ESSAY

THE RISE OF THE SPONSOR-IN-POSSESSION AND IMPLICATIONS FOR SPONSOR (MIS)BEHAVIOR

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ABSTRACT

Changes in the capital markets and developments in the law and judicial practice have shifted the balance of power in many distress situations from creditors to financial sponsors. Only recently has there been a recognition by a subset of academics that this reflects a new prism through which to view the bankruptcy process. These studies have been largely theoretical—focusing on how these developments have come about and their implications for stakeholders and bankruptcy outcomes. This Essay offers an insider's perspective, in the form of case studies of the role that private equity played in the bankruptcies of Caesars Entertainment and Neiman Marcus. These case studies show how the unchecked incentives of private equity sponsors have resulted in increasingly aggressive tactics that tilt the playing field in their favor, by siphoning value away from creditors for their own benefit prior to and during bankruptcy proceedings. In particular, this Essay shows how sponsors in those cases undermined basic corporate governance protections and used questionable interpretations of covenants meant to protect creditor interests to further their own self-interest. These examples further show how sponsors' use of favored bankruptcy venues and "independent" directors have become part of the private equity sponsor toolkit. These behaviors can be viewed within a broader set of developments affecting creditor bargaining in bankruptcy and upending bankruptcy priorities that have taken

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hold within the bankruptcy and restructuring process for large corporate debtors. Part I introduces the case studies of Caesars Entertainment and Neiman Marcus. Part II showcases the strategies employed by the financial sponsors in those case studies, how they came about, and their implications for corporate governance, control rights, and bankruptcy outcomes. These case studies challenge many of the assumptions of court decisions, in particular North American Catholic Educational Programming Foundation, Inc. v. *Gheewalla, that have rolled back creditor protections over the past twenty years. Part III recommends a series of changes in law and bankruptcy practice to address the problems raised by this behavior and restore creditor bargaining power. This Essay argues that absent intervention by the courts, these problems will persist.*

"Someone gave me an analogy which I think is a good one.
You steal my car out of my garage.
And I say, 'That's my car.'
You say, 'Well, that used to be your car.'
So I say, 'Well I am going to file a lawsuit to recover the car.'
'Well, alright, let's talk. What about, I let you have the car one weekend every month and you can drive it from Friday to Sunday?'
And, more times than not, there's a deal, and I think that is the mentality.
[So,] we're not going to get to keep it all, we have to give some back."[1]

—David Kurtz, Global Head of Restructuring & Capital Solutions, Lazard

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1 The Beard Group, *The Economy and Current and Future Cases*, YOUTUBE (Nov. 28, 2022), https://www.youtube.com/watch?v=35HNBV3Ih9Q&t=978s [https://perma.cc/3RGJ-5XDF].

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INTRODUCTION

Over the past twenty years, bankruptcy scholarship has by and large concluded that bankruptcy outcomes can be largely explained by the behavior of powerful creditor interests.[2] Famed practitioner Harvey Miller famously coined the phrase "The Creditor-in-Possession" in 2003 to explain how bankruptcy outcomes had swung too far in favor of secured creditors.[3] However, changes in the capital markets over the past twenty years and developments in the law and judicial practice have shifted the balance of power in many distress situations to financial sponsors.[4] As a result, the Creditor-in-Possession has now become The Sponsor-in-Possession. How has this come about?

Historically low interest rates over the last twenty years have fundamentally altered the face of corporate bankruptcies.[5] More and more, large corporate debtors tend to be portfolio companies of private equity firms. Private equity, as an asset class, has exploded in popularity as investors have sought higher returns in this lower rate environment.[6] The total capital raised by private equity firms has exceeded $500 billion every year since 2019.[7] In

2 *See generally* Douglas Baird & Robert Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002) (arguing that contractual control rights have replaced the need for corporate reorganization); David Skeel, *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 919 (2003) (arguing that creditors use DIP covenants to control companies during bankruptcy); Kenneth Ayotte & Jared Ellias, *Bankruptcy Process for Sale*, 39 YALE J. ON REGUL. 1, 14 (2021) (explaining the increase in control to which DIP loans have been subjected over time).

3 Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession*, ALM LAW.COM (Nov. 2003), https://www.lawjournalnewsletters.com/sites/lawjournalnewsletters/2003/11/01/the-creditor-in-possession/?slreturn=20240020155430 [perma.cc/JF44-XKFH].

4 *See* Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporate Reorganization*, 90 U. CHI. L. REV. 1, 4 (2023) [hereinafter Buccola, *Sponsor Control*] (taking note of these trends and concluding they reflect a new paradigm for corporate reorganization).

5 Interest rates have experienced a multi-decade downtrend channel. *See* Email from Katie Stockton, Fairlead Strategies (September 7, 2021) (on file with author).

6 *See* Miriam Gottfried, *Buyout Boom Gains Steam in Record Year for Private Equity*, WALL ST. J. (Nov. 28, 2021), https://www.wsj.com/articles/buyout-boom-gains-steam-in-record-year-for-private-equity-11638095402 [perma.cc/946D-UTMH] (explaining that ultra-low interest rates had fueled the demand for the buy-out boom).

7 *See* Katrina Lau, APAC Dries Up Amid Global Fundraising Slowdown, PRIVATE EQUITY INT'L (May 8, 2024), https://www.privateequityinternational.com/download-private-equity-fund-closes-reach-six-year-low// (showing data on PE fundraising since 2019).

2021, private equity funds spent nearly $1 trillion in dollar value to acquire companies through leveraged buyouts ("LBO"), nearly double the prior peak of LBO volume in 2007.[8] The amount of debt borrowed by sponsor-controlled companies to finance these buyouts has likewise skyrocketed, topping 60% of the entire leveraged loan primary market every year since 2020.[9] These sponsor-controlled companies are more likely to default.[10] Not surprisingly, over 50% of all large corporate defaults during the most recent COVID-related default cycle of 2020 involved a financial sponsor.[11] Private equity now plays, and will continue to play for the foreseeable future, the dominant role in the restructuring process.

At the same time, the low-rate environment has fundamentally changed the profile of the leveraged loan market. Gone are the days of relationship lending where a money-center bank such as J.P. Morgan served as a company's ongoing corporate finance partner.[12] Instead, loan vehicles called Collateralized Loan Obligations ("CLO") are now the primary funding source for the leveraged loan market.[13] A CLO's mandate is to invest in a portfolio of loans, making them passive vehicles that are not expected to mitigate the risk of individual loan defaults.[14] The prevalence of these passive vehicles has altered the relationship between borrower and lender during times of distress. CLOs do not have the same incentive as traditional loan parties to enforce remedies or negotiate with borrowers to mitigate individual loan losses.[15] At the same time, sponsors are willing to take more aggressive positions with CLOs than with relationship banks during loan restructurings.

8 Gottfried, *supra* note 6.

9 LevFin Insights, *Volume Stats 2017 Through Q2-2023* (on file with author).

10 Recent research has concluded that portfolio companies experience financial distress and bankruptcy at a significantly higher rate than peer firms. *See* Brian Ayash & Mahdi Rastad, *Leveraged Buyouts and Financial Distress*, FIN. RSCH. LETTERS, Feb. 20, 2020, at 3 (finding a bankruptcy rate of 20% for portfolio companies compared to 2% for a control sample).

11 *See* Mayra Rodriguez Valladares, *Over Half of Rated Company Defaulters Are Owned by Private Equity Firms*, FORBES (July 16, 2020), https://www.forbes.com/sites/mayrarodriguezvalladares/2020/07/16/over-half-of-rated-company-defaulters-are-owned-by-private-equity-firms/?sh=1dbf44c57b1c [https://perma.cc/YH8S-NLAQ] (citing Moody's data that over 50% of defaulted companies during COVID are sponsor-owned).

12 The one notable exception is that money-center banks continue to provide revolving lines of credit to corporate borrowers. *See generally* Mitchell Berlin, Greg Nini & Edison G. Yu, *Concentration of Control Rights in Leveraged Loan Syndicates*, 137 J. FIN. ECON. 249 (2020) (discussing control rights of revolving bank lenders).

13 Professor Edward Altman reports that as much as 70% of new leveraged loans have been purchased by CLOs in recent years. Edward Altman, *COVID-19 and the Credit Cycle*, J. CREDIT RISK, June 2020, at 1, 7.

14 *See* Jeremy McClane, *Reconsidering Creditor Governance in a Time of Financial Alchemy*, 2020 COLUM. BUS. L. REV. 192, 195-96 (2020) (arguing that the shift from relationship lending to securitization has led to less monitoring).

