incentives - sanctions and rewards, sticks and carrots - for particular director behavior. Most commonly these are economic, but reputation matters too.

a. Sanctions (sticks)

The most potent stick during the period was the risk of monetary liability for breach of various duties under state fiduciary law and the federal securities law; both sets of duties foster director independence by requiring director attention to the business and affairs of the corporation, a precondition to the exercise of independent judgment. [54] But how real was such liability exposure? **[*1484]** Early in the period, liability for breach of the duty of care uncomplicated by self-dealing was famously described as the "search for a very small number of needles in a very large haystack," [55] and risk of securities fraud liability was non-existent. At the end of the period, Professors Black, Cheffins, and Klausner tell us that liability in duty of care cases is still quite rare and that outside director liability exposure in securities fraud litigation is limited to rare "near-perfect-storm" cases. [56] Nevertheless the directors' perception of risk seems to have increased over the period, perhaps because of lawyers' exaggerations, [57]

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[53] See Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47,654, Investment Company Act Release No. 26,001, 79 SEC Docket 2876 (Apr. 9, 2003); *17 C.F.R. §240.10A-3(b) (2007)* (codifying Exchange Act Rule 10A-3(b)).

[54] The traditional formulation of the duty of care, requiring of directors the care level that "ordinarily careful and prudent [people] would use in similar circumstances," *Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963),* dates back to the 1800s. 1 Denis J. Block et al., The Business Judgment Rule: Fiduciary Duties of Corporate Directors 117 (5th ed. 1998). The duty of loyalty is also a precondition for director independence. Moreover, monetary exposure for breach of the duty of loyalty is a more plausible threat because self-interested behavior forfeits the protection of the business judgment rule and the exculpatory statutes and may be hard to insure against. Nevertheless, the liability threat associated with the duty of loyalty may offer only limited incentives for director independence because it is not ordinarily triggered by complaisance in the self-interested behavior of others. At least historically, the conflicts that lead to liability are gross, not subtle. In other words, where the director has not personally profited from the action in question, it may be difficult to tag him for the profits wrongfully obtained by others, such as a controlling shareholder. But cf. In re Emerging Commc'ns, Inc., No. Civ.A. 16415, 2004 WL 1305745, at 40 (Del. Ch. May 3, 2004, revised June 4, 2004) (finding that a conflicted director failed to use his financial expertise in a going-private transaction that shifted value to controlling shareholder).

[55] Joseph W. Bishop, Jr., Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L.J. 1078, 1099 (1968) (finding four cases); accord Stuart R. Cohn, Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule, *62 TEX. L. REV. 591, 591 nn.1-2 (1983)* (noting only seven successful cases); Henry Ridgely Horsey, The Duty of Care Component of the Delaware Business Judgment Rule, *19 DEL. J. CORP. L. 971, 982 (1994)* (confirming Bishop's study).

[56] Bernard Black et al., Outside Director Liability, *58 Stan. L. Rev. 1055, 1061, 1139 (2006).* See generally Bernard Black et al., Liability Risk for Outside Directors: A Cross-Border Analysis, 11 European Fin. Mgmt. 153 (2005); Brian R. Cheffins & Bernard S. Black, Outside Director Liability Across Countries, *84 TEX. L. REV. 1385 (2006).* Black et al. found approximately ten post-1980 cases in which outside directors made out-of-pocket payments to settle securities fraud claims. Black et al., Outside Director Liability, supra, at 1070 tbl.2. They argue that appropriate D&O insurance should eliminate liability even further, leaving open only cases of insolvency and losses beyond D&O policy limits like Enron (where the directors paid out approximately $ 13 million) and WorldCom (approximately $ 25 million). Id. at 1057-62.

[57] Bernard Black et al., Outside Director Liability (Before Enron and WorldCom) 51 (Stanford Law & Econ. Olin Working Paper No. 250, 2003), available at *http://ssrn.com/abstract=382422*.

perhaps because of scare-mongering by liability insurers, [58] or perhaps because of the saliency of outlier cases like Enron and WorldCom, in which outside directors paid out-of-pocket to settle claims. [59]

Indeed, a better (though softer) measure of director apprehension than monetary payouts may be the series of liability insulation mechanisms that were adopted during the period. State corporate indemnification statutes diffused rapidly in the 1950s, and soon covered all negligent behavior. [60] Director and Officer ("D&O") insurance arose in the 1950s and 1960s to cover liability that was not indemnifiable. [61] Yes, these measures protected directors, but their promotion, which required concerted political activity at the state level, presumably stemmed from growing liability concerns and the risks of liability "loopholes." The most famous liability insulation measure was the **[*1485]** mid-1980s adoption by Delaware (and then quickly by other states) of director exculpation statutes for breach of the duty of care. [62] This followed immediately upon the visible ratcheting up of liability standards in Smith v. Van Gorkom. [63]

In the immediate aftermath of the Enron et al. financial scandals, it appeared that state courts, particularly the Delaware courts, might become more receptive to liability theories that would increase a director's monetary exposure for the insiders' wrongful behavior, on the ground of directors' failure to undertake adequate inquiry or oversight. [64] These new theories of director malfeasance often flew under the banner of "good faith." [65] The speculative flurry was soon put to rest, however. Prolonged litigation over the $ 130 million severance paid by the Walt Disney Company to former president Michael Ovitz ended in victory for the directors (but after eight years of litigation), despite behavior that fell far below "best practices." [66] In affirming, the Delaware Supreme Court made it clear that "gross negligence (including a failure to inform oneself of available material facts), without more" does not constitute bad faith, [67] which seemed to require something like scienter, "intentional dereliction of duty, a conscious disregard for one's responsibilities." [68] Subsequently, the Delaware Supreme Court went even further, holding that

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[58] See Bishop, supra note 55, at 1078.

[59] See Joann S. Lublin et al., Directors Are Getting the Jitters - Recent Settlements Tapping Executives' Personal Assets Put Boardrooms on Edge, Wall St. J., Jan. 13, 2005, at B1.

[60] See MODEL BUS. CORP. ACT §4(o) (1957); JOSEPH BISHOP, LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE §6.01-.02 (1996).

[61] See sources cited supra note 60.

[62] See DEL. CODE ANN. tit. 8, §102(b)(7) (2001); see also Carl Samuel Bjerre, Note, Evaluating the New Director Exculpation Statutes, 73 CORNELL L. REV 786, 786 (1988).

[63] 488 A.2d 858 (Del. 1985). The case was ferociously criticized, see, e.g., Daniel R. Fischel, The Business Judgment Rule and the Trans Union Case, 40 Bus. Law. 1437, 1455 (1985) (criticizing the majority opinion as "one of the worst decisions in the history of corporate law"), and raised the specter of a D&O liability insurance crisis, see generally Roberta Romano, Corporate Governance in the Aftermath of the Insurance Crisis, 39 Emory L.J. 1155 (1990). Romano observes that within two years of Van Gorkom, forty-one states adopted exculpatory statutes. Id. at 1160.

[64] Some speculated that Delaware might feel pressure to demonstrate that state corporate law could check managerial wrongdoing to protect its domain against further encroachment by the federal government. See generally William B. Chandler III & Leo E. Strine, Jr., The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State, 152 U. Pa. L. Rev. 953 (2003).

[65] See Hillary A. Sale, Delaware's Good Faith, 89 Cornell L. Rev. 456 (2004). See generally Melvin A. Eisenberg, The Duty of Good Faith in Corporate Law, 11 Del. J. Corp. L. 1, 1 (2006) ("The explicit recognition of the duty of good faith in recent Delaware cases shines a spotlight on that duty and therefore makes it especially important to develop the contours of the duty and to examine the duty from a normative perspective.").

[66] See In re Walt Disney Co., 907 A.2d 693, 697 (Del. Ch. 2005), aff'd, 906 A.2d 27 (Del. 2006).

[67] 906 A.2d at 64-65.

"bad faith" was not an independent basis for director liability but rather one precipitating condition for liability under the duty of loyalty. [69] Nevertheless, **[*1486]** the protracted litigation, the courts' willingness to set forth in embarrassing detail the deficiencies of directors' decisionmaking processes, and the implicit threat about liability "next time" may increase directors' vigilance and independence.

Similarly, the potential stick of directors' liability under the federal securities law was muted by institutional realities, yet the fear remained. Even if managers' wrongful conduct could be framed as also constituting a disclosure violation, the applicable liability standard that emerged over the period for directors' liability was a "scienter" test: whether the directors had knowledge of the wrongful disclosure (or were reckless in not knowing). [70] Moreover, plaintiffs' attorneys in securities class actions have no incentive to prove scienter because this could undercut the D&O insurers' obligation to fund settlements. [71]

Yet for disclosure in connection with a public offering of securities, directors have a "due diligence" obligation to assure the accuracy of the disclosed statements. A recent WorldCom decision on this due diligence obligation means that directors cannot necessarily rely on an auditor's certification where there are "red flags" in the issuer's financials. [72] Rather than face a trial on what precisely they knew or should have known, and opposed by a public pension fund plaintiff who insisted on personal liability for the directors rather than simply insurance proceeds, the WorldCom independent directors agreed to settle the litigation. Each director's contribution was designed to be approximately 20% of his or her net worth, approximately $ 20 million in total. [73] In general, the "shelf-registration" rules that permit immediate issuance of debt and equity securities by large public firms heightened the negligent disclosure liability risk for directors. [74] Since detailed knowledge about the corporation's financial disclosure enhances the capacity **[*1487]** for independent judgment, WorldCom - which creates additional reasons for directors to acquire such knowledge - should enhance director independence. [75]

b. Rewards (carrots)

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[68] *Id. at 66.*

[69] *Stone v. Ritter, 911 A.2d 362, 369-70 (Del. 2006).* The Stone court also refused to broaden the prior pre-Enron standard of directors' oversight liability, affirming the standard articulated in *In re Caremark International Inc., 698 A.2d 959, 971 (Del. Ch. 1996)* (opining that "only a sustained or systematic failure of the board to exercise oversight - such as an utter failure to attempt to assure a reasonable information and reporting system exists - will establish the lack of good faith that is a necessary condition to liability"). See *Stone, 911 A.2d at 370.*

[70] See *Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).*

[71] See Black et al., Outside Director Liability, supra note 56, at 1103-04.

[72] *In re WorldCom, Inc., 346 F. Supp. 2d 628 (S.D.N.Y. 2004).* WorldCom seems to impose greater demands on directors than the previous leading case on director liability for prospectus misstatements, *Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).*

[73] Gretchen Morgenson, Ex-Directors at WorldCom Settle Anew, N.Y. Times, Mar. 19, 2005, at C1.

[74] This is mostly because of the time crunch, which deprives underwriters of time to scrutinize the issuer's financial statements before issuing securities. See John C. Coffee, Jr. & Joel Seligman, Securities Regulation 271-85 (9th ed. 2003) (discussing shelf registration rules and liability risks). Indeed, Bernard Black et al. found that the negligence standard of section 11 was the critical element in most of the identified post-1980 instances of outside director out-of-pocket payments. Black et al., Outside Director Liability, supra note 56, at 1070 tbl.2, 1074.

[75] For a recent discussion of the post-Disney, post-WorldCom environment for directors, see Symposium, Director Liability, *31 Del. J. Corp. L. 1011 (2006).*

There were a number of innovations during the period aimed at creating incentives for good performance by outside directors. [76] Circa 1950, director compensation was low and sometimes nonexistent. The tradition, going back to the nineteenth century, was not to pay directors, on the view that the opportunity to monitor management was reward enough for a substantial stockholder. [77] As it became desirable for firms to put "outsiders" on the board and necessary to compensate them for their time, significant compensation became common; indeed, it became increasingly lavish throughout the period. [78] Such compensation, of course, can undercut independence if the CEO has influence over director retention.

One 1990s-era governance innovation was to compensate directors in stock (or stock options) to strengthen the alignment of director and shareholder interests. [79] Despite some evidence that suggests a connection between stock-based director compensation and improved governance, [80] stock-related **[*1488]** compensation was hardly a panacea. Few directors actually acquired a great enough equity interest to generate a strong incentive effect (assuming that incentives are increasing in ownership levels). Directors typically obtained their equity stake through annual stock-based compensation rather than an initial grant of stock options or restricted stock. Over time the stake accumulates, but this also undercuts director independence where the CEO has influence over director retention.

More seriously, perhaps, stock-based compensation may create a distinctive set of perverse incentives for the directors, as demonstrated by the wave of financial disclosure problems in the late 1990s and early 2000s. The director receiving stock-based compensation, like the similarly compensated CEO, may be tempted to accept aggressive accounting rather than stock-price-puncturing disclosure. [81] It is important to remember that with respect to disclosure obligations, the public board has a dual duty - not only to the firm's shareholders, but to capital market participants more generally. This is because of the positive (negative) externalities associated with accurate

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[76] See generally David Yermack, Remuneration, Retention, and Reputation Incentives for Outside Directors, 59 J. Fin. 2281 (2004) (investigating the incentives received by outside directors of Fortune 500 firms from 1994 to 1996).

[77] Charles M. Elson, Director Compensation and the Management-Captured Board - The History of a Symptom and a Cure, *50 SMU L. Rev. 127, 135-36 (1996).* Indeed, director compensation was not legally recognized in the United States until the late 1940s, although informal modes flourished, such as meeting fees, passing of stock tips, and even salaries. *Id. at 138, 142.* As of 1979, the median NYSE firm paid an annual director retainer of less than $ 10,000. SEC STAFF REPORT, supra note 11, at 605 tbl.9.

[78] Elson, supra note 77, at 147-56.

[79] See Eliezer M. Fich & Anil Shivdasani, The Impact of Stock-Option Compensation for Outside Directors on Firm Value, 78 J. Bus. 2229, 2229 (2005) (noting that the number of Fortune 1000 firms using stock-based remuneration increased from just over 200 in 1992 to almost 500 in 1995).

[80] Fich and Shivdasani report that the presence of outside director stock-option plans is associated with economically significantly higher market-to-book ratios, a greater fraction of independent directors on the board, higher institutional investor ownership, and stock price effects that suggest that investors believe that such plans improve monitoring. See id. at 2230-31. Some studies have associated significant stock ownership with increased firm value, see Randall Morck et al., Management Ownership and Market Valuation: An Empirical Analysis, 20 J. Fin. Econ. 293 (1988) (using Tobin's q as the measure of value), and with lower executive compensation and better connection to pay for performance, see Tod Perry, Incentive Compensation for Outside Directors and CEO Turnover (July 1999) (unpublished manuscript), available at *http://papers.ssrn.com/abstract=236033*. Moreover, courts came to give greater deference to target board defensive measures where the outside directors were substantial stockholders, most notably in*Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995).*

[81] For example, there is some evidence that outside directors participated along with managers in taking backdated stock options. See Lucian Arye Bebchuk et al., Lucky Directors (John M. Olin Ctr. for Law, Econ. & Bus., Harvard Law Sch., Discussion Paper No. 573, 2006), available at *http://ssrn.com/abstract=952239*.

(misleading) disclosure. [82] With such divided duties, it's hard to know which way to set the optimal stock-based incentive effects. [83]

c. Reputation

Reputation provides another sort of stick or carrot that could enhance director independence. Presumably directors would not want to be associated with a poorly performing firm or a firm that is stigmatized because of a business scandal, and instead would want to be associated with a bellwether firm. But the incentive effects of reputation consist not merely in the director's subjective distaste for embarrassment and his preference for respect, but also in the business opportunities, including other directorships, that are affected by reputation. [84] The effectiveness of reputation-based incentives is limited by the noisiness of reputation markets. Plainly a director suffers a reputational **[*1489]** sanction if there is a financial catastrophe or major legal problem at the firm. In the more typical case of firm underperformance or a minor legal problem, however, there may be little or no reputational effect. [85]

In general, reputation markets became more effective over the period, particularly beginning in the 1980s. The salience of hostile takeovers drew media attention - newspapers, books, magazines, and movies - not simply to the actors in a particular case but to governance activity more generally. [86] High-stakes transactions gave rise to high-stakes litigation, which often was closely followed by the business press. Delaware courts issued opinions that publicly evaluated the behavior of directors as well as other corporate actors, often in harsh terms. [87] Indeed, in light of the Delaware courts' reluctance to impose monetary liability on directors, the most significant independence-enhancing effect of litigation is probably through improving the operation of the reputation market rather than through the threat of monetary sanctions. [88]

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[82] See Jeffrey N. Gordon, Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley, *35 Conn. L. Rev. 1125 (2003).*

[83] See Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, *69 U. Chi. L. Rev. 1233 (2002)* (arguing that audit committee members should receive no stock-based compensation).

[84] See, e.g., Stuart C. Gilson, Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default, 27 J. Fin. Econ. 355 (1990) (finding that directors of firms that go bankrupt subsequently serve on fewer boards); Yermack, supra note 76 (2004) (finding that association with high-performing firms leads to new board seats and reputation provides half of directors' total incentives). See generally Black et al., supra note 57.

[85] First, a relatively routine problem will not attract sufficient media attention to achieve the salience necessary to attach the director to the matter. Second, it is generally hard to make judgments about director responsibility when a firm underperforms. In the egregious cases, Enron or WorldCom for example, particularized judgments seem hardly necessary since surely someone on the board should have been sounding an alarm. No longtime director's reputation emerged unscathed. In the more typical case, the competence of director monitoring rarely seems relevant.

[86] See generally Alexander Dyck & Luigi Zingales, The Corporate Governance Role of the Media (Ctr. for Research in Sec. Prices, Working Paper No. 543, 2002), available at *http://ssrn.com/abstract=335602*.

[87] See, e.g., *Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261 (Del. 1989); In re Walt Disney Co., 907 A.2d 693 (Del. Ch. 2005).* See generally Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, *44 UCLA L. REV. 1009, 1103-04 (1997);* David A. Skeel, Jr., Shaming in Corporate Law, *149 U. PA. L. REV. 1811 (2001).*

[88] Thus the greatest importance of Disney may be the scope of director decisions potentially subject to detailed public scrutiny. Previously high-profile litigation arose in hostile takeovers or management buyouts. But Disney signals that the Delaware courts may be willing to scrutinize director actions in important but not bet-the-company matters, particularly where management interests may clash with shareholder interests (like executive compensation). This will improve the effectiveness of the reputational sanction and thus strengthen director independence.

Reputation markets also became more effective because of the activity of activist institutional investors. For example, beginning in the 1990s CalPERS publicly targeted firms (and their boards) for poor performance and for noncompliance with its corporate governance code. [89] Other activist **[*1490]** shareholders also began to use press campaigns to promote change. [90] A 1993 article by Professor Joseph Grundfest unleashed what became the institutional investor's reputational strategy of choice: a "just vote no" campaign against directors as a group or individually. [91] A full-blown proxy campaign to replace the board or particular directors was not attractive to the institutions because of familiar collective action problems. Yet they could "just vote no" against management's candidates, and publicize their reasons for doing so. [92] The potential embarrassment factor of being a targeted director heightened the potency of reputation markets.

3. Intra-board structures and functions

Another important mechanism for director independence is the creative use of board structure to create a spirit of teamwork and mutual accountability among independent directors that helps foster independence-in-fact. Structural innovations multiplied over the period, including: board committees tasked with specific functions, "special committees" for specific legal or transactional issues, and various institutions to restrain the CEO's agenda-setting authority, such as the "lead director" and the "executive session."

a. Board committees

One particularly important innovation was the board committee assigned a specific key function. Beginning in the 1970s, "best practice" pronouncements called for three specific committees: the audit committee, the compensation committee, and the nominating committee, each with a majority of independent directors. [93] Each committee is functionally tasked in areas where the interests of managers and the shareholders may conflict. Independence-in-fact may be enhanced in two respects. First, the ownership and accountability for a specific critical task may lead to greater autonomy from the CEO in performing that **[*1491]** task. Second, the practice of acting jointly and autonomously in a targeted area may carry over to other important roles of the board, such as evaluating managerial performance and strategy. The potential for enhanced independence from this structural/functional

[89] In 1990, for example, CalPERS and the New York State and Local Retirement System published a letter to the GM board that attacked the board and that spurred governance reform. Letters to GM Directors Trigger Pension Fund Uproar, CORP. GOVERNANCE BULL. (Investor Responsibility Research Ctr., Gaithersburg, Md.), Jan.-Feb. 1990, at 18. More generally, see, for example, Calpers, Politicians Respond to Corporate Downsizing, CORP. GOVERNANCE BULL. (Investor Responsibility Research Ctr., Gaithersburg, Md.), Apr.-June 1996, at 11. CalPERS began filing corporate governance proposals in 1986. In 1991, Shareholders Will Cast Sharp Eye on Boards of Directors, CORP. GOVERNANCE BULL. (Investor Responsibility Research Ctr., Gaithersburg, Md.), Sept.-Oct. 1990, at 3.

[90] In 1992, for example, activist shareholder Robert Monks publicly shamed the Sears-Roebuck board into accepting proposed reforms through disparaging advertisements in the Wall Street Journal. Dyck & Zingales, supra note 86, at 2.

[91] Joseph A. Grundfest, Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates, *45 STAN. L. REV. 857 (1993).*

[92] This strategy was facilitated by the SEC's 1992 amendment of the proxy rules that loosened some constraints on coordinated institutional action. See Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, Investment Company Act Release No. 19,031, 52 SEC Docket 2028 (Oct. 16, 1992). The rules permitted institutions to engage in "conscious parallelism" without triggering proxy filing requirements. Such "non-concerted" behavior does not trigger filing obligations as a "group" under section 13(d) of the 1934 Act.

[93] See, e.g., ABA Comm. on Corporate Laws, supra note 31; Bus. Roundtable, Statement, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 BUS. LAW. 2083, 2108-10 (1978).

mechanism source grew gradually over the period, beginning in the 1970s. One limiting factor was that only at the end of the period, via a NYSE rule, were these committees necessarily staffed solely by independent directors. [94]

The most important board committee was the audit committee, a major objective of corporate governance reformers. Although calls for the creation of an audit committee began as early as 1939, [95] critical mass did not coalesce until the 1970s. [96] In 1974, the SEC began requiring disclosure of the existence of an audit committee (or lack thereof), [97] and in 1978 the SEC published general guidelines for what an audit committee should do. [98] The NYSE began requiring audit committees in 1977. [99] Indeed, by 1979, virtually all NYSE-listed companies had audit committees, and for 92% of the firms, the members were non-management directors. [100] By the end of the 1980s, the NASDAQ and the Amex introduced audit committee requirements as well. [101] Current **[*1492]** standards, through both exchange listing rules and Sarbanes-Oxley, mandate audit committees for every publicly owned company, as well as stringent standards of independence and financial expertise. [102]

Instituting the compensation committee came somewhat later than the audit committee. For example, the SEC began to require disclosure of whether a firm had a compensation committee and the committee's composition only in 1992. [103] Throughout much of the period, it was common for management directors to sit on the compensation

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94 See NYSE, Inc., Listed Company Manual §§303, 303A (2007); text accompanying notes 36-37. It should also be noted that the Enron audit committee was staffed solely by independents, and that the structural innovation of the compensation committee coincided with the controversial run up in executive compensation.

95 The NYSE made such a suggestion in 1939. Edward F. Greene & Bernard B. Falk, The Audit Committee - A Measured Contribution to Corporate Governance: A Realistic Appraisal of Its Objectives and Functions, 34 BUS. LAW. 1229, 1233 n.16 (1979) (citing Report of Subcommittee on Independent Audit and Audit Procedure of NYSE Commission on Stock List 7 (1939)). The SEC made an audit committee proposal in 1940. In re McKesson & Robbins, Inc., Exchange Act Release No. 2707, [1940 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 72,020 (Dec. 5, 1940).

96 The American Institute of Certified Public Accountants advocated the use of audit committees in 1967; the leading accounting firm, Arthur Anderson & Co., signed on in 1972. See Greene & Falk, supra note 95, at 1233 & n.16, 1234. An important congressional committee picked up the theme in 1976. See Subcomm. on Oversight & Investigations of the H. Comm. on Interstate and Foreign Commerce, 94th Cong., Report on Federal Regulation and Regulatory Reform 29-42 (Subcomm. Print 1976).

97 Item 8(e), Schedule 14A, *17 C.F.R. §240.14a-101 (1978)*.

98 Proposed Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 14,970, 15 SEC Docket 291 (July 18, 1978).

99 See supra note 36 and accompanying text.

100 ALI PRINCIPLES, supra note 46, §3.05 n.4 (citing a 1979 study of the American Society of Corporate Secretaries). On the other hand, apparently one-third of audit committee members were "affiliated" directors, and affiliated directors constituted the majority of the audit committee for nearly a quarter of firms. See David Vicknair et al., A Note on Audit Committee Independence: Evidence from the NYSE on "Grey" Area Directors, 7 Acct. Horizons 53, 55, 56 (1993) (using a sample of 100 NYSE firms in the 1980s). This was permitted until the 1999 amendment of the NYSE listing standard. See supra text accompanying note 37.

101 The ASE "recommended" audit committees to its listed companies in 1980 and made them mandatory in 1991. Douglas C. Michael, Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act, *47 Bus. Law 1461, 1474 (1992).* The NASDAQ required its listed companies to have independent audit committees in 1987. *Id. at 1475.*

102 See sources cited supra note 53; see also Bus. Roundtable, Principles of Corporate Governance 16 (2002), available at *http://www.businessroundtable.org/pdf/704.pdf*.

103 See Executive Compensation Disclosure, Securities Act Release No. 6962, Exch. Act Release No. 31,327, Investment Company Act Release No. 19,032, 52 SEC Docket 1961 (Oct. 16, 1992) (currently reflected in Regulation S-K Item 402(j)). The proposed release had much more stringent disclosure standards for ties and interests that might undercut independence,

committee, although outsiders were typically the majority. [104] Nominating committees (separately discussed below) also became more prevalent during the period, [105] in response to pressure from institutional investors. [106] Compensation and nominating committees, both staffed by independent directors, are now required by the NYSE listing standard. [107]

At best, functionally tasked board committees should enhance independence, particularly in regard to the targeted task. Actual practices, until the post-Enron reform wave, made the committees less effective in that regard. For the audit committee, management hired (and fired) the auditor and also determined the level of more lucrative non-auditing consulting work assigned to the auditor, undercutting the auditor's allegiance to the audit committee. This managerial power over the auditor relationship was, of course, known to the audit committee members and would have dampened their independent engagement with significant auditing issues. Sarbanes-Oxley, passed in 2002, now gives the audit committee power (and responsibility) over the firm's **[*1493]** auditor relationships and audit policies. [108] This, in turn, should make the audit committee a stronger source of director independence.

The compensation committee also has a similar story of dampened independence. In setting executive pay, compensation committees typically have relied on the compensation consultant who also provided firm-wide compensation and human resources guidance. Such a management-retained consultant, earning the largest portion of its fees from the firm-wide assignment, is unlikely to make recommendations or offer viewpoints that senior management would find distressing. Reliance on such a consultant will inevitably dampen the committee's independence. [109]

b. The "special committee"

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including non-profit organization director interlocks. Compare Securities Act Release No. 6940, Exchange Act Release No. 30,851, *57 Fed. Reg. 29,583, at 29,596* (proposed July 2, 1992), with Securities Act Release No. 6962, Exchange Act Release No. 31,327, Investment Company Act Release No. 19,032, *57 Fed. Reg. 48,126, at 48,142-43* (adopted Oct. 21, 1992).

[104] See ALI Principles, supra note 46, §3A.05 n.1.

[105] A 1992 Korn/Ferry study showed that, of the companies studied, 98% had audit committees, 95% had compensation committees, and 67% had nominating committees. Korn/Ferry Int'l, Board of Directors Nineteenth Annual Study 9 (1992). By 1995, those percentages had increased to 100%, 99%, and 71%, respectively. Korn/Ferry Int'l, Twenty-Seventh Annual Board of Directors Study 13 (2000).

[106] Gregory V. Varallo & Daniel A. Dreisbach, Fundamentals of Corporate Governance: A Guide for Directors and Corporate Counsel 24 (1996).

[107] NYSE, Inc., Listed Company Manual §303A.04-.05 (2007).

[108] Section 301 of the Sarbanes-Oxley Act of 2002 makes the audit committee "directly responsible for the appointment, compensation, and oversight of the work" of the firm's auditor. Sarbanes-Oxley Act of 2002 §301, *15 U.S.C. §78j-1*(m)(2) (2007). Section 202 of Sarbanes-Oxley provides that "all auditing services . . . provided to an issuer by the auditor of the issuer shall be preapproved by the audit committee of the issuer." Id. §78j-1(i)(1)(A). Section 201 of Sarbanes-Oxley prohibits the provision of certain non-audit services by the firm's auditor, id. §78j-1(g), and required preapproval of the audit committee for non-prohibited services, id. §78j-1(h). See Strengthening Requirements Regarding Auditor Independence, Securities Act Release No. 8183, Exchange Act Release No. 47,265, Public Utility Holding Company Act Release No. 27,642, Investment Company Act Release No. 25,915, Investment Advisers Act Release No. 2103, *68 Fed. Reg. 6006* (Feb. 5, 2003).

[109] See Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation 37-39 (2004). As part of a new initiative on executive compensation disclosure, the SEC now requires more stringent disclosure of relationships that potentially undercut the independence of the compensation committee members (and other directors) and disclosure of whether the committee itself retains any compensation consultant. The Commission does not require disclosure of the consultant's other possible economic relationships with the corporation. See Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54,302A, Investment Company Act Release No. 27,444A, *71 Fed. Reg. 53,158, at 53,205* (Sept. 8, 2006) (discussing compensation committee disclosure as required in new Item 407(e) to Regulation S-K). In the 2007 proxy season, shareholder activists began to press for the disclosure of such potential conflicts for compensation consultants.

The model for the maximally independent board committee is the "special committee" that a company sets up in cases where the interests of senior management seem to most directly conflict with the corporation's. This structural innovation came into widespread use beginning in the 1970s, but only in a limited set of circumstances. [110] One case was a control transaction, such as a management buyout, in which management is part of a group that **[*1494]** seeks to buy out the public shareholders; [111] or a parent-subsidiary merger, in which it is assumed that the target management's allegiance is likely to be towards the controlling shareholder who appointed them. [112] Another case was a shareholder derivative suit, in which officers and directors allegedly violated a fiduciary duty to the corporation. [113] In these cases the nominal independence of the committee was buttressed by the committee's hiring of independent advisors, particularly independent legal counsel. Such independent advisors, whose allegiance was not to management, could drive the process and promote the directors' sense of independence. However, "special committees" had little pervasive effect on board practice. Most often, they were convened in "final period" situations, after which the entity disappeared. Moreover, the potency of a committee's (or the board's) retaining its own advisors was well understood by corporate management and thus strongly resisted. [114] The lesson learned from special committees underpins the Sarbanes-Oxley decision to give the audit committee authority over the auditor's employment (and to give the audit committee the power to hire its own counsel and other advisors). [115]

c. Executive session; "lead director"

Another notable structural element was the emerging practice of the board's meeting in executive session (meaning, without senior management present) under the guidance of a "lead director," as part of each regularly scheduled board meeting. An executive session gives the board the opportunity for candid discussion free of senior management's possibly inhibitory presence. Holding executive sessions became regular practice in the 1990s. [116] The 1996 Korn/Ferry study indicated that the boards of 62% of respondents met in executive session during that year. [117] General Motors' 1994 Corporate Governance Guidelines, a bellwether in U.S. corporate governance development, established executive sessions to be held at least three times per **[*1495]** year. [118] "Regularly scheduled executive sessions" are now required by the NYSE listing requirements. [119] Because institutionalized,

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[110] See generally Scott V. Simpson, The Emerging Role of the Special Committee - Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest, *43 Bus. Law. 665 (1988).*

[111] See generally William T. Allen, Independent Directors in MBO Transactions: Are They Fact or Fantasy?, *45 Bus. Law. 2055 (1990).*

[112] See *Weinberger v. UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983).*

[113] E.g., *Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).*

[114] See, e.g., ALI Principles, supra note 46, §3.04 cmt. c (imposing full-board or judicial approval requirements for such retentions).

[115] See Sarbanes-Oxley Act of 2002 §301, *15 U.S.C. §78j-1*(m)(5)-(6) (2007). Similarly, NASDAQ has adopted a requirement that related party transactions be approved by the audit committee or another committee consisting solely of independent directors. NASDAQ, Inc., Marketplace Rules R. 4350(h) (2007).

[116] See Working Group on Corporate Governance, A New Compact for Owners and Directors, Harv. Bus. Rev., July-Aug. 1991, at 141, 142 (suggesting outside directors meet in executive sessions "no less than once a year").

[117] Korn/Ferry Int'l, 24th Annual Board of Directors Study 21 (1996). Interestingly, however, this percentage dropped to 60% by 2000. Korn/Ferry Int'l, 27th Annual Board of Directors Study 13 (2000).

[118] Gen. Motors Bd. of Dirs., Corporate Governance Guidelines 7 (1994).

[119] NYSE, Inc., Listed Company Manual §303A.03 (2007). See Working Group on Corporate Governance, supra note 116.

such a meeting does not require special director initiation that might well be regarded by senior management as a hostile act.

The naming of a "lead director" - an independent director who convenes the board, where the chair is a senior executive, typically the CEO - was itself a structural innovation. It represented a compromise between those who, following the U.K. model, wanted to separate the roles of chair and CEO by making a non-executive director the chair, and those who felt that such separation would undermine the CEO's authority. [120] Following the 1992 release of the Cadbury Report in the United Kingdom, [121] calls for lead directors became more pronounced. [122] Lead directors came to play an increasingly important role in U.S. corporate governance practice, [123] providing an organizational focal point for crises where the CEO's actions have been challenged. [124]

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4. Reducing CEO influence in director selection and retention

A director's independence-in-fact may be seriously affected by the route by which the director arrived on the board - the director's "genealogy." Until recently, CEOs heavily influenced - if not controlled outright - director selection. [125] Directors picked in this way are likely to feel a strong sense of loyalty, even gratitude, to the CEO. [126]

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120 Two leading corporate reform groups, the Council of Institutional Investors and Institutional Shareholder Services, argue for separation of roles. Apparently such separation is relatively common among all public companies - approximately 50%, according to the National Association of Corporate Directors - but still uncommon among the largest firms - only 14% of the top 100, according to a Shearman & Sterling report. See Ann Therese Palmer, Should the Top Roles Be Split?, Chief Executive, May 2005, at 16, 16.

121 Cadbury Comm., The Financial Aspects of Corporate Governance 58 (1992) ("Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board, with a recognized senior member.").

122 See, e.g., Lipton & Lorsch, supra note 21, at 70.

123 The fraction of Business Roundtable firms with an independent chairman, lead director, or presiding director increased from approximately 25% in 2002 to 55% in 2003, to 71% in 2004, to 83% in 2005, and to 91% in 2006. See Bus. Roundtable, supra note 20; Press Release, Bus. Roundtable, New Business Roundtable CEO Survey Shows Continuing Improvements in Corporate Governance Practices (Mar. 9, 2004), available at *http://www.businessroundtable.org/newsroom/document.aspx?qs=5626BF807822B0F13D3429167F75A70478252*; Press Release, Bus. Roundtable, The Business Roundtable Releases Corporate Governance Survey (July 15, 2003), available at *http://www.businessroundtable.org/newsroom/document.aspx?qs=55B6BF807822B0F1DD6449167F75A70478252*.

124 Take two examples from 2005 and 2006: First, as the investigation of AIG Corp. began to reveal evidence of senior management's involvement in transactions that produced questionable accounting results, the lead director steered the board towards the ouster of the incumbent chair and CEO and the selection of a new CEO. Second, in the face of widespread dissatisfaction within Morgan Stanley and its shareholder base with the strategy and leadership of the chairman and CEO, the lead director eventually promoted the resignation of the incumbent and his replacement with a former senior executive. The NYSE listing standards require that a company specify in its proxy statement the name or method of selection of the "presiding director" for executive sessions. NYSE, Inc., Listed Company Manual §303A.03 (2007). In many cases the role of "lead director" is played by the chair of the nominating/corporate governance committee. See Shearman & Sterling LLP, supra note 20, at 5.

125 See, e.g., LORSCH WITH MACIVER, supra note 23, at 20-23 (arguing that even with the advent of nominating committees, CEOs still have a strong hand in the selection process); Mace, supra note 22, at 94-101 (arguing that CEOs pick directors).

126 See, e.g., James Wade et al., Golden Parachutes: CEOs and the Exercise of Social Influence, 35 Admin. Sci. Q. 587 (1990) (finding that directors elected during the CEO's tenure may feel obligation and loyalty); James D. Westphal & Edward J. Zajac, Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection, 40 Admin. Sci. Q. 60 (1995) (finding that CEO influence in director selection leads to demographically similar directors sympathetic to the CEO); see also Anil Shivdasani & David Yermack, CEO Involvement in the Selection of New Board Members: An Empirical Analysis, 54 J. Fin. 1829 (1999) (finding that boards with CEO involvement in director selection have a higher fraction of pick-affiliated ("grey") directors

Moreover, as CEO-influenced director selection also implies some CEO role in the director retention decision, a director whose "independence" aggravates the CEO may find himself politely invited not to stand for reelection. [127] Throughout almost the entire period from the 1950s to the 2000s, CEOs successfully resisted reforms that would have increased shareholder influence in director selection, including the SEC's 2003 shareholder ballot access proposal. On the other hand, the increasing use of nominating committees later in the period, and the growing practice of staffing the nominating committee solely with independent directors, did reduce CEO influence to some extent.

CEOs won a number of battles in the period over the practical scope of the shareholders' nominal right to present director nominees at the annual meeting. The most important barrier facing dissidents is the expense, including the compliance costs of the SEC's proxy rules and the printing, mailing, and publicity costs of waging an election contest in a diffusely owned firm. [128] The **[*1497]** campaign finance rules that emerged in the 1950s strongly favor the managerial incumbents: the dissidents must fund their campaign from their own pockets; the incumbents have virtually unlimited access to the corporate treasury. As a practical matter, the dissidents are reimbursed only if they successfully obtain control of the board. [129] Subsequent proposals for qualified reimbursement - for example, tied to the dissident's fraction of the votes received - have gone nowhere.

The obvious low cost alternative to a separate proxy contest would be to grant shareholders access to the management proxy to present director candidates. However, CEOs won a victory from the SEC in the 1950s and again in the 2000s that have kept shareholders from accessing the management proxy. In fashioning its shareholder proposal rule in the 1950s following a series of high profile proxy contests, the SEC gave the issuer the right to exclude a proposal "that relates to an election for membership on the company's board of directors" from the management proxy. [130] As a result, instead of piggy-backing on the management proxy, a dissident needs to wage an independent proxy contest. Five decades later, in 2003 the Business Roundtable successfully fended off the SEC's proposed "security holder nomination" rule, which would have provided dissidents with access to the management proxy in specified circumstances. [131] Similarly, CEOs prevailed in a campaign to unwind cumulative

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than of true independents and finding a recent trend away from CEO involvement); Edward J. Zajac & James D. Westphal, Accounting for the Explanations of CEO Compensation: Substance and Symbolism, 40 Admin. Sci. Q. 283 (1995).

[127] An interesting variation on the CEO/board selection question arises when the board recruits the CEO. (An inside CEO successor probably has been groomed, if not directly chosen, by the outgoing CEO and may inherit, instead of independently generating, the board's support.) A board that has recruited the CEO presumably will be more independent, particularly when the CEO is an outsider. Common lore is that one of the missions of a new CEO is to stock the board with his loyalists.

[128] The cost of waging a proxy contest is also affected by the fraction of institutional ownership; concentrated ownership reduces the costs of solicitation. In January 2007, the SEC adopted a rule that would allow an insurgent to post proxy materials on the Internet rather than to print and mail the materials (though it must provide a paper copy to a requesting shareholder). See Internet Availability of Proxy Materials, Exchange Act Release No. 55,146, Investment Company Act Release No. 27,671, *72 Fed. Reg. 4148* (Jan. 29, 2007). This will significantly reduce an insurgent's costs.

[129] *Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291 (N.Y. 1955).* The consequence is that insurgent efforts will be undersupplied because insurgents are likely to bear the full cost of the election contests while at best receiving only the gains proportional to their ownership stake. Such a reimbursement rule creates a particular barrier to electoral success. Shareholders who might be persuaded to add one or two dissident directors will be very leery about a shift in control through an election contest to insurgents who, by hypothesis, are unwilling to pay a control premium. Yet if the insurgents run and win with a "short slate" that substitutes one or two dissident directors for management's nominees, the new board - on which the dissidents are an unwelcome minority - is unlikely to reimburse the insurgents despite their electoral success.

[130] Securities Exchange Act of 1934 Rule 14a-8(i)(8), *17 C.F.R. §240.14a-8(i)(8) (2007)*. See generally Jeffrey N. Gordon, Institutions as Relational Investors: A New Look at Cumulative Voting, *94 Colum. L. Rev. 124, 152-54 (1994)* (describing how an increased number of high profile proxy contests in the 1950s led to Congressional and SEC hearings and fanned general alarm about the potential power of shareholder dissidents). A recent Second Circuit case has apparently opened the door to shareholder-proposed bylaws that would mandate access to the management proxy for shareholder nominees. See *Am. Fed'n of State, County & Mun. Employees v. Am. Int'l Group Inc., 462 F.3d 121 (2d Cir. 2006).*

voting, a historically important mechanism **[*1498]** that uses proportional representation in a way that facilitates shareholder access to the board. [132]

One piece of the reform agenda did prevail: the creation of a nominating committee with responsibility for vetting and selecting director candidates. In 1979, only 19% of the companies sampled in a SEC study had nominating committees; by 1981, a subsequent SEC study showed an increase to 30%; in 1989, a Korn/Ferry study reported that 57% of the responding firms had a nominating committee. [133] As of 1992 when ALI published Principles of Corporate Governance, "best practice" called for a nominating committee that had no officer members but could have affiliated directors as members. [134] As per the 2003 revision of the NYSE listings standards, NYSE-listed companies were required to have a nominating committee consisting solely of "independent" directors, under a standard that would exclude most affiliated directors as well as officers. [135]

The usefulness of a nominating committee in promoting independence-in-fact of directors is not altogether clear. [136] On the one hand, the ALI project made it clear that a CEO "can be expected to be highly active" in recommending and discussing candidates with the committee and in recruiting candidates for the board. [137] The CEO often will select the executive search firm that the committee uses to look for director candidates. On the other hand, the nominating committee process might shield a director who has begun to challenge the CEO from retaliation. Extensive new SEC rules adopted in 2004 **[*1499]** require disclosure of nominating committee practices, particularly the attributes the committee regards as essential and the committee's search and evaluation process, including the process for vetting director candidates suggested by shareholders. [138] The goal, presumably, is to force the nominating committee to set forth the standards that guide its work so as to provide a

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[131] See Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003). For a discussion of the Business Roundtable lobbying efforts, see Lucian Arye Bebchuk, The Case for Shareholder Access: A Response to the Business Roundtable, 55 Case W. Res. L. Rev. 557 (2005).

[132] See Gordon, supra note 130. Cumulative voting operates in two distinct settings. First, a single shareholder (or cohesive group) owning a significant minority block can automatically elect a director to the board. But second, cumulative voting lowers the cost of mobilizing diffuse shareholders because electoral success - in the sense of placing a nominee on the board - requires much less than 50% of the votes. For example, for a ten-person board elected annually, a dissident need to rally only a 10% shareholder vote to put a director on the board. So cumulative voting offers significant potential for shareholder selection of at least some directors who would be independent in this genealogical sense. Alarmed by the role that cumulative voting played in some prominent proxy contests of the 1950s, CEOs and their allies went to work. The hostile takeovers of the 1980s brought a further wave of managerial efforts to eliminate cumulative voting as a route to board representation. Circa 1950, twenty-two states had mandatory cumulative voting; circa 1990, only six did. Id. at 142-46, 148-54.

[133] See ALI Principles, supra note 46, §3A.04 reporter's n.1.

[134] Id. §3A.04.

[135] See NYSE, Inc., Listed Company Manual §§303, 303A (2007). NASDAQ's rules, which are geared to the size diversity of NASDAQ-listed companies, require either a nominating committee or a practice under which nominations are made by the independent directors of the board.

[136] See, e.g., Mace, supra note 22, at 95 (quoting a CEO who stated, "Once I have decided on the man who should be our new board member, I discuss this informally outside of board meetings with our three-man committee of the board that officially nominates people to the board"). Writing in 1989, Lorsch with MacIver, supra note 23, at 20, found that 55% of the directors they surveyed said that the CEO was heavily involved in the identification of possible candidates.

[137] ALI Principles, supra note 46, §3A.04 cmt. c.

[138] See Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Securities Act Release No. 8340, Exchange Act Release No. 48,825, Investment Company Act Release No. 26,262, 68 Fed. Reg. 66,992 (Nov. 28, 2003); see also NYSE, Inc., Listed Company Manual § 303A.02 (2007); NASDAQ, Inc., Marketplace Rules R. 4350(c)(4) (2007).

basis for ex post scrutiny. Moreover, involvement by the CEO presumably would be a point for disclosure and that alone may tamp down the CEO's influence.

In measuring the effect of a nominating committee, the different conceptions of "independence" are important. By the end of the period, CEOs came to accept a nominating committee composed of "independent" directors, if only because the directors' views of the firm were likely to be have been shaped by the CEO's vision. However, CEOs continued to fight tooth and nail against measures that would increase direct shareholder access to the board. From the CEO's perspective, the shareholder-nominee director was not independent, but rather dependent on the proposing shareholder group and its particularistic agenda. [139] On this view, nominating committees produce directors independent of both shareholders and the CEO.

C. Summary of Part I.B

This nonexhaustive survey of the mechanisms of director independence shows that reform efforts over the 1950-2005 period did, on balance, enhance substantially the conditions that foster director independence. The relationship rules created obvious protections, and the structural innovations within the board have been promising. Putting aside the independent nominating committee, which will have some pro-independence effect, other efforts to strengthen the shareholder hand in director selection did not succeed. However, it is reasonable to conclude that the cumulative effect of innovations in these various mechanisms significantly increased director independence over the period. But the difficult problem remains: independence is more a disposition, a state of mind, rather than a concrete fact. What might have been more significant than the mechanisms themselves was the constant advocacy of director independence that led to their adoption. Adoption of these various governance innovations both reflected a cultural change in the expectations of director behavior and helped create the cultural change. Thus the shift in the **[*1500]** proportion of independent directors on the board from 20% in the 1950s to 75% by the mid-2000s is more than a superficial increase of nominally identified outsiders: board composition and board attitude have notably shifted toward independence-in-fact.

II. Changing Board Composition: The Search for Evidence that It Makes a Difference

Evidence that connects the increased presence of independent directors to shareholder benefit is weak at best. The empirical studies on the effects of board composition can be broken down into two types: (1) effects on firm performance, using, variously, accounting measures, stock price returns, and market valuation metrics such as Tobin's q; and (2) effects on discrete tasks, such as CEO compensation and termination and decisions in connection with takeovers, whether as acquirer or target. [140] Teasing out the effects of board composition from the many other factors that affect performance is economically and econometrically difficult, [141] so the lack of a strong positive connection between board independence and performance is perhaps unsurprising. This has motivated the "discrete tasks" line of research, on the theory that even if ultimate performance effects are hard to find in the data,

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[139] This perception significantly influenced the Business Roundtable's opposition to the SEC's shareholder ballot access proposal. See, e.g., Letter from Henry A. McKinnell, Chairman, Bus. Roundtable, to Jonathan Katz, Sec'y, Sec. & Exch. Comm'n (Dec. 22, 2003), available at *http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf*.

[140] The leading surveys are Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, *54 Bus. Law. 921 (1999);* Benjamin E. Hermalin & Michael S. Weisbach, Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature, FRBNY Econ. Pol'y. Rev., Apr. 2003, at 7; Jonathan L. Johnson et al., Boards of Directors: A Review and Research Agenda, 22 J. Mgmt. 409 (1996). Bhagat and Black are more precisely focused on the role of independent directors.

[141] For example, underperforming firms may add more independent directors in the hope that the governance change will improve performance; on cross-sectional comparison, that causal connection will be blurred. Alternatively, the tests may be underpowered, thus, in the absence of a relatively large impact, performance effects will be obscured by statistical noise. For example, if the average effect were +$ 0.01 per firm for the 25% of firms that were early adopters of board independence, that would cash out to a nontrivial $ 30 billion across $ 12 trillion in equities but might be undetectable through conventional methodology. (Of course the undetectable effect could, in principle, be negative.)

certain governance actions should have a bottom-line effect. Yet even for discrete tasks, there is only limited evidence that board independence generates differences in board behavior, and the differences are not stark.

A. Uncertain Effect on Firm Performance and Behavior

1. Firm performance tests

The most thorough survey of the empirical evidence on board composition effects is a 1999 paper by Bhagat and Black. In describing efforts to show correlation between firm performance and board independence, they report that **[*1501]** "most studies find little correlation, but a number of recent studies report evidence of a negative correlation between the proportion of independent directors and firm performance - the exact opposite of conventional wisdom." [142] They include their own 1999 study in those negative studies, with results driven by negative outcomes in firms that have an especially high fraction of independent directors, firms with only one or two insiders. One criticism of cross-sectional studies that regress board composition on performance measures is the potential lag between good governance and the visible effect on performance. Bhagat and Black attempt to address this in a detailed 2001 follow-on study with a large sample and long horizon, but the conclusion is the same: that increasing the degree of board independence does not improve firm performance. [143]

2. Discrete task tests

Bhagat and Black's 1999 survey also takes a dim view as to whether boards with a majority (or supermajority) of independent directors do a better job on important discrete tasks undertaken by boards. A possible exception is avoiding financial fraud, where the studies suggest that a predominance of independent directors on the board may make a difference. Here are some important examples of board decisionmaking that test whether board composition matters.

[*1502]

a. CEO terminations

Weisbach's widely-cited 1988 study of CEO terminations in NYSE-listed firms over the 1974-1983 period concludes "that when boards are dominated by outside directors, CEO turnover is more sensitive to firm performance than it is in firms with insider-dominated boards." [144] But the effect is relatively minor: for firms in the bottom decile of performance, CEO turnover is roughly 5% more likely for boards with more than 60% independent

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[142] Bhagat & Black, supra note 140, at 942; accord Bhagat & Black, supra note 17, at 235-37. The 2003 survey by Hermalin & Weisbach, supra note 140, reaches a similar conclusion. In contrast, two other studies find a positive correlation; however, both are methodologically flawed in ways that undercut their conclusion. Baysinger & Butler, supra note 15, purport to show a correlation between board composition in 1970 and performance ten years later in 1980. A statistically significant persistence of such an effect over such an extended period seems highly unlikely. Statistical significance was tested only with respect to one measure of performance and has not been replicated by other studies. MacAvoy and Millstein argue that prior studies fail to take account of the emergence of the "active board" in the 1990s and that the critical variable is not board composition per se but its attitude. They report that firms with the best boards generate significantly higher returns than all others. Ira M. Millstein & Paul W. MacAvoy, The Active Board of Directors and Performance of the Large Publicly Traded Corporation, *98 Colum. L. Rev. 1283 (1998).* Given their board evaluation measure, the results seem so remarkable as to be improbable. MacAvoy and Millstein focus on the extent to which boards followed the 1992 activist stance of the GM board, as measured by grades (A+ to F) that CalPERS assigned in 1995. CalPERS's grades were based on a board's response to the guidelines fashioned by the GM board, not by activism in practice. In other words, if the board went through a process and adopted GM-like guidelines, it would get an A+. Moreover, there was no systematic correlation for grades below A+ and relative performance. See *id. at 1313.* These results do not seem robust.

[143] Bhagat & Black, supra note 17. The time horizon is important because of the potential lag between board changes and performance improvements.

[144] Hermalin & Weisbach, supra note 140, at 14 (characterizing Michael S. Weisbach, Outside Directors and CEO Turnover, 20 J. Fin. Econ. 431 (1988)).

directors than boards with less than 40%. Moreover, during the subsequent period from 1984 to 1993, the board composition effect on CEO turnover disappears. [145] This suggests that the increasing pressures in the market for control swamped the pro-governance effects of independent directors. Thus Bhagat and Black conclude that, at most, there is "some evidence that independent directors behave differently than inside directors when they decide whether to replace the current CEO"; but the differences are small, and, after taking into accout post-termination stock price studies, it's not clear whether the sign is positive or negative when independents dominate the board. [146]

b. Takeover activity as target

Evidence is mixed on whether target firms in fact benefit from the theoretical advantages of board independence.

Target gains. Consistent with theory, target firms with majority-independent boards get a higher bid price. A widely-cited study by Cotter et al. (1997) of tender offers from 1989 to 1992 reports that targets with majority independent boards obtained substantially higher premia (twenty percentage points higher on average) than firms without such boards. [147] Similarly, Lee et al. find that the presence of a majority-independent board increased shareholder returns upon the announcement of a management buyout. [148] This suggests that majority-independent boards may be more effective bargaining agents and are less likely to succumb to managerial pressure in the takeover process.

Target defensive measures. Theory would also predict that majority-independent boards should behave differently in adopting preemptive defensive measures. However, various studies do not find differences in majority- **[*1503]** independent boards' likelihood of adopting the poison pill, opting out of Pennsylvania's highly protective antitakeover laws, or having a classified board. [149] Other studies present an inconsistent pattern of board composition effects on stock market returns upon the adoption of defensive measures. [150] Thus the potential post-bid performance advantages of an independent target board may be undercut by its pre-bid performance, which does not improve the rate at which bids are made.

c. Takeover activity as acquirer

Acquisitions give rise to many species of managerial agency problems that board independence might better control, such as managerial empire building, over-optimism bias, and winner's curse. But the evidence conflicts on whether firms with independent boards are less likely to make value reducing bids; in any event, the effect is small. Byrd and Hickman (1992) report that majority independent boards deliver marginally better returns to shareholders in bidding for acquisitions. [151] Although the average announcement-date abnormal return for their whole sample

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[145] Wayne H. Mikkelson & M. Megan Partch, The Decline of Takeovers and Disciplinary Managerial Turnover, 44 J. Fin. Econ. 205 (1997).

[146] Bhagat & Black, supra note 140, at 925-26.

[147] James F. Cotter et al., Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?, 43 J. Fin. Econ. 195, 202 tbl.1 (1997) (finding that targets with majority-independent boards received on average a 62% premium versus a 41% premium for those without such boards).

[148] Chun I. Lee et al., Board Composition and Shareholder Wealth: The Case of Management Buyouts, Fin. Mgmt., Spring 1992, at 58, 66.

[149] See Bhagat & Black, supra note 140, at 930.

[150] Compare, e.g., James A. Brickley et al., Outside Directors and the Adoption of Poison Pills, 35 J. Fin. Econ. 371 (1994) (finding positive returns for pill adoption with majority independent board and negative returns without), with Chamu Sundaramurthy et al., Board Structure, Antitakeover Provisions, and Stockholder Wealth, 18 Strat. Mgmt. J. 231, 237 (1997) (finding negative returns increasing with independent directors). See generally Bhagat & Black, supra note 140, at 929-30.

[151] John W. Byrd & Kent A. Hickman, Do Outside Directors Monitor Managers?, 32 J. Fin. Econ. 195 (1992) (regressing a sample of 128 tender offer bids from 1980 to 1987). Using regression analysis, the authors also identify a curvilinear relationship between the fraction of independent directors and improved acquirer returns that is positive except at the high end of

was negative (-1.23%), the average return for acquirers with majority independent boards was roughly zero (-0.07%) while return for others acquirers was more negative (-1.86%). Yet Subrahmanyam, Rangan, and Rosenstein (1997), in a sample of firms from the banking industry, find that abnormal returns are negatively related to the proportion of outside directors. [152]

d. Executive compensation

Executive compensation decisions arguably present the sharpest clash between shareholder and managerial interests. The empirical evidence on the compensation effects of independent directors is equivocal, with "little evidence that independent directors do a better job than inside directors in **[*1504]** establishing CEO pay." [153] One surprising result is that boards with more independent directors are more likely to award "golden parachutes" (change-in-control severance payments typically equal to approximately three times annual salary and average bonus). [154] One defense of these plans is that they may reduce managerial resistance to a takeover bid, but a more independent board presumably should be better able to control managers directly.

One implication of the studies is that the definition of "independent" may be insufficiently granular. Core, Holthausen, and Larker (1999) show that executive compensation is positively correlated with the fraction of outside directors and that the percentage of compensation associated with board composition is negatively correlated with firm performance. [155] Yet what explains these results are the characteristics of the outside directors, in particular, the number of outside directors appointed during the CEO's tenure, the number of "gray directors," and the presence of interlocked directors. [156] This fits with what compensation practitioners have called the "giraffe effect" - the sharp increase in CEO pay associated with the influx of CEOs or former CEOs on the board and on the compensation committee, in response to pressure to add independent directors in the late 1970s and 1980s.

e. Avoidance of financial fraud

The best-developed evidence of board composition effects is the positive association between board independence and financial reporting accuracy. The exact channel of this effect is not well-specified, but some studies suggest it could be through the independent audit committee.

A strong negative association between accounting fraud and a more independent board are reported by Beasley [157] and Dechow, Sloan, and Sweeney, [158] who compare firms with a high likelihood of having committed **[*1505]** accounting fraud (e.g., targeted by an SEC enforcement action) with control firms. Klein also finds a negative

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independence where returns become negative. Interestingly, that inflection point is 60%, a low percentage by today's standards. Id. at 213.

[152] Vijaya Subrahmanyam et al., The Role of Outside Directors in Bank Acquisitions, Fin Mgmt., Autumn 1997, at 23, 34. The authors also suggest that the regulatory structure of the banking industry may explain the surprising result. Id. at 24.

[153] Bhagat & Black, supra note 140, at 931.

[154] See Philip L. Cochran et al., The Composition of Boards of Directors and Incidence of Golden Parachutes, 28 Acad. Mgmt. J. 664, 668 (1985); Harbir Singh & Farid Harianto, Management-Board Relationships, Takeover Risk, and the Adoption of Golden Parachutes, 32 Acad. Mgmt. J. 7, 20 (1989).

[155] John E. Core et al., Corporate Governance, Chief Executive Officer Compensation, and Firm Performance, 51 J. Fin. Econ. 371 (1999).

[156] Id. at 388; see also Kevin F. Hallock, Reciprocally Interlocking Boards of Directors and Executive Compensation, 32 J. Fin. & Quantitative Analysis 331, 332 (1997).

[157] Mark S. Beasley, An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud, 71 Acct. Rev. 443, 455 (1996); see also Mark S. Beasley et al., Fraudulent Financial Reporting: Consideration of Industry Traits and Corporate Governance Mechanisms, 14 Acct. Horizons 441, 452 (2000) (finding a negative relationship between board independence and financial fraud across several industries).

[158] Patricia M. Dechow et al., Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC, 13 Contemp. Acct. Res. 1, 21 (1996).

association between board independence and abnormal accruals, often a fraud precursor. [159] Uzun et al. use a broader definition of fraud and find a similar relationship. [160]

Subsequent studies emphasize the importance of audit committee independence [161] and even the financial expertise of the board or the audit committee. [162] These studies, plus the various others that show no independent effect of board composition beyond audit committee effects, [163] suggest once again that structural elements may be crucial to directors' independence in fact.

3. Understanding the evidence

It is thus possible to read the U.S. evidence as suggesting that board independence has only minimal effects on board behavior and shareholder value. In my view, this interpretation would be mostly wrong. First, the anomalous empirical results may have conventional explanations. The strongest explanation is the diminishing marginal returns hypothesis: most of the empirical evidence assesses incremental changes in board independence in firms where there is already substantial independence and after the cultural entrenchment of norms of independent director behavior. [164] But, as I will argue, the most important effects of the move to independent directors, particularly over the long term, are systematic rather than firm specific and thus are unlikely to show up in cross-sectional studies. One systematic effect, the **[*1506]** lock-in of shareholder value as virtually the exclusive corporate objective, could have benefits for early adopters, but other effects, such as the facilitation of accurate financial disclosure and corporate law compliance, have principally external effects.

a. Tradeoffs

One explanation for the weak evidence on director independence is a potential tradeoff between the different attributes that insiders and independents bring to a board. Yes, a higher fraction of independent directors may produce outcomes that could be associated with value-increasing governance. But there may well be costs. Inside directors or affiliated directors - outsiders with an interest - may contribute valuable advice and insights that are lost in a thoroughly independent board. [165] Although the predominant model of board behavior has moved towards the

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[159] April Klein, Audit Committee, Board of Director Characteristics, and Earnings Management, 33 J. Acct. & Econ. 375, 387 (2002); see also Biao Xie et al., Earnings Management and Corporate Governance: The Role of the Board and the Audit Committee, 9 J. Corp. Fin. 295, 296, 305 (2003) (finding a statistically significant negative relationship between discretionary current accruals and directors with corporate backgrounds but not other backgrounds).

[160] Hatice Uzun et al., Board Composition and Corporate Fraud, Fin. Analysts J., May-June 2004, at 33.

[161] See Jeffrey Cohen et al., The Corporate Governance Mosaic and Financial Reporting Quality, 23 J. Acct. Literature 87, 99-102 (2004) (surveying studies assessing the relationship between governance characteristics and incidences of earnings manipulation and fraud).

[162] See Anup Agrawal & Sahiba Chadha, Corporate Governance and Accounting Scandals, *48 J.L. & Econ. 371 (2005).*

[163] See, e.g., Lawrence J. Abbott et al., The Effects of Audit Committee Activity and Independence on Corporate Fraud, Managerial Fin., Nov. 11, 2000, at 55, 56; Lawrence J. Abbott et al., Audit Committee Characteristics and Financial Misstatement: A Study of the Efficacy of Certain Blue Ribbon Committee Recommendations 3 (Mar. 2002) (unpublished manuscript), available at *http://ssrn.com/abstract=319125*.

[164] Cf. Bernard S. Black et al., Does Corporate Governance Predict Firms' Market Values? Evidence from Korea, 22 J.L. Econ. & Org. 366 (2006) (finding a significant effect in Korea from more independent directors even though such an effect does not appear in the United States).

[165] Compare, e.g., Jeffrey Pfeffer & Gerald R. Salancik, The External Control of Organizations: A Resource Dependence Perspective (1978) (discussing "resource dependence" theory and suggesting that affiliations may help firms obtain critical resources), with A. Burak Guner et al., The Impact of Boards with Financial Expertise on Corporate Policies (Nat'l Bureau of Econ. Research, Working Paper No. 11914, 2006), available at *http://ssrn.com/abstract=875673* (suggesting that commercial bankers on boards may lead to excessive debt finance and that investment bankers on boards may lead to acquisitions that

monitoring board and away from the advisory board, boards still participate in the firm's strategic planning and otherwise advise the CEO and the senior management team. If the monitoring and other governance functions are better in a predominantly independent board, perhaps the advising is not as good. [166]

b. Sorting (optimal differences)

Another explanation for the data is a variant on the tradeoff hypothesis that looks to the diversity among firms. If there is no "one size fits all" for board composition, then the heterogeneity in the board composition data may reflect firms finding their optimal insider/independent mix. Take, for example, the cross-sectional data that regresses firm performance on the fraction of independent directors. Assume that firms differ in the optimal fraction because of firm-specific tradeoffs: for particular firms inside directors or affiliated **[*1507]** outsiders may be more (less) useful, influenced perhaps by the relevant ownership structure or product market competition that reduces (increases) the managerial agency costs addressed by independent directors. [167] In any event, in a competitive market, we would expect firms to move toward their optimal governance structure. On this view, the regression results are expectedly economically insignificant - as is the general pattern - but only because out-of-equilibrium governance structures do not persist, not because director independence has little value for many firms.

The weakness, or rather, incompleteness, of the sorting hypothesis (as well as the general tradeoff hypothesis) is that it cannot account for the long-term secular trend towards director independence, a quite radical shift, as noted above, and mostly occurring over only a thirty-year period. The story is not only the increasing average fraction of independent directors in public firms but also the increasing fraction of firms with only one or two inside directors, 90% according to the 2004 Korn/Ferry Study. It seems unlikely that the local, firm-by-firm pursuit of shareholder value could produce such a strong trend.

c. Diminishing marginal returns

The most persuasive conventional explanation for the nominal results of the general empirical pattern is that director independence may well be positive for shareholder value but that above a critical fraction, the returns are diminishing, and, given the plausibility of firm-specific tradeoffs, sometimes may even be negative. Bhagat and Black, for example, say their negative performance measures are driven by firms with "super-majority" independent boards - instances where the board went beyond majority independent directors to only one or two insiders.

A significant part of the reason for the diminishing marginal returns from greater independence is the important institutional complement of hard and soft control markets that also help control managerial agency problems. In robust control markets managers face ouster for subpar performance, which in turn disciplines managerial performance. As will be elaborated on below, although hostile bids have become rare in the United States following the 1980s, their influence is still ubiquitous, particularly through the pervasive focus on shareholder value. This is built into managerial compensation packages through stock-related compensation, "golden parachutes" that blossom lucratively in a takeover, and termination decisions keyed to lagging stock prices. Moreover, the culture of shareholder value has become entrenched on U.S. boards and, indeed, among managerial elites. There is probably a critical threshold of independent directors that exposes the firm to significant control market **[*1508]** pressure, both in the board's willingness to entertain a takeover bid and in the board's willingness to terminate an

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reduce firm value). Indeed, even Eugene Fama and Michael Jensen, who argued on behalf of the monitoring role of boards, suggest that some insider presence (beyond the CEO) is valuable as a distinctive source of information for the board and as a proving ground for prospective CEO candidates. See Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control,26 J.L. & Econ. 301 (1983).

[166] Indeed, such a tradeoff in making good acquisition decisions is suggested by the curvilinear relationship found by Byrd & Hickman, supra note 151, in which acquirer returns start decreasing as the fraction of independent directors exceeds 60%. See also April Klein, Firm Performance and Board Committee Structure, *41 J.L. & Econ. 275 (1998)* (finding that insiders on strategic development committees may increase performance).

[167] For a model of a tradeoff between outside and inside control, see Milton Harris & Artur Raviv, A Theory of Board Control and Size (Ctr. for Research in Sec. Prices, Working Paper No. 559, 2005), available at *http://ssrn.com/abstract=607861*.

underperforming CEO. So long as that threshold is achieved, control market pressure has a greater effect than incrementally more vigorous board monitoring that might be associated with more independent directors. [168]

d. Firm-specific vs. systematic effects

The evidence is also consistent with a view that the main effects of the change in board composition are systematic and that the firm-specific effects are very hard to isolate. In the U.S. environment of substantial ownership by economically motivated institutional investors, a dominant pattern of board independence locks in shareholder value as the corporation's principal objective. [169] This pattern changes the competitive environment for all firms, regardless of the board structure of any particular firm. Thus any firm-specific effects that might be associated with "early adoption" of greater board independence will be quickly obscured by competitive imitation. Assume, for example, that a firm with a predominantly independent board will be more likely to initiate cost-cutting to gain market share and increase profits. A rival firm, irrespective of board structure, is likely to imitate this pattern for competitive survival. The rival may change its degree of board independence to signal its intention to engage in similar behavior. But the new board composition may in turn lock the second firm into shareholder wealth-maximizing strategies in other areas where it may not yet face a competitive threat. The point is that effects of changing board composition must be measured, from a shareholder point of view, across the economy of firms, particularly as a practice becomes dominant. This is econometrically very difficult.

The evidence is also consistent with changes in board composition as driven by factors that may serve general shareholder objectives, not firm specific factors. In the United States, regulators have turned to independent directors to help assure the reliability of financial disclosure. This began with the call for audit committees staffed by independent directors in the 1970s and culminated in the post-Enron reforms that look to independent directors to take control of critical elements of the disclosure process. [170] To be sure, better disclosure has firm-specific benefits, insofar as it facilitates market monitoring **[*1509]** of managerial performance. [171] This occurs through more accurate stock price formation that can be used in both intrafirm performance comparisons over time and cross-sectional comparisons with other comparably situated firms. It also occurs through more informative securities analyst evaluation of managerial performance, which can be reflected in narrative form as well in stock-picking advice. But better disclosure also generates benefits for other firms, i.e., interfirm externalities. By providing useful comparative information, it facilitates monitoring of other firms' managements (and thus may improve a rival's performance). It also provides competitively valuable information that other firms can use in their planning (and also may therefore improve a rival's performance). More generally, more accurate disclosure can lead to more informative stock prices, as well as more accurate narratives, that can more efficiently guide the behavior of market actors. In short, if independent directors make the firm's disclosure more reliable, then markets presumably will be allocatively more efficient. Yet none of this systematic effect will appear in cross-sectional studies of firm performance (although the evidence that independent directors do a better job in controlling financial fraud [172] is consistent with the presence of interfirm externalities).

