

WHEN YOUR CLIENT IS UNDER INVESTIGATION: WHAT BANKRUPTCY CHANGES—AND WHAT IT DOESN'T

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CLIENTS UNDER CRIMINAL OR REGULATORY investigation often ask: *Should we file bankruptcy?* The implicit assumption is that a bankruptcy filing will delay or stop government action or protect assets from things like forfeiture or restitution awards.

The Bankruptcy Code, however, is designed to address financial distress, not to provide shelter from criminal or regulatory enforcement. While bankruptcy can affect financial remedies, it rarely alters or slows the government's ability to investigate, charge, or prosecute. Indeed, in some cases, bankruptcy results in increased exposure through required disclosures, testimony, and asset transparency.

This article focuses on this question: *If your client is under investigation, what does bankruptcy actually change?* The short answer is that bankruptcy changes the process and, in some circumstances, the distribution of the debtor-target's assets but generally does not interfere with the government's ability to investigate, prosecute, or enforce remedies other than money judgments.

The Persistent Myth: Bankruptcy as a "Pause Button"

The misconception that bankruptcy stops government action is understandable. The automatic stay contained in section 362(a) of the Bankruptcy Code (11 U.S.C. §§ 101 *et seq.*) is one of the Bankruptcy Code's most powerful features, and in many civil contexts it immediately halts litigation. Clients—and sometimes non-bankruptcy lawyers—assume that the stay is universal. It is not.

Bankruptcy does not insulate debtors from the consequences of criminal and most regulatory wrongdoing. Key exceptions to the automatic stay demonstrate Congress's policy judgment that bankruptcy should not interfere with the exercise of police and regulatory powers.

Criminal Proceedings Are Not Stayed

The clearest rule in this area is also the most frequently misunderstood. Criminal proceedings are categorically excluded from the automatic stay. The Bankruptcy Code unequivocally provides that bankruptcy "does not operate as a stay . . . of the commencement or continuation of a criminal action or proceeding against the debtor." 11 U.S.C. § 362(b)(1).

A bankruptcy filing, thus, does not stay criminal investigations, grand jury proceedings, indictments, prosecutions, sentencing, appeals, or even post-sentencing actions to enforce

probation or restitution for individuals or corporations, whether the wrongful conduct occurred before or after the bankruptcy started. *See, e.g., U.S. v. Colasuonno*, 697 F.3d 164, 173-76 (2d Cir. 2012) (explaining the logically broad definition of "criminal proceedings"); *In re Gruntz*, 202 F.3d 1074, 1085-87 (9th Cir. 2000) (same). In practical

terms, this means bankruptcy does not justify ignoring subpoenas, refusing interviews, or delaying interaction with law enforcement, either pre- or post-conviction. Prosecutors do not operate on a bankruptcy court's schedule, and the bankruptcy court has no authority to supervise or control criminal or regulatory enforcement.

Although bankruptcy courts retain the equitable power to enjoin criminal proceedings in extraordinary circumstances, they rarely, if ever, do. Once a matter falls within the criminal exception, the burden shifts entirely to the debtor to convince the bankruptcy court that continuation of criminal proceedings should be enjoined. *See, e.g., In re Fussel*, 928 F.2d 712, 715-16 (5th Cir. 1991) (enjoining criminal proceedings is only appropriate where: (1) the party requesting the injunction is without adequate remedy at law; (2) the party stands to suffer irreparable injury that is both great and immediate; (3) the threatened injury relates to federally protected rights and cannot be eliminated by a defense against a single criminal

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prosecution; and (4) where expressly authorized by Congress or when necessary in aid of the bankruptcy court's jurisdiction or to protect or effectuate its judgments).

Civil Enforcement and the Police and Regulatory Power Exception

Bankruptcy also often does not halt the exercise of a governmental unit's police or regulatory powers. Section 362(b)(4) exempts police and regulatory powers from the automatic stay as follows:

. . . does not operate as a stay . . . of the commencement of continuation of an action or proceeding by a governmental unit . . . to enforce such governmental unit's or organization's police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental units' or organization's police or regulatory power . . . ;

11 U.S.C. § 362(b)(4).

Courts determine whether this exception applies by examining the purpose of the governmental action. If the government action is intended to protect public health, safety, welfare, or to deter unlawful conduct by regulating or enjoining the conduct giving rise to enforcement of police or regulatory power, it is likely to proceed despite bankruptcy. If, by contrast, the action is merely an attempt to collect a debt, impose a fine, or obtain a pecuniary advantage, the action may be allowed to proceed to determine the amount owed, but it is more likely to be stayed. This distinction explains why many civil enforcement actions—environmental, securities, consumer protection, healthcare, and regulatory investigations—continue after a bankruptcy filing, whether the relief sought is injunctive or to establish the amount owed. *See, e.g., In re McMullen*, 386 F.3d 320, 324-330 (5th Cir. 2004) (discussing the framework to determine whether an action falls inside or outside section 362(b)(4)).

