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A. Mechele Dickerson

Article

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Bankruptcy and corporate governance scholars continue to debate "control rights" in Chapter 11 reorganization proceedings and how those rights should be allocated when a firm seeks to restructure in bankruptcy.[1] Most of this scholarship concludes that, as a positive matter, creditors now contractually control who will be hired to run firms in bankruptcy cases. The scholarship then considers whether this allocation of control rights is efficient or consistent with the goals of bankruptcy laws.

The scholarship fails to consider adequately one normative matter that is a critical factor in deciding whether control rights have been properly allocated in corporate insolvencies, namely, how ethical and fiduciary duties should be constructed or how those duties should be imposed on the people who control firms in bankruptcy. Moreover, the scholarship fails to question whether, as a normative matter, creditors should be allowed to insert a creditor-controlled private trustee into a position normally held by a public, statutorily authorized trustee. This Article fills that void by first highlighting the increased presence and influence of managers who are hired as a result of creditor demands—that is, privatized trustees. The Article con-

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† Fulbright and Jaworski Professor of Law, University of Texas Law School.

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1. *See infra* notes 133, 134, and 136.

cludes by arguing that privatized trustees should have the same ethical obligations and duties in bankruptcy cases as the duties the Bankruptcy Code[2] (the Code) imposes on public, statutorily authorized trustees.

Part II of this Article reviews the statutory and common law fiduciary duties that directors and officers (i.e., managers) of firms have outside of bankruptcy.[3] Part III discusses the presumption, under earlier bankruptcy laws, that existing managers would *not* be allowed to operate the company during the reorganization and would instead be replaced by a trustee authorized by the statute. It explains that the Code reverses this presumption by giving the firm's managers control of the firm during the bankruptcy case. Part III then describes the procedures firms must use when hiring entities during bankruptcy cases and notes the Code's requirement that the people who control firms in bankruptcy proceedings be disinterested and not have actual or perceived conflicts of interest.

Part IV shows how notwithstanding a statutory presumption of control by prepetition managers, creditors use various credit arrangements to seize control of a bankruptcy firm's cash, and that creditors increasingly control the firm's ultimate disposition in the bankruptcy proceeding. Part V documents how creditors—especially hedge funds and other distressed debt traders—have seized the right to force firms to appoint turnaround specialists, chief restructuring officers, and other managers who ultimately exercise the powers of public statutory trustees. Though these private trustees have become common, especially in large Chapter 11 reorganizations, the Code does not authorize them and, indeed, makes no reference to

2. 11 U.S.C. § 1–1532 (2000).

3. *See* LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 101 (2001). Some states impose fiduciary duties specifically on directors, while others also impose fiduciary duties on nondirector officers who control the firm. *See, e.g.*, Strougo v. Bassini, 282 F.3d 162, 173 (2d Cir. 2002) ("Maryland courts have clearly established the proposition that . . . officers owe fiduciary duties to . . . the shareholders."); Lama Holding v. Smith Barney, Inc., 668 N.E.2d 1370, 1375 (N.Y. 1996) (acknowledging the same fiduciary duty in Delaware); MODEL BUS. CORP. ACT § 8.42(a) (2008). Because the CEOs of most firms also are directors (often Chair of the Board), this Article will use the term "manager" to refer both to directors and also the high-ranking officers who operate the firm. W. Steve Albrecht et al., *Fraud and Corporate Executives: Agency, Stewardship and Broken Trust*, 5 J. FORENSIC ACCT. 109, 112 n.3 (2004) (noting that eight of the ten most prominent companies that had significant financial scandals had board chairs who were also CEOs).

them. Moreover, it is unclear how privatized trustees can adequately represent the interests of all parties in the case when they are hired because of, and often report to, one creditor or creditor group.

Part VI stresses that the duties and responsibilities of these new private trustees are not clearly defined and shows how their presence in cases often dramatically increases administrative costs. This Part also highlights the agency conflicts that arise when privatized trustees—who are not authorized by the Code and who often remain employed by entities other than the debtor firm—are allowed to control the firm. The Article concludes by arguing that these new privatized trustees should be allowed to control firms in bankruptcy only if they show they can comply with the fiduciary duties the Code and former bankruptcy laws impose on statutorily appointed public trustees. Specifically, private trustees should be required to prove that they are disinterested, that they have no interest adverse to the firm or the firm's other constituents, and that any relationship they have with a particular creditor in the case will not prevent them from protecting the interests of all other parties involved in the case.

I. MANAGERS' NONBANKRUPTCY DUTIES AND POWERS

A. State Law

The fiduciary duties managers have during a bankruptcy case are largely created by nonbankruptcy laws. These duties outside of bankruptcy vary somewhat depending on whether the firm is solvent, approaching insolvency, or insolvent.

1. Solvent Firms

In general, managers have duties of loyalty and care to a solvent company's shareholders. The duty of loyalty requires managers to act in the corporation's best interest, to refrain from using confidential information for personal gain, and to refrain from putting their or another party's interests ahead of the company's interest.[4] The duty of care requires managers to

4. *See* Mann v. GTCR Golder Rauner, L.L.C., 483 F. Supp. 2d 884, 900 (D. Ariz. 2007) ("Instead, the best interest of the corporation and its shareholders [must] take precedence over any interest possessed by a director, officer[,] or controlling shareholder and not shared by the shareholders generally." (alteration in original) (citation omitted)); Cede & Co. v. Technicolor, Inc., 634

make decisions that do not negligently cause harm to the firm and to act when their attention to a situation would prevent harm.[5] Directors who use a rational decisionmaking process can raise the business judgment rule as a defense to a claim for breach of due care.[6] Indeed, some courts presume that directors are informed, act in good faith, and intend to make decisions that are in the firm's best interest.[7] Given this, the business judgment rule ensures that most breach of due care suits will not succeed, excepting some highly publicized scandals such as Enron or WorldCom, where either plaintiffs or public officials sue to "send a message."[8]

Managers generally owe no duties to the firm's employees or the creditors of a solvent firm, presumably because those entities are protected by the terms of their contracts with the firm. Creditors are deemed not to need additional protections

A.2d 345, 361–62 (Del. 1993) ("Essentially, the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."); Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) ("A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.").

5. A number of states allow corporate charters to include provisions, however, that protect directors from civil liability based on a failure to monitor the firm's business activities (or a failure to act). *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

6. *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003) ("The business judgment rule is a 'presumption in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'" (citation omitted)).

7. *See, e.g.*, Notinger v. Costa (*In re* Robotic Vision Sys., Inc.), 374 B.R. 36, 45–46 (Bankr. D.N.H. 2007) (discussing the interplay between the business judgment rule and the duty of care). Directors who engage in self-dealing cannot, however, use the business judgment rule to defend their decision to engage in a self-interested transaction. *See, e.g.*, tit. 8, § 102(b)(7); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

8. *See* E. Norman Veasey, *A Perspective on Liability Risks to Directors*, DIRECTORS MONTHLY, Feb. 2005, at 3 (citing an assertion by a former Chief Justice of the Delaware Supreme Court that the "time-honored business judgment rule" continues to protect "conscientious directors who exercise due care, good faith, and independent judgment"); Ben White, *Former Directors Agree to Settle Class Actions*, WASH. POST, Jan. 8, 2005, at E1. Moreover, any damages assessed against directors almost always are paid by the company's directors' and officers' insurance policy. *Cf.* Bernard Black, et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059–60 (2006) (noting that although outside directors are frequently sued, they rarely make out-of-pocket payments because they are protected by indemnification agreements, director and officer insurance, shareholders, or by the company itself).

because, unlike shareholders, their contracts ostensibly are arms-length transactions with terms that protect the creditors' interests.[9] Until the Enron era, virtually all courts assumed that a solvent—even if poorly run—business could pay its bills and that creditors needed only their bargained-for protections.[10]

2. Firms in the Vicinity or Zone of Insolvency

Over the last decade, creditors have increasingly argued that managers were approving risky transactions that rendered solvent firms insolvent.[11] In response, corporate and insolvency scholars and lawyers have considered whether courts should impose duties on the managers of a solvent firm when the firm approaches insolvency—that is, when it is in the vicinity or zone of insolvency.

"Zone of insolvency" describes the period when a firm's finances are precarious, but the firm is still solvent.[12] Some con-

9. Lorenz v. CSX Corp., 1 F.3d 1406, 1417 (3d Cir. 1993); Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524–25 (S.D.N.Y. 1989) (citing *Meinhard*, 164 N.E. at 546); Katz v. Oak Indus., Inc., 508 A.2d 873, 879–80 (Del. Ch. 1986). It is unclear what (if any) duties managers have to tort victims and other creditors who have an involuntary relationship with the firm since they have no implied or actual contractual rights. *See also* Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1349 (2007) (advocating the abolition of the duty-shifting doctrine, with a duty to creditors only arising upon the firm filing a bankruptcy petition).

10. *See In re* Lifschultz Fast Freight, 132 F.3d 339, 346 (7th Cir. 1997) ("Creditors extend credit voluntarily to a debtor. The debtor owes no duties to the creditor beyond those it promises in its contract . . . ."); United States v. Jolly, 102 F.3d 46, 48 (2d Cir. 1996) ("Borrower-lender relationships are typically at arm's-length, and a firm's obligations to creditors are generally regarded solely as contractual."); Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC (*In re* Radnor Holdings Corp.), 353 B.R. 820, 843 (Bankr. D. Del. 2006) (describing how the business judgment rule protects "solvent, barely solvent, and insolvent corporations" from creditors' challenges to business decisions) (citation omitted); *see also* Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 544 (1977) ("As to contract creditors, fundamental rights and expectations are hard to come by, for the parties can and often do bargain about the allocation of risks and the compensation for bearing them.").

11. *See, e.g.*, Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 653–54 (Bankr. N.D. Ill. 1998).

12. *See, e.g.*, Teleglobe USA Inc. v. BCE Inc. (*In re* Teleglobe Commc'ns Corp.), 493 F.3d 345, 384 (3d Cir. 2007) (defining insolvency as either a balance-sheet test in which assets are fewer than liabilities or as the inability to pay debts as they become due); *id.* at 356 & n.9 (describing the zone of insolvency as the "amorphous" and "ill-defined" period before insolvency); Carrieri v. Jobs.com Inc., 393 F.3d 508, 515 (5th Cir. 2004) (noting that the debtor en-

tend that, when a firm enters the zone of insolvency, managers have a duty to consider the interests of the entire corporate community (i.e., creditors, employees, and shareholders).[13] During the zone of insolvency, managers would have a duty to the corporate community to maximize the enterprise's long-term wealth-creating capacity—presumably the same duties of loyalty and due care owed to shareholders of a healthy corporation.[14] Likewise, in assessing whether managers breached their duties (however defined and to whomever owed), courts ostensibly will continue to apply the business judgment rule.[15]

Imposing dual duties on managers when a firm is in the zone of insolvency exacerbates the uncertainty and agency conflicts that already exist because of the divergent interests shareholders and creditors have in a firm once the firm is either in the vicinity of insolvency or is insolvent.[16] The differing interests of creditors and shareholders can create significant agency conflicts for managers, since the managers theoretically run the company for the benefit of both groups. That is, because creditors are entitled to receive no more than the amount of debt provided in the contract and rarely receive any financial benefits from risky ventures, they prefer that managers avoid high-risk but potentially high-value activities that erode the

tered the zone of insolvency when it projected a cumulative negative cash flow for the next six months, at which time the company would run out of cash). Indications that a company may be in the "zone" include whether corporate liabilities exceed assets, whether it faces liquidity crises/cash flow problems (current or projected), whether there are potential or actual loan defaults, or whether a corporate transaction unreasonably depletes corporate capital. *See* Sherri Morissette, *Directors' Duties in the Zone of Insolvency: The Quandary of the Nonprofit Corp.*, AM. BANKR. INST. J., Mar. 2004, at 12.

13. Justin Wood, *Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany, and Japan*, 26 PENN ST. INT'L L. REV. 139, 147–48 (2007); Christopher L. Barnett, Comment, Healthco *and the "Insolvency Exception": An Unnecessary Expansion of the Doctrine?*, 16 BANKR. DEV. J. 441, 441–43 (2000).

14. *See* Wood, *supra* note 13, at 147–48 (discussing the expanded duties owed to creditors in the zone of insolvency); Barnett, *supra* note 13, at 441–43 (same).

15. *See* Trenwik Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 174 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. 2007) (noting that the business judgment rule applies when evaluating managers' conduct during the zone of insolvency).

16. *See* E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1429–31 (2005) ("The obvious tension between the interests of creditors and those of stockholders is palpable and a vexing challenge for directors.").

firm's value, even if those activities might be financially beneficial for the firm's shareholders.[17] In contrast, shareholders prefer that managers engage in riskier business ventures when the firm approaches insolvency because they will reap the upside in benefits if the risky venture succeeds.[18] Notwithstanding creditor preferences, managers have an incentive to engage in high-risk activities that benefit shareholders because directors are often shareholders themselves. More importantly, managers always have an incentive to advance equity's interests because shareholders have the power to call a board meeting to replace directors (and, thus, officers).

For a number of reasons, managers who ignore creditors' interests face few risks based on the zone-of-insolvency theory. First, it is not clear when a company enters the zone of insolvency, and this lack of a well-defined temporal boundary makes it difficult to prove that managers failed to comply with any modified or additional duties arising in the zone.[19] The zone-of-insolvency theory of liability is somewhat amorphous because it replaces an event (balance sheet or equity insolvency) with a condition (a weakened financial state) as the trigger for imposing additional duties on managers.[20] Thus, even if managers have a duty to consider or protect creditor interests in the zone, it is unclear exactly what duties managers owe to shareholders or other constituents, let alone how to judge whether managers have complied with those duties.[21] Moreover, it is unclear

17. A. Mechele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 19 & n.67 (2003).

18. *Id.* at 19.

19. Teleglobe USA Inc. v. BCE Inc. (*In re* Teleglobe Commc'ns Corp.), 493 F.3d 345, 356 n.9 ("A footnote from the Delaware Supreme Court's latest opinion on a related issue explains that this 'zone' is yet ill-defined . . . .").