Finally the evidence is also consistent with changes in board composition that serve social interests that may not directly track shareholder interests. Independent directors may be more likely to promote the firm's compliance with legal norms. Some of the push for independent directors arose from efforts to control bribes and other questionable payments. [173] Others have looked to independent directors to monitor the corporation's law compliance more

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[168] Note that arguments about thresholds and diminishing marginal effects would play differently in the United States, where a diffuse pattern of ownership leads to managerial agency problems, than it would in most other countries, where concentrated ownership patterns produce controlling shareholder agency problems. A robust control market may constrain managerial agency costs but will not rein in controlling shareholders.

[169] See the argument for this claim infra text accompanying notes 245-62.

[170] See supra notes 93-102 and accompanying text and infra notes 297-98.

[171] This discussion, which tracks the general argument for mandatory disclosure, follows Gordon, supra note 82.

[172] See supra notes 157-63 and accompanying text.

generally. If independent directors are effective in this regard, the benefits (which in some cases may come at the expense of the firm's shareholders) have a society-wide reach. These effects, too, are not reflected in conventional empirical studies.

B. Summary of Parts I and II

Parts I and II have put together three important bodies of evidence on boards of U.S. public firms over the 1950-2005 period: first, the evidence of a strong trend toward an increasing fraction of independent directors; second, the evidence of increasing independence-in-fact for directors and boards; and third, the anomalous evidence that changes in board composition seem to have had no (or little) effect on firm performance as measured cross-sectionally. My argument is that the anomalous performance evidence does not undercut the case for independent directors because the empirical tests are looking in the **[*1510]** wrong place. The major performance effects of board independence are systematic; and, as I argue below, the major drivers of the trend toward board independence are systematic as well. The independent board both reflects the shift toward shareholder value as the ultimate corporate objective and locks in the shareholder value criterion for the firm and for the economy of such firms. The independent board is made feasible by stock prices that are increasingly informative because of greater firm-specific disclosure; by enhancing the reliability of the firm's disclosure, the independent board helps to maintain stock price informativeness.

III. The Rise of Shareholder Value, 1950-2005

This Part traces some of the relevant history over the 1950-2005 period in the changing role of corporate boards, in which the "advising" board was replaced by the "monitoring" board. This compressed account attempts to weave together some of the principal factors that produced this change, but its emphasis is on the co-evolution of shareholder wealth maximization and board independence.

Boards are obviously not a creation of the late twentieth century. Adam Smith addressed the role of boards in the joint stock company and the difficulty in getting directors to monitor appropriately in 1776. [174] Nevertheless the post-World War II period has been an especially dynamic period in the history of boards because of the heightened competitive pressures that led to rapid changes in the board's role. The recent history usefully makes us aware both of different potential board functions, not all of which might have been conceived of by Adam Smith, and of the changing weights of the different functions in our conception of the well-functioning board.

The history also makes us aware that many aspects of board function are jointly determined with the corporate purpose. For example, a corporation that evaluates managerial performance almost exclusively in terms of shareholder value will inevitably produce a board in composition and function quite different from a corporation in which managers are charged with trying to balance and in some way maximize total stakeholder value. As a positive matter, in competitive global capital and product markets, the shareholder value **[*1511]** objective is likely to be of greater importance and therefore will drive the conception of the board. [175]

Finally, the history makes us aware that the stance of managers towards boards has changed considerably. In addition to compensation, managers are interested in autonomy, and, generally speaking, an activist independent

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[173] See infra notes 199-200 and accompanying text and supra note 30 and accompanying text.

[174] Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations para V.1.103 (Edwin Cannan ed., Methuen and Co. 1904) (1776), available at http://www.econlib.org/LIBRARY/Smith/smWN20.html#B.V,%20Ch.1 ("Removal from an office which can be enjoyed only for the term of three years, and of which the lawful emoluments, even during that term, are so very small, seems to be the utmost punishment to which any committee-man is liable for any fault, except direct malversation, or embezzlement, either of the public money, or of that of the company; and the fear of that punishment can never be a motive of sufficient weight to force a continual and careful attention to a business to which he has no other interest to attend.").

[175] I mean to bracket for now the question of whether this corporate objective is efficient, and whether other goals might transcend efficiency. Certainly the thrust of current shareholder activism, much of which is propelled by public and union pension funds, is to advance the shareholder value objective. Some may find considerable irony in this.

board encroaches on managerial autonomy. Yet the history shows that as other forces become important, for example, the hostile takeover market or interventionist government regulation, managers embrace the idea of an independent board while in practice often resisting the mechanisms that would generate genuine independence.

This thumbnail sketch of the relevant history can be broken down into five periods, each focusing on a characteristic view of the corporation's most important objective and the board's corresponding function, and the prevalent managerial attitude. In the general trajectory, there is an increasingly tight link between the independent board and the priority of shareholder value.

A. The 1950s: The Heyday of Stakeholder Capitalism and Corporate Managerialism

The 1950s is famously the high-water mark of managerialism in U.S. corporate governance, in which boards were largely passive instruments of the CEO, chosen by him and strongly disinclined to challenge his decisions or authority. For a 1950s firm, in addition to the profit-making objective, there were two other important elements: first, the impetus to balance among competing stakeholder objectives; second, the role of corporate management as a central planner. Both of these important elements arguably led to an "advisory" board, in which the CEO's trust in the board was critical, rather than a "monitoring" board, in which the board's trust in the CEO was the question.

The 1950s conception of the corporation and the board reflects what was also the post-World War II high-water mark of stakeholder capitalism in the United States. The political climate favored such a conception of the corporation, and the dominant economic position of the United States in the immediate post-war period permitted it. The shared sacrifice of World War II produced a strong national feeling that the fruits of post-war prosperity should also be shared. Organized labor was never stronger, and the demands for employee sharing in enterprise rents enjoyed strong social legitimacy. [176] **[*1512]** "Pluralism" was the innovation in the political science debate, and the idea of log-rolling-as-sharing (versus creating deadweight loss) enjoyed currency. [177] Notwithstanding the inevitable battling over the appropriate employee share, managers of large public firms did not reject outright such stakeholder claims. [178] In part this was because of managers' identification with the ideological contest with communism over which system could provide a better life for the "workers." [179] Moreover, the strong global position of U.S. firms - which had avoided physical and economic devastation during the war - was a source of rents that managers could allocate away from shareholders without harsh capital market punishment. [180] Thus a 1961 Harvard Business Review survey of 1700 executives revealed that approximately 83% of the respondents agreed that "for corporation executives to act in the interests of shareholders alone, and not also in the interests of employees and consumers, is unethical." [181]

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176 See Kenneth M. Thompson, Human Relations in Collective Bargaining, Harv. Bus. Rev., Mar.-Apr. 1953, at 116, 118-20 (arguing that employees should receive a "fair wage" from their employers, though also asserting that the determination of "fairness" is unresolvable because of divergent values within American society).

177 Compare Robert A. Dahl, A Preface to Democratic Theory (1956) (considering log-rolling as pluralist trading), with William H. Riker, Liberalism Against Populism (1982) (considering log-rolling as creating deadweight loss).

178 See Robert N. Anthony, The Trouble with Profit Maximization, Harv. Bus. Rev., Nov.-Dec. 1960, at 126, 133 ("Whereas 50 or 100 years ago the profit maximizing manager would perhaps have been tolerated in some circles of some communities, today society clearly expects the businessman to act responsibly."); Paul G. Hoffman, The Survival of Free Enterprise, Harv. Bus. Rev., Autumn 1946, at 21, 25 (arguing that businesses had the "responsibility," i.e., obligation, to promote employee self-actualization).

179 See Hoffman, supra note 178, at 23, 26 (arguing that the survival of the "free capitalistic economy" depends upon businessmen acting in the general public interest); John W. Welcker, Fair Profit?, Harv. Bus. Rev., Mar. 1948, at 207, 207 (asserting that "socialistic tendencies in the rest of the world, a critical attitude toward private enterprise here at home, and the development of a feeling of broad public responsibility on the part of American businessmen themselves are all working toward the concept of "fair profits"').

180 Mark J. Roe, Rents and Their Corporate Consequences, ***53 Stan. L. Rev. 1463 (2001).***

181 Raymond C. Baumhart, How Ethical Are Businessmen?, Harv. Bus. Rev., July-Aug. 1961, at 6, 10. A look at articles published in the Harvard Business Review during this period illuminates the development of this receptiveness to stakeholders.

[*1513] World War II and the contemporary influence of socialism affected the firm in other ways. The war was waged and won by huge centralized bureaucracies that were able to surmount logistical and planning challenges. These lessons could be applied to the private firm in shaping and managing its environment, it was thought. Moreover, serious intellectual efforts were dedicated to showing how a centralized planned economy - socialism - might successfully function and the advantages that such a system might have over an economy of discrete firms. [182] Here too the lesson was that bureaucratic rationality could shape and manage a complex economic environment. [183] Thus one of the purposes of the firm could be said to create, organize, and administer markets within the firm rather than simply to respond to pricing signals provided by markets, particularly the stock markets. [184]

The senior management team, headed by the CEO, was thus perceived as having two tasks: running the centralized planning and production-oversight structures within the firm and then allocating enterprise rents among the various potential claimants on the firm. This conception fit with the idea of an advisory board that included many insiders and outsiders with important economic relationships with the firm, such as bankers, lawyers, and suppliers. Such knowledgeable parties could serve as a useful sounding board for the CEO, a kitchen cabinet, and could provide expertise in the face of increasing **[*1514]** complexity. [185] In an important sense, boards were an extension of management. [186] Similarly, the 1950s-style board could also play a useful role in finding the right

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Initially, the legitimacy of stakeholder claims was justified by advertence to the long-term interests of shareholders, which would benefit by increased employee morale and an improved public image. See Frank W. Abrams, Management's Responsibilities in a Complex World, Harv. Bus. Rev., May 1951, at 29, 30 (arguing that business firms "can be made to achieve their greatest social usefulness . . . when management succeeds in finding a harmonious balance among the claims of the various interested groups: the stockholders, employees, customers, and the public at large"); Wallace B. Donham, The Social Significance of Business, Harv. Bus. Rev., July 1927, at 406, 415 (emphasizing the benefits of "the good standing of [the] institution" to the bottom line). Such attitudes also may have stemmed from fear of advancing socialism both at home and abroad. However, as time wore on, the interests of stakeholders began to be seen by some as legitimate in their own right, to be balanced even against the long-term interests of the shareholders. See Robert W. Austin, Code of Conduct for Executives, Harv. Bus. Rev., Sept.-Oct. 1961, at 53 (laying out a code of conduct for executives based on balancing competing stakeholder interests); Gordon Donaldson, Financial Goals: Management vs. Stockholders, Harv. Bus. Rev., May-June 1963, at 116, 119 (describing the role of management as arbitration between stockholder interests and "other interests such as the labor union or the consumer"); J. Elliot Janney, Company Presidents Look at Their Successors, Harv. Bus. Rev., Sept.-Oct. 1954, at 45, 49 (claiming that managers "regard themselves as stewards who were responsible to stockholders, employees, customers, and the general public"). See generally Herman E. Krooss, Executive Opinion: What Business Leaders Said and Thought on Economic Issues, 1920s-1960s, at 50-53 (1970) (describing the 1950s preoccupation with the concept of "social responsibility"). For other representative statements to similar effect, see many of the essays in The Corporation in Modern Society (Edward S. Mason ed., 1959).

[182] See, e.g., Oskar Lange & Fred M. Taylor, On the Economic Theory of Socialism (Benjamin E. Lippincott ed., 1938) (arguing that a socialist government could solve the "calculation problem" by setting shadow prices and, because the central planner would have more information, could do so more efficiently than the market).

[183] See, e.g., Arnold J. Toynbee, Thinking Ahead, Harv. Bus. Rev. Sept.-Oct. 1958, at 23, 26 ("The connotation of the word "business' is changing. Instead of its original association with the notions of enterprise and profit, it is coming to be associated in our minds more and more with the very different notions of administration and organization.").

[184] See, e.g., Adolf A. Berle, Jr., The 20th Century Capitalist Revolution 31-32, 40-41 (1954); John Kenneth Galbraith, The Affluent Society (1958); John Kenneth Galbraith, The New Industrial State 5-6, 118, 365 (3d ed. 1978); Robin Marris, The Economic Theory of "Managerial' Capitalism (1964); Andrew Shonfield, Modern Capitalism: The Changing Balance of Public and Private Power (1965); see also Elmer W. Johnson, An Insider's Call for Outside Direction, Harv. Bus. Rev., Mar.-Apr. 1990, at 46, 47 (noting that a former GM officer observed that a "control mentality [in the 1960s and 1970s] gave top managers great confidence in their ability to predict and control the future"). Indeed, the conglomerate form that rose to prominence in the 1960s relied on a theory about centralized monitoring and capital allocation capacities of the headquarters team. See infra text accompanying notes 305-06.

[185] Thus another way to understand the movement from the advisory to the monitoring board is in terms of the rise of consultants, who can better provide cross-industry expertise and strategic counseling than board members recruited by the CEO.

balance to the corporation's mission statement. [187] Indeed, social commentators such as Peter Drucker argued that board alignment with shareholder interests would undercut the desirable capacity of managers to manage in the public interest. [188]

On this view, a "monitoring board" would inject dissonance and distrust. How could the CEO trust and thus confide in directors whose ultimate mission was to hold him to account? The board selection and nomination mechanism followed upon the managerialist conception of the board's role. If the CEO was looking for trusted advisors who might widen his decisional frame, then it followed that the CEO would play a large role in director selection.

B. The 1970s: The Rise of the Monitoring Board

The 1970s were characterized by a double disillusionment about corporate performance, and the passivity of directors that contributed to it. There were two powerful shocks: first, the unexpected collapse of Penn Central and second, the Watergate-related illegal domestic campaign contributions and **[*1515]** "questionable payments," (less politely, probable bribes) to foreign government officials. [189] The bankruptcy of the Penn Central Railroad, regarded as the bluest of blue chips, resonated in its day like the fall of Enron, and the "questionable payments" scandal revealed at least as much rot as the accounting abuses in the late 1990s. The reaction was to push the board away from an advisory model to a monitoring model, at least in aspiration. In a sense, much subsequent corporate governance reform is a working out of the forces put in motion by the 1970s. The decline of insiders on the board and the rise of independents began then; so did the regularization of audit committees.

1. The Penn Central collapse and the absence of performance monitoring

The Penn Central story laid bare the failure of the 1950s board conception since it became apparent that the board had little inkling of the financial troubles facing the railroad. The board was simply unaware as to how poorly the railroad had performed. Indeed, as working capital deteriorated and indebtedness escalated in the two years before the collapse, the board nevertheless approved over $ 100 million in dividends. [190] The Penn Central's directors (and, as it turned out, directors of many other firms) had been neither advisors nor monitors, but figureheads. [191]

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[186] Nat'l Indus. Conference Bd., Inc., Studies in Business Policy, No. 90: Corporate Directorship Practices 5-6, 59 (1959).

[187] Margaret Blair and Lynn Stout have developed an alternative "team production" explanation of the stakeholder balancing of the 1950s, one that focuses on the efficiency advantages of a board that acts as a "mediating heirarch" among competing stakeholder claims so as to encourage firm-specific investment, especially by employees. Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, *85 VA. L. REV. 247 (1999).* But cf. John C. Coates IV, Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?, 24 J. Corp. L. 837 (1999).

[188] Peter F. Drucker, The New Society: The Anatomy of Industrial Order 340-43 (1950); see also C.A. Harwell Wells, The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-First Century, *51 U. Kan. L. Rev. 77, 99-111 (2002).* Andrew Shonfield put the point colorfully in 1965: Nowadays the manager, who is not the owner, is neither driven into automatic responses by the forces of the market place nor guided by the exclusive desire to make the maximum profit on behalf of his shareholders. . . . So long as the management of a large public company is reasonably successful at making a profit, it is normally left alone to conduct the business as it sees fit and to appoint its own successors. The position of the shareholders, which is sometimes presented by the ideologues of business in the image of a parliament telling ministers what to do, is in fact much closer to that of a highly disciplined army, which is permitted by law to riot against its generals if, but only if, rations should happen to run out. Shonfield, supra note 184, at 377-78. Even those who were concerned about corporate power and suspicious of management's benevolence did not see a reformed board as a potential counterweight but looked instead, in a corporatist mode, to countervailing power from unions, customers, and various sorts of substantive government regulation. See, e.g., Douglas M. Branson, Corporate Governance "Reform" and the New Corporate Social Responsibility, *62 U. Pitt. L. Rev. 605, 609 (2001)* (discussing John Kenneth Galbraith).

[189] A very useful account, with references to original sources, is provided by Joel Seligman, A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project, *55 Geo. Wash. L. Rev 325, 328-40 (1987).*

[190] Joseph R. Daughen & Peter Binzen, The Wreck of the Penn Central 256, 336 (1971).

Much like Enron's collapse foreshadowed financial frauds at many other firms, the Penn Central collapse preceded other 1970s debacles such as the Equity Funding scandal [192] and the failures of high-profile firms such as LTV, [193] Ampex, [194] and Memorex. [195]

[*1516] Myles Mace's widely-read book, Directors: Myth and Reality, which appeared in 1971, exposed the pervasiveness of director passivity and underscored the failure of the advisory board model. Based on extensive field research extending over the prior managerialist decades, he declared that the board's putative "advise and counsel" function had only limited impact - "very rarely" leading "to a reversal of a management commitment or decision." [196] The "discipline" purportedly provided by the CEOs need to be accountable to his board peers was highly attenuated because "managements [knew] from previous experience that members of the board will not ask penetrating, discerning, and challenging questions." [197] In short, the "advising board" had been something like a fraud - simply a way of giving managers the appearance of accountability. [198]

2.

"Questionable payments" and the absence of controls monitoring

The second 1970s shock - the diversion of corporate funds for illicit domestic and foreign advantage - called attention to the board's limited information about the corporation's accounting practices and raised the question about the extent of board responsibility for assuring the corporation's compliance with law. Boards did not think it their responsibility to oversee the firm's accounting or law compliance, to engage in "controls monitoring."

The "questionable payments" scandal unfolded as a consequence of the Special Prosecutor's investigation into the series of abuses known as "Watergate." [199] More than fifty public firms became the subject of criminal prosecution or SEC enforcement action; another 400 firms, prompted by the threat of prosecution, voluntarily admitted having made illegal campaign contributions or bribes abroad and in the United States. In the aftermath it became clear that while senior corporate officers often knew of these payments, outside directors had not been clued in and were not otherwise "in the loop" of the corporation's internal controls. Inquiry that would lead to such knowledge was beyond

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191 See Robert Townsend, The Wreck of the Penn Central, N.Y. Times, Dec. 12, 1971, at BR3 (book review). One Penn Central director who joined the board shortly before the collapse described his colleagues this way: They sat up there on the eighteenth floor in those big chairs with the [brass name] plates on them and they were a bunch of, well, I'd better not say it. The board was definitely responsible for the trouble. They took their fees and they didn't do anything. Over a period of years, people just sat there. That poor man from the University of Pennsylvania [Gaylord P. Harnwell], he never opened his mouth. They didn't know the factual picture and they didn't try to find out. Daughen & Binzen, supra note 190, at 303.

192 Robert J. Cole, Insurance Fraud Charged by S.E.C. to Equity Funding, N.Y. Times, Apr. 4, 1973, at 1; see also William E. Blundell, Equity Funding's Worth Is $ 185 Million Less than Firm Had Claimed, Trustee Estimates, Wall St. J., Feb. 22, 1974, at 6. The way in which the public became aware of the insurance and accounting frauds at Equity Funding set the stage for the famous insider-trading case *Dirks v. SEC, 463 U.S. 646 (1983).*

193 See LTV Recounts Its Many Ills, Bus. Wk., Dec. 19, 1970, at 42.

194 See James E. Bylin, Ampex Expects $ 40 Million Loss for Fiscal 1972, Wall St. J., Jan. 12, 1972, at 4; James E. Bylin, The Music Stopped: How Ampex Saturated Recorded Tape Market and Got Soaked Itself, Wall St. J., Mar. 9, 1972, at 1.

195 Richard R. Leger, Memorex Concedes It's in Financial Morass and that Bank of America Has Intervened, Wall St. J., May 16, 1973, at 4.

196 Mace, supra note 22, at 180.

197 Id.

198 See also Eisenberg, supra note 29, at 170-202 (identifying corporate failures of early 1970s as evidence of the failure of the advising board model).

199 See Seligman, supra note 189, at 333-36; see also Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices, Sec. Reg. & L. Rep (BNA), No. 353, Special Supplement (May 19, 1976).

the job description of the advising board. This was evident in the Delaware Supreme Court's 1963 exoneration of a board that was unaware of criminal antitrust violations by the corporation: "Absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect **[*1517]** exists." [200] This seemed to give the advising board a free pass on a duty to become informed and monitor.

3. Corporate social responsibility

Additional pressure on the advising board model came from a different direction as well, the corporate social responsibility movement fueled in the 1970s by concern about corporations' involvement in the Vietnam War and their policies on the environment, employment, and other social issues. The 1970s social responsibility movement presented a different challenge than the stakeholder claims that traditionally were the main competitor with shareholder claims. In addressing stakeholder claims, the corporation of the 1950s and 1960s was asked to give due weight to the interests of those within the corporate family, most importantly, the employees and the communities in which they lived. [201] Directly addressing broader social issues was at the margin, a justification for limited charitable giving. [202] The 1970s movement argued for a broader sense of corporate purpose that would attend to the well-being of the general society, not the corporation, even broadly defined, and often asked for much deeper corporate engagement with social problems. [203]

The most common tactic of the social responsibility movement was to try to put forward a shareholder proposal for vote at the annual meeting as a way to call public attention to the issue and to pressure management for an accommodation. This was the heart of the "Campaign GM" approach, [204] which, as a structural reform measure, also called for liberalization of the SEC rule giving shareholders limited access to the corporate proxy. Other governance reform proposals were much further reaching and focused on the **[*1518]** board. Nader, Green, and Seligman famously called for federal incorporation of major firms under rules that required full-time directors who were nominated exclusively by disinterested shareholders and that gave weight to board representation of various constituency groups. [205] There were other calls for so-called "constituency directors." [206]

Thus the social responsibility movement and the "monitoring board" movement found common ground on the importance of the independent director, although there was no genuine meeting of the minds. Independent directors who monitored vigorously on behalf of shareholder interests would pursue an agenda quite different from a "constituency director" infused with a broader sense of corporate mission. One irony of the social responsibility movement was its kindred spirit to managerialist claims about the need for appropriate balance in the corporation's objectives. One difference, of course, was the managers' persistent desire for control and autonomy, the exclusive

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200 *Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).*

201 Indeed, one might distinguish between "corporate stakeholder responsibility" and "corporate social responsibility."

202 E.g., *A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581 (N.J. 1953)* (permitting a charitable contribution to Princeton University).

203 Compare Norman A. Adler, The Sounds of Executive Silence, Harv. Bus. Rev., July-Aug. 1971, at 100, 102 ("Even the most profit-motivated stockholder can have no legitimate cause for complaint when the corporation contributes reasonable sums in support of the public weal."), with Burton G. Malkiel & Richard E. Quandt, Moral Issues in Investment Policy, Harv. Bus. Rev., Mar.-Apr. 1971, at 37, 38 ("In recent years portfolio managers (especially those of nonprofit private institutions) have been asked to deploy their funds with specific reference to social, political, and moral objectives."). The corporate social responsibility movement made increasingly broad appeals for corporate action. The call in the late 1960s for the corporation to address urban decay and racial tension may be seen as less far-reaching than the 1970s claims made by the consumer and environmental movements. The former called for plant location and job training decisions well within the corporation's traditional roles; the latter called for a quite different relationship to society. See Wells, supra note 188, at 112-13.

204 See Donald E. Schwartz, The Public-Interest Proxy Contest: Reflections on Campaign GM, 69 Mich. L. Rev. 419 (1971).

205 See Ralph Nader et al., Taming the Giant Corporation 123-28 (1976).

206 See Victor Brudney, The Independent Director - Heavenly City or Potemkin Village?, 95 Harv. L. Rev. 597, 598-607 (1982).

power to strike the balance, without the noisome assistance of constituency directors. So if there was broad support in the 1970s for an infusion of "independent directors" into board activity, there was no crisp consensus on exactly what ends these directors were to pursue.

4. Reconceptualization of the board

The cumulative effect of these pressures led, by the end of the 1970s, to a significant reconceptualization of the board's role and structure. First, the advising board model was replaced as aspirational paradigm by the "monitoring board," as presented in Mel Eisenberg's influential 1976 book, The Structure of the Corporation: A Legal Analysis. The new model rapidly became conventional wisdom, endorsed by the Chairman of the SEC, [207] the corporate bar, [208] and even the Business Roundtable. [209] Second, the audit committee, staffed by independent directors, came to be seen as an essential part of the board's monitoring capacity. The SEC initially had made the existence of an **[*1519]** audit committee a matter of disclosure only, but in 1976 requested that the NYSE amend its listing requirements to include an audit committee composed of independent directors with access both to accounting information and to the outside auditors on a private basis. [210] Ironically by the time the NYSE adopted the requirement, audit committees had become a widely accepted element of board structure, found in almost 95% of large public companies. [211] Third, the composition of the board began to shift in favor of independent directors rather than insiders and pressure grew to increase the independence of the nominating committee. [212] The idea of a "constituency director" never gained real traction, but nevertheless the view persisted that independent directors could help the corporation find that sweet spot where maximizing shareholder welfare over an appropriate horizon could coincide with attention to social interests as well.

The result of the corporate governance reforms of the 1970s might be described as reflecting a mixed strategy, in which managerial elites made significant concessions to address the governance failures revealed by Penn Central's bankruptcy and the questionable payments scandal, but held onto significant managerial prerogative over the composition and function of the board. The rhetoric of the monitoring board and independent directors gained

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[207] See Seligman, supra note 189, at 338 ("What is missing on too many boards is a truly independent character that has the practical capacity to monitor and to change management." (quoting Corporate Rights and Responsibilities: Hearings Before the S. Comm. on Commerce, 94th Cong. 303-04 (1976) (statement of Roderick Hills, Chairman, Securities and Exchange Commission))).

[208] See ABA Comm. on Corporate Laws, supra note 31 ("The board of directors is [the] reviewer of management initiatives and monitor of corporate performance . . . .").

[209] Bus. Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 Bus. Law. 2083, 2087, 2092-93 (1978). The Business Roundtable's acceptance of the full entailments of the "monitoring board" should not be overstated. For example, Business Roundtable insisted on the importance of the traditional function of the board as a strategic advisor and the value of inside directors in this context. Id. at 2098, 2107.

[210] See Seligman, supra note 189, at 338.

[211] In 1972, the SEC "endorsed the establishment by all publicly held companies of audit committees composed of outside directors." Standing Audit Committees Composed of Outside Directors, Exchange Act Release No. 33-5237, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,670 (Mar. 23, 1972), 1972 WL 125505. In 1974 and 1978, the SEC adopted rules requiring disclosures about audit committees. Additionally, in 1978, the New York Stock Exchange required all listed securities to have an audit committee composed of non-management members meeting its policy standards. ABA Comm. on Corporate Laws, The Overview Committees of the Board of Directors, 34 Bus. Law. 1837, 1839 (1979). In 1967, the Conference Board found audit committees at 19% of manufacturing companies and 31% of nonmanufacturing companies, as compared to 93% and 94%, respectively, in 1977. Jeremy Bacon, Corporate Directorship Practices: Membership and Committees of the Board 50 (1973) (Conf. Bd. Report No. 588); ABA Committee on Corporate Laws, supra note 208, at 1644 (citing Jeremy Bacon, The Board of Directors: Perspectives and Practices in Nine Countries (1977) (Conf. Bd. Report No. 728)).

[212] The Business Roundtable went so far as suggest that the nominating committee have a "majority of outside directors," i.e., substantial insider representation, but was cold to the idea of shareholder access to the proxy statement for the purpose of nominating directors. Bus. Roundtable, supra note 209, at 2108. For evidence on the shifting composition of the board in the 1970s, see supra Figures 1 and 2 and infra Appendix Table 1.

widespread currency, but the work of genuine change in the habits and practices of the board had barely begun. Moreover, the traditional stakeholder balancing as now broadened by the corporate social responsibility movement was employed by managerial elites to counter a potentially single-minded board focus on shareholder welfare that would threaten managerial control. In the midst of the Business Roundtable's 1978 acceptance of the performance-monitoring board, it finds a link between social responsibility and profitability **[*1520]** as necessary to assure "the political and social viability of the enterprise over time." [213]

By contrast, Milton Friedman's 1970 essay, The Social Responsibility of Business Is to Increase Its Profits, [214] was a scandale because of its unvarnished emphasis on the shareholder value as virtually the sole criterion by which corporate performance should be judged. This view seemed far out of the mainstream.

C. 1980s: The Takeover Movement, Shareholder Value, and the Rise of the Independent Director

The 1980s were the crucial decade in cementing the connection between independent directors and shareholder value. The decade was marked by an emerging belief about shareholder value as the ultimate measure of corporate success and by the deepening acceptance of a governance model focused on the monitoring board composed of independent directors. The hostile takeover was a catalyst for both developments.

1. The monitoring board as safe harbor in the "Deal Decade"

The dominance of the monitoring board model was by no means assured by the end of the 1970s, since its endorsement by managerial elites was at least partially a tactical concession to forestall further reaching reforms, such as national chartering. Indeed, as the national political consensus, as reflected in the presidential and congressional elections, turned away from the critique of corporate power, the Business Roundtable retreated on prior positions. [215] Yet by the end of the decade managerial elites were aggressively promoting the **[*1521]** virtues of the monitoring board, since a robust board seemed to offer a safe harbor against the pressure of the takeover movement.

The 1980s became known as the "Deal Decade." Although in aggregate terms, hostile transactions were dominated by friendly deals, the "hostile bid" became a fearful threat. Nearly a quarter of the major U.S. corporations received an unwanted bid. [216] Many "friendly deals" were negotiated in the shadow of a potential hostile bid. [217] Even very large firms came under attack from financial buyers whose access to the junk bond market meant they could engineer a highly leveraged transaction that would ultimately be repaid through the sale of various corporate divisions and other assets (a "bust-up"). The stakes never seemed higher for managerial autonomy.

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[213] Bus. Roundtable, supra note 209, at 2099.

[214] Milton Friedman, The Social Responsibility of Business Is to Increase Its Profits, N.Y. Times Mag., Sept. 13, 1970, at 32, reprinted in Thomas G. Marx, Business and Society: Economic, Moral and Political Foundations 145-50 (1985). Friedman had two points: the first was that the direction of corporate activity other than to maximize shareholder welfare was inefficient; the second was that use of corporate funds for any other purpose amounted to theft from shareholders. For another argument regarding the economic efficiency point, see Eugene V. Rostow, To Whom and for What Ends Is Corporate Management Responsible?, in The Corporation in Modern Society, supra note 181, at 46.

[215] This was reflected in the Business Roundtable's vehement exception to the American Law Institute's new project on corporate governance, which promised (or threatened) fuller elaboration of the legal entailments of the monitoring board model. See generally Seligman, supra note 189. The attacks included the objection that the ALI's Principles of Corporate Governance "would make every board of directors adopt a monitoring method that cannot work." Id. at 326 (quoting Andrew Signler, Chairman, Business Roundtable Corporate Responsibility Task Force). Some academics also attacked the monitoring board model. See, e.g., Daniel J. Fischel, The Corporate Governance Movement, *35 Vand. L. Rev. 1259 (1982).*

[216] Mark L. Mitchell & J. Harold Mulherin, The Impact of Industry Shocks on Takeover and Restructuring Activity, 41 J. Fin. Econ. 193, 199 (1996).

[217] Often the difference between a "hostile" and a "friendly" bid is just a timing question of when the proposed transaction becomes public. See G. William Schwert, Hostility in Takeovers: In the Eyes of the Beholder?, 55 J. Fin. 2599 (2000).

Hostile takeovers in the United States were highly controversial during the 1980s and raise similar controversies in other countries when they appear for the first time. Economists typically describe merger activity as arising from economic adjustment to industry shocks, and in particular have identified some specific shocks as important in the 1980s: deregulation, oil price shocks, foreign competition, and financial innovation. [218] But the argument that legitimated hostile bids throughout the 1980s was that such activity was a corrective to managerial inefficiency. [219] The U.S. economy had not thrived in the 1970s, and for the first time it seemed that firms modeled on the U.S. model of managerialist governance were out-competed on the world stage.

The market in corporate control was offered as the cure for economic sclerosis, with both specific and general effects. First, a hostile bid was described as an expression of the competition among management teams for control over the assets of a particular firm. The team that could put the assets to highest and best use would be able to offer the highest price and would prevail. Thus a successful hostile bid would make particular assets more productive. Second, the background threat of a hostile bid would have a disciplining and stimulating effect on other managements. This would lead to more productive use of assets throughout the economy.

An additional factor in the "Deal Decade" (and beyond) was the increasing importance of institutional investors. By 1980, institutions held more than 40% **[*1522]** of the value of U.S. equity markets, concentrated in the largest firms. [220] This created a class of shareholders singularly focused on shareholder value and quite willing, indeed eager, to sell to a bidder offering a significant market premium. In part this was because institutional investors observed that target managements' claims that the bid was "low ball," that higher values were just around the corner, rarely proved out. [221] In part the eagerness to sell was because institutional investment performance was often assessed on the basis of a relatively short track record. For example, a mutual fund marketed itself on the basis of annual performance; a money manager for a pension fund or an endowment benchmarked itself against an unmanaged index, or against peers, often on a quarterly basis. [222] Moreover, institutions were crucial funding sources for financial buyers. Some provided equity capital to buyout firms; others purchased the indebtedness that financed leveraged acquisitions. Early in the cycle, the return from such investments was spectacular. [223] This, in turn, drew in even more money.

Obviously many incumbent managers disagreed with the efficiency-enhancing justification for hostile takeovers, instead seeing such activity as driven by control arbitrageurs looking for quick profits through the exploitation of stock market mispricing and other quick-buck strategies. Even worse, many managers argued, an active market in corporate control was itself a cause of inefficiency, because of the "short-termism" induced in managerial time horizons. [224] Instead, the key to the European and Japanese success, they alleged, was "patient capital." [225] Nevertheless, hostile bids were powerful phenomena; what to do?

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218 See Gregor Andrade et al., New Evidence and Perspectives on Mergers, 15 J. Econ. Persp., Spring 2001, at 103, 108.

219 See, e.g., William E. Fruhan, Jr., Corporate Raiders: Head'em Off at Value Gap, Harv. Bus. Rev., July-Aug. 1988, at 63 ("Raiders and arbitrageurs . . . are a symptom of the large value gaps that persist throughout corporate America"); Peter D. Goodson & Donald J. Gogel, Managing as if Shareholders Matter, Harv. Bus. Rev., May-June 1987, at 24, 26 ("The economics behind the takeover phenomenon are simply too powerful.").

220 For time-series information on institutional ownership, in absolute terms and as a fraction of U.S. public equity, see infra Table 4 and Figure 6 in the Appendix.

221 See Michael Bradley et al., The Rationale Behind Interfirm Tender Offers: Information or Synergy?, 11 J. Fin. Econ. 183 (1983).

222 See Michael Useem, Investor Capitalism: How Money Managers are Changing the Face of Corporate America (1996).

223 See Steven Kaplan, The Effects of Management Buyouts on Operating Performance and Value, 24 J. Fin. Econ. 217 (1989).

224 See, e.g., Warren A. Law, A Corporation Is More than Its Stock, Harv. Bus. Rev., May-June 1986, at 80, 81 (arguing that managers have "resisted debt until prodded by takeover fears" because of their long-run view as opposed to the short-run view of investors).

In this environment, managers turned to the monitoring board and to independent directors as the best available protection against the hostile takeover movement, despite the encroachment on managerial autonomy. First, business elites needed a credible board-centered governance mechanism to address performance issues in substitution for the market-centered approach **[*1523]** associated with the hostile tender offer. What was the answer, after all, to institutional and other shareholders who might strongly suspect management's motives in resisting a hostile bid? The blessing of takeover resistance by independent directors who would, in theory, independently evaluate the adequacy of the hostile bid against the firm's "intrinsic value," was an indispensable part of the legitimating mechanism. [226] But note that management's (and then the board's) objection to the hostile bid was almost invariably framed in terms of shareholder value: the unwanted bid "undervalued" the target, from the shareholder point of view. [227]

Second, independent directors also provided legal cover under the developing Delaware fiduciary standards for resistance to a hostile bid. (Delaware's standards were important because of the number of large public firms incorporated there and because of Delaware's leadership role in the fashioning of fiduciary duty law.) In a series of pivotal cases, the Delaware Supreme Court permitted a target board to "just say no" to a hostile bid. [228] Boards were permitted to adopt and maintain a so-called "poison pill," a clever corporate finance artifice that imposed potentially ruinous costs on a hostile bidder. But judicial approval of such measures appeared to be tied to informed decisionmaking by independent directors. And the conditions of director independence became more stringent throughout the period.

2. Judicial promotion of director independence

Director independence was a touchstone of Delaware takeover cases even before the tumultuous 1980s, but it became especially critical then because of the extraordinary, unprecedented measures undertaken by targets to thwart hostile bids. The courts were faced with unpalatable choices: prohibit tactics such as the poison pill and leave the matter of corporate control to shareholder action, which Delaware law otherwise strongly constrained; [229] give managements unbridled discretion to resist hostile bids, which raised obvious conflict problems; or put it to courts to decide on the reasonableness of **[*1524]** takeover defenses in particular transactions, which would transform courts into economic regulators. By contrast, placing the onus on the board of directors had a statutory base, [230] a doctrinal foundation, [231] and might thread the needle of the warring parties with conflicting agendas.

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[225] E.g., Michael E. Porter, The Competitive Advantage of Nations 528-29 (1990); Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, *58 U. Chi. L. Rev. 187, 201-24 (1991);* Michael E. Porter, Capital Disadvantage: America's Failing Capital Investment System, Harv. Bus. Rev., Sept.-Oct. 1992, at 65.

[226] E.g., Martin Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101, 119-22 (1979); Ira M. Millstein, The Evolution of the Certifying Board, *48 Bus. Law. 1485, 1493-95 (1993).*

[227] As discussed below, managements (and boards) almost always declined the gambit of state "constituency statutes" (and language in *Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985))* that would have permitted invocation of the interests of non-shareholder constituents. See infra note 237.

[228] For a doctrinal account, see Jeffrey N. Gordon, Corporations, Markets, and Courts, ***91 Colum. L. Rev. 1931 (1991).*** See also Alan R. Palmiter, Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence, *67 Tex. L. Rev. 1351 (1989).*

[229] See, e.g., *Del. Code Ann. tit. 8, §§141(a)*, 251(b) (2007). See generally Jeffrey N. Gordon, Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law, *60 U. Cin. L. Rev. 347 (1991).*

[230] Section 141(a) of the Delaware Code says, "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ." *Del. Code Ann. tit. 8, §141(a)* (2007)

[231] See *Cheff v. Mathes, 199 A.2d 548 (Del. 1964).* The defensive measure in question was an early instance of "greenmail," in which the target repurchased a putative raider's 17.5% block at an above-market price to end a takeover threat. In holding that

Yet the 1970s were too fresh to permit casual assumptions about board diligence if the Delaware courts wanted to mollify key pro-takeover constituencies such as institutional investors and the federal government. [232] Thus we saw a strategy emerge in which the court policed not only board process but also director independence.

The invocation of board independence was a critical component in the sustaining of unprecedented defensive measures in the two pivotal takeover cases of the 1980s, Unocal Corp. v. Mesa Petroleum Co. [233] and Moran v. Household International, Inc. [234] In Unocal, which sustained a self-tender that (remarkably) discriminated against a significant shareholder, here, the raider, the Delaware Supreme Court repeatedly invoked the role of the independent directors in the board's evaluation of the raider's bid and the particular defensive measures: the independent directors constituted a majority (eight of thirteen) of the board, the board heard from independent experts, the independent directors met privately with financial advisors and attorneys and met privately together, and the board unanimously agreed on the measures. [235] This focus on independence-in-fact was a development from prior doctrine. [236] It was not merely that a majority of the directors were independent, in the sense of no personal pecuniary interest, but that the independent directors had played an independent role in reviewing and approving the defensive undertaking. [237] **[*1525]** Similarly, in Moran, which validated the implementation of a poison pill, the court noted approvingly the independence of the directors and described the process of director deliberation. [238] A majority of the board (ten of sixteen) were independent, and all but two of the independent directors (one of whom was contemplating a leveraged bid for the firm) voted for the plan. The directors extensively discussed the shareholder rights plan with the corporation's financial advisors and counsel, illuminated by debate with the particular independent director who opposed the plan most vigorously. The board had the burden of

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such use of corporate funds was valid unless the board "acted solely or primarily because of the desire to perpetuate themselves in office," *id. at 554,* the court provided a roadmap of how a board could show that a defensive measure was "primarily in the corporate interest," id. (quoting *Bennett v. Propp, 187 A.2d 405, 409 (Del. 1962)).* Because only two of seven directors had a "personal pecuniary interest" in the board's decisions, the board was not held to the "self-dealing" standard, id., and could satisfy its burden simply "by showing good faith and reasonable investigation," id. at 555, the now-standard formulation of the business judgment rule. In other words, the presence of (relatively) independent directors insulated the corporation and its management from attack for a deal-stopping defensive measure.

[232] See Mark J. Roe, Delaware's Competition, *117 Harv. L. Rev. 588 (2003)* (describing Delaware's responsiveness to the federal government's pro-takeover stance).

[233] *493 A.2d 946 (Del. 1985).*

[234] *500 A.2d 1346 (Del. 1985).*

[235] See *Unocal, 493 A.2d at 950.*

[236] See also supra note 231 and accompanying text; cf. *Cheff, 199 A.2d 548.*

[237] As to why the Unocal court rested so heavily on the mechanics of independent director scrutiny - rather than the mere fact of an independent majority - there are at least two related explanations. First, the court might have been influenced by the 1970s debates about the activist role of independent directors (as embodied in the then ongoing work of the ALI corporate governance project). Second, the court might have been looking for as much cover as possible for the genuinely radical step of permitting corporate action that discriminated against a shareholder. The court was of course disingenuous in asserting that the discriminatory self-tender in Unocal was just a version of the targeted repurchase permitted in Cheff v. Mathes, which "discriminated" by giving the raider a selling opportunity not available to other shareholders. This analogy omitted a critical difference. In Cheff, the discriminated-against shareholders purportedly benefited from the greenmail payment, because it drove away a bidder who was offering too low a price, and was undertaken by their agent, the board, whose interests were aligned with theirs. In Unocal, the discriminated-against shareholder, Boone Pickens/Mesa Petroleum, did not benefit, indeed was the target of the discrimination by a board consciously acting against his interests. In other words, the distortion of traditional corporate antidiscrimination norms could be defended as truly necessary to protect the corporation and its other shareholders only because of the heightened independence in fact as well as in form of the Unocal board.

[238] *500 A.2d at 1348 n.2, 1356.*

showing that the defensive measure was ""reasonable in relation to the threat posed"' [239] but "that proof is materially enhanced ... where, as here, a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards." [240]

Perhaps most tellingly, in Paramount Communications, Inc. v. Time, Inc., [241] the pivotal 1990 case that opened the way to a "just say no" defense, [242] the Delaware Supreme Court opened the opinion with an elaborate description of the directors, [243] in particular the independents (twelve of sixteen), and then emphasized throughout the independents' decisionmaking role. After Paramount's bid, Time's independent directors met frequently in executive session, both among themselves and with the corporation's financial advisor and legal counsel, we are told. [244] Indeed, the court's narrative presents the board as the protagonist of Time's strategy and choices, as opposed to, say, the CEO who was actually driving the Warner merger. Thus the court invokes the engagement of independent directors as a key element in a remarkable legal conclusion: that a target may adopt preclusive defensive measures to block an **[*1526]** all-cash, all-shares bid at a substantial premium to market. The lesson to a planner was clear. The price of the power to "just say no" to a hostile bidder was a board that consisted of a majority of independent directors and a process that would call on those directors to exercise (at least the appearance of) independent judgment. [245]

3. Summary

The hostile takeover movement of the 1980s brought unprecedented emphasis to shareholder value as the ultimate corporate objective. In response, director independence came to be understood as a critical element in the intellectual and legal architecture necessary to preserve managerial autonomy against the pressure of the market in corporate control. A managerial elite that in prior decades had no use for independent directors now embraced them as an essential element of shareholder capitalism. The reformers' case for independent directors in the 1970s pointed in several different directions. The takeover movement of the 1980s crystallized that the independent directors' role would be crucially tied to shareholder value.

D. The 1990s: The Triumph of Shareholder Value and the Independent Board

1. Introduction

In the 1990s the independent board came to be heralded as the solution to a three-way paradox. First, shareholder wealth maximization gained increased acceptance as the ultimate corporate objective and also the ultimate measure of managerial performance. Second, business elites were increasingly successful in persuading the courts to permit far-reaching defensive measures against a hostile bid, a driver of shareholder wealth maximization. And third, hostile bids came to be seen as too costly a way of solving the managerial agency problem. The independent

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[239] *Id. at 1356* (quoting *Unocal, 493 A.2d at 955).*

[240] Id.

[241] *571 A.2d 1140 (Del. 1990).*

[242] See Gordon, supra note 228, at 1944-45.

[243] *Paramount, 571 A.2d at 1143.*

[244] *Id. at 1147-48.*

[245] The Delaware Supreme Court also excoriated nominally independent directors who had not fulfilled their role of vetting and legitimating what would otherwise be a conflicted transaction, most notably in the management buyout case *Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. 1989):* The board was torpid, if not supine, in its efforts to establish a truly independent auction, free of Evans' interference and access to confidential data. By placing the entire process in the hands of Evans, through his own chosen financial advisors, with little or no board oversight, the board materially contributed to the unprincipled conduct of those upon whom it looked with a blind eye.

board could resolve this trilemma by benchmarking managerial performance in terms of stock market prices. This was expressed in both executive compensation contracts that heavily used stock-based compensation and in greater reliance on stock market returns in CEO termination decisions. These moves, in turn, produced two immediately visible developments: first, the highest level of CEO compensation in U.S. business **[*1527]** history and second, the shortest average CEO tenure. In this way the independent board helped lock in shareholder value as the guide for management behavior.

2. Shareholder value without hostile bids

The 1980s had a somewhat paradoxical legacy. On the one hand, the shareholder value criterion became increasingly influential, yet hostile bids - a straightforward application of the shareholder value principle - became more difficult as a legal matter and came under some challenge as a business strategy. As the 1990s progressed, managerial elites were increasingly successful in persuading the courts to permit far-reaching defensive measures against a hostile bid. For example, in a series of cases culminating with Unitrin, Inc. v. American General Corp. in 1995, [246] the Delaware Supreme Court seemed to narrow the conception of a "preclusive," and thus legally objectionable, defensive measure to a limited realm of interference with the shareholder franchise. Almost anything else was permitted, giving the target management (assuming the board agreed) a virtual veto over a hostile bid. [247]

Indeed, the economic failure of many high profile late-1980s contested transactions - highly leveraged deals, financed in part with exotic debt securities dumped on junk bond mutual funds - had damaged the business credibility of hostile bids generally. [248] The post-1980s conventional wisdom was that the hostile bid was a high cost mechanism to solve the managerial agency problem. Where the raider was a "financial" bidder, a 1980s pattern, the hostile bid could disrupt the target's business, distract management, and often end in a financial crisis that reduced organizational rents. Where the raider was a "strategic" corporate bidder, a 1990s pattern, a hostile bid often proceeded in **[*1528]** a relatively impoverished information environment, which reduced the chances of a successful bidder/target match. Moreover, the transaction costs associated with a hostile takeover meant that they could directly address only cases of a substantial shortfall in managerial performance and such visible "lumpiness" might reduce the general deterrence effects.

Underlying the concern about hostile bids was also a nagging suspicion that unfettered control markets might be subject to "common mode failure," meaning a ubiquitously adopted innovation that proved, in the end, disadvantageous. For example, adding significant leverage to the capital structure initially seemed to be a value-creating innovation with wide application, [249] but the troubles that plagued many later deals and the rate of reverse LBOs [250] seemed to indicate strong limits. It was apparent that the mergers and acquisitions market was subject to

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[246] *651 A.2d 1361, 1382 (Del. 1995).*

[247] As a practical matter, the veto was much more effective in the case of a classified board than otherwise, because of the interaction between the poison pill and classification. In the case of a board elected at a single election, the board veto could be readily overridden by coupling a proxy contest to a conditional bid. A classified board makes an override much tougher, since the electoral coalition that would replace the vetoing board with one that would accept the bid must hold together over two election cycles. See Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, *19 Cardozo L. Rev. 511 (1997).* In *Moore Corp. v. Wallace Computer Services, Inc., 907 F. Supp. 1545 (D. Del. 1995),* a federal district court purporting to apply Delaware law permitted a classified target board to maintain its poison pill even after the insurgents had prevailed in an initial election. But as the recent Oracle v. PeopleSoft litigation demonstrated, the validity of such resistance is an open matter of Delaware law. In other jurisdictions, statutory innovations protected managerial autonomy. For example, boards were given explicit permission in "constituency statutes" to balance the interests of the competing corporate stakeholders; shareholders need not be privileged.

[248] See, e.g., Berkshire Hathaway, Inc., 1989 Annual Report (1990), quoted in Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions 438-40 (2d ed. 1995).

[249] See, e.g., Michael C. Jensen, Eclipse of the Public Corporation, Harv. Bus. Rev., Sept.-Oct. 1989, at 61.

[250] See, e.g., Steven N. Kaplan, The Staying Power of Leveraged Buyouts, 29 J. Fin. Econ. 287 (1991).

fads and fashions. A successful transaction in an industry spurred imitators long before the value of the new configuration proved out. [251] The concern was that if the barriers to a hostile takeover were too low, raiders could quickly pursue a takeover of a firm that was not following the current conventional wisdom, in effect treat a nonconforming firm as an arbitrage opportunity - and that this threat would, in turn, make managers too responsive to consensus opinion. [252] This sort of critique was in the spirit of skepticism about the allocative validity of the efficient market hypothesis that increased after the 1987 stock market break. [253] The implication was that some friction was desirable in the control markets to slow down the transmission of a structural or strategic innovation so that its virtues might be tested over some meaningful period.

Nevertheless the shareholder value criterion was ascendant, an increasingly powerful guide to managerial behavior. In significant measure this was fueled by the shareownership and activism of institutional investors, who benchmarked managerial performance in shareholder value terms. [254] Indeed, one of the most striking trends throughout the 1950-2005 period was the rise of **[*1529]** institutional ownership, both in absolute terms and as a percentage of public traded stock. [255] Institutional investors publicly targeted firms that underperformed, [256] strongly backed stock-based compensation for senior management to align their interests with shareholders, [257] and organized "just vote no" campaigns in director elections to protest continued poor performance. [258]

But no less significantly, the maximization of shareholder value as the core test of managerial performance had seeped into managerial culture. The nod to "corporate social responsibility" in the 1978 Business Roundtable statement on corporate governance was omitted from the comparable 1997 statement. Instead, we are given to understand that "the paramount duty of management and of boards of directors is to the corporation's stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders." [259] Managerial elites rejected the invitation tendered by so-called "constituency statutes" adopted by many states in the heat of the takeover movement that specifically countenanced the balancing of stakeholder and shareholder interests. [260] A

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[251] Steven N. Kaplan & Bengt Holmstrom, Corporate Governance and Takeovers in the United States: Making Sense of the 1980s and 1990s, 15 J. Econ. Perspectives, Spring 2001, at 121.

[252] See Gordon, supra note 130.

[253] See generally Andrei Shleifer, Inefficient Markets: An Introduction to Behavioral Finance (2000).

[254] See generally Useem, supra note 222; James M. Tobin, The Squeeze on Directors - Inside Is Out, *49 Bus. Law. 1707 (1994).* The role of institutions was buttressed by the SEC's 1992 proxy rule reforms that made it easier for institutions to confer and to influence shareholder votes without incurring the expense of a proxy filing. See *17 C.F.R. § 240.14a-1(2) (2007)*. On institutional investor activism generally, see Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, *39 UCLA L. Rev. 811 (1992).*

[255] Figure 6 in the Appendix vividly illustrates the increasing growth of institutional ownership, both in absolute amount and as a percentage of publicly traded stock of U.S. firms. See also Appendix Table 4.

[256] See Steven L. Nesbitt, Long-Term Rewards from Shareholder Activism: A Study of the "CalPERS Effect," 6 J. Applied Corp. Fin., Winter 1994, at 75 (describing campaign by California Public Employees Retirement System and its purported performance effects).

[257] See, e.g., James E. Heard, Executive Compensation: Perspective of the Institutional Investor, *63 U. Cin. L. Rev. 749, 766 (1995)* (noting institutional focus has not been on level of executive compensation but on aligning "pay and performance"); CalPERS, Why Corporate Governance Today? (Aug. 14, 1995), available at *http://www.calpers-governance.org/viewpoint/default.asp*.

[258] See Grundfest, supra note 91 (advocating a "just vote no" campaign to symbolically chastise underperforming management).

[259] Compare Bus. Roundtable, supra note 209, at 2099 (identifying "corporate social responsibility" as a discreet function of the board of directors, where "the owners have an interest in balancing short-range and long-term profitability, in considering political and social viability of the enterprise over time"), with Bus. Roundtable, Statement on Corporate Governance (Sept. 1997) [hereinafter 1997 BRT Statement], available at *http://www.businessroundtable.org/pdf/11.pdf*.

shareholder-oriented focus seemed part of the necessary restructuring of the American economy in a more competitive world. [261] It also **[*1530]** seemed to fit an historical moment in which maximizing the overall size of the pie had greater acceptance than distributional considerations. [262] By the end of the 1990s, the triumph of the shareholder value criterion was nearly complete.

3. Resolving the paradox through the market for managerial services

So now we come to the paradox: serving shareholder value was paramount, yet a major force for addressing the managerial agency problem, the hostile takeover, was off the table. The 1990s board undertook to solve the dilemma by focusing on the market in managerial services, employing three strategic elements: executive compensation contracts, termination decisions, and severance packages. All three mechanisms were designed to build in the pursuit of shareholder value into managerial behavior.

a. Executive compensation

The first strategy was to fashion executive compensation contracts that better aligned managerial and shareholder objectives, to give managers high-powered incentives to maximize shareholder value. [263] In light of other institutional constraints, this meant stock options. Both tax and accounting rules favored the use of "plain-vanilla" stock options, meaning immediately exercisable, at-the-money options on the company's stock. Such options were taxable to the executive only when exercised, not when issued; the grant of such options did not reduce the corporation's net income (in other words, they were not expensed). The consequence was to work a revolution in managerial compensation over the period. [264] For example, the composition of CEO compensation in the largest firms, as reflected by the S&P 500, shifted over the **[*1531]** 1992-2000 period from 27% in stock options to 51% in stock options. [265] Using a broader definition of equity-based compensation that includes stock grants, the stock-

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[260] See ABA Comm. on Corporate Laws, Other Constituencies Statutes: Potential for Confusion, *45 Bus. Law. 2253, 2268-69 (1990)* (rejecting effort to sever management action from shareholder welfare because it "would conflict with directors' responsibility to shareholders and could undermine the effectiveness of the system that has made the corporation an efficient device for the creation of jobs and wealth"). Ironically constituency statutes have often in practice worked out to the detriment of the stakeholders they purport to protect. Managers who have invoked these statutes to resist a takeover bid typically accede after the bidder raises its price; but this additional benefit for the shareholders of course puts more financial pressure on the bidder to cut jobs or wages at the target.

[261] See Jeffrey N. Gordon, Employees, Pensions, and the New Economic Order, *97 Colum. L. Rev. 1519 (1997).*

[262] *Id. at 1520, 1534* (discussing evidence on increased income inequality in the United States). The well known empirics show decreasing inequality in the two immediate post-WWII decades and increasing inequality thereafter. On most standard indices, inequality sharply increased in the 1990s. See U.S. Census Bureau, Press Briefing on 2001 Income and Poverty Estimates, Chart 12 (Sept. 2002), available at *http://www.census.gov/* hhes/www/img/incpov01/fig12.jpg; see also U.S. Census Bureau, The Changing Shape of the Nation's Income Distribution, 1947-1998 (June 2000), available at *http://www.census.gov/prod/2000pubs/p60-204.pdf* (including several methods to show accelerating inequality in the 1990s). The focus on shareholder value could be the variable that links the rise of income inequality to the rise of director independence.

[263] This was consistent with the advice of academic observers, who had contended that managers were "paid like bureaucrats," meaning that their pay was increasing with the size of their organization and was relatively insensitive to performance. See, e.g., Michael C. Jensen & Kevin J. Murphy, CEO Incentives - It's Not How Much You Pay, But How, HARV. BUS. REV. May-June 1990, at 138; Michael C. Jensen & Kevin J. Murphy, Performance Pay and Top-Management Incentives, 98 J. POL. ECON. 225 (1990). But see Brian J. Hall & Jeffrey B. Liebman, Are CEOs Really Paid Like Bureaucrats?, 113 Q.J. Econ. 653 (1998).

[264] Some of this Part follows Gordon, supra note 82.

[265] See Kevin Murphy, Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options, *69 U. Chi. L. Rev. 847, 848* fig.1 (2002) (calculating valuations in 2001 dollars). The options were valued as of the grant day using a modified version of the standard Black- Scholes option pricing model, which will yield a much lower figure than the value of the option when exercised after substantial market appreciation. This latter figure is the one that is typically reported by the business and popular press. See also Brian J. Hall & Kevin J. Murphy, Stock Options for Undiversified Executives, 33 J. Acct. & Econ. 3

related portion of compensation for so-called "New Economy" CEOs shifted over the same period from 34% to 83%, and for other CEOs, from 25% to 59%. [266] This had two pronounced effects: first, it led to unprecedented levels of CEO compensation, [267] but second, it also produced compensation packages that, more than ever, embedded an explicit focus on shareholder value. [268]

b. CEO termination

The second strategic element of the 1990s boards' focus on shareholder value was increasingly to evaluate CEO performance with respect to shareholder returns and to terminate more quickly. This view seems to have been accepted even among the managers whose tenures were therefore at greater risk. [269] The change in board behavior is borne out by a number of **[*1532]** empirical studies. A study by Booz Allen Hamilton of CEO turnover in the 1995-2001 period for the 2500 largest companies worldwide shows a near doubling in the 1995 versus 2000 CEO turnover rate and a trebling of the rate of explicitly performance-related turnovers (twenty-five in 1995 versus eighty in 2000). The study indicates that stock prices had become the bellwether performance measure. [270] Its "first and most obvious[]" conclusion is that

CEOs must deliver acceptable and consistent total returns to shareholders. In the U.S. and Europe, the growing democratization of shareholding has clearly placed total shareholder returns higher on the management and board agenda than it was in years past, when net income and return on assets were the measures by which a firm's managers were judged. In those bygone days, management focused on effective stewardship; the relevant benchmarks were competitors in the same industry. Today, however, shareholders - from individual investors to giant pension funds - are increasingly judging each company against all others ... . This requires a fundamental change in management behavior and perspective. [271]

(2002); Michael C. Jensen & Kevin J. Murphy, Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them 26 fig.2, 31 fig.3 (European Corporate Governance Inst., Finance Working Paper No. 44/2004, 2004) available at *http://ssrn.com/abstract=561305*.

266 Kevin J. Murphy, Stock-Based Pay in New Economy Firms, 34 J. Acct. & Econ. 129, 132-33 (2003).

267 Bebchuk & Fried, supra note 109, at 1.

268 This shift to accept stock-based compensation was facilitated by a historical contingency. To address "unearned excesses" in managerial compensation, Congress in 1993 adopted a "reform" that would deny a public corporation a business deduction for compensation greater than $ 1 million, unless the compensation is paid "solely on account of the attainment of one or more performance goals." *I.R.C. §162(m)* (2007). In effect, the tax code placed a $ 1 million cap on salary and discretionary bonus payments and required a showing that additional compensation was performance-based. One very clear qualifier was a stock option plan using plain-vanilla options, see id. §1.162-27(e)(2)(vi), and it was a virtual corollary that any level of stock option grant would qualify as "performance-based," since the value of the option was increasing the stock price. Moreover, since plain-vanilla options were not expensed, their grant was "free" to the corporation. By contrast, a cash bonus geared to accounting or other measures would be expensed. Thus, boards would predictably be more generous in stock option grants than other performance-related compensation that might not have such a sharp shareholder value focus. In sum, the tax reform deprived managers of large flat salaries, but in trade for allegiance to the shareholder value criterion, it held out the promise of higher compensation overall.

269 For example, in its 1997 Statement on Corporate Governance, the Business Roundtable, an association of 200 CEOs, stated that "the principal objective of a business enterprise is to generate economic returns to its owners" and that "good corporate governance practices provide an important framework for a timely response by a corporation's board of directors to situations that may directly affect stockholder value." 1997 *BRT Statement, supra* note 259, at 1. The BRT also asserted that "selection and evaluation" of the chief executive officer and his or her team "is probably the most important function of the board," and that this role "includes considering compensation, planning for succession and, when appropriate, replacing the CEO or other members of the top management team." Id. at 5.

270 Chuck Lucier et al., Booz Allen Hamilton, Why CEO's Fall: The Causes and Consequences of Turnover at the Top, 3-7 (2002), available at *http://extfile.bah.com/livelink/livelink/110173/?func=doc.Fetch&nodeid=110173*.

271 Id. at 9 (emphasis in original).

Similarly, in evaluating CEO turnover in a sample of large U.S. firms in the 1992 to 2005 period, Kaplan and Minton found that CEO turnover increased in the post-1998 period and that the performance-to-turnover effect strengthened in the later period. [272] One of the most notable findings of a 2001 study by Huson, Parrino, and Starks of CEO turnover in the 1971-1994 period is that the rate of CEO firings in large firms (both in absolute terms and as a fraction of CEO turnover) was as high (or higher by some measures) in the 1989-1994 period as in the 1983-1988 period, the height of the hostile takeover wave, and much higher than in earlier periods in the evolution of corporate governance. [273] They also show that for the poorest performing firms, where the likelihood of a CEO firing is highest, industry-adjusted stock returns were a better predictor of a firing than income measures, and that the relevance of this predictor was highest in the 1989-1994 period. [274] Moreover, it appears that the use of industry-adjusted returns in the Huson et al. study may have masked **[*1533]** evidence of a straightforward reliance on shareholder returns by the 1990s board; this becomes apparent from an event study they performed that captures stock returns upon announcement of a CEO firing. For the 1989-1994 period, the average cumulative abnormal return upon such a termination is 4.00% compared to only 1.75% for the 1983-1988 period, [275] suggesting that firings by the 1990s board were, to a greater degree than previously, guided by the anticipation of an increased stock price. [276]

These trends are consistent with related work by Farrell and Whidbee, whose analysis of CEO turnover in the 1986-1997 period shows that the rate of CEO firings (both in absolute terms and as a fraction of CEO turnover) was higher in the 1995-1997 period than in the preceding 1989-1994 period. [277] Moreover, they show that a significant predictor of managerial turnover is failure to meet analysts' consensus earnings forecasts, that is, a strongly unexpected negative earnings surprise. [278] Although they do not map this onto stock price changes, the association between a negative earnings surprise and a stock price decline seems straightforward.

The result of this more demanding standard for CEO performance was, according to the Booz Allen study, to shorten average CEO tenure from 9.5 years (1995) to 7.3 years (2001) and to shorten the average tenure of fired CEOs from 7.0 years (1995) to 4.6 years (2001). [279]

c. Golden parachutes

The third element of the 1990s board's focus on shareholder value in the market for managerial services was the "golden parachute," a generous severance package that was another alignment mechanism. The typical "chute"

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[272] Steven N. Kaplan & Bernadette A. Minton, How Has CEO Turnover Changed? Increasingly Performance Sensitive Boards and Increasingly Uneasy CEOs (Nat'l Bureau of Econ. Research Working Paper No. W12465, 2006), available at http://ssrn.com/ abstract=924751.

[273] Mark R. Huson et al., Internal Monitoring Mechanisms and CEO Turnover: A Long- Term Perspective, 56 J. Fin. 2265, 2279-90 (2001).

[274] Id. at 2290 tbl.V.

[275] Id. at 2295 tbl.VII. The difference between the two periods is statistically significant.

[276] In other words, the board has rational expectations about whether a CEO firing will increase the stock price and acts accordingly. For further discussion on stock returns versus earnings as predicting CEO turnover, see Benjamin A. Hermalin & Michael S. Weisbach, Endogenously Chosen Boards of Directors and Their Monitoring of the CEO, 88 Am. Econ. Rev. 96 (1998). Cf. Dirk Jenter & Fadi Kanaan, CEO Turnover and Relative Performance Evaluation 18- 19 (MIT Sloan Research Paper No. 4594-06, 2006), available at http://ssrn.com/abstract=885531 (evaluating 1995-2001 CEO turnovers and finding that CEOs are more likely to be replaced following poor industry and poor market performance, suggesting that boards incompletely filter out the effects of exogenous factors; average CARs are negative following forced turnover).

[277] Kathleen A. Farrell & David A. Whidbee, Impact of Firm Performance Expectations on CEO Turnover and Replacement Decisions, 36 J. Acct. & Econ. 165, 173 tbl.1 (2003).

[278] Id. at 166-67, 175.

[279] Lucier et al., supra note 270, at 8-9.

provided for a severance of approximately three times salary plus the average bonus of prior years, and, in the case of a change in control transaction, added the accelerated vesting of stock options that had been granted but were not yet **[*1534]** vested. [280] The severance payments were nice but the option acceleration provisions could make the CEO genuinely rich. The chute could be a seen as compensation for the depreciation in the terminated CEO's human capital in respect of the termination decision. This was a significant consolation prize for the terminated CEO, which presumably reduced resistance, and also made it easier for the board to attract a replacement CEO under similarly unforgiving performance expectations. In the case of an uninvited premium takeover bid, such packages often converted CEOs from opposition to acquiescence. One consequence was that despite the availability for many U.S. firms of the nearly bullet-proof antitakeover defense of a poison pill combined with a classified board, [281] takeover activity in the United States reached new heights in the 1990s. In particular, in the 1996-2000 period, fewer than 100 (of 40,000 total) acquisitions in the U.S. takeover market were reported as "hostile"; only in thirty-two did managers resist to the point where the target remained independent. [282]

The intensity of takeover activity despite the availability of strong defenses illustrates the power of the shareholder value criterion in the 1990s corporate culture. Boards seemed to welcome, not fight, an appropriately rich bid, and managers went along because of compensation contracts that truly did align their interests with those of the shareholders. The shift in elite managerial opinion during the 1990s in favor of the shareholder value criterion even at the cost of some managerial autonomy had a certain historical contingency and much self-interest, but was real nevertheless.

[*1535]

4. Markets generally

A final element in the 1990s embrace of shareholder value in contrast to 1950s managerialism is a different conception of the role of markets. As argued previously, the 1950s tendency was to believe that the firm could create and manage markets. By contrast, as evidenced by the growth of disaggregated, networked firms, the 1990s tendency was to use market signals to manage the firm. [283] Independently, the collapse of the Soviet Union was taken to demonstrate the superiority of market-based governance over centralized planning. From a different perspective, one important consequence of the downfall of communist regimes was the elimination of a potential political competitor for the allegiance of workers. If part of the rationale for the 1950s concern for stakeholders

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[280] See generally Michael S. Sirkin & Lawrence Cagney, Executive Compensation §9 (1998).