Moreover, bankruptcy may impact the ultimate outcome of an investigation. Even where the government proceeds to judgment, enforcement of money judgments remains subject to bankruptcy's priority and distribution scheme.

The Illusion of “Breathing Room”

Clients often ask whether bankruptcy will provide breathing room in responding to an investigation. From a government-enforcement perspective, the answer is usually no. Prosecutors

and regulators pursue investigations on their own timelines and based on their own enforcement priorities, not based on bankruptcy timelines. Filing bankruptcy does not pause interviews, suspend compliance with investigative demands, or defer charging decisions, absent agreement or extraordinary circumstances.

Where Bankruptcy Does Matter

Although bankruptcy does not stop investigations, it can affect remedies.

Compensatory vs. Punitive Claims – Bankruptcy law distinguishes between compensatory claims (intended to make governmental unit whole) and punitive or penal claims (intended to punish or deter) arising from pre-bankruptcy conduct. That distinction matters. While pre-bankruptcy compensatory governmental claims are classified with other pre-bankruptcy general unsecured claims, punitive fines and penalties may be subordinated behind those general unsecured claims for distributions purposes, *see* 11 U.S.C. § 726(a)(4), even though those fines and penalties, as set forth below, are generally nondischargeable.

Dischargeability – For individuals, many government-related debts are nondischargeable. Criminal fines and fraud-based liabilities, securities-law violations, tax-related fraud, and other enforcement-driven debts frequently survive bankruptcy intact. *See, e.g.,* 11 U.S.C. § 523(a)(2), (4), (6), (7). For corporate debtors, discharge operates differently, often relieving debtors of these kinds of prepetition debts. This does not eliminate criminal exposure or immunize officers, directors, or the entity itself from prosecution. Bankruptcy does not cleanse criminal liability.

Chapter 11 Leverage – In Chapter 11, bankruptcy can affect negotiating leverage. Any global resolution with the government must be incorporated into a bankruptcy court approved settlement or confirmable plan. Once a plan is proposed and negotiated, flexibility narrows. Timing also matters because settlements reached early may look very different from those reached after confirmation dynamics take hold. This is where bankruptcy can influence outcomes—not by stopping enforcement, but by constraining available resolutions.

Forfeiture – Although beyond the scope of this article, we note that if the government seeks criminal or civil forfeiture of a debtor's assets, there are additional bankruptcy implications. Under 21 U.S.C. § 853(c), assets subject to forfeiture, that is assets or their proceeds that derive from the criminal or unlawful civil conduct, vest in the federal government as

of the date the improper conduct commenced. Texas law also contains a criminal forfeiture provision, although vesting typically does not occur until a final judgment is rendered. TEX. CODE CRIM. P. §§ 59.01 *et seq.* In these circumstances, there may well be a dispute as to whether any assets are available for distribution to creditors through the bankruptcy.

Bankruptcy as an Evidence-Generating Process

One of the most underappreciated aspects of bankruptcy is its mandatory disclosure regime. Debtors must file petitions, schedules of assets and liabilities, and statements of financial affairs that account for certain dispositions of property and identify who has relevant books and records, under penalty of perjury. They must appear at Section 341 meetings and answer questions under oath. They may be examined under oath pursuant to Federal Rule of Bankruptcy Procedure 2004, which provides for broader than ordinary civil discovery. From a criminal perspective, this is a high-risk environment. Many bankruptcy-related prosecutions do not arise from the misconduct that prompted the filing, but from *what happens next*: false statements, omissions, inconsistent disclosures, concealment of assets, or obstruction of the bankruptcy process. *See, e.g.*, 18 U.S.C. §§ 152 (concealment of assets; false oaths and claims; bribery), 153 (embezzlement against estate), 156 (knowing disregard of bankruptcy law or rule), 157 (bankruptcy fraud).

Bankruptcy judges, the United States Trustee and chapter 7 or chapter 11 trustees have statutory reporting obligations for suspected bankruptcy-related crimes. 18 U.S.C. § 3057(a) (“Any judge, receiver, or trustee having reasonable grounds for believing that any violation under chapter 9 of this title [governing bankruptcy crimes] or other laws of the United States relating to insolvent debtors . . . has been committed . . . shall report to the appropriate United States attorney all the facts and circumstances of the case . . .”). Referrals, however, are often confidential and prosecution of bankruptcy related crimes by United States attorneys is discretionary and unevenly pursued.

For clients already under investigation, bankruptcy can function as a force multiplier, generating sworn testimony and documentary evidence for prosecutors.

How Criminal Investigations Play Out in Bankruptcy

Bankruptcy and criminal enforcement tend to interact in one of two ways: *coordination*, where bankruptcy becomes part of the government’s resolution strategy, or *parallelism*, where the criminal case proceeds independently of the bankruptcy process. Two cases—*In re Purdue Pharma L.P.*

and *In re FTX Trading Ltd.*—illustrate these models.

