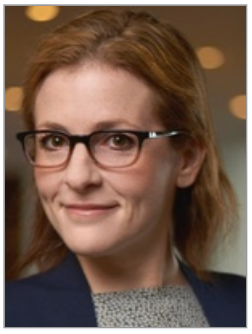
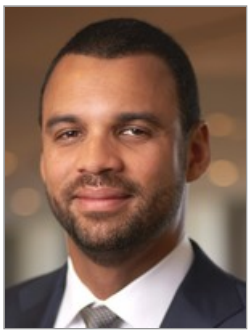
Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

A Bankruptcy Probe Primer For White Collar Attorneys

By **Rachel Maimin, Gregory Baker, Michael Kaplan and Patrick Thomas** (May 28, 2020, 4:03 PM EDT)



Rachel Maimin



Gregory Baker

Michael Kaplan

As the country begins on the path toward reopening in the current economic climate, white collar defense practitioners will need to become experts in an unfamiliar area of the law: bankruptcy.

Because there will be an unprecedented number of bankruptcy filings across all sectors of the economy, firms will look to lawyers in various practice groups — including white collar practitioners — to capitalize on the forthcoming influx of cases requiring investigation of pre- and post-petition conduct by debtors and their insiders.

Pivoting to bankruptcy investigations will not be as simple or straightforward as may seem: Bankruptcy court is often described as the Wild West with cases operating under their own sets of rules, both written and unwritten.

This article provides white collar practitioners a primer on conducting investigations of pre- and post-petition conduct in bankruptcy cases and highlights certain factors that are unique in the restructuring space. While most seasoned white collar practitioners are familiar with conducting mine-run internal investigations, bankruptcy-related investigations are unique and require particularized substantive legal knowledge and skills.

First, the conduct under investigation in bankruptcy proceedings is often different from that encountered in ordinary internal investigations. White collar practitioners are accustomed to searching for blatant wrongdoing in internal investigations — usually a violation of law or a company's internal policies — such as fraud, self-dealing or harassment.

The bankruptcy context is different — the conduct being investigated may have been entirely permissible depending on the circumstances. In particular, the question of whether a particular action is subject to scrutiny in a bankruptcy proceeding often depends on whether or not the company was solvent when the action was taken by the debtors and its management.

Directors and officers of corporations owe three kinds of fiduciary duties to the corporations they manage: care, good faith and loyalty.[1] Ordinarily, shareholders enforce those duties. But when a corporation is insolvent, while directors and officers still owe their fiduciary duties to the corporation, a new group of interested parties — creditors— gains standing to enforce those fiduciary duties.[2]

Through the investigatory tools available in a Chapter 11 case, discussed in detail below, creditors often investigate and challenge transactions and conduct as fiduciary breaches that might not otherwise be unlawful. For example, decisions: to increase inventory levels; to reorganize corporate structures; to increase executive compensation, severance payments, and expense reimbursements; to not abide by corporate formalities; to acquire assets; to purchase stock; and to close facilities have all recently been

challenged as fiduciary duty breaches.


Patrick Thomas

Moreover, under certain circumstances, seemingly ordinary transactions may be subject to fraudulent transfer claims if the transaction occurred while the debtor was insolvent, or caused the debtor to become insolvent.[3] Thus, in addition to breach of fiduciary duty claims, creditors have prosecuted a panoply of other causes of action, including:

- Fraudulent transfer;[4]
- Equitable subordination;[5]
- Debt characterizations;[6]
- Avoidance actions;[7]
- Disallowance;[8]
- Corporate waste;[9]
- Lawful distribution actions;[10]
- Turnover;[11] and
- Racketeering influenced and corrupt organizations act violations.[12]

Thus, white collar lawyers conducting bankruptcy investigations must be aware that bankruptcy investigations will often encompass a broader spectrum of conduct than typical internal investigations.

Understanding the relevant scope of the investigation is half the battle; the other half is utilizing the tools available in bankruptcy cases to properly execute that investigation. Before discussing the principal investigatory tool — Bankruptcy Rule 2004 — it is helpful to compare a bankruptcy investigation to a traditional internal investigation.

In the typical scenario, an entity engages a white collar practitioner to conduct an internal investigation in response to a particular incident. The entity is motivated to cooperate with the investigation — even if individuals within the entity are not — to achieve the desired outcome.