[281] See supra note 247.

[282] Lucian Arye Bebchuk et al., The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy, *54 Stan. L. Rev. 887 (2002).* In this study, of the 100 hostile bids, only thirty-two firms remained independent over the long term, twenty-one of which had "effective staggered boards." Losses to target shareholders from defeated hostile transactions were approximately $ 30 billion if calculated using the figures in the study, *id. at 926* tbl.2, 933 fig.4, 935 tbl.3. But, there were over 40,000 acquisition transactions in the period, valued at $ 6.4 trillion; the accrued gains were $ 1.9 trillion. This means that the percentage of defeated transaction was vanishingly small (0.08%); those cases account for 1.2% of the total M&A activity and 1.5% of the gains. Moreover, the study presents no evidence of a selection effect of targets based on the availability of a classified board, and the sheer volume of acquisition activity combined with the ubiquity of classified boards (approximately half of public firms) makes a powerful selection effect unlikely. The study's findings in the context of the overall U.S. takeover market demonstrate the limited effect of antitakeover measures in the United States. See Jeffrey N. Gordon, An American Perspective on Anti-Takeover Laws in the EU: A German Example, in Reforming Company and Takeover Law in Europe (Guido Ferrarini et al. eds., 2004).

[283] Naomi R. Lamoreaux et al., Beyond Markets and Hierarchies: Toward a New Synthesis of American Business History, Am. Hist. Rev., Apr. 2003, at 404; William Savitt, A New New Look at Corporate Opportunities (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 235, 2003), available at *http://ssrn.com/abstract=446960* (reviewing network industries literature); cf. Charles F. Sabel & Jonathan Zeitlin, Neither Modularity nor Relational Contracting: Inter-Firm Collaboration in the New Economy, 5 Enterprise & Soc'y 388 (2004) (describing richer forms of collaboration relying on pragmatist theories of knowledge).

rested on the Cold War, that particular ideological competition was over. Capitalism, and capitalism's recourse to markets, was the only game in town. It was simply a lot easier for managers (and others) to ignore some of the adjustment costs associated with market-guided decisionmaking, what might be called the "transition costs of capitalism," in this environment. Managers were able to rest on the normatively attractive claim that shareholder wealth maximization would in fact maximize social surplus, and so workers in general, even if not a particular group of laid off workers, would be better off. [284]

E. The 2000s: New Roles for Independent Directors and New Standards of Director Independence

1. Introduction

The collapse of Enron, WorldCom, and similar but less catastrophic disclosure failures vividly demonstrated weaknesses in the board governance system produced by the 1990s and pointed the way towards new roles for **[*1536]** independent directors and standards of independence. [285] The 1990s system depended on an independent board's contracting with managers using stock market-based measures of managerial success to determine both compensation and tenure. Appropriate operation of the contracts critically depended upon the quality of the firm's disclosure, since otherwise stock prices would not reflect managerial performance. Yet the managers whose compensation and tenure depended on these stock prices were principally responsible for producing the disclosure on which the contracts relied. Boards had simply failed to appreciate and protect against some of the moral hazard problems that stock-based compensation created, in particular, the special temptations to misreport financial results. [286] The principal objective of the Sarbanes-Oxley Act of 2002, then, was the protection of the integrity of financial disclosure, both through extensive new regulation of accountants and through new disclosure monitoring responsibilities imposed on directors.

2. Contractual vulnerabilities

As noted above, the favored form of performance-based compensation in the 1990s was a large load of plain-vanilla stock options. The payoff from a stock option is asymmetric by design: unlimited upside potential, limited downside exposure. This is particularly the case where options are doled out so freely as to be almost free (i.e., no foregone cash compensation) and where underwater options may be repriced. The payoff from stock is itself asymmetric (and hence has been likened to an option), but stock has value (is "in the money") at any positive price, whereas an option that expires below its exercise price ("out of the money") is valueless. Thus, a too-rich stock option package can create a distinctive set of moral hazard problems. [287] First, and most obviously, stock options can be redistributive. Exercised stock options increase the number of shares outstanding and thus dilute the existing holders' claim on the firm's cash flows. Stock options grants are redistributive if the value of the options is greater than the executive services received; large or "mega" grants of nonexpensed options seem likely candidates.

Second, more seriously, managers with large option grants may be strongly tempted to manipulate financial results, most typically through the overstatement of earnings. Several recent studies find that the probability of **[*1537]**

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[284] There are, of course, critical ways of reading the history. Englander and Kaufman, for example, claim that during the 1990s U.S. managerial capitalism shifted from a "technocratic" form concerned with balancing stakeholder interests to a "proprietary" form in which managers competed in tournaments whose ultimate payoff was a disproportionate share of the firm's wealth and society's wealth. Ernie Englander & Allen Kaufman, The End of Managerial Ideology: From Corporate Social Responsibility to Corporate Social Indifference, 5 Enterprise & Soc'y 404 (2004).

[285] Some of this Part draws from Gordon, supra note 82, and Gordon, supra note 83.

[286] The emerging evidence of questionable practices in the timing of stock option grants suggests that board members were insufficiently attentive to this temptation as well. See, e.g., Randall A. Heron & Erik Lie, Does Backdating Explain the Stock Price Pattern Around Executive Stock Options Grants?, 83 J. Fin. Econ. 271 (2007). This could be because of their own stock-based compensation. See Bebchuk et al., supra note 81 (finding favorable timing in option grants to outside directors that is inconsistent with sheer chance).

[287] For further exploration of problems associated with the use of options, see Gordon, supra note 83.

accounting fraud, though small, nevertheless increases with the amount of stock-based compensation, and increases as well with the fraction of total compensation that is stock-based. [288] The source of the temptation becomes apparent in comparing two forms of incentive compensation, cash bonuses and stock options. Bonus payments will typically increase linearly with earnings but the value of stock options can increase (decrease) exponentially because of the double effect that earnings changes have on stock prices. Earnings changes affect prices both through operation of the price/earnings ratio and through the impact on the market's perception of the company's growth rate and thus the p/e ratio itself. [289]

Nevertheless, on the "chickens come home to roost" theory, [290] it might appear that achieving financial results through manipulation would be irrational, and thus not so serious a threat. The firm's true condition will eventually come to light, the stock price will fall, and the executives' options may well become worthless. (This is not to mention the potential legal sanctions for fraud.) But such reasoning does not appreciate the benefits and risks from the executive's perspective. Before the revelation, the executive may have become rich through prior option exercises (and a prompt sale of the underlying stock, or a "cashless exercise") at the inflated price; the firm might reprice the worthless options or grant some new ones; the necessary earnings restatement may be buried with some other extraordinary adjustment; or a positive shift in market conditions may overtake the earlier misrepresentation. Certainly under prevailing practices in the 1990s, even a significant restatement was unlikely to trigger an SEC enforcement action, much less a criminal prosecution, and any civil litigation would be resolved well short of a finding of fraud, meaning that either the D&O insurer or the company (but not executive) will fund any settlement. Thus, as compensation came increasingly to consist of **[*1538]** high-powered incentives like stock options and as the absolute level of potential stock option payout over a short period of time increased, management's temptations grew. This is the source of the most difficult moral hazard problem associated with the 1990s governance pattern. [291]

In short, managements had high-powered incentives with foreseeable moral hazard problems. The necessary institutional complement was high-powered monitoring by the board. This was missing at many firms.

3. Contracting failures

The problems with stock option packages arose not only from the asymmetric payoff structure but also from their very size. The temptation to manipulate earnings was presumably increasing with the size of the payoff. Certainly the risks of shareholder dilution were increasing with the size of the option package. Observers have debated whether boards pervasively failed in their obligation to establish arm's length bargaining with the senior managers. [292] Regardless of the board's independence in other matters, it seems clear that independence was undercut in the

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[288] These studies are canvassed in Jensen & Murphy, supra note 265. See also David J. Denis et al., Is There a Dark Side to Incentive Compensation? (Mar. 2005) (unpublished manuscript), available at *http://ssrn.com/abstract=695583*.

[289] To take a simple example: Assume in year t=1 a company earns $ 5 per share and its stock trades with a p/e ratio of 10, so the stock price is $ 50 a share. In year t=2 the company earns an additional $ 1 per share, that is, earnings increase by 20%. Assume there are 1 million shares outstanding and that the CEO has 50,000 expiring options with a $ 50 exercise price. A cash bonus will amount to some fraction of the total additional earnings, but obviously would never exceed $ 1 million. By contrast, through operation of the p/e ratio alone, the additional $ 1 of earnings produces a $ 10 per share increase. But if this 20% year-over-year improvement changes the market's perception of the company's growth rate and thus the p/e ratio, it will generate a much greater increase in the stock price. So, for example, if the p/e ratio increases from 10 to 15, the price will increase not from $ 50 to $ 60, but from $ 50 to $ 90. The effect on CEO wealth is amazing: an increase of $ 2 million, double the total amount of additional earnings. The calculation, via the Black-Scholes method, becomes more complex for options of greater duration, but the point remains. Thus, it is not surprising that earnings manipulations to generate and sustain a higher p/e ratio is more tempting as the level of options increases.

[290] Cf. *In re Pure Resources, Inc., Shareholders Litig., 808 A.2d. 421, 446 (Del. Ch. 2002)* (explaining the "goose and gander rule").

[291] Another moral hazard problem arguably arose from the board's focus on stock price performance in its termination decision, see supra Part III.D.3.b, which added to management's temptation to manipulate results.

setting of compensation. In some cases the CEO or other members of the management team participated in compensation committee activities. This participation included retaining the same consultants hired by senior managers for larger and more lucrative human resource assignments for the firm. Often nominally independent directors were not actually independent in this domain, either because of a pecuniary relationship with the firm that management could control or because of the "backscratch" problem that arose because of director interlocks. The conception of director "independence" had been insufficiently rigorous to manage the powerful managerial self-interest that was unleashed by the writing of increasingly rich executive compensation agreements.

4. Director independence reconsidered

The principle institutional failure that produced Enron and its ilk was the failure of the gatekeepers, especially the accountants, not the insufficiency of director independence. [293] Yet boards had not performed well either, having **[*1539]** failed to address management's undercutting of gatekeeper integrity. There certainly was a substantive case for enhancing the independence-in-fact of directors, particularly if the managerial agency problem was to be addressed through incentive-based compensation and termination contracts rather than through control markers. As post-Enron reform pressure mounted, managerial elites moved to ramp up board independence as an alternative to more intrusive regulation, in this way protecting managerial autonomy to the extent possible in the changed environment. The New York Stock Exchange impaneled a corporate governance task force to restore public confidence and to show that private regulation could address the governance failures that Enron revealed without need for federal legislation. This was the origin of the tightened director independence requirements added to the NYSE's listing standards, including compensation committees staffed solely by these more stringently qualified independents. [294] The Business Roundtable emphasized the importance of independent directors and the importance of the board's role in "focusing on the integrity and clarity of the corporation's financial statements and financial reporting." [295] Just as it seemed that managerial elites were going to succeed in defeating legislative action, the WorldCom scandal broke in spring 2002, which raised the saliency of corporate governance problems and created unstoppable momentum for the legislation that became Sarbanes Oxley. Ironically, then, some of the emphasis on director independence in the post-Enron environment is the byproduct of a failed effort to offer up stronger board monitoring to forestall legislative change. Most recently, managerial elites have invoked the independent board, especially its nominating committee, as part of the effort to beat back the SEC's proposal for limited shareholders access to the management proxy statement to make director nominations.

The post-Enron reforms lay the groundwork for a revised model of corporate governance. The model operates at many different levels. It ratchets up the liability for primary wrong-doers, particularly corporate officers. It imposes new duties, new liabilities, and a new regulatory structure on certain gatekeepers, accountants in particular but also lawyers and, in a fashion, securities analysts. The effect of the reforms on the board's role is to make the role of the independent director more important than ever. Both the federal securities law and the stock exchange listing requirements imposed more rigorous standards of director independence. [296] Boards, particularly the audit committee, are given a specific mandate to supervise the firm's relationship with the accountants and thus to oversee the corporation's internal financial controls and financial disclosure. [297] Boards are more likely to hear about their lawyers' concerns that the firm's managers are not in compliance with the **[*1540]** federal securities

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[292] Compare Bebchuk & Fried, supra note 109 (explaining high compensation levels as managerial rent- seeking), with Jeffrey N. Gordon, Executive Compensation: If There's a Problem, What's the Remedy? The Case for Compensation Discussion and Analysis, 30 J. Corp. L. 675 (2005) (arguing that many other factors also important, perhaps more so in most cases).

[293] See John C. Coffee, Jr., Gatekeepers: The Professions and Corporate Governance (2006); John C. Coffee, Jr., Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, *84 B.U. L. Rev. 301 (2004).*

[294] See supra notes 50-52, 107 and accompanying text.

[295] Bus. Roundtable, supra note 102, at 5 (emphasis omitted).

[296] See supra notes 50-53, 107-09 and accompanying text.

[297] Id.

laws or even state fiduciary duty. [298] Directors, then, will have a particularized monitoring role, what might be called "controls monitoring," in addition to "performance monitoring."

F. Summary

This brief and partial history aims to give context to the secular trend observed in Part I: a dramatic shift in the composition of the board away from insiders and toward independents. The shift towards independent directors is reflected not just in the numbers or percentages but also in the likelihood of independence in fact. What the history also reveals is that the rise of the independent board is associated with an increasing orientation of the corporate purpose toward shareholder wealth maximization and with a growing role for the board in mediating between the firm and the stock market. The legal resolution of the hostile takeover battles of the 1980s was, first, that the firm is not always up for sale (meaning the shareholders don't decide), but second, that the ultimate decisionmaker was not to be the highly conflicted managers but the somewhat conflicted board. The growing focus on director independence was stimulated by the desire to enhance the credibility of such decisionmaking to the relevant audiences, particularly increasingly active institutional investors. But the board's mediation between the firm and market was not limited to accepting or refusing a hostile takeover bid. Rather, in acceptance of the claim that the managerial goal was to maximize shareholder value, boards increasingly employed stock prices in compensation arrangements and in making termination decisions. Managers were thus exposed to "soft-form" stock market pressure rather than the "hard form" pressure of hostile bids. What was insufficiently recognized in this transformation is the importance of a new role for the board: the monitoring of financial controls and disclosure. Stock market prices were not spontaneous creations; they could be manipulated and inflated by self-interested managerial action, and the new approach that incorporated stock prices into both compensation and termination created powerful incentives for such behavior. This would place new and greater demands on the monitoring capacity of boards and would lead in turn to more rigorous standards of director independence.

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III. The Increasing Informativeness of Stock Prices, 1950-2005

A. Introduction

This Part argues that the rise of independent directors is partly explained by the increasing informativeness of stock prices over the 1950-2005 period. As more information about the firm is impounded in the stock price, insiders lose a privileged claim of insight about the firm's performance and prospects. More importantly, the nature of performance monitoring changes. As stock prices become more informative, the directors' monitoring role increasingly consists of using stock price metrics to measure the firm's performance over time and against relevant intra-industry comparisons. This is not to deny the existence of private information nor the value of the directors' critical perspective on stock market measures, particularly over short time frames. Nevertheless, in light of the positional conflicts that undermine insiders' capacity to monitor senior management, the increasing informativeness of stock prices changes the comparative advantage of independent directors. The independents' information debilities decrease and their monitoring advantages become more apparent.

An informal model may help to clarify the point. Assume that directors' monitoring capabilities are a function of two variables, information about the firm (which includes information about expected future results as well as current results) and independence from the senior management team. Start with a polar case, a private firm, in which there is no public disclosure and thus no stock market prices that impound disclosure. The tradeoff between firm-specific information and independence may favor a predominantly inside board, even for monitoring purposes. Independent directors (which excludes significant shareholders or their agents or other affiliated directors) have insufficient incentives to become informed and get no help from public investors' assessment of value. Uninformed

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[298] See Sarbanes- Oxley Act of 2002 §307, 15 U.S.C. §78j- 1 (2007) (as implemented by 17 C.F.R. pt. 205 (adopted by Implemenation of Standards of Professional Conduct for Attorney, Securities Exchange Act Rel. No. 47,276, 79 SEC Docket 1351 (Jan. 29, 2003))).

independence has limited value; hence we should expect to see more insiders on the board. Assume instead that the firm is public. As the market becomes increasingly well informed about the firm's performance and prospects, the directors get increasing help in understanding the firm from competitive stock price formation (and softer forms of market feedback, such as analysts' reports). The independents' information deficit is ameliorated. All other things equal, from the monitoring perspective, board composition will shift in favor of the independents. In other words, holding other things constant, the percentage of insiders (independents) should be decreasing (increasing) in the degree of stock price informativeness.

There is a second explanatory element that followed from the increasing informativeness of stock prices over the period. Managers increasingly turned to stock market signals for strategic guidance, rather than relying solely on internally-generated information. This too undermined the case for insiders on the board. The 1950s firm embodied a strong belief in the power of **[*1542]** bureaucratic rationality to accurately sense and determine the appropriate strategy, indeed, of bureaucratic rationality's power to shape the market environment in which the firm operated. The success of this managerial form was celebrated by Alfred Chandler's Strategy and Structure, which emphasized the importance of management's information gathering, forecasting, planning, and resource allocation. [299] Indeed, as firms undertook more complex tasks of planning and organization, many companies apparently replaced outside directors with insiders, precisely because of their deep knowledge. [300] Moreover, information was power. As Chandler observed: since senior managers "provided the board and the stockholders and, of course, any government or regulatory agency with whatever detailed data about the company these groups might want, their actions were controlled only negatively by their legal superiors." [301]

But it was actually the 1960s conglomerate firm that reflected the high water mark of the managerial belief in internally generated information as the ultimate strategic tool. Managers took the multidivisional or "M-form" structure that had evolved in the early 20th century to manage the large firm that focused on a unitary, if complex, business [302] and extended it to the management of diverse business units that had no necessary relation to one another. The conglomerate was premised on the belief that the headquarters team could outperform external capital markets in monitoring the managers of diverse business units and in making appropriate resource allocations among them. [303] The failure of several conglomerates in the 1970s, the evidence of the general inefficiency of the conglomerate form, [304] and the successful leveraged bust-up of many conglomerates in the 1980s led to an emphasis on "focus" in drawing the boundaries of the firm. [305] One important implication of this shift **[*1543]** was heightened appreciation of stock market prices as a guide to capital and other resource allocation as against internally generated information in the complex firm. The insiders' firm-bound information did

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299 Alfred D. Chandler, Jr., Strategy and Structure: Chapters in the History of the Industrial Enterprise 99, 149, 152, 282, 291-92, 396 (1962) [hereinafter Chandler, Strategy and Structure]. Chandler sounds similar themes about the rise of "managerial capitalism" (the "visible hand"): although the market "remained the generator of demands for good and services . . . modern business enterprise took over the functions of coordinating flows of goods through existing processes of production and distribution, and of allocating funds and personnel for future production and distribution." Alfred D. Chandler, Jr., The Visible Hand: The Managerial Revolution in American Business 1 (1977).

300 See Peter F. Drucker, The New Society: The Anatomy of Industrial Order 223 (rev. ed. 1993).

301 Chandler, Strategy and Structure, supra note 299, at 314.

302 The M-form structure replaced "the centralized, functionally departmentalized or unitary (U-form) structure" that proved a much less efficient way to manage large enterprise. Oliver E. Williamson, The Modern Corporation: Origins, Evolution, Attributes, 19 J. Econ. Literature 1537, 1555 (1981). Identifying and describing this shift was Chandler's signal achievement in Strategy and Structure, supra note 299.

303 Williamson, supra note 302, at 1557-60.

304 See Gilson & Black, supra note 248, at 336-46 (summarizing evidence).

305 See, e.g., Philip G. Berger & Eli Ofek, Bustup Takeovers of Value-Destroying Diversified Firms, 51 J. Fin. 1175 (1996); Sanjai Bhagat et al., Hostile Takeovers in the 1980s: The Return to Corporate Specialization, 1990 Brookings Papers on Econ. Activity: Microeconomics 1.

not necessarily give them superior insight into how best to monitor managers or allocate capital. An independent director looking to increasingly informative stock prices might have insight unbiased by the internal perspective. [306]

There are many reasons to believe that stock prices have became more informative over the 1950-2005 period. First, important empirical work by financial economists shows that individual stock price movements over the period became increasingly decoupled from overall market movements, meaning that firm-specific factors became increasingly influential. This greater firm-specific return variation is best explained, in the United States, in terms of increasingly informative stock prices. Second, firms in fact have been disclosing increasingly more information, as measured by a simple survey of public filings over the period. Third, the SEC's disclosure regime has promoted more disclosure, and more useful disclosure, through: (i) mandatory disclosure of information that firms were unlikely to disclose voluntarily, (ii) permissive disclosure of information (like projections) that the SEC had previously prohibited, and (iii) prescriptive standardization that has made comparisons easier. Fourth, the pronouncements of the Financial Accounting Standards Board (and its predecessors) have led to the disclosure of more value relevant information and also aided uniformity. Fifth, a grab bag of other factors also have made stock prices more informative, including an increase in the number of analysts and other investment professionals, the rise of mutual funds and other institutional investors with sufficient scale to undertake securities research, and information technology and information dissemination mechanisms that lower the cost of securities research.

B. Market-Level Empirical Evidence on Stock Price Informativeness: Synchronicity and R2

Important recent work by financial economists provides evidence that U.S. stock prices have become more informative over a long time frame, particularly since 1950. Using a 1926-1995 time series, Morck et al. show that the movement of U.S. stock prices has become less "synchronous" over time, meaning that a decreasing fraction of stocks move up or down together. [307] (See **[*1544]**

Figure 3. Declining Synchronicity of U.S. Stock Prices

[SEE FIGURE 3 IN ORIGINAL]

Figure 3.) This pattern gains importance in light of cross-country evidence that shows that synchronicity is inversely related to capital market development. Emerging market economies exhibit a high degree of synchronous stock price movement; developed market economies exhibit a low degree. Moreover, although U.S. stock price volatility has remained roughly constant over the period, an increasing percentage of the returns on individual stocks is attributable to firm-specific factors, rather than market factors. This effect is captured by a variable called R2, which measures the extent to which the market model accounts for the variation in stock returns. As with synchronicity, R2 has declined over the 1926-1995 period, particularly since 1950. [308] (See Figure 4 below.)

Morck et al. attribute the declines in synchronicity and R2 to an increasing payoff to arbitrageurs from a focus on firm-specific factors rather than market-wide factors, including speculation and fads. Looked at from the cross-country perspective, the value of a firm-specific focus is principally a function of the levels of property right protection and investor protection. For the United **[*1545]** States, where these institutions have been relatively

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[306] Thus, the increasing informativeness of stock prices helps address the "monitoring vs. managing" tradeoffs that some thought were inherent in the independent board. See, e.g., Jill E. Fisch, Taking Boards Seriously, *19 Cardozo L. Rev. 265 (1997).*

[307] See Randall Morck et al., The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements?, 58 J. Fin. Econ. 215 (2000). The article's principal thrust is a cross-country study of cross-sectional variation in synchronous stock price movements, which shows much greater synchronicity in emerging markets than in developed markets. The article also explores U.S. time- series data, noting the sharp changes over time. See also Merritt B. Fox et al., Law, Share Price Accuracy, and Economic Performance: The New Evidence, *102 Mich. L. Rev. 331 (2003).*

[308] For confirmation of the decline of R2 in the United States in the post-1960 period, see Cambell et al., Have Individual Stocks Become More Volatile? An Empirical Exploration of Idiosyncratic Risk, 56 J. Fin. 1, 23-25 (2001).

stable, particularly in the post-1950 period, the increasing information content of prices seems likely to account for the decline in synchronicity and R2. Durnev et al. support this argument with evidence that firms with lower R2 exhibit a higher correlation between current stock returns and future earnings. [309] This suggests that R2 reflects the extent to which information about future returns is impounded into the stock price. Thus, the post-1950 decline in average R2 for U.S. stocks can be taken as a measure of the increasing informativeness of stock prices during the period. [310]

C. Firm-Level Empirical Evidence of More Disclosure by Firms

The stock market evidence that increasingly more firm-specific information has been impounded into stock prices is supported by additional evidence that examines the disclosure practices of firms. We conducted a simple survey to assess the amount of public firm disclosure over the 1950-2004 period. [311] The general strategy was to look at the key annual disclosure document required by the SEC, the Form 10-K, for a sample of large public firms over the period. The Form 10-K includes a narrative description of the firm, its businesses, and its competitive situation, as well as detailed financial information. A major driver, if not the principal driver, of the growth in Form 10-K disclosure has been changing SEC requirements and new accounting pronouncements. [312] Important information that firms "voluntarily" disclosed would ordinarily be subject to subsequent inclusion in the Form 10-K, so the Form 10-K should be a good general disclosure indicator.

We measured the Form 10-K in different categories: the number of total pages, the number of pages of financial information, the number of notes to the **[*1546]**

Figure 4. Declining Fraction of U.S. Stock Return Variation Explained by the Market

[SEE FIGURE 4 IN ORIGINAL]

financial statements, and the number of pages of notes. Our sample was drawn from the seventy-seven firms that have appeared in the Fortune 500 since its inception in 1955, and the page counts were based on Form 10-Ks on digitized microcards from Thompson ONE Banker, microfiche, and film microcards. Where only annual reports were available (typically the case before 1969, when regulatory change more clearly distinguished the Form 10-K from the annual report), we subtracted pages that, on the basis of section headings and content, were not Form 10-K material (picture spreads, etc.). Occasionally the Form 10-K included detailed information about employee retirement plans, specifically, informational pamphlets for employees, that would be of dubious value to an investor. We omitted these from the page count. More generally, Form 10-Ks identify key contracts (such as loan agreements) that are occasionally attached but more often are "made available" elsewhere. Such exhibits were not included in the tally. Nor did we count the pages of material about the issuer's officers and directors, board

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[309] Artyom Durnev et al., Does Greater Firm-Specific Return Variation Mean More or Less Informed Stock Pricing?, 41. J. Acct. Res. 797 (2003) (covering 1983-1995 period); see also Qi Chen et al., Price Informativeness and Investment Sensitivity to Stock Price, Rev. Fin. Stud. 619 (2007) (showing that the R2 measure of private information impounded in stock prices predicts sensitivity of corporate investment to stock price); Art Durnev et al., Value-Enhancing Capital Budgeting and Firm-Specific Stock Return Variation, 59 J. Fin. 65 (2004) (marginal changes in Tobin's q performance measure are positively correlated with increased informativeness as measured by R2). But see Kewei Hou et al., R2 and Price Inefficiency (Fisher Coll. of Bus., Working Paper No. 2006-03-007, 2006), available at http://ssrn.com/abstract=954559 (finding a negative relationship between R2 and overreaction-driven price momentum, suggesting a connection between R2 and inefficiency, and citing to other working papers skeptical of a positive relationship to efficiency).

[310] Other empirical work also supports the disclosure/informativeness link by showing that stock returns of firms with higher Association for Investment Management Research-Financial Analysts Federation corporate disclosure ratings are better predictors of future earnings changes. See, e.g., David S. Gelb & Paul Zarowin, Corporate Disclosure Policy and the Informativeness of Stock Prices, 7 Rev. Acct. Stud. 33 (2002).

[311] Benjamin Whetsell bore the laboring oar in this project.

[312] See infra text accompanying notes 315-78.

structure, and executive compensation that is typically incorporated by reference into a Form 10-K from the issuer's Form 14A, the proxy statement. Mandatory proxy statement disclosure has certainly increased during the period, so non-inclusion of this material will understate the level of additional disclosure.

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Figure 5. Increased Disclosure, 1950-2005 (Form 10-K and Components)

[SEE FIGURE 5 IN ORIGINAL]

As Appendix Table 2 and Figure 5 illustrate, the number of pages in all categories substantially increased over the period. The average number of pages in a Form 10-K was approximately sixteen in 1950, twenty in 1965, but then grew rapidly thereafter, from forty in 1970 to 125 in 2000, and, in the post-Sarbanes-Oxley world, 165 in 2004. The financials (including notes) grew from four pages in 1950 and 1960 to ten pages in 1970, twenty-three in 2000, and thirty-eight in 2004. The number of notes to the financial statements grew in parallel, from five notes in 1950 to nineteen notes in 2000 and 2004. Most of the increase in the length of the financials was from the addition of notes.

This reflects an enormous increase in firm-specific disclosure over the period. The 1970s marked a period of especially rapid growth in these disclosure categories. As described above, this is the decade of corporate governance upheaval, and, in terms of board composition, the point at which the number of insiders began to decline and independents to increase.

[*1548]

D. Additional Disclosure Because of SEC Regulation

Changes in SEC disclosure regulation have led to considerably more disclosure, and more useful disclosure, over the 1950-2005 period and have thus enhanced the informativeness of stock prices. SEC regulatory action has affected disclosure in three ways. First, some actions have been disclosure forcing, leading to more information disclosure than would have voluntarily occurred. Second, some actions have been disclosure permitting, eliminating barriers to disclosures that firms would make voluntarily. Third, some actions have been disclosure standardizing, making firm-specific disclosure more readily comparable across firms.

The claim that SEC action enhanced the level of disclosure over the period depends only in part on the case for mandatory disclosure, since some of the most important interventions over the period were first, the elimination of barriers to forward-looking disclosure that firms wanted to make and investors wanted to have and, second, the establishment of disclosure conventions that made disclosure more useful. Without engaging the mandatory disclosure debate in full force, [313] it seems straightforward that an effective regulator could mandate disclosure of information that firms would not voluntarily disclose and that would otherwise not be available to the market. First, because disclosure affects shareholder monitoring, managers would exercise discretion to produce suboptimal disclosure from the shareholder point of view. Suboptimal disclosure is one element of managerial agency costs, and good mandatory disclosure policy can help overcome it. Second, because disclosure often reveals competitively sensitive information, optimal disclosure from a firm-specific perspective is suboptimal from a social perspective. Shareholders of any particular firm face a classic prisoner's dilemma: full disclosure by other firms enables better managerial monitoring because of comparative performance benchmarks, yet each firm's locally rational course is not to disclose. Mandatory disclosure overcomes this collective action problem and produces particular gains when shareholders are diversified. Third, the alternative way of delivering information to the market,

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[313] This is ably canvassed in Fox et al., supra note 307, at 335-44. See also Allen Ferrell, The Case for Mandatory Disclosure in Securities Regulation Around the World (John M. Olin Ctr. for Law, Econ., and Bus., Harvard Law Sch., Paper No. 492, 2004), available at *http://ssrn.com/abstract=631221*.

insider trading, is a noisy, awkward vehicle for disclosure, and in any event has probably declined in importance since the SEC began its enforcement efforts in the 1960s. [314]

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1. Disclosure forcing

Section 13(a) of the 1934 Securities Exchange Act requires public companies listed on an exchange to file annual and quarterly reports as prescribed by the SEC. The practice of sending annual reports to security holders apparently derived from early state corporate and tax law requirements for the annual filing of financial statements and for the issuer's distribution of such reports, sometimes only upon request, to all security holders or a certain proportion of security holders. [315] The New York Stock Exchange independently required the distribution of annual and quarterly reports for listed companies in 1933. [316] In 1942, the SEC required that an annual report "containing such financial statements for the last fiscal year as will, in the opinion of the management, adequately reflect the position and operations of the issuer" be sent to security holders in connection with a management proxy solicitation for the annual election of directors. [317] Professor Loss's 1961 edition of Securities Regulation suggests, through an absence of discussion, that the SEC during the 1950s did not attempt to deepen disclosure. [318] To the contrary, the SEC backed down in 1953 on a proposal to require quarterly reports, and, in its subsequent adoption of a semiannual reporting requirement, permitted, in effect, informal financial statements. [319] The SEC appeared to be deferring to managers, who, among other reasons, objected to possible competitive disadvantage from disclosure, despite the protestations of securities analysts, "who reported through their national organization that their efforts to obtain voluntary agreement from companies to provide quarterly sales reports had been discouraging." [320] Managerial deference seemed to be a theme of the Eisenhower-era SEC, reflected in a narrowing of shareholder access to the management proxy, as well as budgetary cutbacks for the agency. [321]

[*1550]

a. Disclosure integration.

In the ensuing decades, however, beginning around 1970, there were many new disclosure requirements. [322] It is sufficient for illustrative purposes here to sketch some of the most important, including the development of segment reporting beginning in 1969 and the development of "management discussion and analysis" (MD&A) beginning in

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[314] See, e.g., *SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968),* aff'g in part and rev'g in part *258 F. Supp. 262 (S.D.N.Y. 1966),* cert. denied ***394 U.S. 976 (1969);*** *Cady, Roberts & Co., 40 S.E.C. 907 (1961).*

[315] See 2 Louis Loss, Securities Regulation 825 (2d ed. 1961). But cf. David F. Hawkins, The Development of Modern Financial Reporting Practices Among American Manufacturing Corporations, 37 Bus. Hist. Rev. 135, 142-43 (1963) (showing only some states required distribution).

[316] 2 Loss, surpra note 315, at 804-08.

[317] Exchange Act Release No. 3347, 1942 WL 34864 (Dec. 18, 1942).

[318] See 2 Loss, supra note 315, at 809-57.

[319] Id. at 815- 16.

[320] Id. at 815; see also Hawkins, supra note 315, at 140- 42, 160-61 (describing the persistence of competitive concerns about disclosure). The major effort of the reformers was aimed at broadening the coverage of Securities Exchange Act disclosure to include public companies that were not listed on an exchange. See, e.g., Joel Seligman, The Transformation of Wall Street 310-14 (1982); Philip A. Loomis, Jr., The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940, 28 Geo. Wash. L. Rev. 214, 220, 226-28 (1959). These efforts culminated in the Securities Acts Amendments of 1964, Pub. L. No. 88-467, *78 Stat. 565.*

[321] See Seligman, supra note 320, at 265- 73.

[322] See generally 2 Louis Loss & Joel Seligman, Securities Regulation 599-751 (3d ed. rev. 1999).

1972. But a pervasive source of disclosure deepening over the period was the effort to "integrate" the disclosure requirements of the 1933 and 1934 securities acts. As famously argued by Milton H. Cohen in 1966, the happenstance enactment sequence of the 1933 Act (addressing public offerings) followed by the 1934 Act (addressing secondary market activity) distorted the disclosure system. [323] In light of the small number of public offerings and the massively greater volume of share turnover in secondary market trading, "integration" of the two schemes should proceed by building on the continuous disclosure pattern of the 1934 Act, he argued. Thus, a seasoned issuer should market securities through a 1933 Act registration process that relied substantially on information already disclosed to the market through the 1934 Act filings. "Yet, as a broad generalization, the disclosure process under the 1934 Act (apart from proxy solicitations) appears never to have been taken quite as seriously as under the 1933 Act, very likely because of differences in the attendant liabilities and sanctions and in Commission procedures." [324]

The SEC came to embrace the project of disclosure integration wholeheartedly. [325] It saw that robust continuous disclosure was an essential component, and thus at every turn it sought to ratchet up the 1934 Act periodic filings to the same depth and currency as would be expected of a 1933 Act registration statement. Notably, in 1977 the SEC adopted Regulation S-K, which prescribes the substance and form of non-financial disclosure for both **[*1551]** 1933 Act and 1934 Act filings. [326] Similarly, through Regulation S-X and various accounting pronouncements, the SEC has developed a common standard for the substance and form of financial disclosure for filings under both acts whose consequence is much deeper disclosure for 1934 Act filings than previously. [327]

b. Segment reporting

In 1969, the SEC began to require firms to disclose "industry segment" data, meaning disclosure that broke out revenues and income for separate lines of business. [328] The impetus for this change was the conglomerate merger movement of the 1960s, in which firms expanded through unrelated diversification. Under the prevailing consolidation rules, the operating and financial results of substantial enterprises could disappear into undifferentiated totals. This created problems for antitrust enforcement as well as shareholder monitoring. Although some firms voluntarily disclosed line-of-business results, the overwhelming majority did not. [329] The SEC's initial approach was to require segment disclosure for a "product-line" that accounted for at least ten percent of the firm's

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[323] Milton H. Cohen, "Truth in Securities" Revisited, 79 Harv. L. Rev. 1340, 1341-42 (1966). For a dissenting view, which argues that Congress would not have contemplated 1933 Act disclosure requirements incorporated into 1934 Act filings, see Paul G. Mahoney, Mandatory Disclosure as a Solution to Agency Problems, *62 U. Chi. L. Rev. 1047, 1081-88 (1995)* (arguing that 1934 Act disclosure was aimed at controlling self-dealing and other duty of loyalty problems, not enhancing stock price accuracy).

[324] Cohen, supra note 323, at 1361.

[325] The key moments were the so-called "Wheat Report" in 1969, Sec. & Exch. Comm'n, Disclosure to Investors: A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts (1969), which was named after the director of the small group which prepared the report, Commissioner Francis M. Wheat, and the "Sommer Report" in 1977, H. Comm. on Interstate & Foreign Commerce, 95th Cong., 1st Sess., Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission (Comm. Print 1977) [hereinafter Sommer Report], which was named after the committee's chairman, former Commissioner A.A. Sommer, Jr. See 2 Loss & Seligman, supra note 322, at 599-624.

[326] Industry Segment Reporting, Securities Act Release No. 5893, Exchange Act Release No. 14,306, Investment Company Act Release No. 10,070, *42 Fed. Reg. 65,554* (Dec. 30, 1977); see 2 Loss & Seligman, supra note 322, at 627-724.

[327] See 2 Loss & Seligman, supra note 322, at 724-32.

[328] This is account is based principally on Seligman, supra note 320, at 433-38, and 2 Loss & Seligman, supra note 322, at 654-64.

[329] See Daniel W. Collins, SEC Product-Line Reporting and Market Efficiency, 2 J. Fin. Econ. 125, 126 & nn.2- 3 (1975). Of 600 firms surveyed, twenty-one had some segment reporting in 1967, ninety-three in 1968, and 194 in 1969 (the last year in the shadow of impending regulatory change). The survey did not test the voluntary disclosure against the ultimate regulatory standard.

total revenues or pre-tax income, but giving management considerable discretion to define product lines and address issues like common costs and intra-company transfers. Although this initial formulation of segment reporting was sharply criticized for the discretion given managers (by the FTC, for example), contemporary empirical studies found that the additional disclosure still enabled investors to better anticipate future earnings and improved the accuracy of analysts' earnings forecasts. [330]

By 1977, the SEC's Advisory Committee on Corporate Disclosure weighed in on the question, reporting, among other things, "the almost universal **[*1552]** dissatisfaction analysts express with the level of segmentation currently provided by the registrants in SEC disclosure documents." [331] Acting quickly, the SEC simply embraced the recently (1976) promulgated accounting standard that imposed a more exacting test based on "whether products and services are related (and, therefore, should be grouped into a single industry segment) or unrelated (and, therefore, should be separated into two or more industry segments) ... ." [332] Although the standard admitted of certain management discretion, it added to investors' capacity to see the different elements of the business.

Twenty years later, in 1997, the Financial Accounting Standards Board revisited the question with a new accounting standard that framed segment disclosure in terms of the enterprise's internal organization. Among other features, a "segment" is a component of the enterprise "whose operating results are regularly reviewed by the enterprise's chief operating decisionmaker to make decisions about resources to be allocated to the segment and assess its performance"; in effect, a profit center approach. [333] The goal was to move away from the subjectivity of the industry approach, which had been gamed by some large firms that reported all their activities as occurring in one large industry. In contrast, the internal organization approach was designed to permit financial statement users "to see an enterprise "through the eyes of management[,]' [which] enhances a user's ability to predict actions or reactions of management that can significantly affect the enterprise's prospects for future cash flows." [334] The structure of Regulation S-K, which requires reporting in terms of "generally accepted accounting principles," automatically picked up this further elaboration of the segment reporting requirement. [335] The reformulated segment accounting standard, as incorporated into mandatory disclosure, provided new information to the market and thus made stock prices more informative. [336]

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[330] See id.; Daniel W. Collins, SEC Line-of-Business Reporting and Earnings Forecasts, 4 J. Bus. Res. 117 (1976). Compare Bertrand Horwitz & Richard Kolodny, Line of Business Reporting: A Rejoinder, 9 Bell J. Econ. 659 (1978) (viewing the effect negatively), with Richard R. Simonds & Daniel W. Collins, Line of Business Reporting and Security Prices: An Analysis of an SEC Disclosure Rule, 9 Bell J. Econ. 646 (1978) (rebutting Horwitz and Kolodny's argument). Among other things, Collins's 1975 study showed that differences in stock price movements between firms that did and did not voluntarily disclose segment data disappeared after 1970. See Collins, supra note 329.

[331] 2 Loss & Seligman, supra note 322, at 659 (quoting Sommer Report, supra note 325).

[332] See Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 14, Financial Reporting for Segments of a Business Enterprise P 100 (1976). The standard used a 10% threshold for revenues, profits (losses), and assets.

[333] Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 131, Disclosure About Segments of an Enterprise and Related Information P 10(b) (1997).

[334] Id. P 60.

[335] Reg. S-K, *17 C.F.R. §229.101(b) (2007)* (Financial Information About Segments). It is also noteworthy that Item 101 also requires financial information about geographic areas, another way to disaggregate overall results into national segments. Id. §229.101(d).

[336] See Bruce K. Behn et al., The Predictive Ability of Geographic Segment Disclosures by U.S. Companies: SFAS No. 131 vs. SFAS No. 14, 1 J. Int'l Acct. Res. 31 (2002) (using a sample of 172 of the largest 1000 firms and finding that the new standard led to more informative geographic sales data that increased reliability of forecasting models); Don Herrmann & Wayne B. Thomas, An Analysis of Segment Disclosures Under SFAS No. 131 and SFAS No. 14, 14 Acct. Horizons 287, 287 (2000) (finding that in a sample of 100 of the 250 largest U.S. firms under the new accounting standard, more firms reported segments and reported them in more detail; authors concluded that the change in reporting requirements had a "relatively significant impact on the disclosure of segment information"); Donna L. Street et al., Segment Disclosures Under SFAS No. 131: Has

[*1553] What bears underscoring about segment reporting, then, is that it makes available to the market information about the separate businesses within the firm that the firm itself has collected for internal management purposes. Seeing the information from management's perspective, investors can better measure the firm's past performance and can better predict the future. This makes stock prices more informative. Moreover, the various regulatory changes in segment reporting over the period made "external" segments (i.e., what is disclosed) more closely reflect the firm's "internal" segments. This increase in "congruency" made the resulting disclosure increasingly reliable throughout the period and thus enhanced informativeness. [337]

c. Management's discussion and analysis

In 1974, the SEC began to require a so-called "Management's Discussion and Analysis" (MD&A) to be added to disclosure documents to provide a narrative account of the financial results and, in particular, to provide a managerial perspective on material changes. Intially these changes were to be measured in quantitative terms. [338] In 1980, the SEC considerably broadened the MD&A requirement in response to criticisms of the quantitative test. The new full title is quite descriptive: "Management's Discussion and Analysis of Financial Condition and Results of Operations." [339] As the SEC later explained, "MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company." [340]

A major goal of the 1980 reformulation of MD&A was to advise investors how things might change, not just a retrospective account of why they did. Management was called upon to "identify known trends or uncertainties" that **[*1554]** could have material positive or negative results for any of earnings, liquidity or capital resources. In particular, MD&A was to "focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition." [341] Although historically the SEC had been quite skeptical of forward-looking information, [342] MD&A disclosure required firms to project "known trends or uncertainties" onto the company's future prospects. [343]

Although the MD&A formulation remained substantially unchanged in the 1980-2000 period, the SEC prodded firms at various times to provide richer accounts of prospective developments that could affect future performance. [344]

Business Segment Reporting Improved?, 14 Acct. Horizons 259 (2000) (finding that in a sample of 160 of the 1000 largest firms, fewer firms claimed to operate in one line- of-business, more segments were reported, and more detail was included in segment reports).

[337] Laureen A. Maines et al., Implications of Proposed Segment Reporting Standards for Financial Analysts' Investment Judgments, 35 J. Acct. Res. 1 (Supp. 1997).

[338] The quantitative threshold was non-trivial: a 10% change in revenues or expenses from the prior period coupled with a 2% change in net income. See Securities Act Release No. 5520, Exchange Act Release No. 10,961, ***39 Fed. Reg. 31,894*** (Sept. 3, 1974). This discussion follows 2 Loss & Seligman, supra note 322, at 688-98, and Fox et al., supra note 307, at 369-70.

[339] See Reg. S-K, *17 C.F.R. §229.303 (2007)*.

[340] Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No 6711, Exchange Act Release No. 24,356, 38 SEC Docket 145 (Apr. 17, 1987).

[341] Reg. S-K, *17 C.F.R. §229.303(a)*, Instruction 3 (2007).

[342] See infra Part IV.D.2.

[343] Reg. S-K, *17 C.F.R. §229.303(a)(3)(ii) (2007)*.

[344] See, e.g., Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6711, Exchange Act Release No. 24,356, 38 SEC Docket 145 (Apr. 17, 1987); Management's Discussion and Analysis of Financial Condition and Results of Certain Operations, Securities Act Release No. 6835, Exchange Act Release No. 26,831, Investment Company Act Release No. 16,961, 43 SEC Docket 1330 (May 18, 1989).

The Enron shock revealed the way that off-balance sheet and other contingent liabilities could affect future prospects (to put it mildly), and, in 2003 the SEC added substantial new requirements in this area to MD&A. [345]

The SEC's efforts to promote deeper discussion of the firm's financial statements are reflected in the growth of MD&A disclosure over the period. As Appendix Table 3 indicates, the average length of MD&A disclosure in Form 10-Ks among the sampled firms grew significantly, from two pages (1974, the original requirement) to four pages (1980, expanded version) to six pages (1990) to eleven pages (2000). The effect of the new post-Enron disclosure requirements and the generally heightened demand for a heads-up on risk factors was dramatic: average MD&A more than doubled to twenty-four pages (2004).

One important question is whether mandatory MD&A did in fact make stock prices more informative. Conceivably (if improbably) the information had been otherwise communicated to the market through indirect means. Fox et al. test the proposition with an application of the R2 methodology referred to above. In a before-after test of the effects of MD&A, they find that the new regime leads to earlier disclosure of information with earnings implications, meaning that the R2 for a group of firms expected to be slow disclosers is lower **[*1555]** after the new regulation. [346] This implies that post-MD&A, stock price changes derive less from market-wide movement and more from firm-specific factors. Such evidence supports the view that disclosure-forcing regulatory action can and did make stock prices more informative. [347]

2. Disclosure permitting

One of the most significant SEC actions with respect to stock price informativeness over the period was to permit the disclosure of "soft" or "forward-looking" information that many firms wanted to disclose (often because of investor and analyst pressure) but were constrained from doing so. [348] From the 1930s through 1973, the SEC prohibited the disclosure of earnings projections or other forward-looking information, at one point declaring that projections were per se misleading. [349] Multiple factors played a role in the SEC's position, including: an investor protection mindset framed in terms of the least sophisticated investor; an intellectual conservatism that mimicked the accountant's traditional reliance on historical information, in which the verifiability of figures trumped the possible utility of projections; and a cross-cutting belief that investors, given the "facts," were as competent as managers to make projections. [350] An influential 1970 article by Professor Homer Kripke, a one-time SEC staffer, rebutted these various concerns: managements, which were already generating such projections in internal decisionmaking, had immense advantages over investors in such forecasting. The efficient market would protect

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345 See Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Release No. 8182, Exchange Act Release No. 47,264, 79 SEC Docket 1251 (Jan. 28, 2003) (adding Regulation S-K Item 303(a)(4) ("Off-balance sheet arrangements") and Item 303(a)(5) ("Tabular disclosure of contractual obligations," which focuses on long-term financing contracts). These new MD&A requirements respond to the mandate in Section 401(a) of the Sarbanes-Oxley Act for enhanced disclosure in this area. Id.

346 See Fox et al., supra note 307, at 370-78 (using the period before implementation of the 1980 changes as the baseline).

347 Another important recent empirical test of mandatory disclosure's role in stock price informativeness is provided by Allen Ferrell, Mandated Disclosure and Stock Returns: Evidence from the Over-the-Counter Market (John M. Olin Ctr. for Law, Econ., and Bus., Harvard Law Sch., Discussion Paper No. 453, 2003), available at *http://ssrn.com/abstract=500123*. See also Michael Greenstone et al., Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments, 121 Q.J. Econ. 399 (2006).

348 In general, this account is based on John C. Coffee, Jr. & Joel Seligman, Securities Regulation: Cases and Materials 231-33 (9th ed. 2003); 2 Loss & Seligman, supra note 322, at 629-48; Mahoney, supra note 323, at 1105-07. See also Garry F. Goldring, Note, Mandatory Disclosure of Corporate Projections and the Goals of Securities Regulation, 81 Colum. L. Rev. 1525 (1981); Kimberly Till, Note, The SEC Safe Harbor for Forecasts - A Step in the Right Direction?, 1980 Duke L.J. 607.

349 See Securities Act Release No. 5699, Exchange Act Release No. 12,371, 9 SEC Docket 472 (Apr. 23, 1976) (withdrawing earlier statement relating to projections of future economic performance).

350 For a sense of the zeitgeist of the SEC staff, see Harry Heller, Disclosure Requirements Under Federal Securities Regulation, 16 Bus. Law. 300, 307 (1961).

unsophisticated investors against non-credible projections because of the role of analysts and sophisticated investors **[*1556]** in price formation. In any event, knowingly false projections were subject to SEC anti-fraud rules. [351]

In 1973, the SEC announced its intention to permit but not require disclosure of projections that met various criteria for reliability and general dissemination. [352] Therein lay the rub, because firms and their advisers were quite concerned about liability for projections that subsequently turned out otherwise. For almost five years and several iterations of proposals, the SEC struggled to produce a satisfactory "safe harbor rule," eventually succeeding in 1979. [353] Rule 175 provided that a "forward looking statement" is not a "fraudulent statement ... unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith." "Forward looking statement" was defined broadly to include projections of revenues and various financial items as well as earnings, and statements of management's "plans and objective for future operations." [354]

Notwithstanding the safe harbor protections and generally favorable judicial interpretations, [355] firms and their advisors became leery in light of attorney-driven shareholder plaintiff litigation in the 1990s and succeeded in including in the Private Securities Litigation Reform Act of 1995 ("PLSRA") statutory protection for forward looking information. [356] New section 27A of the 1933 Securities Act and new section 21E of the 1934 Act provide a safe harbor for a forward-looking statement that is identified as such and "is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." [357]

There is some uncertainty about firms' willingness to make forward-looking statements outside the mandatory provisions of MD&A. [358] For **[*1557]** example, some evidence suggests that as many as half of the firms in the high-tech area, where the prediction of future trends is particularly important, voluntarily provide forward-looking information. [359] But many practitioners believe that making projections entails unacceptable legal risk, given possible new duties to update a projection once made. [360] The PSLRA may have encouraged more firms to

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[351] Homer Kripke, The SEC, the Accountants, Some Myths and Some Realities, 45 N.Y.U. L. Rev. 1151, 1197-99 (1970).

[352] See Securities Act Release No. 5362, Exchange Act Release No. 9984, 1973 WL 149257 (Feb. 2, 1973) (describing prior history and intention to change in light of strong consensus reflected in public hearings and comments).

[353] See Securities Act Release No. 6084, Exchange Act Release No. 15,944, 1979 WL 181199 (June 25, 1979) (adopting rule 175, *17 C.F.R §230.175*).

[354] The parallel 1934 Act rule was Rule 3b-6.

[355] See Coffee & Seligman, supra note 348, at 232-33.

[356] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, §102, ***109 Stat. 737, 749*** (amending Securities Act of 1933 §27A, *15 U.S.C. §77z-2* (1994); Securities Exchange Act of 1934 §21E, *15 U.S.C. §78u-5* (1994)).

[357] Securities Act of 1933 §27A(c)(1)(A)(i), *15 U.S.C. §77z*- 2(c)(1)(A)(i) (2007); Securities Exchange Act of 1934 §21E(c)(1)(A)(i), *15 U.S.C. §78u*- 5(c)(1)(A)(i) (2007). The statutory safe harbor essentially brigades Rule 175 with the "bespeaks caution" approach of courts in construing the safe harbor in suits alleging securities fraud.

[358] Compare Marilyn F. Johnson et al., The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms, 39 J. Acct. Res. 297, 306-07 (2001) (before PSLRA, only 44% of sample of high tech firms made voluntary forward-looking disclosure; 50% made such disclosure after PSLRA), with David M. Levine & Adam C. Pritchard, The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws, *54 BUS. LAW. 1, 43 & n.219 (1998)* (citing trade association survey that found 17% of firms made voluntary forward-looking statements pre-PSLRA).

[359] See Johnson et al., supra note 358, at 306-07.

disclose projections and other forward-looking information. [361] In any event, disclosure-permitting regulation has made firms freer to provide forward-looking information across a broad domain of the firm's activity, which will make stock prices more informative.

3. Disclosure standardizing

Apart from the effect on the volume of disclosure from mandatory rules, SEC regulation played an important role in standardizing how disclosure was made. This too made stock prices more informative. Conceivably pressure from investors and analysts would have led firms to make more extensive disclosure over the period. Such voluntary disclosure would have itself made stock prices more informative. But SEC standardization made disclosure more valuable by reducing the information processing costs for analysts and investors of firm-specific information. Moreover, standardization made inter-firm comparisons easier as well. The consequence was information that was more quickly and completely impounded in stock prices.

E. Additional Disclosure Because of Accounting Pronouncements and Changes

Although the debates about the connection between mandatory disclosure and stock price informativeness have focused on SEC action, another important source of disclosure regulation has been the standard setting bodies of the accounting profession, the Financial Accounting Standards Board ("FASB") and its predecessors. [362] We have already seen the interaction of accounting **[*1558]** standards with SEC disclosure requirements in the case of segment reporting. In the first instance, the SEC promoted segment reporting and the accounting standard setters followed; subsequently, FASB tightened the standard and the SEC followed. In many other cases, however, the accounting standard setters were at the leading edge, in effect mandating additional disclosure with the adoption of new accounting standards. The dissolution of the Accounting Principles Board (APB) and its replacement by FASB in 1973 had two important consequences: first, an increase in the output of accounting standards; second, enhanced authoritativeness of the announced standard and less tolerance for deviations. These developments led to more disclosure and also greater standardization of existing and new disclosure requirements. In both respects, new accounting standards during the period enhanced the informativeness of stock prices.

This is not the place to canvass the myriad accounting standards changes over a fifty year period, but there are several examples that demonstrate the importance of new accounting standards as expanding the scope of mandatory disclosure and enhancing stock price informativeness. Four seem particularly noteworthy: first, APB No. 22, Disclosure of Accounting Policies, adopted in 1972; second, SFAS No. 52, Foreign Currency Translation, 1982; third, SFAS No. 95, Statement of Cash Flows, 1987; and fourth, SFAS No. 106, Employers' Accounting for Post-Retirement Benefits Other than Pensions, 1990.

1. APB No. 22, Disclosure of Accounting Policies (1972)

APB Opinion No. 22 mandates that "a description of all significant accounting policies of the reporting entity should be included as an integral part of the financial statements." [363] Frequently, accounting permits alternative

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[360] See, e.g., Harvey L. Pitt & Matt T. Morley, Through A Glass Starkly: A Practical Guide for Management's Forward-Looking Disclosures, Insights, June 1993, at 3; see also *Backman v. Polaroid Corp., 910 F.2d 10, 17 (1st Cir. 1990); In re Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1245 (3d Cir. 1989).*

[361] See Johnson et al., supra note 358, at 323 (finding evidence of "a significant post-Act increase in both the frequency of firms issuing forecasts and the mean number of forecasts issued . . . primarily attributable to managers issuing more long horizon forecasts of good news and short horizon forecasts of bad news"). But see Levine & Pritchard, supra note 358, at 46-48 (finding at best only a small change in frequency of voluntary forward-looking statements).

[362] For accounts of this succession and why FASB's predecessors were deemed inadequate, see Gilson & Black, supra note 248, at 578-586; 2 Loss & Seligman, supra note 322, at 733-51. On the SEC decision to privatize the setting of accounting standards despite its undoubted power to set them, see Coffee & Seligman, supra note 348, at 67 n.1. Professor Lawrence A. Cunningham was particularly helpful in identifying important accounting standards adopted over the period.

[363] Accounting Principles Bd., Opinion No. 22, Disclosure of Accounting Principles P 8 (1972).

presentations for a particular transaction or account. The opinion requires the firm to state which convention it is following, which avoids confusion in cases where alternatives exist and enhances comparability of data across firms. At least one contemporary study demonstrates the value of the opinion. In a before-after survey of 120 firms, Rao showed that before the adoption of APB No. 22, approximately 75% of firms disclosed common accounting policies, such as the conventions they followed for depreciation and amortization. After adoption, 97% did. [364] The opinion seems to have made disclosure more informative by reducing accounting confusion.

[*1559]

2. SFAS No. 52, Foreign Currency Translation (1982)

SFAS No. 52 addressed some of the failings of a predecessor accounting standard, SFAS No. 8 (1975), which was a first attempt to address systematically the accounting problems that arose in foreign operations. Unfortunately, SFAS No. 8 did not take a functional approach, meaning that "firms were compelled to report foreign currency gains and losses that bore little correspondence to the economic effects that they were actually experiencing." [365] SFAS No. 52 remedied this and provided better disclosure by requiring firms to measure the results of foreign operations in the foreign country's "functional currency," typically (but not always) the local currency. The translation technique of SFAS No. 8 had, in effect, required the U.S. dollar as the functional currency for all countries. Various contemporary studies suggest that the change enriched the information environment. [366]

3. SFAS No. 95, Statement of Cash Flows (1987)

SFAS No. 95 responded to a change in valuation methodology associated with the leveraged buyouts of the 1980s, namely, a focus on cash flow as opposed to accounting earnings as a critical measure of enterprise value, on the view that cash flow was less distorted by accounting conventions. Investors and other users of financial statements wanted better and more standardized measures of cash flow. SFAS No. 95, which required cash flow reporting, replaced APB Opinion No. 19, Reporting Changes in Financial Position, 1971, which had required instead a "change in financial position" under a formula that could be confused with a cash flow measure. [367]

The informativeness of earnings and cash flow has been a major topic in the accounting literature, which investigates the information content ("value relevancy") of a profitability indicator by measuring its association with returns. Earnings are demonstrably a primary indicator; whether cash flow **[*1560]** disclosure provided additional information was an open question. [368] Before SFAS No. 95, most studies reported mixed results. But after SFAS No. 95, the results of cash flow studies sharply changed; there appears to be no doubt that cash flow disclosure as required by SFAS No. 95 enhances stock price informativeness. [369] Cash flows are particularly informative when

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[364] Kailis J. Rao, An Evaluation and Empirical Study of the Disclosure of Accounting Policies in Published Financial Statements, 30 J. Fin. 1160, 1160 (1975).

[365] Lawrence Revsine, The Rationale Underlying the Functional Currency Choice, 59 Acct. Rev. 505, 505 (1984).

[366] See, e.g., Billy S. Soo & Lisa Gilbert Soo, Accounting for the Multinational Firm: Is the Translation Process Valued by the Stock Market?, 69 Acct. Rev. 617 (1994) (examining market incorporated foreign translation gain and loss information reported in stockholders' equity under SFAS 52 when valuing equity securities); David A. Ziebart & David H. Kim, An Examination of the Market Reactions Associated with SFAS No. 8 and SFAS No. 52, 62 Acct. Rev. 343 (1987) (showing event studies found positive market response upon adoption of SFAS No. 52, but negative response upon adoption of SFAS No. 8 and interim FASB decisions postponing final action).

[367] APB Opinion No. 19 was an apparently unsuccessful attempt to improve on a 1963 predecessor, APB Opinion No. 3, The Statement of Source and Application of Funds. See Earl A. Spiller & Robert L. Virgil, Effectiveness of APB Opinion No. 19 in Improving Funds Reporting, 12 J. Acct. Res. 112 (1974) (presenting a before-after study of 143 firms and concluding that the new opinion did not substantially improve on APB Opinion No. 3).

[368] See generally Ashiq Ali, The Incremental Information Content of Earnings, Working Capital from Operations, and Cash Flows, 32 J. Acct. Res. 61 (1994).

the firm reports outlier earnings (meaning out of line with prior years and thus not likely to persist), [370] for firms that are cash-dependent because of high leverage or shorter operating cycles, [371] and for firms where earnings management [372] or fraud [373] is a risk.

4. SFAS No. 106, Employers' Accounting for Post-Retirement Benefits Other than Pensions (1990)

Before SFAS No. 106, employers accounted for post-retirement benefits on a cash basis. An actual payout produced an expense, meaning "pay as you go." SFAS No. 106 requires firms to account for post-retirement benefits on an accrual basis, meaning expensed over the life of an employment contract, not on a cash basis. For a young employee hired today, a firm must accrue - meaning take as a charge to earnings - an actuarially determined amount reflective of future post-retirement benefits, even though there is no current cash payment. (SFAS No. 106 also mandates extensive disclosure about pension plan funding and payment projections.) The accounting standard requires companies to account for distant post-retirement obligations (like retiree health care benefits) that in many cases were grossly under-funded, [374] **[*1561]** made perhaps cavalierly without full appreciation of the ultimate liability, [375] and which were poorly disclosed to investors. [376]

There appears to be general agreement that this post-retirement benefit disclosure mandated by the new accounting standard added to the informational landscape and led to more fine-grained evaluation by investors. [377] It certainly had a powerful effect on observed behavior by firms, triggering wide-scale cutbacks in post-retirement health benefits in anticipation of the 1993 effective date. [378] Presumably managers believed that shareholders would take account of the earnings impact of a non-cash accrual, reflecting, as it did, a genuine future liability.

In sum, what these examples show is that throughout the 1950-2004 period, particularly in the post-1970 period, the FASB's accounting standard setting process has added to the informativeness of stock prices by requiring more disclosure and by limiting the variations in the presentation of similar information.

F. Other Factors Enhancing the Informativeness of Stock Prices

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369 See, e.g., C.S. Agnes Cheng et al., Earnings Permanence and the Incremental Information Content of Cash Flows from Operations, 34 J. Acct. Res. 173 (1996).

370 C.S. Agnes Cheng & Simon S.M. Yang, The Incremental Information Content of Earnings and Cash Flows from Operations Affected by Their Extremity, 30 J. Bus Fin. & Acct. 73 (2003) (finding that cash flow disclosure has mixed impact on firm valuation, with greatest impact when earnings are high and cash flows are moderate).

371 Mark DeFond & Mingyi Hung, An Empirical Analysis of Analysts' Cash Flow Forecasts (Univ. S. Cal. Leventhal Sch. of Accounting Working Paper, 2001), available at http://ssrn.com/abstract=265773.

372 Paul M. Healy & James M. Wahlen, A Review of the Earnings Management Literature and Its Implications for Standard Setting, 13 Acct. Horizons 365 (1999).

373 Thomas A. Lee et al., The Difference Between Earnings and Operating Cash Flow as an Indicator of Financial Reporting Fraud, 16 Contemp. Acct. Res. 749 (1999).

374 Eli Amir, The Market Valuation of Accounting Information: The Case of Postretirement Benefits Other than Pensions, 68 Acct. Rev. 703 (1993).

375 Fin. Accounting Standards Bd., Statement of Financial Accounting Standards (SFAS) No. 106, Employers'Accounting for Postretirement Benefits Other than Pensions P P 124-26 (1990).

376 Id.

377 See, e.g., Amir, supra note 374. Eli Amir, The Effect of Accounting Aggregation on the Value-Relevance of Financial Disclosures: The Case of SFAS No. 106, 71 Acct. Rev. 573 (1996); Paquita Y. Davis-Friday et al., The Value Relevance of Financial Statement Recognition vs. Disclosure: Evidence from SFAS No. 106, 74 Acct. Rev. 403 (1999).

378 See Jensen & Murphy, supra note 263.

Several other additional factors also have made stock prices more informative over the period, including an increase in the number of analysts and other investment professionals, the rise of mutual funds and other institutional investors with sufficient scale to undertake securities research, and information technology and information dissemination mechanisms that lower the cost of securities research. For example, membership in the Financial Analysts Federation, the national association of securities analysts, grew from approximately 2400 in 1950 to approximately 11,750 in 1967. [379] By 2000, the successor organization, the CFA Institute, [380] had approximately 38,500 North American members (45,750 worldwide), [381] and in 2005, more than 70,000 **[*1562]** members worldwide. [382] There are simply many more people devoting their careers to assessing firm valuations.

This rise in the number of security analysts is linked on the demand side to the increasing stake of financial intermediaries that invest in sufficient scale to make economical use of securities research. The value of institutional ownership increased dramatically during the period. As Appendix Table 4 indicates, institutional investors owned domestic equities valued at a mere $ 12 billion in 1950 (approximately 9% of the U.S. domestic equity market capitalization) and only $ 56 billion in 1960 (14%). Over the remainder of the period, institutional investor ownership skyrocketed, both in absolute terms and as a fraction of the market value of U.S. domestic equity. As of 2004, institutions owned $ 9.6 trillion in equity, representing 68% of the market value of U.S. firms. [383] With these sums at stake, the competitive focus on firm-specific information has become ever more intense.

The growth and spread of information technology has expanded access to firm-specific data, lowering the cost of securities research and increasing the informativeness of stock prices. Originally SEC documents were made available at the SEC's offices in Washington, and lawyers of a certain vintage can remember a booming trade in services that would physically copy documents using increasingly better copying technology for shipment to users, or, in urgent cases, for reading over the telephone of crucial provisions. Beginning in the mid-1980s, and required in the 1990s, companies made electronic filings with the SEC's EDGAR system (for "Electronic Data Gathering, Analysis, and Retrieval"). [384] Initially private firms, like Disclosure, Inc., compiled databases of this information for resale, but as the internet became increasingly robust in the 1990s, highly detailed, firm-specific information became available to all at virtually no cost, and the proprietary databases became ever more sophisticated in their flexibility of data presentation and manipulation. The rise of the computer, then the personal computer, drastically reduced the cost of information processing, which fostered cross-sectional and time-series analysis of a firm's performance. [385] As costs fell, sophisticated information gathering and analysis became increasingly "democratized"; institutional investors were no longer the only ones with these **[*1563]** capabilities. All of these factors contributed to the informativeness of stock prices over the period.

Conclusion: A New Corporate Governance Paradigm

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[379] 2 Loss & Seligman, supra note 322, at 609 (citing 1969 Wheat Report).

[380] The CFA Institute is the new name of the Association for Investment Management and Research, which was created in the 1990 merger of the Financial Analysts Federation and the Institute of Chartered Financial Analysts. See CFA Inst., History of CFA Institute, *http://www.cfainstitute.org/aboutus/overview/history.html*.

[381] See Ass'n for Investment Mgmt. & Res., 2002 Annual Report: Placing Investors First 40 (2002), available at *http://www.cfainstitute.org/aboutus/reports/pdf/ar2002.pdf*.

[382] See Ass'n for Investment Mgmt. and Res., 2005 Annual Report: Serving the Global Investment Community 27 (2005), available at *http://www.cfainstitute.org/aboutus/reports/pdf/cfa* ar final.pdf.

[383] Compiled from Federal Reserve System, Flow of Funds, Table L213 (compilation provided by Bogle Financial Markets Research Center, on file with author).

[384] Sec. & Exch. Comm'n, Important Information About EDGAR (Feb. 3, 2005), *http://www.sec.gov/edgar/aboutedgar.htm*; see Donald C. Langevoort, Information Technology and the Structure of Securities Regulation,*98 Harv. L. Rev. 747, 758 n.41 (1985).*

[385] Langevoort, supra note 384, at 757-59.