15 *Id.*

Sponsors historically worked with relationship banks across a wide range of financial transactions (including fundraising, financing, and strategic advice) making them more willing to work out loan defaults consensually. But CLOs do not have broader ongoing relationships with sponsors. This has led sponsor-controlled portfolio companies to pursue ever more aggressive equity-friendly strategies during times of distress.[16]

Sponsors have unique incentives to use this changed landscape to their advantage.[17] Unlike in public companies, sponsors populate these sponsor-controlled companies with insiders to align the interest of these companies with the sponsors.[18] As purely private companies, they are not regulated by the SEC, and they have no statutory guardrails on their financial disclosures or obligations to inform their creditors of material developments. Whatever protections are provided are carefully crafted through debt instruments with debtholders and are oftentimes a skeleton of what would have been historically required in the marketplace. From a corporate governance perspective, these insider-controlled companies are inherently conflicted in the event of any related party transaction.[19]

The case studies discussed in this Essay reflect the singular focus of sponsors to act in their own self-interest without regard to reputational risk, counterparty relationships, or harm that could be caused to the underlying portfolio company even in the face of legal and contractual obligations intended to limit their behavior. This Essay showcases how private equity sponsors have used questionable interpretations of financial covenants and the changing landscape of common law protections to shift the playing field to their advantage both inside and outside of bankruptcy. This development has implications for many of the historical assumptions that have informed bankruptcy scholarship and jurisprudence.[20] Additionally, the emergent and

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16 *See* Samir D. Parikh, *Creditors Strike Back: The Return of the Cooperation Agreement*, 73 DUKE L.J. ONLINE 1, at 25 n.113 (2023) ("The fear of future retribution for past dealings makes CLOs particularly vulnerable to relational leverage [aggressive equity-friendly strategies].").

17 *See* Buccola, *Sponsor Control*, *supra* note 4, at 26-27 (describing sponsors' interest in preserving option value, maintaining management fees, and avoiding bankruptcy litigation).

18 *Cf. id.* at 22-23 (explaining the close relationship a sponsor will have with a company's board). If these companies were instead listed on either the NYSE or NASDAQ, their Boards would need to be comprised of a majority of independent directors. NYSE Listed Company Manual Section 303A.01; NASDAQ Listing Rule 5605(b)(1).

19 Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. 1083, 1092 (2022) [hereinafter Ellias, *Bankruptcy Directors*] ("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.").

20 Control rights are the starting point for many academics, particularly in the law and economics field, to understand and analyze bankruptcy practice. *See, e.g.*, Douglas Baird & Robert Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1211–12 (2006) (starting from the premise of control rights in solving corporate governance problems).

dominant role of financial sponsors and changes in the syndicated loan market have implications for bankruptcy bargaining and the coalition formation that occurs in bankruptcy.

Through a discussion of the Caesars and Neiman Marcus bankruptcies, this Essay will highlight the following trends:

- Sponsors' desire to "extend runway" or siphon value for their sole benefit even if detrimental to the borrower through aggressive liability management techniques;
- Sponsors' selective disclosure of information to management and outsiders to further their own self-interest;
- Sponsors' exploitation of covenant loopholes or questionable interpretations of contractual provisions to improve their position vis-a-vis creditors;
- Sponsors' use of changes in Delaware law (from *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* to the use of LLCs, which limit the traditional creditor oversight function) to siphon value away from borrowers with little or no consequence;
- Sponsors' avoidance of third-party independent scrutiny because of the failure of professional legal ethics to adequately police conflicts of interest in bankruptcy; and
- Sponsors' use of favored venues and "independent" directors to further their own self-interest during bankruptcy proceedings.

The net effect of these developments has been a re-ordering of the Bankruptcy Code's priority scheme and an upending of the traditional process of bargaining over value that occurs in bankruptcy. This has resulted in a skewing of distributional priorities with distributional decisions oftentimes made in advance of a bankruptcy filing through the siphoning of value for the benefit of financial sponsor equity-holders or their chosen beneficiaries. On some level, this may not seem problematic. How value is allocated among different beneficiaries may seem like a wash overall. But the misalignment of incentives between out-of-the-money sponsors and creditors can result in actual economic harm, especially through the stripping of value and weakening of portfolio companies' financial resources. In the end, many of the criticisms leveled against purported secured lender control can, and should, be leveled against private equity control of the bankruptcy process for undermining the rehabilitative power of the Bankruptcy Code.

The perception of creditor control rights has played a prominent role in rolling back creditor protections. *See infra* Section II.D.

I. ARES & APOLLO

A. *Apollo and the Acquisition of Caesars*

In December 2006, affiliates of Apollo and Texas Pacific Group announced the acquisition of Caesars Entertainment, Inc. for $30.9 billion, or approximately 10.9x 2007 pro forma EBITDA. This acquisition included $25.2 billion of debt and $5.7 billion of equity, making it the fourth-largest leveraged buyout of all time.[21] However, in 2008, the financial crisis hit Las Vegas hard, resulting in strip casino revenues dropping from $14.6 billion in 2007 to a low of $12.1 billion in 2010. In addition to the economic downturn, Atlantic City was also hit particularly hard by the expansion of gambling into neighboring states, and revenue in the Atlantic City market fell by over 40% between 2007 and 2014.[22] As a result of these two factors, Caesars EBITDA dropped from $2.8 billion in 2007 to $1.7 billion by the end of 2014, increasing debt to EBITDA from 9.1x at the time of the LBO to an unsustainable 13.3x by December 2012.[23]

B. *Ares and the Acquisition of Neiman Marcus and MyTheresa*

In September 2013, Ares announced its acquisition of Neiman Marcus in a $6.4 billion dollar leveraged buyout, or 9.5x 2013 adjusted EBITDA, including $4.7 billion of debt and $1.6 billion of equity, making it Ares' most prominent deal at the time.[24] In 2014, a year after the acquisition, Neiman Marcus acquired the fast-growing luxury online retailer MyTheresa for $239 million (including earn-outs) using cash from Neiman's balance sheet.[25] The acquisition of MyTheresa by Neiman Marcus represented a shrewd hedge by Ares against the risk that Neiman Marcus would turn out to be just another brick and mortar retailer about to be rendered obsolete by the internet. MyTheresa represented a very different business model. With no brand value whatsoever, MyTheresa relied on its first mover advantage within the newly created online marketplace for luxury goods to achieve significant scale to gain and keep market share. Ares likely hoped that the upstart fast-growing

21 Kristin Mugford & David Chan, *Bankruptcy at Caesars Entertainment*, HARV. BUS. SCH. PUBL'G, Mar. 28, 2019, at 1, 3.

22 Atlantic City Gaming Revenue, UNLV CTR. FOR GAMING RSCH., https://gaming.library.unlv.edu/reports/ac_hist.pdf [perma.cc/4FM3-TYE3] (last visited Feb 24, 2024).

23 *Id.* at Ex. 3.

24 William Alden, *Ares Management Set to Go Public, Joining Rivals*, NY TIMES (May 1, 2014), https://archive.nytimes.com/dealbook.nytimes.com/2014/05/01/joining-rivals-ares-management-set-to-make-public-markets-debut/ [perma.cc/3JM7-XYTH]; Neiman Marcus Group Ltd. LLC, Current Report (Form 8-K) (Oct. 7, 2013).

25 Neiman Marcus Group Ltd. LLC, Quarterly Report (Form 10-Q) (Apr. 29, 2017).

online retailer could help keep the business afloat if Neiman's brick and mortar prospects faltered. The MyTheresa acquisition occurred just in the nick of time. By 2015, it was clear that Neiman Marcus would not be immune from changing consumer habits and trends affecting the wider brick and mortar retail industry. Cash flows began to deteriorate significantly a year after the leveraged buyout, forcing Neiman Marcus to draw over $250 million from its revolving line of credit to fund operations by mid-2017.[26] It was a rapid change in fortune for then-CEO Karen Katz, who admitted that "business ha[d] been challenging on every front."[27] The results were, she concluded, "very disappointing."[28]

II. A SIMPLE PLAYBOOK: EXTEND RUNWAY AND SIPHON VALUE

A. *Caesars Creates a "War Chest"*

The combination of the financial crisis and draw-down in leisurely spending hit the prices of Caesars securities hard.[29] This presented an opportunity for Apollo to create *runway* by offering debtholders added benefits in exchange for extending the maturity dates of Caesars' debt while waiting for the gaming industry to recover.[30] By 2012, Caesars had engaged in over 30 liability management transactions to extend the maturity dates of its debt stack to 2015 and beyond, as well as to cut expenditures to the bone.[31] But the writing was on the wall, and Apollo realized the "substantial risk" that the runway would run out resulting in an eventual restructuring.[32] Apollo had a choice to make. It could sit back and wait to see if the gaming market recovered sufficiently to enable it to refinance its indebtedness when it came due, or it could seek to strengthen its hand in any eventual restructuring. It chose the latter approach.[33] As outlined in a detailed report prepared by a court-appointed Examiner in the bankruptcy case, Apollo hatched a plan to strip billions of dollars of assets from the operating company for the benefit

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26 Neiman Marcus Group Ltd. LLC, Annual Report (Form 10-K) (Oct. 10, 2017).