Purdue illustrates a coordinated model in which bankruptcy served as the implementation forum for a global criminal and civil resolution. The Department of Justice negotiated a settlement that was expressly embedded in the chapter 11 case and subject not only to federal district court approval in the jurisdiction where the criminal indictment was issued but also to bankruptcy-court approval. Bankruptcy was not a brake on enforcement; it was the mechanism through which the government structured victim compensation and corporate reform. Key features of this coordination included: (i) the criminal and civil resolution was designed to be approved and enforced through the chapter 11 process, tying compliance and payments to plan confirmation; (ii) the settlement traded criminal exposure for fixed payments and structural commitments, similar to a consent agreement, but enforced through bankruptcy; and (iii) government and bankruptcy interests converged around victim recovery and institutional reform, even as the structure drew criticism for pushing policy decisions into the bankruptcy forum. *See, e.g.*, Adam J. Levitin, *Purdue’s Poison Pill: The Breakdown of Chapter 11’s Checks and Balances*, 100 Tex. L. Rev. 1079 (2022); Judith Resnik, Alexandra D. Lahav, Elizabeth Chamblee Burch & Charles Silver, *Against Bankruptcy: Public Litigation Values versus the Endless Quest for Global Peace in Mass Litigation*, 133 Yale L.J. Forum 525 (2024).

Purdue demonstrates that when the government chooses to coordinate, bankruptcy can facilitate a comprehensive resolution.

FTX illustrates the opposite end of the spectrum: no documented coordination between the chapter 11 process and the criminal prosecution. The bankruptcy filings began almost immediately after the company’s collapse in November 2022, but the criminal case against Sam Bankman-Fried proceeded on a completely independent track. Indictment, trial, conviction, and sentencing all occurred on the prosecutors’ timetable, apparently without regard to chapter 11 dynamics. *See* Press Release, U.S. Dep’t of Justice, Office of the U.S. Attorney, S.D.N.Y., *United States Attorney Announces Charges Against FTX Founder Samuel Bankman-Fried* (Dec. 13, 2022), <https://www.justice.gov/usao-sdny/pr/united-states-attorney-announces-charges-against-ftx-founder-samuel-bankman-fried>; Press Release, U.S. Dep’t of Justice, Office of the U.S. Attorney, S.D.N.Y., *Statement of U.S. Attorney Damian Williams on the Conviction of Samuel Bankman-Fried* (Nov. 2, 2023), <https://www.justice.gov/usao-sdny/pr/statement-us-attorney-damian-williams-conviction-samuel-bankman-fried>; U.S.

Dep't of Justice, Office of Public Affairs, *Samuel Bankman-Fried Sentenced to 25 Years in Prison for His Orchestration of Multiple Fraudulent Schemes* (Mar. 28, 2024), <https://www.justice.gov/archives/opa/pr/samuel-bankman-fried-sentenced-25-years-his-orchestration-multiple-fraudulent-schemes>. In that sense, *FTX* confirms that bankruptcy does not constrain criminal enforcement.

At the same time, *FTX* shows a more subtle – but important – point for practitioners. Although there was no coordination on prosecution, bankruptcy became a central forum for recovery and regulatory resolution. Civil regulators coordinated with the *FTX* estate on settlements designed to support creditor distributions, and the chapter 11 process marshaled assets and structured payouts. *See, e.g.*, Press Release, *CFTC Obtains \$12.7 Billion Judgment Against FTX and Alameda* (Aug. 8, 2024), <https://www.cftc.gov/PressRoom/PressReleases/8938-24> (announcing that a federal district court entered a consent order in the CFTC's litigation requiring *FTX* and *Alameda* to pay \$12.7 billion in restitution and disgorgement to victims, and that in a related settlement approved in the bankruptcy case, the CFTC agreed to subordinate its claims so that victim compensation could be prioritized). That coordination, however, stopped at the edge of criminal law. Prosecutors moved forward independently, even as regulators and the estate worked in parallel to maximize creditor and victim recoveries.

The practical lesson from these cases is that bankruptcy may become the venue for asset recovery and civil settlements, but it should not be expected to slow, shape, or moderate a criminal case.

Practical Takeaways for Counsel

For lawyers advising clients under investigation:

1. Do not assume bankruptcy stops investigations. It does not.
2. Expect enforcement to continue on its own timeline. Prosecutors and regulators are not constrained by bankruptcy procedure.
3. Recognize bankruptcy as a criminal-risk event. Mandatory disclosures and testimony can create new or expanded exposure.
4. Distinguish enforcement from collection. Bankruptcy may reshape remedies and priority; it will not negate culpability or permit unlawful conduct to continue.

Conclusion: Bankruptcy Can Change Outcomes but Not Accountability

The Bankruptcy Code preserves the government's enforcement authority by design. Criminal proceedings continue. Regulatory investigations proceed. The automatic stay was never meant to be a sanctuary from the consequences of unlawful conduct.

What bankruptcy can change is the financial landscape: priorities, economic remedies, leverage, and process. It can facilitate global resolutions, protect estates, and promote victim recovery. But it does not erase accountability. And in many cases, it brings accountability into sharper focus.

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