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Considerations of Examiner Appointments In Bankruptcy Actions

By David J. Baldwin and R. Stephen McNeill

Examiner appointments in Chapter 11 bankruptcy cases are uncommon, and despite Judge Peter J. Walsh's statement that he had appointed an examiner only two or three times during his career as a bankruptcy judge, he recently ordered the appointment of an examiner in the case of *In re DBSI, Inc.*, Case No. 08-12687 (Bankr. D. Del. Mar. 25, 2009). In granting the Idaho Department of Finance's motion, Judge Walsh found that the allegations of fraud against DBSI and some of its current officers and directors were substantial enough to warrant the appointment of an examiner. Relying upon a review of recent examiner cases, the authors of this article conclude that a court is most likely to appoint an examiner when the movant: 1) alleges substantial acts of fraud, especially securities fraud, by the debtor and its management team; 2) establishes a complex interrelationship among the debtor, its management, and non-debtor entities; and 3) has the support of the United States trustee ("Trustee") and any other significant creditor groups.

The Four-Part Test of 11 U.S.C. § 1104

A straightforward reading of 11 U.S.C. § 1104 directs a court, after notice and a hearing, to appoint an examiner "on request of a party in interest or the United States trustee" if four conditions are satisfied. First, the court cannot appoint an examiner if it has previously ordered the appointment of a Chapter 11 trustee. A court is not required to expressly deny a motion to appoint a Chapter 11 trustee before an examiner can be appointed. *See Keene Corp. v. Coleman* (*In re Keene Corp.*), 164 B.R. 844, 855 (Bankr. S.D.N.Y. 1994). Second, a court must order the appointment of an examiner "before confirmation of a plan." 11 U.S.C. § 1104(c).

Third, a court shall appoint an examiner if an investigation is "appropriate." Although the term appropriate is subject to many possible interpretations, § 1104(c) appears to provide examples of when a court should order an investigation. Specifically, appropriate investigations of the debtor include "an investigation of

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any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor … ." *Id.* Finally, even if the investigation is appropriate, the court shall appoint an examiner only if: "(1) such appointment is in the interests of the creditors, any equity security holders, and other interests of the estate; or (2) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000." *Id.* at § 1104(c)(1)–(2).

Is the Appointment Mandatory?

When analyzing the merits of an examiner motion, a creditor's first consideration should be the interpretation of § 1104(c)(2) in the relevant jurisdiction. Although the use of the word "shall" could be read to mean that the appointment of an examiner is mandatory if the four requirements of § 1104(c) are met, not all courts subscribe to that view. In every case, the $5 million threshold amount of § 1104(c)(2) either is met or not, and many proponents of an examiner have argued that the appointment of an examiner is mandatory if the monetary threshold is satisfied. In fact, the Office of the United States Trustee has taken the position that § 1104(c)(2) is a mandatory provision. *See DBSI*, Docket No. 2415. As bankruptcy cases continue to increase in magnitude, courts that interpret 1104(c)(2) as a mandatory provision are more likely to appoint an examiner.

Despite the textual argument that § 1104(c)(2) is a mandatory provision, courts across the country have reached contrary positions when interpreting that provision. One line of cases, led by the Sixth Circuit, has interpreted the statute to mean that a court must appoint an examiner if the statutory requirements are met. *See, e.g., Morgenstern v. Revco D.S., Inc.* (*In re Revco D.S., Inc.*), 898 F.2d 498, 500 (6th Cir. 1990); *In re Loral Space & Commc'ns, Ltd.*, 2004 WL 2979785, *4 (S.D.N.Y. 2004); *In re UAL Corp.*, 307 B.R. 80, 84 (Bankr. N.D. Ill. 2004); and *In re Big Rivers Electric Corp.*, 213 B.R. 962, 965–66 (Bankr. W.D. Ky. 1997). Another line of cases has determined that § 1104(c)(2) is not a mandatory provision. *See, e.g., In re Rutenberg*, 158 B.R. 230, 233 (Bankr. M.D. Fla. 1993); *In re GHR Cos., Inc.*, 43 B.R. 165, 171, 175–76 (Bankr. D. Mass. 1984); and *In re Shelter Res. Corp.*, 35 B.R. 304, 305 (Bankr. N.D. Ohio 1983). Under either approach, most courts have found that the scope of the investigation lies within the discretion of the bankruptcy judge.