27 *Neiman Marcus CEO on Conf Call – Operational Challenges in Q1 Included Inventory Management System Transition*, REUTERS (Dec. 13, 2016), https://www.reuters.com/article/idUSFWN1E80L3 [perma.cc/DF95-MDAK].

28 *Id.*

29 *See* Final Report of Examiner, Richard J. Davis at 32, *In re* Caesars Ent. Operating Co., Inc., No. 15-01145 (Bankr. N.D. Ill. July 22, 2015), *vacated*, 808 F.3d 1186 (7th Cir. 2015), *remanded to* 561 B.R. 441 (Bankr. N.D. Ill 2016) [hereinafter Caesars Examiner Report] (explaining Caesars' engagement in liability management exercises to take advantage of depressed securities prices).

30 *Id.* at 4.

31 *See id.*; *id.* at app. 8-14 (noting analyst conclusions that the company was at a competitive disadvantage due to cost cutting).

32 *Id.* at 32.

33 *Id.* at 32-33.

of the sponsors to accomplish its goal.[34] Apollo admitted internally this was "the only way we see it to 'have our cake and eat it too.'"[35] The first step of Apollo's plan involved the creation of a new entity called Growth that would raise capital from investors to purchase assets from the operating company "with as little capital outlay as possible"—in other words, at cents on the dollar.[36] Apollo saw this as an opportunity to create a "war chest" upon a potential restructuring event,[37] which would come at the expense of the operating company.[38] Apollo stood on both sides of these transactions, cherry picking which assets Growth would buy and hand picking the parent-company directors that would consider approving the transactions on behalf of the operating company.[39] No independent directors considered the transaction from the perspective of the operating company and its creditors.[40] Apollo went so far as to hold back its rationale for the deal in its presentation materials to the board, which was a sign that Apollo was concerned that management may not appreciate the company becoming a guinea pig in a potential show-down with creditors.[41] The Growth transactions closed in October 2013, the month after Ares announced its acquisition of Neiman Marcus.[42]

B. *Ares Hatches Its Plan*

In early 2017, as debt prices cracked below 60 cents on the dollar, indicating significant distress, the chairman of Neiman's board and co-founder of Ares emailed another co-founder to relay how he intended an eventual restructuring of Neiman Marcus to play out.[43] He wrote, "My prioritization is playing for . . . MyTheresa flexibility over discount capture."[44] This was private equity speak for Ares' desire to move MyTheresa out from under the loan party group rather than negotiate its fate with

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34 *Id.* at 3-4 (describing Apollo's strategy of strengthening its hand in a potential restructuring by removing assets from Caesars to the detriment of its creditors).

35 *Id.* at 33.

36 *Id.* Apollo paid $360 million for properties worth between approximately $800 and $950 million or between 38% and 45% on the dollar. *Id.* at 39.

37 *Id.* at 34.

38 *See id.* at app. 8-14 at 42 ("Although the company is receiving cash consideration for this transaction, we do not expect it will be sufficient to arrest the liquidity drain.").

39 *Id.* at 36.

40 *See id.* at 38 ("While the directors on the Committee were disinterested from the perspective of CEC, they were not disinterested insofar as CEOC was concerned.").

41 *Id.* at 37-38.

42 *Id.* at 40.

43 Transcript of Kaplan Deposition at 169:4-19, *In re* Neiman Marcus Group LTD LLC, Debtors, No. 20-32519 (Bankr. S.D. Tex. July 13, 2020).

44 *Id.* at 169:18-170:4.

creditors. With the company's nearest debt maturity nearly four years away, the company's financial advisor, Lazard, recommended that "the Company . . . take advantage of its runway to analyze, design, and potentially implement one or more transactions . . . . In addition, [it] should consider . . . transactions that would enhance long-term shareholder value by moving . . . assets with strategic value, such as the MyTheresa business, outside of the loan party group" in order to "maximize the long-term value of MyTheresa for the Sponsors."[45] Ares knew that this strategy carried legal and reputational risk. Lazard warned them that

> any transaction that removes material value . . . from the existing loan party group could attract potential litigation . . . [and] [t]he Company must be mindful of its . . . fiduciary duty obligations, as certain transactions may implicate such duties even if technically permissible under the Company's debt documents and allowable from a fraudulent conveyance perspective.[46]

In a sign that Ares saw risk in the transaction, Ares worked with Lazard to keep information about the potential MyTheresa transaction hidden from company management (who presumably would not want to lose their crown jewel asset to the sponsors).[47]

C. *Exploitation of Loopholes or Gray Areas of Interpretation in Debt Documents Provide Flexibility*

Both Apollo and Ares faced a major hurdle to its plan to extract value from the portfolio companies they owned: the debt documents that governed the leveraged buyouts contained various restrictions and limitations (known as covenants) on the portfolio company's activities. In the case of Caesars, value could only flow to Apollo through the holding company, but the holding company had guaranteed all of the operating company's indebtedness. In the case of a bankruptcy, this guarantee would wipe out all the potential equity value flowing up to the sponsors. In the case of Neiman Marcus, the debt documents governing the operating company contained restrictions on Ares'

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45 Lazard Presentation, Neiman Marcus Discussion Materials dated Jan. 12, 2017 at 1, *In re* Neiman Marcus Ltd. LLC, No. 20–35219 (Bankr. S.D. Tex. July 24, 2020) [hereinafter Lazard Presentation].

46 *Id.* at 11.

47 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 4, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. July 24, 2020) [hereinafter Preliminary Report] (citing emails where Ares asked Lazard to keep information from the company).

ability to transfer the MyTheresa business outside of the loan party group to the sponsors.

During times of distress, these covenants had historically served an important function of preserving value for creditors. However, with the advent of ever-more complex debt arrangements and the help of sophisticated (and as explained below, conflicted) lawyers,[48] Apollo and Ares would use gray areas of interpretation as another weapon in their private equity playbook to accomplish their goals.[49] Even covenants that on their face seemed to restrict certain sponsor behavior could be manipulated, as discussed later on in this section, to permit seemingly prohibited transactions.

Apollo found itself facing a significant hurdle to having its cake and eating it too: all of the operating company debt was guaranteed by the holding company, cutting off any value to the equity held by the financial sponsors. It was paramount that this guarantee be released for Apollo to siphon any value away from the company's creditors. On the other hand, junior bondholders would most certainly be wiped out without the value associated with the parent company guarantee.[50]

Fortunately for Apollo, the guarantee (arguably) could be released if the operating company ceased to be a wholly-owned subsidiary of the public parent company.[51] In other words, if the parent company merely sold some equity of its wholly-owned operating subsidiary to a third party, Apollo (and other public company equity-holders) could side-step the guarantee. Unfortunately for Apollo, its operating subsidiary was hopelessly insolvent with debt trading at levels indicating significant distress. As a result, no third-party buyer would ever buy the operating company's worthless equity. To overcome that difficulty, Apollo approached hedge fund holders of the parent company's equity in an 'I scratch your back, you scratch mine' trade whereby the worthless equity would be taken up by investors with no economic rationale for buying it other than their own ownership of the parent company's equity.[52] The uncertainty surrounding the guarantee's release created such a significant overhang for Apollo during the bankruptcy

48 *See* Sneha Pandya & Eric Talley, *Debt Textualism and Creditor-on-Creditor Violence: A Modest Plea to Keep the Faith* 23-24 (Eur. Corp. Governance Inst. L., Working Paper No. 673/2023) (arguing that complex contracts present challenges for textualist courts that are exploited by lawyers incentivized to exploit loopholes).

49 *See* Samir D. Parikh, *Financial Disequilibrium*, 171 U. PA. L. REV. 1925, 1946 (2023) [hereinafter Parikh, *Financial Disequilibrium*] (arguing that sponsors use ambiguity to "create loopholes and trapdoors" in debt documents to get around restrictions).