This Article starts with a puzzle. There is a powerful trend in favor of independent directors for public firms in the United States, yet the empirical evidence adduced thus far gives us no convincing explanation. The Article suggests that this trend reflects two interrelated developments in the U.S. political economy. First is the shift to shareholder value as the primary corporate objective; the second is the greater informativeness of stock market prices. The overriding effect is to commit the firm to a shareholder wealth-maximizing strategy as best measured by stock price performance. Stock prices are taken as the measure of most things. In this environment, independent directors are more valuable than insiders. They are less committed to management and its vision. Instead, they look to outside performance signals and are less captured by the internal perspective, which, as stock prices become more informative, becomes less valuable. They can be more readily mobilized by legal standards to help provide the public goods of more accurate disclosure and better compliance with law. In this way, independent directors are an essential part of a new corporate governance paradigm. In the United States, independent directors have become a complementary institution to an economy of firms directed to maximize shareholder value. Thus, the rise of independent directors, a very important change in the political economy landscape, should be evaluated in terms of this overall conception of how to maximize social welfare.

Although this new paradigm is bound up with the use of stock market signals in the monitoring of managers, including the evaluation of management's strategic choices, it also opens up space for a distinctive role for the independent board: deciding when prevailing prices misvalue the firm and its strategies. In light of imperfectly efficient capital markets, such a role may be efficiency-based rather than an ineradicable residue of agency costs. For a particular firm, a disfavored strategy may in fact maximize shareholder value over a reasonable time horizon. If the market got it wrong, rejecting its signals may lead to putting the firm's assets to highest and best use. But the most significant efficiency gains (or losses) are systematic: idiosyncratic decisions of an independent board may keep a particular subsector of the economy from converging too rapidly on today's conventional wisdom.

The board's role in this regard is most vividly expressed in the case of an unwanted takeover bid, which, if the board resists, will ultimately be decided through an election contest rather than an immediate market test, under current Delaware law. Presumably the shareholders who would (almost always) accept a premium tender offer would (almost always) vote for directors who would be receptive to the premium offer. The differences between the two mechanisms **[*1564]** of acceptance are transaction costs and time. On the imperfectly efficient markets view, this small dose of sand in the gears may give markets the opportunity to test predictions of how to create value before the prescription has been universally applied. Some frictions may be efficient. Note that this element of the new paradigm is not inconsistent with maximizing shareholder value; it merely imagines a somewhat longer horizon for its realization than today's stock price.

One open question is whether the independent board has even this independence from the stock market. Before, barring the arrival of a hostile bidder, the board had substantial insulation from shareholder pressure. The costs of maintaining a proxy contest interacted with the collective action problems of diffuse share ownership to produce this result. After the advent of hostile takeovers, the adoption of the pill reinvigorated the board's importance. Now, however, as institutional ownership approaches 70% of the market and activist shareholders have learned to coordinate their activities without triggering either the notice obligations of the federal securities laws or the target's poison pill, independent boards have much less space to protect an idiosyncratic strategy. The apogee of a corporate governance paradigm resting on independent directors and the independent board may also mark the moment of its decline.

[*1565]

Appendix

Table 1. Board Composition, 1950-2004

Year	Inside (%)	Affiliated (%)	Independent (%)

Table 1. Board Composition, 1950-2004

Year	Inside (%)	Affiliated (%)	Independent (%)
1950a	49	26	22
1955b	47	30	23
1960b	43	31	24
1965b	42	33	25
1970b	41	34	25
1970c	58	21	21
1970d	54	26	20
1971e	49	13	38
1975f	39	31	30
1977g	35	29	36
1980f	33	30	37
1980d	43	26	31
1983e	34	12	54
1985f	30	31	39
1990h	26	14	60
1991i	26	14	60
1995j	21	15	64
1997k	19	15	66
2000k	18	15	67
2000l	16	15	69
2003m	16	11	73
2004n	16	11	73
2005n	15	11	74

a Lehn et al., supra note 8. The breakdown of outside directors is based on the 1970 breakdown in Baysinger & Butler, supra note 15 (based on proxy statement analysis of 266 large firms); accord *Smith, supra* note 10, at 48 (based on estimate of affiliates and independents on "typical" board). The Baysinger and Butler 1970 breakdown, in which approximately 43% of the outsiders are "independent," is applied to the 1950-1970 period as a conservative assumption. There is some anecdotal suggestion that genuine independents were even rarer before 1970. See Baysinger & Butler, supra note 15, at 103 n.2 (citing sources).

b Lehn et al., supra note 8.

c *Smith, supra* note 10.

d Baysinger & Butler, supra note 15, at 113 (reporting the board composition of large public firms in 1970 and 1980, and finding that the boards of 266 firms from Forbes list existed in substantially the same form in both 1970 and 1980).

e Hermalin & Weisbach, supra note 16, at 593 (reporting the board composition of 288 NYSE-traded firms with available information over the 1971-1983 period).

f Lehn et al., supra note 8. The breakdown of outside directors is based on SEC Staff Report, supra note 11, which, for 1200 major firms surveyed in 1978-1979, classified 55% of outside directors as independent.

g SEC Staff Report, supra note 11, at 598 tbl.2 (surveying 1200 major firms drawn from NYSE, Amex, Nasdaq, and OTC, in 1978-1979).

[*1566] h Lehn et al., supra note 8. The breakdown of outside directors is based on Bhagat & Black, supra note 17, at 245 tbl.1, which, for 934 large firms included in the Institutional Shareholder Services database in 1991, classified 81% of outside directors as independent.

i Bhagat & Black, supra note 17, at 245 tbl.1 (934 large firms in the Institutional Investor Services database). This is consistent with the multi-year composites of Nikos Vafeas, Board Meeting Frequency and Firm Performance, 53 J. Fin. Econ. 113, 121 tbl.1 (1999) (307 firms in Fortune 500 over 1990-1994 period: 28% insider, 19% affiliated, and 53% independent), and David Yermack, Higher Market Valuation of Companies with a Small Board of Directors, 40 J. Fin. Econ. 185, 191 tbl.1 (1996) (452 Fortune 500 firms over 1984-1991 period: 36% insider, 10% affiliated, 54% independent).

j Lehn et al, supra note 8. The breakdown of outside directors is based on Vidhi Chhaochharia & Yaniv Grinstein, The Transformation of U.S. Corporate Boards: 1997-2003, at 36-42 tbls.1-2, panel B (May 2004) (unpublished manuscript), available at http://ssrn.com/abstract=556270 (showing that in 1997, firms in the S&P 500 classified 81% of outside directors as independent).

k Chhaochharia & Grinstein, supra note j, at 36-42 tbls.1-2, panel B. This is consistent with Ivan E. Brick & N.K. Chidambaran, Board Monitoring and Firm Risk 12, 20 (EFA 2005 Moscow Meetings Paper, July 2005), available at http://ssrn.com/abstract=677123 (approximately 2841 firms in 1997-2001 from IRRC and Corporate Library universe).

l Lehn et al, supra note 8. The breakdown of outside directors based on Chhaochharia & Grinstein, supra note j, at 36-42 tbls.1-2, panel B.

m Chhaochharia & Grinstein, supra note j, at 36-42 tbls.1-2, panel B. Brick & Chidambaran, supra note k, report the percentage of non-insider directors for 2001 as 82%.

n Investor Responsibility Research Center (now Institutional Shareholder Services), S&P 500 Corporate Governance Database (accessed through Wharton Research Data Services).

[*1567]

Table 2. Increases in Disclosure, 1950-2004 (Form 10K and Components)

Date	Total 10-K Pages	Financials Pages	Notes Number	Notes Pages
1951	15.71	4.41	5.2	1.2
1955	17.37	4.26	6.22	1.26
1960	18.37	4.47	6.68	1.34
1965	19.42	4.47	6.89	1.26
1970	40.56	10.17	12.67	6.22
1975	61.53	13.16	14.47	9.26
1980	74.7	13.95	17.2	9.85
1985	75.15	12	16.95	8.4
1990	88.6	13.55	18.6	9.73
1995	105.75	19.15	19.15	14.75
2000	126.1	23.2	19.15	18.7
2004	166.25	38.15	19.85	33.3

Source: Average page counts (means) of Form 10-Ks and components compiled at five-year intervals for a sample (n=20) of Fortune 500 firms that continuously made public disclosure over the period (universe=77). Once the firm is drawn by a random process, its Form 10-Ks are tracked throughout the period. Not every firm has data for every year. "Financials pages" includes footnote pages. Medians were checked as well as means; the results are qualitatively unchanged. There is no adjustment for firm size other than continuous inclusion in the Fortune 500.

Table 3. Increases in Management's Discussion and Analysis, 1974-2004

	1974	**1975**	**1980**	**1985**	**1990**	**1995**	**2000**	**2004**
MD&A Pages	1.88	2.61	3.5	4.45	5.85	8.8	10.6	24.05

Source: Average page counts (means) of Management's Discussion and Analysis compiled at approximately five-year intervals beginning in 1974 for a sample (n=20) of Fortune 500 firms that continuously made public disclosure over the 1955-2004 period (universe=77). Once the firm is drawn by a random process, its MD&A is tracked throughout the period. Medians were checked as well as means; the results are qualitatively unchanged. There is no adjustment for firm size other than continuous inclusion in the Fortune 500.

[*1568]

Table 4. Institutional Ownership of U.S. Public Equities, 1950-2004

Year	**Institutional Ownership (Billions of U.S. Dollars)**	**Institutional Ownership (Fraction of U.S. Market Cap)**
1950	$ 12	9%
1955	$ 30	11%
1960	$ 56	14%
1965	$ 115	16%
1970	$ 266	33%
1975	$ 345	43%
1980	$ 599	42%
1985	$ 1183	55%
1990	$ 1713	53%
1995	$ 4201	56%
2000	$ 8874	58%
2004	$ 9632	68%

Source: Compilation provided by the Bogle Financial Markets Research Center based on Federal Reserve System, Flow of Funds, Table L213 (on file with author). Figures are in nominal dollars.

Figure 6. Growth of Institutional Ownership of U.S. Public Equities

[SEE FIGURE 6 IN ORIGINAL]

Source: Compilation provided by the Bogle Financial Markets Research Center based on Federal Reserve System, Flow of Funds, Table L213 (on file with author). This graph vividly illustrates the increasing growth of institutional ownership, both in absolute amount (billions of dollars on the right axis) and as a percentage of publicly traded stock of U.S. firms (on the left axis). See supra note 255.

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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Maxus Ch. 11 Plan Confirmed With Support From Creditors

By **Vince Sullivan**

Law360, Wilmington (May 22, 2017, 6:42 PM EDT) -- Bankrupt oil and gas firm Maxus Energy Corp. received court approval Monday in Delaware for its Chapter 11 plan of liquidation after reaching consensus with its creditors to create three post-bankruptcy trusts to administer its assets.

During a confirmation hearing in Wilmington, attorneys for Maxus told the court the debtor realized about three months ago that creditors were not pleased with a planned settlement with Maxus parent company YPF SA and began pursuing an alternate path. The plan confirmed Monday preserves claims against YPF for the benefit of its creditors.

"I'd like to suggest that was not an about face, not a reversal of feel, but rather the exercise of informed judgment by the independent directors in active discussion with creditor representatives," Maxus attorney James M. Peck of Morrison & Foerster LLP said. "It became crystal clear as a consequence of interaction with the creditors committee… that there was extreme hostility on the part of creditor representatives to the proposed settlement with YPF."

Beginning in March, Peck said the approach changed and resulted in the largely consensual plan that enjoys the support of more than 99 percent of the company's creditors. Initially, the debtor proposed a far-reaching settlement that would release YPF from claims related to environmental remediation at a site near New Jersey's Passaic River in exchange for a $130 million payment for cleanup costs, plus bankruptcy and exit financing packages.

Maxus switched horses earlier this year when it became clear that the YPF settlement would lead to costly opposition from essentially every creditor constituency.

Under the confirmed plan, a litigation trust will be created for the benefit of creditors, including the federal agencies tasked with performing cleanup duties, that is expected to garner proceeds far in excess of the $130 million proposed in the original settlement. An environmental remediation and restoration trust will also be created under the plan that will be the instrument by which creditors can recover for their out-of-pocket cleanup costs at other sites.

A third trust to administer the debtor's property will be created under the plan to sell the debtor's properties as needed once the company exits bankruptcy.

All but two of the seven objections lodged against the plan were resolved or withdrawn ahead of Monday's hearing. Opposition from the Passaic River Sewage Commission was overruled after testimony from the debtor's noticing agent regarding creditor balloting.

The United States trustee raised concerns about exculpation provisions included in the plan for the benefit of the trustee's and oversight groups that will run the three post-bankruptcy trusts, which the watchdog thought were excessive and unwarranted.

An attorney for the official committee of unsecured creditors, Adam C. Harris of Schulte Roth & Zabel LLP, told the court the exculpation provisions are becoming commonplace in many trusts of this nature in order to give people added comfort before taking on roles with these trusts.

"It has become customary for corporate trust departments to put this language in there to induce parties to serve in these capacities," Harris said.

Trustee's representative Linda Casey said that similar trusts don't grant the same protection in other instances and that these exculpation provisions are new.

"It's a very recent change to add these to the public trust documents," Casey said. " Chapter 7 trustees with the same sort of obligations don't have these kinds of exculpations."

U.S. Bankruptcy Judge Christopher S. Sontchi overrule the objection but noted that the specific circumstances of this case and the breadth and difficulty of the work to be done by the trustees post-bankruptcy justifies the exculpation.

"It's an interesting question and one I don't think I've seen before in the context of one of these trusts, which of course makes me wary because it's either that I'm missing it, it hasn't been raised or it's new," Judge Sontchi said. "Given the difficulty associated with this trust pursuing what it's got to do and the less than convivial relationship among certain of the creditor groups I think it's appropriate in this case so I'll overrule the objection."

Before Judge Sontchi confirmed the plan, Peck offered comment on the course of the case and how much progress had been made in the last 90 days when the debtor shifted gears.

"The last 90 days of the case has been one of remarkable collaboration that brings me to the point of asking the court to enter a form of order confirming our plan as jointly proposed with the creditors committee," Peck said.

Judge Sontchi said he was pleased to confirm the plan after what he called "a difficult case."

Maxus filed for Chapter 11 protection in nearly a year ago, with the deal with its parent in hand that also provided $63 million in post-petition financing, days before it was supposed to go to trial with Occidental Chemical Corp. over which company was responsible for paying part of the remediation cost connected to dumping in the Passaic River decades ago.

Maxus had spun off its chemical subsidiary to Occidental in 1986 but agreed to hold onto its liability for certain contamination predating the sale.

New Jersey sued Occidental, YPF, Maxus and others in 2005, accusing them of violating the state's Spill Compensation and Control Act by dumping TCDD, a toxic chemical component of Agent Orange, and other hazardous substances into the Passaic River, which then spread into other bodies of water.

Maxus is represented by M. Blake Cleary, Joseph M. Barry, Justin P. Duda and Travis G. Buchanan of Young Conaway Stargatt & Taylor LLP, and James M. Peck, Lorenzo Marinuzzi, Jennifer L. Marines and Jordan A. Wishnew of Morrison & Foerster LLP.

The committee is represented by Norman L. Pernick and J. Kate Stickles of Cole Schotz PC, and Adam C. Harris, David M. Hillman and Lucy F. Kweskin of Schulte Roth & Zabel LLP.

The case is In re: Maxus Energy Corp. et al., case number 1:16-bk-11501, in the U.S. Bankruptcy Court for the District of Delaware.

--Additional reporting by Matt Chiappardi and Jeff Montgomery. Editing by Joe Phalon.

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AKIN GUMP STRAUSS HAUER & FELD LLP
Daniel H. Golden
Arik Preis
David M. Zensky
Mitchell P. Hurley
One Bryant Park
New York, New York 10036
Telephone: (212) 872-1000
Facsimile: (212) 872-1002
dgolden@akingump.com
apreis@akingump.com
dzensky@akingump.com
mhurley@akingump.com

Counsel to the Official Committee of Unsecured Creditors of Nine West Holdings Inc., et al.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	)	Chapter 11
NINE WEST HOLDINGS, INC., *et al.*,[1]	)	Case No. 18-10947 (SCC)
Debtors.	)	(Jointly Administered)

MOTION OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS FOR ENTRY OF AN ORDER GRANTING LEAVE, STANDING, AND AUTHORITY TO COMMENCE AND PROSECUTE CERTAIN CLAIMS ON BEHALF OF THE NWHI ESTATE AND EXCLUSIVE SETTLEMENT AUTHORITY IN RESPECT OF SUCH CLAIMS

[1] The Debtors in these chapter 11 cases, along with the last four digits of each Debtor's federal tax identification number, are: Nine West Holdings, Inc. (7645); Jasper Parent LLC (4157); Nine West Management Service LLC (4508); Kasper Group LLC (7906); Kasper U.S. Blocker LLC (2390); Nine West Apparel Holdings LLC (3348); Nine West Development LLC (2089); Nine West Distribution LLC (3029); Nine West Jeanswear Holding LLC (7263); One Jeanswear Group Inc. (0179); and US KIC Top Hat LLC (3076). The location of the Debtors' service address is: 1411 Broadway, New York, New York 10018.

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TO THE HONORABLE SHELLEY C. CHAPMAN
UNITED STATES BANKRUPTCY JUDGE:

The Official Committee of Unsecured Creditors (the "Committee") of the above-captioned debtors and debtors-in-possession in these chapter 11 cases (collectively, the "Debtors") hereby submits this motion (the "Motion"), by and through its undersigned counsel, for entry of an order, pursuant to §§ 105(a), 1103(c), and 1109(b) of 11 U.S.C. § 101 *et seq.* (as amended, the "Bankruptcy Code"), in substantially the form attached hereto as Exhibit A[2] (the "Proposed Order") granting the Committee (A) leave, standing, and authority to commence and prosecute certain claims, as set forth in more detail in the draft complaint attached hereto as Exhibit B (the "Proposed Complaint"), on behalf of the estate of Debtor Nine West Holdings, Inc. ("NWHI")[3] against (i) Sycamore Management Partners L.P., Sycamore Partners, L.P., Sycamore Partners A., L.P., Sycamore Partners Management, L.L.C., Sycamore Fund I, and other Sycamore affiliates, the names of which are currently unknown to the Committee (collectively, the "Sycamore Fund Entities"); (ii) Jasper Apparel LLC ("Jasper Apparel"), Jasper Footwear Limited ("Jasper Footwear"), and Jasper SW LLC ("Jasper SW," and collectively with Jasper Apparel and Jasper Footwear the "Sycamore Affiliates"); (iii) Stefan Kaluzny and Peter Morrow, cofounders and principals of Sycamore, and directors of NWHI, in their individual capacities (the "Sycamore Principals"); (iv) Sycamore employees Ryan McClendon, Adam Weinberger, Dary Kopelioff, and other unknown Sycamore employees who participated in the conduct alleged in the Proposed Complaint (collectively, the "Sycamore Employees," and collectively with the Sycamore Fund Entities and the Sycamore Principals, "Sycamore"); (v)

[2] "Exhibits" refer to the exhibits attached to the accompanying Declaration of Daniel H. Golden in Support of the Motion ("Golden Decl."), filed concurrently herewith.

[3] The Committee continues to investigate the Proposed Claims (defined below), and may add other Debtors as plaintiffs in the final complaint as may be necessary or appropriate.

John T. McClain ("McClain"), the former Chief Financial Officer of Jones Group Inc. ("Jones Inc.") and former director of NWHI; (vi) the former directors of Jones Inc. (the "Jones Inc. Directors," and together with Sycamore, the Sycamore Affiliates and McClain, the "Third Party Defendants"); and (vii) Cortland Capital Market Services, LLC ("Cortland"), GLAS Trust Company, LLC ("GLAS"), Wells Fargo Bank, National Association ("Wells Fargo"), and John/Jane Roes 1-100, lenders under the Secured Term Loan, Unsecured Term Loan, and ABL Facility[4] ("Roes," and collectively with Cortland GLAS, and Wells Fargo, the "Lender Defendants") (the foregoing A(i)-(vii) are collectively referred to herein as the "Defendants"); and (B) sole authority to compromise and settle the Proposed Claims on behalf of the NWHI estate.[5] In support of this Motion, the Committee respectfully represents as follows.

PRELIMINARY STATEMENT

1. The Committee seeks leave to prosecute fraudulent transfer and other claims for well over $1 billion (the "Proposed Claims") – excluding pre-judgment interest of about $350 million (and growing) – that Debtor Nine West Holdings, Inc. ("NWHI") has unjustifiably refused to assert against Sycamore and other potential defendants.

2. For a few days, it appeared this Motion might be unnecessary. As the Court is aware, two major unsecured creditor groups – the unsecured term lenders and the holders of unsecured notes due in 2019 and 2034 – believed they had resolved their internecine disputes in favor of a plan that could garner the support of all creditors and the Debtors. Under the creditors' proposed plan, all of the Debtors' secured lenders would be paid in full, in cash, the unsecured term lenders would receive 92.5% of the equity of the reorganized debtors plus $40

[4] To the extent necessary, conflicts counsel appearing herein will file a separate complaint and prosecute claims with respect to recovery interest against individual lenders.

[5] NWHI also has valuable claims against other parties, such as NWHI's former shareholders prior to the LBO and Carve-Out Transactions (defined below). The Committee reserves all rights in respect to such claims.

million in cash, and NWHI's valuable claims against Sycamore would be placed in a litigation trust for prosecution post-emergence. The litigation trust proceeds would supply the vast majority of recoveries for NWHI's bondholders and trade creditors. Creditor representatives put the terms of the proposed plan on the record at a hearing before this Court on September 26, 2018.

3. The settlement plan reached by these creditors – calling for plenary litigation of the $1 billion-plus claims against Sycamore – was exactly the type of outcome Sycamore was desperate to avoid. Indeed, for months beforehand, Sycamore sought to coerce the Debtors into releasing the claims against Sycamore on the cheap by threatening to cause another Sycamore portfolio company – a chain of department stores called Belk – to end its profitable relationship with NWHI, unless NWHI agreed to release its claims against Sycamore for a fraction of their value.

4. Sycamore's threats were not rational. Among other things, Sycamore and its two founders – Stefan Kaluzny and Peter Morrow – are and/or were fiduciaries to both Sycamore and Belk, and could only multiply their already massive litigation exposure by interfering – out of spite – with NWHI's business relations with Belk, in rank violation of their fiduciary and other duties to both entities, and the Bankruptcy Code's automatic stay.

5. Once the consensual creditor plan was announced, however, Sycamore's wrath at being disobeyed apparently overcame its reason. Just hours after the creditors put their deal-in-principle on the record before this Court, Defendant Kaluzny retaliated by sending the following letter to NWHI (which was forwarded to the Committee by Kirkland & Ellis LLP ("Kirkland") at 6:57 p.m. on September 26, 2018):

> I have directed Belk to immediately cease purchasing any products from Nine West Holdings, including, where practicable, cancelling any undelivered purchase orders. Belk will no longer do business with Nine West Holdings.

6. As a result, Belk has stopped doing business with NWHI. Sycamore and its principals and investors will be fully liable for the damage Sycamore inflicts on NWHI by interfering with the Belk relationship, and will be required to restore any lost value, and then some, to the estate and its creditors.[6] Nevertheless, Sycamore's bullying misconduct has driven a wedge between the unsecured creditor constituencies, who have not yet been able to finalize the bargain their counsel described in open court on September 26, 2018, due in large part to the unsecured term lenders' concerns about the potential loss of the Belk business.

7. Worse, the Committee understands that the Debtors are likely to release the claims against Sycamore for a small fraction of their value, before even filing a complaint detailing those claims. The Debtors have barred the Committee from participating in its settlement negotiations with Sycamore, so the Committee knows only the range of settlement consideration under discussion. A settlement even at the top end of that range would represent but a small fraction of the value of the claims against Sycamore, would constitute a breach of the Debtors' fiduciary duties, and would be manifestly contrary to the interests of NWHI and its creditors. Until those claims are firmly in the control of a determined and truly independent adversary – the Committee – Sycamore will continue to toy with the parties and the bankruptcy process itself in its desperate attempt to avoid answering for its myriad pre-petition wrongs and breaches of duty to NWHI.

8. And there can be no doubt that the Proposed Claims are orders of magnitude more valuable than the range of settlement under discussion between the Debtors and Sycamore. As

[6] For the avoidance of doubt, the Committee does not seek to bring any claims against Belk itself, but only Belk's overlords at Sycamore, whose conduct (principally designed to harm the Debtors) likely also will harm Belk.

detailed in the accompanying Proposed Complaint (see Exhibit B), the majority of the Proposed Claims arise out of a leveraged buyout of Jones Inc. (the "LBO") engineered by Sycamore, a private equity fund with about $10 billion under management.[7] Sycamore designed the transaction to unfairly deflect the risk of the LBO from Sycamore to NWHI's creditors, who shared none of Sycamore's potential upside. In the end, despite NWHI's bankruptcy, Sycamore reaped a massive financial windfall, while NWHI and its creditors lost upwards of $1 billion.

9. To achieve its purpose, Sycamore concocted a scheme to fund the LBO by (i) breaking Jones Inc. into five business segments, (ii) causing NWHI to sell three of those segments (the "Carve-Out Assets") to Sycamore Affiliates at prices hundreds of millions of dollars below their true value (the "Carve-Out Transactions"), (iii) adding more than $800 million (the "LBO Debt") to the balance sheet of the now hollowed-out survivor (NWHI), and (iv) causing NWHI to turn the bulk of the loan and sale proceeds – more than $1.2 billion – over to Jones Inc.'s former shareholders in exchange for no value. When the dust settled, NWHI was left with a crushing debt burden of $1.5 billion (with nothing to show for it), and had been stripped of its most valuable assets. NWHI as it existed following the Carve-Out Transactions is sometimes referred to in this Motion and in Jones Inc.'s definitive proxy as "RemainCo."

10. The lynchpin of Sycamore's scheme was to strip the Carve-Out Assets away from NWHI and transfer them to the Sycamore Affiliates at vastly under-market prices set by Sycamore itself. A single Sycamore fund entity – Sycamore Fund I – was the ultimate beneficial owner of all of Sycamore's interests in both RemainCo and the Carve-Out Assets, and Sycamore's equity investment in RemainCo was just a sliver of the more than $1.5 billion in debt RemainCo was left with after the LBO. In contrast, Sycamore financed the Carve-Out

[7] Capitalized terms used but not defined in this Motion shall have the meanings ascribed to them in the Proposed Complaint.

Transactions with a much higher proportion of equity to debt. Hence, as long as Sycamore set the prices paid by the Sycamore Affiliates for the Carve-Out Assets far enough below their true value, Sycamore was virtually guaranteed to make a profit on the LBO even if RemainCo failed completely.

11. And that is exactly what happened. In a series of transactions that began just months after the LBO and Carve-Out Transactions closed, Sycamore siphoned off tens of millions of dollars of dividends from the Carve-Out Assets, and then resold them *for almost double (about $1.1 billion) the amount paid by the Sycamore Affiliates in the LBO ($641 million).* As a result, even after RemainCo filed for bankruptcy – costing Sycamore its comparatively meager equity investment, but costing NWHI's creditors a fortune – *Sycamore still reaped a nearly $300 million net windfall on the LBO.*

12. To justify selling the Carve-Out Assets to its affiliates for below market prices, Sycamore engaged in outright fraud. Among other things, beginning in October 2013, when it made its bid to buy Jones Inc., through April 8, 2014, when the LBO closed, Sycamore prepared increasingly aggressive "pro forma" estimates and projections to inflate the supposed value of RemainCo, while simultaneously driving down the implied value of and forecasts for the Carve-Out Assets. Sycamore's projections depended not only on highly speculative and subjective "sponsor addbacks" and other adjustments, they also were moving in the exact opposite direction of contemporaneous trends in the businesses at issue.

13. Sycamore then tapped Duff & Phelps to prepare a RemainCo solvency opinion (the "<u>RemainCo Solvency Opinion</u>") using Sycamore's hyper-optimistic projections. Duff & Phelps, a firm Sycamore has engaged on about 60 other deals, gladly obliged. Incredibly, as soon as Sycamore obtained its solvency opinion and the LBO closed, Sycamore abandoned its

pie-in-the-sky RemainCo projections. When preparing internal valuations of RemainCo after the LBO, Sycamore used much lower, unadjusted projections that would have shown insolvency had they been used by Duff & Phelps in its discounted cash flow analysis in connection with the LBO. Similarly, contemporaneous with the LBO itself NWHI issued projections – which were shared with Sycamore but not disclosed publicly – that would have shown insolvency if used by Duff & Phelps in its market multiple analysis.

14. And there can be no serious doubt that NWHI was rendered insolvent by the LBO. Sycamore's $15 per share bid, which followed a vigorous eight-month sale process, set the ceiling for Jones Inc.'s total enterprise value at the time the LBO closed of about $2.103 billion. Market transactions demonstrate that the Carve-Out Assets were worth around a billion dollars or more at the time of the LBO, which necessarily means that RemainCo – the only part of Jones Inc. left after the Carve-Out Assets were stripped away – was worth no more than about $1.1 billion, far less than its post-LBO debt of about $1.55 billion. [8]

15. It was only Sycamore's manipulation of RemainCo's estimated and projected performance in the run up to the LBO that prevented RemainCo's insolvency from being obvious to all. For its part, the agent for the LBO term lenders knew (or should have known) that the LBO would be financially disastrous for RemainCo despite Sycamore's manipulated financial data and projections. The term loan agent prepared its own "base case" projections for RemainCo that were much more realistic than Sycamore's. If weighted average cost of capital and long term growth sensitivities were applied to the agent's projections in the range used by Duff & Phelps, insolvency would have been shown in virtually all scenarios. The term lenders

[8] NWHI is entitled to recover the entire value of the Carve-Out Assets because (i) Sycamore acted in bad faith by knowingly underpaying NWHI for the Carve-Out Assets and fraudulently inflating the value of RemainCo, and (ii) the majority of the funds that Sycamore paid to acquire the Carve-Out Assets were used to redeem the Jones Inc. shareholders, and thus provided no value to RemainCo as a matter of law.

could afford to be cavalier about NWHI's solvency, however, because their debt was guaranteed by RemainCo's operating subsidiaries, unlike NWHI's bond debt. Hence, the new term loans could be repaid in full even if the parent, NWHI, was deeply insolvent. As discussed below, the lenders of the LBO Debt all knew that most of the proceeds of their loans would immediately be re-conveyed to former Jones Inc. shareholders for no value, and the obligations and liens NWHI incurred in connection with the LBO Debt should therefore be avoided.

16. No one was watching out for the interests of NWHI and its creditors in connection with the LBO. Happy to cash out their own substantial stock in the company, Jones Inc.'s legacy directors stuck their heads in the sand, purporting to disclaim any opinion as to the fairness of either the Carve-Out Transactions or the debt incurred to fund the LBO. The post-LBO board of NWHI was controlled by Sycamore's two founders – proposed defendants Stefan Kaluzny and Peter Morrow – who would have been incapable of exercising independent judgment concerning the LBO transactions even if they tried, and the record indicates they did not try. In other words, no fiduciary for NWHI and its creditors (or for the legacy Jones Inc. creditors) ever considered whether the LBO would result in insolvency, or whether it would be fair to anyone other than Sycamore and Jones Inc.'s former shareholders. By themselves, these facts demonstrate clear violations of each of the directors' fiduciary duties of care, loyalty and good faith and shift the burden to the fiduciaries to demonstrate that the transactions were entirely fair to NWHI and its stakeholders. That is a burden the fiduciaries will never be able to carry.

17. Sycamore's breaches of duty did not end with the LBO. Just months after the LBO closed, Sycamore caused NWHI to waive a nearly $65 million working capital true-up payment owed to it by one of the Sycamore Affiliates without the slightest justification, in a further effort to secrete assets from the reach of creditors of a manifestly insolvent NWHI. More

recently, Sycamore took a worthless stock deduction that resulted in NWHI losing the benefit of substantial tax credits in the form of Net Operating Losses ("NOLs"). In addition, as noted, Sycamore and the Sycamore Principals threatened to cause Belk to end its profitable business relationship with NWHI if the estate refused to release its claims against Sycamore on the cheap. Sycamore and the Sycamore Principals have since purported to follow through on that threat, retaliating against NWHI and its stakeholders for seeking to forge a consensual creditor plan that preserved all of the claims against Sycamore for litigation post-emergence.[9] Sycamore could hardly make its contempt for the rights of NWHI and its creditors, and its disregard of its own fiduciary duties, more clear if it tried.

18. NWHI is entitled to recover well over $1 billion from Sycamore, not including prejudgment interest, based on Sycamore's fraudulent transfers and other misconduct described in this Motion and in the Proposed Complaint. In addition, the liens and obligations NWHI incurred in connection with more than $800 million in LBO debt should be avoided, with all payments of interest on the LBO Debt made by or on behalf of NWHI returned to the estate. NWHI also is entitled to recover damages for breach of fiduciary duty from Sycamore and the Jones Inc. directors, and to recover from the directors the full amount of transfers made to Jones Inc.'s shareholders (about $1.2 billion). Finally, an award of actual damages, punitive damages, and attorneys' fees should be entered in favor of NWHI in connection with its claims for tortious interference and actual fraudulent conveyance and other willful misconduct.

19. Allowing the Debtors to release these extraordinarily valuable claims in exchange for the relatively paltry sum the Debtors previously appeared poised to accept would constitute yet another windfall for Sycamore. For its part, Sycamore is acutely aware of the stakes

[9] Letter from S. Kaluzny to NWHI dated Sept. 26, 2018 (Ex. Q).

involved in avoiding plenary litigation against the Committee and its creditor constituents. Indeed, Sycamore was so desperate to thwart post-emergence litigation of the claims against it that Sycamore was willing to openly parade its bad faith disregard for NWHI and its creditors before this Court, commit multiple additional torts, and subject itself to still more potential liability to stakeholders of both NWHI and Belk. There can be no doubt that Sycamore believes the Debtors' settlement range would be a steal compared to the actual value of the claims against it, and Sycamore is right. Standing to prosecute the Proposed Claims should be granted to the Committee for the benefit of the estate, including stakeholders like NWHI's bondholders and trade creditors whose recoveries are largely dependent on maximizing the value of those claims.

BACKGROUND[10]

20. Prior to the LBO, Jones Inc. was a publicly-traded company predominantly focused on a wholesale footwear and apparel business selling such brands as Nine West, Anne Klein, and Gloria Vanderbilt to retailers like Macy's, Lord & Taylor, and Walmart/Sam's Club. Mid-tier footwear and apparel businesses like Jones Inc. faced a challenging economic environment in 2013, driven in part by consumers' continuing recovery from the recession that began in 2008. Analysts predicted that these challenges would continue into 2014, and in fact, the performance of mid-tier footwear and apparel retailers continued to trend downwards through 2015 and 2016.

Jones Inc. Auction Process Implies $2.1 Billion Total Enterprise Value

21. Jones Inc. performed poorly in 2013 and for years before, with flat sales, falling stock prices and declining operating income, EBITDA, and EBITDA margins. At the apparent urging of at least one large shareholder that was looking for an exit from the company, Jones Inc.

[10] The Committee refers the Court to the Proposed Complaint for a full recitation of all relevant facts. What follows below is a highly-truncated summary of the key facts at issue.

began exploring options for the sale of all or some of its businesses.[11] The company embarked on a robust, eight-month sale process, involving some seventeen sophisticated financial and strategic buyers, who each reviewed confidential information concerning Jones Inc.'s performance and prospects in an effort to determine the value of the enterprise.[12]

22. On December 19, 2013, Jones Inc.'s Board of Directors unanimously approved and executed an Agreement and Plan of Merger (the "Merger Agreement" or the "Merger") with two entities controlled by Sycamore: Jasper Parent LLC ("Jasper Parent") and Jasper Merger Sub, Inc. ("Merger Sub").[13] At $15.00 per share, the deal with Sycamore indicated that Jones Inc. – inclusive of all of its brands and businesses – had a total enterprise value of about $2.2 billion.[14] Had Jones Inc. been worth materially more than $2.2 billion, another buyer would have offered more, but none ever did. By the time the LBO closed on April 8, 2014, the enterprise value for Jones Inc. implied by Sycamore's bid was approximately $2.103 billion, due to a decrease in the number of outstanding Jones Inc. shares and an increase in the amount of Jones Inc.'s excess cash.[15]

23. Under the terms of the Merger Agreement, Jones Inc. merged with a Sycamore subsidiary that was created for that purpose, survived the merger, and assumed the name Nine West Holdings, Inc. (NWHI).[16] At the same moment, Jones Inc.'s shares were converted to a right to receive the merger consideration, totaling about $1.2 billion, from NWHI.[17] Simultaneously with the closing of the LBO, Sycamore caused NWHI to (i) borrow the LBO

[11] Proposed Complaint ("Compl.") (Ex. B) ¶ 72.
[12] Compl. ¶¶ 73-81.
[13] Compl. ¶ 85.
[14] Compl. ¶¶ 80-81.
[15] Compl. ¶ 24 & n.6.
[16] Compl. ¶ 85.
[17] Compl. ¶ 91.

Debt, and (ii) sell the Carve-Out Assets to the Sycamore Affiliates, with much of the proceeds of the LBO Debt and Carve-Out Transactions immediately transferred to Jones Inc.'s former shareholders for no value.[18]

NWHI's LBO Debt Dwarfs Sycamore's Equity Investment

24. As noted elsewhere, the LBO Debt Sycamore caused NWHI to incur amounted to more than $800 million, including (i) a $300 million unsecured term loan credit facility (the "Unsecured Term Loan"), (ii) a $445 million term loan credit facility (the "Secured Term Loan," and with the Unsecured Term Loan, the "Term Loans"), both arranged by Morgan Stanley, and (iii) a $129 million drawn on an asset-backed loan facility (the "ABL Facility") administered and arranged by Wells Fargo ($70 million of which was used to repay a prior ABL facility and $59 million of which was used to finance the LBO).[19]

25. In addition, NWHI also owed another approximately $700 million to bondholders, including Jones Inc. legacy creditors. Repayment of the Term Loans was guaranteed by virtually all of NWHI's operating subsidiaries (the "Guarantor Subsidiaries"), entities that were not obligors of any kind with respect to NWHI's bonds.[20] As a result, the Term Loan lenders had structural priority over NWHI's unsecured bondholders, and could be repaid in full by the Guarantor Subsidiaries even if NWHI was deeply insolvent. A total of $120 million in equity was contributed to RemainCo by Sycamore ($108 million) and its minority co-investor, Kohlberg Kravis Roberts & Co. L.P. ("KKR") ($12 million), a small fraction (less than 1/10) of the debt left on RemainCo's books after the LBO.[21]

[18] Compl. ¶¶ 86, 89, 91-96.
[19] Compl. ¶¶ 91-96.
[20] Compl. ¶ 210.
[21] Compl. ¶¶ 91, 96.

Sycamore Causes NWHI to Sell Carve-Out Assets to Sycamore Affiliates for a Pittance

26. The Carve-Out Assets were stripped out of NWHI pursuant to three purchase agreements entered into by Jasper Parent – controlled by Sycamore – and the applicable Sycamore Affiliate – also controlled by Sycamore – as buyer. Sycamore/Jasper Parent agreed to cause NWHI to sell the Carve-Out Assets immediately after the merger at prices set unilaterally by Sycamore. Each purchase agreement – essentially between Sycamore and Sycamore – was signed by Sycamore founder Stefan Kaluzny on behalf of Jasper Parent/NWHI, and by Sycamore co-founder Peter Morrow on behalf of the Sycamore Affiliate buyer. In its resolutions relating to the merger and in the Merger Agreement itself, Jones Inc.'s board expressly disclaimed any opinion concerning the prudence or fairness of the sale by NWHI of the Carve-Out Assets. The conflicted Sycamore Principals approved the Carve-Out Transactions before the LBO closed. Apparently, however, no person acting in the capacity of a fiduciary of either Jones Inc. or NWHI ever deliberated or voted on the incurrence of the LBO Debt, the prices set by Sycamore for NWHI's sale of the Carve-Out Assets to the Sycamore Affiliates, or the impact of those transactions on NWHI and its creditors.[22]

27. Sycamore knew that the Carve-Out Assets were worth far more than what the Sycamore Affiliates paid NWHI for such assets – indeed that was Sycamore's objective – and immediately set about to capitalize on having separated the underperforming assets from the crown jewels at artificially deflated prices. Sycamore commenced a series of dividend and resale transactions shortly after the LBO closed that demonstrate that the prices paid by the Sycamore

[22] Compl. ¶¶ 84-87.

Affiliates – set unilaterally by Sycamore itself – to obtain the Carve-Out Assets were a fraction of their actual values[23]:

	Self-Dealing Sycamore Price (April 8, 2014)	Resale Price and Net Dividends (Date)	Difference Between Price Paid and Resale Price/Net Dividends
Stuart Weitzman	$395 million	$548 million sale (Jan. 2015)	$153 million
Kurt Geiger	$136 million	$371 million sale (Dec. 2015)	$235 million
Jones Apparel	$110 million	$40 million net dividend (Sept. 2014) $145 million sale (in two parts, Apr. 2015 and Jan. 2017)	$ 75 million
Totals	$641 million	$1.10 billion	$463 million

28. As if this market evidence were not enough, Sycamore's own valuation firm – Duff & Phelps – also concluded that the Carve-Out Assets were worth far more than the amounts paid for them by the Sycamore Affiliates. For example, Sycamore commissioned Duff & Phelps to prepare a valuation of each of Jones Apparel and Stuart Weitzman in August 2014 – just months after the LBO – to justify Sycamore taking a total of more than $160 million in dividends from the companies (substantially more than Sycamore's total equity investment in RemainCo). In those opinions, Duff & Phelps reckoned that Jones Apparel and Stuart Weitzman by themselves were worth about $1 billion or more. Any contention that all three Carve-Out Assets were worth just the $641 million paid to NWHI in April 2014 is ludicrous.[24]

NWHI Was Rendered Deeply Insolvent by the LBO

29. As discussed briefly below, and in detail in the Proposed Complaint, the estimates and projections for RemainCo and the Carve-Out Assets Sycamore created and presented to the market were a farce, and if realistic projections had been used, RemainCo's insolvency would

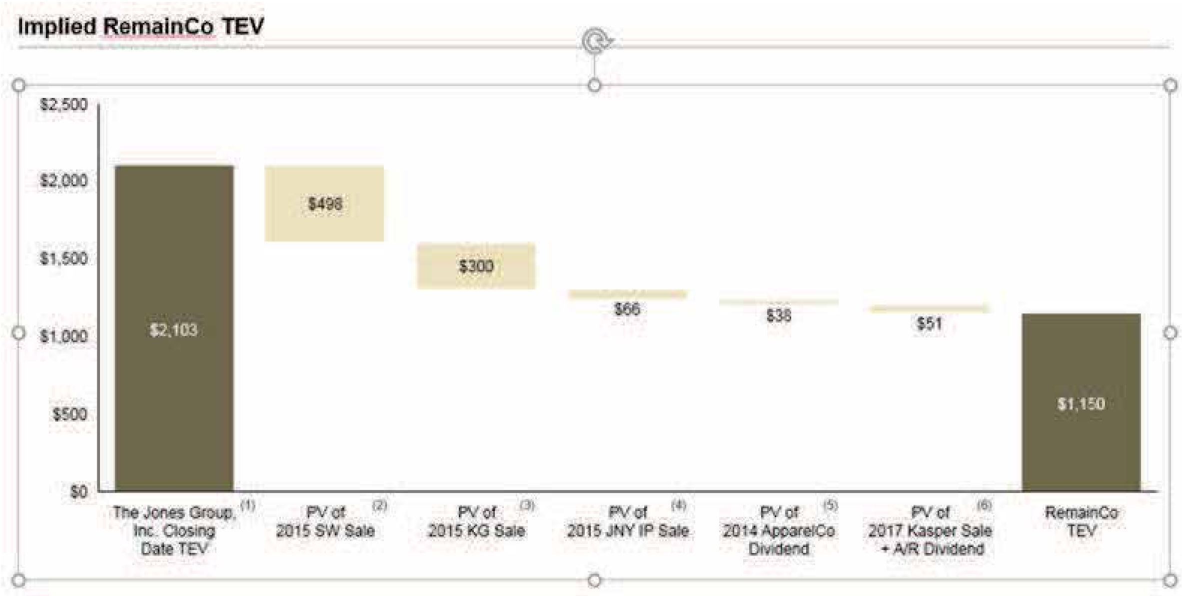
[23] Compl. ¶¶ 21-22, 154-164.

[24] Compl. ¶¶ 151-158.

have been obvious. Indeed, Sycamore procured the RemainCo Solvency Opinion only by supplying Duff & Phelps with its upside case for RemainCo. But it is unnecessary to dig into the projections to see that RemainCo was deeply insolvent at the time of the LBO. All one need do is look at the values set by the market for (i) Jones Inc. as a whole, and (ii) the Carve-Out Assets that were peeled away from Jones Inc. in the LBO to create RemainCo.

30. A robust sale process led by Citigroup established the value of Jones Inc. at no more than about $2.2 billion, and that implied value was reduced to $2.103 billion by the time the LBO closed.[25] Since Jones Inc. consisted only of RemainCo and the Carve-Out Assets, subtracting the true value of the Carve-Out Assets from Jones Inc.'s overall value, each as set by the market, yields the true value of RemainCo. Even if the Carve-Out Assets were worth only the $641 million purchase price set by Sycamore's self-dealing, RemainCo would have been in, or teetering on the edge of, insolvency given the debt Sycamore heaped on it in the LBO. As market transactions and other objective evidence clearly demonstrates, however, the Carve-Out Assets were collectively worth about $1 billion or more at the time of the LBO, even after present valuing the sale prices back to April 8, 2014 using discount rates selected by Duff & Phelps itself. Hence, RemainCo necessarily was worth far less than the $1.551 billion in debt it was left with after the LBO. A chart illustrating this bridge to RemainCo insolvency follows:

[25] Compl. ¶ 24 & n.6.



Source: Company records; LBO Funds Flow; Purchase Agreements
(1) Reflects $1.18 billion purchased equity plus $1.01 billion of Pre-LBO debt less $91 million of excess cash (assuming $10 million minimum cash requirement)
(2) 2015 SW Sale Value of $548 million (includes $18 million earnout adjustment) discounted to April 8, 2014 at 13.5% WACC, based on SW WACC per D&P Stuart Weitzman Solvency Analysis (August 28, 2014)
(3) 2015 KG Sale Value of $371 million discounted to April 8, 2014 at 13.5% WACC, based on KG WACC per D&P TJG PPA Report (August 7, 2014)
(4) 2015 JNY IP Sale Value of $75 million discounted to April 8, 2014 at 12.75% WACC, based on mid range WACC per D&P Jones Apparel Solvency Analysis (August 28, 2014)
(5) 2014 ApparelCo Dividend of $40 million discounted to April 8, 2014 at 12.75% WACC, based on mid range WACC per D&P Jones Apparel Solvency Analysis (August 28, 2014)
(6) 2017 Kasper Sale and A/R Dividend of $71 million discounted to April 8, 2014 at 12.75% WACC, 12.75% WACC, based on mid range WACC per D&P Jones Apparel Solvency Analysis (August 28, 2014)

<u>Sycamore Manipulates Estimates, Projections and Valuations Leading to LBO</u>

31. Had Sycamore been honest about the true value of the Carve-Out Assets, it could not have sold those assets off to Sycamore Affiliates at the bargain-basement prices it did. Indeed, Sycamore's early, internal estimates of the valuation splits between RemainCo and the Carve-Out Assets showed that RemainCo could not support even close to $1.5 billion in debt, and that the Carve-Out Assets were substantially more valuable than the price Sycamore ultimately set for them in the LBO. Over time, however, Sycamore moved its estimates farther

and farther away from reality, until finally Sycamore arrived at valuations that suited its purposes. Sycamore's valuation machinations are illustrated in the chart below[26]:

Date of Sycamore Valuation	RemainCo Value	Carve-Out Asset Value	Total Enterprise Value
10/29/13	$1,330	$840	$2,170
11/01/13	$1,410	$760	$2,170
11/04/13	$1,505	$665	$2,170
11/29/13	$1,560	$640	$2,200
12/16/13	$1,570	$670	$2,240
1/31/14	$1,570	$660	$2,230
3/5/14	$1,580	$640	$2,220

32. To justify RemainCo's ever-increasing share of enterprise value, Sycamore created and manipulated estimates and projections of performance that were contrary to the actual performance and trends of RemainCo's businesses. For example, Sycamore gradually increased its estimate for RemainCo's 2013 management pro forma EBITDA from $178 million in October 2013 to $198 million in February 2014 (including tens of millions of dollars in "management adjustments"), notwithstanding contemporaneous information that the actual performance of RemainCo's businesses was moving in the opposite direction.[27] Sycamore then piled on growing and highly speculative "Sponsor Addbacks," until Sycamore "estimated" 2013 adjusted EBITDA for RemainCo of $236 million, *or about $100 million more than estimated RemainCo 2013 EBITDA (i.e., RemainCo EBITDA without adjustments by Sycamore or anyone else).* The chart below shows how Sycamore's 2013 estimates changed, and how those changes impacted RemainCo's estimated values[28]:

[26] Compl. ¶¶ 14-15, 98-99, 111.
[27] Compl. ¶¶ 101-104.
[28] Compl. ¶¶ 105-108.

Date	RemainCo Pro Forma Unadjusted EBITDA ($ in millions)	RemainCo Sponsor Addbacks ($ in millions)	Total Sycamore RemainCo Pro Forma Adjusted 2013 EBITDA ($ in millions)	Sycamore RemainCo Valuation ($ in millions)
10/23/13	$178	$28	$206	$1,300
10/29/13	$187	$28	$215	$1,330
11/01/13	$187	$28	$215	$1,410
11/04/13	$188	$28	$216	$1,505
11/29/13	$188	$17	$205	$1,560
12/16/13	$189	$29	$218	$1,570
1/31/14	$195	$36	$231	$1,570
3/5/14	$198	$38	$236	$1,580

33. When Sycamore sought the RemainCo Solvency Opinion, it supplied Duff & Phelps with the highest RemainCo 2013 EBITDA figure that Sycamore ever estimated, at any time – $236 million. Sycamore also provided uber-aggressive five-year projections secretly premised on Sycamore's *upside* case, while representing to Duff & Phelps that it was the best, most accurate and most likely estimate for RemainCo's performance. The projections given by Sycamore to Duff & Phelps were also far higher than Jones Inc.'s contemporaneous projections. As just one example, whereas the projections that Sycamore gave Duff & Phelps assumed that RemainCo would generate $244 million of EBITDA in 2014, Jones Inc. management's own projections from April 2014 projected just $193 million for that year.[29]

34. Meanwhile, over the same period of time, Sycamore's estimated pro forma 2013 EBITDA for the Carve-Out Assets collectively dropped from $101 million to $65 million, even though there were no developments in the underlying businesses that would have justified such dramatic changes[30]:

[29] Compl. ¶¶ 106, 123-128.

[30] Compl. ¶ 120.

Date	Total Carve-Out Adjusted EBITDA (millions)	Total Sycamore Carve-Out Valuation (millions)
10/23/13	$101	$790
10/29/13	$92	$840
11/01/13	$68	$760
11/04/13	$66	$665
11/29/13	$65	$640
12/16/13	$74	$670
1/31/14	$66	$660
3/5/14	$65	$640

35. Tellingly, it appears that Sycamore never used its supercharged 2013 RemainCo EBITDA and upside case projections other than in connection with the LBO. For instance, when Sycamore prepared an internal RemainCo valuation just months after the LBO, it did not include any of the speculative Sponsor Addbacks, and instead premised its valuation on much lower "unadjusted" EBITDA numbers. The chart below compares the projections Sycamore gave to Duff & Phelps to use for its RemainCo solvency analysis, with the projections Sycamore itself used for RemainCo in an internal valuation in September 2014[31]:

Projected EBITDA		
Year	**Duff & Phelps LBO Solvency Analysis, April 2014 (millions)**	**Sycamore Internal Valuation, September 2014 (millions)**
2014	$244	$191
2015	$254	$193
2016	$263	$196
2017	$272	$200
2018	$282	$204

36. If Duff & Phelps had used Sycamore's more pessimistic RemainCo projections from the third quarter of 2014 in its RemainCo Solvency Opinion, Duff & Phelps would have determined that RemainCo was deeply insolvent at the time of the LBO. Conversely, having

[31] Compl. ¶¶ 136-139.

stripped the Carve-Out Assets from NWHI, Sycamore became immediately more optimistic about the Carve-Out Assets' prospects. For example, when Sycamore wished to take an $80 million dividend from Stuart Weitzman in August 2014, it supplied Duff & Phelps with significantly *higher* projections than it used for the same business before the LBO. A comparison of the two sets of Stuart Weitzman projections is provided below[32]:

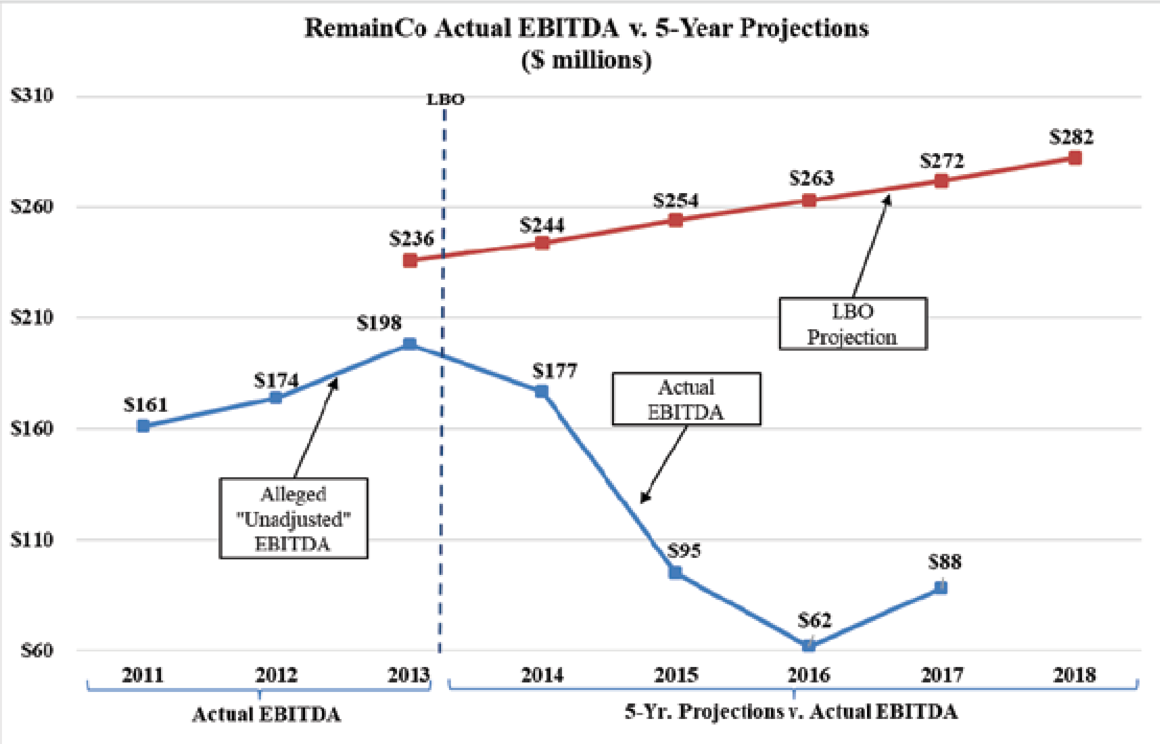
Sycamore EBITDA Projections for Stuart Weitzman		
($ in millions)	**Pre-LBO Lender Syndication Forecast**	**Post-LBO Solvency Analysis Forecast**
2013 (Actual)	$52.4	$50.4
2014	$58.8	$56.9
2015	$65.8	$76.1
2016	$69.7	$101.0
2017	$73.8	$130.5
2018	$78.0	$164.6

37. Using these higher estimates, Duff & Phelps concluded that Stuart Weitzman was worth between $705 million and $770 million, a far cry from the $395 million purchase price Sycamore set for its Affiliates in connection with the LBO just a few months before.[33] Likewise, in a series of post-LBO sale transactions, Sycamore resold Jones Apparel and Kurt Geiger at prices that collectively were about $270 million more than the prices Sycamore Affiliates paid in the LBO. Sycamore's clumsy manipulation of the pre-LBO estimates and projections, and sudden abandonment of those distorted models as soon as the LBO closed, are detailed in the Proposed Complaint.[34]

[32] Compl. ¶¶ 154-155.
[33] Compl. ¶ 158.
[34] *See* Compl. ¶¶ 159-163.

RemainCo Immediately and Disastrously Misses Sycamore Projections

38. RemainCo's performance after the LBO provides further corroboration that Sycamore's pre-LBO projections were worse than a fantasy. RemainCo's actual EBITDA never came close – in any year – to Sycamore's claimed $236 million Adjusted EBITDA for 2013, the number Sycamore used to claim RemainCo was worth more than the $1.55 billion in post-LBO debt.[35]



39. Sycamore's projections for 2014 and beyond were equally far-fetched. Sycamore predicted that RemainCo would earn a total of about $1.03 billion in EBITDA between 2014 and 2017,[36] but RemainCo actually earned less than half of that amount, about $450 million. In the years 2015, 2016 and 2017, RemainCo's actual EBITDA was just 37%, 24% and 32% of

[35] 2017 RemainCo EBITDA ($88 million) as presented in the chart includes financial results of Kasper, which was acquired in 2017. *See* Compl. ¶ 131.

[36] Compl. ¶ 124.

Sycamore's pre-LBO forecast, respectively. These disastrous results almost certainly would have required a near-term bankruptcy filing, but RemainCo had no significant funded debt maturities until 2019. As it was, RemainCo limped along outside of bankruptcy for a few years, despite its manifest balance sheet insolvency, finally giving into the inevitable on April 6, 2018, when it filed for Chapter 11.

Sycamore's Self-Dealing Working Capital Waiver

40. In the months after the LBO, Sycamore also deprived RemainCo of approximately $64.5 million in excess working capital due from Jones Apparel and transferred the money to itself by means of a dividend.

41. The purchase agreement for Jones Apparel included a standard working capital purchase price adjustment, or "true up," provision.[37] Under the true-up, Jasper Apparel (the buyer) agreed to pay an aggregate amount equal to any net working capital at closing in excess of the normalized working capital for the twelve months preceding the closing of the Carve-Out Transactions.[38]

42. Jones Apparel had substantial excess net working capital on its balance sheet, approximately $74.2 million, at the time of the LBO.[39] Nevertheless, on July 8, 2014, Sycamore wrongly caused NWHI to waive the working capital adjustment in the amended Jones Apparel Purchase Agreement ("Working Capital Waiver"), causing a cash loss to NWHI of approximately $64.5 million, and a concurrent benefit to Jasper Apparel in the same amount.[40] Sycamore papered the waiver with a fraudulent and improper calculation worksheet. Thirty days later,

[37] Compl. ¶ 165.

[38] Compl. ¶ 165.

[39] Compl. ¶ 166. Internal Sycamore calculations from late June 2014 arrive at the slightly lower sum of $62 million. Compl. ¶ 168.

[40] Compl. ¶ 166.

Jones Apparel paid an $80 million dividend to Sycamore, funded in part by $40 million in cash, definitively demonstrating that Jones Apparel had significant excess capital that was wrongfully withheld from RemainCo.[41]

43. The Working Capital Waiver occurred three months after the LBO closed, when it was plainly apparent that RemainCo was performing far worse than Sycamore's pie-in-the-sky projections forecasted.[42] Sycamore nevertheless caused RemainCo to gift $64.5 million to Sycamore in exchange for nothing.

Sycamore Takes Worthless Stock Deduction, Depriving NWHI of NOLs

44. Sycamore's self-dealing has continued into the present. Just one week before the Debtors filed for bankruptcy, Sycamore informed RemainCo that it had claimed a tax deduction for Sycamore's basis in RemainCo's worthless stock (the "Worthless Stock Deduction").[43] Typically, the IRS views the taking of such a deduction as a "change of control" precluding the company from simultaneously claiming net operating losses ("NOLs") to offset its tax liabilities.[44] Thus, Sycamore deprived the Debtors of the opportunity to claim the NOLs themselves.

45. It appears, moreover, that Sycamore took the Worthless Stock Deduction in a bad faith effort to obtain leverage against the Debtors – for whom Sycamore and its principals remain fiduciaries – and to coerce a cheap settlement from the Debtors of their valuable claims against Sycamore. Indeed, during the course of this pending litigation, Sycamore has suggested in several communications that it would consider unwinding the Worthless Stock Deduction in

[41] Compl. ¶ 166.
[42] Compl. ¶¶ 131-135.
[43] Compl. ¶ 171.
[44] Compl. ¶ 170.

exchange for a release of all estate claims against it. As discussed below, Sycamore's election to take the Worthless Stock Deduction is avoidable as a fraudulent conveyance, and entitles the Debtors to an award of damages for breach of fiduciary duty.[45]

Sycamore's Bad Faith Belk Threats, and the Debtors' Inadequate Investigation

46. From the beginning of these cases, the Committee urged the Debtors to put the Proposed Claims in a trust to be prosecuted after confirmation of a plan, so the Debtors and their creditors can focus on reorganization without rushing into a settlement that would likely greatly undervalue those claims.

47. This is exactly the outcome Sycamore most feared, and that Sycamore was desperate to avoid. In an effort to intimidate creditors, Sycamore began threatening to cause its portfolio company Belk to stop buying products from NWHI unless NWHI released its claims against Sycamore on the cheap, and as part of the plan process.[46] Sycamore is controlled by Defendants Morrow and Kaluzny, and acquired Belk on December 10, 2015.[47] Morrow is a member, and Kaluzny is the chairman, of the Belk Board of Directors, and until just days ago, also sat on NWHI's board of directors.[48]

48. Sycamore's threats by themselves demonstrated its bad faith, and constituted a violation of the fiduciary and other duties owed by Sycamore and its principals to NWHI. The threats also were irrational, since they could only expose Sycamore to still more liability, and appeared calculated to try to intimidate the parties into releasing the claims against Sycamore for less than their value

[45] *See infra* Part II.A.1-3.

[46] Compl. ¶ 175; Depo. Tr. of Ralph Schipani (Ex. D) at 208-18:21 (July 17, 2018).

[47] Compl. ¶ 173.

[48] Compl. ¶ 173.

49. Sycamore's brazen misconduct regarding Belk – and the Debtors' tepid response – compounded the Committee's existing concern that the Debtors would not investigate, prosecute or resolve the Sycamore claims in a value-maximizing fashion. The Committee worried openly that the longstanding and lucrative connections (i) between Sycamore and the Debtors' primary bankruptcy counsel, Kirkland, and (ii) between Kirkland and Munger Tolles & Olsen LLP ("MTO") would hamstring any serious inquiry into Sycamore's misconduct. In six other recent bankruptcy cases MTO has assumed a similar role to that taken here, "represent[ing] independent directors or managers for the debtors . . . where [Kirkland] has served as primary bankruptcy counsel for the debtors."[49]

50. The Committee's concerns were justified. For example, although the Debtors insisted that MTO should work alongside professionals for the Committee in exploring the Proposed Claims, MTO sought no documents from Sycamore beyond those that Sycamore selected itself and provided voluntarily before Rule 2004 discovery began. MTO attended each of the Rule 2004 depositions taken by the Committee, but asked just a handful of questions of a single witness concerning the Working Capital Waiver. Remarkably, MTO chose not to demand and review the Debtors' privileged documents relating to the LBO, though it undoubtedly had the right to do so. Nor did MTO conduct interviews of many of the Debtors' key executives (current and former) concerning the transaction at issue.

51. On June 5, 2018, this Court granted the Committee's motion for expedited discovery of the Debtors and various third parties pursuant to Rule 2004 of the Bankruptcy Code. Since then, the Committee has diligently investigated the circumstances surrounding the LBO and Carve-Out Transactions, including by reviewing approximately 110,000 documents and

[49] *See* Letter from T. Walper to D. Zensky dated May 28, 2018 (Ex. C), at 1-2.

taking eleven depositions. The Rule 2004 examination has culminated in the Proposed Complaint attached hereto, which describes in detail the wrongful behavior engaged in by the Defendants that rendered NWHI insolvent and stripped away its best assets for far less than equivalent value.

<u>The Debtors' Unjustifiable Refusal to Prosecute Claims Against Sycamore</u>

52. On August 20, 2018, the Committee formally demanded that the Debtors prosecute the Proposed Claims to recover NWHI's assets for the benefit of the NWHI estate and its creditors. In the alternative, the Committee requested that the Debtors assign the Proposed Claims to a Litigation Trust to pursue the claims after NWHI's emergence from bankruptcy for the benefit of NWHI's unsecured creditors in accordance with a confirmed plan of reorganization.[50]

53. The Debtors refused, indicating instead that they planned to engage in settlement negotiations with Sycamore. The Committee repeatedly requested, orally and in writing, that its counsel be permitted to attend and participate in any settlement meetings. MTO rejected the Committee's requests.[51] MTO opted instead to provide only sporadic updates to the Committee concerning the lopsided movement of MTO's "ask"—which dramatically undervalued the Proposed Claims—towards Sycamore's relatively static, and woefully insufficient "bid."[52]

54. Notwithstanding the Debtors' lack of transparency and Sycamore's bullying,

[50] *See generally* Letter from D. Zensky to T. Walper dated Aug. 20, 2018 (Ex. G). The Committee updated its demand by letter dated September 21, 2018 (Ex. M).

[51] The Committee's 2004 motion did not encompass depositions of the independent directors, but the Committee will likely take such depositions prior to a hearing on this motion. Such depositions will include, among other things, questions respecting the independent directors' rationale for excluding the Committee from negotiations with Sycamore.

[52] *See* Letter from D. Zensky to S. Goldman dated Aug. 10, 2018 (Ex. E); Email from D. Zensky to S. Goldman et al. dated Aug. 17, 2018 (Ex. F); Email from D. Zensky to T. Walper et al. dated Aug. 20, 2018 (Ex. H); Letter from H. Schub to T. Walper dated Aug. 21, 2018 (Ex. I); Email from S. Goldman to D. Zensky et al. dated Aug. 24, 2018 (Ex. J); Letter from T. Walper to D. Zensky and H. Schub dated Aug. 30, 2018 (Ex. K); Email from D. Zensky to T. Walper et al. dated Aug. 30, 2018 (Ex. L); Golden Decl. ¶ 14.

NWHI's unsecured creditors negotiated diligently with one another to resolve their intra-creditor disputes and preserve the valuable claims against Sycamore for a post-emergence trust.[53] The creditors neared an agreement over the weekend ending Sunday, September 23, 2018. On Monday, September 24, 2018, Kaluzny and Morrow abruptly announced their resignation from Sycamore's board of directors.[54] The creditors reached a deal on Tuesday, September 25, 2018,[55] and put the terms of their agreement on the record at a hearing before this Court on Wednesday, September 26, 2018, including assignment of the claims against Sycamore to a litigation trust for prosecution after emergence.[56] Later that day, Kaluzny wrote NWHI advising that Belk would no longer do business with NWHI.[57] The letter provided no explanation, and was a clumsy and transparent attempt to retaliate against NWHI and its creditors for their refusal to settle the claims against Sycamore on the cheap as part of a plan process. The Debtors demanded that Sycamore and Kaluzny withdraw the Belk letter, which they promptly refused.[58]

55. Sycamore's maneuver unnerved the unsecured term lenders, and may have derailed the creditors' agreement. It now seems the Debtors will again seek to settle the Sycamore claims for a small fraction of their value. In so doing, the Debtors are playing directly into Sycamore's hands, and demonstrating – once again – that they simply are not the right parties to maximize the value of the Proposed Claims.

56. The Committee already has unearthed sufficient facts through its Rule 2004 examination to demonstrate that the Proposed Claims are worth substantially more than is

[53] Compl. ¶ 176.

[54] *See* Letter from M. Thomas to D. Golden dated Sept. 25, 2018 (Ex. O).

[55] *See* Creditor Settlement Agreement dated Sept. 25, 2018 (Ex. N).

[56] *See* Hr'g Tr. at 19:6-29:4 (Sept. 26, 2018) (Ex. P).

[57] Compl. ¶ 177; Letter from S. Kaluzny to NWHI dated Sept. 26, 2018 (Ex. Q).

