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The Role of a Creditors' Committee to Investigate, Preserve, and Pursue Causes of Action in Crypto Bankruptcies

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Lowenstein Sandler's previous articles on crypto bankruptcies discussed the role of a creditors' committee in protecting the rights of customers and confirmation issues arising in crypto cases. This article will delve deeper into the administration of a crypto bankruptcy case by discussing the role of a creditors' committee in investigating, preserving, and pursuing causes of action for the benefit of a debtor's creditors.

In a Chapter 11 case, the committee is empowered to oversee and investigate the past and current business of the debtor and the conduct of management and others. The committee, by right, may request documents, depose the debtor's management and board of directors, subpoena records, and generally use any appropriate form of discovery for its inquiry. It is imperative for the committee to understand the true causes of the debtor's Chapter 11 filing and how the Chapter 11 process can maximize recovery for unsecured creditors. However, in most Chapter 11 cases, a debtor's pre-bankruptcy management remains in place, controlling the administration of the Chapter 11 case for the benefit of management and other insiders. As a result, many Chapter 11 debtors fail to properly investigate the causes of bankruptcy and the potential causes of action that may exist against management and insiders. Moreover, as discussed in more detail below, in many cases a debtor will seek releases of management and insiders in a bankruptcy plan to ensure the committee cannot pursue recovery from such parties.

The Committee's Investigation

Upon its appointment in a crypto case, the committee will likely review the following issues as part of its investigation:

- Conduct by management and other insiders prior to the bankruptcy filing, potentially including undertaking excessive risk, misleading customers and other creditors about the debtor's risk profile, insider trading of coins (especially prior to implementing a customer freeze), and market manipulation of crypto assets.
- Excessive compensation of management and board members, including bonuses, pay increases, and other forms of compensation prior to the debtor's bankruptcy filing, and in some instances after the filing.
- Any investigations conducted by governmental agencies, including the SEC, against the debtor or its management and/or insiders.
- Any significant business transaction that saddled the debtor with excessive debt, resulted in inadequate working capital, or exposed the debtor to significant risk.
- Any new financing or amendments to financing that may have been above the market rate, imposed onerous covenants, or provided the lender with new collateral or a better priority of repayment. This investigation would include lending of the debtor's own crypto assets and loans using customers' crypto assets.
- Prepetition marketing efforts to sell the debtor's business or assets and whether such efforts preferred insiders and management instead of maximizing returns for general unsecured creditors.

In addition to the committee's ability to investigate, the Bankruptcy Code provides grounds for the mandatory or permissive appointment of an examiner. The appointment of an examiner is a less drastic alternative to the appointment of a bankruptcy trustee, providing an independent third party to investigate the debtor's assets and liabilities generally. An examiner can be appointed for limited purposes so as to not duplicate the investigative

efforts of the committee. Upon the conclusion of its investigation, the examiner typically files a public report of its findings, including whether potential causes of action exist.

In the bankruptcy cases of Celsius Network LLC and its affiliated entities, the Office of the United States Trustee moved for the appointment of an examiner, and the committee filed a limited objection. The committee supported the appointment of an examiner, but only with a limited investigative scope in order to avoid duplication of the investigation already being conducted by the committee. The limited scope of the appointed examiner includes an examination of Celsius' prepetition crypto holdings and Celsius' prepetition change in account offerings for certain customers. The examiner's findings, in conjunction with the committee's own investigation, will almost certainly shape the future of Celsius' bankruptcy cases and help determine if management committed any wrongdoing.

Preserving Causes of Action

The committee must be vigilant to preserve causes of action for general unsecured creditors as there are many instances in the administration of a bankruptcy case where causes of action may be assigned, sold, or released with little or no value flowing to general unsecured creditors.

Typically, the first instance in any bankruptcy case where causes of action may be lost is through a motion to approve debtor-in-possession (DIP) financing. Nearly all DIP financing motions provide that the debtor will grant liens on all unencumbered assets to the proposed DIP lender, including causes of action and the proceeds of such actions. Courts typically only approve such provisions subject to the entry of final DIP financing orders, as interim financing orders are usually entered after the first day of the hearing, before a committee is appointed. For this reason, one of the first critical duties of the committee is to negotiate revised terms with the proposed DIP lender to ensure that liens do not attach to causes of action or their proceeds.