50 SUJEET INDAP & MAX FRUMES, THE CAESARS PALACE COUP 95-96 (2021).

51 *Id.*

52 *Id.* at 96-97.

proceedings that it became an important factor in forcing Apollo to eventually settle with creditors.[53]

For Ares to get MyTheresa, it had to overcome the fact that MyTheresa was a 'restricted' subsidiary of Neiman Marcus under the indenture governing the unsecured bonds. As a result of this contractual restriction, Neiman could not transfer its equity interest in MyTheresa away from Neiman's creditors unless it first redesignated MyTheresa as an 'unrestricted' subsidiary.

Neiman Marcus had "basket capacity" of $505 million under its covenants, meaning that it would only be permitted to transfer MyTheresa out of the credit group under the debt documents if the value of the MyTheresa business was less than $505 million.[54] Duff & Phelps, the firm hired by the sponsors to determine the fair market value of the MyTheresa business for purposes of covenant compliance, concluded it was only worth $280 million.[55] This represented just $50 million more than its original purchase price three years earlier despite a 2x revenue increase since then.[56]

Duff & Phelps assumed a 7.6% terminal EBITDA margin for the business for purposes of its valuation.[57] This assumption was inconsistent with projections prepared by management and by the company's investment banker at around the same time. A month before Duff & Phelps performed its valuation, management assumed an 11.7% terminal EBITDA margin for the business for purposes of internal management projections.[58] The company's investment banker, Lazard, used an 11.3% terminal EBITDA margin for purposes of its presentation to management a few months later.[59] That difference of nearly 400 basis points would reduce the Duff & Phelps valuation by hundreds of millions of dollars.[60] It appeared Duff & Phelps was using an artificially low margin assumption to support a lower value for

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53 Bondholders had earlier sued and won a significant ruling prior to the bankruptcy filing that could have forced Caesars's parent to make good on its guarantee. While this ruling remained on appeal during the pendency of the bankruptcy case, it created significant enough uncertainty for the sponsors to force them to the bargaining table. *Id.* at 191-93.

54 This was calculated as total basket capacity of $578 million less $73 million attributable to properties redesignated as part of the proposed transactions. Neiman Marcus' Opposition to Marble Ridge's Amended Motion to Dismiss Counterclaims Pursuant to the TCPA at Ex. 6 at 9, 11, Marble Ridge Capital LP v. Neiman Marcus Grp. Inc., No. DC-18-18371, 2019 WL 11343539 (Tex. Dist. Apr. 9, 2019).

55 *See* Initial Expert Report of the Michel-Shaked Group Executive Summary at 15, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. July 24, 2020) (finding that Duff & Phelps valued MyTheresa at EURO 265 million or approximately $280 million).

56 *Id.* at 12, 17.

57 *Id.* at 17.

58 *Id.*

59 *Id.*

60 Lazard would arrive at a mid-point valuation based on a multiple of revenue using comparable transactions of $532 million, exceeding the covenant capacity by over $20 million. *Id.* at 15.

MyTheresa (which was only disclosed in the subsequent bankruptcy). In fact, the valuation prepared by an expert retained by the official committee in the subsequent bankruptcy concluded that MyTheresa was worth at least $662 million as of March 2017, thus exceeding the amount permitted by over $100 million.[61] Only by massaging its financial assumptions could Neiman Marcus succeed in designating the MyTheresa business as unrestricted, a necessary first step in freeing up this crown jewel asset for its eventual taking by the sponsors in late 2018.

D. *Developments in Case Law Undermine Creditor Protections*

Private equity firms have to learn how to juggle multiple hats when dealing with their portfolio companies. Sometimes, these roles conflict.[62] Private equity owners sitting on the Board of a portfolio company may simultaneously have duties to their own investors, to the companies that they manage, and, in times of distress, to the creditors of those companies.[63] A private equity owner's decision to pay itself a dividend from a portfolio company would serve the interests of its investors, but it could also conflict with its duties as a director if the company is distressed.[64]

In 1991, in response to these conflicts, Delaware Chancery Judge Allen announced a new common law rule favoring the interests of creditors over those of private equity owners during times of financial distress.[65] He opined that directors' fiduciary duties embraced creditor interests in the vicinity of insolvency.[66] Creditors could (and, in fact, often times did) police sponsor misconduct by bringing direct claims against directors for crossing over the red-line into blatant self-opportunism at the expense of creditors interest.[67] That began to change in 2007 with a series of decisions that slowly eroded the

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61 *Id.* at 13.

62 *See generally* Bo Becker & Per Strömberg, *Fiduciary Duties and Equity-Debtholder Conflicts*, 25 REV. OF FIN. STUD. 1931 (2012).

63 *See* Jared Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CALIF. L. REV. 745, 756-57 (2020) (discussing the agency problems that appear between shareholders and creditors when a firm approaches insolvency) [hereinafter Ellias & Stark, *Bankruptcy Hardball*].

64 *See, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) ("The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors.").

65 *Id.* at *34.

66 *See id.* ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise. The Ladd management was not disloyal in not immediately facilitating whatever asset sales were in the financial best interest of the controlling stockholder.").

67 *See generally* Becker & Strömberg, *supra* note 62 (analyzing the impact of the Credit Lyonnais decision on Board behavior).

ability of creditors to hold private equity appointed directors accountable for placing sponsor interests above those of creditors during times of distress.[68]

In 2007, the Delaware Supreme Court changed course in the *Gheewalla* decision and rolled back the fiduciary duties owed by directors to creditors during times of financial distress.[69] After *Gheewalla*, directors would no longer owe any direct duties to creditors during the "zone of insolvency."[70] Instead, they would owe their duties to the corporation for the benefit of shareholders unless the corporation was insolvent, effectively gutting the protections of the common law rule.[71] As a result of *Gheewalla*, corporate directors no longer had to look over their shoulder during times of distress. Another shoe would drop in 2010.

In *CML V, LLC v. Bax*, the Delaware Chancery Court determined that creditors of a limited liability company (in contrast to corporations) did not have standing to bring derivative claims against directors or shareholders of a limited liability company even when the company was actually insolvent.[72] This decision had the effect of eliminating the ability of third-party creditors to bring any claims against insiders of a limited liability company.

Ares employed an acquisition structure to take advantage of these precedents in effectuating the buy-out. It converted the corporate structure of Neiman Marcus at the time of the LBO from a corporation to a chain of single-member-managed limited liability companies to hold its Neiman Marcus investment.[73] This action had the effect of protecting Ares against any direct or derivative third-party creditor claims. Ares then used the flexibility

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68 In *Bankruptcy Hardball* the authors present the case that changes in the common law have effectively undermined the formal machinery of creditor protection, including related doctrines like standing to bring derivative claims and the law governing fraudulent conveyance. Ellias & Stark, *supra* note 62, at 749, 768.

69 *See N. Am. Cath. Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007) (declaring that creditors cannot assert direct claims for breaches of fiduciary duties, but are rather "afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, [and] bankruptcy law . . . ."); Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 815-17 (2008) (arguing that proposals for further expansion of fiduciary duties for creditors should be rejected).

70 After *Gheewalla*, "creditors cannot bring direct claims for breach of fiduciary duty. After a corporation becomes insolvent, creditors gain standing to assert claims derivatively for breach of fiduciary duty." Quadrant Structured Prods. Co. v. Vertin, 115 A.3d 535, 546 (Del. Ch. 2015).

71 *Id.* at 546-47.

72 *See* CML V, LLC v. Bax, 6 A.3d 238, 254 (Del. Ch. 2010) (finding that an LLC creditor, of "an insolvent LLC," is not a proper plaintiff in a derivative suit). The case caught many commentators off guard. *See, e.g.*, *Rumors of the Demise of Creditor Derivative Suits on Behalf of LLCs not an Exaggeration*, JONES DAY PUBL'N (Mar./Apr. 2011), https://www.jonesday.com/en/insights/2011/04/rumors-of-the-demise-of-creditor-derivative-suits-on-behalf-of-llcs-not-an-exaggeration [perma.cc/MWH9-U6VC] ("CML represents an abrupt turn in the area of creditor derivative standing with respect to Delaware LLCs.").

73 Neiman Marcus Group Ltd. LLC, Quarterly Report (Form 10-Q) (June 11, 2014) at 7.

of the limited liability structure to eliminate the traditional board of managers that would have existed at each level of the corporate structure.[74] This left Neiman's control to individuals appointed by Ares at the ultimate parent company.[75] This structure eliminated any governing body at Neiman Marcus that would have been able to act on behalf of Neiman Marcus if a conflict ever arose between parent and subsidiary.