Witnesses and documents are made available upon request, and the majority of the investigation is conducted confidentially. Witness interviews are not under oath, and the witness is given appropriate notice of who the investigator represents. The investigation's findings are usually reduced to written form, e.g., a report or presentation, and delivered to a small group of people who are tasked with implementing the investigators' recommendations.

White collar practitioners should, in the first instance, consider whether this typical informal and confidential approach to internal investigations is appropriate in the context of a bankruptcy; often this approach will afford a greater degree of transparency from the debtor or third party being investigated. Exploring this approach is also consistent with the fiduciary duty each estate professional has to act in a manner that preserves estate resources.

And, at least with respect to former employees or third parties, there is no obligation to proceed on notice — i.e., including your adversary in witness interviews or sharing documents received (though other considerations may counsel in favor of doing so). Proceeding informally and without adversary process often leads to a more free and efficient exchange of information.

That said, it is usually the case that, in order to obtain information, white collar practitioners conducting investigations will need to use the formal procedure set forth in Bankruptcy Rule 2004 to obtain the information sought. Bankruptcy Rule 2004 provides that on the motion of any party in interest, a bankruptcy court may order the examination and the production of documentary evidence concerning any matter that relates:

> to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or ... any matter relevant to the case or the formulation of a plan.[13]

To that end, "[t]hird parties having knowledge of the debtor's affairs as well as a debtor itself, are

subject to examination."[14] The scope of a Rule 2004 examination is "unfettered and broad," as the plain language of the rule indicates.[15] Courts have repeatedly recognized that the scope of Rule 2004 examinations is akin to a fishing expedition.[16] Indeed, Bankruptcy Rule 2004 affords parties-in-interest an extremely broad right of discovery and "is even broader than that of discovery permitted under [the Federal Rules of Civil Procedure], which themselves contemplate broad, easy access to discovery."[17]

Rule 2004 is designed to "assist a party in interest in determining the nature and extent of the bankruptcy estate, revealing assets, examining transactions and assessing whether wrongdoing has occurred."[18] It permits discovery "to determine the extent of the estate's assets and recover those assets for the benefit of creditors."[19]

Even in instances in which estate representatives try to ascertain whether or not to pursue estate claims, Rule 2004 is recognized as a proper prelitigation device that can uncover facts and circumstances that may demonstrate whether a debtor's estate holds a claim against a third party and the strength of any such claim. Courts have recognized that "[o]ne of the primary purposes of a Rule 2004 examination is as a pre-litigation device."[20]

Though far broader than discovery available in typical federal civil proceedings, Rule 2004 is not without its limits. The most recognized limitation on Rule 2004 examinations is the pending proceeding rule, which states that, "once an adversary proceeding or contested matter is commenced, discovery should be pursued under the Federal Rules of Civil Procedure," and not Rule 2004.[21] The pending proceeding rule ensures that parties cannot circumvent an adversary's rights by utilizing Rule 2004 to assist with a pending action.[22]

The rule is not limited to federal actions; state court proceedings are pending proceedings within the meaning of the rule as well.[23] And there are some cases that suggests that once a party has discovered sufficient evidence to commence an adversary proceeding, it can no longer use Rule 2004 and must abide by the traditional rules of discovery.[24]

The second notable limitation to Rule 2004 is that it is not an automatic right conferred upon a party in interest in a bankruptcy case. That is, unlike discovery in a civil proceeding — in which a party can issue documents requests or subpoenas without leave of the court — the ability to issue a subpoena or demand pursuant to Rule 2004 must be sought from, and approved by, the bankruptcy court:

> The party seeking Rule 2004 discovery has the burden to show good cause for the examination it seeks, and relief lies within the sound discretion of the Bankruptcy Court.[25]

Among other things, the party seeking Rule 2004 power must show that the proposed examination "is necessary to establish the claim of the party seeking the examination, or ... denial of such request would cause the examiner undue hardship or injustice."[26] Moreover, some jurisdictions, like Delaware, have local rules that require a party to seek voluntary compliance from the examinee prior to filing a Rule 2004 motion.