20. For example, one court suggested that if managers approved transactions that caused the business to become insolvent or undercapitalized, then the company was in the zone of insolvency when they approved the transaction. *See* Brandt v. Hicks, Muse & Co. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 300–01 (Bankr. D. Mass. 1997). However, if the business was neither insolvent in the balance sheet or equity sense, it is unclear how directors would (or could) have known that it was in the vicinity of insolvency. A business is balance sheet insolvent "when the fair market value the firm's assets is less than its total liabilities." Dickerson, *supra* note 17, at 15. A business is equitably insolvent when it can no longer pay its bills "as they mature in the ordinary course of the business." *Id.*

21. *See* Veasey & Guglielmo, *supra* note 16, at 1429 ("There is a very challenging issue of whether (and to what extent) directors, in making their business decisions when the corporation is in the vicinity of insolvency, may be required to consider the interests of creditors . . . .").

whether imposing additional duties will have the negative unintended consequence of causing risk-averse directors to either resign or take overly conservative actions.[22]

If managers' duties are to exercise due care and to avoid self-interested transactions, and if they continue to be protected by the business judgment rule, then managers are not required to engage in drastic actions (like liquidating the firm's assets to pay creditor claims) if doing so would detrimentally harm shareholders' interests.[23] Instead, while in the zone of insolvency managers should continue to have the discretion to determine whether an insolvent company can work out its problems, whether it should file for bankruptcy,[24] or whether it should liquidate the firm either in or outside of bankruptcy.[25]

3. Insolvent Firms

Most courts and commentators conclude that managers' fiduciary duties shift from shareholders to creditors when the firm is insolvent because creditors of insolvent firms must be paid on their claims before shareholders can receive distributions on their equity interests.[26] Though most courts and com-

22. Risk-averse directors may choose to resign when the business approaches the zone to avoid these additional duties. This result could be devastating, since businesses approaching insolvency cannot afford additional disruptions. A duty *not* to resign theoretically could be imposed if the resignation will harm the company or leave assets unprotected. Such a duty would make managers liable for postresignation breaches that occurred or began before they resigned. Likewise, a manager ostensibly could be liable if he breached fiduciary duties before resigning or if any postresignation acts violate any ongoing fiduciary duties. *See, e.g.*, Gerdes v. Reynolds, 28 N.Y.S.2d 622, 649, 651 (N.Y. Sup. Ct. 1941); Bruce H. White & William L. Medford, *Preparing for Bankruptcy: Director Liability in the Zone of Insolvency*, AM. BANKR. INST. J., Apr. 2001, at 30–31.

23. *See* Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 792 (Del. Ch. 2004) ("[T]he fact of insolvency does not change the primary object of the director's duties, which is the firm itself.").

24. Official Comm. of Unsecured Creditors of RSL Com Primecall, Inc. v. Beckoff (*In re* RSL Com Primecall), No. 01-11457, 2003 WL 22989669, at *8 (Bankr. S.D.N.Y. Dec. 11, 2003); *cf.* Roth v. Mims, 298 B.R. 272, 286–87 (N.D. Tex. 2003) (discussing the bankruptcy court's conclusion that managers unduly delayed seeking bankruptcy protection for the business).

25. *See RSL Com Primecall*, 2003 WL 22989669, at *8.

26. *See, e.g.*, Unsecured Creditors Comm. of Debtor STN Enters. v. Noyes (*In re* STN Enters.), 779 F.2d 901, 904–05 (2d Cir. 1985); Miller v. Dutil (*In* re Total Containment, Inc.), 335 B.R. 589, 604 (Bankr. E.D. Pa. 2005); A.R. Teeters & Assocs. v. Eastman Kodak Co., 836 P.2d 1034, 1043 (Ariz. Ct. App. 1992); Rosebud Corp. v. Boggio, 561 P.2d 367, 372 (Colo. Ct. App. 1977); Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 789–90 (Del. Ch. 1992); Rutheford B. Campbell, Jr. & Christopher W. Frost, *Managers' Fiduciary Duties in Finan-*

mentators conclude that managers owe creditors duties once the firm becomes insolvent,[27] there is a wide range of views concerning when those duties shift.[28] Likewise, there is a breadth of views concerning the scope of those postinsolvency fiduciary duties.[29] While liability is clear where managers engage in fraud, self-dealing, or preferential treatment, courts are split over whether the business judgment rule shields managers from liability if they are sued by creditors for breaching their postinsolvency duty of care.[30]

cially Distressed Corporations: Chaos in Delaware (And Elsewhere), 32 J. CORP. L. 491, 493 (2007) (describing four stages of corporate financial health and proposing that managers owe fiduciary duties to different constituencies during the different stages); Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1331–48 (2007) (tracing the development of the duty-shifting doctrine incorporate governance and bankruptcy jurisprudence, and advocating the abolition of the doctrine).

27. *But cf.* Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1189 (2003) (calling into question "the widely held view that the fiduciary duties that corporate directors ordinarily owe to or for the benefit of shareholders should 'shift' to creditors when the corporation is in financial distress"). Some suggest that directors and officers manage an insolvent firm's assets in a trust for the benefit of creditors because creditors are the owners of an insolvent firm. *See, e.g.*, Jewel Recovery, L.P. v. Gordon, 196 B.R. 348, 354–55 (N.D. Tex. 1996).

28. *See, e.g.*, Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45, 101–02 (1998); Campbell & Frost, *supra* note 26, at 494 (describing the difficulty faced by managers understanding their shifting duties); Hu & Westbrook, *supra* note 26, at 1342–43 (noting that much of the analysis of the duty-shifting doctrine focuses on which financial event should trigger the shift); Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1513–15 (1993).

29. Some courts and commentators narrowly characterize managers' duties as the traditional preinsolvency duties (loyalty and due care) owed to shareholders, others suggest that they have only contractual duties (duty of good faith and fair dealing) to creditors, while others suggest that managers are required only to act legally and not divert or dissipate the firm's assets. *See* Mosser v. Darrow, 341 U.S. 267, 274 (1951) (discussing prohibition against trustees allowing insiders to engage in self-interested trading); Ford Motor Credit Co. v. Weaver, 680 F.2d 451, 461 (6th Cir. 1982) (discussing fiduciary duties of due care); Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 655–56 (Bankr. N.D. Ill. 1998); St. James Capital Corp. v. Pallet Recycling Assocs. of N. Am., Inc., 589 N.W.2d 511, 516 (Minn. Ct. App. 1999); Dickerson, *supra* note 17, at 13, 18 n.66 (citing divergent views).

30. *See, e.g.*, Bank of America v. Musselman, 222 F. Supp. 2d 792, 797, 799 (E.D. Va. 2002) (noting that in contrast with the majority of states, the general rule in Virginia is that "no direct action lies to a creditor" for improper or failed performance of a manager's fiduciary duties). *Compare* Comm. of the

Finally, conflict-of-interest issues increase[31] when the managers' duties shift at insolvency. As an initial matter, it is unclear whether the managers' fiduciary duty to creditors replaces or is coextensive with a duty to shareholders and others with an interest in the firm (including employees).[32] Courts have split on the question of whether managers continue to have duties to shareholders upon insolvency.[33] Again, share-

Creditors of Xonics Med. Sys., Inc. v. Haverty (*In re* Xonics, Inc.), 99 B.R. 870, 876 (Bankr. N.D. Ill. 1989) (applying the business judgment rule), *with* Mims v. Kennedy Capital Mgmt., Inc. (*In re* Performance Nutrition, Inc.), 239 B.R. 93, 111 (Bankr. N.D. Tex. 1999) (refusing to apply the rule), *and* Askanase v. Fatjo, No. H-91-3140, 1993 WL 208440, at *5 (S.D. Tex. Apr. 22, 1993) (holding that the business judgment rule "is of no effect" in insolvency proceedings), *aff'd*, 130 F.3d 657, 658 (5th Cir. 1997). Presumably, if the duty applies, decisions managers made during the firm's insolvency will be deemed to have been taken in good faith as long as the directors were adequately informed and utilized a rational decision-making process.

31. Even before insolvency, managers must consider potentially conflicting interests when they make decisions since state laws prevent them from making distributions to stockholders if doing so would render the corporation insolvent or leave it with unreasonably small capital. *See, e.g.*, Brandt v. Hicks, Muse & Co. (*In re* Healthco Int'l., Inc.), 208 B.R. 288, 301 (Bankr. D. Mass. 1997) (rejecting the argument that requiring directors to consider the interests of both groups creates an irreconcilable conflict since a "distribution to stockholders which renders the corporation insolvent . . . threatens the very existence of the corporation.").

32. *See* Pay 'N Pak Stores v. Court Square Capital Ltd. (*In re* PNP Holdings Corp.), No. 96-35835, 1998 WL 133560, at *4 (9th Cir. Mar. 18, 1998) (declining to resolve the question of when managers' fiduciary duty should shift to creditors); Clarkson Co. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981) (noting that in New York, a manager's duty to creditors arises upon insolvency); Miller v. Dutil (*In re* Total Containment, Inc.), 335 B.R. 589, 603–04 (Bankr. E.D. Pa. 2005) (indicating that a controlling shareholder may also have a fiduciary duty to the corporation itself and that this duty shifts to corporate creditors at insolvency); Ass'n of Haystack Prop. Owners v. Sprague, 494 A.2d 122, 125 (Vt. 1985) ("[S]ome courts have held that corporate directors do owe a fiduciary duty to creditors, particularly when the corporation becomes insolvent."); JAMES D. COX & THOMAS L. HAZEN, CORPORATIONS § 10.14, at 217–19 (2d ed. 2003) (discussing the body of law that imposes on directors fiduciary duties to creditors when the firm is insolvent); Campbell & Frost, *supra* note 26, at 500–02 (describing three competing notions regarding the fiduciary duties of managers to shareholders and creditors upon insolvency); Remus D. Valsan & Moin A. Yahya, *Shareholders, Creditors, and Directors' Fiduciary Duties: A Law and Finance Approach*, 2 VA. L. & BUS. REV. 1, 25 (2007) (noting that the shifting fiduciary duties of management are complicated by confusion between the interests of various stakeholders and of the corporation itself).

33. For cases concluding that managers have no duties to shareholders at insolvency, see FDIC v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982); Hovis v. Powers Constr. Co. (*In re* Hoffman Assocs., Inc.), 194 B.R. 943, 964 (Bankr. D.S.C. 1995). For cases concluding that managers have a duty to both creditors and shareholders, see Ed Peters Jewelry Co. v. C & J Jewelry Co., 124 F.3d 252, 276 (1st Cir. 1997); Butler v. Bantz (*In re* Howe Grain, Inc.), 209

holders have an incentive to encourage managers to engage in risky behavior to resuscitate an insolvent firm because their limited liability to the firm's creditors protects them even though the higher-risk activities make it more likely that the business will lose money and ultimately be liquidated.[34] Even if managers understand that they have a fiduciary duty to protect nonshareholder claims or interests, however, they may feel conflicting loyalties upon the firm's insolvency, and current law does not clearly explain how they can simultaneously protect those potentially conflicting interests.[35]

4. Deepening Insolvency

Just as some courts have suggested that managers should have enhanced fiduciary duties when the firm is in the zone of insolvency, managers (or financial advisors) who fraudulently prolong an insolvent firm's corporate life by causing the firm to unnecessarily sink deeper into debt may be sued based on the theory of deepening insolvency.[36] This relatively new tort theory expands the traditional conceptualization of managers' fiduciary state-law duties by penalizing managers whose fraudulent or negligent conduct during the zone of insolvency damages the corporation.[37]

B.R. 496, 499 (Bankr. D. Neb. 1997); Value Prop. Trust v. Zim Co. (*In re* Mortgage & Realty Trust), 195 B.R. 740, 750–51 (Bankr. C.D. Cal. 1996).

34. *See* Valsan & Yahya, *supra* note 32, at 2–3 ("The shareholders will prefer that directors engage in risky projects . . . much to the chagrin of creditors who would rather the directors engage in less risky activities so that they may recover some of their principal."); *see also* Barondes, *supra* note 28 at 49–50 (noting that as corporations approach insolvency, shareholders may be "essentially indifferent," since negative returns of a distressed corporation are "almost entirely borne by the creditor").

35. In *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343 (1985), the Supreme Court noted that shareholder interests must be subordinated to creditor interests, but did not delineate the nature of the duties directors owed creditors. *Id.* at 355. *See also In re* Cent. Ice Cream Co., 836 F.2d 1068, 1072–73 (7th Cir. 1987) (agreeing that the debtor's primary duty was to ensure sufficient assets to pay creditor claims, but also considering the shareholders' interests in being paid).

36. *See In re* Vartec Telecom, Inc., 335 B.R. 631, 636 (Bankr. N.D. Tex. 2005) (defining deepening insolvency as the "fraudulent prolongation of a corporation's life beyond insolvency, resulting in damage to the corporation caused by increased debt" (citing Kittay v. Atlantic Bank of New York (*In re* Global Serv. Group, LLC), 316 B.R. 451, 456 (Bankr. S.D.N.Y. 2004))).

37. For example, managers and shareholders may be liable to creditors for negligently increasing debt or providing misleading financial information that either causes creditors to extend credit or prevents creditors from being paid. *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d

Although new, the deepening-insolvency theory of liability is increasingly disfavored. Courts generally have been unwilling to impose liability based on this theory and also have found that the business judgment rule protects managers as long as they act in a way that benefits the corporate enterprise.[38]

B. FEDERAL LAW: THE SARBANES-OXLEY ACT

State laws traditionally defined the scope of managers' duties and the civil liability they face if they violate those duties.[39] However, in response to the financial scandals involving Enron, WorldCom, and other large businesses,[40] Congress imposed additional duties on managers under federal law by enacting the Sarbanes-Oxley Act.[41]

340, 349–50 (3d Cir. 2001) (concluding that "deepening insolvency" may give rise to cognizable injury); Tabas v. Greenleaf Ventures, Inc. (*In re* Flagship Healthcare, Inc.), 269 B.R. 721, 732 (Bankr. S.D. Fla. 2001) (holding that a fiduciary duty was owed and breached by negligent performance of services); Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 656 (N.D. Ill. 1988) (noting that directors who cause corporations to incur unnecessary debt may be liable to creditors for breach of duty).