This structure resulted in an ethical landmine. The traditional corporate structure would have allowed for separate independent decision-making at the parent and subsidiary to make decisions fairly in furtherance of their own potentially differing interests and duties. The structure adopted by Ares, however, had the intended consequence of eliminating the subsidiary's independence in favor of the parent's sole control. Ares, thus, ensured complete domination and control over Neiman Marcus even if conflicts arose between the two. Instead of protecting creditors during times of distress and insolvency, corporate law could now be used to insulate Ares from any liability or obligations owed to Neiman Marcus' creditors, seemingly turning fiduciary law on its head.

This structure removed any guardrails on Ares' conduct. Given the singular interest of Ares to further its own self-interest, all that was needed was a match to cause a massive explosion.

E. *The Weakening of Professional Ethics Adds Fuel to the Fire*

Private equity has become an important growth engine for law firms. Not only does the initial LBO assignment result in hefty M&A fees, but the subsequent corporate work for the newly acquired portfolio company can be extremely lucrative. The sponsor business can be so profitable that law firms will bend over backwards to purchase competing practices to lock up their corner of the market.

In July 2011, Paul, Weiss took a leap into the private equity big leagues by poaching the O'Melveny & Myers legal team that had represented Apollo in

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74 Limited liability companies, unlike corporations, are creatures of contract and can waive fiduciary duties or eliminate customary corporate governance protections. DEL. CODE ANN. 6, § 18-1101(c) (2023).

75 *See* Neiman Marcus Grp. LTD LLC, Amended and Restated Limited Liability Company Agreement of Neiman Marcus Group LTD LLC (8-K) (October 28, 2013) ("At no time shall the Company have any board of managers, board of directors or similar governing body.").

the buy-out of Caesars.[76] This ensured that Paul, Weiss would play a key role in representing Apollo and Caesars going forward.[77]

Despite conflict-of-interest rules that prohibit legal counsel from representing clients on both sides of the same transaction when their interests conflict,[78] the sponsors retained a single law firm to represent both the sponsors and the portfolio company simultaneously in Caesars and Neiman Marcus. In the case of Caesars, Apollo retained Paul, Weiss to represent both the sponsors and the operating company in virtually every transaction investigated by the bankruptcy examiner in the subsequent bankruptcy.[79] In 2016, the Examiner explained that:

> It is important to understand that it is not unusual for lawyers to represent portfolio companies of their private equity clients . . . . Nor is it unusual for the same law firm to represent a parent corporation and its 100% owned subsidiary. [H]owever, the situation changes once the company being represented becomes insolvent. . . . In that case the interests of the two entities diverge. And, once such a divergence of interest occurs, a lawyer can only undertake or continue representing multiple clients if it is clear that the lawyer can competently represent both clients and if both clients provide informed consent based on a full disclosure by the lawyer of the issues involved in the simultaneous representation. Here it does not seem that either requirement was satisfied.[80]

The Examiner not only concluded that Paul, Weiss had an ethical conflict by the Fall of 2013, but also analyzed whether a claim for aiding and abetting a breach of fiduciary duty could be brought against Paul, Weiss. Even though damages would be difficult to prove in bringing such a claim, the Examiner concluded that independent counsel for the operating company would have

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[76] Caesars Examiner Report, *supra* note 29, at 14. Kirkland & Ellis would follow suit in 2019 by buying out the group of Proskauer Rose attorneys who had represented Ares in connection with its 2013 acquisition of Neiman Marcus. *Cf.* Debtors' Application for Entry of an Order Authorizing the Retention and Employment of Kirkland & Ellis LLP and Kirkland & Ellis International LLP Attorneys for the Debtors and Debtors in Possession Effective as of May 7, 2020 at Ex. A at 18, *In re* Neiman Marcus Grp. LTD LLC, No. 20-32519 (Bankr. S.D. Tex. Sept. 25, 2020) [hereinafter *Kirkland Retention Application*] (listing employment timeline).

[77] As noted in *The Caesars Palace Coup*, "Now that Paul, Weiss had lured the O'Melveny team, Caesars was going to be a Paul, Weiss client . . . . Apollo could be worth many, many multiples of [millions of dollars]." Indap & Frumes, *supra* note 50, at 117.

[78] *See* MODEL RULES OF PROF. CONDUCT r. 1.7 cmt. 28 (Am. Bar Ass'n 2020) ("[A] lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other . . . .").

[79] Caesars Examiner Report, *supra* note 29, at 14-19.

[80] *Id.* at 14-15.

taken different positions than Paul, Weiss against Apollo on key points affecting the value of consideration offered in the Growth transactions.[81]

Despite the clear admonition from the Caesars case just a year prior, Ares did not hire separate counsel to advise the operating company in connection with the redesignation transaction and subsequent distribution of MyTheresa to the sponsor-controlled parent company (which occurred in 2018).[82] Instead, the same counsel represented both the sponsor-controlled parent and operating subsidiary in connection with these related party transactions. Caesars wasn't proving to be a cautionary tale but a roadmap of how to siphon more value from a portfolio company and engage in even more risky behavior. The official committee would later find that Neiman Marcus was insolvent by more than $1 billion by the time of the redesignation in March 2017 (a fact undisputed by the independent director appointed by Ares during the bankruptcy case).[83] It appeared that Ares was not interested in creating any procedural safeguards to derail it from its chosen path, nor did its self-selected counsel take any affirmative steps to address its own potential ethical conundrum in representing both the sponsors and the insolvent operating company.

When Neiman Marcus filed for bankruptcy in May 2020, Kirkland, the law firm that had represented the sponsor-controlled parent and operating company in the pre-petition related party transactions, filed a retention application seeking to represent the bankrupt operating company.[84] Section 327 of the Bankruptcy Code required the firm to be "disinterested" and possess undivided loyalty to the estate, seemingly mirroring the state law ethical requirement of undivided loyalty to one's client.[85]

The official committee replied to the retention application by asking the judge to exclude the law firm from participating in the investigation of the MyTheresa transactions.[86] Not only had the law firm structured the

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81 *See id.* at 15 ("[W]hether to consider . . . indirect benefits as consideration was . . . a judgment made by . . . the financial advisor involved in the transaction, whether on the facts of this case it was appropriate to do so also involved a legal issue (which Paul Weiss in fact analyzed). A zealous advocate for CEC would argue that including these benefits as consideration was legally justified. A zealous advocate for CEOC could well have taken the opposite position.").

82 *See* Kirkland Retention Application, *supra* note 76, at Ex. A at 14-15 (stating that Kirkland advised the operating company and parent company in connection with various transactions between 2017 and 2019).

83 Preliminary Report, *supra* note 47, at 10.

84 Kirkland Retention Application, *supra* note 76.

85 11 U.S.C. § 327 (a). Rule 1.7 of the ABA Model Rules of Professional Conduct prohibits lawyers from having conflicts of interest between existing clients. MODEL RULES OF PRO. CONDUCT r. 1.7 (AM. BAR ASS'N 2009).

86 Debtors' Application for Entry of an Order Authorizing the Retention and Employment of Kirkland & Ellis LLP and Kirkland & Ellis International LLP as Attorneys for the Debtors and

distribution of MyTheresa, but it had advised the Ares-led board and operating company on the proprietary nature of the transaction.[87] In fact, the litigation partner who advised Ares of its fiduciary duties and reviewed the solvency analysis with the board in connection with approving the distribution would be the same lead litigation partner in connection with the bankruptcy.[88]

But bankruptcy courts tend to view Section 327's disinterested requirement through a different lens than they do conflict of interest rules outside of bankruptcy (a problem plaguing corporate governance practices generally in bankruptcy proceedings as discussed below).[89] Bankruptcy courts routinely sidestep state law professional ethics requirements, finding that the Bankruptcy Code imposes different obligations on professionals even though both requirements should presumably be seeking to protect the client debtor-in-possession from the conflicting interests of its professionals.[90]

Additionally, and more important to the outcome of the official committee's request, was that the request would be decided in Ares' chosen venue, in front of a judge Ares' counsel had helped advise on how to attract mega bankruptcy cases to his courtroom.

F. *Judges Compete to Become the Preferred Debtor-Friendly Venue for Large Corporate Bankruptcies*

Much historical commentary has focused on how lax venue rules have allowed debtors to pretty much pick any district in which to file for bankruptcy protection.[91] This commentary has focused on the rise of

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Debtors in Possession Effective as of May 7, 2020 at 2, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. June 3, 2020).

87 *See* Kirkland Retention Application, *supra* note 76, at Ex. A at 18 (explaining that Kirkland represented Ares in connection with the pre-petition transactions).