[58] Letters from S. Goldman to Belk and Sycamore dated Sept. 27, 2018 (Exs. R-S); Letter from M. Thomas to S. Goldman dated Sept. 28, 2018 (Ex. T).

reflected in the Debtors' proposed settlement range, and NWHI's claims – and the estate's bargaining position – only will become stronger as the investigation continues. For example, the Committee has recently discovered that many of the key valuation spreadsheets maintained by Sycamore and others contained hidden worksheets with a wealth of important data and calculations. Further analysis of these hidden calculations is certain to yield important evidence and insight into Sycamore's misconduct.

57. In addition, in light of the compressed timeframe available for the Rule 2004 Examination, it would have been impractical for the Committee to seek document discovery from all of key advisors to the LBO, including advisers to Sycamore, or to take depositions of numerous witnesses whose testimony would be crucial in a plenary proceeding, including current and former officers and directors of RemainCo and the Carve-Out Assets and representatives from Sycamore's LBO advisers. Nor has the Committee yet fully examined the numerous claims of privilege asserted by Sycamore and other producing parties. Successful challenges to those assertions could result in the production of potentially significant additional materials. Given the evidence that has been unearthed to date, the Committee is confident that further efforts in discovery will only strengthen its claims.

58. Sycamore should not be permitted to cut short the investigation into its misconduct with a premature and inadequate settlement. For the reasons described below, standing should be granted to the Committee to pursue the Proposed Claims.

ARGUMENT

I. Legal Standard for Derivative Standing

59. "The practice of authorizing the prosecution of actions on behalf of an estate by committees, and even by individual creditors, upon a showing that such is in the interests of the estate, is one of long standing, and nearly universally recognized." *Adelphia Commc'ns Corp. v.*

Bank of Am., N.A. (*In re Adelphia Commc'ns Corp.*), 330 B.R. 364, 373 (Bankr. S.D.N.Y. 2005); *see also Official Comm. of Unsecured Creditors of Cybergenics Corp ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548, 568 (3d Cir. 2003) (recognizing that a "straightforward application" of a bankruptcy court's equitable powers allows for a grant of derivative standing upon creditors' committees to assert causes of action on behalf of, and for the benefit of, the debtor's estate); *La. World Exposition v. Fed. Ins. Co.*, 858 F.2d 233, 247 (5th Cir. 1988) (similar); *Neb. State Bank v. Jones*, 846 F.2d 477, 478 (8th Cir. 1988) (similar). In order to be granted derivative standing in the Second Circuit, a creditors' committee must:

(i) "present[] a colorable claim or claims for relief that on appropriate proof would support a recovery," and

(ii) demonstrate that the debtor "unjustifiably failed to bring suit." *Unsecured Creditors Comm. of Debtor STN Enters., Inc. v. Noyes* (*In re STN Enters.*), 779 F.2d 901, 905 (2d Cir. 1985); *see also Official Comm. of Unsecured Creditors of AppliedTheory Corp. v. Halifax Fund, L.P.* (*In re AppliedTheory Corp.*), 493 F.3d 82 (2d Cir. 2007).

60. A colorable claim is one "that on appropriate proof would support a recovery." *STN*, 779 F.2d at 905. The standard for presenting a "colorable" claim is a "relatively easy one to meet," and is satisfied where the proposed litigation will not be a "hopeless fling." *Adelphia*, 330 B.R. at 376, 386; *see also Hobby Ctr. v. Hudson United Bank* (*In re America's Hobby Ctr., Inc.*), 223 B.R. 275, 288 (Bankr. S.D.N.Y. 1998) (standing should be denied only if claim is "facially defective"); *In re Colfor, Inc.*, No. 96-60306, 1998 Bankr. LEXIS 158, at *7 (Bankr. N.D. Ohio Jan. 5, 1998) (a "colorable" claim is one which is "plausible" or "not without some merit"). A debtor's refusal to bring suit is unjustifiable when bringing suit would be likely to benefit the reorganization estate, after taking account of any associated costs or delays. *STN*, 779 F.2d at 905. Both factors are readily met here, and the Committee's motion should be granted accordingly.

II. <u>The Committee Should Be Granted Derivative Standing</u>

A. The Proposed Claims Are Colorable

61. Sycamore and the Debtors themselves acknowledge at least tacitly that the claims against Sycamore are "colorable," they just massively understate the value of those claims. As discussed above, the Debtors previously appeared poised to release all claims against Sycamore for far less than those claims are worth. While any amount in the range under discussion would be woefully inadequate to compensate NWHI and its creditors for releasing their $1 billion-plus claims against Sycamore, it is more than any party would pay to escape claims the party believed to be a mere "hopeless fling." *See, e.g., Adelphia*, 330 B.R. at 376, 386. Sycamore's desperate efforts to preemptively settle the claims against it rather than face them outside of bankruptcy further demonstrate the colorability of those claims. The basis for each of NWHI's claims – and their evident colorability – is discussed briefly below.

1. NWHI's Constructive Fraud Claims Are Colorable

62. NWHI is entitled to (i) avoid and recover from Sycamore the value of the Carve-Out Assets, the Working Capital Waiver and the Worthless Stock Deduction and (ii) avoid the liens and obligations it incurred in connection with the LBO Debt. NWHI was insolvent at the time, or rendered insolvent by, each transfer and/or incurrence, and NWHI received less than reasonably equivalent (or fair) value for each, as discussed below. *See, e.g.,* N.Y. Debt. & Cred. Law §§ 273, 274, 275, 278, 279; Del. Code. Ann. tit. 6 §§ 1304(2), 1305, 1307; 12 Pa. C.S.A. §§ 5105, 5105, 5107).

(a) The LBO Rendered NWHI Insolvent

63. As described briefly above and in detail in the Proposed Complaint, the established market values of (i) the Jones Inc. enterprise and (ii) the Carve-Out Assets demonstrate conclusively that NWHI (RemainCo) was insolvent after the LBO. The

overwhelming evidence regarding the true value of the Carve-Out Assets – as opposed to the self-dealing, deflated prices Sycamore arranged for its Affiliates to pay – is described in the Proposed Complaint.[59] Once that true value – about $1 billion or more – is subtracted from Jones Inc.'s pre-transaction enterprise value of just about $2.1 billion, RemainCo's post-LBO insolvency is manifest.

64. Sycamore sought to justify the Carve-Out Assets' bargain-basement LBO sale prices by manipulating estimates and projections for the business segments created by the LBO, which exaggerated the value of RemainCo (and consequently understated the value of the Carve-Out Assets).[60] Notably, most actual performance trends of the relevant businesses pointed in exactly the opposite direction of Sycamore's projections at the time.[61] Sycamore never used those projections again other than in connection with the LBO, relying instead on much less aggressive forecasts for RemainCo, and much more optimistic estimates of likely future performance of the Carve-Out Assets for its post-LBO internal valuations and dividend and sale transactions.[62] The EBITDA contortions Sycamore went through to obtain the RemainCo Solvency Opinion and arrive at its desired value splits – and the manifest unreliability of Sycamore's approach and estimates – are alleged in detail in the Proposed Complaint.[63]

[59] *See* Compl. ¶¶ 13-23.
[60] *See* Compl. ¶¶ 82-90, 98-122.
[61] *See* Compl. ¶¶ 101-104, 116-122.
[62] *See* Compl. ¶¶ 123-130, 136-141, 150-158.
[63] *See* Compl. ¶¶ 98-130.

(b) **NWHI Received Less than Reasonably Equivalent Value for the Property Transferred to Sycamore, and the Liens and Obligations Incurred for the LBO Debt**

1) **NWHI Transferred the Carve-Out Assets to Sycamore for far Less than their Value**

65. Regarding the sale of the Carve-Out Assets, lack of reasonably equivalent value is not a close call. As discussed at length above and in the Proposed Complaint, the actual market transactions demonstrate that the Carve-Out Assets were worth *at least* $400 million more than NWHI received from the Sycamore Affiliates. Similarly, Sycamore's internal valuations and forecasts and other contemporaneous evidence establish that the Carve-Out Assets were worth far more than $641 million.

2) **NWHI Incurred the Liens and Obligations to the LBO Lenders for far Less than the Value Received in Return**

66. The LBO Lender Defendants (and/or their predecessors) had actual or constructive knowledge that the vast majority of the proceeds of the LBO Debt would be immediately transferred to Jones Inc.'s former shareholders for no value.[64] It is well settled that multilateral lending transactions may be collapsed and treated as phases of a single transaction for purposes of evaluating whether a transferor or obligor received reasonably equivalent value. *See HBE Leasing Corp. v. Frank*, 48 F.3d 623, 635 (2d Cir. 1995); *U.S. v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1302 (3d Cir. 1986). The "paradigmatic scheme" justifying collapsing is where "one transferee gives fair value to the debtor in exchange for the debtor's property, and the debtor then gratuitously transfers the proceeds of the first exchange to a second transferee."

[64] *See* Compl. ¶¶ 142-149, 206-213. A corporation receives no value when it re-conveys the proceeds of loans to shareholders in the form of stock redemptions or dividends. *See, e.g., Wirum v. Wilson* (*In re SDR Capital Mgmt., Inc.*), No. 05-34008 TEC, 2007 WL 3450999, at *1 (Bankr. N.D. Cal. Nov. 14, 2007); *see also, e.g., Consove v. Cohen* (*In re Roco Corp.*), 701 F.2d 978, 982 (1st Cir. 1983); *Daley v. Chang* (*In re Joy Recovery Tech. Corp.*), 286 B.R. 54, 75 (Bankr. N.D. Ill. 2002); *Vadnais Lumber Supply, Inc. v. Byrne* (*In re Vadnais Lumber Supply, Inc.*), 100 B.R. 127, 136 (Bankr. D. Mass. 1989); *Joshua Slocum, Ltd. v. Boyle* (*In re Joshua Slocum, Ltd.*), 103 B.R. 610, 618 (Bankr. E.D. Pa. 1989).

HBE Leasing, 48 F.3d at 635. As a result, the "first transferee receives the debtor's [repayment obligation], and the second transferee receives the consideration, while the debtor retains nothing." *Id*. "This approach finds its most frequent application to lenders who have financed leveraged buyouts of companies that subsequently become insolvent." *Id*.

67. Further, although not required in order to satisfy the collapsing analysis, the Proposed Complaint also alleges that the original arranger and placement agent for the Term Debt – Morgan Stanley – knew or should have known that the LBO would result in NWHI's financial impairment, including by causing NWHI to be unable to repay the Unsecured and Secured Term Loans as they came due.[65] For example, Morgan Stanley created its own base and downside projections for NWHI that were materially lower than those provided by Sycamore.[66]

68. The Morgan Stanley model did not include a solvency analysis for NWHI.[67] However, applying assumptions in the range used by Duff & Phelps to Morgan Stanley's projections results in a finding of NWHI insolvency in virtually all scenarios.[68] Thus, the agent for the Unsecured Term Loans knew or should have known before the LBO closed that (i) Sycamore's projections for NWHI were overly aggressive, and that (ii) if projections reflecting Morgan Stanley's own view of NWHI's likely performance were used, the LBO Debt would render NWHI insolvent.[69] Concerns regarding NWHI's insolvency were also evident to individual lenders under the Secured and Unsecured Term Loans.[70]

[65] *See* Compl. ¶¶ 147-149, 208-211.

[66] *See* Compl. ¶¶ 147-149.

[67] *See* Compl. ¶ 148.

[68] *See* Compl. ¶ 148.

[69] *See* Compl. ¶¶ 148-149.

[70] *See* Compl. ¶ 208. Indeed, one of the largest lenders under the Unsecured Term Loan stated in an internal email that it was "pretty likely" that NWHI would find itself in "real trouble" over the next three years. Compl. ¶ 208.

69. Morgan Stanley, however, like other Term Loan lenders, could afford to ignore, or willfully blind itself to, clear evidence of NWHI's post-LBO insolvency.[71] Repayment of the LBO Debt was guaranteed by NWHI's key operating subsidiaries, which accounted for much of NWHI's value, but were encumbered by barely half of NWHI's debt.[72] Those subsidiaries were not liable to repay, and did not guarantee, any of NWHI's $700 million of bond debt. Hence, the Secured and Unsecured Term Loans could be repaid in full even if NWHI was insolvent, as long as the operating subsidiaries were solvent. Morgan Stanley therefore was prepared to proceed with arranging and financing the Term Loans despite its actual or constructive knowledge of NWHI's financial impairment.[73]

3) NWHI Received No Value for Waiving a $64 Million-Plus Payment Owed by Sycamore Affiliate Jones Apparel

70. There is no question that RemainCo was contractually entitled to all of the net working capital at Jones Apparel at the time of the LBO – an amount which appears to have been approximately $64.5 million – and Sycamore simply waived that valuable right for no value.[74]

4) NWHI Received No Value in Exchange for its NOLs

71. Several decisions have held that NOLs are estate property subject to the automatic stay. *See Official Comm. of Unsecured Creditors v. PSS S.S. Co.* (*In re Prudential Lines Inc.*), 928 F.2d 565 (2d Cir. 1991) (upholding an order enjoining a parent corporation from taking a post-petition worthless stock deduction that would have prevented its subsidiary, the debtor, from using $74 million worth of NOLs); *Triad Guar. Inc. v. Triad Guar. Ins. Corp.* (*In re Triad Guar. Inc.*), No. 14-1464 (GMS), 2016 WL 3523834, at *10 (D. Del. June 26, 2016) (similar). By

[71] *See* Compl. ¶¶ 210-211.
[72] *See* Compl. ¶¶ 210-211.
[73] *See* Compl. ¶¶ 210-211.
[74] *See* Compl. ¶¶ 165-169.

taking the Worthless Stock Deduction, Sycamore deprived RemainCo of the NOLs for no value.

(c) **The Value of NWHI's Avoidance Claims Is Immense**

72. In light of the above, NWHI is entitled to recover over $1 billion in fraudulent transfers to Sycamore. This amount includes: the value of the Carve-Out Transactions as evidenced by market transactions, i.e., re-sales and dividends (approximately $1 billion or more); the working capital that Jasper Apparel should have but failed to turn over ($64.5 million); and the value of the Worthless Stock Deduction.[75] NWHI is also entitled to avoid liens and obligations incurred to the benefit of the LBO Lenders in connection with the more than $800 million in LBO Debt.

2. NWHI Has Colorable Claims for Intentional Fraudulent Conveyance

73. NWHI's claims for intentional fraudulent conveyance for the same transfers and incurrences also are colorable. Indeed, evidence of intentional fraudulent conduct here is overwhelming, and demonstrates Sycamore's willful and deliberate effort to repeatedly utilize its control of NWHI to benefit itself at the expense of NWHI's creditors.

74. A debtor can avoid any transfer or incurrence made "[w]ith actual intent to hinder, delay or defraud any creditor of the debtor." Del. Code Ann. tit. 6 § 1304; 12 Pa. Cons. Stat. § 5104(a)(1). Since "individuals are rarely willing to admit intent, actual fraud is rarely proven by direct evidence," *Shubert v. Stranahan* (*In re Pa. Gear Corp.*), No. 02-36436DWS, 2008 WL 2370169, at *9 (Bankr. E.D. Pa. Apr. 22, 2008), and instead may be shown by "badges of fraud." *See Holber v. Dolchin Slotkin & Todd, P.C.* (*In re Am. Rehab & Physical Therapy, Inc.*), No. 04-014562, 2006 WL 1997431, at *15-16 (Bankr. E.D. Pa. May 18, 2006).

[75] *See* Compl. ¶ 197.

75. This is the rare case where the Debtor already has actual evidence of Sycamore's fraud based solely on the limited Rule 2004 discovery taken to date. As alleged in detail in the Proposed Complaint, Sycamore created projections that fraudulently inflated the value of RemainCo, and fraudulently deflated the value of the Carve-Out Assets, among other things.[76] In addition, the Proposed Complaint alleges a number of badges of fraud in connection with the Carve-Out Transactions, Working Capital Waiver, and Worthless Stock Deduction, and thus plainly states colorable claims that these transfers constitute intentional fraudulent conveyances.[77] For instance, the Proposed Complaint alleges that (1) the Carve-Out Assets were transferred to Sycamore, an insider of the Debtors, (2) Sycamore paid NWHI significantly less for the Carve-Out Assets than those assets were worth, (3) the Carve-Out Transactions rendered NWHI insolvent, and (4) the Carve-Out Transactions occurred immediately after the Debtors incurred the enormous LBO Debt.[78] Likewise, the Proposed Complaint alleges that both the Working Capital Waiver and the Worthless Stock Deduction were intended to hinder, delay, and or defraud RemainCo's creditors.[79]

3. NWHI Has Colorable Claims for Breach of Fiduciary Duty Against the Sycamore and Jones Inc. Fiduciaries Arising from their Pre-Petition Misconduct

76. The Sycamore Fund Entities, the Sycamore Principals, the Jones Inc. Directors, and McClain are all liable for breach of their fiduciary duties to NWHI and its creditors. Directors and controlling shareholders of a corporation owe the corporation and its shareholders fiduciary duties of care, loyalty, and good faith. When a corporation becomes insolvent, the

[76] *See* Compl. ¶¶ 98-122, 136-141, 150-163.
[77] *See* Compl. ¶¶ 98-122, 136-141, 150-163, 165-171.
[78] *See* Compl. ¶¶ 80-122, 136-141, 150-163.
[79] *See* Compl. ¶¶ 165-171.

creditors replace shareholders as the residual stakeholders of the corporation and have standing to sue for breach of fiduciary duty. *See, e.g., N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101-02 (Del. 2007); *Official Comm. of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged)*, 659 F.3d 282, 290 (3d Cir. 2011).

77. The duty of care requires directors to "use that amount of care which ordinarily careful and prudent men would use in similar circumstances." *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005) ("*Disney I*"); *Stanziale v. Nachtomi* (*In re Tower Air, Inc.*), 416 F.3d 229, 241-42 (3d Cir. 2005) (due care violation is "synonymous with engaging in an irrational decision-making process" by failing to obtain information necessary to make an informed decision, or reaching irrational conclusions in light of available information). The standard for a duty of care violation—"gross negligence"—is somewhat "nebulous." *See Jardel Co. v. Hughes*, 523 A.2d 518, 530 (Del. 1987). While the term "signifies more than ordinary inadvertence or inattention," it "is nevertheless a degree of negligence," as distinct from recklessness, which "connotes a different type of conduct akin to the intentional infliction of harm." *Alberts v. Tufts* (*In re Greater Se. Cmty. Hosp. Corp. I*), 353 B.R. 324, 339 (Bankr. D.D.C. 2006) (citing *Jardel*, 523 A.2d at 530). Notably, a director's burden to act with care is heightened where a major corporate transaction such as an LBO is being considered. *Brandt v. Hicks, Muse & Co.* (*In re Healthco Int'l, Inc.*), 208 B.R. 288, 305 (Bankr. D. Mass. 1997). Board action with respect to such a transaction "will fail to meet the standard of due care" if it suggests "indifference to a potential risk of harm" to the corporation. *Official Comm. of Unsecured Creditors of TOUSA, Inc. v. Technical Olympic, S.A.* (*In re TOUSA, INC.*), 437 B.R. 447, 462 (Bankr. S.D. Fla. 2010) (citation omitted).

78. The duty of loyalty "is an affirmative obligation to protect and advance the interests of the corporation and mandates that [the director] absolutely refrain from any conduct that would harm the corporation." *Autobacs, Strauss, Inc. v. Autobacs Seven Co.* (*In re Autobacs*), 473 B.R. 525, 562 (Bankr. D. Del. 2012); *see also Lampe v. Lampe* (*In re Lampe*), 665 F.3d 506, 515 (3d Cir. 2011) (fiduciary is required "in dealing with the affairs of the corporation to promote the interests of the corporation rather than its own interest"). A breach of the duty of good faith (which is a subset of the duty of loyalty) occurs where a fiduciary intentionally acts with a purpose other than advancing the best interests of the corporation, acts with the intent to violate positive law, or intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his or her duties. *See, e.g., Burtch v. Seaport Capital, LLC* (*In re Direct Response Media, Inc.*), 466 B.R. 626, 652 (Bankr. D. Del. 2012). A complaint sufficiently pleads breach of the duty of loyalty if it alleges that the fiduciaries (1) were interested in the transaction at issue, (2) acted without good faith, or (3) lacked independence. *See Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 981 (Del. Ch. 2000) (declining to dismiss duty of loyalty claim where only single basis was pled); *see also Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000).

79. All of the fiduciary defendants breached their duties to NWHI shamelessly in connection with the LBO, as well as certain other pre-petition misconduct. In approving the LBO, the Jones Inc. Directors disavowed concern for any constituency other than Jones Inc. shareholders – a constituency of which each director was a part. In so doing, the Jones Inc. Directors considered only their own interests, and failed to evaluate whether the interrelated LBO transactions would result in the insolvency of the surviving corporation, or the impact the LBO transactions would have on the surviving corporation's creditors. All elements of the LBO

– the Merger, the Carve-Out Transactions and the LBO Debt – were part of a single, unified transaction, and the Jones Inc.'s Directors' malfeasance and/or nonfeasance constituted a clear violation of their fiduciary duties. *See Giuliano v. Schnabel* (*In re DSI Renal Holdings, LLC*), 574 B.R. 446, 470-71 (Bankr. D. Del. 2017)

80. Sycamore[80] and the Sycamore Principals had become fiduciaries of NWHI by the time the LBO Debt was incurred and Carve-Out Assets were transferred to the Sycamore Affiliates, but considered only their own parochial interests in those transactions, despite their obvious and devastating impact on NWHI and its creditors, as detailed above and in the Proposed Complaint. Likewise, Sycamore, its principals and John McClain (who served as a director of NWHI from April 15, 2014 to October 9, 2015) violated their fiduciary duties when they caused NWHI to execute the Working Capital Waiver, which inured solely to Sycamore's benefit and provided no benefit whatsoever to RemainCo. Finally, Sycamore and the Sycamore Principals violated their duties of care and loyalty to NWHI by taking the Worthless Stock Deduction shortly before the petition was filed.

81. Sycamore has informed the Committee that it intends to argue that NWHI's breach of fiduciary duty claims are time-barred. In fact, NWHI's claims accrued well within the six-year statute of limitations provided under applicable New York law. *See* N.Y. C.P.L.R. § 213(7) (providing that "an action by or on behalf of a corporation against a present or former director, officer or stockholder . . . to recover damages for waste or for an injury to property" must be brought within six years of the alleged breach.). Federal courts apply the choice of law principles of the state in which the court is located. *See, e.g., Bianco v. Erkins* (*In re Gaston &*

[80] A sole or majority stockholder such as Sycamore owes the same fiduciary duties of care, loyalty, and good faith as corporate officers and directors. *See Official Comm. of Unsecured Creditors of Hechinger Inv. Co. v. Fleet Retail Fin. Grp.* (*In re Hechinger Inv. Co.*), 274 B.R. 71, 93 (D. Del. 2002).

Snow), 243 F.3d 599, 601-02 (2d Cir. 2001). The rule in New York is that if a claim accrues (i) in the state or (ii) in favor of a resident of the state, New York's statute of limitations governs. *See* N.Y. C.P.L.R. § 202; *Stuart v. Am. Cyanamid Co.*, 158 F.3d 622, 627 (2d Cir. 1998).

82. Since NWHI, and Jones Inc. before it, both had their headquarters in New York, they are deemed New York residents, and the derivative claims against NWHI's and Jones Inc.'s fiduciaries are subject to New York's six-year limitations period. *See, e.g., Guzman v. Macy's Retail Holdings, Inc.,* No. 09 Civ. 4472 (PGG), 2010 WL 1222044, at *10 (S.D.N.Y. Mar. 29, 2010) ("A corporation's principal place of business . . . determines its residence."); *Pereira v. Centel Corp.* (*In re Argo Commc'ns Corp.*), 134 B.R. 776, 783-84 (Bankr. S.D.N.Y. 1991) (applying New York's six-year period to bankruptcy trustee's claims against controlling shareholder in connection with failed merger brought "in the name of the debtor and for the benefit of creditors"); *see also Lippe v. Bairnco Corp.*, 230 B.R 906, 913 (S.D.N.Y. 1999) (similar); *Bartle v. Markson*, 299 F. Supp. 958, 965 (N.D.N.Y. 1969) (similar), *aff'd*, 423 F.2d 637 (2d Cir. 1970).

4. NWHI Has Colorable Claims for Aiding and Abetting Breach of Fiduciary Duty Against the Sycamore Principals, Sycamore, the Sycamore Employees, and the Jones Inc. Directors

83. The Complaint also states colorable claims for aiding and abetting the breaches of fiduciary duty described above. Under Delaware law, a claim for aiding and abetting breach of fiduciary duty has four elements: (1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty, (3) knowing participation in that breach by the defendants, and (4) damages proximately caused by the breach. *In re Primedia, Inc. S'holders Litig.*, 67 A.3d 455, 496 (Del. Ch. 2013). The third element, knowing participation, requires that the third party act with the knowledge that the conduct advocated or assisted constitutes a breach fiduciary duty. *See In re Novell, Inc. S'holder Litig.*, C.A. No. 6032-VCN, 2013 WL 322560, at *17 (Del. Ch. Jan. 3,

2013). Knowing participation may be inferred where a fiduciary breaches its duty in an "inherently wrongful manner," and the plaintiff alleges specific facts from which the Court could reasonably infer knowledge of the breach by the non-fiduciary. *See id.*

84. Various parties knowingly participated in the breaches of fiduciary duty described above. The Sycamore Employees aided and abetted the Sycamore Principals, Sycamore, and the Jones Inc. Directors, because they knew that the projections on which the LBO Debt and Carve-Out Transactions were premised were fraudulent, but nevertheless assisted the Sycamore Principals, Sycamore, and the Jones Inc. Directors in consummating those transactions, by, *inter alia*, (i) devising the LBO structure, including the carve out and quick resale of Jones Inc.'s crown jewel assets; (ii) creating artificially low "historical" financial information and going-forward projections for the Carve-Out Assets to justify their low-ball purchase price; (iii) creating "historical" financial information and going-forward projections for RemainCo, including the Sponsor Addbacks, that were used to artificially inflate the value of RemainCo; (iv) providing misleading "historical" financial information and going-forward projections for RemainCo to Duff & Phelps, for the purpose of fraudulently obtaining a solvency opinion; (v) disseminating false and misleading projections to the public, including to the Lender Defendants, prospective investors, and rating agencies; (vi) assisting in securing debt financing for the LBO; and (vii) assisting in managing the overall LBO process.[81] The Sycamore Employees knew that by doing so, they were helping the Sycamore Principals, Sycamore, and the Jones Inc. Directors earn huge profits at RemainCo's expense.

85. Additionally, for all the reasons described herein, both the Sycamore Principals and Sycamore itself are liable for aiding and abetting the breaches of fiduciary duty by the Jones

[81] *See* Compl. ¶¶ 82-141, 150-163, 165-171.

Inc. Directors.[82] Likewise, the Jones Inc. Directors are liable for aiding and abetting the breaches of fiduciary duty by the Sycamore Principals and Sycamore, by knowingly facilitating the LBO, LBO Debt, and Carve-Out Transactions by approving the Merger (which contemplated the Carve-Out Transactions and LBO Debt), and then abdicating the fiduciary duties they owed to NWHI to ensure that the Merger did not result in harm to the corporation.[83]

5. The Estate Has Colorable Claims for Unlawful Stock Redemption and Dividends Against the Jones Inc. Directors and the Sycamore Principals

86. Stock redemptions and dividends are illegal when the capital of the corporation either already is or would be impaired as a result of the distributions. *See, e.g.,* DGCL § 160(a)(1)*;* 15 Pa. Cons. Stat. § 1551. Directors who authorize such payments are liable to the corporation and its creditors for the amount of the illegal dividends or redemptions, with interest. DGCL § 174; 15 Pa. Cons. Stat. § 1553. A corporation's capital is impaired if a redemption or dividend renders a corporation "balance sheet" insolvent within the meaning of the Bankruptcy Code. *See SV Inv. Partners, LLC v. Thoughtworks, Inc*., 7 A.3d 973, 982 (Del. Ch. 2010); *see also* 15 Pa. Cons. Stat. § 1551(b) (prohibiting redemptions and dividends where "the total assets of the corporation would be less than the sum of its total liabilities"). Here, the LBO rendered NWHI insolvent, and the Sycamore and Jones Inc. fiduciaries are liable to NWHI for the more than $1.2 billion in stock redemption payments made in connection with the LBO.

6. The Estate Has Colorable Claims for Unjust Enrichment Against Sycamore and the Jones Inc. Directors

87. To establish unjust enrichment a plaintiff must show (1) a benefit to the defendant (2) at the plaintiff's expense, and (3) that equity and good conscience require restitution. *Mid-*

[82] *See* Compl. ¶¶ 82-141, 150-163, 165-171.
[83] *See* Compl. ¶¶ 80-96.

Island Hosp., Inc. v. Empire Blue Cross & Blue Shield (*In re Mid-Island Hosp., Inc.*), 276 F.3d 124, 129 (2d Cir. 2002); *see also BAE Sys. Info. & Elec. Sys. Integration v. Lockheed Martin Corp.*, No. 3099-VCN, 2009 Del. Ch. LEXIS 17, at *25-26 (Del. Ch. Feb. 3, 2009) (internal quotations omitted) (similar). Here, Sycamore was unjustly enriched when, among other things, it (i) caused NWHI to (a) sell the Carve-Out Assets to Sycamore for significantly less than they were worth and (b) execute the Working Capital Waiver for nothing in exchange, and (ii) took the Worthless Stock Deduction, which deprived NWHI of its ability to utilize its NOLs to offset its tax obligations.[84] The Jones Inc. Directors were unjustly enriched when they approved the Merger, which provided them with $14.3 million in the aggregate in exchange for their shares.[85] Equity and good conscience demand that Sycamore and the Jones Inc. Directors provide restitution to NWHI of the amounts they received from these unjust transactions.

7. NWHI Has Additional Claims for Breach of Contract and Tortious Interference with Contract Related to the Working Capital Waiver

88. The Working Capital Waiver also gives rise to claims by NWHI for breach of contract and tortious interference with contract. The elements of a breach of contract claim are: (1) a contractual obligation; (2) a breach of that obligation; and (3) resulting damages. *See Interim Healthcare, Inc. v. Spherion Corp.*, 884 A.2d 513, 548 (Del. Sup. Ct. 2005). NWHI was an express third-party beneficiary of the purchase agreement between Jasper Apparel and Jasper Parent that included the working capital purchase price adjustment provision.[86] Sycamore induced Jasper Apparel to breach that agreement by failing to pay to NWHI the amount by which

[84] *See* Compl. ¶¶ 82-89, 150-171.
[85] *See* Compl. ¶¶ 59, 337.
[86] *See* Compl. ¶ 165.

the Closing Working Capital exceeded the Target Working Capital, which was approximately $64.5 million.[87]

8. Sycamore's Post-Petition Misconduct Relating to Belk Gives Rise to Additional NWHI Claims Against Sycamore

89. NWHI also has colorable claims against the Sycamore Fund Entities, Kaluzny, and Morrow for tortious interference with business relations, breach of fiduciary duty, prima facie tort, and violation of the automatic stay based on their direction to Belk to terminate its business relationship with NWHI.[88] The elements of a claim for tortious interference with business relations are: (1) business relations with a third party; (2) the defendant's interference with those business relations; (3) that the defendant acted with the sole purpose of harming the plaintiff or used dishonest, unfair, or improper means; and (4) injury to the business relationship. *A.V.E.L.A., Inc. v. Estate of Marilyn Monroe, LLC*, 241 F. Supp. 3d 461, 486 (S.D.N.Y. 2017).

90. The Proposed Complaint satisfies each of these elements: the RemainCo businesses and Belk had a longstanding and mutually beneficial business relationship; Kaluzny, Morrow and the Sycamore Fund Entities caused Belk to sever that relationship in retaliation for RemainCo's refusal to release the estate's claims against Sycamore, for the sole purpose of harming RemainCo, and in violation of the fiduciary duties that they owed to RemainCo and to Belk.[89] These allegations are more than sufficient to plead a claim for tortious interference with business relations. *See Mission Measurement Corp. v. Blackbaud, Inc.*, 287 F. Supp. 3d 691 (N.D. Ill. 2017) (private equity firm that induced its portfolio company to cut business ties with plaintiff subject to claim for tortious interference with economic advantage).

[87] *See* Compl. ¶¶ 166-169.

[88] As noted above, the Committee does not seek standing to assert any claims against Belk itself, which may be as much of a victim of Sycamore's misconduct as NWHI.

[89] *See* Compl. ¶¶ 172-179.

91. The estate also has colorable claims against the Sycamore Fund Entities, Kaluzny, and Morrow for breach of fiduciary duty arising from their actions with respect to Belk. As fiduciaries of NWHI, the Sycamore Fund Entities, Kaluzny, and Morrow had an absolute duty to refrain from any conduct that would harm NWHI and its creditors, and to put NWHI's interests ahead of their own. Instead, by causing Belk to terminate its business relationship with NWHI, the Sycamore Fund Entities, Kaluzny, and Morrow have intentionally caused harm to NWHI's business for their own parochial advantage. This Court will not find a more clear-cut violation of the duty of loyalty.

92. To the extent Kaluzny and Morrow argue that their abrupt resignation from the NWHI board on September 24, 2018 inoculates them from liability, they will be mistaken. A director may be held liable for breach of fiduciary duty if they "engage[d] in transactions that had their inception before the termination of the fiduciary relationship or were founded on information acquired during the fiduciary relationship." *BelCom, Inc. v. Robb*, No. CIV. A. 14663, 1998 WL 229527, at *3 (Del. Ch. Apr. 28, 1998) (holding former director liable for breach of fiduciary duty for conduct that occurred after his termination from the board); *Antaramian Props., LLC v. Basil Street Partners, LLC* (*In re Basil Street Partners, LLC*), No. 9:12-ap-00863-FMD, 2012 WL 6101914, at *19 (Bankr. M.D. Fla. Dec. 7, 2012) ("[A fiduciary] cannot escape liability for breach of a fiduciary duty merely by resigning when the acts or conduct that give rise to the breach began while the fiduciary duty was in existence."). Moreover, the Sycamore Fund Entities were and remain the sole equity owners of the Debtors, and owe continuing fiduciary duties to NWHI irrespective of the composition of NWHI's board of directors.

93. The Estates also have colorable claims for prima facie tort, which requires a plaintiff to allege (1) an intentional infliction of harm; (2) resulting in special damages; (3) without excuse or justification; (4) by an act that would otherwise be lawful. *Sadowy v. Sony Corp. of Am.*, 496 F. Supp. 1071, 1074-76 (S.D.N.Y. 1980). A claim for prima facie tort may be alleged in the alternative to claims for specific, recognized torts. *Bd. of Educ. of Farmingdale Union Free Sch. Dist. v. Farmingdale Classroom Teachers Ass'n*, 343 N.E.2d 278, 284 (N.Y. 1975). Here, in the event that it is found that the conduct relating to Belk does not give rise to claims for breach of fiduciary duty and tortious interference, all of the elements of a claim for prima facie tort are met: the Sycamore Fund Entities, Kaluzny, and Morrow intentionally harmed RemainCo by causing Belk to terminate its business relationship with RemainCo, for the sole purpose of retaliating against RemainCo and without excuse or justification, which resulted in special damages to RemainCo in the form of lost business from Belk.

94. And lastly, the termination of the Belk business constitutes a clear violation of the automatic stay. 11 U.S.C. § 362(a)(3) prohibits "all entities" from taking any "act" to "exercise control over property of the estate." Under the Bankruptcy Code, estate property encompasses, among other things, "all legal or equitable interests of the debtor in property as of the commencement of the case," and "[a]ny interest in property that the estate acquires after the commencement of the case." 11 U.S.C. § 541(a)(1), (7); *see In re Prudential Lines Inc.*, 928 F.2d at 572-73 (property of the estate is "anything of value that the debtors have in the estate"). RemainCo's goodwill and reasonable expectation of continued business with Belk are property of the estate, and the termination of that business relationship is an impermissible attempt to exert control over that property in violation of the stay. *See Alert Holdings, Inc. v. Interstate Protective Servs., Inc.* (*In re Alert Holdings, Inc.*), 148 B.R. 194, 203 (Bankr. S.D.N.Y.

1992) (noting that goodwill and other intangible assets are property of the estate and holding that interference with debtor's customer relationships constituted a violation of the automatic stay).

B. The Debtors Have Unjustifiably Refused to Prosecute the Proposed Claims[90]

95. In order to decide whether a debtor unjustifiably failed to bring suit so as to give the creditors' committee standing to bring an action, the court should examine "whether an action asserting such claim(s) is likely to benefit the reorganization estate." *STN*, 779 F.2d at 905 (citation omitted). The debtor need not have an "improper motive" for failing to bring the suit, *Adelphia*, 330 B.R. at 379 & n.19 (*citing STN*, 779 F.2d at 905), and the creditor is not required to plead facts alleging the debtor's reason or motive for inaction, *see Canadian Pac. Forest Prods. Ltd. v. J.D. Irving, Ltd.* (*In re Gibson Grp.*), 66 F.3d 1436, 1439 (6th Cir. 1995). "Rather, the burden may be met through notice pleading by alleging the existence of an unpursued colorable claim that would benefit the estate. Thereafter, the burden shifts to the debtor, who is then obligated to show that its failure to act is justified." *In re Sabine Oil & Gas Corp.*, 547 B.R. 504, 516 (Bankr. S.D.N.Y. 2016) (citing *Canadian Pac. Forest Prods.*, 66 F.3d at 1446).

96. "While the Court "need [not] undertake a mini-trial" to determine whether the suit is likely to benefit the estate, it should assure itself that there is a "sufficient likelihood of success to justify the anticipated delay and expense to the bankruptcy estate that the initiation and continuation of litigation will likely produce," *STN*, 779 F.2d at 905-06, and that there is a "fair chance that the benefits to be obtained from the litigation will outweigh its costs," *Hobby Ctr.*, 223 B.R. at 284. Courts also consider other "common sense factors" such as "(i) whether the deputization of the committee would permit the debtor to concentrate its resources on

[90] The Debtors have not disclosed to the Committee their position with respect to McClain and the Jones Inc. Directors. Those claims arise out of the same transactions and occurrences as the claims against the Sycamore Defendants and are therefore included in the Proposed Complaint.

rehabilitating its business, (ii) whether the committee's interests do not conflict with those of the estate, and (iii) whether the assignment would prejudice the equity of distribution amongst the debtor's creditors." *Sabine*, 547 B.R. at 517 (citing *Adelphia*, 330 B.R. at 375).

97. There is no question here that pursuit of the Proposed Claims would benefit the estate, or that the Debtors have unjustifiably refused to pursue them. As described above, the Proposed Claims have a significant likelihood of success, and could lead to a judgment of more than a billion dollars. Indeed, avoidance of the Carve-Out Transactions ***alone*** could result in a judgment of more than a billion dollars. Successful prosecution of the claims of breach of fiduciary duty (and aiding and abetting breach of fiduciary duty), unjust enrichment, and illegal share redemptions and dividends could result in similar judgments, and the claims related to the Working Capital Waiver, Worthless Stock Deduction, and unlawful actions concerning Belk could lead to additional damages. Avoidance of the LBO Debt would yield a decrease of up to $800 million or more in claims against the estate (before interest).

98. Further, there is little doubt that NWHI would be able to realize value on such judgments. Avoidance of the Lender Defendants' claims at NWHI is self-effectuating. Sycamore is a prominent private equity fund with $10 billion of assets under management, and defendants Kaluzny and Morrow – who, like the other Sycamore personnel, presumably have rights of indemnification from Sycamore – are very wealthy on their own. Sycamore and the various Director Defendants also have substantial insurance coverage that should be available to fund part of a judgment or settlement. We believe the face amounts of these policies alone collectively equal or exceed the amount at which the Debtors are considering settling the claims against Sycamore.

C. This Court Should Grant the Committee Exclusive Authority to Settle the Proposed Claims

99. This Court should also grant the Committee exclusive authority to settle the Proposed Claims, subject to Court approval in accordance with Bankruptcy Rule 9019. Similar relief has been granted by this and other courts in similar circumstances. *See, e.g., In re Old CarCo LLC (f/k/a/ Chrysler LLC)*, Case No. 09-50002 (AJG) (Bankr. S.D.N.Y. Aug. 13, 2009) [Docket No. 5151 at ¶ 2] (granting unsecured creditors' committee the exclusive right to prosecute and settle claims on behalf of the debtors' estate); *In re Majestic Capital, LTD.*, Case No. 11-36225 (CGM) (Bankr. S.D.N.Y. Dec. 12, 2011) [Docket No. 211 at ¶ 3] (same); *U.S. Bank N.A. v. DHL Global Forwarding* (*In re Evergreen Solar, Inc.*), Case No. 11-12590 (MFW) (Bankr. D. Del. Oct. 28, 2011) [Docket No. 382 at ¶ 3] (same). Granting exclusive settlement authority to the Committee would ensure that the Debtors are not able to settle the Proposed Claims at a discounted value, and is particularly appropriate given that the Debtors have already demonstrated a willingness to do so.

RESERVATION OF RIGHTS

100. The Committee reserves its right to seek authority to commence and prosecute other claims and/or causes of action against the Defendants on behalf of the Debtors' estate.

NOTICE

101. This Motion was served on: (i) the Office of the United States Trustee for the Southern District of New York; (ii) the Debtors and their counsel; (iii) counsel to Sycamore; and (iv) counsel to the named Lender Defendants.

CONCLUSION

WHEREFORE, the Committee respectfully requests that the Court (i) enter the proposed order, substantially in the form attached hereto as Exhibit A, granting the Committee standing to commence and prosecute the Proposed Claims on behalf of the Debtors' estate; and (ii) grant such additional relief as the Court may deem just, proper and equitable.

New York, New York
Dated: October 5, 2018

AKIN GUMP STRAUSS HAUER & FELD LLP

By: /s/ *Daniel H. Golden*

Daniel H. Golden
Arik Preis
David M. Zensky
Mitchell P. Hurley
Deborah Newman
One Bryant Park
New York, New York 10036
Telephone: (212) 872-1000
Facsimile: (212) 872-1002
dgolden@akingump.com
apreis@akingump.com
jrubin@akingump.com
djnewman@akingump.com

Counsel to the Official Committee of Unsecured Creditors of Nine West Holdings, Inc.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
PURDUE PHARMA L.P., *et al.*,	:	Case No. 19-23649 (RDD)
Debtors.[1]	:	(Jointly Administered)

REPORT OF STEPHEN D. LERNER, EXAMINER

Stephen D. Lerner, as the Examiner in the above-captioned cases (the "Examiner"), pursuant to the June 21, 2021 *Order Appointing an Examiner Pursuant to 11 U.S.C. § 1104(c)* [ECF No. 3048] (the "Examiner Appointment Order"), the *Notice of Appointment of Examiner* [ECF No. 3063], and the June 29, 2021 *Order Approving Appointment of Examiner* [ECF No. 3078], respectfully submits this report in accordance with the Examiner Appointment Order.

I. Summary of the Examiner's Key Findings and Conclusions

A. Appointment

The Examiner was appointed on June 24, 2021. Shortly thereafter, the Examiner retained Scott A. Kane of Squire Patton Boggs (US) LLP as his counsel. On June 30, 2021, the Examiner filed the *Application of Examiner for Authority to Employ and Retain Scott A. Kane as Attorney for the Examiner* Nunc Pro Tunc *to June 24, 2021* [ECF No. 3095]. The July 16, 2021 objection deadline to the application passed without any party objecting, and on July 18, 2021, the Examiner

[1] The Debtors in these cases, along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014). The Debtors' corporate headquarters is located at One Stamford Forum, 201 Tresser Boulevard, Stamford, CT 06901.

filed the *Certificate of No Objection Under 28 U.S.C. § 1746 Regarding Notice of Application of Examiner for Authority to Employ and Retain Scott A. Kane as Attorney for the Examiner* Nunc Pro Tunc *to June 24, 2021* [ECF No. 3249]. The application has not yet been approved by the Court as of the filing of this Report.

The Examiner was appointed in response to a June 1, 2021 *Motion for Order to Appoint Examiner Pursuant to 11 U.S.C. § 1104(c)* [ECF No. 2963] ("Examiner Motion") by Peter W. Jackson ("Mr. Jackson") through his counsel, Jonathan C. Lipson ("Prof. Lipson"). The Debtors, the Official Committee of Unsecured Creditors (the "Official Committee"), the Multi-State Governmental Entities Group (the "MSGEG"), and the Ad Hoc Committee of Governmental and Other Contingent Litigation Claimants (the "Ad Hoc Committee") filed objections to the Examiner Motion. (*See* ECF Nos. 3020, 3021, 3022, 3023). Mr. Jackson, through Prof. Lipson, filed a reply to those objections. (*See* ECF No. 3034). The Court held a hearing on the Examiner Motion on June 16, 2021. At the conclusion of that hearing, the Court partially granted the relief requested in the Examiner Motion, as subsequently memorialized in the Examiner Appointment Order.

B. Scope of Examination and Report

The Examiner Appointment Order narrowly and specifically defines a limited scope of inquiry for the Examiner. Recognizing this narrow scope of the Examiner's mandate is key to a proper understanding of this report. This report is ***not*** a determination by the Examiner of: the merits of the Debtors' Fifth Amended Joint Chapter 11 Plan of Reorganization[2] [ECF No. 2982], now as amended by the Debtors' Sixth Amended Joint Chapter 11 Plan of Reorganization [ECF No. 3185] (as amended, the "Plan"); the desirability or reasonableness of the "Shareholder Settlement" defined and contained in the Plan; the nature, extent, or merits of any actual or

[2] This is the version of the Plan that was effective as of the date of the Examiner's appointment and that was referred to in the Examiner Appointment Order.

potential claim or cause of action against any person or entity, or the defenses thereto; whether any person or entity has legal or moral responsibility for the circumstances associated with the Debtors' bankruptcy cases; or the wisdom of any decision to support or oppose the Plan and Shareholder Settlement by any creditor or party in interest. Indeed, these issues are expressly excluded from the Examiner's permitted scope by the terms of the Examiner Appointment Order. (*See* Examiner Appt. Order at ¶ 2).

Instead, the Examiner's specific mandate is to determine whether the Special Committee of the Board of Directors of Purdue Pharma, Inc. (the "Special Committee") "***acted independently and not under the direction or influence of the Sackler Families with respect to the Shareholder Settlement***" reflected in the Plan. (*Id.*, emphasis added, footnote omitted). In other words, stated in the most basic sense, it is not up to the Examiner to offer any conclusion on how or why the Debtors and other parties in interest arrived at the terms of the Plan or whether those terms are appropriate. Rather, the Examiner may only consider and report on whether the Special Committee's decision to support the Shareholder Settlement contained in the Plan was made independently and free of any direction or influence of the Sackler Families.[3] The Examiner views this limited scope to be fundamental to his appointment and this report is confined to the singular issue for which the Examiner was appointed.

C. Executive Summary of Findings and Conclusions

The Examiner found no evidence that the Special Committee acted other than independently in its consideration and recommendation of the Shareholder Settlement and the Plan. The Examiner found no evidence that the Sackler Families either attempted to, or did, influence the Special Committee in its work. To the contrary, all of the evidence identified in the

[3] As used in this report, the "Sackler Families" has the same definition used in the Examiner Appointment Order.

course of the Examiner's investigation indicated that the Special Committee acted independently in evaluating and recommending the Shareholder Settlement and Plan and that it was not controlled or influenced, or subjected to attempted control or influence, by the Sackler Families.

The Examiner cannot report with metaphysical certitude that the Special Committee acted with absolute independence. That conclusion would struggle with the dynamic of "proving a negative" as to the non-existence of hypothetical influence. But the Examiner can state definitively, based on the investigation described in this report, including the review of thousands of pages of discovery material, communications received in response to information requests, Special Committee minutes, and other documents and information, that: 1) he found no evidence of any lack of independence of the Special Committee or attempted direction or influence by the Sackler Families; 2) he found significant evidence that the Special Committee acted independently and free from actual or attempted influence or direction by the Sackler Families; and 3) given the Examiner's findings as to the circumstances of the formulation of the Plan, he believes it is not necessary or appropriate to expend additional time and estate resources attempting to prove further the absence of actual or attempted influence over the Special Committee.

Regarding affirmative evidence of independence, the Examiner interviewed each member of the Special Committee. Each of them asserted specifically and credibly that he acted independently as a member of the Special Committee, exercising his own judgment without actual or attempted influence by the Sackler Families. Likewise, the Examiner interviewed members of the Raymond Sackler family and Mortimer Sackler family, as well as a representative of one of the shareholder trusts for the Mortimer Sackler family, all of whom asserted specifically and credibly that they never sought to influence or control the Special Committee in its work. The Examiner views these interviews as significant evidence of the independence of the Special Committee and the absence of attempted influence by the Sackler Families. Additionally, and in response to a hypothetical critic observing that significant proof is not absolute proof, the Examiner notes that the interviews are consistent with the available documentary evidence, the absence of any evidence of attempted influence, and the circumstances of the formulation of the Plan discussed in more detail below.

D. Timing of the Examiner's Report

The Examiner Appointment Order directed that the Examiner "exercise good faith reasonable efforts to prepare and file the Report on or before July 19, 2021." (Examiner Appt. Order ¶ 4). The report is filed as the result of the Examiner's good faith and reasonable efforts to meet that directive of the Examiner Appointment Order.

Completing this report was not without its challenges. While the Examiner's area of focus is limited, the scope of activity to be examined was expansive. The chapter 11 cases have been pending for nearly two years, the issues are complex, the Debtors are on the sixth iteration of the Plan, and the parties in interest are numerous and varied. While the Examiner has not interacted with all of them, he understands there are approximately 12 different committees representing the interests of various creditor groups. The Special Committee itself has been working for more than 22 months, the Official Committee has conducted an active and informed investigation of issues bearing on the Shareholder Settlement and Plan, and the issues in the case continue to evolve significantly, as reflected in the recent filing of the Sixth Amended Joint Chapter 11 Plan of Reorganization and the developments related thereto.

In contrast to all of this, the Examiner has been appointed for a period of only 25 days, which spanned the Fourth of July holiday. Obtaining and reviewing relevant information, undertaking necessary analysis, conducting diligence calls and witness interviews, and preparing the report required intensive effort over this short time period. That effort was facilitated by the responsiveness of the parties in interest. Issuing a report on this timetable would not have been possible if not for the prompt and complete cooperation of the parties to which the Examiner directed requests for information. All of them responded comprehensively and quickly to requests for information and communications from the Examiner. This included the Debtors, the Official Committee, Prof. Lipson and his co-counsel on behalf of Mr. Jackson, both sides of the Sackler Families, the Ad Hoc Committee, the MSGEG, and the Ad Hoc Group of Non-Consenting States ("NCSG"). In the Examiner's view, all of these parties (and in particular, their legal counsel) are to be commended for their prompt and thorough cooperation with the Examiner's investigation.

The Examiner admits to some degree of trepidation in issuing his report on this timetable. The instinct of every competent legal professional is to be thorough and careful before making conclusions in order to ensure that they are fully and accurately supported. Those instincts are magnified in a matter as significant and high profile as these cases. In other circumstances, including where the Examiner may have been appointed earlier in the cases or where more time remained prior to Plan-related deadlines, the Examiner very likely would have performed additional work, including likely conducting additional witness interviews. But the Examiner wishes to be very clear with the Court and parties in interest on this point: there is no uncompleted work necessary to support the Examiner's conclusions set forth in this report. If the Examiner believed further work was necessary to complete the scope of investigation delineated in the Examiner Appointment Order, the Examiner would have performed such work prior to filing this report.

Any additional work the Examiner would have performed would have been confirmatory diligence to demonstrate further the thoroughness of the Examiner's search for evidence of possible influence on the Special Committee. Any such additional work would have been performed in the interests of cautiousness and meticulousness and not out of necessity to reach the conclusions set forth in this report. Given the significant evidence of the independence of the

Special Committee, the absence of any evidence of the lack of independence or attempted influence or control by the Sackler Families, and the Examiner's reasonable and informed belief that additional investigation is not in any way likely to produce additional unique evidence, the Examiner is filing this report now, with the context of the foregoing discussion, in the exercise of "good faith reasonable efforts to prepare and file the Report on or before July 19, 2021." (Examiner Appt. Order ¶ 4).

II. Process of the Examiner's Investigation

Immediately following his appointment on June 25, 2021, the Examiner began reviewing information and commenced communications with the parties in interest. The Examiner had an introductory call with counsel for the Debtors that same day. The following discussion summarizes the principal activities of the Examiner, as assisted by his counsel. It does not purport to catalog every activity or area of analysis undertaken by the Examiner. As discussed below, the Examiner's investigation included witness interviews of Robert S. "Steve" Miller, Kenneth Buckfire, Michael Cola, and John Dubel (each a "member" and sometimes collectively the "members" of the Special Committee), David Sackler, Mortimer D.A. Sackler, and Jonathan White. The Examiner believes and respectfully submits to the Court that the process and scope of his investigation was sufficient to support the conclusions set forth in this report.

A. Initial Information Gathering

Upon appointment, the Examiner reviewed materials related to his appointment, including the Examiner Appointment Order, the Examiner Motion, the oppositions and reply thereto, and the transcript of the hearing on the Examiner Motion. The Examiner's review of those materials began even before his formal appointment but the Examiner and counsel reviewed those materials in detail upon appointment. The purpose of that review was not to draw conclusions related to the substance of the Examiner's work but rather to understand the circumstances giving rise to the request for the appointment of an examiner and the positions of various parties related to those circumstances. In addition to these materials, throughout the course of his investigation, the Examiner and counsel also reviewed other publicly available information, including but not limited to:

- the Plan;
- the Disclosure Statement for Fifth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P. and its Affiliated Debtors [ECF No. 2983] ("Disclosure Statement");
- legal press and other news articles regarding the bankruptcy cases and the request for appointment of an examiner;
- materials regarding the background of the members of the Special Committee;
- a family tree for the Sackler Families;
- a chart of dates of services of current and former directors on the board of Purdue Pharma Inc.;
- filings in the cases to understand the composition and role of creditor groups, including the Ad Hoc Committee, the MSGEG, and the NCSG;
- a July 15, 2020 letter from Mr. Jackson to the Court requesting that an examiner be appointed in these cases [ECF No. 1538];
- the Third Amended Protective Order [ECF No. 1935] (the "Protective Order");
- the Debtors' Informational Brief [ECF No. 17];
- a Motion to Compel filed by the Official Committee [ECF No. 1753], as well as a declaration, filings in opposition; and the reply filed by the Official Committee [ECF No. 2014];
- a December 16, 2019 report of the Special Committee prepared by AlixPartners titled Cash Transfers of Value [ECF No. 654];
- a May 28, 2020 report of the Special Committee prepared by AlixPartners titled Intercompany and Non-Cash Transfer Analysis [ECF No. 1194];
- transcripts of the depositions taken by creditor groups of Cecil Pickett, Craig Landau, David Sackler, Ilene Sackler Lefcourt, Kathe Sackler, Marianna Sackler, Mortimer D.A. Sackler, Peter Boer, Richard Sackler, and Theresa Sackler; and
- the transcripts of the May 26, June 1, and June 2, 2021 hearings on the Debtors' motion to approve the Disclosure Statement.

The Examiner reviewed the foregoing and other materials from the cases to facilitate his understanding of issues in the cases and to guide his investigation of the scope of work set forth in the Examiner Appointment Order.

B. Diligence Calls with Counsel for Parties in Interest

Shortly after appointment, the Examiner contacted counsel for parties in interest to conduct diligence calls intended to advance the Examiner's work. The Examiner conducted such diligence calls with counsel for the Official Committee, counsel for the Debtors (including a call with Charles Duggan as the Davis Polk attorney responsible for leading the representation of the Special Committee), Prof. Lipson and his co-counsel for Mr. Jackson, Marc Kesselman as General Counsel of the Debtors, counsel for both sides of the Sackler Families, counsel for the Ad Hoc Committee, counsel for the NCSG, and counsel for the MSGEG. As noted above, all of these counsel were responsive and prompt in replying to requests by the Examiner and answered all questions posed by the Examiner freely and candidly.

These calls were not evidentiary in nature and the Examiner's requests for them did not characterize them as witness interviews. Nonetheless, the calls were integral to the Examiner's investigation. The Examiner used these diligence calls to further his understanding of the cases generally, to comprehend the nature and activities of the various committees, to facilitate the identification of subjects for information requests, and to ask for and receive perspective from these counsel on the subject matter of the Examiner's work. The Examiner asked each counsel specifically if she or he had any concerns about the independence of the Special Committee or influence over it by the Sackler Families.

Other than Prof. Lipson, no counsel expressed a concern that the Special Committee failed to act independently or that it may have been subjected to influence or control by the Sackler Families. In fairness, other than counsel for the Debtors, no counsel expressed an affirmative conclusion or finding that the Special Committee was independent and free from any influence by the Sackler Families. Rather, and notably to the Examiner, counsel for the creditor groups shared the consistent perspective that the independence of the Special Committee was not an area of focus or special significance for them. These counsel explained that their clients were not relying directly on the Special Committee and instead had conducted an independent investigation of potential claims and formed their own views regarding the Shareholder Settlement and the Plan. Counsel further shared, in response to questions by the Examiner directed to the topic, that in mediations and negotiations regarding the Shareholder Settlement and Plan, they negotiated directly with the Sackler Families and not through the Special Committee. This dynamic is discussed further in Section III.C of the Examiner's report below.

One objective of the Examiner in these diligence calls with counsel was to identify potential witnesses for interviews. Prior to the calls, the Examiner's expectation was that he would interview client representatives from each of the major creditor groups. However, based on discussions with counsel and the negotiation dynamic described above, the Examiner did not seek interviews of client representatives of the Official Committee, the Ad Hoc Committee, the MSGEG, or the NCSG. Based on discussions with counsel, and the absence of any direct Plan-related negotiations between these creditor groups and the Special Committee, the Examiner's informed conclusion was that interviews of client representatives of these groups would not advance the Examiner's investigation or further his understanding of issues within the scope of the Examiner's mandate beyond the diligence calls with their counsel.

The Examiner also did not interview Mr. Jackson. In the diligence call with Prof. Lipson, he shared that Mr. Jackson would not have factual knowledge of issues related to any possible lack of independence of the Special Committee or alleged influence by the Sackler Families beyond those set forth in the court filings made on his behalf. The Examiner did not draw any negative inference from this position and it was consistent with the Examiner's expectation. Prof. Lipson, like counsel for the other parties in interest, was helpful and candid in sharing his perspective on the issues within the scope of the Examiner's mandate. Prof. Lipson and his co-counsel indicated that they were summarizing their thoughts and suggested areas of inquiry for the Examiner in a written memorandum, which they shared with the Examiner following the diligence call. This memorandum and the information in the appendices was reviewed and considered in the course of the Examiner's investigation.

C. Information Requests by the Examiner

Following initial discussions with the Examiner, the Debtors provided background materials including: the Disclosure Statement; an Amended & Restated Shareholders Agreement of Purdue Pharma Inc. effective as of May 14, 2019; a Restated Certificate of Incorporation of Purdue Pharma Inc. dated May 14, 2019; a Certificate of Amendment of the Certificate of Incorporation of Purdue Pharma Inc. dated September 3, 2019; an Amendment to the Shareholders Agreement of Purdue Pharma Inc. dated September 3, 2019; a Letter Agreement between the shareholders of Purdue Pharma Inc. dated November 6, 2019 regarding "Specified Director Rights and Other Matters" (the "November 6, 2019 Letter Agreement"); a March 3, 2020 Order Appointing Mediators [ECF No. 895]; a September 30, 2019 Order Expanding Scope of Mediation [ECF No. 1756]; a Mediators' Report dated September 23, 2020 [ECF No. 1716]; a Mediators' Report dated March 23, 2021 [ECF No. 2548]; the Examiner Motion, oppositions, and reply; the transcript of the June 16, 2021 hearing on the Examiner Motion; a copy of the Examiner Appointment Order; and the minutes of all meetings of the Special Committee. The Examiner reviewed and considered these materials as part of his investigation. As noted above, Prof. Lipson shared a written memorandum with the Examiner, including detailed appendices encompassing a timeline of events in the case and numerous quotes from time entries of professionals, exhibits, and other filings in the cases. The Examiner reviewed and considered these materials as part of his investigation. Counsel for the Official Committee also shared certain documents with the Examiner following the diligence call with the Examiner. The Examiner reviewed and considered these materials as part of his investigation.

In addition to these materials shared voluntarily with the Examiner and his review of other filings in the cases and publicly available materials, as described above, the Examiner made specific information requests to the Debtors and Special Committee, the Raymond Sackler family, and the Mortimer Sackler family. The information requests to each of them included a request for all communications between members of the Sackler Families and members of the Special Committee from the time of their contemplated service on the board of Purdue Pharma Inc. to the present. With respect to the Debtors, the Examiner also sought copies of any discovery production made to other parties concerning the subject of independence of the Special Committee or alleged or attempted influence by the Sackler Families, including communications between members of the Sackler Families and members of the Special Committee. This included the Debtors' production in response to discovery requests from the NCSG seeking such communications for the period from January 1, 2017 until the time each member of the Special Committee joined the board. The Examiner received responses to these requests from the Debtors (including the Debtors' response to the NCSG requests), the Mortimer Sackler family, and the Raymond Sackler family. The Examiner reviewed and considered these materials as part of his investigation.

In addition to the foregoing requests, the Examiner also made information requests to the Debtors, including but not limited to, for: corporate governance documents for Purdue Pharma Inc., including bylaws, regulations, board or committee charters, and similar documents; shareholder agreements for Purdue Pharma Inc., if any, in addition to the May 14, 2019 and September 3, 2019 agreements and amendments; the partnership agreement and all governance documents for Purdue Pharma L.P.; common interest agreements to which either Purdue Pharma Inc. or Purdue Pharma L.P. was a party in effect or related to any period from January 1, 2018 to the present; minutes of the board of directors of Purdue Pharma Inc.; and all formation or governance documents for the Special Committee. The Examiner received responses from the Debtors to these requests, which were reviewed and considered as part of the Examiner's investigation.

Additionally, the Examiner made some information requests to the Debtors where the Debtors indicated that, after a diligent search, they were unable to locate any responsive information. These included requests for: documents or communications other than filings of record with the Court (like the Examiner Motion) alleging that the members of the Special Committee were not acting independently or were subjected to actual or attempted influence by the Sackler Families; documents regarding the contemplated, potential, requested, or threatened removal of any of any of the members of the Special Committee as directors or Special Committee members; written analyses of the independence of the members of the Special Committee under internal governance documents or external standards like NYSE guidelines; and copies of any presentations to the Special Committee (by any legal or financial advisor to the Debtors, any official or unofficial committee in the Bankruptcy cases, or any other party) that were subsequently provided to the Sackler Families. The absence of materials responsive to these requests was considered as part of the Examiner's investigation.

The Examiner also requested and received access to the Document Reserve for Confirmation, as defined in the Second Amended Order Granting Debtors' Motion for Order Establishing Confirmation Schedule and Protocols [ECF No. 2989] (the "Document Reserve"). The Examiner accessed the Document Reserve and ran searches therein, which proved to be of limited utility for the Examiner's purposes. Nothing from the Document Reserve or those searches forms the basis for any of the conclusions set forth in this report.

D. Witness Interviews

The Examiner interviewed the following witnesses: Steve Miller, Kenneth Buckfire, Michael Cola, and John Dubel (*i.e.*, each of the members of the Special Committee), David A. Sackler, Mortimer D.A. Sackler, and Jonathan White. No person refused any interview request by the Examiner. During the interviews, each witness answered all questions posed by the Examiner and his counsel. No witness refused to answer any question and no response to any question was restricted by the assertion of legal privilege or for any other reason. All of the witnesses were cooperative during the interviews and answered questions directly.

At the Examiner's request, each of the witnesses signed a declaration pursuant to 28 U.S.C. § 1746 confirming what the Examiner believed to be the key points from the interview. No witness refused to include in his declaration any substantive issue requested by the Examiner. Copies of those declarations (the "Witness Declarations") are attached hereto as Exhibits 1-7, respectively. Prior to the interviews, the Examiner reserved the right to question witnesses under oath with transcription but communicated to the parties in interest that the Examiner's intention was first to proceed with unsworn interviews to be memorialized in a declaration. This was the Examiner's decision, which in his judgment facilitated the progress of the Examiner's work and promoted the free exchange of information in the interviews. Based on the conduct of the interviews, the direct responses by witnesses to questions therein, and the witnesses providing the Witness Declarations requested by the Examiner, the Examiner did not seek any further questioning under oath. The information obtained in the witnesses interviews and the confirming Witness Declarations form a key part of the Examiner's investigation and, in the Examiner's view, strongly support the conclusions and findings set forth in this report.

III. Discussion & Analysis

A. Evaluation of Possible Indications of Lack of Independence or Actual or Attempted Influence Over the Special Committee

1. There was a general absence of post-petition interactions between the Special Committee and the Sackler Families

The Examiner's investigation revealed the general absence of communications between the Sackler Families and the members of the Special Committee after the filing of the Debtors' bankruptcy cases. The Examiner issued information requests to the members of the Special Committee, the Debtors, and both sides of the Sackler Families for all post-petition communications between the Special Committee and the Sackler Families or their representatives. The Examiner also received information voluntarily produced by the Official Committee and Prof. Lipson. The Examiner obtained and reviewed the responses to his information requests and the other materials provided to him, which demonstrated the absence of extensive or significant post-petition contacts. None of the handful of interactions indicated or suggested any attempt to influence the Special Committee's work or called into question the independence of the Special Committee.

The responses to the Examiner's information requests did not include any written communication between the Special Committee and the Sackler Families or their representatives relating to the subject matter of the Special Committee's work. The few post-petition communications that occurred instead consisted of: non-substantive group calendar invites for periodic general information updates sent to a wide distribution, including members of the Special Committee, other members of the Board of Purdue Pharma, Sackler family members, legal counsel for various parties, and others (in most instances, the communications appeared to be Outlook updates cancelling meetings scheduled at some point in the past); a brief, non-substantive email exchange scheduling a breakfast between Kenneth Buckfire and Jonathan White, described below;

and periodic summaries of media coverage of the Debtors, which were individually emailed from one lawyer at Norton Rose Fulbright US LLP to each member of the Special Committee and which did not include any substantive communication regarding the Special Committee's work. No post-petition written communication indicated or suggested any attempt to influence any member of the Special Committee. Indeed, no post-petition written communication related to the substance of the Special Committee's work.

In addition to obtaining and reviewing post-petition written communications, the Examiner also questioned each member of the Special Committee about any post-petition communications with the Sackler Families or their representatives. Each member of the Special Committee confirmed to the Examiner, without qualification, that he had no communication with the Sackler Families or their representatives regarding the work of the Special Committee and no communication where any member of the Sackler Families or their representatives sought to influence the Special Committee. (*See* S. Miller Decl. ¶¶ 3-5; K. Buckfire Decl. ¶ 3-5; M. Cola Decl. ¶ 3-5; J. Dubel Decl. ¶ 3-5).

The Examiner also questioned members of the Sackler Families about post-petition communications. Each of them also confirmed the absence of any post-petition communications related to the Special Committee's work and the absence of any communications seeking to influence the Special Committee. (*See* Mortimer D.A. Sackler Decl. ¶ 3-5; David A. Sackler Decl. ¶ 3-5; J. White Decl. ¶¶ 3-4). Each witness interviewed by the Examiner confirmed these responses under oath in the Witness Declarations. For whatever incremental context it provides, the Examiner observed each witness he interviewed to be credible and frank in answering questions during the interviews.