38. *Cf.* Production Resources Group, LLC v. NCT Group, Inc., 863 A.2d 772, 793, 795 (Del. Ch. 2004) (holding that the general state statute protecting directors from personal liability does not insulate them with regards to "acts of disloyalty" to the firm). Imposing liability on managers who engage in certain activities (including increasing the firm's debt) while the firm is insolvent or approaching insolvency is new in the United States but quite common in other nations. Directors in a number of countries face civil and criminal liabilities and may be forced to contribute their personal assets to the firm's insolvency proceeding if they are found to have "traded while insolvent" or if they delay placing the firm in an insolvency proceeding. *See* A. Mechele Dickerson, *The Many Faces of Chapter 11: A Reply to Professor Baird*, 12 AM. BANKR. INST. L. REV. 109, 128 & n.95 (2004) (discussing liability under British, Australian, Canadian, and French law). For a more comprehensive discussion of director liability under British and Australian law, see Vanessa Finch, *The Recasting of Insolvency Law*, 68 MODERN L. REV. 713, 733–36 (2005) (discussing British law); Paul James et al., *Insolvent Trading—An Empirical Study* 4–9 (Univ. of Melbourne Faculty of Law, Research Paper No. 72, 2004), *available at* http://www.ssrn.com/abstract=555892 (discussing Australian law).

39. *See* Kelli A. Alces, *Moving Toward a Federal Law of Corporate Governance*, 31 S. Ill. U. L.J. 621, 623 ("The internal affairs of corporations, particularly those relating to corporate management, have long been the province of state law.").

40. *See The Fall of Enron: How Could It Have Happened?: Hearing Before the S. Comm. on Governmental Affairs*, 107th Cong. 6 (2002) [hereinafter *Fall of Enron*] (statement of Sen. Levin, Member, S. Comm. on Government Affairs) ("The deceptions and the accounting gimmicks, the shredding of documents that have occurred shake the very foundation of our confidence in corporate America.").

41. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

The Sarbanes-Oxley Act alters managers' duties and expands the authority of federal agencies and courts to regulate managers' powers and duties.[42] To a great extent, Sarbanes-Oxley focuses on changing the "tone at the top" and revises existing law to impose more penalties on directors or officers who set the wrong tone.[43] The Act substantively regulates the qualification criteria for directors, defines and increases the duties of directors who sit on certain board committees, and restricts the relationships directors can have with the firm's officers, employees, lawyers, accountants, and other professionals.[44] The Act also enhances (and, to some extent, federalizes) state corporate-governance laws based on the premise that federal law needs to respond to managers' conduct, since managers are at least partially to blame for the financial demise of firms.[45]

42. *See* Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 394, 397–402 (2005) (discussing the "federalization" of directors' duty of care).

43. *See Implementation of the Sarbanes-Oxley Act of 2002: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 35 (2003) (statement of William H. Donaldson, Chairman, Securities and Exchange Commission). Sarbanes-Oxley's principal objectives "can be grouped into the following themes: to strengthen and restore confidence in the accounting profession; to strengthen enforcement of the Federal securities laws; to improve the 'tone at the top' and executive responsibility; to improve disclosure and financial reporting; and to improve the performance of 'gatekeepers.'" *Id.*

44. For example, the Act requires that the audit committee consist of independent directors who essentially receive no compensation from the firm except for directors' fees. *See* Sarbanes-Oxley Act § 301. The Act requires the audit committee to appoint the firm's auditors, supervise the audit, receive the auditor's report, and establish an anonymous method for whistleblowers to reveal suspicious accounting practices. *See id.* It also restricts the types of relationships accountants and attorneys can have. *See id.* § 201. The Act primarily focuses on the firm's reporting obligations and is designed to ensure that the company's financial statements are both technically accurate and not materially misleading. *See, e.g.*, *id.* § 302 (requiring signing officers to maintain internal controls and to certify that they have disclosed any fraud or deficiencies therein). The Act also significantly alters the duties and qualifications of directors who serve on the firm's audit committee. *Id.* §§ 304, 306, 403, 906. As a result, companies now routinely employ a corporate governance officer, or CGO, to oversee their corporate governance programs. *See* Heather Brewer, *Snap Judgments: Add a Dash of CGO*, BUS. L. TODAY, Sept.–Oct. 2003, at 7 (citing the examples of Tyco International and Walt Disney). The Act also directs the Securities and Exchange Commission to promulgate rules and regulations to require public companies to disclose whether they have a code of ethics for senior financial officers and if not, to explain why they do not have one. *See* Sarbanes-Oxley Act § 406.

45. *See Fall of Enron*, *supra* note 40, at 5 (statement of Sen. Thompson, Member, S. Comm. on Government Affairs) (citing the problems caused by "unscrupulous corporate executive[s]"); *id.* at 11 (statement of Sen. Durbin, Member, S. Comm. on Government Affairs) (noting the responsibility of "cor-

II. MANAGER CONTROL IN BANKRUPTCY CASES

A. STATUTORY OUSTER OF MANAGERS

Bankruptcy laws have vacillated between presumptively displacing the firm's managers with a public trustee and presumptively giving those managers control of the firm in bankruptcy reorganizations. In all instances, however, the entity that is given control of the firm in the reorganization acts for the benefit of all interested parties, and has a duty to protect those interests in the bankruptcy proceeding.

1. Bankruptcy Act

Chapter X of the Bankruptcy Act of 1898,[46] as amended by the Chandler Act in 1938, mandated automatic replacement of large public companies' existing managers with a disinterested, independent trustee who would operate the business if the debts of the business exceeded $250,000.[47] The trustee was required to assess the debtor's property, liabilities, and financial condition and to investigate the debtor's acts and conduct to determine how best to formulate a plan of reorganization or how best to discontinue the business.[48] It was imperative that the trustee be disinterested, since the trustee's duties included examining the debtor's prefiling management team, deciding whether the firm had been mismanaged or whether managers had engaged in fraud, and investigating other financial or operational irregularities.[49]

porate insiders at Enron"); *The Role of the Board of Directors in Enron's Collapse: Hearing Before the Perm. Subcomm. of Investigations of the S. Comm. on Gov't Affairs*, 107th Cong. 3–4 (2002) (statement of Sen. Levin, Chairman, Perm. Subcomm. on Investigations of the S. Comm. on Gov't Affairs) (discussing the role Enron's board of directors played as a "facilitator" in accommodating unethical managers); *see also* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 953–57, 971–72 (2003) (noting, for example, the Act's prohibition against corporations making loans to managers).

46. Bankruptcy Act of 1898, Pub. L. No. 55-171, 30 Stat. 544 (repealed 1978).

47. Chandler Act of 1938, Pub. L. No. 75-696, § 575, 52 Stat. 840, 888 (repealed 1978); *see generally* DAVID A. SKEEL, JR., DEBT'S DOMINION 119–20 (2001) (discussing the role of the trustee in Chapter X of the Chandler Act).

48. *See* Chandler Act, § 167(1)–(5).

49. *See* Myron N. Krotinger, *Management and Allocation of Voting Power in Corporate Reorganizations*, 41 COLUM. L. REV. 646, 651 (1941). In addition, Krotinger discusses Congress's desire to "rid the debtor of personnel whose past activities indicated a high probability of continued inefficiency or disre-

Managers received radically different treatment if the firm filed for relief under Chapter XI of the Act, which was designed to be used by individuals, partnerships, smaller firms, and firms that had little secured debt.[50] In Chapter XI, a public trustee was not required and the existing managers retained the right to control the business operations and the restructuring process, including the right to propose a plan of reorganization.[51] Chapter XI also did not mandate that the entity who controlled the reorganization proceeding investigate the debtor's affairs to determine whether management engaged in fraud, misconduct, irregular conduct, or otherwise mismanaged the firm.[52]

Congress determined that managers should not be left in control during the reorganization proceeding because they would have no incentive to scrutinize their own conduct, bring lawsuits that might reveal that they had engaged in misconduct, or provide a complete accounting of the firm's financial picture.[53] By ousting senior managers, Congress presumed that the managers of large businesses were disregarding their fiduciary duties and were generally responsible for firms' financial problems, and that allowing them to keep their jobs openly invited them to continue harming the firm, its creditors, and its investors.[54] However, in subsequent years the policy of automatically ousting experienced managers was criticized, because it hampered firms' ability to reorganize successfully and efficiently.[55] Critics argued that, unlike the existing managers,

gard of fiduciary duty." *Id.*

50. *See Bankruptcy Act Revision: Hearing Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong. 2164, 2172–73 (1976) (report of Securities and Exchange Comm'n on Proposed Bankr. Leg. (H.R. 31 and H.R. 32)) (describing differences between Chapters X and XI).

51. *See* H.R. DOC. NO. 93-137, pt. I, at 244, 247 (1973) ("Control belongs to the debtor in Chapter XI.").

52. *See* H.R. REP. NO. 95-595, at 233 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6182 ("[F]or a small business there was felt to be no need for a trustee to investigate the affairs of the debtor . . . .").

53. Krotinger, *supra* note 49, at 650–61.

54. *See* H.R. REP. NO. 95-595, at 232 (noting that the requirement of a trustee under the Bankruptcy Act of 1938 was a reaction to the widespread fraud and dishonesty of management, which often led the business into bankruptcy); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 674 (1993) (discussing how the SEC sought to diminish the role of "self-serving" corporate managers in the 1938 Act).

55. *See* H.R. REP. NO. 95-595, at 233 ("[V]ery often, the creditors will be

public trustees needed time to become familiar with the business and its operations and that it was inefficient for an inexperienced public trustee to focus on rehabilitating the debtor.[56]

The harsh treatment managers received in Chapter X discouraged managers from using that Chapter and ultimately caused Chapter XI to become the dominant reorganization vehicle for even large, publicly traded companies that ostensibly should have filed under the trustee-controlled Chapter X.[57] Indeed, Chapter X's trustee-controlled procedures increasingly became unworkable because the managers of larger businesses filed under Chapter XI, avoided filing for bankruptcy altogether, or delayed filing until the firm's financial condition was beyond repair.[58] Congress responded to the increasingly negative consequences associated with Chapter X's automatic ouster of management by combining the previous acts into one reorganization chapter and establishing a presumption that the firm's prebankruptcy managers would retain control of firms seeking to reorganize in bankruptcy.[59]

benefited by continuation of the debtor in possession [since the debtor] will be better able to operate [the business] during the reorganization case.").

56. *See id.*

57. *See Bankruptcy Reform Act: Hearing Before the Subcomm. on Improvements in Judiciary Machinery of the S. Comm. on the Judiciary*, 94th Cong. 709 (1975) (statement of Philip A. Loomis, Commissioner, Securities and Exchange Commission); H.R. REP. NO. 95-595, at 222 ("[I]n spite of the original intention of the authors of [C]hapter XI, it is used as often by large public companies as by small private ones."); *id.* at 233 ("One of the main reasons that debtors use [C]hapter XI so much more frequently than [C]hapter X is because they know they will not be ousted of possession and operation of the business."); SKEEL, *supra* note 47, at 162 (discussing the incentives for managers of distressed firms to file under Chapter XI). In fact, the Act contained no explicit requirement that large companies use Chapter X. Instead, the standard for courts in determining whether a case should be filed under Chapter X or Chapter XI was "the needs to be served." Gen. Stores Corp. v. Shlensky, 350 U.S. 462, 466 (1956).

58. *See* H.R. REP. NO. 95-595, at 223, 233–34 (noting that debtors "too often wait too long to seek bankruptcy relief"); *see also* SKEEL, *supra* note 47, at 125; Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 IOWA L. REV. 669, 674–75 (1993).

59. *See* Korobkin, *supra* note 58, at 674 (discussing the "unified Chapter 11" under the 1978 Bankruptcy Code). For a discussion of the debate before Congress among creditors, lawyers, and bankruptcy judges on allowing managers to retain control of the bankruptcy process, see SKEEL, *supra* note 47, at 177–78.

2. Bankruptcy Code

The Bankruptcy Code replaced the Act and rejects the manager-displacing/trustee-controlled model. Chapter 11 creates a new entity, the debtor-in-possession (DIP), and gives control of the Chapter 11 firm to existing managers.[60] While a public trustee can still be appointed to replace management,[61] Chapter 11 reverses the presumption that the court will replace managers with a public trustee. Instead, the Code creates a presumption that existing managers will control the business during the reorganization process.[62]

While the SEC continued to assume that firms filed for bankruptcy because of "the failure of the management and its methods,"[63] Congress concluded that replacing the Act's trustee-controlled regime with a manager-controlled regime makes it more likely that viable companies will successfully reorganize and not be forced to liquidate.[64] The decision to replace the Act's trustee-controlled regime with a manager-controlled regime seems to have resulted from the conclusion that most financial failures are caused by factors that have little to do with the management skills or capabilities of the firm's managers.[65]

60. *See* 11 U.S.C. § 1107(a) (2000).

61. *See id.* § 1104(a)(1)–(3) (2000 & Supp. 2006).

62. *See id.* § 1107(a).

63. *Bankruptcy Act Revision: Hearing Before the Subcomm. on Civil and Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong. 2177 (1976) (report of Securities and Exchange Comm'n on Proposed Bankr. Leg. (H.R. 31 and H.R. 32)).

64. *See* H.R. REP. NO. 95-595, at 233 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6182 (stating that as a result of the manager's greater familiarity with the business, "a debtor continued in possession may lead to a greater likelihood of success in the reorganization"). However, this manager-controlled model, though now dominant in the United States, is not the only insolvency model. The insolvency laws of a number of countries are similar to the 1898 and 1938 Bankruptcy Acts in that they replace management with a court-appointed administrator or provisional liquidator as soon as the firm files for relief in an insolvency proceeding. *See* Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. L.J. 431, 444 (1995). For a comparative overview of international models and discussion of the impact of U.S. bankruptcy law, see Alan Tilley, *'U.S. Invasion' Influences European Insolvency Practices: Major Hurdles Remain to Chapter 11-Type Restructurings*, J. CORP. RENEWAL, Sep. 2004, at 4, *available at* http://www.turnaround.org/Publications/Articles.aspx?objectID=3650.

65. *See* H.R. REP. NO. 95-595, at 233 ("[T]he need for reorganization . . . often results from simple business reverses, not from any fraud, dishonesty, or gross mismanagement on the part of the debtor's management."); *see also* SKEEL, *supra* note 47, at 178 (discussing the view that managers should not be

Presumptively retaining existing managers removes the disincentive (i.e., the fear of being fired) managers had to avoid bankruptcy until the firm was hopelessly insolvent; theoretically, this should result in more efficient restructurings.[66]

The DIP has most of the statutory rights and duties of a statutory trustee.[67] It does not have the right to be compensated. Not surprisingly, it also has no duty to investigate manager misconduct, competence, or mismanagement. The DIP ostensibly has the same fiduciary duties as a public, statutory trustee,[68] though the Code fails explicitly to impose those duties on the DIP[69] and does not delineate exactly what those duties would be.[70] While courts have not precisely defined the pa-

displaced if the firm's financial distress was due to circumstances beyond the control of the managers (citing *Bankruptcy Reform Act: Hearing Before the Subcomm. on Improvements in Judiciary Machinery of the S. Comm. on the Judiciary*, 94th Cong. 650 (1975) (statement of John J. Creedon, American Life Insurance Ass'n))).