88 *See* Kaplan Deposition Transcript, *supra* note 43, at 154:22-155:9 ("Throughout the entire process, we had a significant amount of legal advice . . . . Fiduciary duty considerations would absolutely have been considered."); *id.* 190: 11- 191:15 ("Mr. Zeiger . . . is the Kirkland & Ellis attorney . . . [who] 'reviewed the work done by the Company's executives' and [concluded] that we passed the solvency test." "We came to a conclusion based upon two sets of financial advisors [and] two lawyers . . . that we were solvent.").

89 For example, *In re Boy Scouts of America*, the bankruptcy court declined to adopt a rule that courts must always consider applicable Rules of Professional Conduct in reaching a conclusion on § 327. 630 B.R. 122, 133-34 (Bankr. D. Del. 2021) (finding that the Rules of Professional Conduct are relevant but not dispositive—citing cases in the Third Circuit).

90 *See id.* at 135 (citing to cases that show that disqualification motions are denied even when there "'appear to be obvious conflicts'").

91 Debtors use various strategies to manufacture venue including "bootstrapping" (using affiliates to create jurisdiction for a corporate parent) or creating shell entities in a preferred district to provide jurisdiction for a subsequent bankruptcy filing. Adam J. Levitin, *Judge Shopping in Chapter 11 Bankruptcy*, U. ILL. L. REV. 351, 36-61 (2023); *see also* Jared A. Ellias, *What Drives Bankruptcy Forum*

Delaware and the Southern District of New York as the preferred destinations for large corporate bankruptcies.[92] Competition among these venues has led to fundamental and detrimental changes to the bankruptcy system, leading courts to compete for cases by becoming more and more debtor-friendly and creating a perceived, if not actual, home-field advantage for debtors.[93]

This competition has led certain judicial districts to set up specialized judicial panels to attract mega Chapter 11 cases. Crafty lawyers can now even choose the particular judge that will hear their case within these districts.[94] This trend has become one of the more disturbing dynamics in large corporate bankruptcies.[95]

In the case of Neiman Marcus, Ares chose to file the bankruptcy case in the Southern District of Texas, Houston division, even though Neiman Marcus' headquarters was located in the Northern District, near Dallas. The Houston division had become the destination of choice for Neiman's counsel, powerhouse Kirkland & Ellis, leading to nearly 50% of all mega cases countrywide heard by the court.[96] One academic concluded that the two judges sitting on the complex case panel "are not selected by debtors for their expertise . . . but for their willingness to rubberstamp procedurally illegal transactions."[97] Although the head of Kirkland's bankruptcy practice was based out of Chicago and not admitted to practice in Texas, the Chief Judge of the Houston Bankruptcy Court appointed him to serve on an advisory board tasked with bringing large complex bankruptcy cases to the Southern District of Texas.[98]

The advisory board had recommended changes to local rules (subsequently adopted) that allowed all complex bankruptcy cases to be heard by just two judges in the district.[99] Chief Judge David Jones, who had heard

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Shopping? Evidence from Market Data, 47 J. LEGAL STUD. 119, 120 (2018) [hereinafter Ellias, *Forum Shopping*] (reviewing rationales for forum shopping).

92 *See generally* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (Univ. Michigan Press 2005) (detailing the rise of the Southern District of New York and the District of Delaware as preferred bankruptcy forums).

93 *See id.* at 137 (arguing that court shopping corrupts the judicial process). Another school of thought argues that these venues dominate because their expertise makes bankruptcy more predictable. *See* David A. Skeel, *What's So Bad About Delaware?*, 54 VAND. L. REV. 309, 325-27 (2001) (responding to criticisms and arguing that Delaware has specific qualities that attract cases).

94 Levitin, *supra* note 91, at 374.

95 LOPUCKI, *supra* note 92, at 97 (arguing that preferred forums (such as Delaware) have higher failure rates).

96 Levitin, *supra* note 92, at 381-82.

97 *Id.* at 358.

98 *Id.* at 373 n.168.

99 Although the local rules provide that the assignment of cases between the two judges is random, a recent analysis found that large corporate bankruptcies filed in the Southern District of Texas were disproportionately assigned to the Chief Judge. *See Court Opinion Review: Aearo*

nearly three times more large complex cases from Kirkland & Ellis than any other law firm in the country, was chosen to hear Kirkland's case.[100] With its hand-selected Judge in charge, Ares could be sure its chosen counsel, even if conflict-ridden, would not be disqualified. Thus, unsurprisingly, the Court rubberstamped the retention application and rejected the official committee's request without even holding a hearing.[101]

G. *The Use of Self-styled Independent Directors Further Insulates Conflicts of Interest from Creditor Oversight*

With the filing of Neiman Marcus for bankruptcy in May 2020, Ares faced the real threat that the MyTheresa transaction would be unwound. Fraudulent conveyance law is an important tool to preserve the distributional priorities between creditors and equity holders.[102] This bedrock principle from the 1571 Statute of 13 Elizabeth protects creditors from the looting of assets by providing broad powers to creditors to bring direct claims against third parties to claw back fraudulently transferred assets.[103] In fact, the Delaware Supreme Court reasoned in its *Gheewalla* decision that fiduciary duty protections were unnecessary precisely because creditors were otherwise able to amply protect themselves by resorting to fraudulent conveyance remedies or contractual protections.[104]

The bankruptcy filing of Neiman Marcus dramatically affected the playing field for bringing fraudulent conveyance claims against the sponsors.

Dismissed, Houston Venue Hijinks, DSG has to Pay up for Baseball Rights and Dubious Appellate Mootness Demand Denied in National CineMedia, REORG AMS. CT. OP. (June 21, 2023), https://reorg.com/reorg-court-opinion-review-2/ [perma.cc/G7YJ-2DSJ] (finding that two-thirds of corporate bankruptcies filed with the panel in Q2 2023 were assigned to Judge Jones).

100 Judge Jones heard nineteen cases from Kirkland & Ellis, as lead Debtors counsel, for large complex cases between 2019 and 2023 compared to seven cases from Latham & Watkins, the next most popular firm, according to data from BankruptcyData.com. BANKRUPTCY DATA, https://www.bankruptcydata.com/ (last visited May 17, 2024).

101 Judge Jones resigned from the bench after the Fifth Circuit filed a formal ethics complaint against him on October 13, 2023 that alleged that he was in a long-term intimate relationship with a partner at Jackson Walker, a firm which regularly acted as local counsel to Kirkland in cases in front of him, without disclosing their intimate relationship in retention applications (including in the Neiman Marcus case). United States Trustee's Amended and Supplemental Motion For (1) Relief from Judgment or Order Pursuant to Federal Rule of Civil Procedure 60(B)(6) of Civil Procedure and Federal Rule of Bankruptcy Procedure 9024 Approving the Retention and Compensation Applications of Jackson Walker LLP, (2) Sanctions, and (3) Related Relief, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. Feb. 2, 2024).

102 *See* DOUGLAS BAIRD, THE UNWRITTEN LAW OF CORPORATE REORGANIZATIONS 10-15 (Cambridge Univ. Press 2022) [hereinafter Baird, THE UNWRITTEN] (recounting the history of fraudulent conveyance).

103 *See generally* Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725 (1984).

104 *N. Am. Cath. Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 100-02 (Del. 2007).

As a result of the filing, all of the claims against Ares would become an asset of the estate. This change in legal fiction from non-debtor to debtor, with a bankruptcy estate, meant that individual creditors could no longer bring fraudulent conveyance claims directly against Ares; instead, those claims would now be held and controlled by the estate for the benefit of all stakeholders. The estate, however, would be administered and controlled by the Debtor-in-Possession, or the same pre-petition directors (in this case, Ares) that approved of those transactions in the first place. In effect, Ares had now indirectly taken over control of the claims against it for siphoning off assets from the company.

Ares anticipated that its pre-bankruptcy conduct would be targeted by creditors during the bankruptcy and that it needed to come up with a strategy to try to legitimize its actions and deflect attention away from its conflict-ridden position. Two weeks before the filing, Ares reconfigured the Neiman Marcus corporate structure to appoint two "disinterested managers" to a newly created governing board at the operating company.[105]

Outside of bankruptcy, independent directors play a critical role in policing self-interested transactions.[106] Recently, Delaware courts have taken an even more exacting view of director independence.[107] In bankruptcy, the role of independent directors takes on even greater importance, since they must act as neutral experts who will impartially and skillfully assess what claims the estate should bring against the company's insiders.

