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Recent Demand for Examiners in Major Chapter 11 Cases Highlights Ambiguity in the Code

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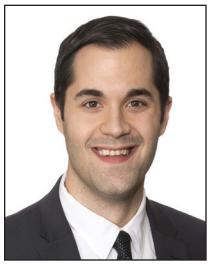

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The role for examiners in chapter 11 cases, as contemplated by § 1104(c) of the Bankruptcy Code, is inherently controversial, and has been so since the concept was first introduced in the American bankruptcy system, prior to the modern Code. At the present moment, when major chapter 11 cases are as high-profile as they have ever been, if not more so, the potential involvement of examiners in overseeing the past and present actions of debtors in possession has come back into focus.

Let's examine two examples. On Dec. 15, 2021, the U.S. Trustee filed a motion in the chapter 11 case of LTL Management LLC (a subsidiary of Johnson & Johnson) seeking the appointment of a bankruptcy examiner to consider the debtor's use of the "Texas Two-Step," a relatively untested method of separating a company's assets from large liabilities such as the mass tort claims faced by LTL.[2] On Dec. 20, 2021, a small group of creditors in the cases of Grupo Aeroméxico, S.A.B. de C.V., and its debtor affiliates urged the U.S. Trustee to file a similar motion seeking the appointment of an examiner to investigate alleged conflicts of interest and transparency concerns related to the treatment of insiders under a proposed reorganization plan.

Underlying both requests was an ambiguity that has persisted in the Bankruptcy Code for decades: Under what circumstances *must* a bankruptcy court grant a request for the appointment of an examiner, and how much discretion may the court exercise in determining its mandate? Examiners can be afforded broad authority to investigate a debtor at the debtor's expense, to publicize the results of that investigation, and to even recommend further legal action based on the results of their investigation.

Section 1104(c) of the Bankruptcy Code provides that in a chapter 11 case in which no trustee is appointed, the bankruptcy court "shall order" the appointment of an examiner "to conduct such an investigation of the debtor as is appropriate ... if ... such appointment is in the interest of creditors, any equity security holders, and other interests of the estate,"[3] or if "the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000."[4] In turn, an examiner's duties are set out in § 1106, which requires the examiner, "except to the extent that the court orders otherwise, [to] investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan," and to file a report regarding that investigation.[5]

Some courts interpret § 1104(c)(2) as mandating the appointment of an examiner (upon the request of a party-in-interest),[6] while others choose to circumscribe an examiner's activities by curtailing its authority or budget.[7] Other courts have found that notwithstanding the "shall order" language, appointment is *not* mandatory.[8]

The question of the proper role for examiners is not merely academic. They may have broad investigative powers, they can serve an important "estate neutral" function, and their findings can induce parties to reach consensual settlements, identify issues in the debtor's business practices, or surface valuable pre-petition claims, fraudulent conveyances or preferential transfers. On the other hand, examiners' costs are borne by the debtors' estates, the role of an examiner (or the threat of a motion to appoint one) can be used solely for inappropriate leverage by creditor groups, and there often are legitimate concerns about duplications of efforts by other estate professionals.

However, the varying approaches taken by bankruptcy courts with respect to whether such appointments are mandatory creates unnecessary opportunities for gamesmanship and can hamper courts' ability to craft appropriate limitations on an

1 The views expressed herein are those of the authors and not those of Cleary Gottlieb Steen & Hamilton LLP.

2 At the bankruptcy court's request, the motion was subsequently withdrawn without prejudice. *See also* Jeffrey R. Gleit & Matthew R. Bentley, "When the Music Stops: The Texas Two-Step and Forecasting Its Future Application," XL *ABI Journal* 12, 12, 52-53, December 2021, *available at* abi.org/abi-journal.

3 11 U.S.C. § 1104(c)(1).

4 11 U.S.C. § 1104(c)(2).

5 11 U.S.C. § 1106(a)(3)-(4).

6 *See, e.g., In re Loral Space & Commc'ns Ltd.*, 2004 WL 2979785, at *5 (S.D.N.Y. Dec. 23, 2004).

7 *See, e.g.*, Hr'g Tr. at 167:11-170:22, ECF No. 546, *In re Innkeepers USA Trust*, No. 10-13800 (Bankr. S.D.N.Y. Sept. 30, 2012); *In re Erickson Retirement Communities LLC*, 425 B.R. 309, 317 (Bankr. N.D. Tex. 2010); *In re Asarco LLC*, Case No. 05-21207 (Bankr. S.D. Tex. March 4, 2008), ECF. No. 7081.

8 *See, e.g., In re Spansion Inc.*, 426 B.R. 114, 128 (Bankr. D. Del. 2010).

examiner's function. Replacing the operative word "shall" in § 1104 with the permissive "may" would make it clear that the appointment of an examiner, and the extent of its mandate, should be left to the bankruptcy court's discretion.