Given the relatively low threshold to obtain Rule 2004 power, and few limitations thereon, white collar practitioners should not hesitate to use the specter of a Rule 2004 examination, and any attendant litigation, as leverage to obtain voluntary cooperation with document or interview requests. Moreover, it is common that even after the Rule 2004 motion is filed, parties become more amenable to agreeing on discovery requests and resolutions for consensual 2004 examinations are entered.

Because bankruptcy investigations are so specialized, it will be particularly important for creditors seeking relief to hire counsel experienced in this area. Bankruptcy investigations must often be conducted quickly and tactical decisions made with little information. A successful investigative team must have a depth of knowledge in the bankruptcy arena in order to achieve maximum value for creditors prosecuting claims.

Rachel Maimin is a partner at Lowenstein Sandler LLP. Previously, she was a federal prosecutor at the U.S. Attorney's Office for the Southern District of New York.

H. Gregory Baker is a partner at Lowenstein Sandler and former senior counsel at the U.S. Securities and Exchange Commission.

Michael A. Kaplan is counsel at Lowenstein Sandler.

C. Patrick Thomas is an associate at the firm.

[1] See e.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

[2] Quadrant Structured Prod. Co. v. Vertin, 102 A.3d 155, 176 (Del. Ch. 2014).

[3] See 11 U.S.C. § 548 (authorizing fraudulent transfer claim where, among other things, the debtor "was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation.").

[4] Pursuant to 11 U.S.C. § 548 and applicable state law.

[5] Pursuant to 11 U.S.C. § 510 and applicable state law.

[6] Pursuant to applicable state law.

[7] Pursuant 11 U.S.C. § 502 and applicable state law.

[8] Pursuant to 11 U.S.C. § 506.

[9] Pursuant to applicable state law.

[10] Pursuant to applicable state law, see e.g., 6 DE Code § 18-607.

[11] Pursuant to 11 U.S.C. §542 and applicable state law.

[12] Pursuant to 18 U.S.C. § 1962(c) and applicable state law.

[13] Fed. R. Bankr. P. 2004; see also Harrow v. Street (In re Fruehauf Trailer Corp.), 369 B.R. 817, 827-28 (Bankr. D. Del. 2007) (noting the "extensive document discovery" that occurred pursuant to a subpoena issued under Fed. R. Bankr. P. 2004).

[14] In re Valley Forge Plaza Assoc., 109 B.R. 669, 674 (Bankr. E.D. Pa. 1990).

[15] See 9 Collier on Bankruptcy ¶ 2004.02[1] at 2004-6 (15th ed Rev. 1997) (quoting In re Table Talk, Inc., 51 B.R. 143, 145 (Bankr. D. Mass. 1985)).

[16] In re Countrywide Home Loans, Inc., 384 B.R. 373, 400 (Bankr. W.D. Pa. 2008) (citing In re Lev, No. 05-35847, 2008 WL 207523, at *3 (Bankr. D.N.J. Jan. 23, 2008); In re Silverman, 36 B.R. 254 (Bankr. S.D.N.Y. 1984); In re Vantage Petroleum Corp., 34 B.R. 650 (Bankr. E.D.N.Y. 1983)).

[17] In re Valley Forge Plaza Assocs., 109 B.R. 669, 674 (Bankr. E.D. Pa. 1990) (citations omitted).

[18] In re Recoton Corp., 307 B.R. 751, 755 (Bankr. S.D.N.Y. 2004); see also In re Teleglobe Commc'ns Corp., 493 F.3d 345, 354 n. 6 (3d Cir. 2007) (Rule 2004 allows parties with an interest in the bankruptcy estate to conduct discovery into matters affecting the estate).

[19] In re Madison Williams & Co., LLC, No. 11-15896, 2014 WL 56070, at *3 (Bankr. S.D.N.Y. Jan. 7, 2014).

[20] See e.g., Wash. Mut., 408 B.R. at 53.

[21] In re Sunedison, Inc. , 572 B.R. 482, 490 (Bankr. S.D.N.Y. 2017).

[22] Id.

[23] Id.

[24] See e.g., In re Washington Mut., Inc ., 408 B.R. 45, 50 (Bankr. D. Del. 2009) (collecting cases).

[25] In re AOG Entm't, Inc , 558 B.R. 98, 108 (Bankr. S.D.N.Y. 2016).

[26] Id. at 109.