One of those directors, Marc Beilinson, had a checkered past.[108] He had been termed a 'super repeater' for the large number of bankruptcy cases he served in, entirely on behalf of debtor-friendly law firms or financial sponsors.[109] He had served in the much-maligned Caesars case and other cases

105 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 at 9, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. May 15, 2020).

106 *See* Jonathan Rosenberg & Alexandra Lewis-Reisen, *Controlling-Shareholder Related-Party Transactions Under Delaware Law*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 30, 2017), https://corpgov.law.harvard.edu/2017/08/30/controlling-shareholder-related-party-transactions-under-delaware-law/ [https://perma.cc/R5KC-DATF] (describing the role of independent directors in approving related-party transactions).

107 *See In re* BGC Partners, Inc. Derivative Litig., C.A. No. 2018-0722-LWW, 2021 WL 4271788, at *8-9 (Del. Ch. Sept. 20, 2021) (finding in *In re BGC Partners* that dependence on a sponsor for "a crucial source of income" or even mere admiration could result in the disqualification of a director based on independence concerns).

108 *See generally* Transcript of September 1, 2010 Hearing at 417-21, *In* re Innkeepers Trust, 422 B.R. 227 (Bankr. S.D.N.Y. 2010) (illustrating the presiding judge's trouble with Beilinson's actions and questioning his credibility).

109 *See* Ellias, *Bankruptcy Directors*, *supra* note 19, at 1133 ("Marc Beilinson, a bankruptcy director in the Neiman case, had served on fifteen boards, about half of them bankrupt companies.").

where his independence had been questioned.[110] Beilinson served at the pleasure of the sponsors and could be replaced at will but was in control of determining whether the sponsors should bear any responsibility for the MyTheresa transfer. Unsurprisingly, Beilinson, together with the other recently appointed disinterested manager, approved a bankruptcy filing that would ratify the MyTheresa transfer (without conducting any independent investigation) and hand over control of Neiman Marcus to creditors without requiring any payment by the sponsors for taking the MyTheresa business.

Kirkland argued that any investigation should be left to these "disinterested managers."[111] During a hearing to consider whether an independent third-party should be appointed to review the transaction, Beilinson failed to show even a basic familiarity with the appropriate legal standards.[112] He did not understand what issues would need to be analyzed as part of the 'independent' investigation he was touting.[113] At one point during cross-examination, the judge warned that if he was going to serve in this capacity, "he needs to understand his job, and he cannot simply give lip-service, knowing a bunch of buzzwords . . . . I do not want to see a fiduciary to this estate ever appear in front of me ever again unprepared, uneducated, and borderline incompetent."[114]

Even though Beilinson's credibility was shot (and within a few weeks, he would resign from the board), the judge nevertheless concluded that there was no need for an independent investigation since the official committee and the bankruptcy directors would investigate the transaction.[115] Ultimately, Ares would exit the bankruptcy proceeding with a substantial amount of the MyTheresa value for itself after striking settlements with the vast majority of creditors.

A little over a year after Neiman Marcus exited bankruptcy, Ares would bring MyTheresa public through an initial public offering valuing the company at $2.3 billion. At that valuation, the sponsors would be walking away with close to $1 billion, even though their investment in Neiman Marcus

110 As noted by the Financial Times, "Mr[.] Beilinson has played key roles in several high-profile restructurings, including those of gaming empire Caesars and hotel group Innkeepers USA. Both of those companies had been bought by affiliates of another private equity firm, Apollo Global Management, in debt-fuelled [sic] deals that ended in bankruptcy." Mark Vandevelde & Sujeet Indap, *Neiman Marcus Director Lambasted by Bankruptcy Judge*, FIN. TIMES (June 1, 2020), https://www.ft.com/content/0166cb87-ea50-40ce-9ea3-b829de95f676 [perma.cc/MY7J-5J5Z].

111 Debtors' Opposition to Marble Ridge's Expedited Examiner Motion at 2, *In re* Neiman Marcus Grp., No. 20–35219 (Bankr. S.D. Tex. May 28, 2020).

112 *See* Ellias, *Bankruptcy Directors*, *supra* note 19, at 1102 n.89 (explaining that Beilinson failed to articulate the standard for intentional fraudulent conveyance).

113 *Id.* at 1102-03.

114 *Id.* at 1102.

115 *See Id.* at 1102-03 ("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.").

should have been wiped out. For any private equity sponsor looking at Neiman Marcus for a guidepost for their own behavior or for any counsel looking to represent a sponsor, it would be hard to argue with the actions of Ares or its chosen counsel, given the result.

III. PROPOSALS TO ADDRESS PROBLEMS RAISED BY THE SPONSOR-IN-POSSESSION

Since the Neiman Marcus case, academics have taken notice, by publishing articles addressing judge shopping,[116] the role of independent directors in undermining the bankruptcy process,[117] and tying many abusive restructuring tactics to the role of sponsors in the restructuring process.[118]

Headlines have bemoaned the latest aggressive liability management techniques.[119] Members of Congress have proposed legislation to eliminate the use of independent directors and third-party releases, which are two of the strategies employed in the new private equity playbook.[120] Industry organizations have called on the Judicial Conference to adopt a uniform and national rule to bar judge shopping for large bankruptcy cases.[121] Finally, two of the most influential district courts overseeing bankruptcy cases have ruled that the third-party releases (used by independent directors to insulate third parties like private equity sponsors from liability) in those cases were invalid ultimately leading to a show-down in the Supreme Court.[122] Two of the most active federal districts have revised their case assignment rules to eliminate

116 *See generally* Levitin, *supra* note 91.

117 *See generally* Ellias, *Bankruptcy Directors*, *supra* note 19.

118 *See generally* Buccola, *Sponsor Control*, *supra* note 4.

119 *See, e.g.*, Vandevelde & Indap, *supra* note 110 (titling an article as *Neiman Marcus Director Lambasted by Bankruptcy Judge*).

120 *See* Alexander Saeedy, *Elizabeth Warren Floats Expanded Powers for Bankruptcy Creditors Against Private Equity*, WALL ST. J. (Oct. 20, 2021), https://www.wsj.com/articles/elizabeth-warren-floats-expanded-powers-for-bankruptcy-creditors-against-private-equity-11634750237#:~:text=17%20pm%20ET-,Sen.,selected%20by%20those%20investment%20firms [perma.cc/XMK6-MQF9].

121 On January 19, 2024, a group of stakeholders submitted a proposal to the Judicial Conference to adopt a new Federal Rule of Bankruptcy Procedure that would require random assignment of large bankruptcy cases among all bankruptcy judges in the district. Creditor Rights Coalition, *Submission of a Proposal to Adopt a Rule to Require Random Case Assignment for Mega Bankruptcy Cases-Rule Suggestion (24-BK-B)* (Jan. 19, 2024), https://www.uscourts.gov/file/77988/download [perma.cc/7A2Q-SVRV] [hereinafter Creditor Rights Coalition (24-BK-B)].

122 On August 10, 2023, the U.S. Supreme Court granted certiorari to review non-consensual releases of claims held by third-parties against nondebtors in a case that may well have consequences beyond the issues presented. *In re* Purdue Pharma L.P., 69 F.4th 45 (2d Cir. 2023) *cert. granted sub nom.*, Harrington v. Purdue Pharma L.P., 144 S. Ct. 44 (2023).

any appearance of judge shopping.[123] However, the Southern District of Texas is not among those districts that have revised their rules.[124]

Given that portfolio companies are singularly focused on serving the interests of their financial sponsors, they are unlikely to change course and embrace new norms of conduct, leaving the only avenues for changing sponsor behavior either in tightening contractual restrictions or in changes in judicial practice.[125] Can more restrictive contracting limit aggressive behavior? There is evidence that the loan market has closed some loopholes that have allowed sponsors to engage in some of their more aggressive liability management techniques,[126] but this is only a partial answer to the myriad of strategies employed by sponsors.[127] In the end, for the tide to turn, judges must roll back some of the changes over the past 20 years that have enabled sponsor misconduct.

The following changes would restore a more balanced relationship between equity sponsors and creditors and reinvigorate the priority mechanism of the bankruptcy code:

- *Gheewalla* and its progeny should be reversed, and the Delaware courts should once again recognize that fiduciary duties are owed directly to creditors when a corporation is in the 'zone of insolvency.' Given the experience since *Gheewalla*, it cannot be said other remedies adequately protect creditor interests.[128] Changes in the loan markets and weaker

123 *See* Order Establishing Judge Assignment Protocol for Mega Chapter 11 Cases, Bankr. E.D. Va., Standing Order 21-21 (Nov. 30, 2021) (requiring random assignment of judges); Assignment of Cases and Proceedings, Bankr. S.D.N.Y., Rule 1073-1 (Aug. 14, 2023) (same).