Apart from written communications, the Examiner's investigation revealed a limited number of interactions of any type between members of the Special Committee and members or representatives of the Sackler Families following the filing of the Debtors' bankruptcy cases. None of those few interactions related to the substance of the Special Committee's work. None indicated or suggested a lack of independence of the Special Committee or any attempt to influence any member of the Special Committee. According to the Examiner's investigation, the few post-petition interactions consisted of: 1) a scheduled meeting where legal counsel for the Sackler Families (but not family members themselves) made a presentation to members of the Special Committee and others regarding the Sackler Families' position as to potential claims; 2) a breakfast that Kenneth Buckfire and Jonathan White attended in December of 2019; 3) a group call in December of 2019, not relating to the Special Committee's work, where some members of the Special Committee and some members of the Sackler Families may have participated; and 4) the possibility that Steve Miller may have met with a lawyer from Debevoise & Plimpton LLP[4] (with whom he had a pre-existing relationship) unrelated to the work of the Special Committee. Each of these interactions is discussed below. In the Examiner's view, none of them calls into question the independence of the Special Committee and none reflects any attempt by the Sackler Families to influence any member of the Special Committee in its or their work.[5]

Regarding the first item, the presentation by counsel for the Sackler Families to members of the Special Committee and others occurred on January 29, 2020. In investigating this issue, the Examiner: reviewed the minutes of a meeting of the Special Committee from January 29, 2020; discussed the issue with counsel for the Debtors; discussed the issue with counsel for the Mortimer Sackler family and counsel for the Raymond Sackler family; reviewed a written copy of the

[4] Debevoise & Plimpton LLP represents the Mortimer Sackler family.

[5] To the extent that the presentation was technically an attempt to influence the Special Committee's thinking, it was a fully-disclosed and appropriate one including counsel for both sides, as discussed below.

presentation given by counsel for the Raymond Sackler family; reviewed the website[6] where (as the Examiner understands) a subsequent, substantially similar version of the presentation is publicly available; questioned each member of the Special Committee regarding the issue; and questioned members of the Sackler Families regarding the issue. The Examiner views the Special Committee's willingness to receive the presentation as unremarkable and an appropriate exercise of its diligence.

The Examiner's investigation revealed that counsel for the Sackler Families gave a substantially identical presentation to creditor groups during these bankruptcy cases. The Special Committee receiving the same presentation ensured that it had the same information as other parties in interest in the case. The presentation was made at a scheduled meeting of the Special Committee where counsel and other invited parties were present. Following the presentation, the Special Committee excused everyone other than its own counsel. In the Examiner's view, nothing about this presentation indicates a lack of independence or an attempt at inappropriate influence by the Sackler Families. To the contrary, the Examiner believes the presentation reflects appropriate diligence by the Special Committee in considering available information regarding the potential claims it was evaluating, including in the form of a presentation by the Sackler Families that already had been shared with creditor groups.

Regarding the few other post-petition interactions noted above, the Examiner does not believe that any of them indicates a lack of independence by the Special Committee or any attempted influence by the Sackler Families or their representatives. Kenneth Buckfire and Jonathan White had breakfast in December of 2019. (*See* Buckfire Decl. ¶ 4; J. White Decl. ¶ 4). The Examiner understands that Mr. White is the director of a trust company that serves as a trustee

[6] *See* Raymond Sackler Family Defense Presentation, https://www.judgeforyourselves.info/wp-content/uploads/2021/05/Defense-Presentation.pdf (last visited July 19, 2021)

for the trust holding certain shares beneficially owned by the Mortimer Sackler family. Both Mr. White and Mr. Buckfire confirmed that the breakfast was social in nature and did not include any substantive discussion of the work of the Special Committee or potential claims by the Debtors against the Sackler Families. (*See* Buckfire Decl. ¶ 4; J. White Decl. ¶ 4). Similarly, Mr. Miller reported that it is possible (but not certain) that he met with Jeffrey Rosen of the Debevoise firm, with whom he had a pre-existing relationship, at some point after the filing of the Debtors' bankruptcy cases. (S. Miller Decl. ¶ 4). Mr. Miller indicated that he did not discuss the Special Committee's work with Mr. Rosen or any other representative of the Sackler Families. (*Id.*). Based on the Examiner's investigation, including the questioning of witnesses, nothing about these types of isolated social interactions[7] represents a lack of independence of the Special Committee or any attempt by the Sackler Families or their representatives to influence the members of the Special Committee.

Regarding the group call in December of 2019 in which members of the Special Committee and members of the Sackler Families may have participated, the Examiner's investigation revealed that it was an instance of a periodic call (sometimes referred to as a "Beneficiaries Call") in the nature of a management update to the Debtors' shareholders. It did not relate to the work of the Special Committee. And while the Examiner's investigation indicates that members of the Special Committee and members and representatives of the Sackler Families each may have attended, so did numerous others, including legal counsel. The Examiner's investigation of this issue included the review of the calendar invite for the call, discussions with counsel for the Debtors and both sides of the Sackler Families, and questioning of numerous witnesses during interviews. Based

[7] Mr. Miller could not say with certainty that any post-petition interaction with Mr. Rosen occurred but indicated he wanted to be cautious in mentioning the possibility. Thus, the number of such interactions may be limited to the single breakfast meeting between Mr. Buckfire and Mr. White in December of 2019.

on that investigation, the Examiner concludes that this was a conference call with coincident attendance, not a vehicle for communications between the Special Committee members and the Sackler Families, and there was no direct relation to, or attempt to influence, the work of the Special Committee. (*See* David A. Sackler Decl. ¶ 4; Mortimer D.A. Sackler Decl. ¶ 4). The Examiner's investigation did not indicate that any "Beneficiaries Call" or similar call ever took place after December of 2019.

Without revealing the details of the communications, both members of the Sackler Families interviewed by the Examiner noted that they and their family members had been advised by legal counsel against having any post-petition interactions with members of the Special Committee. This is consistent with the results of the Examiner's investigation indicating no substantive post-petition communications and an extremely limited number of interactions, none of which indicated an attempt to influence the members of the Special Committee in their independent judgment.

2. There was limited pre-petition interaction between the Special Committee and the Sackler Families

The Examiner Appointment Order limited the scope of the Examiner's investigation to the Special Committee's independence in connection with the Plan and the Shareholder Settlement reflected therein. (Examiner Appt. Order ¶ 2). It specifically excluded from the Examiner's scope the investigation of any action by the Special Committee "other than its determination to advance and ultimately agree to the Shareholder Settlement." (*Id.*). Accordingly, the Examiner's investigation of pre-petition activities of the Special Committee generally was limited to an inquiry into the possible existence of any relationships or dealings between members of the Special Committee and the Sackler Families that might reasonably be expected to affect the Special Committee's subsequent judgment to proceed with the Shareholder Settlement and Plan. The Examiner's investigation revealed no such relationships or dealings.

Three of the four members of the Special Committee had no prior relationship or dealings of any kind with the Sackler Families or Purdue Pharma before becoming an independent director of Purdue Pharma Inc. (S. Miller Decl. ¶ 6; K. Buckfire Decl. ¶ 6; J. Dubel Decl. ¶ 6). The fourth, Michael Cola, interviewed for a director or officer position with Purdue Pharma in approximately 2013. (M. Cola Decl. ¶ 6). He was identified as a candidate for such a position through an executive search firm and not through any prior relationship with Purdue Pharma or the Sackler Families. (*Id.*). Following the interviews in approximately 2013, Mr. Cola withdrew from consideration as a candidate and no position with Purdue Pharma was ever offered to him. (*Id.*). Other than this, Mr. Cola had no other relationship or connection to Purdue Pharma or the Sacklers prior to becoming an independent director in 2019. (*Id.*).

Steve Miller joined the board of Purdue Pharma, Inc. as Chairman effective July 1, 2018. All of the other members of the Special Committee joined the board at various points in 2019 after all individual members of the Sackler Families had resigned from the board. Thus, Mr. Miller was the only member of the Special Committee to serve on the board during the tenure of members of the Sackler Families. During the Examiner's investigation, he questioned both the members of the Special Committee and two members and a representative of the Sackler Families regarding the selection of the members of the Special Committee, including interviews prior to their joining the board. The Examiner's investigation revealed nothing about the process of identifying and selecting the members of the Special Committee as independent directors that called into question their independence, the independence of the Special Committee, or that suggested actual or potential influence by the Sackler Families. To the contrary, the findings from the Examiner's investigation are consistent with the explanation given to the Examiner by counsel to the Debtors and representatives of the Sackler Families: the members of the Special Committee were selected because of their strong professional qualifications and background and exactly because they were independent. (*See* David Sackler Decl. ¶ 6; Mortimer D.A. Sackler Decl. ¶ 6).

The Examiner is aware of and has reviewed communications where members of the Sackler Families commented on independent director candidates and their interviews prior to their appointment to the board. Those communications address subjects like the candidate's background, experience, and diversity considerations. None of those communications suggests or addresses prior relationships with any of the candidates or any issues that reasonably could be viewed as relating to the possibility of future control or influence over them as members of the board.

In addition to the foregoing, the Examiner's information requests to the Debtors, the Raymond Sackler family, and the Mortimer Sackler family sought copies of their discovery responses and prior productions concerning pre-petition communications between any members of the Special Committee and the Sackler Families. In the case of the Examiner's information request to the Debtors, this included copies of the Debtors' responses to discovery requests by the NCSG seeking communications between any Sackler family members and any member of the Special Committee from January 1, 2017 until such individual joined the board of directors. The Examiner received copies of the requested information in response to his requests. The Examiner's review of that information did not reveal any fact or circumstance suggesting a lack of independence of any member of the Special Committee or actual or attempted influence by the Sackler Families.

3. There were no indications of outside influence or control of the Special Committee

The Examiner's investigation revealed no evidence indicating or suggesting that the Special Committee failed to conduct an independent analysis in deciding to advance the

Shareholder Settlement contained in the Plan. All of the members of the Special Committee, in response to varied and extensive questioning by the Examiner, confirmed that the Special Committee conducted its activities independently and free from any actual or attempted influence by the Sackler Families. (*E.g.*, J. Dubel Decl. ¶ 9; M. Cola Decl. ¶ 9; K. Buckfire Decl. ¶ 9; S. Miller Decl. ¶ 9). Additionally, in response to questioning by the Examiner, the members of the Special Committee confirmed that the other directors of Purdue Pharma respected the separateness of the Special Committee and did not attempt to influence its work. The Examiner's investigation, as described in this report, found nothing to contradict these statements by the members of the Special Committee. All of the available evidence and information – including the minutes of the meetings of the Special Committee, discussions with counsel for the Debtors, the responses to the Examiner's information requests, and the Examiner's interviews of members of the Sackler Families – corroborated the accounts of the members of the Special Committee, as confirmed in the Witness Declarations.

In response to specific questioning by the Examiner, all of the members of the Special Committee understood that they were free to consider and advance alternatives to the Shareholder Settlement if they did not find its terms to be in the best interests of the Debtors and creditors. Specifically, all of the members of the Special Committee understood that litigation of claims by the Debtors against the Sackler Families was an alternative to the Shareholder Settlement. They indicated their understanding that the Special Committee was not precluded by the pre-petition Settlement Framework (as described in the Disclosure Statement) or otherwise from considering or recommending such alternatives, if they so determined in the exercise of their independent judgment. In summary, the Examiner's investigation, as described in this report, found no evidence or indication that the work of the Special Committee was restricted, controlled, or influenced by the Sackler Families in any way.

B. Evaluation of Possible Contractual or Governance-related Restrictions on the Special Committee

The Examiner reviewed governance materials for the Debtors and Special Committee, including all of the materials provided to and requested by the Examiner as discussed in Section II.C above. None of these materials calls into question the independence of the Special Committee, restricts the Special Committee's authority regarding consideration of the Shareholder Settlement, Plan, or potential claims against the Sackler Families, or indicates or suggests control over the Special Committee by the Sackler Families. The governance documents, as amended in 2019, recognize the existence of the Special Committee and its authority to consider potential claims against shareholders, among other matters. There was a suggestion in the Examiner Motion and during the hearing on the Examiner Motion that perhaps the bylaws or other governance documents of the Debtors somehow restrict the authority of the Special Committee or permit control over the Special Committee's work by the Sackler Families. (Examiner Motion ¶¶ 26, 35; Tr. of June 16, 2021 hearing at 26, 117, 119). The Examiner has reviewed those materials and found no support for that proposition.

The Examiner is aware that Purdue Pharma Inc. and Purdue Pharma L.P. are parties to a certain Memorandum of Understanding Regarding Joint Defense and Common Interest Agreement dated May 15, 2018 ("Common Interest Agreement"). The Common Interest Agreement is referenced in the Debtors' Disclosure Statement (ECF No. 2983 at 79) and also was the subject of certain proceedings between the United States Trustee and certain professionals to the Debtors. (ECF No. 2763). Based on his investigation, including a review of the Common Interest Agreement, communications with counsel, and questioning of witnesses, the Examiner does not believe that the Common Interest Agreement calls into question the independence of the Special Committee or reflects actual or potential influence by the Sackler Families.

The Common Interest Agreement pertains generally to certain pre-petition litigation claims filed against members of the Sackler Families and Purdue Pharma. The Common Interest Agreement does not require any particular action by the Debtors regarding those claims, in conjunction with the Sackler Families or otherwise. Rather, the Common Interest Agreement permits communications and the sharing of information regarding issues as to which the parties share a common interest without waiving privilege or protection from discovery as to third parties. The Examiner views this type of arrangement between joint defendants to pre-petition litigation as unremarkable.

Importantly, based on the Examiner's investigation, there is no evidence that the Special Committee acted with, or pursuant to, any common interest with the Sackler Families in evaluating the Shareholder Settlement contained in the Plan. There was no common interest with respect to the Special Committee's consideration of potential claims against the Sackler Families or its decision to advance the Shareholder Settlement as a proposed resolution of such claims. Based on the Examiner's investigation, each member of the Special Committee clearly understood this. As discussed above, there were few post-petition interactions of any type between the Special Committee and the Sackler Families. The Examiner found no indication of any communication, interaction, or activity of the Special Committee that reflected any actual or perceived common interest between the Special Committee or Debtors and the Sackler Families with respect to the Special Committee's evaluation of the Shareholder Settlement contained in the Plan.

The Examiner is aware generally (without any detailed understanding) that the Common Interest Agreement may have been implicated in prior discovery proceedings involving the Debtors, the Official Committee, and the Sackler Families. (*See, e.g.*, ECF 2161at ¶ 57, Exhs. 4-8, 14 & 48). The Examiner did not investigate such discovery issues and views them as not relevant to his mandate in light of the findings above regarding the Special Committee's post-petition activities and independent consideration of the Shareholder Settlement. Moreover, the evaluation of the investigatory efforts of creditor groups is specifically excluded from the Examiner's permitted scope. (Examiner Appointment Order ¶ 2).

In addition to confirming generally the absence of restrictions on the Special Committee that could call into question its independence from the Sackler Families, the Examiner investigated two specific issues that the Examiner understood to be possible areas of concern. Each is discussed below.

1. No covenant not to sue or similar agreement restricted the power of the Special Committee

During the diligence process for the Examiner's investigation described above, counsel for a party in interest suggested that the Examiner investigate whether there is a covenant not to sue or other contractual restriction prohibiting or limiting potential claims by the Debtors against the Sackler Families. There is not. The Examiner understands the request for investigation of this issue to be based on a reference in a redacted exhibit from 2008 produced during the extensive discovery in these cases that generally references a covenant not to sue. (*See* ECF No. 2255-1 at Exh. 6). The redacted information in the exhibit remains subject to the Protective Order, to which the Examiner is deemed a party. The Examiner can confirm, however, that his investigation (including a review of the unredacted exhibit) did not indicate the existence of any covenant not to sue or similar agreement purporting to restrict the ability of the Debtors to bring claims against the Sackler Families. The matter in the exhibit did not relate to the Sackler Families. Based on the Examiner's investigation, there is no covenant not to sue or other agreement that limits or affects the independence of the Special Committee.

Neither counsel for the Debtors nor either side of the Sackler Families believes that such an agreement ever existed. Counsel for the Debtors confirmed that they are not aware of any such agreement. No communications, minutes of the Special Committee, or other materials reviewed by the Examiner referred to any such agreement or pointed to the existence of any such agreement. Additionally, the Examiner confirmed with each member of the Special Committee that he was not aware of any such agreement and that no such agreement influenced the director's independent judgment or his work on the Special Committee. (S. Miller Decl. ¶ 7; K. Buckfire Decl. ¶ 7; M. Cola Decl. ¶ 7; J. Dubel Decl. ¶ 7). The Examiner also questioned members of the Sackler Families regarding this subject. None of them is aware of the existence of any such agreement. (Mortimer D.A. Sackler Decl. ¶ 7; David A. Sackler Decl. ¶ 7; J. White Decl. ¶ 7). The Examiner observes that during the course of bankruptcy cases, the Sackler Families were analyzing and preparing to defend potential claims by the Debtors. (*See* "Defense Presentation" *supra*, note 6; *see also* David A. Sackler Decl. ¶ 5; Mortimer D.A. Sackler Decl. ¶ 5; S. Miller Decl. ¶ 5; K. Buckfire Decl. ¶ 5; M. Cola Decl. ¶ 5; J. Dubel Decl. ¶ 5). Similarly, the Special Committee expended significant effort analyzing the basis for potential claims. (*See* ECF No. 654 - Cash Transfers of Value Report; ECF No. 1194 - Intercompany and Non-Cash Transfer Analysis Report).

In summary, the Examiner's investigation found no basis to believe that any covenant not to sue or similar agreement limiting potential claims against the Sacklers ever existed. The Examiner's investigation revealed direct, significant, and consistent evidence across multiple sources indicating that no such agreement either existed or influenced the Special Committee.

2. The November 6, 2019 Letter Agreement does not indicate a lack of independence of the Special Committee

During the diligence process for the Examiner's investigation described above, counsel for a party in interest suggested that the November 6, 2019 Letter Agreement indicated a lack of independence of the Special Committee prior to November 6, 2019. The November 6, 2019 Letter Agreement imposed restrictions on the ability of shareholders of Purdue Pharma Inc. (*i.e.*, the

Sackler Families) to remove at-large directors and the Chairman of Purdue Pharma Inc. The at-large directors and the Chairman encompass the members of the Special Committee.

During the Examiner's investigation, he requested information related to any contemplated, suggested, or threatened removal of any member of the Special Committee. The Debtors responded that they are not aware of any such information and had nothing to produce in response to the Examiner's request. The Examiner asked each member of the Special Committee whether he was aware of any suggested or threatened removal of any member of the Special Committee. None was so aware. All of them indicated that the November 6, 2019 Letter Agreement was a general, prophylactic governance measure not precipitated by any particular action or concern. (S. Miller Decl. ¶ 8; K. Buckfire Decl. ¶ 8; M. Cola Decl. ¶ 8; J. Dubel Decl. ¶ 8). The members of the Sackler Families interviewed by the Examiner stated that they never suggested or threatened removal and that, to the best of their knowledge, they are unaware of any member of the Sackler Families ever suggesting or threatening that any member of the Special Committee should be removed. All of this is consistent with the explanation of counsel for the Debtors that the November 6, 2019 Letter Agreement was a general governance measure.

Based on this examination, the Examiner does not view the November 6, 2019 Letter Agreement as indicative of a lack of independence of the Special Committee or prior control by the Sackler Families. There is an absence of any evidence regarding possible removal of the members of the Special Committee or any threat or suggestion thereof. The November 6, 2019 Letter Agreement is an extra governance protection beyond what the Examiner and his counsel have observed in other special committee circumstances. The Examiner does not view this prophylactic governance measure as an indication of control by the Sackler Families.

C. The Negotiation of the Shareholder Settlement and Plan is Inconsistent with any Hypothesis of Improper Influence

The Examiner is mindful that the Examiner Appointment Order provided that he was not to investigate or report on "the quality of the investigations conducted by the Debtors, the UCC, the Ad Hoc Committee, the MSGE or any other parties into claims against the Sackler Families before or during these chapter 11 cases." (Examiner Appt. Order ¶ 2). The following discussion does not represent any intention by the Examiner to ignore that admonition from the Court. Instead, the Examiner's intention is to report on the findings of his investigation regarding the role of the Special Committee in the overall negotiation and advancement of the Plan and Shareholder Settlement. Rather than any intention to assess or characterize the quality of any investigation by any party in interest, the Examiner's observation as expounded below is that the *existence* of those separate investigations and direct negotiations between creditor groups and the Sackler Families is inconsistent with any hypothesis of improper influence by the Sackler Families on the Special Committee.

As discussed above, during the Examiner's investigation, it became clear that creditor groups conducted their own, independent investigation of potential claims against the Sackler Families and negotiated directly, and not through the Special Committee, regarding their acceptance or not of the proposed terms of the Shareholder Settlement and Plan. During his investigation, the Examiner inquired whether parties in interest were aware of any occasion after the filing of the Debtors' bankruptcy cases where any creditor group negotiated directly with the Special Committee regarding the terms of the Shareholder Settlement or Plan. None was so aware.

Instead, creditor groups were negotiating with the Sackler Families directly, including based on their independent evaluation of potential claims. (*See* discussion at § II.B, supra). For example, and without intending to offer any judgment as to the merits either in the abstract or compared to other groups, it is abundantly clear the Official Committee conducted a highly-motivated, independent evaluation of potential claims in connection with the negotiation and consideration of the Plan and the Shareholder Settlement contained therein. Other creditor groups apparently did the same.

The Examiner's findings regarding settlement dynamics and investigatory roles strongly support, in the Examiner's view, the conclusions set forth in the report. Beyond the Special Committee's evaluation and recommendation of the Shareholder Settlement and Plan for the Debtors, the parties in interest understood that the Sackler Families needed to negotiate and reach direct agreement with motivated and capable creditor groups. In this context, there would be no benefit or incentive for the Sackler Families to seek to influence or control the Special Committee. If anything, there would be only potential downside for the Sackler Families in attempting to do so, including if any of the independent directors on the Special Committee reported any attempted influence to counsel or the Court (as all suggested they would have had any attempted influence occurred).

The Examiner is aware that the foregoing observations are not factual findings. The Examiner offers them not as evidence but rather as additional context for the conclusions set forth in this report. Where the Examiner's investigation found no evidence of any lack of independence of the Special Committee or attempted influence by the Sackler Families, and where the investigation identified significant evidence that the Special Committee acted independently and free from actual or attempted influence by the Sackler Families, the Examiner's findings as to the circumstances of the formulation of the Shareholder Settlement lead the Examiner to conclude that further investigation is not necessary. In the Examiner's view, there is no reasonable basis to believe that further investigation would produce additional unique evidence bearing on the issues of the independence of the Special Committee or the possibility of influence by the Sackler Families.

D. Willingness to Consider Contrary Evidence

The Examiner approached and conducted his investigation with an open mind and with no preconceived notions as to the outcome. The Examiner pursued inquiry into all issues that he reasonably believed could relate to the scope of his investigation as set forth in the Examiner Appointment Order. Certain issues the Examiner investigated, and ultimately concluded, did not indicate a lack of independence by the Special Committee or influence by the Sackler Families, are discussed below. Other issues that the Examiner was encouraged to investigate, but did not, are also referenced below together with a brief explanation of the reasons why.

1. Additional issues considered by the Examiner

The Examiner considered the compensation of the members of the Special Committee. None of the members of the Special Committee is or was compensated based on the substance or outcome of their work or any matter related to the Shareholder Settlement or Plan. It would be fair to characterize Mr. Miller as highly compensated for his service as Chairman of the Board of Directors of Purdue Pharma Inc. The Examiner is aware that he received a significant bonus in early 2019 for his service to the company from July 1 to December 31, 2018. The Examiner determined Mr. Miller's compensation, including payment of the bonus, to be consistent with the terms of the written agreement between Mr. Miller and Purdue Pharma, Inc. when he joined the board effective July 1, 2018. The Examiner further observes that Mr. Miller is a highly regarded professional who has been involved in some of the largest and most significant restructuring matters in history. Nothing about the structure or amount of his compensation, or that of the other members of the Special Committee, caused the Examiner to conclude that compensation arrangements created or suggested a lack of independence. Other than making this determination, the Examiner viewed further inquiry into this area to be beyond the scope of his mandate as delineated in the Examiner Appointment Order.

The Examiner is aware that Mr. Miller published an opinion article in the Wall Street Journal titled "Litigation Won't Solve the Opioid Crisis" on May 27, 2019.[8] The Examiner reviewed the article and communications related to it, including some involving members of the Sackler Families. The Examiner is aware of certain communications between members of the Sackler Families, which are subject to the Protective Order, characterizing requested changes to the article. Having reviewed drafts of the article, communications related thereto, and the final form of the article, the Examiner has no concerns that this matter evinces a lack of independence of Mr. Miller or the Special Committee (which did not then exist in its current form) or control by the Sackler Families. Beyond that basic finding, in the Examiner's view, this matter is beyond the scope of his mandate as set forth in the Examiner Appointment Order. Mr. Miller's decision to publish an opinion article during a pre-bankruptcy period while serving as Chairman of the Board of Purdue Pharma is not improper and does not relate to the Special Committee's later consideration of the Shareholder Settlement or the Plan.

The Examiner is aware of a communication suggesting that Mr. Cola may previously have done consulting work for Purdue Pharma and interacted with the members of the Sackler Families in doing so. During the course of his investigation, the Examiner raised questions regarding this issue and received confirmation that this was a mistaken reference to Mr. Cola's interview at Purdue Pharma in approximately 2013. Mr. Cola indicated in his interview with the Examiner that he had no prior dealings with the company or the Sackler Families other than the disclosed 2013

8 The Wall Street Journal, "Litigation Won't Solve the Opioid Crisis," https://www.wsj.com/articles/litigation-wont-solve-the-opioid-crisis-11558989157 (last visited July 19, 2021).

interview and he confirmed this in his Witness Declaration. (M. Cola Decl. ¶ 6). Representatives of the Sackler Families confirmed the same in their interviews and Witness Declarations. (Mortimer D.A. Sackler Decl. ¶ 6; David A. Sackler Decl.¶ 6).

2. Additional issues not considered by the Examiner.

The Examiner was urged to investigate other issues that he determined not to pursue. These issues related to: 1) settlements with the Department of Justice by the Debtors as to criminal and civil claims and by the Sacker Families as to civil claims; 2) questions asked of, or information requests made to, the Debtors and the Special Committee by the Official Committee or other creditor groups; 3) why the Special Committee and Official Committee have not released publicly their analyses of potential claims; 4) issues related to venue for the filing of the Debtors' bankruptcy cases; and 5) representation of the Special Committee by Davis Polk & Wardwell LLP ("DPW") as counsel rather than independent counsel. In the Examiner's view, these issues do not bear on the Examiner's limited mandate: to investigate whether the Special Committee acted independently and not under the influence or direction of the Sackler Families in its consideration of the Shareholder Settlement contained in the Plan.

Moreover, many of these subjects are foreclosed by the language in the Examiner Appointment Order providing that the Examiner's permitted scope does not include: decisions or resolutions of the Special Committee other than related to the Shareholder Settlement; and the quality of investigations conducted by the Debtors, the Official Committee, and other creditor groups. (Examiner Appt. Order ¶ 2). Regarding the last issue noted above, the Examiner is aware of decisions of courts considering the independence of special committees in connection with their engagement of independent advisors. Such decisions typically relate to special litigation committees and special negotiating committees outside the bankruptcy context and whether a special committee's process entitles it to a different standard of review or burden shift under non-bankruptcy law. The Examiner Appointment Order does not direct the Examiner to provide legal analysis. Moreover, it directs the Examiner not to investigate other "decisions or resolutions of the Special Committee" such as, arguably, those relating to its retention of advisors.

In any event, as a matter of fact, the Examiner's investigation revealed no evidence that DPW was a vehicle for potential control by the Sackler Families. To the contrary, as far as the Examiner can determine from his investigation, as described in this report, DPW consistently and effectively counseled the Special Committee regarding its independent evaluation of the Shareholder Settlement contained in the Plan. Without divulging details of privileged communications, all of the members of the Special Committee referred to frequent guidance and admonitions by DPW (and Mr. Huebner in particular) regarding the subject of independence. Nothing regarding the work of the Special Committee's legal and professional advisors leads the Examiner to limit or qualify the conclusions set forth in this report.

3. Limitations on the Examiner's Investigation

No person or entity sought to limit or restrict the Examiner's investigation. As discussed in this report, other parties and their counsel responded to communications and requests from the Examiner promptly and cooperatively. As provided in the Examiner Appointment Order, parties in interest were not required to provide attorney-client privileged documents or information to the Examiner. (Examiner Appt. Order ¶ 3). The Examiner observes that the minutes of the Special Committee meetings received by the Examiner contained extensive redactions for privilege. Similarly, the Examiner was not permitted to access or review confidential submissions or communications that are protected by mediation confidentiality, except to the extent they were communications between members of the Special Committee and the Sackler Families. (*Id.*) The Examiner found no evidence of the existence of such communications. The Examiner does not believe that attorney-client privilege or mediation confidentiality unduly restricted his investigation and believes his investigation provides an adequate basis for the conclusions set forth in this report.

IV. Conclusion

Based on his investigation as described in this report, which should be considered together in its entirety, the Examiner: 1) found no evidence of any lack of independence of the Special Committee or attempted direction or influence by the Sackler Families; and 2) found significant evidence that the Special Committee acted independently and free from influence or direction by the Sackler Families. The Examiner offers no conclusion on any other subject, including specifically the merits of the proposed Shareholder Settlement and Plan, consistent with the limited scope of the Examiner's authority as provided in the Examiner Appointment Order. The Examiner believes that no further investigation is required but stands ready to address any further or additional issues as he may be directed by the Court.

Respectfully submitted,

/s/ Stephen D. Lerner
Examiner

Counsel to Examiner
Scott A. Kane
SQUIRE PATTON BOGGS (US) LLP
201 E. Fourth St., Suite 1900
Cincinnati, OH 45202
Tel: (513) 361-1200
Fax: (513) 361-1201
scott.kane@squirepb.com

Exhibit 1

Steve Miller Declaration

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
PURDUE PHARMA L.P., *et al.*,	:	Case No. 19-23649 (RDD)
Debtors.[1]	:	(Jointly Administered)

DECLARATION OF ROBERT S. MILLER

Robert S. "Steve" Miller declares as follows:

1. I am providing this declaration upon the request of Stephen D. Lerner, the Court-appointed Examiner in the above-captioned cases (the "Examiner"). On July 12, 2021, I submitted to an interview by the Examiner and his counsel (the "Interview").

2. I answered all questions posed to me during the Interview truthfully and completely, to the best of my knowledge and recollection.

3. Confirming my response to questions by the Examiner during the Interview, my service and actions on the Special Committee of the board of directors of Purdue Pharma, Inc. (the "Special Committee") was based only on my own judgment, informed by the legal and professional advisors to the Special Committee. No member of the Sackler family, either directly or through any representative (other than the planned meeting described in paragraph 5 below), ever tried to influence me in connection with any analysis, conclusion, decision, reasoning,

[1] The Debtors in these cases, along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014). The Debtors' corporate headquarters is located at One Stamford Forum, 201 Tresser Boulevard, Stamford, CT 06901.

evaluation, or other activity of the Special Committee, including but not limited to, in connection with the Special Committee's consideration and recommendation of the terms of the proposed shareholder settlement reflected in the *Fifth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P. and Its Affiliated Debtors* [Docket No. 2982], as subsequently amended, or any actual or potential claim against any member of the Sackler family or affiliated entity (the "Special Committee Work"). I am not aware of any member of the Sackler family attempting to influence any other member of the Special Committee.

4. To the best of my knowledge and recollection, since the filing of the Debtors' bankruptcy cases, I have not spoken to or communicated with any member of the Sackler family. Although it is possible that I have spoken to Jeffrey Rosen of the Debevoise firm since the filing of the Debtors' bankruptcy cases, I have no specific recollection of that and I did not communicate with Mr. Rosen regarding the Special Committee Work. Other than this possibility, to the best of my recollection, since the filing of the Debtors' bankruptcy cases, I have not communicated with any representative of the Sackler family.

5. I have never communicated with any member of the Sackler family regarding any aspect of the Special Committee Work. On January 29, 2020, I attended a meeting with the other members of the Special Committee, Purdue Pharma, Inc. directors Anthony Roncalli and Peter Boer, senior officers for Purdue Pharma, Inc., and counsel for Purdue Pharma where legal counsel for members of the Sackler family made a presentation regarding the family's position concerning potential claims. My understanding is that the presentation corresponded to one given to creditor groups and is substantially similar to information the Sackler family thereafter made publicly available. After the presentation, counsel to the Sackler family were excused from the meeting along with Anthony Roncalli and Peter Boer, and the Special Committee met separately thereafter.

Other than this planned presentation, to the best of my knowledge and recollection, I am not aware of any communication to any member of the Special Committee by a member of the Sackler family or any representative of the Sackler family concerning the Special Committee Work.

6. Prior to the time I was asked to consider joining the board of Purdue Pharma, Inc., I had no professional, personal, social, or other relationship with any member of the Sackler family or with Purdue Pharma, Inc. or its affiliates.

7. I am not aware of any covenant not to sue or other agreement purporting to restrict or limit any potential claims by the Debtors against members of the Sackler family. No such agreement limited the Special Committee Work.

8. Pursuant to an agreement on November 6, 2019 that was disclosed to the Court, the ability of any shareholder of Purdue Pharma, Inc. to appoint or remove any member of the Special Committee was irrevocably delegated to the General Counsel of Purdue Pharma, as proxy for the shareholders. This November 2019 agreement was not precipitated by any specific event and was instead a general and prophylactic governance action. To my knowledge, no member of the Sackler family or any representative ever requested, threatened, or suggested in any way that any member of the Special Committee should be removed.

9. The Special Committee conducted the Special Committee Work independently of the Sackler family and its representatives and I am not aware of any fact suggesting otherwise.

Pursuant to 28 U.S.C. § 1746, I declare under penalty of perjury that the foregoing is true and correct. Executed on July 16 2021.

Robert S. Miller

Robert S. Miller

Exhibit 2

Kenneth Buckfire Declaration

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
PURDUE PHARMA L.P., *et al.*,	:	Case No. 19-23649 (RDD)
Debtors.[1]	:	(Jointly Administered)

DECLARATION OF KENNETH BUCKFIRE

Kenneth Buckfire declares as follows:

1. I am providing this declaration upon the request of Stephen D. Lerner, the Court-appointed Examiner in the above-captioned cases (the "Examiner"). On July 12, 2021, I submitted to an interview by the Examiner and his counsel (the "Interview").

2. I answered all questions posed to me during the Interview truthfully and completely, to the best of my knowledge and recollection.

3. Confirming my response to questions by the Examiner during the Interview, my service and actions on the Special Committee of the board of directors of Purdue Pharma, Inc. (the "Special Committee") was based only on my own judgment, informed by the legal and professional advisors to the Special Committee. No member of the Sackler family, either directly or through any representative (other than the planned meeting described in paragraph 5 below), ever tried to influence me in connection with any analysis, conclusion, decision, reasoning,

[1] The Debtors in these cases, along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014). The Debtors' corporate headquarters is located at One Stamford Forum, 201 Tresser Boulevard, Stamford, CT 06901.

evaluation, or other activity of the Special Committee, including but not limited to, in connection with the Special Committee's consideration and recommendation of the terms of the proposed shareholder settlement reflected in the *Fifth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P. and Its Affiliated Debtors* [Docket No. 2982], as subsequently amended, or any actual or potential claim against any member of the Sackler family or affiliated entity (the "Special Committee Work"). I am not aware of any member of the Sackler family attempting to influence any other member of the Special Committee.

4. To the best of my knowledge and recollection, since the filing of the Debtors' bankruptcy cases, I have not spoken to or communicated with any member of the Sackler family. Although I met with Johnathan White on one occasion for breakfast since the filing of the Debtors' bankruptcy cases, I did not communicate with Mr. White regarding the Special Committee Work. Other than the foregoing instance, to the best of my recollection, since the filing of the Debtors' bankruptcy cases, I have not communicated with any representative of the Sackler family.

5. I have never communicated with any member of the Sackler family regarding any aspect of the Special Committee Work. On January 29, 2020, I attended a meeting with the other members of the Special Committee, Purdue Pharma, Inc. directors Anthony Roncalli and Peter Boer, senior officers for Purdue Pharma, Inc., and counsel for Purdue Pharma where legal counsel for members of the Sackler family made a presentation regarding the family's position concerning potential claims. My understanding is that the presentation corresponded to one given to creditor groups and is substantially similar to information the Sackler family thereafter made publicly available. After the presentation, counsel to the Sackler family were excused from the meeting along with Anthony Roncalli and Peter Boer, and the Special Committee met separately thereafter. Other than this planned presentation, to the best of my knowledge and recollection, I am not aware

of any communication to any member of the Special Committee by a member of the Sackler family or any representative of the Sackler family concerning the Special Committee Work.

6. Prior to the time I was asked to consider joining the board of Purdue Pharma, Inc., I had no professional, personal, social, or other relationship with any member of the Sackler family or with Purdue Pharma, Inc. or its affiliates.

7. I am not aware of any covenant not to sue or other agreement purporting to restrict or limit any potential claims by the Debtors against members of the Sackler family. No such agreement limited the Special Committee Work.

8. Pursuant to an agreement on November 6, 2019 that was disclosed to the Court, the ability of any shareholder of Purdue Pharma, Inc. to appoint or remove any member of the Special Committee was irrevocably delegated to the General Counsel of Purdue Pharma, as proxy for the shareholders. This November 2019 agreement was not precipitated by any specific event and was instead a general and prophylactic governance action. To my knowledge, no member of the Sackler family or any representative ever requested, threatened, or suggested in any way that any member of the Special Committee should be removed.

9. The Special Committee conducted the Special Committee Work independently of the Sackler family and its representatives and I am not aware of any fact suggesting otherwise.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on July 16, 2021.

DocuSigned by:
Ken Buckfire
309A64B28FEB492...
____
Kenneth Buckfire

Exhibit 3

Michael Cola Declaration

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
PURDUE PHARMA L.P., *et al.*,	:	Case No. 19-23649 (RDD)
Debtors.[1]	:	(Jointly Administered)

DECLARATION OF MICHAEL COLA

Michael Cola declares as follows:

1. I am providing this declaration upon the request of Stephen D. Lerner, the Court-appointed Examiner in the above-captioned cases (the "Examiner"). On July 12, 2021, I submitted to an interview by the Examiner and his counsel (the "Interview").

2. I answered all questions posed to me during the Interview truthfully and completely, to the best of my knowledge and recollection.

3. Confirming my response to questions by the Examiner during the Interview, my service and actions on the Special Committee of the board of directors of Purdue Pharma, Inc. (the "Special Committee") was based only on my own judgment, informed by the legal and professional advisors to the Special Committee. No member of the Sackler family, either directly or through any representative (other than the planned meeting described in paragraph 5 below), ever tried to influence me in connection with any analysis, conclusion, decision, reasoning,

[1] The Debtors in these cases, along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014). The Debtors' corporate headquarters is located at One Stamford Forum, 201 Tresser Boulevard, Stamford, CT 06901.

evaluation, or other activity of the Special Committee, including but not limited to, in connection with the Special Committee's consideration and recommendation of the terms of the proposed shareholder settlement reflected in the *Fifth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P. and Its Affiliated Debtors* [Docket No. 2982], as subsequently amended, or any actual or potential claim against any member of the Sackler family or affiliated entity (the "Special Committee Work"). I am not aware of any member of the Sackler family attempting to influence any other member of the Special Committee.

4. To the best of my knowledge and recollection, since the filing of the Debtors' bankruptcy cases, I have not spoken to or communicated with any member of the Sackler family. To the best of my recollection, since the filing of the Debtors' bankruptcy cases, I have not communicated with any representative of the Sackler family.

5. I have never communicated with any member of the Sackler family regarding any aspect of the Special Committee Work. On January 29, 2020, I attended a meeting with the other members of the Special Committee, Purdue Pharma, Inc. directors Anthony Roncalli and Peter Boer, senior officers for Purdue Pharma, Inc., and counsel for Purdue Pharma where legal counsel for members of the Sackler family made a presentation regarding the family's position concerning potential claims. My understanding is that the presentation corresponded to one given to creditor groups and is substantially similar to information the Sackler family thereafter made publicly available. After the presentation, counsel to the Sackler family were excused from the meeting along with Anthony Roncalli and Peter Boer, and the Special Committee met separately thereafter. Other than this planned presentation, to the best of my knowledge and recollection, I am not aware

of any communication to any member of the Special Committee by a member of the Sackler family or any representative of the Sackler family concerning the Special Committee Work.

6. Prior to the time I was asked to consider joining the board of Purdue Pharma, Inc., I had no professional, personal, social, or other relationship with any member of the Sackler family. In approximately 2013, as arranged through an executive search firm, I interviewed for a possible board or officer position at Purdue Pharma. After the interviews, I decided to withdraw from consideration and no position was offered to me. Other than these interviews in 2013, I had no prior relationship or connection with Purdue Pharma, Inc. or its affiliates.

7. I am not aware of any covenant not to sue or other agreement purporting to restrict or limit any potential claims by the Debtors against members of the Sackler family. No such agreement limited the Special Committee Work.

8. Pursuant to an agreement on November 6, 2019 that was disclosed to the Court, the ability of any shareholder of Purdue Pharma, Inc. to appoint or remove any member of the Special Committee was irrevocably delegated to the General Counsel of Purdue Pharma, as proxy for the shareholders. This November 2019 agreement was not precipitated by any specific event and was instead a general and prophylactic governance action. To my knowledge, no member of the Sackler family or any representative ever requested, threatened, or suggested in any way that any member of the Special Committee should be removed.

9. The Special Committee conducted the Special Committee Work independently of the Sackler family and its representatives and I am not aware of any fact suggesting otherwise.

Pursuant to 28 U.S.C. § 1746, I declare under penalty of perjury that the foregoing is true and correct. Executed on July 16, 2021.

DocuSigned by:
Mike Cola
5A4D7429D96F402...

Michael Cola

Exhibit 4

John Dubel Declaration

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
PURDUE PHARMA L.P., *et al.*,	:	Case No. 19-23649 (RDD)
Debtors.[1]	:	(Jointly Administered)

DECLARATION OF JOHN S. DUBEL

John S. Dubel declares as follows:

1. I am providing this declaration upon the request of Stephen D. Lerner, the Court-appointed Examiner in the above-captioned cases (the "Examiner"). On July 12, 2021, I submitted to an interview by the Examiner and his counsel (the "Interview").

2. I answered all questions posed to me during the Interview truthfully and completely, to the best of my knowledge and recollection.

3. Confirming my response to questions by the Examiner during the Interview, my service and actions on the Special Committee of the board of directors of Purdue Pharma, Inc. (the "Special Committee") was based only on my own judgment, informed by the legal and professional advisors to the Special Committee. No member of the Sackler family, either directly or through any representative (other than the planned meeting described in paragraph 5 below), ever tried to influence me in connection with any analysis, conclusion, decision, reasoning,

[1] The Debtors in these cases, along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014). The Debtors' corporate headquarters is located at One Stamford Forum, 201 Tresser Boulevard, Stamford, CT 06901.

evaluation, or other activity of the Special Committee, including but not limited to, in connection with the Special Committee's consideration and recommendation of the terms of the proposed shareholder settlement reflected in the *Fifth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P. and Its Affiliated Debtors* [Docket No. 2982], as subsequently amended, or any actual or potential claim against any member of the Sackler family or affiliated entity (the "Special Committee Work"). I am not aware of any member of the Sackler family attempting to influence any other member of the Special Committee.

4. To the best of my knowledge and recollection, since the filing of the Debtors' bankruptcy cases, I have not spoken to or communicated with any member of the Sackler family. To the best of my recollection, since the filing of the Debtors' bankruptcy cases, I have not communicated with any representative of the Sackler family.

5. I have never communicated with any member of the Sackler family regarding any aspect of the Special Committee Work. On January 29, 2020, I attended a meeting with the other members of the Special Committee, Purdue Pharma, Inc. directors Anthony Roncalli and Peter Boer, senior officers for Purdue Pharma, Inc., and counsel for Purdue Pharma where legal counsel for members of the Sackler family made a presentation regarding the family's position concerning potential claims. My understanding is that the presentation corresponded to one given to creditor groups and is substantially similar to information the Sackler family thereafter made publicly available. After the presentation, counsel to the Sackler family were excused from the meeting along with Anthony Roncalli and Peter Boer, and the Special Committee met separately thereafter. Other than this planned presentation, to the best of my knowledge and recollection, I am not aware

of any communication to any member of the Special Committee by a member of the Sackler family or any representative of the Sackler family concerning the Special Committee Work.

6. Prior to the time I was asked to consider joining the board of Purdue Pharma, Inc., I had no professional, personal, social, or other relationship with any member of the Sackler family or with Purdue Pharma, Inc. or its affiliates.

7. I am not aware of any covenant not to sue or other agreement purporting to restrict or limit any potential claims by the Debtors against members of the Sackler family. No such agreement limited the Special Committee Work.

8. Pursuant to an agreement on November 6, 2019 that was disclosed to the Court, the ability of any shareholder of Purdue Pharma, Inc. to appoint or remove any member of the Special Committee was irrevocably delegated to the General Counsel of Purdue Pharma, as proxy for the shareholders. This November 2019 agreement was not precipitated by any specific event and was instead a general and prophylactic governance action. To my knowledge, no member of the Sackler family or any representative ever requested, threatened, or suggested in any way that any member of the Special Committee should be removed.

9. The Special Committee conducted the Special Committee Work independently of the Sackler family and its representatives and I am not aware of any fact suggesting otherwise.

Pursuant to 28 U.S.C. § 1746, I declare under penalty of perjury that the foregoing is true and correct. Executed on July 16, 2021.

John S. Dubel

Exhibit 5

David Sackler Declaration

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

In re:	:	Chapter 11
PURDUE PHARMA L.P., *et al.*,	:	Case No. 19-23649 (RDD)
Debtors.[1]	:	(Jointly Administered)

DECLARATION OF DAVID A. SACKLER

David A. Sackler declares as follows:

1. I am providing this declaration upon the request of Stephen D. Lerner, the Court-appointed Examiner in the above-captioned cases (the "Examiner"). On July 13, 2021, I submitted to an interview by the Examiner and his counsel (the "Interview").

2. I answered all questions posed to me during the Interview truthfully and completely, to the best of my knowledge and recollection.

3. Confirming my response to questions by the Examiner during the Interview, I never attempted to influence any members of the board of directors of Purdue Pharma, Inc. in their capacities as members of the Special Committee (the "Special Committee"), either directly or through representatives. Specifically, I never sought to influence any member of the Special Committee in connection with any analysis, conclusion, decision, reasoning, evaluation, or other activity of the Special Committee, including but not limited to, in connection with the Special

[1] The Debtors in these cases, along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014). The Debtors' corporate headquarters is located at One Stamford Forum, 201 Tresser Boulevard, Stamford, CT 06901.

Committee's consideration and recommendation of the terms of the proposed shareholder settlement reflected in the *Fifth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P. and Its Affiliated Debtors* [Docket No. 2982], as subsequently amended, or any actual or potential claim against any member of the Sackler family or affiliated entity (the "Special Committee Work"). I am not aware of any other member of the Sackler family attempting to so influence any member of the Special Committee or any aspect of the Special Committee Work and I do not believe that any such attempt was ever made.

4. To the best of my knowledge and recollection, since the filing of the Debtors' bankruptcy cases, I have not communicated with any member of the Special Committee, directly or through representatives. I believe I was included in a calendar invite for a group call in December 2019 that included members of the Special Committee, other representatives of the Debtors, legal counsel, and others (although I have no specific recollection of whether I or any members of the Special Committee participated). To the best of my recollection, I have not spoken to, communicated in writing with, or interacted with any member of the Special Committee since the filing of the Debtors' bankruptcy cases.

5. I have never communicated with any member of the Special Committee regarding any aspect of the Special Committee Work. I am not aware of any other member of the Sackler family communicating with any member of the Special Committee regarding any aspect of the Special Committee Work and I do not believe that any such communication was ever made. I understand that legal counsel for the Raymond Sackler family provided a presentation to the board of Purdue Pharma, Inc. (including the members of the Special Committee) and its advisors regarding the family's position concerning potential claims. My understanding is that this presentation corresponded to a presentation given to creditor groups and is substantially similar to

information the Raymond Sackler family thereafter made publicly available. Other than this presentation, and a similar presentation that I understand may have been provided by counsel for the Mortimer Sackler family to the board of Purdue Pharma Inc., to the best of my knowledge and recollection, I am not aware of any communication to any member of the Special Committee by any representative of the Sackler family concerning the Special Committee Work and I do not believe that any such communication was ever made.

6. From my perspective, the members of the Special Committee were chosen as directors of Purdue Pharma, Inc. because of their experience and independence. To the best of my recollection, prior to the time they joined the board of Purdue Pharma, Inc., I had no professional, personal, social, or other relationship with any member of the Special Committee and I am not aware of any such relationship between any of them and any other member of the Sackler family.

7. I am not aware of any covenant not to sue or other agreement purporting to restrict or limit any potential claims by the Debtors against members of the Sackler family.

8. I believe that the Special Committee conducted the Special Committee Work independently of the Sackler family and its representatives and I am not aware of any fact suggesting otherwise.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on July 15, 2021.

D 15

David A. Sackler

Exhibit 6

Mortimer D.A. Sackler Declaration

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
PURDUE PHARMA L.P., *et al.*,	:	Case No. 19-23649 (RDD)
Debtors.[1]	:	(Jointly Administered)

DECLARATION OF MORTIMER D.A. SACKLER

Mortimer D.A. Sackler declares as follows:

1. I am providing this declaration upon the request of Stephen D. Lerner, the Court-appointed Examiner in the above-captioned cases (the "Examiner"). On July 15, 2021, I submitted to an interview by the Examiner and his counsel (the "Interview").

2. I answered all questions posed to me during the Interview truthfully and completely, to the best of my knowledge and recollection.

3. Confirming my response to questions by the Examiner during the Interview, I never attempted to influence any member of the Special Committee of the board of directors of Purdue Pharma, Inc. (the "Special Committee") in their capacity as members of the Special Committee, either directly or through representatives. Specifically, I never sought to influence any member of the Special Committee in connection with any analysis, conclusion, decision, reasoning, evaluation, or other activity of the Special Committee, including but not limited to, in

[1] The Debtors in these cases, along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014). The Debtors' corporate headquarters is located at One Stamford Forum, 201 Tresser Boulevard, Stamford, CT 06901.

connection with the Special Committee's consideration and recommendation of the terms of the proposed shareholder settlement reflected in the *Fifth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P. and Its Affiliated Debtors* [Docket No. 2982], as subsequently amended, or any actual or potential claim against any member of the Sackler family or affiliated entity (the "Special Committee Work"). I am not aware of any other member of the Sackler family attempting to influence any member of the Special Committee or any aspect of the Special Committee Work and I do not believe that any such attempt was ever made.

4. To the best of my knowledge and recollection, since the filing of the Debtors' bankruptcy cases, I have not communicated with any member of the Special Committee, directly or through representatives. I believe I may have participated in one or more group calls after the filing of the bankruptcy cases to provide the shareholders with general updates. Representatives of the Debtors, legal counsel, and others participated (although I have no specific recollection of whether any members of the Special Committee did so, although I believe Mr. Miller may have been an organizer for the calls). No such call related to the Special Committee Work. Otherwise, to the best of my knowledge and recollection, I have not spoken to, communicated in writing with, or interacted with any member of the Special Committee since the filing of the Debtors' bankruptcy cases.

5. I have never communicated with any member of the Special Committee regarding any aspect of the Special Committee Work. I am not aware of any other member of the Sackler family communicating with any member of the Special Committee regarding any aspect of the Special Committee Work and I do not believe that any such communication was ever made. I have been made aware that legal counsel for the Sackler family provided a presentation to the board of Purdue Pharma, Inc. (including the members of the Special Committee) and its advisors

regarding the family's position concerning potential claims in January of 2020. I did not attend this presentation and my understanding is that this presentation corresponded to a presentation given to creditor groups and contains information substantially similar to that contained in publicly available filings by the Mortimer D. Sackler family in the Bankruptcy Court. Other than this presentation, to the best of my knowledge and recollection, I am not aware of any communication to any member of the Special Committee by any representative of the Sackler family concerning the Special Committee Work and I do not believe that any such communication was ever made.

6. From my perspective, the members of the Special Committee were chosen as directors of Purdue Pharma, Inc. because of their experience and independence. I am aware that Michael Cola interviewed for a position with Purdue Pharma many years ago after being identified as a candidate by an executive search firm. I have no specific recollection of interviewing Mr. Cola at that time but it is possible that I did as a member of the board at that time. Otherwise, prior to the time they joined the board of Purdue Pharma, Inc., I had no professional, personal, social, or other relationship with any member of the Special Committee and I am not aware of any such relationship between any of them and any other member of the Sackler family.

7. I am not aware of any covenant not to sue or other agreement purporting to restrict or limit any potential claims by the Debtors against members of the Sackler family.

8. I believe that the Special Committee conducted the Special Committee Work independently of the Sackler family and its representatives and I am not aware of any fact suggesting otherwise.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on July 16, 2021.

DocuSigned by:

0818885DABF44D8...

Mortimer Sackler

Exhibit 7

Jonathan White Declaration

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
PURDUE PHARMA L.P., *et al.*,	:	Case No. 19-23649 (RDD)
Debtors.[1]	:	(Jointly Administered)

DECLARATION OF JONATHAN WHITE

Jonathan White declares as follows:

1. I am providing this declaration upon the request of Stephen D. Lerner, the Court-appointed Examiner in the above-captioned cases (the "Examiner"). On July 16, 2021, I submitted to an interview by the Examiner and his counsel (the "Interview").

2. I answered all questions posed to me during the Interview truthfully and completely, to the best of my knowledge and recollection.

3. Confirming my response to questions by the Examiner during the Interview, I never attempted to influence any member of the Special Committee of the board of directors of Purdue Pharma, Inc. (the "Special Committee"), in their capacity as members of the Special Committee, either directly or through representatives. Specifically, I never sought to influence any member of the Special Committee in connection with any analysis, conclusion, decision, reasoning, evaluation, or other activity of the Special Committee, including but not limited to, in

[1] The Debtors in these cases, along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014). The Debtors' corporate headquarters is located at One Stamford Forum, 201 Tresser Boulevard, Stamford, CT 06901.

connection with the Special Committee's consideration and recommendation of the terms of the proposed shareholder settlement reflected in the *Fifth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P. and Its Affiliated Debtors* [Docket No. 2982], as subsequently amended, or any actual or potential claim against any member of the Sackler family or affiliated entity (the "Special Committee Work"). I am not aware of any member of the Sackler family attempting to influence any member of the Special Committee or any aspect of the Special Committee Work.

4. I believe I had breakfast with Ken Buckfire in December of 2019 at his request. To the best of my recollection, nothing of significance was discussed regarding the Special Committee work or otherwise. I did not attempt then or ever to influence him in his Special Committee work. I believe I may have participated in one or more group calls after the filing of the bankruptcy cases to provide the shareholders with general updates. Representatives of the Debtors, legal counsel, and others participated (although I have no specific recollection of whether any members of the Special Committee did so, although I believe Mr. Miller may have been an organizer for the calls). No such call related to the Special Committee Work. Other than the foregoing, I have not spoken to, communicated in writing with, or interacted with any member of the Special Committee since the filing of the Debtors' bankruptcy cases.

5. I have never communicated with any member of the Special Committee regarding any aspect of the Special Committee Work. I am not aware of any member of the Sackler family communicating with any member of the Special Committee regarding any aspect of the Special Committee Work. I have been made aware that legal counsel for the Sackler family provided a presentation to the board of Purdue Pharma, Inc. (including the members of the Special Committee) and its advisors regarding the family's position concerning potential claims in

January of 2020. I did not attend this presentation and my understanding is that this presentation corresponded to a presentation given to creditor groups and contains information substantially similar to that contained in publicly available filings by the Mortimer D. Sackler family in the Bankruptcy Court. Other than this presentation, to the best of my knowledge and recollection, I am not aware of any communication to any member of the Special Committee by any representative of the Sackler family concerning the Special Committee Work and I do not believe that any such communication was ever made.

6. From my perspective, the members of the Special Committee were chosen as directors of Purdue Pharma, Inc. because of their experience and independence. Prior to the time they joined the board of Purdue Pharma, Inc., I had no professional, personal, social, or other relationship with any member of the Special Committee and I am not aware of any such relationship between any of them and any member of the Sackler family.

7. I am not aware of any covenant not to sue or other agreement purporting to restrict or limit any potential claims by the Debtors against members of the Sackler family.

8. I believe that the Special Committee conducted the Special Committee Work independently of the Sackler family and its representatives and I am not aware of any fact suggesting otherwise.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on July 19 2021.

Jonathan White

DAVIS POLK & WARDWELL LLP
450 Lexington Avenue
New York, New York 10017
Telephone: (212) 450-4000
Facsimile: (212) 701-5800
Marshall S. Huebner
Benjamin S. Kaminetzky
Eli J. Vonnegut
James I. McClammy
Gerard X. McCarthy

Counsel to the Debtors
and Debtors in Possession

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	**Chapter 11**
PURDUE PHARMA L.P., *et al.*,	**Case No. 19-23649 (RDD)**
Debtors.[1]	**(Jointly Administered)**

DEBTORS' OPPOSITION TO MOTION FOR
ORDER TO APPOINT EXAMINER

[1] The Debtors in these cases, along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014). The Debtors' corporate headquarters is located at One Stamford Forum, 201 Tresser Boulevard, Stamford, CT 06901.

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Purdue Pharma L.P. ("**PPLP**") and its affiliated debtors in the above-captioned chapter 11 cases, as debtors and debtors in possession (collectively, "**Debtors**"), hereby submit this opposition ("**Opposition**") to the *Motion for Order to Appoint Examiner Pursuant to 11 U.S.C. § 1104(c)* [ECF No. 2963] ("**Motion**") filed by Peter W. Jackson.[2] The Debtors respectfully state as follows:

PRELIMINARY STATEMENT

1. On the eve of confirmation, almost 21 months after the petition date, Peter Jackson ("**Movant**") has moved to appoint an examiner pursuant to 11 U.S.C. § 1104(c). With no factual support, no admissible evidence, and only unsupported innuendo accusing multiple parties including estate fiduciaries and this Court of impropriety, the Movant claims that the historic shareholder settlement embodied in the Debtors' plan of reorganization ("**Shareholder Settlement**," and the plan of reorganization, "**Plan**") was somehow the result of undue influence of members of the Sackler Families. The Movant further asserts that the Official Committee of Unsecured Creditors ("**UCC**"), a statutory fiduciary, "could have" but did not "act[] as a check on questions of independence." (Mot. ¶ 49.) And the Movant contends that even this Court cannot serve as an adequate "check" (notwithstanding its responsibilities to evaluate the Shareholder Settlement and third-party releases contained therein at confirmation) because this Court has already made up its mind and will approve the settlement and releases "with little scrutiny." (Mot. ¶ 55.) The Ad Hoc Committee of Governmental and Other Contingent Litigation Claimants ("**Ad Hoc Committee**") (which represents the interests of 23 attorneys general as well as analogous officials from the inhabited territories) and the Multi-State Governmental Entities ("**MSGE**") seemingly do not even merit a mention. Thus, in the

[2] To be clear, the position of the Debtors on this inappropriate request for relief is in no way, shape, or form intended to denigrate the unspeakably tragic loss suffered by the Movant and his family.

Movant's through-the-looking-glass world, an examiner must be appointed to investigate and report on the process by which the Debtors have determined to settle the so-called Sackler Allegations and whether that process and the resulting decision "was undertaken independently of the direct or indirect influence of, or interference by, the Sackler Families and their Related Entities, made in good faith, and w[as] negotiated at arm's length." (Proposed Order ¶ 2.)

2. This baseless Motion does not even bother to address the actual facts—that the Ad Hoc Committee, the UCC, and the MSGE each <u>independently</u> negotiated and agreed to the proposed settlement after extensive mediation. The Motion is utterly devoid of evidence, grossly distorts the record, and reflects either a reckless disregard for the truth or willful misrepresentation of all that has transpired and the highly adversarial process by which the Shareholder Settlement contained in the Plan—and negotiated by <u>four</u> parties opposite the Sackler Families after more than a year of discovery and months of mediation—came to be.

3. After over a year of intense, hard-fought negotiations prior to the Debtors' bankruptcy, the Debtors, the Debtors' shareholders, and a critical mass of plaintiff constituencies reached an agreement in principle on a framework ("**Settlement Framework**") of a global resolution of litigation in connection with Purdue's marketing, manufacturing, and sale of opioid medications. The Settlement Framework had, broadly speaking, three core pillars pursuant to which Purdue's shareholders would: (1) relinquish their equity interests in the Debtors; (2) engage in a sale process for their ex-U.S. pharmaceutical businesses; and (3) make a multi-billion-dollar payment to the Debtors' estates. The plaintiff constituencies that negotiated and supported the Settlement Framework included no fewer than 23 state attorneys general and analogous officials from the five U.S. territories, as well as the court-appointed Plaintiffs' Executive Committee and Co-Lead Counsel in the federal multi-district opioid litigation pending in Ohio. It was <u>these</u> parties, including many of the nation's most prominent class action lawyers, that negotiated opposite the Sackler Families in the lead-up to Purdue's bankruptcy—

not the Special Committee of the Board of Directors. The Movant's ignorance of (or willful attempt to rewrite) history notwithstanding, these formidable plaintiff constituencies played the critical role in shaping the Settlement Framework opposite the Sackler Families.

4. At the same time, the Debtors and all parties in interest recognized that the Settlement Framework was just that—a framework and starting place for achieving a value maximizing resolution of the Debtors' bankruptcy. As early as the first day hearing, the Debtors made clear that they intended to "listen hard and . . . work to expand the number of parties supporting the [S]ettlement [F]ramework" (Sept. 17, 2019 Hr'g Tr. at 17:21–25), and that there would be "plenty of opportunity over the next many months to discuss and join issues on various difficult subjects" including "[t]he shape and contours of the global resolution." (Sept. 17, 2019 Hr'g Tr. at 19:10–13.) Also early in these cases, the Debtors explained that, in their view, any settlement would have to pass through "four gates." The first of these was reaching an agreement in principle on a settlement framework with a critical mass of parties, and the second of these was memorializing that framework in a written term sheet (which was filed on October 8, 2019). (Nov. 19, 2019 Hr'g Tr. at 70:8–14.) Gate three was proposing a comprehensive restructuring transaction based on the Settlement Framework, which the Debtors informed the Court and parties in interest would require "massive amounts of diligence, structuring, and negotiation." (Nov. 19, 2019 Hr'g Tr. at 70:15–19.) And the fourth gate is the confirmation hearing where the Debtors' Plan (hopefully) is approved. (Nov. 19, 2019 Hr'g Tr. at 70:20–21.)

5. Exactly as the Debtors committed, "massive amounts of diligence, structuring, and negotiation" ensued. The UCC and other parties embarked on a comprehensive investigation of claims that spanned nearly a year and a half, at a cost of many tens of millions of dollars. The Special Committee of the Debtors' Board of Directors continued their searching review of the claims of the Debtors and their estates against the Sackler Families and related entities. In addition, more information and discovery was exchanged "with respect to elements

of [the] settlement with the Sacklers than [this Court] had[] ever seen, and [perhaps] ha[s] ever been provided in any [c]hapter 11 case." (Mar. 24, 2021 Hr'g Tr. 56:6–9.)

6. These processes culminated during the so-called "phase two mediation" with respect to claims against members of the Sackler Families and related entities, and discussions that continued after the phase two mediation formally concluded. This mediation was overseen by two of the finest mediators in the country,[3] and the Debtors were far from the only protagonists negotiating. The economic terms of the Shareholder Settlement in the Plan and the resulting (and materially improved) $4.275 billion contribution were the direct result of a joint recommendation made by the mediators (as set forth in the mediator's report at docket no. 2548). It was the <u>mediators</u>, after almost a year of work, who jointly proposed $4.275 billon as the appropriate amount to resolve these cases, which led to a series of offers and counteroffers between the UCC, the Ad Hoc Committee, the Multi-State Governmental Entities Group, and the Debtors, on the one hand, and representatives of the Sacklers, on the other, with respect to timing and other terms. This led to the filing of the Debtors' Plan and settlement term sheet on March 15, 2021.

7. Then, over the following weeks, these same parties continued their intense, near-constant negotiations to resolve open issues in connection with the Shareholder Settlement, which culminated in the filing of the amended Plan and approval of the Debtors' Disclosure Statement on June 3, 2021. Now, only after having run the gauntlet of these difficult and at times antagonistic negotiations, the Shareholder Settlement and the Plan more generally have the support of almost every key creditor constituency in these chapter 11 cases.

8. Against this backdrop, the Movant's request for the appointment of an examiner borders on frivolous. The Movant claims that the appointment of an examiner is in the interests

[3] The mediators were the Honorable Layn Philips and Kenneth Feinberg.

of the estates and "necessary to determine whether the decision to settle was made independently and at arm's length." (Mot. at 25.) As set forth above, and extensively in the Disclosure Statement, the Shareholder Settlement reflected in the Plan was brutally hard fought by the Ad Hoc Committee, the MSGE, and the UCC. These parties formed entirely independent views of the settlement. Moreover, the examination proposed by the Movant would not only squander significant time and substantial resources but would also usurp the role of this Court at confirmation, where one factor the Court must consider is assessing the Shareholder Settlement under the standards set forth by the Second Circuit in *In re Iridium Operating LLC*, 478 F.3d 452, 465 (2d Cir. 2007), is whether the settlement is the product of arm's length bargaining. To the extent the Movant wants to litigate the issue of the Special Committee's independence or the reasonableness of the Shareholder Settlement more generally—and he is of course free to do so—he must proceed pursuant to the confirmation discovery and litigation procedures recently entered by this Court, as to which the Movant did not object.

9. Nor is the appointment of an examiner "mandatory" under section 1104(c)(2), as the Movant contends. First, the relevant statutory debt threshold is not satisfied by the claims of the United States identified by the Movant because those claims are either not in existence today, or subject to contingencies. Even were that threshold satisfied, however, appointment of an examiner would still be unwarranted under the circumstances. Section 1104(c) provides that a court should only appoint an examiner to conduct an investigation of the debtor "as is appropriate," and many courts have held that this language confers upon courts discretion to refuse to appoint an examiner notwithstanding satisfaction of the debt threshold. Indeed, courts routinely do so where the examiner motion "was filed for an improper purpose such as a litigation tactic to delay a case, or if there is no factual basis to conclude that an investigation needs to be conducted, or if an appropriate and thorough investigation has already been conducted (or is nearly complete) by a creditors committee or governmental agency." *In re*

Residential Capital, LLC, 474 B.R. 112, 121 (Bankr. S.D.N.Y. 2012). Every one of these circumstances is met here, perhaps more than in any prior case. At least two comprehensive investigations have been conducted (one by the Debtors' Special Committee and the other by the UCC), there is no factual basis whatsoever to conclude an examination along the lines suggested by the Movant needs to be conducted, and the Motion smacks of a litigation tactic—particularly as it comes with no prior notice (1) on the heels of this Court's rejection of the Movant's recent attempt to thwart solicitation of the Plan and stymie the Debtors' reorganization by objecting to the Debtors' Plan as "patently unconfirmable"; (2) nearly 21 months after the petition date; and (3) a mere day before this Court approved the Debtors' Disclosure Statement.

10. Finally, the doctrines of waiver and laches provide a separate and independent basis to deny the Motion. Nearly a year ago, in July 2020, the Movant filed a letter requesting an examiner but declined this Court's invitation to treat that letter as a motion. (Jackson Decl. ¶ 3.) Moreover, in November 2019—19 months before this Motion was filed—the Movant's now-counsel (then without a client) sent a letter to the U.S. Trustee urging the U.S. Trustee to seek appointment of an examiner, for among other reasons, because of his (speculative and erroneous) concern that the Special Committee might not be independent.[4] Rather than pursue relief at those earlier times, the Movant (and his counsel) now (in one case almost two years later) seek the appointment of examiner approximately 60 days before the confirmation hearing. Courts have often found that the right to request an examiner has been waived where, as here, the Movant waits until the eve of confirmation to make such a motion, a waiver only amplified by the Movant's and Professor Lipson's abandonment of their previous requests.

[4] *See* Jonathan C. Lipson, Letter of Bankruptcy Law Professors to United States Trustee Requesting an Examiner in the Purdue Pharma Chapter 11 Reorganization (Nov. 5, 2019), https://ssrn.com/abstract=3532642.