Additionally, in a bankruptcy sale process, the committee must ensure that causes of action are excluded from the assets being conveyed unless the purchaser pays fair value for them. Customarily, the winning bidder in a going concern sale will seek to acquire certain causes of action and "bury" them, as the winning bidder intends to continue a relationship with the potential defendants, such as vendors and current management. Unless adequate consideration is carved out for general unsecured creditors, the committee may decide to object to a sale that seeks to convey estate causes of action.

Finally, the committee must be involved in the negotiation of any plan of reorganization or liquidation in a bankruptcy case to ensure, where appropriate, that causes of action are preserved for general unsecured creditors and not released. The most common types of releases included in bankruptcy plans are indemnification and exculpation clauses, which provide releases for the debtor's officers, employees, and agents for conduct related to the bankruptcy case. Bankruptcy courts generally require these provisions to be narrowly tailored, but they are commonly allowed. Similarly, third-party releases, which release creditors' claims against *non-debtor* third-parties for conduct that predates, and generally is not related to the bankruptcy case, are frequently sought by debtors and other interested parties in Chapter 11 bankruptcy cases. These releases, if granted, typically eliminate the ability of creditors to seek recovery from such parties for their wrongdoing. While the law on third-party releases is complicated and differs substantially in various jurisdictions, the committee must carefully evaluate any third-party releases contained in a Chapter 11 plan to ensure that improper releases are not granted.

Pursuing Causes of Action

Once causes of action are identified and preserved, the committee must implement a mechanism to obtain recoveries on account of such causes of action.

Under the Bankruptcy Code, all of a debtor's interests in property become property of the bankruptcy estate, including causes of action the debtor could have asserted prior to the bankruptcy, and a DIP is given control over the bankruptcy estate and the assets comprising the estate (unless a trustee is appointed). Derivative claims against third parties arise from injuries to the estate more generally and thus belong to the estate and are controlled by the debtor, not creditors themselves.

The committee may seek derivative standing where the debtor is reluctant to bring claims against insiders or against certain preferred creditors whose goodwill they want to maintain, or where existing management is unwilling to sue on a matter if it was involved in the alleged misconduct.

As a threshold issue, a court must determine whether a litigant has the right to pursue claims before the court can adjudicate the dispute, a legal concept known as "standing." In the bankruptcy context, various provisions of the Bankruptcy Code confer standing on various entities to, among other things, participate generally in a bankruptcy case or commence litigation involving causes of action or claims that either belonged to the debtor prior to filing for bankruptcy or are created by the Bankruptcy Code.

Section 1109(b) of the Bankruptcy Code provides that any "party in interest," including the debtor, the trustee, a committee of creditors or equity security holders, a creditor, an equity security holder, or an indenture trustee, "may appear and may be heard on any issue" in a Chapter 11 case. This general right to participate, however, does *not* confer standing upon every party in interest to engage in litigation on behalf of the estate. Standing to prosecute estate claims is expressly given by the Bankruptcy Code to the DIP or a bankruptcy trustee. Most courts, however, will allow a committee to commence litigation on behalf of the estate under narrowly defined circumstances.

In the Second Circuit, a committee may bring suit even if the DIP justifiably refuses to do so as long as (i) the DIP consents and (ii) the court finds that the litigation is (a) in the best interests of the estate and (b) necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings. *See Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.)*, 262 F.3d 96 (2d Cir. 2001). Where a debtor fails to provide consent to a committee, the committee may have derivative standing to initiate an action where the following requirements have been met: (i) a demand has been made upon the debtor to take action, (ii) the demand is declined, (iii) a colorable claim that would benefit the estate, if successful, exists, based on a cost-benefit analysis performed by the court, and (iv) the inaction is an abuse of discretion in light of the debtor's duties in a Chapter 11 case.

Standing may also be conferred to specific parties under a confirmed bankruptcy plan, such as where estate claims are assigned to a post-confirmation trust. A post-confirmation trustee, in its capacity as a representative of the estate, is treated as a successor to the DIP or trustee and the prepetition debtor on the matters assigned and is generally bound by their acts and omissions.

Lowenstein continues to monitor crypto bankruptcy cases and the entire crypto market for new developments and will be publishing additional articles providing more detail regarding the issues summarized above.

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