The Disagreement Among Courts

Despite the existence of examiners in the U.S. bankruptcy system for more than 80 years, courts continue to disagree as to whether § 1104(c)(2) currently *requires* the appointment of an examiner for debtors with debts exceeding $5 million. Indeed, according to a 2016 study, only 46 percent of requests for the appointment of an examiner were granted, which is a surprisingly low number given the seemingly mandatory language of § 1104.[9] The disagreement stems in part from concerns about the potential breadth of an examiner's role, the costs an investigation might impose on the debtor's estate, and the proportionality between those costs and the potential benefits to estate stakeholders.

Congress, for its part, appeared to assume that § 1104 would lead to the routine appointment of examiners. In connection with the last substantive amendment to the provision, one senator remarked that "[t]here will automatically be appointed an examiner in [large cases], but not a trustee," and that examiners would provide "special protection for the large cases having great public interest."[10] The Sixth Circuit — the only court of appeals to have considered the question to date — expressed a similar sentiment, holding that examiners should be common in all chapter 11 cases, and that in cases involving debts greater than $5 million, where a motion is properly brought "the statute requires the court to appoint an examiner."[11]

Many bankruptcy judges have taken the opposite view. Hon. **Robert E. Gerber**, a prominent former bankruptcy judge in the Southern District of New York, opined in 2009 in *In re Lyondell Chem. Co.* that "mandatory appointment [of examiners] is terrible bankruptcy policy, and the Code should be amended, forthwith, to ... give bankruptcy judges (subject to appellate review, of course) the discretion to determine when an examiner is necessary and appropriate."[12] Hon. **Kevin J. Carey**, a former bankruptcy judge in the District of Delaware, came to a similar conclusion in *In re Spansion*, rejecting the workaround used by some bankruptcy courts appointing an examiner with limited or no authority.[13]

One of the most high-profile uses of an examiner in recent history was in the chapter 11 proceedings of *Residential Capital LLC* (*ResCap*), in which Hon. **Martin Glenn** held that the "shall order" language is limited by subsequent language that refers to "an investigation of the debtor as is appropriate."[14] Judge Glenn looked to legislative history to hold that appointment of an examiner is not mandatory in cases where "evidence establishes that the protection of an examiner is not needed under the facts and circumstances of the case," where, for example, the motion seeking the appointment of an examiner was filed as a litigation tactic, or the requested investigation is not necessary, or the requested investigation would be duplicative of work already carried out by another party.[15] However, Judge Glenn ultimately held that the situation before him did call for the appointment of an examiner, and granted the motion.[16]

Current Workarounds Employed by Courts

Despite courts' varying conclusions with respect to whether the appointment of an examiner is mandatory, there is broad agreement that courts enjoy discretion with respect to the scope of any ordered examination. This discretion is a powerful tool, particularly given the potential business disruption that a wide-reaching examination can cause, and the added costs to the estates.[17] These concerns are not hypothetical.

In *ResCap*, the appointed examiner — whose broad mandate included examining various transactions, board activities, corporate relationships, potential causes of action and matters related to a proposed reorganization plan[18] — issued a report spanning more than 2,000 pages (after an 11-month-long investigation) at a cost of nearly $90 million to the estate.[19] What's more, the report was issued only after the debtors and major creditors had reached a comprehensive settlement.[20]

To some, the examiner's expense might seem to have been effectively a waste of estate resources; to others, the impending release of the report forced the parties to the negotiating table. Either way, the *ResCap* examiner provides an acute example of the time and expense that an examiner can add to a chapter 11 case.

Perhaps in recognition of that risk, some bankruptcy courts, often together with the parties seeking the appointment of an examiner, have sought to avoid the prospect of an extensive (and expensive) investigation by strictly limiting the scope of the examiner's authority. This approach was taken in *Lyondell*, where the appointed examiner's investigation was strictly limited to whether the debtors had breached their fiduciary duty or acted in bad faith with respect to a proposed rights offering and certain other discrete terms of a proposed plan of reorganization.[21] Upon review of the examiner's report, the court denied a motion to expand the examiner's mandate.[22]

In certain cases, the parties themselves have sought to circumscribe the potential scope of the examiner's investigation. For example, after extensive motion practice in *Parmalat USA Corp.*, the bankruptcy court granted a consensual proposed order upon request, appointing an examiner and granting it two weeks and a budget of $5,000 to complete its investigation.[23] In the chapter 11 proceedings of *Neiman Marcus Group Ltd.*, the court found no basis to appoint an examiner,

9 Jonathan C. Lipson & Christopher Fiore Marotta, "Examining Success," 90 *Am. Bankr. L.J.* 1, 1 (2016). The study found that an examiner was sought in less than 10 percent of cases.

10 24 Cong. Rec. S17, 403-34 (daily ed. Oct. 6, 1978) (statement of Sen. Dennis DeConcini) (quoted in *Collier on Bankruptcy*, app. 14.4(f)(iii) (15th ed. rev. 2002)).

11 *In re Revco D.S. Inc.*, 898 F.2d 498, 501 (6th Cir. 1990).

12 *See* Jason Hsu, "A (Brief) Examination of Examiners in Chapter 11," *Fordham Corp. L. F.* (January 2013) (quoting Judge Gerber in *Lyondell*, who ultimately granted request for appointment of examiner, but strictly limited substantive scope of its investigation).