BACKGROUND

I. The Pre-Petition Litigation

11. Prior to the commencement of these chapter 11 cases, the Debtors and their related parties, including their ultimate owners, the Sackler Families, faced nearly 3,000 lawsuits spread across dozens of state and federal courts throughout the United States arising from the Debtors' manufacturing, marketing, and sale of opioid pain medications (the "**Pending Actions**").[5] Case-by-case litigation of the Pending Actions, however, would have been immensely value-destructive. Not only did the Pending Actions incentivize many inequitable "races to the courthouses" where various plaintiffs attempted to leapfrog one another to be the first to trial, but also they forced Purdue to spend millions of dollars—per week—in legal and professional costs directly related to defending the Pending Actions. (*See* Decl. of J. O'Connell, *Purdue Pharma L.P. v. Commonwealth of Mass.*, Adv. Pro. No. 19-08289 (RDD) (Bankr. S.D.N.Y. Sept. 18, 2019) [ECF No. 6], ¶ 17.) And all of this was in addition to the Department of Justice's civil and criminal investigations of the Debtors, which were ongoing at the time.

12. It ultimately became clear that continued litigation on the scale faced by the Debtors was simply untenable, particularly in light of the unjustifiable costs and the risk of inconsistent judgments. It was equally clear that bankruptcy was the only forum available that could halt the immense destruction of value associated with continued litigation of the Pending Actions and productively orient the parties toward a value maximizing and equitable resolution of the litigation.

II. Pre-Petition Negotiations and the Settlement Framework

13. For the better part of the year proceeding the Debtors' chapter 11 petitions, a number of plaintiff constituencies—including many state attorneys general and the Plaintiffs

[5] Approximately 2,000 of these Pending Actions had been transferred to a multi-district litigation in Ohio ("**Ohio MDL**").

Executive Committee ("**PEC**") in the Ohio MDL—the Sackler Families, and Purdue engaged in discussions concerning a potential global resolution of the Pending Actions. These negotiations resulted in an agreement in principle on the structure of a global resolution of opioid litigations ("**Settlement Framework**") in the days leading up to the Debtors' bankruptcy filings on September 15, 2019. The Settlement Framework, as noted above, had substantial but far from unanimous support and was later memorialized in an unsigned term sheet among the Ad Hoc Committee, the Debtors, and Shareholders Parties. *See* Summary Term Sheet, *In re Purdue Pharma,* No. 19-23649 (RDD) (Bankr. S.D.N.Y. Oct. 8, 2019) (hereinafter, the "**Settlement Framework Term Sheet**") [ECF No. 257].

14. Two important attributes of the Settlement Framework are elided or ignored by the Movant but bear particular emphasis here. First, the Settlement Framework was negotiated with the Sackler Families by a wide and representative swath of plaintiff constituencies, including no fewer than 23 state attorneys' general, the PEC and co-lead counsel in the Ohio MDL. (*See* Settlement Framework Term Sheet at 4 (describing a "comprehensive settlement" among the Debtors, the Ad Hoc Committee (which included the PEC and representative states, municipalities, and others) and the Shareholder Parties).) The PEC, for example, comprised attorneys at law firms that collectively represent over 1,000 municipalities (including cities, counties, towns, and villages), as well as Native American tribes, individuals, and third-party payors.[6] Indeed, these entities, and certain other governmental parties, were directly spearheading negotiations with the Sackler Families. Only after this preliminary, albeit broad-based, support for a potential global resolution was achieved did the Debtors initiate these

[6] *See* Renewed Mot. to Approve Co-Leads, Co-Liaisons, and Executive Committee (ECF No. 34), *In re National Prescription Opiate Litigation*, MDL No. 2804 (N.D. Ohio Jan. 3, 2018); Marginal Entry Order Granting Mot. to Approve Co-Leads, Co-Liaisons, and Executive Committee (ECF No. 37), *In re National Prescription Opiate Litigation*, MDL No. 2804 (N.D. Ohio Jan. 4, 2018).

chapter 11 cases, which were necessary to stem the destruction of value associated with continued litigation of the Pending Actions in the tort system, centralize claims against the Debtors before this Court, and provide the breathing room necessary to further develop the Settlement Framework.[7]

15. Second, and notwithstanding repeated and unsupported characterizations of the Settlement Framework as somehow "foreordained" and "irreversible" (*E.g.*, Mot. ¶ 23), the record of these cases is clear that the Settlement Framework was a launching point—not the end point—for negotiations regarding the shape and contours of an ultimate resolution with the Sackler Families. (*See* Sept. 17, 2019 Hr'g Tr. at 19:10–13; *see* also Mar. 18, 2020 Hr'g Tr. 31:15–18 ("[T]here's still a lot of work they've required in this case to determine whether parties support the settlement framework"); Mar. 24, 2021 Hr'g Tr. 28:18–23 ("[T]he Debtors, the AHC, the UCC, the MSG on the one hand, and the Sacklers on the other, are productively and seriously engaged virtually seven days a week and around the clock working to attempt to bring to fruition the settlement").) The Debtors also emphasized that a critical "precondition[]" to any final resolution with the Debtors' shareholders was "massive amounts of diligence" and information sharing with stakeholders. (Nov. 19, 2019 Hr'g Tr. 70:8–72:3; *see also id.* ("As

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[7] The Movant surprisingly states that the Preliminary Injunction issued by this Court in September 2019 should "create[] questions" concerning the Special Committee's independence. (Mot. ¶¶ 7, 10.) This claim is frivolous and reflects a failure on the part of the Movant and counsel to familiarize themselves with the record in these cases in even the most cursory of ways. This Court has held time and again that the preliminary injunction was necessary to protect this reorganization and prevent irreparable harm. (*See* Eighteenth Am. Order Pursuant to 11 U.S.C. § 105(a) Granting Mot. Prelim. Inj., *Purdue Pharma L.P. v. Commonwealth of Mass.*, Adv. Pro. No. 19-08289 (RDD) (Bankr. S.D.N.Y. May 24, 2021) [ECF No. 264].) Moreover, the preliminary injunction has had the consistent support of key creditor constituencies from the outset, including the UCC and Ad Hoc Committee. (*See* Ad Hoc Committee's Stmt. in Support of a Limited and Conditional Stay, *Purdue Pharma L.P. v. Commonwealth of Mass.*, Adv. Pro. No. 19-08289 (RDD) (Bankr. S.D.N.Y. Oct. 8, 2019) [ECF No. 64]; Official Committee of Unsecured Creditors' Stmt. in Support of Debtors' Mot. for a Prelim. Inj., *Purdue Pharma L.P. v. Commonwealth of Mass.*, Adv. Pro. No. 19-08289 (RDD) (Bankr. S.D.N.Y. Oct. 11, 2019) [ECF No. 79].)

these questions and dozens and dozens of others make clear, there are huge amounts of work to be done on this hugely complicated multi-billion dollar, multi-continent, multi-country, multi-year deal or whatever variant of it we end up with.").) Simply put, nothing about the proposed resolution contemplated by the Settlement Framework was final on day one of these cases. Indeed, in recent motions to extend the Preliminary Injunction, the Debtors were clear that parties at that time still remained "in the midst of intense negotiations concerning a potential resolution of claims by the estates and other parties against members of the Sackler Families" that might not come to fruition and, for that reason, reserved their right to seek more narrow relief or terminate the injunction in the event that "the Debtors and other core estate stakeholders fail to resolve the remaining open terms." (*See, e.g.*, Mem. of Law in Support of Mot. to Extend the Prelim. Inj., *Purdue Pharma L.P., v. Common. Mass.*, Adv. Pro. No. 19-08289 (RDD) (May 6, 2021) [ECF No. 259] at 1–2.) And at the May 20 omnibus hearing, counsel for the Debtors acknowledged that absent progress on critical items, a final settlement might not even be reached.

III. Investigations by the Special Committee of the Board of Directors of the Debtors and the UCC

16. Nor could the Settlement Framework possibly have been final on day one of these case. That is because the Special Committee's investigation of potential claims against the Sackler Families was far from complete and the UCC's investigation had not even commenced (because the UCC had not even been formed).

17. The precursor to the independent Special Committee (the Transaction Committee) was constituted in May 2019 and vested with exclusive authority over all transactions between Purdue and members of the Sackler Families. (*See* Disclosure Stmt. for Fifth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P. and its Affiliated Debtors, *In re Purdue Pharma, L.P.*, No. 19-23649 (RDD) (Bankr. S.D.N.Y. June 3, 2021) [ECF No. 2983] ("**Disclosure Statement**"), at § II.E.2.) In September 2019, shortly before these cases were

commenced, the Special Committee was vested with the additional (and exclusive) authority over the prosecution, defense, and settlement of any causes of action that the Debtors may assert against its shareholders and members of the Sackler Families and their affiliates in bankruptcy. At all times, the Special Committee has been composed of four blue-chip restructuring and pharmaceutical professionals, none of whom had any prior connection to the Sackler Families. (*See* Disclosure Stmt. § II.E.2.) And to yet further safeguard their independence, the members of the Special Committee were protected against removal by the Debtors' shareholders, and have been since November 2019—an extraordinary and all but unprecedented protection. (*See* Disclosure Stmt. § II.E.2.)

18. Beginning in the spring and summer of 2019, and then over the course of the next 22 months, the Special Committee conducted a comprehensive investigation into potential claims that the Debtors may have against the Sackler Families and associated entities, the details of which are set out in detail in the Debtors' recently approved Disclosure Statement. (*See* Disclosure Statement § Y.) This investigation involved, among other things, an exhaustive review of allegations made in lawsuits by the States and in the news media; identification of potential legal claims that might be brought against the Sackler Families and associated entities; analysis of key legal issues; the collection and review of hundreds of thousands of documents; forensic analyses of transfers to or for the benefit of the Sackler Families, including all cash and non-cash transfers (published on the docket); expert analysis of the Debtors' solvency; and material collaboration on all of the foregoing with the UCC. (*Id.*) The Special Committee met no fewer than 56 times between May 2019 and March 2021, during which meetings it received many reports, briefing and updates from its counsel at Davis Polk, Alix Partners, Bates White, and other advisors. (*Id.*)

19. The Special Committee's investigation was not, of course, the only investigation conducted in these chapter 11 cases. The UCC (an independent fiduciary that represents all

unsecured creditors, and whose members include several opioid victims and advocates) conducted its own massive, searching and independent investigation into potential claims against the Sackler Families without relying on the Special Committee's findings—another fact all but ignored by the Movant. The UCC, for example, relentlessly pursued and obtained significant discovery from the Debtors, the Sackler Families and their associated entities and financial institutions on a wide variety of topics going back decades (discussed more below); analyzed millions of documents in furtherance of its investigation; evaluated the legal merits of potential claims against the Sackler Families, including fraudulent transfer, breach of fiduciary duty, and direct claims arising out of the Sackler Families' involvement in the Debtors' prepetition marketing of opioids; and diligenced the proposed resolution contemplated by the Settlement Framework.[8] All told, the UCC's professionals spent thousands of hours and tens of millions of dollars of estate resources completing its investigation. While the Movant has offensively all but dismissed the role that the UCC and many other creditor groups have played in these cases, it is beyond cavil that this investigation was painstaking, independent, and comprehensive.

IV. Information Sharing and Discovery

20. Also at the outset of these cases, and in furtherance of the Debtors' commitments to provide unprecedented amounts of information to key stakeholders, the Debtors embarked an unparalleled discovery production to provide the information necessary for creditors to investigate potential claims and consider whether to support the Settlement Framework—an effort that was substantially complete in late 2020 but which still continues today.

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[8] (*See, e.g.*, Official Committee of Unsecured Creditors' Motion to Compel Production of Purportedly Privileged Documents, or for In Camera Review, Based on Failure of the Sacklers and the Debtors to Demonstrate Documents Identified on Logs Are Privileged, In re Purdue Pharma et al. No. 19-23649 (RDD) (Bankr. S.D.N.Y. Sept. 30, 2020) [ECF No. 1752]; Official Committee of Unsecured Creditors' Motion to Compel Production of Purportedly Privileged Documents, or for In Camera Review, Based on Good Cause, Crime Fraud, and At Issue Exceptions to Claims of Privilege, In re Purdue Pharma et al. No. 19-23649 (RDD) (Bankr. S.D.N.Y. Sept. 30, 2020) [ECF No. 1753].)

21. As just one early example, in the very first month of these cases, the Debtors, the UCC, and the Sackler Families reached an agreement whereby the Debtors and the Sackler Families would provide certain diligence materials to the UCC and others ("**UCC Stipulation**"). *See* Case Stipulation among the Debtors, the Official Committee of Unsecured Creditors and Certain Related Parties at ¶¶ 7, 17, *In re Purdue Pharma L.P.*, No. 19-23649 (Bankr. S.D.N.Y. Oct. 11, 2019) [ECF No. 291].[9] The Debtors began producing materials pursuant to the UCC Stipulation almost immediately. (*See* Decl. Benjamin Kaminetzky, *Purdue Pharma v. Commonwealth of Mass.*, Adv. Pro. No. 19-08289 (RDD) (Bankr. S.D.N.Y. Mar. 12, 2020) [ECF No. 148].) Although the Movant absurdly cites the UCC Stipulation as evidence that the UCC somehow did not serve as an adequate "check" in these chapter 11 cases (Mot. ¶ 49), the reality is that the UCC Stipulation secured for the UCC and the Debtors important commitments from the Sackler Families, including but not limited to a provision barring certain members of the Sackler Families from taking any action with respect to their property with the intent or material effect of frustrating any judgment that might be obtained against them (UCC Stipulation ¶ 13), as well as commitments to provide material amounts of information and presentations on the value, location, and format of their assets (UCC Stipulation ¶ 17).

22. Then, over the next year and a half, the Debtors produced a staggering amount of material—<u>over 90 million pages</u>—to estate stakeholders on a wide variety of issues, including materials going to both estate claims and underlying opioid liability claims. This discovery included, among other things, all documents produced by the Debtors in the federal multi-district

[9] The obligations of the Shareholder Parties were expanded and amended on November 5, 2019 (*see* Amended and Restated Case Stipulation among the Debtors, the Official Committee of Unsecured Creditors and Certain Related Parties ¶ 17, *In re Purdue Pharma L.P.*, No. 19-23649 (Bankr. S.D.N.Y. Nov. 5, 2019) [ECF No. 431-1]) and the Court endorsed the stipulation on November 20, 2019 (*see* Amended and Restated Case Stipulation among the Debtors, the Official Committee of Unsecured Creditors and Certain Related Parties, *In re Purdue Pharma L.P.*, No. 19-23649 (Bankr. S.D.N.Y. Nov. 20, 2019) [ECF No. 518]).

litigation pending in the Ohio MDL and in similar non-MDL civil litigations and millions of pages of documents produced to the DOJ in connection with its investigation of the Debtors; millions of additional pages of material that the Debtors collected from over 50 custodians, including from additional Sackler Family custodians and directors for time periods going back 25 years; as well as reams of additional historical analysis and diligence to enable the parties to assess the economics of the Settlement Framework.

23. Moreover, the UCC, often in conjunction with the Non-Consenting States (a constituency that does not currently support the Shareholder Settlement), vigorously pursued significant amounts of discovery and due diligence in these cases, including directly from the Sackler Families and their associated entities and financial institutions. For example, the UCC moved for, and secured, an order authorizing Rule 2004 discovery of certain individual Sackler family members. (*See* Order Pursuant to Federal Rules of Bankruptcy 2004 and 9016 Authorizing Examination of Third Parties, *In re Purdue Pharma*, No. 19-23649 (RDD) (Bankr. S.D.N.Y. Mar. 27, 2020) [ECF No. 992].) The Non-Consenting States, joined by the UCC, also secured Rule 2004 discovery of certain of the Sackers financial institutions. (*See* Order Pursuant to Federal Rules of Bankruptcy 2004 and 9016 Authorizing Examination of Certain Financial Institutions, *In re Purdue Pharma*, No. 19-23649 (RDD) (Bankr. S.D.N.Y. May 12, 2020) [ECF No. 1143].) The UCC moved to compel the production of privileged documents from the Debtors, which resulted in an agreement under which the Debtors shared over 16,000 of the Debtors' privileged documents with the UCC on a common interest basis (including communications with members of the Sackler Families), all of which go to the heart of the investigation of possible claims against the Sacklers. (*See* Stipulation and Agreed Order Regarding Official Committee's Motions to Compel and the Debtors' Motion for a Protective Order, *In re Purdue Pharma*, No. 19-23649 (RDD) (Bankr. S.D.N.Y. Nov. 15, 2020) [ECF No. 1955].) The UCC and the Non-Consenting States also took 16 depositions of members of the

Sackler Families, current and former Board members, current employees of the Debtors, and other parties. (*See* Disclosure Stmt. § III.R.)

24. The scope of material provided in these cases was historic, and included significant discovery of overseas persons and non-parties, all of which would likely have been difficult, if not impossible, to obtain in civil litigation. As this Court recently observed, "more information has been provided with respect to this [P]lan and more specifically with respect to the elements of a settlement with the Sacklers than [the Court] had[] ever seen, and [perhaps] ha[s] ever been provided in any [c]hapter 11 case." (Mar. 24, 2021 Hr'g Tr. 56:5–9.)

V. Mediation and Continued Negotiations Regarding a Possible Shareholder Settlement

25. As information sharing was reaching its zenith, and as the Debtors' and UCC's investigations were proceeding apace towards their respective conclusions, the Debtors and their creditors turned their attention and focus toward the second phase of mediation, during which the parties agreed to mediate to see if a settlement could be reached with the Sackler Families. Contrary to the Movant's totally made up and utterly false claim that the mediation focused on the "present and future" (Mot. at 4), the mediation was in fact focused on the past, as it addressed the claims that creditors and the Debtors have against the Sackler Families arising from past conduct and how those claims might be settled.

26. In September 2020, following the largely successful mediation of a number of critical allocation issues among the debtors' creditors before two of the countries' most respected and preeminent mediators (*see* Mediators' Report, *In re Purdue Pharma*, No. 19-23649 (RDD) (Bankr. S.D.N.Y. Sep. 23, 2020) [ECF No. 1716]), the Court formally entered an order expanding the scope of mediation to mediate potential claims that may be asserted by the estates and the Non-Federal Public Claimants (which include states, municipalities, cities, and towns) against the Sackler Families (*see* Order Expanded Scope of Mediation, *In re Purdue Pharma*, No. 19-23649 (RDD) (Bankr. S.D.N.Y. Sept. 30, 2020) [ECF No. 1756]). On January 22, 2021,

after weeks of intense negotiations—and over eleven months after they first began work on these cases—the mediators made a joint proposal regarding the economic terms of a potential shareholder contribution. (*See* Mediators Report, *In re Purdue Pharma et. al.*, Case No. 19-23649 (RDD) (Bankr. S.D.N.Y. Mar. 23, 2021) [ECF No. 2548].) The mediation then formally concluded on January 31, 2021.

27. The mediators' $4.275 billion proposal precipitated additional productive negotiations. (*See* Mediators Report, *In re Purdue Pharma et. al.*, Case No. 19-23649 (RDD) (Bankr. S.D.N.Y. Mar. 23, 2021) [ECF No. 2548] (noting that contribution element to Shareholder Settlement agreement "follows in the wake of a recommendation made earlier by the two mediators as part of the Phase Two of the mediation process").) As described at length in the Debtors' Disclosure Statement (Disclosure Stmt. § AA.2), five parties negotiated for the next six weeks. From January 29, 2021 to February 18, 2021, the Sackler Families, the Debtors, the UCC, the Ad Hoc Committee, and the MSGE exchanged <u>eight</u> offers and counteroffers (each of which, as to the Debtors, had been authorized by the Debtors' Special Committee after careful review). (*Id.*) As a result of these intense efforts, the parties agreed to a payment schedule and other key terms for the $4.275 billion settlement, an agreement reached by each of the UCC, the Ad Hoc Committee, and the MSGE, and the Debtors' Special Committee <u>independently</u> of one another. Finally, over the next [eight] weeks, these five parties successfully negotiated regarding other material terms, including payment guarantees, credit support, remedies, and the terms of releases (among many other items). The notion advanced by the Movant—that it was the Special Committee alone that negotiated this deal with the Sacklers—is false and grossly irresponsible.

28. This all culminated in the Debtors' Fifth Amended Joint Plan of Reorganization and corresponding Amended Disclosure Statement (the latter approved on June 3, 2021). (*See* Order Approving Disclosure Statement, *In re Purdue Pharma*, No 19-23649 (RDD) (Bankr. S.D.N.Y. June 3, 2021) [ECF No. 2988].) The Plan has the support of virtually every major

organized creditor constituency in these chapter 11 cases, including the UCC, the Ad Hoc Committee, the MSGE, the Native American Tribes Group, the Ad Hoc Group of Individual Victims, the Ad Hoc Group of Hospitals, the Third-Party Payor Group, the Ratepayer Mediation Participants, and the NAS Committee.

ARGUMENT

29. Notwithstanding all of the foregoing, the Movant seeks the appointment of a "supervisory" examiner at the twelfth hour to conduct an investigation into whether "the Special Committee negotiated the Settlement Framework, Term Sheet, and Shareholder Releases as to the Sackler Allegations independently, in good faith, and at arm's length" (Mot. ¶ 76; *see also* Mot. at 4–5) on two grounds. First, the Movant contends that the appointment is required under section 1104(c)(1) because such an examination is in "the 'interests of creditors' and 'other interests of the estates'—the general public." (Mot. ¶ 60.) Second, the Movant claims that appointment of an examiner is mandatory under section 1104(c)(2) because the Debtors have "fixed, liquidated, unsecured debts" in excess of $5,000,000. Neither argument is availing. To the contrary, the Movant has fallen far short of demonstrating that the appointment of an examiner is either appropriate or warranted—a burden that the Debtors respectfully submit is impossible to carry in the context of, and at the late date in, these chapter 11 cases.

I. The Appointment of an Examiner Would Be Antithetical to the Interests of the Creditors and Other Interests of the Estate

30. Section 1104(c)(1) of the Bankrupt Code provides that an examiner shall be appointed if the Court determines in its discretion that an examiner is "in the interests of creditors, any equity security holders, and other interests of the estate." "Mere allegations" regarding irregularity to be made the subject of an examination "are insufficient to justify the appointment of an examiner under section 1104(c)." *Dewey & LeBoeuf LLP*, 478 B.R. 627, 640 (Bankr. S.D.N.Y. 2012). Instead, "allegations of misconduct must be supported by facts." *Id.* (emphasis added). Moreover, an examiner must "be in the interest of everyone with a stake in

the case" and not serve only the parochial interests of a single creditor or creditor group in opposition to the plan. *In re Gliatech, Inc.*, 305 B.R. 832, 836 (Bankr. N.D. Ohio 2004); *accord In re Sletteland*, 260 B.R. 657, 672 (Bankr. S.D.N.Y. 2001) ("[A] creditor group, no matter how dominant, cannot justify the appointment of a trustee or examiner simply by alleging that it would be in its interests. It must show that the appointment is in the interests of all those with a stake in the estate.").

31. The appointment of an examiner here along the lines proposed by the Movant at this late stage would be antithetical to the interests of the creditors and the estates for at least three reasons. First, the investigation proposed by the Movant is both entirely misconceived and entirely pointless. The proposed examination is misconceived because, as demonstrated above, it rests on a fundamentally false premise as to how and by whom the Shareholder Settlement was negotiated over the last several years and utterly ignores the important roles played by the court-appointed mediators and multiple key estate constituencies, including but not limited to the UCC, AHC, and MSGE. The proposed examination is pointless because in less than two short months there will be a confirmation hearing where the reasonableness of the Shareholder Settlement under Rule 9019 will be litigated, in all likelihood very intensely, and the Court will consider (among many other things) whether the Shareholder Settlement was the product of arm's length negotiation. *See In re Iridium Operating LLC*, 478 F.3d 452, 465 (2d Cir. 2007). Indeed, the Movant's proposed examination seems all but designed to permit the Movant to circumvent the pre-trial discovery and litigation procedures recently put in place by this Court to facilitate an orderly run up to confirmation. (*See* Second Am. Order Granting Debtors' Motion for Order Establishing Confirmation Schedules and Protocols, *In re Purdue Pharma L.P.*, No. 19-23649 (RDD) (Bankr. S.D.N.Y. June 3, 2021) [ECF No. 2989].) If the Movant believes that the Shareholder Settlement was not negotiated at arm's length or in good faith, he should litigate

it at confirmation. The proposed examination should not and cannot be a substitute for the Movant and his counsel undertaking this work.

32. Second, and relatedly, the appointment of an examiner would needlessly squander estate resources that could otherwise be conserved and put to use abating the opioid crisis in accordance with the Plan. In one of the few correct statements in Motion, the Movant acknowledges that the proposed examiner "would duplicate work done by [the Debtors' counsel], counsel to the Creditors' Committee or other key participants in these cases." (Mot. ¶ 77.) Courts have routinely denied requests to appoint examiners in similar circumstances. (*See, e.g.*, Hr'g Tr. at 167:11–170:22, *In re Innkeepers USA Tr.*, No. 10-13800 (SCC) (Bankr. S.D.N.Y. Sept. 30, 2010), ECF No. 546 (declining to appoint an examiner because the requested investigation topics and allegations would be addressed "as part of the [official committee of unsecured creditors'] investigation, or in the plan process"); *see also* Sept. 30, 2020 Omnibus Hr'g Tr. 84:18–85:2 ("Where you have an extremely active group of creditors with an extremely broad base, there's no reason to have a third-party examiner, who in any event can only make recommendations and conclusions, which as many cases where examiners have been appointed illustrate are often contested by the parties thereafter as being simply one party's view").)[10]

33. Finally, the soft and hard costs of appointing an examiner here and the resulting harm to all those communities and individuals that stand to benefit from the Plan cannot be measured in the dollars charged by the examiner and his professionals alone. As the Movant acknowledges, "appointing an examiner at this stage of these cases may be disruptive . . . and

[10] Examiner investigations can be exorbitantly expensive even where the examiner is directed to investigate on a limited basis and avoid duplication of investigations that have already occurred. *See* Jonathan C. Lipson, *Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies*, 84 Am. Bankr. L.J. 1, 53 n.214 (2010) (describing that examiner costs can be "significant" and noting that "examiners in *Enron* famously cost about $100 million."); *In re Enron Corp.*, No. 01-16034 (AJG) (Bankr. S.D.N.Y. Apr. 8, 2002), ECF No. 2838 (ordering that "the Enron Examiner, to the extent possible, shall avoid duplication of effort of Debtors and any official Committee").

may delay resolution." (Mot. at 4 (emphasis added).) Delayed resolution means a delay in concluding these chapter 11 cases and their material costs, and a delay in distributing billions of dollars in value to be put to use abating the opioid crisis. Many parties have worked to the point of collapse to keep the current confirmation schedule and avoid the tragic and very material costs of delay. Such a delay should not and cannot be countenanced, particularly for an examination requested by a single creditor that would serve no useful purpose whatsoever.

34. The Movant's pleading also contains a smattering of additional arguments and asides that bear no relationship to the Motion before the Court or the mildest scrutiny. For example, the Movant contends that the settlement between DOJ and the Sackler Families is "lopsided" because the Debtors are paying significantly more than the Sacklers. (Mot. ¶¶ 44–47.) But that is the agreement that the DOJ struck with the Sacklers; the Debtors and the Special Committee had nothing to do with the terms of that agreement. Moreover, the settlement with the Debtors reflects both civil and criminal resolutions. The DOJ's settlement with the Sackler Families announced in October 2020 resolved only civil liability.

35. The Movant also baselessly suggests—yet again casting direct aspersions on the integrity of this Court—that the Court cannot serve as an adequate "check" in these chapter 11 cases, its obligations under the law to assess the reasonableness of the Shareholder Settlement notwithstanding. (Mot. ¶¶ 51–56.) Finally, to the extent the Movant contends that there is something nefarious about discovery being produced pursuant to protective orders (Mot. ¶ 50), that frivolous argument betrays a profound ignorance of how the U.S. legal system works, and has been repeatedly rejected by this Court.[11] This practice is the norm in any complex litigation,

[11] (*See, e.g.*, Jan 20, 2021 Hr'g Tr. 88:6-14 ("As part of that discovery, as is quite common, customary, the parties, both the targets of the discovery and the parties seeking discovery, agreed to protective orders to be so ordered by me whereby they contemplated that certain information provide in the discovery would remain confidential and, in fact, at different levels of confidentiality. That's a common practice to enable discovery to proceed quickly without fights over what is produced in the first instance.").)

as the Movant's counsel should well know. Indeed, the Movant (and his counsel) are free to sign the protective order at any time and gain access to millions of documents that have been provided to many parties in these cases.[12] None of these arguments come close to carrying the Movant's burden of establishing that the appointment of an examiner is in the interests of the estates.[13]

II. An Examiner Is Not Appropriate Under Section 1104(c)(2)

36. The Movant separately seeks the appointment of an examiner under section 1104(c)(2). Section 1104(c)(2) provides that "the court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate . . . if . . . the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000." The Movant argues that this provision requires appointment of an examiner because "there is no question that . . . the Debtors' fixed, liquidated, unsecured debts" exceed $5,000,000" and, in light of the satisfaction of that threshold, the appointment of an examiner is mandatory. (Mot. ¶¶ 60–66.) Section 1104(c)(2), however, does not and cannot rescue the Movant's late-breaking and deleterious request for an examiner.

A. The Movant Has Not Established That the Fixed, Liquidated, Unsecured Debt Threshold Has Been Satisfied

37. It is well established that the moving party bears the burden of showing that an examiner should be appointed, and to carry that burden in the context of section 1104(c)(2), the

[12] The Movant also raises several objections to the adequacy of the information in the Debtors' Disclosure Statement. (Mot. at 2 ("The Disclosure Statement omits critical statements about the Sackler Families' historic control of, and entanglement with, the Debtors."). But despite filing two objections to the Disclosure Statement (and appearing at each of the hearings on the Disclosure Statement), the Movant never raised these objections, which are plainly meritless. (*See* Disclosure Stmt. § III.Y–BB.)

[13] The Movant offers a series of unsubstantiated allegations as to why, in his opinion, the investigations were either deficient or improperly disclosed. (Mot. ¶¶ 78–80 (alleging that investigations should have focused more direct claims and that results of investigations do not appear in the public record).) But these allegations are simply not credible in light of clear public record in these chapter 11 cases of a robust and adversarial investigation.

Movant must (among other things) "establish fixed, liquidated, unsecured debts of the type specified" in the statute. *In re Dewey & LeBoeuf*, 478 B.R. at 636. Here, the Movant contends that "[t]he Debtors' obligations to the United States under the Purdue-DOJ settlement vastly exceed" the statutory requirement. (Mot. ¶ 60.) That is not correct.

38. The Debtors' obligations under the DOJ settlement do not satisfy section 1104(c)(2). The Bankruptcy Code does not define what constitutes fixed and liquidated debt for purposes of section 1104(c)(2), and the case law is sparse. However, one court (relying on *Black's Law Dictionary*) has observed that "fixed debt" is "generally, a permanent form of debt commonly evidenced by a bond or debenture; long-term debt." *In re Dewey & LeBoeuf*, 478 B.R. at 637. A "fixed debt" is not a "contingent" debt, which is "[a] debt that is not presently fixed but may become fixed in the future with the occurrence of some event," or "one which the debtor will be called upon to pay upon the occurrence or happening of an extrinsic event which will trigger . . . liability." *Id.* (quoting *Mazzeo v. United States (In re Mazzeo)*, 131 F.3d 295, 303–05 (2d Cir. 1997)).

39. Although the Movant does not specify which obligations under the DOJ settlement he contends satisfy the relevant debt threshold, he is presumably referencing the criminal forfeiture claim of $2 billion; the $3.544 criminal fine claim; and the $2.8 billion civil claim arising from the DOJ's civil investigation of the Debtors. But none of these is "fixed." The forfeiture claim and the criminal fine claim will come into existence only as of the later of the District Court accepting Purdue's plea agreement at sentencing or confirmation of the Debtors' plan—both future, contingent events. (*See* Order Pursuant to 11 U.S.C. § 105 and Fed. R. Bankr. Proc. 9019 Authorizing and Approving Settlements Between the Debtors and the United States, *In re Purdue Pharma*, No. 19-23649 (RDD) (Bankr. S.D.N.Y. Nov. 18, 2020) [ECF No. 2004] ("**9019 Order**") ¶¶ 3, 5.) And although the order approving the DOJ settlement provides that "[t]he United States shall have an allowed, unsubordinated, undisputed, non-

contingent, liquidated unsecured" civil claim (9019 Order ¶ 6), that too is not "fixed" because the DOJ has the option to rescind the civil settlement agreement and pursue any claims or actions against the Debtors in the event that no fewer than five contingencies come to pass. (9019 Order ¶¶ 6–7.) For all of these reasons, the Movant's argument that the Debtors' obligations to the United States pursuant to the DOJ resolution satisfies section 1104(c)(2) must be rejected.

B. Appointment of an Examiner Is Neither Mandatory nor Appropriate

40. Far more importantly, even if the Movant had demonstrated that the statutory predicates of section 1104(c)(2) were satisfied, the appointment of an examiner would still be unwarranted and inappropriate. To be sure, certain courts—relying on the phrase "shall order the appointment of an examiner" in the introductory provision of section 1104(c)—have held that the appointment of an examiner is mandatory if the movant establishes that the Debtors' fixed, liquidated, unsecured debts exceed $5,000,000. *See, e.g.*, *In re Revco D.S., Inc.*, 898 F.2d 498, 500–01 (6th Cir. 1990); *In re Loral Space & Communications, Ltd.*, No. 04 Civ. 8645RPP, 2004 WL 2979785, at *4–5 (S.D.N.Y. Dec. 23, 2004). But many other courts have observed that the same introductory provision makes clear any examination ordered by the court must be "as is appropriate," which in turn affords courts discretion to refuse to appoint an examiner where such appointment would, in fact, not be appropriate. *See, e.g., In re Residential Capital, LLC*, 474 B.R. at 121 ("While section 1104(c) expresses a Congressional preference for appointment of an independent examiner to conduct a necessary investigation, the facts and circumstances of the case may permit a bankruptcy court to deny the request for appointment of an examiner even in cases with more than $5 million in fixed debts."); *In re Dewey & LeBoeuf LLP*, 478 B.R. at 639 (concluding "that the Examiner Motion should be denied even if the debt threshold in section 1104(c)(2) is satisfied" because motion was an inappropriate litigation tactic); *In re Spansion, Inc.*, 426 B.R. 114, 126–27 (Bankr. D. Del. 2010) (although debt threshold was met, relying on "as is appropriate" language to deny request to appoint examiner where "[a]ll of the parties have

had ample opportunity to conduct—and have conducted—extensive discovery, and to investigate the Debtors" on the grounds that appointment of an examiner "would cause undue cost to the estate, which would be harmful to the Debtors and would delay administration of th[e] chapter 11 case").[14]

41. Courts have repeatedly refused to appoint an examiner under section 1104(c)(2) in several circumstances, including where: (1) the investigation has already been conducted by other parties; (2) the examination would increase costs and cause a delay with no corresponding benefit; and (3) the motion is a litigation tactic and filed late in the case. *See In re Dewey & LeBoeuf LLP*, 478 B.R. at 639; *In re Spansion, Inc.*, 426 B.R. at 126–27; *see also In re Residential Capital LLC*, 474 B.R. at 120. Here, all three circumstances are present. As set forth above, there have already been robust investigations conducted by not one but two estate fiduciaries (and many other parties) over a nearly two-year period. Appointment of an examiner would increase cost and cause delay with no corresponding benefit. And the Motion, which was filed nearly contemporaneously with this Court's rejection of the Movant's objection to the Debtors' disclosure statement and attempt to thwart solicitation of the Plan, is a barely disguised litigation tactic. Indeed, it appears designed to make an end run around the procedures order entered by this Court entirely and litigate issues that will be before the Court in approximately 60 days. And this follows nearly a year after the Movant filed a letter with this Court seeking the appointment of an examiner (that he subsequently decided not to pursue) and 19 months after the Movant's now-counsel, in his capacity as a professor, wrote to the U.S. Trustee requesting that

[14] This is consistent with the legislative history of section 1104(c). At the time the statute was passed, Congress stated that "[t]he standards for the appointment of an examiner are the same as those for the appointment of a trustee; <u>the protection must be needed</u>, and the cost and expense must not be disproportionately high." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 403 (1977) (emphasis added). In other words, while the statute may express a Congressional preference for the appointment of examiners, the legislature recognized that the appropriateness of such appointment was best left to the discretion of the court.

the U.S. Trustee seek the appointment of an examiner in these cases—a request that did not bear fruit and that he did nothing to pursue further until now.[15]

42. The Movant's reliance on this Court's recent order appointing an examiner in *In re Cenveo*, No. 18-22178 (RDD) (Bankr. S.D.N.Y. Mar. 6, 2018) for the proposition that an examiner is warranted here is entirely misplaced. There, this Court acknowledged that there were "clearly cases" holding that a court retains discretion to refuse to appoint an examiner where the motion "happens towards the end of a case" and the examiner would be "a total waste of time, a litigation delay tactic." (*See* Mar. 6 Hr'g Tr. 86:9–87:19, *In re Cenveo*, No. 18-22178 (RDD) (Bankr. S.D.N.Y. Mar. 6, 2018) (hereinafter, "*Cenveo* Transcript"), ECF No. 367.) In *In re Cenveo*, however, the motion for an examiner was filed "not at the end of the case" but in the beginning, just 10 days after the chapter 11 cases commenced, under circumstances where all parties agreed at least some form of investigation of insider transactions (by someone) was required. (*Id.* at 87:20–88:1.) Against that backdrop, this Court held that the "grounds for the request for an examiner are legitimate enough that the no examination at all approach [did not] really lie" and thus appointed an examiner with a very circumscribed role to, "in essence, look over the shoulder of the committee and focus on their investigation and whether they are within reasonable guidelines looking in the right places." *Id.* at 87:8–90:18.) The facts and circumstances of these almost 21-month old chapter 11 cases could not be more different from

[15] The Debtors firmly believe that appointment of an examiner would be inappropriate here. In the event that this Court determines otherwise and holds that appointment under the circumstances is mandatory, the Debtors respectfully submit that the examination should be limited to a single day of interviews of the lead counsel to the creditor groups who investigated the Sackler Families and negotiated the Shareholder Settlement—namely the UCC, AHC, and MSGE—concerning whether these groups' decisions to support the Shareholder Settlement was made independently of the Special Committee and at arm's length from the Sackler Families.

those present in *In re Cenveo*, and *In re Cenveo* does not support in any way the appointment of examiner here.

C. The Movant Has Waived the Right to Seek Appointment of an Examiner

43. Finally, the doctrines of waiver and laches provide a separate and independent ground for denying the Motion. Courts have long recognized that "[a] party in interest may waive its right to seek the appointment of an examiner." *See In re Bradlees Stores, Inc.,* 209 B.R. 36, 39–40 (Bankr. S.D.N.Y. 1997). Here, the Movant improperly seeks an appointment of an examiner on the eve of confirmation. That alone is sufficient to find waiver. *See* Hr'g Tr. 72:5–73:19; *In re Calpine Corp.,* No. 05-60200 (Bankr. S.D.N.Y. Oct. 24, 2007) [ECF No. 6467] (holding movant "waived its right to request an examiner by waiting . . . almost two years after the petition date . . . and less than two months before the confirmation hearings."); *In re Bradlees Stores, Inc.,* 209 B.R. at 39–40 (denying motion for examiner "regardless of whether section 1104(c)(2) is mandatory or discretionary, [because] a party in interest may waive its right to seek the appointment of an examiner."); *see also In re Schepps Food Stores, Inc.*, 148 B.R. 27, 30 (S.D. Tex. 1992) (denying motion to appoint examiner even after finding § 1104(c)(2) was mandatory because "[t]he request for the appointment of an examiner came on the eve of the confirmation hearing"); 7 Collier on Bankruptcy ¶ 1104.03(2)(b) (16th ed. 2021) ("Failure to make a timely request for the appointment of an examiner may provide the court with a basis for denying the request on the ground of laches.").

44. Nor is there any reason whatsoever to excuse the delay of either the Movant or his previously clientless counsel. To the contrary, the Movant himself filed a letter requesting an examiner in July 2020—nearly one year ago—but declined this Court's invitation to treat that letter as a motion. (Jackson Decl. ¶ 3.) The Movant's counsel sent a letter to the U.S. Trustee in November 2019—<u>19 months</u> before this Motion was filed—urging the U.S. Trustee to seek appointment of an examiner, for among other reasons, because of his (erroneous) concern that

the Special Committee might not be independent.[16] Neither the Movant nor his counsel took any additional steps to seek the appointment of an examiner until filing this Motion on June 1, 2021—approximately **<u>60 days</u>** before trial is set to commence. The delay is fatal and smacks of gamesmanship.

<u>CONCLUSION</u>

45. For all of the foregoing reasons, the Debtors respectfully request that the Court deny the Motion. Many parties unquestionably adverse to the Sacklers—including the UCC, the Ad Hoc Commtitee, and the MSGE—have worked tirelessly for months or years to investigate claims and to negotiate a settlement with the Sackler Families, and those parties—guided by experienced and highly regarded mediators—have <u>independently</u> negotiated and determined that the settlement reached is reasonable and in the best interests of the estates. That Shareholder Settlement is the cornerstone of a Plan that, if confirmed, will effectuate the transfer of billions of dollars to creditors and the American people to help abate the opioid crisis and compensate individual victims. The appointment of an examiner at this late hour, under these circumstances, would serve no useful purpose whatsoever and would introduce unwarranted expense and delay. That result should not be countenanced.

[16] *See* Jonathan C. Lipson, Letter of Bankruptcy Law Professors to United States Trustee Requesting an Examiner in the Purdue Pharma Chapter 11 Reorganization (Nov. 5, 2019), https://ssrn.com/abstract=3532642.

Dated: June 13, 2021
New York, New York

DAVIS POLK & WARDWELL LLP

By: */s/ Marshall S. Huebner*

450 Lexington Avenue
New York, New York 10017
Telephone: (212) 450-4000
Facsimile: (212) 701-5800
Marshall S. Huebner
Benjamin S. Kaminetzky
Eli J. Vonnegut
James I. McClammy
Gerard X. McCarthy

Counsel to the Debtors
and Debtors in Possession

Jonathan C. Lipson
Temple University-Beasley School of Law
1719 North Broad Street
Philadelphia, PA 19122
Counsel to Peter W. Jackson

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re: PURDUE PHARMA L.P., *et al.* [1] Debtors.	Chapter 11 Case No. 19-23649 (RDD) (Jointly Administered)

NOTICE OF MOTION FOR ORDER TO APPOINT EXAMINER
<u>PURSUANT TO 11 U.S.C. § 1104(c)</u>

PLEASE TAKE NOTICE that Peter W. Jackson, a creditor and party in interest ("**<u>Movant</u>**"), by and through its undersigned counsel, filed a motion (the "**<u>Motion</u>**") for entry of an order, pursuant to section 1104(c) of title 11 of the United States Code (the "**<u>Bankruptcy Code</u>**"), for the appointment of an examiner in the above captioned cases.

PLEASE TAKE FURTHER NOTICE that a hearing on the Motion will be held before the Honorable Robert D. Drain at the United States Bankruptcy Court for the Southern District

[1] The debtors in these chapter 11 cases ("**<u>Debtors</u>**" or "**<u>Purdue</u>**"), along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. ("**<u>PPLP</u>**") (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014) (collectively, the "**<u>Bankruptcy Cases</u>**").

of New York, White Plains Division, 300 Quarropas Street White Plains, New York 10601 (the "Bankruptcy Court"), on June 16, 2021 at 10:00 a.m. (prevailing Eastern Time) or as soon thereafter as counsel may be heard (the "**Hearing**").

PLEASE TAKE FURTHER NOTICE that objections, if any, to the Motion must comply with the Federal Rules of Bankruptcy Procedure and the Local Bankruptcy Rules for the Southern District of New York. Objections, if any, to the Motion must be filed with the Court no later than June 13, 2021 at 4:00 p.m. (prevailing Eastern Time) (the "**Objection Deadline**") and served so as to be actually received by such time by (i) counsel to the Movant, Jonathan C. Lipson, Temple University-Beasley School of Law, 1719 North Broad Street, Philadelphia, PA 19122 (jlipson@temple.edu); and Karen F. Neuwirth, Martin S. Rapaport, P.C., 18 East 48th Street 6th Floor, New York, N.Y. 10017 (manhatoffice@yahoo.com); and (ii) all parties on the Master Service List, as defined in the Case Management Order [ECF No. 498], which may be found https://restructuring.primeclerk.com/purduepharma/Home-Index.

PLEASE TAKE FURTHER NOTICE that that if no objections to the Motion are timely filed, served and received in accordance with this notice and the Case Management Order, the Court may grant the relief requested in the Motion without further notice or hearing.

Dated: June 1, 2021
Philadelphia, PA

Respectfully Submitted,

By: /s/ Jonathan C. Lipson

Jonathan C. Lipson
Temple University-Beasley School of Law
1719 North Broad St.
Philadelphia, PA 19122
215-204-0608
jlipson@temple.edu
Counsel to Peter W. Jackson

/s/ Karen F. Neuwirth

Karen F. Neuwirth
Martin S. Rapaport, P.C.
18 East 48th Street
6th Floor
New York, N.Y. 10017
(212) 688-1980
manhatoffice@yahoo.com
Co-counsel to Peter W. Jackson

Jonathan C. Lipson
Temple University-Beasley School of Law
1719 North Broad Street
Philadelphia, PA 19122
Counsel to Peter W. Jackson

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re: PURDUE PHARMA L.P., et al. [2] Debtors.	Chapter 11 Case No. 19-23649 (RDD) (Jointly Administered)

MOTION FOR ORDER TO APPOINT EXAMINER
PURSUANT TO 11 U.S.C. § 1104(c)

[2] The debtors in these chapter 11 cases ("**Debtors**" or "**Purdue**"), along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. ("**PPLP**") (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014) (collectively, the "**Bankruptcy Cases**").

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INTRODUCTION

Peter W. Jackson, a creditor and party in interest (the "**Movant**"), by and through his undersigned counsel, hereby submits this Motion ("**Motion**") to appoint an examiner pursuant to 11 U.S.C. § 1104(c) in the above-captioned cases for the limited purposes set forth in the form of Proposed Order attached as Exhibit A to this Motion (the "**Proposed Order**"). In support of this Motion, Mr. Jackson respectfully represents as follows:

PRELIMINARY STATEMENT

These cases have been overshadowed by a single, critical question: who is responsible for the Debtors' confessed crimes and the harm they caused? While Purdue Pharma, L.P. ("**PPLP**" or "**Purdue**") has agreed to plead guilty to three federal felonies deriving from its marketing, labeling and sale of prescription opioids, no individual has been charged criminally. All civil suits arising from the Debtors' misconduct—including roughly 600 directly against the Debtors' ultimate beneficial owners, the Sackler families—have been enjoined by this Court. There have been strong allegations that certain members of the Sackler families bear this responsibility (the "**Sackler Allegations**"), and equally strong denials from them. While the case has involved massive—perhaps a record amount of—discovery, it has been contained among and analyzed by a small group of case insiders.

Rather than answer this question through litigation, the board of directors of Purdue Pharma, Inc., a New York corporation and PPLP's general partner ("**PPI**" and the "**PPI Board**"), elected to adopt the "Settlement Framework," as defined in the Debtors' proposed plan of reorganization (the "**Plan**").[3] While there may have been good reason to implement the Settlement

[3] Unless otherwise indicated, this Motion relies on and references the Fourth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P. and Its Affiliated Debtors [ECF No. 2936] (the "**Plan**") and the Disclosure Statement for Fourth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P. and Its Affiliated

Framework, there must first be a determination that the decision to settle, rather than to sue, was made independently, in good faith, and at arm's length, as required by applicable case law.

A review of the Disclosure Statement and other pleadings and materials in these Bankruptcy Cases indicates that there may be reason for concern. Among other things, it appears that--

- The Settlement Framework may have been established while the Debtors were still under the control of the Sackler Families;
- The Sackler Families retained the power to influence the PPI Board even after commencement of these cases;
- The Disclosure Statement omits critical statements about the Sackler Families' historic control of, and entanglement with, the Debtors;
- Despite the Sackler Families' alleged control, the settlement with the United States Department of Justice ("**DOJ**") places the great bulk of the cost of the Debtors' criminal misconduct on the Debtors; and
- Other checks in the system (e.g., the Creditors' Committee) have been constrained by stipulations and customs in practice that favor settlement over litigation.

These and similar concerns are red flags calling for scrutiny of the decision to settle the

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Debtors [ECF No. 2937] (the "**Disclosure Statement**"). Movant recognizes that the Debtors and various parties are at work on a subsequent revision to the Plan and Disclosure Statement. For the reasons discussed herein, it is highly unlikely that a revised Disclosure Statement would address the concerns noted in this Motion. At the same time, the Second Amended Order Establishing Certain Notice, Case Management, and Administrative Procedures [ECF No. 498] in these cases requires the Motion to be filed and served fifteen (15) calendar days before the next Omnibus Hearing, which is currently scheduled for June 16, 2021. The Movant reserves the right to amend this Motion in the event subsequent changes to the Plan or Disclosure Statement materially affect the request for relief in this Motion. Capitalized terms used without definition in this Motion have the meanings ascribed to such terms in the Plan and Disclosure Statement.[4] *See* Order Appointing an Examiner Pursuant to 11 U.S.C. 1104(c)(2), *In re Cenveo, Inc*., Case No. 18-22178-rdd, (Bankr. S.D.N.Y. Mar. 15, 2018), ECF No. 203 [hereinafter "**Cenveo Examiner Order**"].

Sackler Allegations pursuant to the Shareholder Settlement described in the Disclosure Statement. If the Shareholder Settlement was a fait accompli from the outset, creditors and the public should know that.

Ordinarily, these concerns would be addressed by way of objection to a motion to approve the Shareholder Settlement or to confirm the Plan. Given the voluminous record in this case, and concerns about maintaining confidentiality and attorney-client privilege, however, it is highly unlikely that these concerns will be addressed credibly and publicly in connection with any such motion. While procedures to confirm the Plan create a "Document Reserve," those materials are available only to those who agree to keep what they see confidential.

Given the unique and undisputed public interest in this case, and the power that the Sackler Families and their Related Entities may have wielded over the PPI Board, there must be an independent assessment of, and public report on, the decision to accept and implement the Settlement Framework as to the Sackler Allegations.

Congress created a mechanism to do this: a chapter 11 examiner. Section 1104(c) of the United States Bankruptcy Code provides that a bankruptcy court "shall" order the appointment of an examiner "to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor, if": (1) "such appointment is in the interests of creditors, any equity security holders, and other interests of the estate"; or (2) "the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes," exceed $5 million. 11 U.S.C. § 1104(c).

The statutory criteria are inarguably satisfied in these cases. No plan has yet been confirmed, and the Debtors' November 2020 settlement with the DOJ created a qualifying unsecured claim in excess of $2 billion. No one questions the public interest in these cases or the need for assurance that settlement with the Sacklers, rather than litigation, is in fact in the interests of creditors, the Debtors' estates, and the public. The plain language of the Bankruptcy Code and sound policy reasons require the appointment of an examiner in these cases.

At the same time, the Movant recognizes that this case has had the benefit of extraordinary expertise, including the participation of leading mediators and a corporate monitor. Unfortunately, while these mechanisms may be laudable, they appear to focus on the Debtors' present and future (and, in the case of mediation, to have occurred largely in secret). Questions about the decision to settle the Sackler Allegations involve the Debtors' *past*. While the Plan would create a "Document Repository" with the Debtors' historical documents, it may not contain those relevant to the Shareholder Settlement and Sackler Allegations. In any case, it will be accessible only *after* the Plan is confirmed—with the Shareholder Releases permanently shielding the Sackler Families from further scrutiny or potential liability arising from the Sackler Allegations.

The Movant recognizes that appointing an examiner at this stage of these cases may be disruptive, would add cost, and may delay resolution. The Bankruptcy Code requires an examiner "to conduct such an investigation of the debtor as is appropriate," (*id.)*—not for any and every purpose.

For these reasons, Movant seeks the appointment of a "supervisory" examiner, adapted from the examination recently ordered by this Court in *In re Cenveo*.[4] As set forth in the form of Proposed Order, the Movant seeks appointment of an examiner for the limited purpose of examining and reporting on whether the decision by the PPI Board to implement the Settlement

[4] *See* Order Appointing an Examiner Pursuant to 11 U.S.C. 1104(c)(2), *In re Cenveo, Inc*., Case No. 18-22178-rdd, (Bankr. S.D.N.Y. Mar. 15, 2018), ECF No. 203 [hereinafter "**Cenveo Examiner Order**"].

Framework as to the Sackler Allegations, including the Shareholder Releases to be provided in the Plan, was made independently, in good faith, and at arm's length, as required by applicable case law.

In further support of this Motion, the Movant respectfully represents as follows:

JURISDICTION

1. On September 15, 2019 (the "**Petition Date**"), the Debtors each commenced a voluntary case under chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York (the "Court"). The Debtors are authorized to operate their businesses and manage their properties as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code.

2. The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334 and the Amended Standing Order of Reference M-431, dated January 31, 2012 (Preska, C.J.). This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2).

3. These cases are being jointly administered pursuant to Bankruptcy Rule 1015(b) and the Order Directing Joint Administration of Chapter 11 Cases [ECF No. 59] entered by the Court in each of these cases.

4. On September 27, 2019, the United States Trustee for the Southern District of New York appointed the official committee of unsecured creditors (the "Creditors' Committee" or "UCC"). No trustee or examiner has been appointed in these Cases.

5. As set forth in the Affidavit of Peter W. Jackson in Support of Motion for Order to Appoint an Examiner Pursuant to 11 U.S.C. § 1104(c) (the "**Jackson Affidavit**"), attached as Exhibit B, the Movant is a creditor and party in interest by virtue of the fact that in August, 2006,

his daughter, Emily Ruth Jackson, passed away due to respiratory depression after ingesting a single OxyContin pill. He timely filed a proof of claim in these cases.

RELIEF REQUESTED

6. The Movant seeks entry of an order, in the form attached hereto as Exhibit A, (i) appointing an examiner in these chapter 11 cases pursuant to Bankruptcy Code section 1104(c) and (ii) granting related relief.

FACTUAL BACKGROUND

A. The Term Sheet, Preliminary Injunction, DOJ Settlements, and Plan

7. These cases have been punctuated by four events:[5] (i) the filing of a term sheet describing the Settlement Framework; (ii) the entry and continuation of a preliminary injunction halting litigation against the Sackler Families; (iii), the settlements with the DOJ; and (iv) the promulgation of the Plan and Disclosure Statement. Each creates questions about the extent to which the PPI Board, and its "**Special Committee**", would have had the capacity to assess the Settlement Framework independently or to challenge it, if appropriate.

1. The Term Sheet

8. According to the Disclosure Statement, "[s]hortly before the Petition Date, the Debtors, the Sackler Families, and the Ad Hoc Committee [of certain consenting creditors] reached an agreement in principle regarding the Settlement Framework." Disclosure Statement, at 65. It appears that this Settlement Framework was reflected in an unsigned, and undated "Summary

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[5] These are not the "four gates" identified in the Disclosure Statement. Disclosure Statement, at 65-66.

Term Sheet" ("Term Sheet") filed by the Debtors October 8, 2018. *See* Notice of Filing of Term Sheet with Ad Hoc Committee, [ECF No. 257].

9. The Term Sheet and Settlement Framework essentially provided that the Sackler Families would cede ownership and control of the Debtors to or for the benefit of creditors, and contribute an additional sum (at the time $3 billion) "[i]n exchange for comprehensive releases in the form and manner to be agreed upon by the parties," (*id.*, ¶¶ 5-6) which now appear to take the form of the "Shareholder Releases" proposed in the Plan.

2. The Preliminary Injunction

10. Shortly after the Petition Date, the Bankruptcy Court granted a preliminary injunction enjoining public and private entities from the commencement or continuation of active judicial, administrative, or other actions or proceedings "arising from or in any way relating to the Debtors' prescription opioid business" ("**Preliminary Injunction**"). *See* Order Pursuant to 11 U.S.C. § 105(a) Granting, in Part, Motion for a Preliminary Injunction, *Purdue Pharma, L.P. v. Commw of Mass.,* Adv. Pro. No. 19-08289 (Bankr. S.D.N.Y Oct. 11, 2019) [ECF No. 82].[6] Among other things, the Preliminary Injunction halted about 600 lawsuits asserting direct personal injury and/or wrongful death claims against members of the Sackler family, and which represent at least certain aspects of the civil claims constituting the Sackler Allegations.[7]

3. The DOJ Settlements

11. On October 21, 2020, the Debtors filed a motion seeking approval to enter into a settlement with the United States. *See* Motion of Debtors Pursuant to 11 U.S.C. § 105 and Fed. R.

[6] The preliminary injunction has been extended repeatedly. *See* Eighteenth Amended Order Pursuant to 11 U.S.C. § 105(a) Granting Motion for a Preliminary Injunction, [ECF No. 2897].

[7] The Disclosure Statement states that such "claims include, but are not limited to, product liability, wrongful death, negligence, including negligent misrepresentation, negligence per se and gross negligence, fraud, fraudulent concealment, deceit and other willful misconduct, unjust enrichment, public nuisance, and claims under state consumer protection and controlled substances laws." Disclosure Statement, at 162.

Bankr. P. 9019 Authorizing and Approving Settlements Between the Debtors and the United States [ECF No. 1828]. On November 18, 2020, the Court approved PPLP entering into: (i) a plea agreement (the "**Plea Agreement**") by and among PPLP and the United States; and (ii) a civil settlement agreement by and between PPLP and the United States. *See* Order Pursuant to 11 U.S.C. § 105 and Fed. R. Bankr. P. 9019 Authorizing and Approving Settlements Between the Debtors and the United States [ECF No. 2004].

12. On November 24, 2020, PPLP pleaded guilty to an information charging it with three felony offenses: one count charging a dual-object conspiracy to defraud the United States and to violate the Food, Drug, and Cosmetic Act, and two counts charging conspiracy to violate the Federal Anti-Kickback Statute. Disclosure Statement, at 124.

13. If the Plea Agreement is accepted by the United States District Court for the District of New Jersey, the Purdue-DOJ settlement will, according to the Disclosure Statement, "fully resolve the United States' civil and criminal investigations into the Debtors' past practices related to the production, sale, marketing and distribution of opioid products." Disclosure Statement, at 18. Among other things, the DOJ settlement gives the United States "an allowed, unsubordinated, undisputed, noncontingent, liquidated unsecured claim against Purdue Pharma in the amount of $2.8 billion arising from the Department of Justice's civil investigation" and a total claim of about $8 billion for other elements of the settlement. Disclosure Statement, at 124.

14. At the same time, the Sacklers entered into a settlement of their civil liability with the DOJ. In exchange for the Sackler Families' payment of $225 million, the DOJ agreed to "release the Named Sacklers . . . from any and all civil or administrative monetary claims." *See* Motion to Confirm That Payment by the Sackler Families Under Settlement with the United States

Department of Justice Is Not Prohibited by This Court [ECF No. 1833], Ex. A, ¶ 4 (unpaginated original) ("**Sackler Settlement Motion**").

15. The DOJ did not at that time release claims against the Sacklers for criminal liability. *See* Sackler Settlement Motion, Ex. A, Addendum A ("**Sackler Addendum**"), ¶ 8.a. According to the DOJ, however, from 2010 to 2018 certain members of the Sackler Families "knowingly caused the submission of false and fraudulent claims to federal health care benefit programs for Purdue's opioid drugs that were prescribed for uses that were unsafe, ineffective, and medically unnecessary, and that were often diverted for uses that lacked a legitimate medical purpose." Sackler Addendum at 2, ¶ 5. Although they "knew that the legitimate market for Purdue's opioids had contracted, the Named Sacklers nevertheless requested that Purdue executives recapture lost sales and increase Purdue's share of the opioid market." *Id.* at 1, ¶ 3. These and similar statements in the DOJ settlements represent at least some aspects of the criminal claims constituting the Sackler Allegations.

4. The Plan, the Disclosure Statement, and the Releases

16. On March 15, 2021, the Debtors filed the Plan and Disclosure Statement with the Court. According to the Disclosure Statement, the Plan—and the Shareholder Settlement and Releases—are part of a "global resolution" of claims against the Debtors and the Sackler Families. Disclosure Statement, at 3.

17. As expected, the Plan apparently contains broad releases and channeling injunctions for the benefit of the Sackler Families, their Related Parties, and other nondebtors. It also contains certain improvements over the Term Sheet, including that the Sackler Families would increase their cash contribution from $3 billion to about $4.2 billion payable over nine or ten years

(depending on how quickly payments are made). The Plan also apparently resolves significant intercreditor disputes.

18. While the Plan would create a "Public Document Repository," it would exclude "any documents or content of documents that are Privileged, including Privileged documents produced to the DOJ under non-waiver agreements and Privileged documents subject to a clawback by Debtors in the Purdue Legal Matters, or documents that are subject to protections against public disclosure by the Health Insurance Portability and Accountability Act or similar state or federal statute, or reveal the names or email addresses of individual employees or former employees of Debtors." Disclosure Statement, at 127. Moreover, it would not be created until *after* the Plan has been confirmed, and the Sacklers presumably released.

B. Questions about the Shareholder Settlement

19. The Disclosure Statement provides exhaustive detail—40-plus pages—about the many steps the Special Committee, its professionals, and other key participants in these cases, such as the Creditors' Committee, took to analyze settlement factors governed by applicable case law. While the Disclosure Statement contains an ample discussion of the estates' property-based (e.g., voidable transfer) claims, it raises more questions than it answers regarding the Sackler Allegations and the decision to settle them.

20. The Disclosure Statement notes that the Shareholder Settlement should be evaluated by the Court pursuant to the so-called *TMT Trailer Ferry* and *Iridium* factors. Disclosure Statement, at 152 (citing *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414 (1968); *In re Iridium Operating LLC*, 478 F.3d 452, 462 (2d Cir. 2007)).[8]

[8] *See also Hr'g Trans*, Mar. 24, 2021, at 103 ("I will apply the *TMT* and *Iridium* factors if I have to, as well as the *Metromedia* standard for a third-party injunction and relief if I have to. But they all have to do with the risks and rewards of the settlement versus litigation, the costs and delay of continued litigation versus the structure of a

21. In *TMT Trailer Ferry*, the Supreme Court held that, when asked to approve a settlement in bankruptcy, the court should "compare the terms of the compromise with the likely rewards of litigation." *TMT Trailer Ferry*, 390 U.S. at 425. Notably, in that case*,* the Supreme Court *reversed* the lower courts' decision to approve a settlement following extensive investigations by a bankruptcy trustee into allegations of self-dealing by certain parties in connection with a plan of reorganization approved by the lower courts.[9] *Id.* (*rev'g* 364 F.2d 936 (5th Cir. 1966)). Although all classes of creditors other than the United States had accepted the plan, and the District Court had confirmed it (*id.* at 422), the Supreme Court reversed the lower courts because it was "essential that every important determination in reorganization proceedings receive the 'informed, independent judgment' of the bankruptcy court." *See TMT Trailer Ferry*, 390 U.S., at 424, (quoting *National Surety Co. v. Coriell,* 289 U.S. 426, 436 (1933)).

22. In *Iridium*, the Second Circuit Court of Appeals articulated a 7-factor test courts should use in deciding whether a settlement should be approved. The seventh *Iridium* factor is "the extent to which the settlement is the product of arm's length bargaining." *Iridium*, 478 F.3d, at 462.

23. As explained below, important decisions leading to the Settlement Framework may have been made before the PPI Board or its Special Committee were "independent" of the Sackler

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settlement, issues pertaining to collectability and ability to pay if a settlement is not reached, and the consequences to other parties, as well as those who won't reach agreement if litigation proceeds.").

[9] The Court explained—

> Fourteen days of hearings were held, 2,200 pages of testimony transcribed, and some 60 exhibits collected. [the trustee's] report from this investigation covers 40 pages in the original record. He concluded that the debtor's business had been 'wrecked by gross mismanagement, by unwise and unsound expansion financed primarily through the sale of securities in disregard of the protective provisions of the Securities Act of 1933,' and that the debtor had substantial causes of action against holders of the Caplan mortgage. Upon the recommendation of Anderson, the trial court vacated its order confirming the 1959 plan, and the Court of Appeals affirmed."

Protective Comm. for Indep. S'holders of *TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 421 (1968).

Families, who may have continued to exert influence over PPI Board during these cases. If so, that framework may have been foreordained and irreversible. Moreover, restrictions on the flow of information in this case mean that the investigations, negotiations, and mediations that followed cannot provide assurance that that predicate decision, from which all else has flowed in this case, was itself independent and made at arm's length. Other checks in the system, such as the Creditors' Committee and this Court, may not be sufficient to permit the "'informed, independent judgment' of the bankruptcy court" required by *TMT Trailer Ferry*. *See* 390 U.S., at 424.

1. The Independence of the Special Committee

24. The Disclosure Statement indicates that, shortly before the Petition Date, the Sackler Families apparently ceded control of the PPI Board to the Special Committee, which was given "exclusive authority over the prosecution, defense, and settlement of any causes of action Purdue Pharma may assert against its shareholders as well as members of the Sackler Families and their affiliates." Disclosure Statement, at 34. The Disclosure Statement states that this rendered the Special Committee "independent." *Id.*[10]

25. Unfortunately, the timing of the formation of the Special Committee, and steps to shield it from the Sackler Families, are unclear, but problematic. It appears that the Special Committee was not given this authority until September 3, 2019—less than two weeks before the Petition Date—and was apparently not insulated from removal by the Sacklers until November 6, 2019—nearly two months into the case.[11]

[10] The Disclosure Statement provides that "Purdue Pharma's governance documents irrevocably granted an independent Special Committee of the Board of Directors exclusive authority over the prosecution, defense, and settlement of any causes of action Purdue Pharma may assert against its shareholders as well as members of the Sackler Families and their affiliates." Disclosure Statement, at 58. As discussed in this Motion, assuming this is true, the important questions involving timing: Was this true before—or only after—the Settlement Framework was established?

[11] The Disclosure Statement provides as follows:

26. To this day, the Sacklers' powers with respect to the Debtors' board of directors are opaque. The Debtors are, and always have been, privately held, so there is little public information about their governance. The Debtors' bylaws, for example, are apparently not publicly available, which makes it impossible to fully evaluate the extent of the board's independence from the Sacklers. The Document Reserve created in connection with Plan confirm is no solution, because it requires those who would review it to keep what they see confidential.

27. It appears that the Debtors did not formally take their first steps toward independence from the Sackler Families until May 14, 2019, when PPI's shareholders (who are unnamed but were presumably members of the Sackler Families or Related Entities, or their designees) "adopted an Amended and Restated Shareholders' Agreement (the "**Shareholders' Agreement**") which, among things, established a 'Transaction Committee,' and on the same date, [] filed a corresponding Restated Certificate of Incorporation ("**Restated Certificate of Incorporation**")."[12] Disclosure Statement, at 58.

To further safeguard their independence, the members of the Special Committee are protected against removal by the shareholders. A letter agreement executed by PPI's shareholders, dated November 6, 2019 ("2019 Letter Agreement"), irrevocably delegated to the General Counsel of PPI, as proxy for PPI's shareholders, several of the shareholders' rights, including the ability to appoint and remove the Chairman of the Board and the At-Large Directors, all of whom serve on the Special Committee. The 2019 Letter Agreement directs the General Counsel of PPI to act in accordance with the vote of two-thirds of the Directors in Office of PPI and, in the case of any decision to remove any Director from the Board, to disregard the vote of any affected Director.

Disclosure Statement, at 59.