66. *See* H.R. REP. NO. 95-595, at 233; *see also* NAT'L BANKR. CONFERENCE'S CODE REVIEW PROJECT, REFORMING THE BANKRUPTCY CODE, i–xv (1994) (providing an overview of changes to the bankruptcy code); Miller, *supra*, note 64, at 446–47 (citing 140 CONG. REC. S14,464 (daily ed. Oct. 6, 1994) (statement of Sen. Brown)); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 372 (1993).

67. DIP manager powers include the right to control the debtor's business operations during the reorganization, the ability to control the flow of information to creditors during the reorganization process, the right to recover certain funds from creditors or to avoid certain transactions on behalf of the DIP, and the right to determine the type of reorganization plan that can be submitted during the first few months of the case. *See* 11 U.S.C. § 1107 (2000) (giving the DIP all the rights, powers, and duties of trustee except those specifically excluded by statute); *id.* § 1108 (providing the DIP the right to operate the debtor's business); *id.* § 1121(b) (affording the debtor the exclusive right to file plan for first 120 days after the petition is filed); *id.* § 544 (granting the DIP the right to avoid certain liens); *cf*. Karen Gross & Patricia Redmond, *In Defense of Debtor Exclusivity: Assessing Four of the 1994 Amendments to the Bankruptcy Code*, 69 AM. BANKR. L.J. 287, 290–91 (1995) (discussing the role of debtor exclusivity).

68. *See* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985); *In re* Marvel Entm't Group, Inc., 140 F.3d 463, 474 (3d Cir. 1998); Ford Motor Credit Co. v. Weaver, 680 F.2d 451, 461 (6th Cir. 1982).

69. *Compare* 11 U.S.C. § 1106(a)(3) (2000 & Supp. 2006) (stating that trustees have such a duty), *with id.* § 1107(a) (stating that DIPs do not have such a duty).

70. Since the Code does not prescribe the duties, they are ostensibly based on state corporate law or federal common law. *See* C.R. Bowles, Jr. & Nancy B. Rapoport, *Has the DIP's Attorney Become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Cases?*, 5 AM. BANKR. INST. L. REV. 47, 52–57 (1997). Others argue that the DIP should have a more stringent standard, akin to the duties imposed on trustees under nonbankruptcy law. *See* Daniel B. Bogart, *Liability of Directors of Chapter 11 Debtors in Possession: "Don't*

rameters of the DIP's fiduciary duties, most conclude that the DIP has the same fiduciary duties of care and loyalty to the estate, its creditors, shareholders, and other parties-in-interest that the firm's managers had prepetition.[71] Courts further conclude that the DIP (and thus its managers) must preserve and protect property of the bankruptcy estate and must refrain from acting in ways that would damage the estate or harm the firm's reorganization efforts.[72]

Managers cannot simply advance one party's interests to the exclusion of others. Courts generally have found that the DIP must treat all parties fairly and cannot favor any one constituent, such as secured or unsecured creditors, tort claimants, shareholders, or employees.[73] Instead, managers must consider the impact that any decision they make during the reorganization might have on other constituents *even if* the favored constituent has rights that have a higher priority under state law.[74]

Look Back—Something May Be Gaining on You," 68 AM. BANKR. L.J. 155, 221–31 (1994) (arguing that bankruptcy courts use stringent standards for DIPs). This type of standard would require the DIP to disclose significantly more information to parties in interest. Additionally, the DIP would not be protected by the business judgment rule even for breaches of the duty of care. *See id.*; Bowles & Rapoport, *supra*, at 55–57.

71. *See* Lange v. Schropp (*In re* Brook Valley VII), 496 F.3d 892, 900–01 (8th Cir. 2007); *In re Marvel Entm't Group, Inc.*, 140 F.3d at 471; *In re* WBE Co., No. BK06-80006, 2007 WL 4893471 (Bankr. D. Neb. Dec. 19, 2007); Comm. of Creditors Holding Unsecured Claims v. Citicorp Venture Capital, Ltd. (*In re* Papercraft Corp.), 187 B.R. 486, 498–500 (Bankr. W.D. Pa. 1995), *rev'd on other grounds*, 211 B.R. 813 (W.D. Pa. 1997) (rejecting a per se rule that insiders cannot purchase claims from debtors without disclosing information); First Union Nat'l Bank v. Tenn-Fla Partners (*In re* Tenn-Fla Partners), 170 B.R. 946, 968 (Bankr. W.D. Tenn. 1994), *aff'd in part, rev'd in part on other grounds*, 229 B.R. 720, (W.D. Tenn. 1999) (reversing the bankruptcy court's determination that no compensatory damages were warranted); *In re* Harp, 166 B.R. 740, 746–48 (Bankr. N.D. Ala. 1993). *See generally* 1 COLLIER ON BANKRUPTCY ¶ 8.01[3][b] (Lawrence P. King ed., 15th ed. 2008) (describing the fiduciary duty of the DIP and the attorney).

72. *See In re Marvel Entm't Group, Inc.*, 140 F.3d at 471; Unsecured Creditors Comm. of Debtor STN Enters. v. Noyes (*In re* STN Enters.), 779 F.2d 901, 904–05 (2d Cir. 1985); Berres v. Bruning (*In re* Bruning), 143 B.R. 253, 255–56 (D. Colo. 1992); Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 653–54 (Bankr. N.D. Ill. 1998); Pacificorp Ky. Energy Corp. v. Big Rivers Elec. Corp. (*In re* Big Rivers Elec. Corp.), 233 B.R. 726, 734–35 (Bankr. W.D. Ky. 1998), *aff'd*, 233 B.R. 739 (W.D. Ky. 1998); *In re* Ionosphere Clubs, Inc., 113 B.R. 164, 169 (Bankr. S.D.N.Y. 1990); *In re* Sharon Steel Corp., 86 B.R. 455, 457 (Bankr. W.D. Pa. 1988), *aff'd*, 871 F.2d 1217 (3d Cir. 1989).

73. Official Comm. of Unsecured Creditors v. Raytech Corp. (*In re* Raytech Corp.), 190 B.R. 149, 151–52 (Bankr. D. Conn. 1995).

74. *See In re* Cent. Ice Cream Co., 836 F.2d 1068, 1072–73 (7th Cir. 1987);

Notwithstanding the general understanding that the DIP and its managers owe fiduciary duties to creditors and must pay creditor claims before distributing property to owners, those fiduciary duties during bankruptcy cases are ill-defined.[75] This is perhaps not surprising, since managers' duties to creditors and shareholders during the firm's prepetition insolvency (or near insolvency) phase also are not clear.[76] One thing, however, *is* clear: the people who have control of the firm in bankruptcy must be independent, impartial, and, if they are retained as "professionals," must disclose all relationships they have with other parties in interest in the Chapter 11 case.[77]

B. RETAINING AND REPLACING MANAGERS

1. Professionals

Attorneys, accountants, consultants and other professionals can be hired under § 327 of the Code as long as the professional is disinterested and holds no interest that is adverse to

Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1070–71 (2d Cir. 1983); Hall v. Perry (*In re* Cochise Coll. Park, Inc.), 703 F.2d 1339, 1357 (9th Cir. 1983).

75. Some courts suggest that the DIP's or trustee's *attorneys* also have fiduciary duties to creditors and shareholders. Zeisler & Zeisler, P.C. v. Prudential Ins. Co. of Am. (*In re* JLM, Inc.), 210 B.R. 19, 25–26 (B.A.P. 2d Cir. 1997); *In re* Rancourt, 207 B.R. 338, 359–60 (Bankr. D.N.H. 1997); *see* Everett v. Perez (*In re* Perez), 30 F.3d 1209, 1219 (9th Cir. 1994). *But cf.* Hansen, Jones & Leta, P.C. v. Segal, 220 B.R. 434, 461 (D. Utah 1998) (refusing to find that counsel owed fiduciary duties to creditors and shareholders). If this duty exists it requires counsel to exhibit an "active" concern for the interests of creditors and shareholders if the managers engage in fraudulent or otherwise improper conduct that harms those interests or if managers fail to satisfy their fiduciary duties to the estate. *See, e.g.*, Jenson v. U.S. Tr. (*In re* Smitty's Truck Stop, Inc.), 210 B.R. 844, 848–49 (B.A.P. 10th Cir. 1997); *In re* Harp, 166 B.R. 740, 747–48 (Bankr. N.D. Ala. 1993); Agresti v. Rosenkranz (*In re* United Utensils Corp.), 141 B.R. 306, 309 (Bankr. W.D. Pa. 1992); *In re* Wilde Horse Enters., 136 B.R. 830, 840 (Bankr. C.D. Cal. 1991); Robb v. Sowers (*In re* Sowers), 97 B.R. 480, 488 (Bankr. N.D. Ind. 1989); *In re* Consupak, Inc., 87 B.R. 529, 549 (Bankr. N.D. Ill. 1988).

76. *See* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985) (stating that the DIP owes a fiduciary duty to stockholders, yet failing to explain how to reconcile this duty with the fiduciary duties owed to creditors); *In re* DN Assocs., 144 B.R. 195, 199–201 (Bankr. D. Me. 1992) (allowing counsel to be compensated from the bankruptcy estate if efforts were undertaken in good faith), *aff'd*, 160 B.R. 195 (D. Me. 1993), *aff'd*, 3 F.3d 512 (1st Cir. 1993); Martin J. Bienenstock, *Conflicts Between Management and the Debtor in Possession's Fiduciary Duties*, 61 U. CIN. L. REV. 543, 543 n.2 (1992) (discussing inherent conflicts raised when a DIP is required to act on behalf of multiple parties who have conflicting interests).

77. 11 U.S.C. § 327(a) (2000).

the estate.[78] A professional cannot be disinterested if she is a creditor or insider of the debtor or if she served as a director, officer, or employee of the debtor within the two years preceding the filing of the bankruptcy petition.[79] The disinterestedness standard is designed to prohibit conflicts of interest by ensuring the independence and impartiality of the professional to be retained. Most courts conclude that the disinterestedness requirement includes the duty to avoid even the appearance of a conflict of interest.[80] Thus, professionals hired in bankruptcy cases should not have even a "scintilla of personal interest" that might affect their ability to make impartial and independent decisions during the reorganization.[81]

The Code also provides, in language similar to state law conflicts rules, that a professional cannot hold or represent "an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders . . . ."[82] While "adverse interest" is not defined in the Bankruptcy Code, courts have interpreted it to mean either "(1) the possession or assertion of any economic interest that would tend to lessen the value of the bankruptcy estate or create an actual or potential dispute with the estate as a rival claimant, or (2) a predisposition of bias against the estate."[83] Thus, attorneys or professionals who have worked for the debtor before the filing often are disqualified from being hired as professionals in the debtor's bankruptcy case because they are owed funds and thus are creditors; they have a right of indemnification against the deb-

78. *Id.*

79. *Id.* § 101(14).

80. Smith v. Marshall (*In re* Hot Tin Roof Inc.), 205 B.R. 1000, 1003 (B.A.P. 1st Cir. 1997); *In re* Vebeliunas, 231 B.R. 181, 191–93 (Bankr. S.D.N.Y. 1999); *In re* Kendavis Indus. Int'l, 91 B.R. 742, 753–54 (Bankr. N.D. Tex. 1988); *In re* Codesco, 18 B.R. 997, 999–1000 (Bankr. S.D.N.Y. 1982).

81. *In re Vebeliunas*, 231 B.R. at 191–93; *In re Codesco*, 18 B.R. at 999, *quoted in In re* Martin, 817 F.2d 175, 181 (1st Cir. 1987); *see also In re* Granite Partners, 219 B.R. 22, 33 (Bankr. S.D.N.Y. 1998); *In re* Roberts, 46 B.R. 815, 828 n.26 (Bankr. D. Utah 1985) (quoting *In re* Phila. Athletic Club, Inc., 20 B.R. 328, 333–34 (E.D. Pa. 1982)), *aff'd in part, rev'd in part on other grounds*, 75 B.R. 402 (D. Utah 1987); 3 COLLIER ON BANKRUPTCY, *supra* note 71, ¶ 327.04[3].

82. 11 U.S.C. § 101(14)(C). While some state law versions of the Model Code of Professional Responsibility or Model Rules of Professional Conduct allow attorneys to represent clients who have adverse interests as long as each party consents, the Code does not allow such waivers of conflicts. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7(b) (2002); MODEL CODE OF PROF'L RESPONSIBILITY Canon 5 (1980).

83. *In re Vebeliunas*, 231 B.R. at 188 (citations omitted).

tor because they served as officers of the company; or because their prepetition engagement letters with the debtor contained an indemnification clause.[84] A professional person who worked for the debtor prepetition can be employed for a specified special purpose, but only if it is in the best interest of the estate and the person does not represent or hold any interest that is adverse to the debtor's estate.[85] Similarly, a professional person who is employed by or represents a creditor in a matter unrelated to the bankruptcy case is disqualified from being hired by the DIP or trustee if the person has an actual conflict of interest.[86]

A person employed as a professional under § 327 must apply to receive compensation under § 330.[87] All parties in interest have the opportunity to object to the fee application, and the bankruptcy court must approve the request to be compensated.[88] In addition, Bankruptcy Rule 2014 requires professional persons to disclose their "connections with the debtor, creditors, any other party in interest, [and] their respective attorneys and accountants."[89] Persons seeking to be hired as professionals must disclose all connections they have with par-

84. Avellino & Bienes v. M. Frenville Co. (*In re* M. Frenville Co.), 744 F.2d 332, 336–37 (3d Cir. 1984); *In re* Mid-Am. Waste Sys., Inc., 228 B.R. 816, 821–22 (Bankr. D. Del. 1999); *In re* Consol. Oil & Gas, Inc., 110 B.R. 535, 538 (Bankr. D. Colo. 1990); *In re* Amfesco Indus., 81 B.R. 777, 781–82 (Bankr. E.D.N.Y. 1988). Some courts hold that the professional can be employed by the debtor if it agrees to waive its prepetition claim, though others adopted a per se rule against employing prepetition professionals. *In re* LKM Indus., 252 B.R. 589, 595 (Bankr. D. Mass. 2000); *In re* Marion Carefree Ltd. P'ship, 171 B.R. 584, 590 (Bankr. N.D. Ohio 1994).