124 *See* James Nani, *Texas Bankruptcy Panel to Survive Ethics Scandal of Its Creator*, BLOOMBERG (Nov. 17, 2023), https://news.bloomberglaw.com/bankruptcy-law/texas-bankruptcy-panel-to-survive-ethics-scandal-of-its-creator [perma.cc/QU3V-YTWT] ("Chief Judge Randy Crane, who heads the Southern District of Texas' district court, wrote in an email [to Reuters]. 'Our Chief Bankruptcy judge has considered all of the media input, academic input as well as the logistics of our court and is making appropriate work orders. He has the complete confidence of our court . . . .'").

125 *See generally* Elisabeth de Fontenay, *Norms, Law, and Contract in the Loan Market*, LSTA (2011), https://t6s1d6.a2cdn1.secureserver.net/wp-content/uploads/2022/06/article.defontenayNormsLawAndContract.pdf [perma.cc/VAV6-3ZUU] (summarizing how norms, contracts, and judicial practice can provide guardrails for parties' conduct, but noting the insufficiency of these tools in the present loan market).

126 *See* Vincent Buccola & Greg Nini, *The Loan Market Response to Dropdown and Uptier Transactions* 34-35 (Nov. 27, 2023) (unpublished manuscript), *https://ssrn.com/abstract=4143928* [perma.cc/Z3D8-JX9B] (discussing how the frequency of contracts blocking "uptiers had nearly doubled" after Serta announced its transaction).

127 Because it takes years for loans to season, mature, and eventually default, the existing malleable terms for currently outstanding loans will remain unchanged for some time.

128 Markets and private contracting no longer provide an effective mechanism to curb manager opportunism. In addition to the lack of incentives of CLOs and highly anonymized primary market participants to negotiate protective contracts, sponsor control has also resulted in the weakening of

covenants have allowed even more aggressive actions to extend runway and siphon value for the benefit of insiders. Fraudulent conveyance laws have lost their bite when insiders can effectively control their resolution in the event of a bankruptcy filing.

- Legal and professional ethics need to be strengthened in bankruptcy. There is no reason for one set of ethical rules to apply outside of bankruptcy and another inside bankruptcy proceedings.[129] If a conflict of interest exists, it should be sufficient to disqualify counsel from representing the Debtor.
- Independent directors should be held to the same standards of independence in bankruptcy as outside of bankruptcy. Just because repeat players have come to control the bankruptcy process that does mean there is a reason to look the other way in analyzing their independence. Bankruptcy courts should take a page from Delaware judges and require independence in fact and in appearance.
- Official committees should be granted greater deference to bring claims against insiders.[130] Granting derivative standing has become the exception rather than the rule. Standards that require the official committee to satisfy

the well-established rights of creditors to bring contractual or equitable claims against insiders in the first place. A recent strategy employed by private equity sponsors has been to include additional procedural hurdles for creditors to have contractual standing to bring contractual or equitable claims. *See* Sujeet Indap, *Slick Lawyers Test the Limits in Distressed Debt Machinations*, FIN. TIMES (Oct. 31, 2022), https://www.ft.com/content/c793931d-7780-412b-9619-1bab24f87e7b [perma.cc/AD4W-GRWM]. For example, in one recent case, the company required lenders to post a cash indemnity to pursue claims challenging the uptier exchange in that case. Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., No. 565123/2020, 2021 WL 3671541, at *5 (N.Y. Sup. Ct. 2021). The Court ultimately rejected those procedural requirements. *Id.* at *7. But it still remains the case that most fraudulent conveyance claims can only be brought after a payment default because of collective action and no-action clauses contained in high-yield debt documents. *See, e.g.*, UMB Bank, N.A. v. Neiman Marcus Group, Inc., 128 N.Y.S.3d 823, 824-827 (N.Y. Sup. Ct. 2020) (granting the motion to dismiss a fraudulent conveyance claim on the grounds that the indentures provided for remedies only when there was an active event of default).

129 *Cf.* Nancy B. Rapoport, *The Need for New Bankruptcy Ethics Rules: How Can 'One Size Fits All' Fit Anybody?*, PRO. LAW., Fall 1998, at 20 (arguing for a separate uniform code of bankruptcy ethics given the difficulties in identifying the client).

130 Congressional proponents of limiting private equity abuses argue that "[l]itigation claims brought against company insiders must be brought by a trustee representing the creditor committee rather than the debtor-in-possession who often put sham *independent* directors on boards." *See* Press Release, Elizabeth Warren: Newsroom, The Stop Wall Street Looting Act of 2021 Section by Section (Oct. 20, 2021), https://www.warren.senate.gov/download/the-stop-wall-street-looting-act-of-2021-section-by-section-final [perma.cc/MP7F-K2LC]; *See also* Justin Ellis & Ryan Yeh, *A Better Guard for the Henhouse: Should Creditors' Committees Control Estate Litigation?*, 40 YALE J. REGUL. 1, 1-2 (2022) (discussing the fact that proponents of the The Stop Wall Street Looting Act believe that independent directors have inherent conflicts that are incompatible with the pursuit of company insiders).

burdensome requirements to bring a suit should be relaxed, particularly when involving an insider transaction.[131]

- Judge shopping should be abolished. In 2022 the Judicial Conference addressed judge shopping for patent cases in the federal district courts.[132] Similarly, the Judicial Conference should adopt the proposal submitted by the Creditor Rights Coalition and other stakeholders urging adopting of a new Federal Rule of Bankruptcy Procedure that would require all bankruptcy cases over $100 million in liabilities to be randomly assigned among all bankruptcy judges in the district.[133] The recent ethics controversy surrounding the Chief Bankruptcy Judge of the Southern District of Texas is a sharp reminder of the pitfalls of concentrating so many cases in the hands of a single judge.[134]

Recent scholarship[135] and experience indicate a frighteningly broken and abused process with implications for other recent trends in bankruptcy.[136] As markets inevitably ebb and flow, new fronts will be fought between shareholders and creditors in the never-ending battle between these opposing forces in the capital formation process. At some point, courts will have to take a more active role in regulating parties' conduct for the pendulum to swing back to a place that will better serve the rehabilitative goals of the Bankruptcy Code.

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131 A recent decision by Judge Goldbatt in the influential Delaware Bankruptcy Court provides some hope of the pendulum swinging back against some of the more egregious conduct of insiders. In February 2024, Judge Goldblatt granted standing to an Official Committee of Creditors to sue insiders of a Delaware limited liability company despite state law requirements limiting standing to members of the limited liability company rather than to third party estate representatives. *In re* Pack Liquidating, LLC, No. 22-10797 (CTG), 2024 WL 409830 at *2 (Bankr. D. Del Feb. 2, 2024).

132 *See* John G. Roberts, 2021 YEAR-END REPORT ON THE FEDERAL JUDICIARY 5 (2021) *https://www.supremecourt.gov/publicinfo/year-end/2021year-endreport.pdf* [perma.cc/8GH5-V395] ("Senators from both sides of the aisle have expressed concern that case assignment procedures allowing the party filing a case to select a division of a district court might, in effect, enable the plaintiff to select a particular judge to hear a case."); *see also* Letter from Roslynn R. Mauskopf, Dir., Admin. Off. U.S. Cts., to Thom Tillis & Patrick J. Leahy, Comm. on Judiciary, U.S. Senate (on file with author) (Dec. 15, 2021) (supporting Senators in their focus on random case assignment procedures).

133 *See* Creditor Rights Coalition (24-BK-B), *supra* note 121.

134 *See* Clifford J. White III, *Recent Ethics Controversy Highlights Needed Bankruptcy Reforms*, CREDITOR RTS. COAL. (October 14, 2023), https://creditorcoalition.org/cliff-white-speaks-up-on-needed-bankruptcy-reforms/ [perma.cc/53W5-R2WD].

135 *See generally* Ellias & Stark, *Bankruptcy Hardball*, *supra* note 63; Levitin, *supra* note 91.

136 More and more, distressed companies engage in vote-buying to obtain consent from bare majorities of creditors in exchange for extending runway at the expense of the excluded creditors. *See, e.g.*, *Dan Kamensky Speaks on Exclusive Opportunism*, CREDITOR RTS. COAL. (Oct. 23, 2022), https://creditorcoalition.org/dan-kamensky-speaks-on-exclusive-opportunism/ [https://perma.cc/EGX9-PH66] (explaining recent trends).