The Delaware Discretionary Approach

In Delaware, bankruptcy courts have determined that § 1104(c)(2) does not mandate the appointment of an examiner simply because a debtor's debts exceed the threshold amount. *See In re Webcraft Techs., Inc.*, Case No. 93-1210 (Bankr. D. Del. Nov. 4, 1993). Nearly 11 years before appointing the examiner in *DBSI*, Judge Walsh ruled that a court should consider only the interest of the creditors of the estate when deciding whether to appoint an examiner. *See In re SA Telecomm., Inc.* Case Nos. 97-2395 through 97-2401 (Bankr. D. Del. Mar. 27, 1998). That approach takes the threshold debt amount of § 1104(c)(2) out of consideration, requiring the court to conduct the examiner analysis under the standard set forth in § 1104(c)(1). The non-mandatory interpretation of § 1104(c)(2) was demonstrated recently, when Chief Judge Carey appointed an examiner pursuant to § 1104(c)(1) even though the Trustee sought the appointment of an

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examiner only pursuant to § 1104(c)(2). *See In re New Century TRS Holdings, Inc.*, Case NO. 07-10416 (Bankr. D. Del. Apr. 17, 2007.

In another case, Judge Sontchi, applying a somewhat different standard, found that the appointment of an examiner was mandatory pursuant to § 1104 (c)(2) only if the court first determines that an investigation is appropriate. *Se In re Am. Home Mortgage Holdings, Inc.*, Case No. 07-11047 (Bankr. D. Del. Oct. 31, 2007). Judge Sontchi's opinion comports with the four-part approach because it would make the appointment of an examiner mandatory

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only if each of the four conditions is satisfied. Using that approach, the bankruptcy court will always retain some discretion to appoint an examiner because it will need to determine whether an investigation is appropriate.

Proving the Interest of Creditors Under § 1104(c)(1)

Regardless of the court's interpretation of § 1104(c)(2), parties in interest can still seek the appointment of an examiner under § 1104(c)(1), which has become known as the discretionary provision because it gives courts discretion to decide what is in the best interest of the estate. In making that determination, courts balance the potential benefits from an appropriate investigation with the potential costs of conducting the investigation. While the costs of an examiner are obvious — an additional layer of administrative costs for the fees and expenses of the examiner and his professionals — an independent examiner provides important benefits to the estate's creditors, especially when certain key facts are present.

Whether those facts are purely coincidental or represent an emerging trend, creditors considering a motion to appoint an examiner should take them in account. In four recent examiner cases, officers of each of the respective debtors were facing class action lawsuits based wholly or in part on violations of state or federal securities laws. *See DBSI* (class action and enforcement action by Idaho); *In re Semcrude, L.P.*, Case No. 08-11525 (Bankr. D. Del. Aug. 12, 2008) (class action against directors of debtor's affiliate who were also directors of the debtor); *In re Syntax-Brillian Corp.*, Case No. 08-11407 (Bankr. D. Del. July 28, 2008) (four class actions and a derivative suit); and *New Century* (17 class actions and 8 derivative suits). Thus, the presence of securities litigation against the debtor's management supports a decision to move for an examiner.

Even if the debtor's officers and directors did not violate securities laws, examiner motions that contain substantial allegations of fraud or mismanagement are more likely to succeed than those that do not. For instance, examiners have been appointed recently based on allegations of accounting irregularities (*New Century* and *DBSI*) and the improper use of funds in connection with a trading strategy (*Semcrude*). Similarly, fraud and deceptive behavior by management served as the basis for the appointments of examiners in *DBSI* and *Syntax-Brillian*. Importantly, because § 1104 requires only "*allegations* of fraud, dishonesty," etc., a court can appoint an examiner without the need for the movant to prove all the elements of fraud. *See* 11 U.S.C. § 1104(c) (emphasis added).