13 *In re Spansion Inc.*, 426 B.R. 114, 127 (Bankr. D. Del. 2010).

14 *In re Residential Cap. LLC*, 474 B.R. 112, 121 (Bankr. S.D.N.Y. 2012).

15 *Id.*

16 *Id.*

17 *See* 11 U.S.C. § 330(a)(1) (providing for compensation of examiner); 11 U.S.C. § 503(b)(2) (allowing, as administrative expense, compensation awarded to estate professionals, including examiners).

18 *In re Residential Cap. LLC*, Case No. 12-12020 (Bankr. S.D.N.Y. July 27, 2012), ECF No. 925.

19 *Id.*, ECF No. 6577, 6578 (March 3, 2014).

20 *Id.*, ECF No. 3698 (May 13, 2013); *id.*, ECF No. 3814 (May 23, 2013).

21 *In re Lyondell Chem. Co.*, Case No. 09-10023 (Bankr. S.D.N.Y. Oct. 28, 2009), ECF No. 3148.

22 *Id.*, ECF No. 3705 (Jan. 27, 2010).

23 *See In re Parmalat USA Corp.*, Case No. 04-11139 (Bankr. S.D.N.Y. May 17, 2004), ECF No. 383.

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but the judge stated that he would order the appointment because he believed that it was mandatory under § 1104(c).[24] However, upon the judge's statement from the bench that he would limit the investigation to two weeks and the examiner's budget to $100,000,[25] the moving party withdrew the motion to appoint the examiner entirely.[26] Another approach taken by parties and bankruptcy courts concerned with the costs of a "mandatory" examiner has been to limit the scope of their requests and orders, respectively, to assessments of the sufficiency of reviews already conducted by the debtors or creditors' committees,[27] supervising ongoing investigations,[28] providing supervision over the audit of financial statements during the pendency of chapter 11 proceedings,[29] or serving as mediator in connection with plan negotiations.[30]

A Simple Solution

For all the concern regarding the negative potential effects of an examiner's appointment, they can provide an important neutral view of contentious or complex issues, and can strengthen the public's confidence in the integrity of chapter 11 proceedings writ large. For example, the examiners' reports in *Enron Corp*. and *Lehman Brothers Holdings Inc*., two of the highest-profile chapter 11 cases in recent memory, provided significant insights into the systemic failures that contributed to those firms' collapse (in addition to identifying significant claims that could lead to the recovery of assets for creditors). More recently, in the *Purdue Pharma LP* bankruptcy,[31] an investigation by an examiner into the influence exerted by the Sackler family on the debtor's board of directors confirmed that the board was not unduly influenced, a conclusion that lent transparency and credibility to the settlement that formed the foundation of Purdue's recently confirmed reorganization plan.

Thus, it is clear that the important role of examiners in the chapter 11 process should be preserved, and that the ambiguity and opportunity for gamesmanship can be reduced with a simple fix: Congress need only change "shall" to "may" in § 1104(c). Permitting bankruptcy courts to exercise discretion over whether to appoint an examiner, and concomitantly over the breadth of any such investigation in the event an appointment is warranted, will reconcile concerns of unnecessary investigations (with all the disruption and expense that they bring) with the potential benefits to all stakeholders of a disinterested third-party investigation into any mis- or malfeasance that might affect the value of distributions or of a reorganized debtor as a go-forward business. abi

24 *In re Neiman Marcus Group Ltd.*, Case No. 20-32519 (Bankr. S.D. Tex. May 29, 2020), ECF No. 827, Hr'g Tr. at 188:21-189:24.
25 *Id.* at 194:12-17.
26 *Id.* at 196:8-15.
27 *In re Loral Space & Commc'ns Ltd.*, 2004 WL 2979785, at *5 (S.D.N.Y. Dec. 23, 2004).
28 *In re Cenveo Inc.*, Case No. 18-22178 (Bankr. S.D.N.Y. March 15, 2018), ECF No. 203.
29 *See In re Adelphia Commc'ns Corp.*, 336 B.R. 610, 647-48 (Bankr. S.D.N.Y. 2006) (collecting cases and evaluating prior bankruptcy courts' analysis of requests for appointment of examiner).
30 *See In re Enron Corp.*, 326 B.R. 497, 499 n.5 (S.D.N.Y. 2005) (discussing appointment of examiner in response to motions of numerous parties for appointment of trustee, examiner, creditors' committee or separate counsel for individual debtor entity); *see generally* 7 *Collier on Bankruptcy* ¶ 1104.03[1] (16th ed. 2020).
31 *In re Purdue Pharma LP*, 2021 WL 5979108 (S.D.N.Y. Dec. 16, 2021). For another perspective on this case, *see* Paul R. Hage, "'The Great Unsettled Question': Nonconsensual Third-Party Releases Deemed Impermissible in *Purdue*," XLI *ABI Journal* 2, 12-13, 43-45, February 2022, *available at* abi.org/abi-journal.