85. 11 U.S.C. § 327(a).

86. *See id.* § 327(a), (c). For example, an attorney who represents a creditor in a matter unrelated to the bankruptcy likely could be hired as a professional in the debtor's bankruptcy case unless another creditor or the United States trustee (a unit of the Justice Department that generally oversees disputes involving professional fees) objects and the court finds that the attorney has an actual conflict of interest. *See In re* Enron Corp., No. 01-16034, 2002 WL 32034346, at *7 (Bankr. S.D.N.Y. May 23, 2002) (finding no actual "adverse interest" under § 327(a) in conjunction with other Code provisions), *aff'd*, 2003 WL 223455 (S.D.N.Y. Feb. 3, 2003); *In re* Caldor, Inc., 193 B.R. 165, 170–71, 174 (Bankr. S.D.N.Y. 1996) (same); Michael P. Richman, *Mega-case Conflict Issues: Enron Committee Counsel*, AM. BANKR. INST. J., Sept. 2002, at 20, 20 (reiterating that "representation of other creditors is not a *per se* basis for disqualification").

87. FED. R. BANKR. P. 2016(a).

88. *See* 11 U.S.C. § 330(a)(1) (2000 & Supp. 2006) (providing for notice to the parties in interest and a hearing to determine the proper level of compensation).

89. FED. R. BANKR. P. 2014(a).

ties in interest in the case even if those connections would not implicate the disinterestedness or adverse interest requirements contained in § 327.[90] Neither the Code nor the Rules define "connections."[91] As a result, this discourages lawyers and other professionals from fully disclosing their relationships with other professionals involved in a bankruptcy case.[92]

2. Officers

Entities can also be hired as officers and subject to § 363 of the Code. Section 363 gives the trustee the authority to use, sell, or lease property of the estate "other than in the ordinary course of business" only "after notice and hearing."[93] Bankruptcy judges typically defer to a debtor's decision to use property in the ordinary course of business and will permit such a use, sale, or lease under § 363 as long as the debtor exercised proper business judgment in good faith upon a reasonable basis and within the scope of authority under the Bankruptcy Code."[94]

Courts interpret § 363(b) liberally to allow bankruptcy judges to respond most effectively to the myriad circumstances involved in business reorganizations and to avoid imposing "unnecessarily rigid rules" on the judge.[95] Further, courts permit the DIP to use § 363, as well as other Code provisions, to retain the managers it regularly employed before filing for bankruptcy and to enter into new contracts with senior managers without having to seek court approval.[96] Unlike profession-

90. *Cf. id.* (creating no distinctions among connections that must be disclosed and those that do not).

91. *Cf.* Michael P. Richman, *Disclose (Publish) or Perish, Revisited*, AM. BANKR. INST. J., Apr. 2006, at 18, 18 (asserting that "connections" are not defined in the Rules, and are instead determined on a case-by-case basis).

92. *See id.* at 18, 65 (discussing the high-profile failure of a law firm to reveal the connections it had with another entity retained in the Adelphia bankruptcy case and the economic and reputational consequences of that failure).

93. 11 U.S.C. § 363(b) (2000 & Supp. 2006).

94. *See, e.g.*, *In* re Nellson Nutraceutical, Inc., 369 B.R. 787, 799 (Bankr. D. Del. 2007). *But see* Mission Iowa Wind Co. v. Enron Corp., 291 B.R. 39, 43 (S.D.N.Y. 2003) (finding such deference inappropriate under the circumstances of that case).

95. Comm. of Equity Sec. Holders v. Lionel Corp. (*In re Lionel Corp.*), 722 F.2d 1063, 1069 (2d Cir. 1983).

96. *Cf. In re* Madison Mgmt. Group, Inc., 137 B.R. 275, 283 (Bankr. N.D. Ill. 1992) (asserting that retention of professionals is allowed under § 327(b)); *In re* All Seasons Indus., Inc., 121 B.R. 822, 825–26 (Bankr. N.D. Ind. 1990) (characterizing retention of management as part of "ordinary . . . operations"); *In re* Phoenix Steel Corp., 110 B.R. 141, 142 (Bankr. D. Del. 1989) (asserting

als employed under § 327, officers employed in the ordinary course of the debtor's business are not required to seek ongoing court approval for their fees, and other parties in interest have no right to object to their salary.[97] A few courts have, however, found it necessary to review the reasonableness of the compensation paid to officers even when the officer was not hired under § 327.[98]

C. APPOINTING A STATUTORY TRUSTEE

Though the Code provides that managers can be replaced or supervised by a public trustee, trustee appointments are, and always have been, rare.[99] A party in interest can seek to have existing managers replaced by a public trustee if the managers have engaged in fraudulent or dishonest conduct, are incompetent, or if appointing a trustee is in the best interest of creditors, investors, or other parties in interest.[100] Responding largely to the Enron and WorldCom scandals, Congress has made it easier to displace managers. Managers are now replaceable by a statutory trustee "for cause" if they are found to be fraudulent, dishonest, or incompetent, or to have grossly mismanaged the company.[101] In addition, pursuant to the 2005

that retention is allowed under § 327(b)); Allison K. Verderber Herriott, Comment, *Toward an Understanding of the Dialectical Tensions Inherent in CEO and Key Employee Retention Plans During Bankruptcy*, 98 NW. U. L. REV. 579, 586 n.59 (2004) (suggesting that debtors use at least three provisions of the Code to justify retention and/or compensation plans and providing examples).

97. *See In re* Pac. Forest Indus., Inc., 95 B.R. 740, 743 (Bankr. C.D. Cal. 1989). *But cf. Madison Mgmt. Group, Inc.*, 137 B.R. at 284 (suggesting that a court can review officer salaries using its equitable powers under § 105(a) of the Code).

98. *In re* eToys, Inc., 331 B.R. 176, 201 (Bankr. D. Del. 2005); *cf. Phoenix Steel*, 110 B.R. at 142–43 (finding it necessary to review compensation for a retained officer who, while professionals, were not hired under § 327(a)).

99. *See In re* Marvel Entm't Group, Inc., 140 F.3d 463, 471 (3d Cir. 1998); *In re* SunCruz Casinos, LLC, 298 B.R. 821, 828 (Bankr. S.D. Fla. 2003) (citing *In re* Sharon Steel Corp., 871 F.2d 1217, 1225 (3d Cir. 1989)); *In re* Hawaiian Airlines, Inc., No. 03-00817, 2003 WL 22945906, at *5 (Bankr. D. Haw. May 16, 2003) (holding that the appointment of a trustee was an extraordinary remedy, but appointing a trustee).

100. *See* 11 U.S.C. § 1104(a) (2000 & Supp. 2006). Most courts conclude that the standard should be clear and convincing evidence. *See, e.g.*, Official Comm. of Asbestos Claimants v. G-I Holdings, Inc. (*In re* G-I Holdings, Inc.), 295 B.R. 502, 507 (D.N.J. 2003), *aff'd*, 385 F.3d 313 (3d Cir. 2004); *In re* Nartron Corp., 330 B.R. 573, 591 (Bankr. W.D. Mich. 2005); Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (*In re* W.R. Grace & Co.), 285 B.R. 148, 157 (Bankr. D. Del. 2002).

101. 11 U.S.C. § 1104(a)(1).

amendments, if there are grounds to convert or dismiss the Chapter 11 case, but "appointment of a trustee . . . is in the best interest of creditors and the estate," then the court is also required to appoint a trustee.[102]

The required showing of ineptitude or incompetence to appoint a statutory trustee is high. Courts typically require the party seeking the appointment of a trustee to prove such elements as managers intentionally seeking to deceive creditors, a complete lack of business acumen or ability, or such ineptitude that allowing them to remain in control of the company would cause harm.[103] Courts will also appoint a trustee if there has been a complete loss of confidence in the managers' ability to run the business or if there are irreconcilable conflicts between the managers, or between the managers and other parties in interest.[104] Courts will *not* replace managers for mere mismanagement or poor business planning;[105] in fact, courts presume

102. *Id.* § 1104(a)(3); *see also* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 442(b), 119 Stat. 23, 116 (codified as amended in scattered sections of 11, 12, 18, and 28 U.S.C.).

103. *See In re* Euro-American Lodging Corp., 365 B.R. 421, 426–27 (Bankr. S.D.N.Y. 2007) (finding gross mismanagement when debtor had not filed tax returns in six years and had been stripped of authority to do business); *In re* New Orleans Paddlewheels, Inc., 350 B.R. 667, 691–92 (Bankr. E.D. La. 2006) (finding intentional dishonesty); *In re Mako, Inc.*, 102 B.R. 809, 812 (Bankr. E.D. Okla. 1988) (requiring extreme ineptitude); *In re Sharon Steel Corp.*, 86 B.R. 455, at 458 (Bankr. W.D. Pa. 1988), *aff'd*, 871 F.2d 1217 (3d Cir. 1989) (citing incompetence as a reason to remove a manager). Courts have appointed trustees where doing so was "necessary to fill the vacuum of lawful management," *In re* Bayou Group, L.L.C., 363 B.R. 674, 681 (S.D.N.Y. 2007), when cost-benefit analysis revealed that appointing a trustee was "in the best interests of the creditors, equity security holders, and other interests of the estate," *In re* National Staffing Servs., LLC, 338 B.R. 31, 34 (Bankr. N.D. Ohio 2005) (citing *SunCruz Casinos*, 298 B.R. at 829), when management exhibited "either incompetent or fraudulent behavior" by making prepetition payments to itself, *In re* Nartron Corp., 330 B.R. 573, 593 (Bankr. W.D. Mich. 2005), and when "significant and numerous conflicts of interest impede[d the Estate's] ability to fulfill its fiduciary duties to all of the bankruptcy estate's creditors," *In re SunCruz Casinos, LLC*, 298 B.R. at 832.

104. *See, e.g.*, *In re* Fiesta Homes of Ga., Inc., 125 B.R. 321, 326 (Bankr. S.D. Ga. 1990); *In re Cardinal Indus., Inc.*, 109 B.R. 755, 765–66 (Bankr. S.D. Ohio 1990); *In re* L.S. Good & Co., 8 B.R. 312, 315 (Bankr. N.D. W. Va. 1980).

105. *See In re* Adelphia Commc'ns Corp., 342 B.R. 122, 129 (S.D.N.Y. 2006) ("[A] debtor in possession's duty to protect the property of its estate does not require overzealous pursuit of every claim, fraudulent conveyance, or avoidance action."), *aff'd*, 342 B.R. 122 (S.D.N.Y 2006); *In re G-I Holdings, Inc.*, 295 B.R. at 511 (upholding the bankruptcy court's decision not to appoint a trustee where creditors "failed to produce clear and convincing evidence of the need for a trustee under either subsection of 1104(a)"); *In re* 4 C Solutions, Inc., 289 B.R. 354, 371 (Bankr. C.D. Ill. 2003) ("As any entrepreneur knows, there is a

that at least some mismanagement and incompetence exists in every bankruptcy case.[106] Indeed, in a case before the Code was amended to require trustee appointments in certain additional circumstances,[107] one court indicated that it would not base a finding that cause existed to appoint a trustee solely because of management incompetence or even gross mismanagement.[108]

Trustee appointments remain the exception despite the recent changes to the Code.[109] Indeed, courts have even resisted appointing trustees in large corporate reorganizations that are tainted with fraud and misconduct, though this may be because the managers who participated in the fraudulent conduct had already been replaced.[110] Courts appear to resist appointing trustees for the same reasons Congress eliminated the Act's requirement that managers automatically be displaced upon the bankruptcy filing.[111] That is, courts appear to fear that appointing a trustee would increase the estate's expenses, would disrupt the business by replacing existing, experienced management (even though trustees can choose to retain managers if doing so is in the debtor's best interests), or would discourage managers from filing timely bankruptcy petitions.[112]

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fine line between calculated risk taking and foolhardiness. What the [creditor] calls gross mismanagement, the DEBTOR calls calculated risk. The evidence favors the DEBTOR.").

106. *See In re* Tricycle Enters., No. 04-65901, 2006 Bankr. LEXIS 4261, at *27–28 (Bankr. N.D.N.Y. Mar. 29, 2006) (citing Schuster v. Dragone, 266 B.R. 268, 272 (D. Conn. 2001); *In re* Anchorage Boat Sales, Inc., 4 B.R. 635, 644–45 (Bankr. E.D.N.Y. 1980)); *In re 4 C Solutions, Inc.*, 289 B.R. at 370; *Mako, Inc.*, 102 B.R. at 812.

107. *See* Bankruptcy Abuse Prevention and Consumer Protection Act § 442(b) (providing additional grounds for appointment of a trustee).

108. *In re Cardinal Indus., Inc.*, 109 B.R. at 765.

109. Entities for which courts recently did appoint trustees in Chapter 11 proceedings include Clarent Corp., Country Seat Stores, Inc., e.spire Communications and Hawaiian Airlines, Inc. *See* THE 2004 BANKRUPTCY YEARBOOK & ALMANAC 325–31 (Christopher M. McHugh & Thomas A. Sawyer eds., 14th ed. 2004). Generally, trustees were appointed to sue corporate officers or to protect the estate from those officers (and their lawyers and accountants) based on allegations that they failed to disclosure certain financial data or misappropriated corporate funds. *Id.*

110. *See No Rush to Appoint Trustee for Enron*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, Feb. 26, 2002, at A1, *available at* Westlaw, 39 No. 1 BCD (LRP) 1. *But see Testimony: Court Competition for Large Ch. 11 Cases*, AM. BANKR. INST. J., Sept. 2004, at 6, 54–55 (suggesting that courts may resist appointing trustees to replace corrupt managers for fear of alienating the people who will decide where to file an important case).

111. *See* H.R. REP. NO. 95-595, at 231 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6182.