Another important element when contemplating a motion to appoint an examiner is the presence of insider transactions and the "complex interrelationship of various corporate entities," including management and non-debtor affiliates. *See In re 1243 20th Street, Inc.*, 6 B.R. 683, 686 (Bankr. D.D.C. 1980). *DBSI* involved approximately 170 affiliated debtors plus another 700 or more affiliated non-debtors, most of which were managed or controlled by the same officer. That overly complex business structure led Judge Walsh to direct the examiner to investigate potential causes of action arising from transfers from the debtors to their non-debtor affiliates and other insiders. *Syntax-Brillian* provides another example of the role that interrelationships play in the decision to appoint an examiner. Although the examiner's role was ultimately suspended, a primary reason for the original appointment was to investigate the "intricate web of relationships" among the debtors, the stalking-horse bidder, several suppliers, and the debtors' officers and directors.

While none of these factors guarantees the appointment of an examiner, the presence of one or more of them improves the odds of achieving that rare examiner appointment. If the facts contain substantial allegations of fraud against the debtor's acting management, the appointment of an examiner becomes more likely. Similarly, if those same managers control other non-debtor entities or have a relationship with other parties in interest, especially a potential purchaser or DIP lender, the court will likely grant an examiner motion absent strong evidence of harm to the estate.

Support from Other Parties In Interest

Support from other parties in interest can also provide an enormous benefit to a moving creditor. Most importantly, the support of the Trustee and the creditors' committee can provide the final push needed to convince a court that the appointment of an examiner is warranted. At other times, a significant constituency of creditors can ban together to provide the necessary support.

Unquestionably, a creditor seeking the appointment of an examiner will need the support of the Trustee. In fact, the Trustee normally will be the party that requests the appointment of an examiner, and a creditor will be hard-pressed to succeed on an examiner motion without the Trustee's support.

While the debtors will almost always object to a motion to appoint an examiner (*but see Semcrude*), other major players in the bankruptcy process are usually more unpredictable. In particular, the creditors' committee will usually pick a side based on a number of considerations. For example, the committees in *New Century* and *DBSI* argued that the appointment of an examiner was not necessary or in the best interests of creditors because the respective committees had undertaken their own investigations, which an examiner would simply duplicate. In contrast, committees in other cases have moved for the appointment of an examiner themselves after determining that an examiner would be appropriate. *See, e.g., In re Planet Hollywood Int'l, Inc.*, Case No. 01-10428 (Bankr. M.D. Fla. June 3 2002); and

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In re 1243 20th Street. Although the creditors' committee often would prefer to conduct the investigation, its other statutory functions sometimes prevent it from conducting an appropriate investigation. In any event, the support of the committee, while helpful, is not mandatory to successfully obtain the appointment of an examiner.

Finally, although not present in every case, if the debtor has a significant creditor group, a creditor wishing to appoint an examiner should solicit the support of that group of creditors. DBSI, for example, had the support of an overwhelming number of "TIC Owners" who were the primary creditors of the estates. While a certain group of TIC Owners withdrew their previous motion to appoint an examiner, they subsequently joined in Idaho's motion. Idaho also had the support of 13 state governments that filed joinders in support of their motion for an examiner. Likewise, several oil and gas producers — out of a group so large that they obtained recognition of their own official committee — joined in the examiner motion in *Semcrude.* Although it is uncertain what role the positions of the major creditor constituencies played in the ultimate decisions to appoint an examiner, they certainly did not harm the movants' efforts.

Conclusion

Although the appointment of an examiner in Chapter 11 cases is unusual, a court may be inclined to appoint one if the case contains the right set of facts. Although examiner appointments are more likely in a jurisdiction that interprets § 1104(c)(2) as a mandatory provision, courts that consider the best interests of creditors test under § 1104(c)(1) may appoint an examiner if the movant has the support of enough parties in interest and substantial allegations of fraud or mismanagement exist. In either case, the application of the four-part test of § 1104 should help a moving creditor evaluate its likelihood of success on an examiner motion.