[12] According to an "Informational Brief" filed by the Debtors at commencement of these cases, "shareholder entities ultimately owned by the descendants of Mortimer Sackler have the right to appoint up to two "Class A Directors," and shareholder entities ultimately owned by the descendants of Raymond Sackler have the right to appoint up to two "Class B Directors." These shareholders apparently also jointly appoint a Board chair and additional "At-Large Directors." *See* Debtor's Informational Brief [ECF No. 17].

According to a report of the Special Committee released in December 2019, the tenures of the members of the Sackler Families on PPI's board were as follows:

28. The Restated Certificate of Incorporation provided that the Transaction Committee would be composed of the "independent Chairman of the Board, who would chair the committee, and such other Directors appointed by a majority of the Board, none of whom could be a member of the Sackler Families." Disclosure Statement, at 58. The Disclosure Statement does not say who the other members of the Transaction Committee were at that time, or how they might have been insulated from direct or indirect influence by the Sackler Family, and thus "independent," other than that they would not be members of the Sackler Families themselves.

29. As of May 2019—when the Transaction Committee was formed—it appears that a majority of the PPI Board may not have been independent, as they were appointed by members of the Sackler Family or their Related Entities: Messrs. Boer (Class B, added 2008); Pickett (Class A added January 2010); Roncalli (Class B; added December 2018); Cola (Class A; added February 2019); and Buckfire (added May 2019).[13] While it is not clear whether Mr. Buckfire was appointed before or after creation of the Transaction Committee, it appears that a majority of the PPI Board as described in the Disclosure Statement (four of the six members) continued to represent one side

Appendix B - List of Sackler Family Members

Name	Purdue Director Begin Date	Purdue Director End Date
Jonathan D. Sackler	10/2/1990	12/8/2018
Ilene Sackler Lefcourt	10/2/1990	10/9/2018
Kathe A. Sackler	10/2/1990	9/27/2018
Richard S. Sackler	10/2/1990	7/24/2018
Raymond R. Sackler	10/2/1990	7/17/2017
Mortimer D. Sackler	10/2/1990	3/24/2010
Mortimer D.A. Sackler	1/15/1993	1/16/2019
Theresa E. Sackler	1/15/1993	9/7/2018
Beverly Sackler	1/15/1993	10/17/2017
Samantha (Sackler) Hunt	1/15/1993	3/8/2003
David A. Sackler	7/19/2012	8/14/2018

See Notice of Filing of Report of the Special Committee (#1) [ECF No. 654].

[13] See Disclosure Statement, at 55-56.

or the other of the Sackler Families—with whom the Debtors were apparently negotiating the Settlement Framework that has shaped this case.

30. On September 3, 2019, PPI's shareholders apparently agreed to convert the Transaction Committee to the "Special Committee" that appears to have made important decisions for the Debtors regarding the Plan and Disclosure Statement going forward.[14] That Special Committee is comprised of Messrs. Miller, Buckfire, Cola and Dubel, none of whom currently appear to be designees of the Sackler Family (although, as noted, Mr. Cola served as a Class A director (apparently representing the Mortimer Sackler side) from February to July of 2019, after which he became an "at large" director). Disclosure Statement, at 57.

31. The Disclosure Statement goes to great lengths to assert that the Special Committee is, in fact, independent of the Sackler Families. This may or may not be true today, but there is reason for concern that the PPI Board was not independent when important decisions were made that set this case on a course that may have rendered the Shareholder Settlement all but inevitable.

32. *First*, as noted, it appears that the Settlement Framework was negotiated and established *before* the Special Committee was formed. While the Term Sheet may have left items to be negotiated and resolved (Disclosure Statement, at 3), it is unclear how much latitude the Special Committee could have had to reverse the decision to settle, and instead to litigate with the Sacklers, even if litigation might have been in the interests of the estates.

[14] The Disclosure Statement provides that

> [A]n amendment of the Shareholders' Agreement that, among other things, renamed the Transaction Committee the "Special Committee," and on the same date, PPI filed a Certificate of Amendment to its Restated Certificate of Incorporation ("A&R Certificate of Incorporation"). The A&R Certificate of Incorporation gave the Special Committee the same authorities as had been granted to the Transaction Committee and, in addition, authority over "Affiliate Litigation," defined as "the prosecution, defense or settlement of any claim or litigation" between the Debtors and the Sackler Families, trusts established by or for the benefit of members of the Sackler Families, and other Sackler-related entities, including the IACs (collectively, the "Sackler Entities").

Disclosure Statement, at 58 (describing September 3, 2019 amendments).

33. The Disclosure Statement asserts that the Special Committee's decision to accept the Settlement Framework should be subject to "business judgment" review. Disclosure Statement, at 128. Under New York law, however, this deferential level of review may not be appropriate where directors "participated in any of the challenged first-tier transactions" or had "prior knowledge of or were in any way involved in any of these transactions." *Auerbach v. Bennett*, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1001 (1979).

34. Here, it appears that the Term Sheet and the Settlement Framework may well have been substantially negotiated by the PPI Board *prior* to formation of the Special Committee, when it was still apparently dominated by members of the Sackler Families or their designees. The Transaction Committee (the Special Committee's apparent predecessor) was not formed until May of 2019, but as noted above, the Disclosure Statement indicates that the Debtors began negotiating the Settlement Framework a year *before* the Petition Date, around the fall of 2018. If the Settlement Framework was negotiated by a Sackler-controlled board, then the Sacklers may, in effect, have been on *both sides* of that transaction with respect to creditors, raising questions about whether a business judgment standard of review is appropriate, and whether it was negotiated at arm's length as required by *Iridium*.

35. *Second*, it appears that the Special Committee was not, in fact, insulated from removal by the Sackler Families until November 6, 2019, nearly two months *after* the Petition Date, and about a month after the Term Sheet was filed. Indeed, to this day, it is not clear what powers the Sackler Families may exert, directly or indirectly, over the Special Committee because the Debtors' bylaws and other governance documents (*e.g.*, the Shareholders Agreement) are apparently not publicly available.

36. *Third*, even if the members of the Special Committee are no longer susceptible to influence by the Sackler Families, they may have been reluctant to challenge the Settlement Framework in light of the insular nature of chapter 11 practice. Messrs Miller and Buckfire are well-known, highly-regarded reorganization specialists. Scholarship has found that large and complex reorganizations, such as the Debtors', are often dominated by a small number of professionals and judges, who frequently appear in the same cases together.[15]

37. Expectations about future interactions may well influence current decision-making. In *Zapata v. Maldonado,* for example, the Delaware Supreme Court recognized that, in the context of reviewing a settlement decision by a special litigation committee, relationships among directors may require "inquiry as to independence, good faith and reasonable investigation [as a] sufficient safeguard against abuse, perhaps subconscious abuse." *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (Del. 1981). It is not difficult to imagine that relationships among the members of the Special Committee and key participants in this case may have affected the decision to settle or sue, whether "conscious" or "subconscious."[16]

38. These concerns about independence are not merely hypothetical: certain statements, acts and omissions in these cases suggest that critical decisions may in fact have favored the Sacklers at the expense of the Debtors and their estates.

2. Conflicting Statements about the Sacklers' Alleged Control of the Debtors

[15] A forthcoming paper by Professor Adam Levitin, for example, argues that: "an attorney with a large case bankruptcy practice has a high likelihood of soon ending up back before one of the handful of judges who are getting most of the large cases. This dynamic makes it imperative for these repeat players to ensure that they stay in the judge's good graces. They know that if they anger the judge by being zealous advocates in one case, they will bear the consequences the next time they appear before the judge, and they worry that clients will not want to hire an attorney who is known to be out of favor with the judge hearing a case." Adam J. Levitin, *Purdue's Poison Pill: The Breakdown of Chapter 11's Checks and Balances,* 110 TEX. L. REV. __ (forthcoming 2021), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3851339.

[16] Mr. Miller, for example, has apparently bragged about napping in Judge Drain's chambers. *See* Steve Miller, *The Turnaround Kid,* 223 (2008).

39. The Disclosure Statement considers whether, or to what extent, creditors or the estate might have "veil piercing" or "single enterprise" claims against the Sackler Families. Both are important because such claims would potentially expose all of the Sacklers Families' assets (allegedly worth much more than their $4.2 billion proposed payments under the Shareholder Settlement) to judgment and recovery by creditors (or the estate, on creditors' behalf). Unfortunately, the Disclosure Statement raises more questions than it answers when read in the light of other important developments in this case.

40. The Disclosure Statement asserts that New York law provides that "a court may pierce a corporation's veil if (1) its owners exercised *complete domination* over the corporation with respect to the transaction at issue; and (2) that domination was used to *commit a fraud or wrong* that injured the party seeking to pierce the veil." Disclosure Statement at 163. Assuming for the sake of analysis that this is the correct standard, it is simply not clear how the Special Committee reconciled this standard with allegations in the DOJ Settlements regarding the Sackler Families' control of the Debtors, which do not appear to be discussed in the Disclosure Statement.

41. As noted above, according to Purdue's Plea Agreement in connection with the DOJ Settlements, before the they resigned from the PPI Board, certain members of the Sackler Families "exercised substantial oversight over management's operations of Purdue." Plea Agreement at 4. The Sacklers were, in the words of the DOJ and the Debtors' own Plea Agreement, the Debtors' "de-facto CEO." *See* Sackler Addendum, at 4, ¶12. Debtors' Addendum at 4, ¶ 14. Although the Sackler Families may deny the Sackler Allegations, it appears that they or Related Entities owned all of the Debtors' voting equity and (at least until November 2019) controlled the composition of the PPI board.

42. Similarly, the Disclosure Statement provides that "where, as here, the corporate family involves a series of holding companies, creditors would either need to establish the veil piercing factors for each separate entity, or they will have to satisfy a different set of factors corresponding to what is termed the "single enterprise theory" to group together an entire corporate family where the individual entities are so "inextricably intertwined" as to be a "'single enterprise.'" Disclosure Statement, at 163.

43. Assuming this is the correct standard, the Disclosure Statement fails to explain how, if at all, the Special Committee reconciled it with the Debtors' own repeated statements that the Debtors and the Sacklers were "inextricably intertwined" for purposes of seeking and obtaining the Preliminary Injunction. The Debtors have frequently argued that they have an "identity of interest" with the Sacklers that justified the granting and continuation of the preliminary injunction in these cases. *See, e.g., In re Purdue Pharm. L.P.*, 619 B.R. 38, 43 (S.D.N.Y. 2020).[17] It is difficult to see how the Debtors and the Sackler Families could be "inextricably intertwined" for purposes of protecting the Sacklers, but *not* for purposes of enabling creditors to recover.

3. The Lopsided DOJ Settlement Agreement

44. The economics of the DOJ settlements also raise questions about the Special Committee's independence. The Purdue-DOJ settlement compromised and resolved potentially ruinous civil and criminal litigation against Purdue by reducing and allowing the United States' various claims against Purdue—allegedly worth as much as $18 billion—for about $8 billion,

[17] *In re Purdue Pharm. L.P.*, 619 B.R. 38, 43 (S.D.N.Y. 2020) (finding the claims against the Sacklers were, Purdue argued, "based on conduct substantially identical to, and inextricably intertwined with, that alleged to have been engaged in by the Debtors").

nearly $2 billion of which will be paid to certain governments, in principle to abate the opioid crisis.

45. While those features were laudable, the Purdue-DOJ settlement presented two problems. *First*, it pushed most of the costs of the Sackler Family's alleged misconduct onto Purdue and, ultimately, to Purdue's creditors. If, however, certain members of the Sackler Families did control Purdue, as alleged, it is not clear why the Sacklers are paying only $225 million, estimated to be about 2% of their wealth, while the Debtors agreed to pay $8 billion—over *thirty-five times more* than the Sacklers. Sackler Settlement Motion, Ex. A, at ¶ 4

46. *Second*, the Purdue-DOJ settlement contained a so-called "poison pill," which makes any serious challenge to the Plan (or the Shareholder Settlement it would embody) very costly. Specifically, it provides that the "Debtors will not propose a Plan of Reorganization or liquidation that is inconsistent with this [Settlement] Agreement," Purdue Settlement at ¶ III.8.e, and if a Plan of Reorganization is not confirmed that "provides for the emergence from the Chapter 11 Cases of a public benefit company (or entity with a similar mission), Purdue and the United States each have the option to rescind this Agreement." *Id.* ¶ III.8.f. If the United States rescinds, it may reinstate all of its claims, including a $2 billion dollar administrative priority claim based on its criminal forfeiture powers, an $8.4 billion dollar unsecured claim, and the right to assert civil forfeiture powers.[18] Purdue Settlement at ¶¶ III.10 & III.8.f.

47. These characteristics of the Purdue-DOJ settlement further cemented the Shareholder Settlement, and raise questions about whether the Special Committee's decision to implement it reflected independent decision-making.

[18] In Claim 137848, the United States claims up to $8.4 billion in treble damages claims, while also reserving the right of civil forfeiture, which would render assets traceable to the alleged wrongdoing forfeit to the government as of the time of the wrongdoing, 18 U.S.C. § 981(f), and therefore not property of the Debtors' bankruptcy estates.

4. The Limits of Other Checks--Forum Shopping

48. Obviously, many other participants in these cases could have (and, in fact, may have) investigated the PPI Board's decision to settle the Sackler Allegations. Unfortunately, there is little evidence of this in the record, and reason for concern that it will never become part of the record without an independent examiner.

49. The Creditors' Committee, for example, could have acted as a check on questions of independence, but early in these cases ceded important powers in order to obtain voluntary discovery. Specifically, at the outset of these cases, the Creditors Committee entered into a stipulation with the Debtors and the Sacklers regarding the production of information.[19] As part of that stipulation, the Creditors' Committee agreed that it would not seek or support the appointment of a chapter 11 examiner or trustee, or the conversion or dismissal of these cases.[20] While it appears that the Creditors' Committee and the Sacklers have since then become more adversarial, it does not appear that the Creditors' Committee has reported on the timing and independence of the creation of the Settlement Framework, and whether that should have been accepted as to the Sackler Allegations.[21]

[19] *See, e.g.,* Case Stipulation Among the Debtors, the Official Committee of Unsecured Creditors and Certain Related Parties, [ECF No. 291] (providing that during the "Initial Stay Period," the "UCC shall not file, directly or indirectly support, or encourage any other party to file, and shall join the Debtors in opposing, any motion by any party seeking (i) to investigate or prosecute, or standing to investigate or prosecute, estate claims or causes of action, (ii) the appointment of a trustee, examiner (with or without expanded powers), responsible person, or any similar relief with respect to the Debtors' or this Bankruptcy Court's current rights, powers, authority and obligations, or (iii) the dismissal or conversion of these chapter 11 cases to chapter 7 cases"). The "Initial Stay Period" was defined as "180 days . . . from October 15, 2019. Id. at 3. This stipulation was subsequently amended and restated November 20, 2019, but did not appear to change the timing of the Initial Stay Period. *See* Amended and Restated Case Stipulation Among the Debtors, the Official Committee of Unsecured Creditors and Certain Related Parties [ECF No. 518].

[20] *Id.*

[21] To be clear, the Creditors' Committee and the Special Committee appear to have devoted significant time and energy to assessing and asserting claims for property transfers to the Sackler (e.g., fraudulent transfer). The examination proposed in this Motion would not assess those, except as necessary to investigate and report on the Examination Topics.

50. Similarly, it would appear that all (or almost all) discovery and investigations and negotiations in these cases have occurred subject to confidentiality agreements and protective orders ("**Protective Orders**") which constrain parties from disclosing publicly any findings they may have with respect to questions regarding the decisions to settle the Sackler Allegations.[22] While the Debtors have created a "Document Reserve for Confirmation," which may well contain responsive material, access to those materials is subject to the Protective Orders. *See* Amended Order Granting Debtors' Motion for Order Establishing Confirmation Schedule and Protocols [ECF No. 2894], at 6. ("The Protective Order entered by the Court, as amended from time to time, shall govern all discovery in connection with the Confirmation Proceedings.").

51. Finally, the Court itself could and should be a check on the independence of the PPI Board, as required by *TMT Trailer Ferry*. There have, however, been concerns that Purdue's connection to White Plains (and thus this Court) were created for this case, which may lead to doubts about any determination this Court makes in this regard.

52. Under 28 U.S.C. § 1408, a debtor may commence a case where its domicile or "principal place of business" is located. Under local rule 1073-1(a), a case shall be assigned to this Court where "the principal place of business . . . set forth on the petition is in Westchester

[22] The Protective Orders in this case appear to limit access to, and the use of, information that may be relevant to the Sackler Allegations. *See, e.g.*, Third Amended Protective Order [ECF No. 1935] at 16 ("No person or entity subject to the Protective Order shall disclose or permit the disclosure of any information designated as Protected Information to any person or entity except as expressly set forth in this Protective Order."). This Protective Order provides that any party receiving confidential information "shall not disclose the contents of such Confidential Information to any person or entity unless such person or entity falls within at least one of the following categories . . . The Court, any trial or appellate court to which an appeal of a decision of the Court is taken, and any members of the courts' staff to whom it is necessary to disclose the information; provided that no such information shall be publicly filed unless required by an order of the Court." Protective Order, at 19-20.

County."[23] The Comments to local rule 1703-1 indicate that "[t]his rule was amended in 2004 to eliminate the use of a post office box address as the basis for case assignment."

53. Here, it appears that PPI is incorporated in New York but has no substantial connection to Westchester County. The "office" of this entity is, according to its Restated Certificate of Incorporation, New York County—not Westchester County. *See* Restated Certificate of Incorporation of Purdue Pharma, Inc. Art. FOURTH, May 14, 2019.

54. On March 1, 2019, six months before declaring bankruptcy and two months before forming the Transaction Committee—that is, while dominated by designees of the Sackler Families—the PPI Board authorized changing its registered agent (not its principal place of business) to White Plains, New York, which appears to be its only connection to Westchester County and thus to venue in this Court. *See* Certificate of Change, Purdue Pharma, Inc. Mar. 1, 2019. [24]

55. If the PPI Board changed its address solely to create venue in this Court, there is at least the appearance that the Debtors, while still controlled by Sackler Family designees, sought this Court in particular in the belief that it would approve the Shareholder Settlement with little scrutiny of the Sackler Allegations. The record thus far in this case indicates that the belief may have been well founded: "[I]t appears to me to have always been the case and will continue to be the case," the Court observed at a September 2020 hearing, that "a plan in which [the Sackler Families] do make a material contribution that satisfies the Second Circuit's test in *In re*

[23] Local Rules, United States Bankruptcy Court, Southern District of New York, Assignment of Cases and Proceedings, available at https://www.nysb.uscourts.gov/rule-1073-1.

[24] The Debtors' petition itself lists no principal place of business for PPNYI other than Stamford, Connecticut. *See* Voluntary Petition for Non-Individuals Filing for Bankruptcy [ECF No. 1] (indicating Debtor's address as One Stamford Forum 201 Tresser Boulevard, Stamford, CT 06901).

Metromedia, Inc., 416 F.3d 136 (2d Circ. 2005), is not only possible but the most likely outcome in this case." *Hr'g Trans*, Sept. 30, 2020, at 79:12-17.

56. This may be true, but the public interest in these cases requires there to be no doubt about the process by which the decision was made to settle rather than to sue. The timing of critical, prebankruptcy acts (e.g., negotiation of the Settlement Framework; the formation of the Special Committee), the residual powers of the Sackler Families to potentially influence the PPI Board, and concerns about checks and balances in the chapter 11 process all raise questions about whether the decision to adopt and implement the Settlement Framework as to the Sackler Allegations was made independently, in good faith, and at arm's length, as required by as required by *TMT Trailer Ferry* and *Iridium*.

57. The most efficient and credible way to address these concerns is to appoint an examiner for the limited purposes described below.

ARGUMENT AND BASIS FOR RELIEF

58. Section 1104(c) of the Bankruptcy Code provides, in pertinent part, that—

> at any time before the confirmation of a plan. . . the court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor, if—
>
> > (1) such appointment is in the interests of creditors, any equity security holders, and other interests of the estate; or
> >
> > (2) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000.

59. Legislative history shows that Congress created the role of examiner to provide "special protection for the large cases having great public interest . . . to determine fraud or

wrongdoing . . . ."[25] Examiners have played important, sometimes crucial, roles in some of the nation's largest and most controversial reorganizations, including in *Enron*,[26] *Worldcom*,[27] *Mirant*,[28] *New Century*,[29] *Lyondell Chemical*,[30] *Washington Mutual*,[31] and *Lehman Brothers*.[32]

A. An Examiner is Required by Statute and Necessary to Determine Whether the Decision to Settle was Made Independently and at Arm's Length.

60. Here, there is no question that no plan has been confirmed, or that the Debtors' fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000. The Debtors' obligations to the United States under the Purdue-DOJ settlement vastly exceed this amount. Moreover, and more important, a supervisory examination as proposed below is in the "interests of creditors" and "other interests of the estate"—the general public—as a way to assure that the Special Committee made the decision to settle rather than litigate with the Sackler Families at arm's length and independently, as required by applicable case law.

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[25] *See* 124 CONG. REC. S17, 403-34 (daily ed. Oct. 6, 1978) (statement of Senator DeConcini) (quoted in COLLIER ON BANKRUPTCY, App. 14.4(f)(iii) (15th ed., Rev 2002)).

[26] *In re Enron Corp.*, No. 01-16034 (Bankr. S.D.N.Y. Dec. 2, 2001).

[27] *In re Worldcom*, No. 02-13533 (Bankr. S.D.N.Y. July 21, 2002).

[28] *In re Mirant Corp*., No. 03-46591 (Bankr. N.D. Tex. July 14, 2003).

[29] *In re New Century TRS Holdings, Inc*., No. 07-10416 (Bankr. D. Del. April 2, 2007).

[30] *In re Lyondell Chemical Co.*, No. 09-10023 (REG) (Bankr. S.D.N.Y. Oct. 26, 2009).

[31] *In re Washington Mutual, Inc.*, et al., No. 08-12229 (Bankr. D. Del. Nov. 1, 2008).

[32] *In re Lehman Brothers Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 15, 2008).

1. Section 1104(c) is Not Optional.

61. Section 1104(c) is not an optional provision. Its command—"shall"—is just that: a requirement in cases in which the statutory criteria have been satisfied. In *In re Loral*, United States District Judge Patterson observed that "[o]n its face, Section 1104(c)(2) mandates the appointment of an examiner where a party in interest moves for an examiner and the debtor has $5,000,000 of qualifying debt." *In re Loral Space & Commc'ns, Ltd.*, No. 04-CIV-8645RPP, 2004 WL 2979785, at *4 (S.D.N.Y. Dec. 23, 2004). In such circumstances the "Bankruptcy Court had no discretion to deny appointment of an examiner." *Id.* at *4.

62. The Second Circuit has not yet considered whether this provision of the Bankruptcy Code is in fact mandatory. The only appellate court to consider the issue, the Sixth Circuit, as well as a number of bankruptcy courts, have stated that it is. *See In re Revco D.S., Inc.,* 898 F.2d 498, 500–01 (6th Cir. 1990) (holding that appointment of an examiner is mandatory in view of the phrase "the court shall order"); *In re UAL Corp.,* 307 B.R. 80, 86 (Bankr. N.D. Ill. 2004) (same); *In re Mechem Financial of Ohio, Inc.,* 92 B.R. 760 (Bankr. N.D. Ohio 1988) (same); *In re The Bible Speaks,* 74 B.R. 511, 514 (Bankr. D. Mass. 1987) (same); *In re 1243 20th Street, Inc.,* 6 B.R. 683, 685 n. 3 (Bankr. D.D.C. 1980) (same); *In re Lenihan,* 4 B.R. 209, 211 (Bankr. D.R.I. 1980) (same).

63. As stated in *Collier on Bankruptcy,* "Section 1104(c)(2) does not leave any room for the court to exercise discretion about whether an examiner should be appointed, as long as the $5,000,000 threshold is met and a motion for appointment of an examiner is made by a party in interest," 7 COLLIER ON BANKRUPTCY ¶ 1104.03[2][b] at 1104–38.

64. It is, of course, true that "[m]ere allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of the debtor of or by current or former management, are insufficient to justify the appointment of an examiner under

section 1104(c). Such allegations of misconduct must be supported by facts." *See* 7 COLLIER ON BANKRUPTCY ¶ 1104.03[3].

65. Here, however, we have not only facts, but the Debtors' own confession that it committed felonies; allegations that the "inextricably intertwined" Sacklers were the Debtors' "de-facto CEO" when the Debtors committed those felonies; and evidence which calls into question whether the Special Committee was in a position independently to decide to settle with, or sue, the Sackler Families.

66. Where courts have denied the appointment of an examiner, they have done so on grounds that the examiner was sought not for informational reasons consistent with sound bankruptcy policy, but instead as an "improper . . . litigation tactic to try to derail approval" of a settlement. *In re Dewey & LeBoeuf LLP*, 478 B.R. 627, 639 (Bankr. S.D.N.Y. 2012); *In re Calpine Corp.*, No. 05-60200 (BRL) (Bankr. S.D.N.Y. 2005), Docket No. 6467 at 73 (refusing to appoint examiner, noting that the request "smacks more of litigation leverage than the protection of the unrepresented public as the statute intended").

2. The Appointment of Examiner for the Limited Purposes Proposed is in the Interests of the Estates and the Public Interest.

67. Here, the Movant believes it will not be possible to approve the Shareholder Settlement under *TMT Trailer Ferry* or *Iridium* without a credible and independent investigation and public report on the analyses that led to the settlement of the Sackler Allegations, for three reasons.

68. *First*, the problems of independence noted above mean that creditors have good reason for concern that the decision to settle was made—and made inevitable—before these cases were commenced, by the Debtors' board when it was under the direct or indirect control of the Sackler Families. By the time the Special Committee was formed, and insulated from influence

by the Sackler Families, it may have been too late for the Special Committee to do anything more than try to improve that settlement, even if litigation may have been in the interests of creditors and the estate.

69. *Second*, mechanisms that would ordinarily establish the independent, arm's length nature of this decision may not be able to address this question here in a public and credible fashion. While key participants in these cases may have scrutinized the Sackler Allegations and the Special Committee's decision to settle them, they, too, may have confronted a situation where the decision to settle had already been made, and was virtually irreversible. In any case, the great bulk of creditors have no such insight because discovery and negotiations in these cases have proceeded in secret.

70. *Third*, there is a unique and undisputed public interest in these cases. That public interest cannot be vindicated if the decision to settle the Sackler Allegations was not made independently and at arm's length, as required by *TMT Trailer Ferry* and *Iridium.* It is perhaps not surprising that there have been over 3800 signatures to a change.org petition calling for an examiner in these chapter 11 cases.[33] The public's view of the public interest in these cases may differ from that of those who run this case on a day-to-day basis.

71. At the same time, the Movant is cognizant of the fact that the key participants in these cases have performed significant amounts of work to investigate, analyze, mediate and negotiate the issues in question here. These cases have already seen professional fees in excess of $400 million, and an examiner should not duplicate the work that has been done. The Court must appoint an examiner to "conduct such an investigation of the debtor as is appropriate"—not any

[33] *See* P.A.I.N./Nan Goldin, *We Demand Accountability and Transparency from Purdue Pharma and the Sacklers!* Change.org, available at https://www.change.org/p/judge-drain?recruited_by_id=4d4cbdf0-f7d1-11e7-8c38-41643502f324 (last visited Dec. 5, 2020).

examiner to do anything merely because the statute says so. 11 U.S.C. § 1104(c). The model developed by this Court in the *Cenveo* case suggests a way to strike the proper balance here.

B. A Supervisory Examination—The Cenveo Example

72. The Movant believes that credible answers to questions surrounding the settlement of the Sackler Allegations can be provided through the use of an examiner on a limited, supervisory basis, much as this Court did in the *Cenveo* case in 2019.[34]

73. Cenveo was apparently a printing business. A creditor, Brigade Capital Partners, LP. ("Brigade"), sought the appointment of an examiner because, it argued, "the Debtors' controlling shareholders, officers and/or directors. . . have been involved in insider/related party transactions."[35]

74. Prior to bankruptcy, an independent director of Cenveo had been appointed to oversee an investigation into potential claims or causes of action against officers, directors, insiders and other parties arising out of prepetition conduct. This was not sufficient, Brigade argued, because the debtors in *Cenveo* allegedly "provided no other details about the scope of the investigation."[36] This was, to the movants, "a red flag and an express concession that an independent investigation into the Debtors' prepetition business affairs is necessary and warranted

[34] *See In re Cenveo, Inc*., No. 18-22178-rdd (Bankr. S.D.N.Y. 2018) ["**Cenveo**"]. It appears that this Court proposed a similar approach in *Loral,* although the movant (appellant) did not accept that. *Loral District Court* at *4 (observing that "Judge Drain had prescribed an investigatory role for the examiner at the hearing. Instead of appointing an examiner to conduct a going concern valuation as the Ad Hoc Committee had requested, he proposed at the hearing to appoint an examiner "to review whether the Debtors and the Creditors' Committee's professionals had followed proper procedures in conducting their valuation analyses").

[35] *See* Motion of Brigade Capital Management, LP for the Appointment of an Examiner Pursuant to 11 U.S.C. § 1104(c), *In re Cenveo, Inc.*, No. 18-22178-rdd at p. 1 (Bankr. S.D.N.Y. Mar. 12, 2018), ECF No. 76-1 ("**Cenveo Motion**"). It appears that movant Brigade was represented in this matter by Akin Gump, counsel to the Creditors' Committee in these cases.

[36] *Id.*

in these chapter 11 cases," but had to be conducted by someone who was not "controlled by the Debtors who already agreed to provide such individuals a full release."[37]

75. This Court apparently agreed, and ordered the appointment of an examiner for the limited purpose of "looking over the shoulder" of primary professionals engaged in the analysis in dispute and, to the extent the debtors chose to continue their own internal investigation, "over their counsel's shoulder, too."[38]

76. Here*,* there is credible reason for concern that the decision to grant the Shareholder Releases, per the Settlement Framework, was made by the PPI Board when it was still under the control of the Sackler Families. As in *Cenveo,* this Court should order the appointment of an independent and experienced litigator with significant plaintiffs' and/or governmental representation experience—and not a chapter 11 practitioner—to investigate and report on whether the Special Committee negotiated the Settlement Framework, Term Sheet, and Shareholder Releases as to the Sackler Allegations independently, in good faith, and at arm's length.[39] As in *Cenveo*, the examiner need not conduct his or her own investigation (except as necessary to address the Examination Topics, as defined in the Proposed Order), but instead draw on and evaluate the significant discovery that has already occurred for purposes of assessing the Examination Topics. Such examiner should then promptly provide a public report of his or her findings.

77. The Debtors may object that enormous amounts of time, energy and professional resources have already been devoted to these cases. Any investigation, even one as tailored in the Proposed Order, would duplicate work done by their counsel, counsel to the Creditors' Committee or other key participants in these cases. But that objection fails for three reasons.

[37] *Cenveo* Motion, at 2.

[38] Report of Susheel Kirpalani, Examiner*, In re Cenveo, Inc*., No. 18-22178 at 1 (Bankr. S.D.N.Y. June 6, 2018).

[39] *Id.* at 1.

78. *First,* it appears that the bulk of the investigations and reports to date have focused on property transfers to or for the benefit of the Sackler Families, and not on the Sackler Allegations, themselves. *See, e.g.,* Notice of Filing of Report of the Special Committee [ECF No. 654] (reporting on Alix Partners' voidable transfer analysis). The Sackler Allegations go to their role in the Debtors' decisions to market, label and sell OxyContin and to influence the PPI Board's decision to settle rather than sue, which may have little do with fraudulent transfer and similar claims.

79. *Second,* while the Disclosure Statement does have some discussion of the types of claims that might be asserted in light of the Sackler Allegations, the Debtors' response is largely that such claims (whether "direct" or "derivative") are complicated, uncertain, and that collection would be difficult. Disclosure Statement at 164. But the Sacklers Families' alleged control of the Debtors, described above, creates a potentially triable issue of fact that may undercut claims of complexity and uncertainty, leaving only collectability as the principal basis for deciding to settle. To say that judgments against the Sackler Families are uncollectible may impliedly concede liability, surely something the Sackler Families would not want to do.

80. *Third,* even if these analyses have been performed by other parties, such as the Creditors' Committee, those analyses do not appear to be in the public record of these cases. Indeed, it appears that the Creditors' Committee may still have unresolved discovery disputes with the Sackler Families, so it is not clear whether or to what extent they have completed such analysis.

81. The Movant recognizes that this Court has approved many innovative mechanisms in this case in an attempt to help rehabilitate the Debtors, including the so-called "self-injunction," the appointment of a corporate monitor, and the use of accomplished mediators. These steps may well have been necessary and helpful to enable the Debtors to produce the Plan and Disclosure

Statement. Unfortunately, all are focused on the Debtors' present and future, and are predicated on the prior decision to settle the Sackler Allegations. While settlement with the Sackler Families may ultimately be in the best interests of the estates and the public, questions about the Sacklers' role in negotiating that settlement, and the PPI Board's capacity to challenge that settlement, require an independent investigation and report.

82. Indeed, the Sackler Families themselves have often noted that they believe they have been unfairly presented in these cases and in the media. The Raymond Sackler side, for example, recently observed that it has "stated before and reiterates now [that] Purdue's documents, which remain confidential despite the family's repeated attempts to have them de-designated and published, will prove that the Sacklers acted ethically and legally at all times." *See* Statement of the Raymond Sackler Family in Support of the Debtors' Motion to Extend the Preliminary Injunction, at 2 [ECF No. 250]. The Sackler Families should welcome a brief, but critical, independent investigation to vindicate their position.

83. If, however, the Sackler Families influenced or predetermined the outcome, or unduly constrained the PPI Board's independence, that may call into question the Settlement Framework and all that followed. In that event, approval of the Shareholder Settlement and confirmation of the Plan may not be appropriate. While that would be a potentially drastic turn of events, it is not worse than a finding in the future that this process, and this Court, were used to advance an improper agenda.

84. At the same time, the Movant is aware that the Court has made statements to the effect that it believes appointing an examiner would not be a productive use of the Debtors'

resources.[40] The Movant has taken these statements seriously, and had hoped that the Disclosure Statement would credibly address the concerns noted above. But, it has not, and what was filed shows that it cannot, because it raises more questions than it answers. The Movant thus hopes that the Court's statements about examiners were not pre-judgments of an issue not then before the Court.

NOTICE

85. Notice of this Motion has been provided (a) to the entities on the Master Service List (as defined in the Case Management Order and available on the Debtors' case website at http://www.restructuring.primeclerk.com/purduepharma/) and (b) any person or entity with a particularized interest in the subject matter of this Motion. The Movant respectfully submits that no other or further notice is necessary.

86. No previous request for the relief sought herein has been made by the Movant to this or any other court.[41]

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[40] As the Court stated in July 2020:

> The press, who in a number of totally irresponsible articles led people who have truly suffered, because of the opioid crisis, to believe that there is no investigation going on, that this case's purpose is somehow to let the Sacklers get away with it and that without the appointment of an examiner there won't be an investigation, is just completely and utterly misguided.
>
> So, for anyone to believe that they should be driven by such trash is just a big mistake. We cannot muzzle the press, but certainly, people should understand that what is being put out as if it was news is completely false and should lead them to decide that they do not want to buy or click on that publication in the future because they cannot trust it to do the basic due diligence that any reporter should do.
>
> So, I don't want to hear some idiot reporter or some bloggist quoted to me again in this case. And you and your client should not be guided by anything of that sort or some misguided law professor who does not take the basic due diligence that you would think he or she would want a first-year law student to do to actually look at the actual transcript and the record in the case before spouting off about the need for an examiner, including completely ignoring the appointment of a corporate monitor, the commitment as part of the injunction to have a full account, and the examinations that are going on.

Hr'g Trans. July 23, 2020, at 56:13-25; 57:1-16. As noted, the mechanisms the Court described—the corporate monitor, the injunction, and ongoing investigations—have nothing to do with scrutiny of the Sacklers, or are subject to onerous confidentiality restrictions. While they may be laudable in their own right, they are not substitutes for the transparency that an examiner could produce.

[41] As noted in the Jackson Affidavit, Movant filed a letter with the Court in July 2020 seeking the appointment of an examiner, but this letter was not taken up as a request for relief by the Court.

CONCLUSION

For the foregoing reasons, the Movant respectfully requests that the Court (i) enter an order, in the form attached hereto as Exhibit A, appointing an examiner in these chapter 11 cases pursuant to Bankruptcy Code section 1104(c), and (ii) grant such other and further relief as the Court deems just, proper, and equitable.

Dated: June 1, 2021
Philadelphia, PA

Respectfully Submitted,

By: /s/ Jonathan C. Lipson

Jonathan C. Lipson
Temple University-Beasley School of Law
1719 North Broad St.
Philadelphia, PA 19122
215-204-0608
jlipson@temple.edu
Counsel to Peter W. Jackson

/s/ Karen F. Neuwirth

Karen F. Neuwirth
Martin S. Rapaport, P.C.
18 East 48th Street
6th Floor
New York, N.Y. 10017
(212) 688-1980
manhatoffice@yahoo.com
Co-counsel to Peter W. Jackson

EXHIBIT A

PROPOSED ORDER

Jonathan C. Lipson
Temple University-Beasley School of Law
1719 North Broad Street
Philadelphia, PA 19122
Counsel to Peter W. Jackson

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In Re: PURDUE PHARMA L.P., et al.[42] Debtors.	Chapter 11 Case No. 19-23649 (RDD) (Jointly Administered)

ORDER TO APPOINT EXAMINER
PURSUANT TO 11 U.S.C. § 1104(c)

Upon the motion of Peter W. Jackson ("**Movant**") pursuant to 11 U.S.C. 1104(c) for the appointment of an examiner in the above-captioned cases [Docket No. __] (the "**Motion**"); and this Court having jurisdiction over this matter pursuant to 28 U.S.C. §§ 157(a)- (b) and 1334(b) and the Amended Standing Order of Reference from the United States District Court for the Southern District of New York, dated January 31, 2012; and this Court having found that this is a core proceeding pursuant to 28 U.S.C. § 157(b) that this Court may decide by a final order consistent with Article III of the United States Constitution; and this Court having found that notice of the Motion and opportunity for a hearing on the Motion were appropriate under the circumstances and that no other notice need be provided; and the Court having reviewed the

[42] The debtors in these chapter 11 cases ("**Debtors**" or "**Purdue**"), along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. ("**PPLP**") (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014) (collectively, the "**Bankruptcy Cases**").

Motion; and the Court having held a hearing to consider the relief requested in the Motion on a final basis (the "**Hearing**"); and the Court having determined that the legal and factual bases set forth in the Motion and at the Hearing establish just cause for the relief granted herein; and the Court having determined that the relief requested is in the best interests of the Debtors, their estates, creditors and all parties in interest; and upon all of the proceedings had before the Court and after due deliberation and sufficient cause appearing therefor,

IT IS HEREBY ORDERED THAT:

The Motion is granted as provided herein, and the United States Trustee is directed to appoint an examiner (the "**Examiner**") in these chapter 11 cases pursuant to section 1104(c) of the Bankruptcy Code qualified to perform the tasks set forth herein.

1. The Examiner shall be an independent and experienced litigator with significant plaintiffs' and/or governmental representation experience, and not a chapter 11 practitioner.

2. Upon appointment, the Examiner shall investigate and report on (i) the process by which the board of directors of Purdue Pharma, Inc., a New York corporation ("**PPI**") decided to settle the "Sackler Allegations" (as provided in the Motion); and (ii) whether that process, and the resulting decision to settle the Sackler Allegations pursuant to the Settlement Framework with the Shareholder Releases, were undertaken independently of the direct or indirect influence of, or interference by, the Sackler Families or their Related Entities, made in good faith, and were negotiated at arm's length (collectively, the "**Examination Topics**"); provided, however that (except as necessary to investigate and report on the Examination Topics) the Examiner shall not conduct his or her own discovery of the Examination Topics but, rather, the Examiner shall, using discovery already produced (and being produced) in these cases, examine and report (as provided in this Order) on the Examination Topics. The Examiner shall be given access to all materials and

discovery produced in these cases, by any party, relevant to the scope of the Examination Topics, however and to whomever produced.

3. No later than seven (7) days after being appointed, the Examiner shall meet and confer with the advisors for the Debtors, the Sackler Families, the Creditors' Committee, the Movant and such other parties as the United States Trustee deems appropriate in its reasonable discretion (the "**Examination Parties**") for the purpose of obtaining an overview concerning the status of each party's respective investigation and analysis of the Examination Topics.

4. The Examiner shall prepare and file a public report (the "**Report**") on his or her findings regarding the Examination Topics within 30 days of the later of (x) the Examiner Retention Date (as defined below), or (y) ten (10) days before the commencement of the Confirmation Hearing on the Plan. The time to file the Report may be extended by Order of the Court upon application by the Examiner for cause shown. The Examiner may file subsequent Reports in the event the Plan is further amended with respect to the Examination Topics.

5. Nothing contained in this Order shall diminish the powers and authority of the Debtors, the Creditors' Committee, or other Examination Parties to investigate any other claims or causes of action of the estates.

6. The Examiner shall be compensated and reimbursed for his or her expenses pursuant to the Order Establishing Procedures for Interim Compensation and Reimbursement of Expenses for Retained Professionals, dated November 21, 2019 [Docket No. 529] (the "**Compensation Procedures Order**"), and such compensation and reimbursement shall be reviewed pursuant to section § 330 of the Bankruptcy Code. The Examiner may retain such counsel and professionals as are reasonably necessary to accomplish the tasks set forth in this Order. The date of an order approving such retention shall be the "**Examiner Retention Date**".

7. In accordance with Rule 502(d) of the Federal Rules of Evidence, all privileges, protections, confidentiality and immunities (including, without limitation, the attorney-client privilege and the work-product doctrine), shall remain in full force and effect as to any information provided to the Examiner, and shall not be waived or in any way impaired in connection with these chapter 11 cases (including in connection with any current or subsequent adversary proceeding outside these chapter 11 cases by disclosure or production by or among the Examination Parties of any materials protected by such privileges, protections, confidentiality and immunities, or compliance with any other aspect of this Order); provided, however, that nothing in this provision shall be construed to require, to preclude, or to govern in any way, the production of privileged materials or to constrain the Examiner's ability to produce and promulgate the Report. In the event of conflict between any protective orders in this case and this Order, this Order shall govern.

8. The Examiner shall be a "party in interest" under section 1109(b) of the Bankruptcy Code with respect to matters that are within the scope of the duties delineated in this Order or as such duties may hereafter be modified by this Court, and shall be entitled to appear at hearings and be heard with respect to matters that are within the Examiner's duties.

Dated: ______________
White Plains, New York

____
THE HONORABLE ROBERT D. DRAIN
UNITED STATES BANKRUPTCY JUDGE

EXHIBIT B
JACKSON AFFIDAVIT

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re: PURDUE PHARMA L.P., *et al.* [1] Debtors.	Chapter 11 Case No. 19-23649 (RDD) (Jointly Administered)

AFFIDAVIT OF PETER W. JACKSON IN SUPPORT OF MOTION FOR ORDER TO APPOINT EXAMINER PURSUANT TO 11 U.S.C. § 1104(c)

STATE OF ILLINOIS)
) S.S.:
COUNTY OF McHENRY)

Peter W. Jackson, being duly sworn, upon his oath deposes and states as follows in support of the *Motion for Order to Appoint Examiner Pursuant to 11 U.S.C. § 1104(c)* (the "**Motion**"):

1. In August 2006, my daughter, Emily Ruth Jackson, passed away due to respiratory depression after ingesting a single OxyContin pill.

2. In light of this, I filed in these Bankruptcy Cases the proof of claim substantially in the form attached as Exhibit 1.[2]

[1] The debtors in these chapter 11 cases ("**Debtors**" or "**Purdue**"), along with the last four digits of each Debtor's registration number in the applicable jurisdiction, are as follows: Purdue Pharma L.P. ("**PPLP**") (7484), Purdue Pharma Inc. (7486), Purdue Transdermal Technologies L.P. (1868), Purdue Pharma Manufacturing L.P. (3821), Purdue Pharmaceuticals L.P. (0034), Imbrium Therapeutics L.P. (8810), Adlon Therapeutics L.P. (6745), Greenfield BioVentures L.P. (6150), Seven Seas Hill Corp. (4591), Ophir Green Corp. (4594), Purdue Pharma of Puerto Rico (3925), Avrio Health L.P. (4140), Purdue Pharmaceutical Products L.P. (3902), Purdue Neuroscience Company (4712), Nayatt Cove Lifescience Inc. (7805), Button Land L.P. (7502), Rhodes Associates L.P. (N/A), Paul Land Inc. (7425), Quidnick Land L.P. (7584), Rhodes Pharmaceuticals L.P. (6166), Rhodes Technologies (7143), UDF LP (0495), SVC Pharma LP (5717) and SVC Pharma Inc. (4014) (collectively, the "**Bankruptcy Cases**").

[2] The form submitted was signed, but I did not retain an image of that version.

3. On or about July 15, 2020, I submitted the letter attached as Exhibit 2 to the Court. At that time, a representative of the Court contacted me to ask if I wished to have the attached letter considered by the Court as a motion. I declined this invitation at the time because I did not have counsel. I did so without prejudice, and now submit in connection herewith the Motion.

Pursuant to 28 U.S.C. § 1746, I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct, and that this Affidavit was executed the 31st day of May, 2021.

Peter W. Jackson
PETER W. JACKSON

SWORN TO AND SUBSCRIBED before
Me this 31st day of May, 2021

NOTARY PUBLIC

"OFFICIAL SEAL"
PAULETTE L. DEBELING
NOTARY PUBLIC, STATE OF ILLINOIS
MY COMMISSION EXPIRES 05/12/22

EXHIBIT 1
(Peter W. Jackson Proof of Claim)

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	Chapter 11
PURDUE PHARMA L.P., *et al.*,	Case No. 19-23649 (RDD)
Debtors.	(Jointly Administered)

Personal Injury Claimant Proof of Claim Form

(Including Parents and Guardians)

You may file your claim electronically at PurduePharmaClaims.com via the link entitled "Submit a Claim."

For questions regarding this Proof of Claim Form, please call Prime Clerk at (844) 217-0912 or visit PurduePharmaClaims.com.

Read the instructions at the end of this document before filling out this form. This form is for individuals to assert an unsecured claim against the Debtors seeking damages based on actual or potential future personal injury to the claimant or another (for example, deceased, incapacitated, or minor family member) related to the taking of a Purdue Opioid and/or the taking of another opioid for which You believe Purdue is responsible for Your damages.

Do not use this form to assert only a non-personal injury claim against the Debtors based on or involving opioids or their production, marketing and sale, including without limitation, the Debtors' production, marketing and sale of Purdue Opioids. File such claims on a General Opioid Claimant Proof of Claim Form. However, if You have a claim against the Debtors based on or involving the production, marketing and sale of opioids, in addition to Your claim based on personal injury, You may include information related to that claim on the Personal Injury Claimant Proof of Claim Form by completing Part 5 of this form.

Do not use this form to assert any other pre-petition claims, including secured claims or claims entitled to priority under 11 U.S.C. § 507(a). Secured claims, claims entitled to priority under 11 U.S.C. § 507(a) and non-opioid related claims should be filed on a Non-Opioid Claimant Proof of Claim Form (Form 410).

Creditor (also referred to as "You" throughout) shall provide information responsive to the questions set forth below. Creditors may include parents, foster parents, and guardians submitting claims on behalf of minors with Neonatal Abstinence Syndrome ("NAS"). Instructions and definitions are provided at the end of this document. You shall provide information reasonably available to You and are not excused from providing the requested information for failure to appropriately investigate Your claim. You shall supplement Your responses if You learn that they are incomplete or incorrect in any material respect.

Personal Injury Claimant Proof of Claim Forms and any supporting documentation submitted with the form shall remain highly confidential and shall not be made available to the public. For the avoidance of doubt, all pages of the Personal Injury Claimant Proof of Claim Form and supporting documentation shall be treated as highly confidential and made available only to Prime Clerk, the Court and to those that agree to be bound by the Protective Order.

Fill in all the information about the claim as of September 15, 2019, the Petition Date. You may also fill in information regarding any claims You believe You may have after September 15, 2019 on this form. This form should be completed to the best of Your ability with the information available to You. If You are unable to answer certain questions at this time, the absence of an answer, by itself, will not result in the denial of Your claim, though You may be asked or required to provide additional information at a later date. You may also amend or supplement Your claim after it is filed.

Please note that supporting documentation is requested in certain portions of the form. Please provide the requested information to the best of Your ability. At Your discretion, You may also provide additional information to supplement Your claim in any manner available to You.

Do not **send original documents**, as they will not be returned, and they may be destroyed after scanning.

Part 1: Identify the Claim

1. Who is the creditor?

Peter W. Jackson

Name of the individual to be paid for this claim. If the creditor is a minor (under 18), please provide only the minor's initials.

Other names the creditor used with the debtor, including maiden or other names used:

If Your claim is based on personal injury to another (for example, a deceased, incapacitated, or minor family member), please provide the name of that other person (that is, the injured person). If the injured person is a minor (under 18), please provide only the minor's initials:

Emily R. Jackson

If You are submitting a claim on behalf of another person, please provide Your name and relationship to that person:

Peter W. Jackson, father of Emily R. Jackson

If you are submitting a claim on behalf of a minor, are You the Legal Guardian?

☐ No ☐ Yes

2. What is the year of birth, gender, and last 4 digits of the social security number of the creditor (or injured person, if the claim is based on the personal injury of another)?	Year of Birth: 1988 Gender: ☐ Male ☒ Female Last 4 Digits of Social Security Number (if available): XXX-XX- 9 9 1 1
3. Where should notices and payments to the creditor be sent? Federal Rule of Bankruptcy Procedure (FRBP) 2002(g)	**Where should notices to the creditor be sent?** 4622 Valley View Road Prairie Grove, IL 60012 Contact phone 224-612-1803 Contact email beepjackson@comcast.net **Where should payments to the creditor be sent?** (if different) Contact phone ____ Contact email ____
4. Does this claim amend one already filed?	☒ No. ☐ Yes. Claim number on court claims registry (if known)____ Filed on ____ MM / DD / YYYY
5. Do you know if anyone else has filed a proof of claim for this claim?	☒ No. ☐ Yes. Who made the earlier filing? ____

Part 2: Attorney Information (Optional)

6. Are You represented by an attorney in this matter? You do not need an attorney to file this form.	☒ No. ☐ Yes. If yes, please provide the following information: Law Firm Name Attorney Name Address City State ZIP Code Contact phone ____ Contact email ____

Part 3: Information as of September 15, 2019, the Petition Date, About Your Claim

7. How much is the claim?	$ ____ or ☐ Unknown.
8. Select all that apply to You.	☐ Creditor has been injured by use of an opioid. ☐ Although Creditor is not currently aware of any injury, Creditor wants to file now to keep the ability to seek payment if Creditor has a future injury or harm due to use of an opioid. ☒ Creditor has a claim arising out of another person's use of an opioid. ***Please answer all questions in Part 4 as if that person (the injured person) is filling out the form.*** ☐ Creditor is submitting a claim on behalf of a minor with NAS. ***Please answer all questions in Part 4 as if the birth mother of the minor is filling out the form (to the extent such information is available to You).***

9. **Briefly describe the type of injury alleged from Your use or another person's use of an opioid. Select all that apply.**
 	
Attach additional sheets if necessary.
	☒ Death
	☐ Overdose
	☐ Addiction/Dependence/Substance Use Disorder
	☐ Lost Wages/Earning Capacity
	☒ Loss of Consortium
	☐ NAS-related
	    ☐ Learning Disability
	    ☐ Spina Bifida
	    ☐ Developmental Disability
	    ☐ Heart Defects
	    ☐ Congenital Defects or Malformations
	☐ Expenses for Treatment
	☐ Other (describe):

10. **Describe the basis for Your claim, including all alleged causes of action, sources of damages, etc., You are asserting against the Debtors.** Attach additional sheets if necessary.	
11. **Please identify and quantify each category of damages or monetary relief that You allege, including all injunctive relief that You seek. Check as many boxes as are applicable.**	☐ Compensatory: $__________ or ☒ Unknown (for example, lost wages, pain and suffering, expenses not reimbursed, loss of consortium, etc.) ☐ Punitive: $__________ or ☒ Unknown ☒ Other (describe): Injunctive relief to include items as specified in enclosed statement of relief being sought.

12. **Have You ever filed a lawsuit against any of the Debtors at any time?**	☒ No ☐ Yes. If yes, please provide the following information and attach supporting documentation: **Case Caption:** ______ **Court and Case/Docket Number:** ______ **Attorney Information:** ______ Law Firm Name ______ Attorney Name ______ Address ______ City ______ State ______ ZIP Code Contact phone ______ Contact email ______

Part 4: **Information About Opioid Use**

If You have a claim arising out of another person's use of an opioid, please answer these questions as if the injured person is filling out the form. If You are submitting a claim on behalf of a minor with NAS, please answer these questions as if the birth mother of the minor is filling out the form (to the extent such information is available to You).

13. **Were You prescribed or administered a Purdue brand name opioid by a healthcare professional?**	☐ Unknown (select if You were prescribed a prescription opioid but do not know the specific medication). ☒ No. ☐ Yes. If yes, please provide the following information to the extent reasonably available: **Please identify the Purdue brand name opioid(s) that You were prescribed or administered by a healthcare professional. Check as many medications as applicable.** ☐ Butrans® ☐ OxyContin® ☐ DHC Plus® ☐ OxyFast® ☐ Dilaudid® ☐ OxyIR® ☐ Hysingla ER® ☐ Palladone® ☐ MS Contin® ☐ Ryzolt ☐ MSIR®
14. **Were You ever prescribed or administered any opioid (other than a Purdue brand name opioid) by a healthcare professional?**	☒ Unknown (select if You were prescribed a prescription opioid but do not know the specific medication). ☐ No. ☐ Yes. If yes, please provide the following information to the extent reasonably available: Non-Purdue Brand Name Opioid, if known: ______ **Please identify the generic opioid(s) that You were prescribed or administered by a healthcare professional. Check as many medications as applicable.** ☐ Buprenorphine transdermal system ☐ Oxycodone extended-release tablets ☐ Hydrocodone and acetaminophen tablets (generic to Vicodin® or Norco®) ☐ Oxycodone immediate-release tablets ☐ Hydromorphone immediate-release tablets ☐ Oxycodone and acetaminophen tablets (generic to Percocet®) ☐ Hydromorphone oral solution ☐ Tramadol extended-release tablets ☐ Morphine extended-release tablets ☐ Other Generic: ______

Part 5: Other (Non-Personal Injury) Opioid-Related Claims

15. **Do You believe You have any other claims against the Debtors based on or involving the Debtors' production, marketing and sale of Purdue Opioids that are not based on a personal injury?**	☒ No. ☐ Yes. If yes, please describe the nature of the claim(s) (Attach additional sheets if necessary).
16. **How much is the claim?**	$ ______________ or ☐ Unknown.

Part 6: Supporting Documentation

17. **Please provide the following supporting documentation if You would like (but You are not required) to supplement this proof of claim.**	▪ Provide any documents supporting Your claim, including but not limited to: any complaint that You have filed against the Debtor(s), prescriptions, pharmacy records or statements showing prescriptions, or any records supporting Your claims of damages.

Part 7: Sign Below

The person completing this proof of claim must sign and date it. FRBP 9011(b).

If you file this claim electronically, FRBP 5005(a)(2) authorizes courts to establish local rules specifying what a signature is.

A person who files a fraudulent claim could be fined up to $500,000, imprisoned for up to 5 years, or both. 18 U.S.C. §§ 152, 157, and 3571.

Check the appropriate box:

☒ I am the creditor.

☐ I am the creditor's attorney, guardian, kinship (or other authorized) caretaker, executor, or authorized agent.

☐ Other (describe): ______________

I have examined the information in this *Proof of Claim* and have a reasonable belief that the information is true and correct.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on date __________(mm/dd/yyyy)

____
Signature

Print the name of the person who is completing and signing this claim:

Name: Peter (First name) William (Middle name) Jackson (Last name)

Title: ______________

Company: ______________

Address: 4622 Valley View Road (Number Street)

Prairie Grove, IL 60012 (City State ZIP Code)

Contact phone: 224-612-1803 Email: beepjackson@comcast.net

EXHIBIT 2
(Peter W. Jackson Letter to Court)

July 15, 2020

Honorable Robert D. Drain
United States Bankruptcy Court
Southern District of New York
300 Quarropas Street
White Plains, NY 10601-4140

Re: *Purdue Pharma, LP, et al.*, case no. 19-23649 (Bankr. S.D.N.Y.)

Dear Judge Drain,

I write to ask this Court to appoint an examiner, pursuant to Section 1104 of the United States Bankruptcy Code, to investigate all Purdue Pharma documents and the role of the Sackler family in the marketing, labeling and sale of OxyContin. Unfortunately, I am a creditor of Purdue Pharma because my daughter, Emily Jackson, died of an overdose on August 18, 2006, after ingesting one OxyContin pill. She was 18 years old.

In 2007, I testified at the Purdue sentencing hearing before the Honorable James P. Jones, a federal District Court judge in West Virginia. At that time, I was unaware of the role the Sackler family had played in the misbranding of OxyContin. Sadly, I was not the only bereaved parent in the courtroom and I was not the only one who was still in the dark.

Since 2007, I have learned that much information was withheld from the public view, both related to Purdue and to the role of the Sacklers who, I now understand, apparently made many of the decisions that led to this crisis. Your Honor, this made me feel as though we were being used as part of a scheme to make it look like the government was taking bold action, while in reality many pertinent facts as to Purdue's conduct and the involvement of the Sacklers were hidden from view. When I learned that this bankruptcy proceeding could result in immunity from civil lawsuits for the Sackler family, I hoped and expected that the Court would understand the importance of making the truth known. For my family, the truth is the only thing that matters. No amount of money could ever fill the hole in my life created by the loss of my sweet daughter.

The best outcome to this bankruptcy proceeding for the many families that have been shattered by this company's aggressive and illegal marketing strategies is a fair, comprehensive and public review of all available evidence as to what exactly this company and the Sackler family have done. It is particularly important to shine a bright light on all available evidence so that the American public can understand, once and for all, exactly how this company and their owners conducted themselves and how their actions sparked the epidemic that continues to harm Americans.

If we are to avoid repeating the same mistakes made in the past, and if we are to learn from mistakes that have been made by our government in allowing this company to conduct itself in a manner detrimental to the public health, the secrecy must end – here and now. Your Honor, we know that this is our last chance.

As one of the many thousands of parents who have had their families ripped apart by the fraudulent marketing of OxyContin and the ensuing opioid epidemic, I believe it is critical that an independent examiner be appointed to credibly report the evidence in this case. Additionally, as someone who testified at the 2007 sentencing hearing, I would like to know how it is possible for Purdue Pharma and the Sacklers to have caused even more damage after a federal criminal prosecution and guilty plea.

Your Honor, I am not an attorney, I am not represented by an attorney in this case and I do not have access to the legal resources available to Purdue Pharma or the Sacklers. I respectfully ask the Court to give my request the consideration due to a creditor's motion.

Sincerely,

Peter W. Jackson

Peter W. Jackson

[redacted]

Faculty

John Castellano is a partner and managing director in the Chicago office of AlixPartners, LLP and has 30 years of experience in management and advisory roles, as well as restructuring experience based on his expertise in resolving complex and challenging issues. He has experience in the energy, oil & gas, and infrastructure industries, with areas of special expertise in business plan development, liquidity management, contingency planning, bankruptcy administration and creditor negotiations. Mr. Castellano specializes in guiding companies through complex reorganizations by his leadership skills and hands-on approach in working collaboratively with clients, in implementing business turnarounds, and in providing interim-management services as a CRO, CFO and interim CEO. He received his M.S. in management studies from Northwestern University's Kellogg School of Management.

Michael J. Epstein is the global special situations leader for Deloitte Transactions and Business Analytics' restructuring practice in New York. His practice is centered on crisis management, financial advisory services and insolvency consulting activities in both middle-market and large transactions. Mr. Epstein works with management teams, creditors, creditors' committees and boards of directors in many aspects of distressed businesses, operational reengineering and financial restructuring. Previously, he was CEO of the largest provider of software solutions for specialized asset-based finance and back-office support for lease administration. He helped found that company's first business unit outside of the U.K., and he held a board seat for the parent company for nearly six years. In 2017, Mr. Epstein was inducted as a Fellow into the American College of Bankruptcy. He is the author of "Own Up to The Truth," *MediaWeek* (September 2010), "Furthering Insolvency," *Institutional Investor Corporate Governance Guide* (October 2003) and "Beyond Investor Relations: Communicating with Stakeholders in a Crisis," *Investor Relations* (Spring 2003). A frequent industry panelist and an author of articles regarding corporate governance and stakeholder communications, Mr. Epstein received his B.S. from Tufts University and his M.B.A. from The Wharton School at the University of Pennsylvania.

William H. Henrich, CPA is co-chair of Getzler Henrich & Associates LLC in New York and has nearly 40 years of experience in turnaround and crisis management, loan workouts and bankruptcy consulting, with over 400 engagements. His areas of expertise include operational restructuring, improving business operations, management practices, cash flow and profitability; financial restructuring, negotiating and implementing corporate finance solutions including debt-restructuring, refinancing, and distressed mergers and acquisitions; evaluating/crafting company operations, business plans and financial projections; guiding companies through workout, turnaround and chapter 11 processes and maximizing their value and recovery as CRO, interim CEO or independent board member; advising secured and unsecured creditors during chapter 11 proceedings, including developing plans of reorganization and providing forensic analysis to support litigation; and providing expert testimony on valuation, solvency, bankruptcy and distressed company issues. In 2018, Mr. Henrich was inducted into the Turnaround Management Association's Hall of Fame. He is a fomer president and current advisory board member of the TMA's New York chapter, a current TMA Global board member and ABI's Treasurer. In addition, he is a member of the Association of Corporate Growth and a regular speaker and author, and he co-chaired ABI's Commission to Study the Reform of Chapter 11's Governance Committee. Mr. Henrich received his B.B.A. from Baruch College, City University of New York, and his M.B.A. from Harvard Business School.

Samuel S. Kohn is a partner in the New York office of Dorsey & Whitney LLP and practices in the area of business reorganizations, including complex chapter 11 cases and out-of-court restructurings. He represents large corporate debtors, creditors' committees, secured lenders, distressed-asset-acquirers, investment funds and banks. His experience spans a broad range of industries, including airlines, municipalities, health care, retail, real estate, food, financial services, energy, telecommunications, entertainment, manufacturing and shipping. Mr. Kohn has been involved in virtually every major municipal restructuring in recent memory, both in and out of court, including the chapter 9 cases of Detroit and Jefferson County, Ala. In addition, he has represented major creditors in out-of-court restructurings of municipalities, including municipal debt issued by Harrisburg, Pa., Scranton, Pa., Atlantic City, N.J., and Hartford, Conn. Mr. Kohn has authored numerous articles and is a frequent panelist on issues relating to municipal restructurings. Prior to becoming a lawyer, he was a Certified Public Accountant in the State of New York and founded and managed his own accounting firm. Mr. Kohn received his B.A. from City University of New York, Queens College and his J.D. *cum laude* from Brooklyn Law School.

Jeremy Matican is a managing director in the Debt Advisory and Restructuring Group at Jefferies in New York, where he advises on a variety of out-of-court and in-court restructuring and special-situation assignments for companies, creditors and other stakeholders, with experience across several industries. He joined Jefferies in 2020 from Evercore, where he was a managing director in its Restructuring and Debt Advisory Group. He also has held positions as a turnaround and restructuring consultant with Zolfo Cooper (prior to its acquisition by AlixPartners) and an accountant with Arthur Andersen. Mr. Matican received his B.S.B.A. with a dual concentration in financing and accounting from the Boston University School of Management.

Hon. Jil Mazer-Marino is a U.S. Bankruptcy Judge for the Eastern District of New York in Brooklyn, sworn in on Oct. 23, 2020. She previously was a partner at Cullen and Dykman LLP's Bankruptcy and Creditors' rights department, where her practice was nearly entirely bankruptcy-focused. Judge Mazer-Marino has chapter 11 experience representing debtors, creditors and creditor committees in chapter 11 business reorganizations. She also served as a chapter 7 panel trustee for the Southern District of New York for more than 10 years. Before joining Cullen and Dykman in 2019, Judge Mazer-Marino practiced with Meyer, Suozzi, English & Klein, P.C. from 2008-19, Rosen Slome Marder LLP from 2003-08 and Willkie Farr & Gallagher LLP from 1991-99. She also clerked for former EDNY Chief Bankruptcy Judge Conrad B. Duberstein. Judge Mazer-Marino received her undergraduate degree from the State University of New York at Albany and her J.D. from St. John's University School of Law.

Oscar N. Pinkas is chair of Greenberg Traurig, LLP's New York Restructuring & Bankruptcy Practice and a member of its Corporate and Finance Practices. He focuses on transactions (front-end and back-end), as well as turnarounds, including in-court practice and estate representations. His clients include investors, purchasers, lenders/noteholders, creditors' committees, companies, indenture trustees and collateral agents. Mr. Pinkas advises clients in situations in or out of court involving strategic, operational or financial issues, with an emphasis on assisting investors, sponsors, lenders/noteholders and funds to deploy, manage, exit and recover on their investments, including in M&A, equity or debt (primary or secondary) transactions, growth, realignment, optimization and turnaround of companies, capital recoveries (including workout, taking ownership and foreclosure), and any attendant disputes or litigation. His work is domestic and cross-border in nature, having advised on transactions and situations on six continents involving up to 12 countries in any given instance, and more than 25 different countries in total. Mr. Pinkas has been named in *The Best Lawyers in America* as a Top Restructuring & Turnaround Professional, and an Emerging Leader in M&A, Financing and Turnaround. Restructurings or transactions he has been heavily involved in include abc carpet & home, Accuride, A. Stucki & Co., ATP-UK, bebe stores, Brazos Electric, Deluxe Entertainment, Dura Automotive Systems, Erickson, Fenix Parts, Fontainebleau, Gasfrac Energy, Global A&T Electronics, Lehman Brothers, Magnetation, Mesabi Metallics, Movie Gallery, NewComm Wireless, Ranger Offshore, Refco, Revlon, Sanjel, Sea Containers, Sheridan Production Partners, Tropicana Entertainment, VIVUS, Walter Energy, Westpoint Home and Young Broadcasting. Mr. Pinkas received his B.A. in economics from Rollins College in 2001, his M.B.A. with honors from Solvay Business School, Université Libre de Bruxelles (ULB), in 2002, and his J.D. from Seton Hall University School of Law in 2006, where he was a publishing member of the *Seton Hall Journal of Sports and Entertainment Law*.

Jennifer L. Rodburg is a Restructuring and Insolvency partner with Fried, Frank, Harris, Shriver & Jacobson LLP in New York, where she focuses her practice on the representation of creditors and investors in corporate restructurings both in and out of court. She represents hedge funds, private-equity funds, banks, property owners, asset-acquirers and other strategic parties in connection with prepackaged and traditional bankruptcy proceedings, DIP and exit financings, § 363 sales and other distressed situations. Ms. Rodburg has a broad range of experience in representing official and unofficial creditors' committees and equity committees in connection with chapter 11 cases and out-of-court restructuring situations. She also counsels investment funds, financial institutions and other clients on issues involved in trading distressed debt, analyzing the risks associated with potential investments and acquiring financially distressed companies. Ms. Rodburg is consistently recognized by *Chambers USA: America's Leading Lawyers for Business* as a leading individual in Bankruptcy/Restructuring and by *Legal 500* in Corporate Restructuring. She also was named an "Outstanding Young Restructuring Lawyer" in the April 2009 issue of *Turnarounds & Workouts*. Ms. Rodburg lectures on bankruptcy-related matters for seminars and panels sponsored by the Association of the Bar of the City of New York and other professional organizations. She is a member of ABI, the American Bar Association, the New York State Bar Association and the New York City Bar, and she is admitted to the bar in New York, New Jersey, the District of Columbia and the U.S. District Court for the Southern District of New York. Ms. Rodburg received her B.A. *magna cum laude* from the University of Pennsylvania in 1997 and her J.D. in 2000 from New York University School of Law.