112. *Cf. In re 4 C Solutions, Inc.*, 289 B.R. at 370 (recognizing extra costs

In addition to the fear of losing their jobs, the debtor's managers may resist having a trustee appointed because doing so would prevent the DIP from exercising its exclusive right to propose a plan of reorganization and to solicit support for that plan during the first 120 days of the bankruptcy case under the Code.[113] Unsecured creditors or creditors' committees may also resist seeking the appointment of a trustee if they fear that, without the exclusivity period, the debtor's principal secured creditor will propose a plan that does not fairly consider their interests.[114]

Secured creditors also appear resistant to trustee appointments—so much so that DIP financing agreements routinely provide that the appointment of a trustee (or an examiner) is

incurred); Douglas G. Baird, *The New Face of Chapter 11*, 12 AMER. BANKR. L. REV. 69, 84 (2004) (asserting that creditors do not push for appointment of trustees in large cases); LoPucki & Whitford, *supra* note 54, at 757 n.281 (citing H.R. REP. NO. 95-595, at 231); *see also* Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 577 (3d Cir. 2003) (recognizing both monetary burden and loss of expertise; 7 COLLIER ON BANKRUPTCY, *supra* note 71, ¶ 1104.02[1] (summarizing why appointing a trustee is often to be avoided).

113. *Cf.* 11 U.S.C. § 1121(b), (c)(1) (2000 & Supp. 2006) (providing that "only the debtor may file a plan until after 120 days," unless a trustee is appointed under (c)).

114. *See* Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 995, 1049–50 (1993) (discussing committee reluctance to terminate a debtor's exclusivity period prematurely). Of course, not all creditors avoid seeking the appointment of a public trustee. For example, employees of United Airlines sought the appointment of a trustee because they had no faith in existing management, believed that the managers were determined to run the "proud airline into the ground, taking its workers and customers along with it," and believed that the company's "betrayal" of its employees was the "single largest obstacle to its recovery and emergence from Chapter 11." Press Release, Ass'n of Flight Attendants-CWA, AFL-CIO, Grave Concern for United Airlines Prompts Flight Attendants to Call for New Management (Aug. 31, 2004), *available at* http://www.unitedafa.org/res/pr/details.asp?ReleaseID=119; *see also* Adrian Schofield, *IAM Asks Bankruptcy Court to Appoint Trustee for United*, AVIATION DAILY (Wash., D.C.), Aug. 12, 2004, at 1 (providing that the International Association of Machinists (IAM) "petitioned [the] bankruptcy court to appoint a trustee" because it felt "management ha[d] placed the carrier 'on a collision course for disaster,' and 'the immediate appointment of a trustee [wa]s essential to the recovery' of the airline" (quoting IAM officials)). Other examples are available. *See, e.g.*, Drew DeSilver, *Metropolitan Mortgage Files for Bankruptcy*, SEATTLE TIMES, Feb. 5, 2004, at E1 (reporting that investors asked for the appointment of a trustee, claiming that "[a]ny plan that involves current management staying in control of the company is unacceptable"); Gary T. Pakulski, *OC Alters Plan for Incentives to Retain Key Execs*, THE BLADE (Toledo, Ohio), Mar. 2, 2004, at B7 (reporting that creditors asked the court to appoint a trustee to run Owens Corning because of management's bias in favor of asbestos claimants).

an event of default.[115] It is quite possible that creditors recoil at the thought of having a public trustee appointed because the trustee would be required to investigate *all* the debtor's pre-bankruptcy activities—including preferences and other activities involving the specific creditor. Secured creditors may also have an incentive to avoid having the court replace existing managers with a public trustee because of the control they would lose over the case, since the public trustee would have fiduciary duties to all parties in interest.

D. Appointing an Examiner

If the court has not ordered the appointment of a trustee, the Code permits it to appoint an examiner as long as the appointment is in the best interests of creditors, equity, and others with an interest in the debtor's estate,[116] or if the firm's unsecured, nontrade, noninsider debts exceed five million dollars.[117] If these conditions are met, courts are required to appoint examiners if there are allegations of manager "fraud, dishonesty, incompetence, misconduct, mismanagement, or [management irregularity]."[118] Since the Code gives a court the authority to appoint an examiner if it has not ordered the appointment of a trustee, courts do not appear to have the authority to appoint both an examiner *and* a trustee in the same case.[119]

While the distinction between the duties of a trustee and those of an examiner are not clear-cut and often overlap,[120] examiners typically are hired to focus on discrete matters and

115. *See, e.g.*, Movie Gallery, Inc., Secured Super-Priority Debtor-in-Possession Credit and Guaranty Agreement (Form 8-K, Ex. 10.1), at 97 (Oct. 16, 2007); Silicon Graphics Inc., Post-Petition Loan and Security Agreement (Form 8-K, Ex. 10.1), at 38 (May 8, 2006); Trump Casino Funding, Inc. *et al.*, Loan and Security Agreement (Form 8-K, Ex. 99.1), at 54 (Nov. 22, 2004).

116. 11 U.S.C. § 1104(c) (2000 & Supp. 2006).

117. Though the Code appears to mandate the appointment in large cases, a few courts have concluded that they are not required to appoint an examiner even if the debt levels are met. *See In re* Rutenberg, 158 B.R. 230, 232 (Bankr. M.D. Fla. 1993); *In re* GHR Cos., 43 B.R. 165, 169–70 (Bankr. D. Mass. 1984).

118. 11 U.S.C. § 1104(c).

119. *Cf. id.* § 1104(b), (c) (suggesting only that courts may choose one or the other).

120. For example, one court considered the possibility that a court could appoint either a trustee or an examiner to prosecute a fraudulent conveyance action if the DIP refuses to prosecute the matter but ultimately concluded that only appointment of a trustee would be allowed. *See* Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (*In re* W.R. Grace & Co.), 285 B.R. 148, 156–57 (Bankr. D. Del. 2002).

generally do not operate the business.[121] Most courts conclude that the primary role of the examiner is to investigate; the examiner should not displace the DIP, serve as the estate's representative, or take adversarial positions in the bankruptcy case.[122] Courts will occasionally expand the examiner's duties beyond simple investigations if the debtor refuses to promptly liquidate assets or to engage in meaningful negotiations during the plan confirmation process.[123]

Whether or not examiners *must* be appointed in large business Chapter 11 reorganizations, they routinely *are* appointed in these cases, especially if there are allegations that the managers have engaged in deceptive or fraudulent conduct (especially if the fraud involves complex financial transactions) or if managers have refused to prosecute a fraudulent conveyance action against insiders.[124] In addition, judges or elected officials may support the appointment of an examiner if they

121. For example, the court in the United Airlines bankruptcy case appointed an examiner to investigate the specific issue of whether the debtor fraudulently misled flight attendants into taking early retirement. *Cf. Court Says Flight Attendants Weren't Deceived into Retiring*, WALL. ST. J., Mar. 19, 2004, at A11 (describing findings of examiner on that discrete issue).

122. *See* United States *ex rel.* Rural Util. Serv. v. Schilling (*In re* Big Rivers Elec. Corp.), 355 F.3d 415, 429–30 (6th Cir. 2004); Airline Pilots Ass'n Int'l v. American Nat'l Bank & Trust Co. (*In re* Ionosphere Clubs, Inc.), 156 B.R. 414, 432 (S.D.N.Y. 1993); *In re* FiberMark, Inc., 339 B.R. 321, 324 (Bankr. D. Vt. 2006); *In re* Recoton Corp., 307 B.R. 751, 755 (Bankr. S.D.N.Y. 2004); *In re W.R. Grace & Co.*, 285 B.R. at 156; *In re* Gilman Servs., Inc., 46 B.R. 322, 327 (Bankr. D. Mass. 1985); *In re* Baldwin United Corp., 46 B.R. 314, 316–17 (Bankr. S.D. Ohio 1985).

123. *See* Weld *ex rel.* Patton's Busy Bee Disposal Serv., Inc. v. Sweeney Agency, Inc. (*In re* Patton's Busy Bee Disposal Serv., Inc.), 182 B.R. 681, 685–87 (Bankr. W.D.N.Y. 1995); *In re* Pub. Serv. Co., 99 B.R. 177, 182–83 (Bankr. D.N.H. 1989); *In re* John Peterson Motors, Inc., 47 B.R. 551, 553 (Bankr. D. Minn. 1985); *In re* Carnegie Int'l Corp., 51 B.R. 252, 256–57 (Bankr. S.D. Ind. 1984); *cf. In re* Great Barrington Fair & Amusement, Inc., 53 B.R. 241, 244 (Bankr. D. Mass. 1985) (accepting a plan proposed by the examiner).

124. *See, e.g.*, *In re W.R. Grace Co.*, 285 B.R. at 155–56; *see also* Carrie Johnson, *Enron Bankruptcy Examiner's Fees Soar*, WASH. POST, Dec. 30, 2003, at E1 (discussing role of examiner in Enron and other prominent bankruptcy cases). For example, in 2002 and 2003, examiners were appointed in Enron, WorldCom, Polaroid, NewPower Holdings, Inc., Polymer Group, and other bankruptcy cases. *See* THE 2004 BANKRUPTCY YEARBOOK & ALMANAC, *supra* note 109, at 325–35. In 2005, examiners were appointed in American Business Financial Services, Asia Global Crossing, ATA Holdings, FiberMark, Loral Space, Winn-Dixie, and other bankruptcies. THE 2006 BANKRUPTCY YEARBOOK & ALMANAC 304–14 (Kerry A. Mastroianni ed. 2006). In 2006, examiners were appointed in Desert Health, Desert Health, Current Report (Form 8-K), at 2 (Oct. 4, 2006), and Refco, Final Report of Examiner at 5, *In re* Refco Inc., No. 05-60006 (S.D.N.Y. July 11, 2007).

perceive that one is needed to send a message or otherwise improve the public's confidence in the bankruptcy process.[125]

Though the appointment may be needed, having an examiner in a case can substantially increase the costs of the reorganization and, accordingly, reduce the amount available to pay creditor claims. Because examiners are often appointed in cases that have active creditor committees, courts have refused to appoint an examiner if doing so would increase the number of fiduciaries already involved in a case. Some courts have argued that examiners often duplicate the work already being performed by creditors' committees.[126] The controversy associated with the examiner appointed in the Enron case best illustrates these problems.

The examiner, a lawyer at a major law firm, was appointed to search for assets (including potential claims against former advisors and lending institutions) that could be used to pay Enron's creditors.[127] While the examiner may have uncovered information that helped Enron's creditors recover funds from banks and other financial entities, conducting the investigation involved the examiner and 150 lawyers from his law firm.[128] The examiner at one point billed Enron up to $3 million monthly.[129] Several creditors and law firms involved in the case (including, not surprisingly, some who may have been under investigation) objected to the examiner's fees and actions, contending that the examiner was acting like a "special prosecu-

125. *See* Shawn Young et al., *WorldCom Gets Judge's Approval for $750 Million in Financing*, WALL ST. J., July 23, 2002, at A3 (reporting the U.S. Attorney General's support for an examiner because appointment would create a transparent process that enhances accountability).

126. *See, e.g.*, David Elman, *Adelphia to Probe Boies Fees*, DAILY DEAL, Feb. 9, 2006, 2006 WLNR 2242041 (stating that the court refused to appoint an examiner and add "another $350,000 to accomplish ends" that the court concluded could be addressed in a "more efficient and economical manner").

127. *See, e.g.*, David Barboza, *Lawyer Proves a Thorn for Enron's Partners*, N.Y. TIMES, Sept. 21, 2002, at C1; Johnson, *supra* note 124. The examiner was hired to investigate accounting irregularities, mismanagement, and fraud. *Id.*; *see also* Amy Vincent, *Splitting the WorldCom Spoils*, AM. LAW., Apr. 2004, at 91, 159.

128. Barboza, *supra* note 127. The examiner's law firm, Alston & Bird had at that time approximately 675 lawyers. At one point, more than twenty percent of the firm had billed time to the Enron case. *See* John R. Emshwiller & Mitchell Pacelle, *Enron Examiner Faces Criticism Over Fees in Case*, WALL ST. J. EUR., May 7, 2003, at UKA5. Moreover, the fee was reported to be one-third of the law firm's annual income in 2002. Antony Collins, *Batson to Earn $95m for 18 Months Enron Work*, LEGAL WK. GLOBAL, Mar. 25, 2004.

129. Barboza, *supra* note 127.

tor" and that the examiner's work duplicated the work of the creditors' committee.[130] Whether or not the work benefited the Enron creditors, the Enron examiner ultimately received approximately $90 million for his work in the case.[131]

III. CONTRACTUALLY SEIZING CONTROL OF CORPORATE REORGANIZATIONS

If managers are generally not responsible for causing a firm's insolvency, then experienced and competent managers should be allowed to continue to run the company and should not be replaced by a statutory public trustee who has no specialized knowledge of the business. When Congress reversed the presumption that managers would be displaced by an independent trustee, the Code radically increased the leverage managers had under the Act's trustee-controlled regime. Notwithstanding the potential benefits of manager-controlled reorganizations, creditors (and employees) in large Chapter 11 filings have sought to strip managers of control of insolvent firms because of their belief that the existing managers created, or at least contributed to, the financial distress that

130. *Id.* Creditors in the United Airlines case also objected to the $15 million fee requested by a restructuring firm, contending that such a guaranteed fee was not related to benefits that the firm conferred on either the debtor or the bankruptcy estate. *See* Marilyn Adams, *United Pays Outside Advisers Millions*, USA TODAY, Jan. 8, 2003, at B1. Similarly, creditors raised objections to the $1 million monthly fee requested by a management consulting firm because of their concern that the management firm's work duplicated the work performed by the debtor's managers or other advisers. *See id.*

131. Collins, *supra* note 128; Mitchell Pacelle, *Enron Bankruptcy Specialist to File for Additional Payment*, WALL ST. J., Sept. 3, 2004, at A2. Total court-awarded professional fees in the Enron case amounted to $780 million, but if postpetition fees are included, the amount exceeded $1 billion. *See* Edward Iwata, *Enron's Legacy: Scandal Marked Turning Point for Business World*, USA TODAY Jan. 30, 2006 at B4. By way of contrast, Enron's reorganization plan provided about $11.5 billion to creditors. Kristen Hays, *Enron Takes a New Name*, HOUSTON CHRON. Apr. 3, 2007 at 1. Fees charged by the examiner in WorldCom, while not nearly as large as the Enron examiner fees, exceeded $18 million. Final Fee Application of Kirkpatrick & Lockhart LLP for Court Approval and Allowance for Compensation for Services Rendered and Expenses Incurred as Counsel to the Bankruptcy Court Examiner During the Period August 6, 2002 Through April 20, 2004 at 2–8, *In re* WorldCom, Inc., No. 02-13533 (AJG) (Bankr. S.D.N.Y. Aug. 2, 2004). Total fees and expenses billed in the WorldCom case amounted to about $1 billion. James Doran, *MCI Faces $1 Billion Bill for Chapter 11*, TIMES (London), Apr. 21, 2004 at 26. Though WorldCom was the largest bankruptcy filing in U.S. history at that time, fees in that case were significantly smaller than the fee requests eventually filed in Enron. *See* Tom Becker, *MCI Advisers and Lawyers Demand US $613M in Pay*, NAT'L POST (Ontario), Aug. 17, 2004, at FP8.

caused the business to file for bankruptcy. Likewise, despite the legislative conclusion that Chapter 11's manager-controlled process would lead to a more efficient and successful reorganization,[132] the presumption that business reorganizations should be controlled by existing managers has been bitterly criticized by academic commentators[133] and by participants in the bankruptcy process.[134]

Most opponents of Chapter 11's manager-controlled model argue that it is an inefficient way to repay creditors.[135] Some suggest that the manager-controlled presumption is inconsistent with Chapter 11's sole purpose, which they contend is to protect creditors' state law rights. Other commentators criticize the presumption because it allows managers to protect the interests of shareholders (or their own self-interest in remaining employed) with little direct supervision, which prolongs the bankruptcy case and unduly delays creditors' collection attempts.[136] Critics further argue that a manager-controlled system fails to give managers an adequate incentive to prevent the firm from becoming insolvent and that a regime that presumptively ousted managers would be more efficient.[137]

Several academic commentators have described ways creditors appear to have contractually seized control of companies both before and after the firm files for bankruptcy. These scholars observe that security interests in the debtor's property ef-

132. H.R. REP. NO. 95-595, at 231–33 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6182; *see also* Korobkin, *supra* note 58, at 674–75 (arguing that congressional assumptions regarding efficiency were unfounded).

133. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7–19, 22–27 (1986); Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 362–63 (1997) [hereinafter Adler, *Corporate Insolvency*]; Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 319–23 (1993); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 822–24 (1987); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 678–79 (1992).

134. *See, e.g.*, Jerald I. Ancel et al., *On the Edge: Appointing and Electing the Chapter 11 Trustee After the 1994 Amendments*, AM. BANKR. INST. J., July–Aug. 1995, at 20–21.

135. *See, e.g.*, Adler, *Corporate Insolvency*, *supra* note 133, at 362–63.

136. *See, e.g.*, Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1045–46 (1992); Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 113 n.41 (1998).

137. John Armour et al., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1728–30 (2002); James J. White, *Harvey's Silence*, 69 AM. BANKR. L.J. 467, 471 (1995).

fectively give secured creditors the right to control the firm's management structure and how it will be restructured in bankruptcy.[138] Indeed, this increase in creditor control has caused some academic commentators to suggest that Chapter 11 no longer employs the debtor-in-possession model but instead uses the secured-party-in-possession model.[139] As the next sections show, creditors now use contractual devices to control the debtor's cash; to decide whether the firm will be sold piecemeal, intact, or will continue to operate in its existing corporate form; and, perhaps most importantly, to determine who will control the firm in bankruptcy.

A. CONTROLLING CASH

The increased use of security arrangements (like revolving or secured credit facilities) shifts control of financially distressed firms from managers to creditors by giving creditors control over a firm's most valuable asset: cash.[140] By placing restraints on a company's ability to use existing cash or to obtain new cash in the reorganization proceeding, lenders have regained much of the leverage they had under the Act. Managers' ability to control the reorganization process has been restricted by the control creditors now exert over the debtor's prepetition cash, postpetition cash collateral,[141] and access to (and use of) new capital.

In general, a secured credit facility gives the lead lender control of the debtor's cash collateral, limits the debtor's access

138. *See* SKEEL, *supra* note 47, at 85–86; Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 693–99 (2003) [hereinafter Baird & Rasmussen, *Chapter 11 at Twilight*]; Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 777–89 (2002) [hereinafter Baird & Rasmussen, *The End of Bankruptcy*]; Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 KY. L.J. 839, 848–56 (2004); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 827–54 (2004).

139. *See, e.g.*, Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, AM. BANKR. INST. J., Sept. 2003, at 12, 12 (suggesting that the SPIP model converts Chapter 11 into a process that serves only to permit secured parties to use bankruptcy laws to enforce their state law Article 9 rights).

140. *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1229 (2006) [hereinafter Baird & Rasmussen, *Missing Lever*] (explaining that the ability to cut off a company's cash flow is a greater threat than the ability to repossess collateral because cash is worth as much in the lender's hands as the debtor's).

141. Cash collateral is defined as cash, negotiable instruments, or other cash equivalents and includes the proceeds, products, or profits of property. *See* 11 U.S.C. § 363(a) (2000 & Supp. 2006).

to cash to a prescribed formula, and lets the lender terminate the arrangement and shut down the firm if there is a default (which the lender can declare if it has reasonable grounds to be concerned about its security).[142] In addition, debtor firms are prevented from using cash collateral that is encumbered by another party's interest unless that party consents or the court orders the party to permit the debtor to use the cash.[143] Since the debtor's primary prepetition lender often has a lien on all the debtor's assets, the DIP must get permission to use the cash or cash collateral.

Most large firms that enter Chapter 11 need postpetition capital because they rarely have a sufficient amount of unencumbered cash to continue to operate the business.[144] Though it may seem counterintuitive to lend to a company in bankruptcy, financial institutions actively participate in DIP lending, which can be both profitable and beneficial to a lender's security position. Not only can DIP lenders charge higher fees and interest rates, but these loans typically are secured by a first position security interest, and DIP liens are given superpriority administrative claim status (i.e., are paid first) in the bankruptcy case.[145] In addition, existing lenders often agree to provide DIP

142. *See* Baird & Rasmussen, *Missing Lever*, *supra* note 140, at 1227–28.

143. 11 U.S.C. § 363(c)(2)(A)–(B); *see* David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 935–38 (2003) (discussing DIP lenders' control in Chapter 11 cases).

144. Courts resist giving DIP lenders a lien on the debtor's prepetition assets if doing so would result in a subordination (or "priming") of the lien of an existing creditor. Indeed, since debtors typically lack sufficient unencumbered assets to secure adequate postpetition financing, preexisting lenders often provide DIP financing. *See, e.g.*, Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219, 225 (2004); Jason B. Burnett & Kenneth B. Jacobs, *Cross-Collateralization in the Wake of* Shapiro v. Saybrook Manufacturing Co. (*In re* Saybrook Manufacturing Co.), 9 BANKR. DEV. J. 503, 505 (1993); Bruce A. Henoch, *Postpetition Financing: Is There Life After Debt?*, 8 BANKR. DEV. J. 575, 598 (1991).

145. *See* Sris Chatterjee et al., *Debtor-in-Possession Financing*, 28 J. OF BANKING & FIN. 3097, 3108–09 (2006) (discussing the higher fees and rates charged by DIP lenders); Jonathan Friedland, *The Impact of New Entrants on Chapter 11: Bankruptcy Processes Continue to Evolve*, J. CORP. RENEWAL, Dec. 2007, at 22, *available at* http://www.turnaround.org/Publications/Articles.aspx?objectID=8505; Marshall S. Huebner, *Debtor-in-Possession Financing*, RMA J., Apr. 2005, at 70 (discussing the superpriority status enjoyed by DIP lenders). Administrative expense claims have a higher priority in payment than virtually all other claims. 11 U.S.C. § 507(a) (2000 & Supp. 2006); *see also id.* § 503(b) (detailing administrative expenses eligible for payment); Baird & Rasmussen, *Missing Lever*, *supra* note 140, at 1238–42 (discussing examples of DIP lending agreements involving large Chapter 11 reorganizations).

financing only if the debtor protects their prepetition debt by repaying that debt before other debts (commonly known as a "rollup").[146] DIP lenders also demand that they be released from all liability based on claims the debtor or creditors may assert against them based on their involvement in the debtor's bankruptcy proceeding, and they demand that debtors release potential defenses against the lender and waive actions against the DIP lender if those actions would harm the lender.[147] Likewise, some DIP financing orders give the lender the right to seize its collateral notwithstanding the restrictions imposed by the Code's automatic stay of collection activities.[148]

Because debtors know they will need to use cash collateral and most likely will need postfiling financing, lenders who provide the funds firms need for their long-term survival can exert extraordinary power over the reorganization. As a matter of course, debtors negotiate with the secured creditor who has an interest in the cash collateral or who will provide DIP financing well before the bankruptcy filing. Debtors start these discussions before the bankruptcy petition is filed to ensure that one of the "first-day" orders gives them permission to use or borrow money.[149] First-day orders are entered in virtually all large re-

146. A rollup essentially forces the debtor to pay the lender's prepetition and postpetition claims in cash and in full at the end of the bankruptcy case. Gen. Elec. Capital Corp., v. Nigro (*In re* Appliance Store, Inc.), 181 B.R. 237, 243 (Bankr. W.D. Pa. 1995) (describing rollup provisions in proposed cash collateral order). *See generally In re* Colad Group, Inc., 324 B.R. 208, 217–19 (Bankr. W.D.N.Y. 2005) (discussing problems posed by cross-collateralization and rollup provisions in a first-day order). *But cf.* Craig R. Bucki, *Cracking the Code: The Legal Authority Behind Extrastatutory Debtor-in-Possession Financing Mechanisms and Their Prospects for Survival*, 2005 COLUM. BUS. L. REV. 357, 360–75 (arguing in favor of the efficiency and autonomy benefits of rollups).

147. *In re* Airadigm Commc'ns, Inc., 519 F.3d 640, 655–56 (7th Cir. 2008); *In re* Insilco Techs., Inc., 480 F.3d 212, 220 (3d Cir. 2007) (finding that language in a settlement agreement releasing debtor's claims against certain lenders barred the Trustee's action to recharacterize or equitably subordinate those claims); *In re* MS55, Inc., No. 06-cv-012333-EWN, 2007 WL 2669150, at *3 (D. Colo. Sept. 6, 2007) (discussing the debtor's release of claims against its DIP lenders upon conversion to Chapter 7).

148. *See, e.g.*, sources cited *supra* note 115; *see also* Marrs-Winn Co. v. Giberson Elec., Inc. (*In re* Marrs-Winn Co.), 103 F.3d 584, 594–95 (7th Cir. 1996) (involving an example of such a financing order); *In re* Stoney Creek Techs., LLC, 364 B.R. 882, 895–96 (Bankr. E.D. Pa. 2007) (denying relief requested pursuant to financing order); *In re Colad Group*, 324 B.R. at 218–19 (characterizing financing order as "inappropriately complex").

149. *See* 11 U.S.C. § 364(c)–(d) (2000) (giving DIP the authority to obtain secured credit); *see also* James J. White, *Death and Resurrection of Secured Credit*, 12 AM. BANKR. INST. L. REV. 139, 177–78 (2004) (discussing common

organizations on an expedited basis[150] in order to address time-sensitive matters such as obtaining DIP financing, using cash collateral, paying certain creditor claims,[151] and retaining key executives.[152] While there are benefits to resolving time-sensitive matters early in the case, lenders often demand that debtors cede control of their assets or of the reorganization process in these early complex orders before other parties in interest in the Chapter 11 case (notably, unsecured creditors and employees) have had a chance to organize.[153] Because of this,

practice of prefiling negotiations). *But cf.* David Barboza, *The Meter Runs in Enron Case, as the Lawyers Retain Lawyers*, N.Y. TIMES, Dec. 25, 2002, at C1 (noting that Enron obtained postpetition DIP financing but ultimately never needed to use it because of strong cash flows).

150. Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 574 n.8 (3d Cir. 2003); *see* Marcus Cole, *"Delaware is Not a State": Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 VAND. L. REV. 1845 app. at 1912 (2002).

151. Debtors often seek to pay the prepetition claims of certain creditors by contending that those creditors are "critical vendors" who will refuse to do business with the debtor unless their claims are paid in full. *See, e.g.*, *Cybergenics Corp.*, 330 F.3d at 574 n.8. *See generally In re* NVR L.P., 147 B.R. 126, 127 (Bankr. E.D. Va. 1992) (addressing a prepetition claim for incentive compensation by a former employee); Joseph Gilday, *"Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code*, 11 AM. BANKR. INST. L. REV. 411, 415–30 (2003) (addressing issues surrounding critical-vendor motions). Until the Seventh Circuit questioned whether bankruptcy courts can rely on the equitable "doctrine of necessity" to pay these claims, courts routinely granted critical-vendor motions. *See In re* Kmart Corp., 359 F.3d 866, 871–74 (7th Cir. 2004) (characterizing the doctrine of necessity as "just a fancy name for a power to depart from the Code" and requiring debtors to prove that vendors would cease dealing with the debtor if their claims were not paid in full and that paying the vendors would provide residual benefits to creditors whose claims were not being paid).

152. Courts are frequently asked to approve retention (also called "pay-to-stay") bonuses to key employees to encourage them to remain with the company after the business files for bankruptcy. *See* Rebecca Revich, *The KERP Revolution*, 81 AM. BANKR. L.J. 87 (2007). Recent amendments to the Code now restrict a firm's ability to pay employees (often the managers) large sums to remain with the firm while it reorganizes in Chapter 11 by requiring firms to prove that key employees are essential to the survival of the business and that the bonus is paid to give the employee an incentive to achieve certain performance goals. 11 U.S.C. § 503(c)(1) (2000 & Supp. 2006); *see* Revich, *supra* (discussing Key Employee Retention Plans under new law).

153. *In re* Colad Group, Inc., 324 B.R. 208, 213–14 (Bankr. W.D.N.Y. 2005). *See* Cole, *supra* note 150, app. at 1912 (statement by Delaware bankruptcy judge that creditors receive "little or no notice" of the hearing to decide first-day orders). Critical-vendor motions often are criticized because they place few restrictions on the managers' ability to protect creditors, appear to favor certain vendors who have preexisting relationships with the debtor's managers, and because paying these vendor claims may dramatically reduce the debtor's available cash. *See* Gilday, *supra* note 151, at 419–23.

some courts refuse to approve certain lender-favorable provisions in first-day orders unless the provisions are narrowly tailored to preserve the debtor's business while the Chapter 11 proceeding progresses and are *not* designed to determine the firm's fate during the first few days of the case.[154] Other courts enter DIP financing or cash collateral orders that give creditors' committees a limited right to carefully scrutinize the orders and determine whether to investigate and pursue claims against the lender.[155]

B. CONTROLLING FIRM DISPOSITION

Lenders also appear to be exerting control over the scope of the Chapter 11 plan of reorganization and the ultimate disposition of the firm and its assets.[156] Many large firms that have filed for relief under Chapter 11 in the last few years have been sold or transferred to a new owner as part of a prenegotiated arrangement between the debtor and the debtor's DIP-lender, exit-financier, or new owner.[157] That more firms are selling all their assets in going-concern sales without even confirming a reorganization plan is not necessarily cause for alarm and is not inconsistent with the Code. The Code, unlike the Act, allows debtors to use Chapter 11 to determine whether the firm could (or should) be reorganized, or whether all or part of the firm's assets should be sold efficiently and in an orderly fashion.[158] However, certain powerful creditor groups appear to

154. *See, e.g.*, *In re Colad Group*, 324 B.R. at 213.

155. Cole, *supra* note 150, app. at 1913; *see also* U.S. BANKR. CT., N.D. CAL., GUIDELINES FOR CASH COLLATERAL & FINANCING MOTIONS & STIPULATIONS § E (2006) (refusing to approve cross-collateralization clauses or waivers of avoidance action); U.S. BANKR. CT., S.D.N.Y. GUIDELINES FOR FINANCING REQUESTS § II (2002); U.S. BANKR. CT., W.D. PA., GUIDELINES FOR CASH COLLATERAL ORDERS (2003).

156. *See, e.g.*, *In re* Stoney Creek Techs., LLC, 364 B.R. 882, 891–92, 895 (Bankr. E.D. Pa. 2007) (rejecting debtor's attempts to obtain additional financing under Chapter 11 reorganization provisions because of inadequate protections for creditors); *see also* Baird & Rasmussen, *Missing Lever*, *supra* note 140, at 1239–40 (discussing terms found in DIP agreements).

157. Firms that used Chapter 11 essentially to implement a prearranged sale, merger, or acquisition include Aurora, Bethlehem Steel, Budget, Conseco, Comdisco, Exodus, Fleming, Global Crossing, Integrated Health Care, Iridium, LTV, Rand McNally, XO Communications, Macy's, McLeodUSA, Stroud's PSINet, TWA, and Unicapital. *See* Baird, *supra* note 112, at 69–83; Dickerson, *supra* note 38, at 115 nn.39–40.

158. *See* 11 U.S.C. § 1123(a)(5)(D) (2000 & Supp. 2006) (authorizing the sale of all or part of debtor's assets in Chapter 11 proceeding); H.R. REP. NO. 95-595, at 407 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6182 (stating

demand quick asset sales even if those sales are not in the best interest of other parties involved in the case.[159]

Until relatively recently, most creditors in Chapter 11 reorganizations were either trade creditors or traditional lending institutions.[160] Trade creditors had an interest in helping the firm restructure and remain in business as a partner.[161] Lenders largely consisted of a limited number of relatively sophisticated banks that had longstanding relationships they wanted to maintain with business debtors.[162] This gave them an incentive to help the firm emerge from Chapter 11 as a successful ongoing business.[163] However, the changing nature of debt structures in modern reorganizations has caused creditors who have controlling financial interests in large business debtors to have no desire to have or maintain a close or long-term relationship with the debtor/borrower.[164]

Over the last decade, traditional banking institutions have joined with nontraditional lending entities to spread their investment risks while providing credit to individual debtors as part of a loan syndicate.[165] Lenders that are part of a syndi-

that a Chapter 11 plan, here a liquidation plan, may "propose the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of the sale among creditors and equity security holders"); *see also* Danny Thomas Props. II Ltd. P'ship v. Beal Bank, S.S.B. (*In re* Danny Thomas Props. II Ltd. P'ship), 241 F.3d 959, 963 (8th Cir. 2001) (stating that a sale of assets is a proper part of a reorganization plan); Fruehauf Corp. v. Jartran, Inc. (*In re* Jartran, Inc.), 886 F.2d 859, 866–67 (7th Cir. 1989) (acknowledging liquidation in Chapter 11); Sandy Ridge Dev. Corp. v. La. Nat'l Bank (*In re* Sandy Ridge Dev. Corp.), 881 F.2d 1346, 1352 (5th Cir. 1989) ("[A]lthough Chapter 11 is titled 'Reorganization,' a plan may result in the liquidation of the debtor.").

159. Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 4, 24–25 (2007) (arguing that recoveries in reorganizations are higher than recoveries in quick fire sales).

160. *Cf.* Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century*, 78 AM. BANKR. L.J. 153, 181 (2004) (describing the typical relationship that existed between debtors and creditors in the 1970s and 1980s, and contrasting it with today's practices).

161. *See id.* (explaining that trade creditors, as fellow members of an interconnected and local business community, had an interest in the long-term success of bankrupt enterprises).

162. *Cf. id.* ("[L]ong-standing relationships were also shared among debtors were also shared among debtors and financial institutions.").

163. *See* Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2014 (2002); Miller & Waisman, *supra* note 160, at 181–82.

164. *See* Miller & Waisman, *supra* note 160, at 181–82.

165. *See* Miller, *supra* note 163, at 2014–15; Miller & Waisman, *supra* note

cated loan are often anonymous, do not meet the firm's managers until the firm is in financial distress or default, and have no interest in having an ongoing relationship with the business debtor.[166] Moreover, because many of these creditors cannot legally hold stock, they cannot agree to swap debt for equity in the reorganized business—something that had widely been used to restructure large firms' debts in Chapter 11.[167] Thus, their sole goal is to sell their claims and make a profit.[168] This short-term interest in the debtor gives them an incentive either to encourage managers to quickly sell the debtor or to force the debtor to hire managers who will advance the creditors' goals.[169]

Finally, firms are increasingly being pushed into quick sales because of the active market in the sale of claims in bankruptcy, the presence of second-lien credit facilities, and the increased influence of hedge funds.[170] While these changes provide additional and often needed liquidity in the market, hedge funds and other entities that purchase claims in bankruptcy (often referred to as distressed debt traders or "vulture" investors) generally have no interest in maintaining an ongoing business relationship with the debtor since their goal is often to

160, at 198. Many of the creditors of large businesses are collateralized debt obligations; *see also* Baird & Rasmussen, *Missing Lever*, *supra* note 140, at 1244 (discussing the structure of syndicated loans); Christopher O'Leary, *CDOs Change Nature of Market*, HIGH YIELD REP., Mar. 13, 2000, at 6–7 (discussing the growth of CDOs as investors in a variety of sectors).

166. *See* Steven A. Dennis & Donald J. Mullineaux, *Syndicated Loans*, 9 J. FIN. INTERMEDIATION 404, 407–09 (2000) (detailing the loan syndication process and noting that "[t]he participants [as opposed to the agent bank] are not generally involved in negotiations with the borrower"); *see also* Miller, *supra* note 163, at 2014 ("Distressed debt traders . . . may have no interest in the debtor's long-term viability.").

167. Participants in syndicated loans include "insurance companies, mutual funds, and other institutional fund managers." Dennis & Mullineaux, *supra* note 166, at 407. For example, the Enron plan proposes to pay $12 billion of the $63 billion in creditor claims by selling assets and giving creditors stock in one of the three companies created from the restructuring (and dismantling) of the original Enron corporate structure. Rebecca Smith, *Enron's Reorganization Plan Is Cleared by Bankruptcy Judge*, WALL ST. J., Jul. 16, 2004, at A2.

168. *See* Miller & Waisman, *supra* note 160, at 181–82.

169. *See id.*

170. For a description and discussion of the new players in debt restructurings, see Frederick F. Eisenbiegler & Robert A.J. Barry, *New Players, Debt Structures Will Shape Next Restructuring Wave: Second Liens Worry Borrowers, Lenders, Professionals*, J. CORP. RENEWAL, Mar. 2007, at 10, *available at* http://www.turnaround.org/publications/articles.aspx?objectID=7275.

either quickly collect their debt or take ownership of the company.[171] For this reason, they generally have no interest in and are unwilling to support efforts to help the debtor establish new or improved business operations.[172] Because these creditors typically want to sell their claims and receive a short-term (but often substantial) return on their investment, they aggressively urge or force the debtor to quickly end the Chapter 11 proceeding by selling the company's assets, either to the creditors themselves or to another investor.[173] To resolve any objections to a quick sale, these secured creditors have even been willing to agree to give the unsecured creditors' committee a portion of the sale proceeds in what generally is referred to as a carve-out agreement.[174]

C. FIRING MANAGERS

While court-ordered management changes are rare, shareholders and lenders now exercise tremendous control over an insolvent (or nearly insolvent) firm's management structure. Indeed, despite Chapter 11's presumption of manager control, anecdotal evidence and empirical data indicate that creditors are causing the officers of large firms to be ousted in anticipation of, or just after, the bankruptcy filing. Indeed, shareholders and lenders appear to routinely force the removal of poorly performing officers once the firm approaches insolvency.[175]

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171. *See id.* at 10.

172. *See* Eric B. Fisher & Andrew L. Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, AM. BANKR. INST. J., Dec.–Jan. 2007, at 24, 87 (discussing the impacts of hedge funds and vulture investors on the reorganization process); *Chapter 22: Are Vulture Investors to Blame?*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, Aug. 21, 2001, at A1; Miller & Waisman, *supra* note 160, at 181.

173. *See* Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 156–57 (2005) (discussing how hedge funds and other alternative investors prefer asset sales, which ensure a quick return on their investment, to debtor rehabilitation).

174. *See* Richard M. Bendix, Jr. & David E. Beker, *Carve-Out Agreements for the Benefit of Unsecured Creditors: Unanswered Questions*, AM. BANKR. INST. J., Apr. 2007, at 24 (describing the process secured creditors use to ensure the business is sold as a going concern and that unsecured creditors do not object to the quick sale).

175. *See Courses Help Sharpen Directors' Skills*, CHI. TRIB., Apr. 9, 1995, § 7, at 8 (stating that shareholders have increased the pressure on directors to remove managers of poorly performing companies); Joe Gardyasz, *Touch 1 May Sell Telemarketer*, BISMARCK TRIB., July 18, 1998, at B1 (noting that the founder and CEO of Touch 1 was replaced at the request of the company's secured creditors); Chris Kauffmann, *Two Directors Leave Marine Bank Board*, VERO BEACH PRESS J. (Fla.), June 24, 2003, at B8 (discussing shareholder re-

Empirical studies have found that officers are replaced in roughly half of the firms who are in financial distress, that is, those that are in default on their debt, insolvent, privately restructuring their debt to avoid bankruptcy, or have filed for bankruptcy.[176] Even if the top-level officers are not ousted before the filing, many do not survive large corporate reorganizations.[177] For example, the CEOs of Global Crossing, Flag Telecom and Leap Wireless were all replaced after their cases were filed.[178] A recent study of companies that emerged from bankruptcy in the 1990s found that the companies eliminated thirty-one percent of the workforce.[179] Moreover, ninety percent of the time, CEOs, COOs, and other top-level managers who were employed by the firm when the Chapter 11 proceeding began either resigned or were fired by the time the firm emerged from the reorganization.[180] Of those who are replaced after a firm enters bankruptcy, most are fired (or forced to retire) just after the bankruptcy petition is filed.[181]

An increased desire to replace managers is, of course, consistent with the pre-Code practice of automatically terminating

moval of nine directors at a bank in poor financial condition); Jeff Manning, *Judge Dismisses Claim Ex-Wilshire Executives Improperly Got Funds*, OREGONIAN, July 25, 2000, at A1 (explaining that after gaining majority on board of directors, creditors fired founder and CEO of Wilshire); David Warsh, *Swedish Import May Be Just What Business Needs*, CHI. TRIB., July 4, 1993, § 7, at 4 (stating that high-level executives of IBM, Digital Equipment, General Motors, Salomon Brothers, and American Express were removed by directors as result of pressure from big institutional investors).

176. *See* Ethan S. Bernstein, *All's Fair in Love, War & Bankruptcy? Corporate Governance Implications of CEO Turnover in Financial Distress*, 11 STAN. J.L., BUS. & FIN. 299, 303, 308 (2006); Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241, 261 (1989).

177. *See* Stuart C. Gilson, *Bankruptcy, Boards, Banks and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355, 369–72 & 371 tbl.5, 386 (1990); Gilson, *supra* note 176, at 246–48 & 247 tbl.3; LoPucki & Whitford, *supra* note 54, at 723 (finding a change in CEOs of large, corporate debtors in ninety-one percent of cases studied).

178. *See* Sam Kennedy, *Can RCN Chief David McCourt Hang onto Job in Bankruptcy?*, MORNING CALL (Allentown, Penn.), June 1, 2004, at D1; *see also Noted…*, WALL. ST. J., Jun. 13, 2007, at B10 (revealing that Brad Morrice, CEO and board member of New Century Financial Corp., was fired without cause and immediately replaced two months after New Century filed for bankruptcy).

179. *See* Robert J. Grossman, *Holding Back Bankruptcy*, HR MAG., May 2003, at 44, 46–47, *available at* http://www.shrm.org/hrmagazine/articles/0503/0503covstory.asp.

180. *See id.*

181. Bernstein, *supra* note 176, at 311.

managers once the firm filed for bankruptcy.[182] Moreover, since lenders often want to send a message to new investors that the firm is on track to rehabilitate itself, they have an incentive to remove the managers who ostensibly derailed the firm and sent it into bankruptcy. For whatever reason, shareholders and lenders (especially DIP financiers) increasingly are demanding greater rights to name or remove managers and directors and to force the firm to retain financial advisors selected by the lenders.[183] Directors are rarely removed before the petition is filed, even in prenegotiated or prepackaged reorganization proceedings controlled by the debtor's principal creditor.[184] Directors who did not resign before the filing are, however, almost always replaced with directors selected by the firm's creditors or new owners.[185] Others agree to resign in exchange for an agreement not to have a public trustee appointed.[186] Thus, while the managers of some megafirms were not fired until after the filing (despite allegations of fraud or mismanagement),[187] even managers who are not replaced before the com-

182. *See supra* Part III.A.1.

183. *See* Miller & Waisman, *supra* note 160, at 183 (contending that cash collateral agreements give creditors the power to place a "stranglehold" on debtors); Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases*, BANK. STRATEGIST, Nov. 2003, at 1; Skeel, *supra* note 143, at 922, 926, 931 (describing the trend towards increased lender control of corporate governance in Chapter 11 cases and the cabining of the power of directors and managers).

184. *See* Gilson, *supra* note 176, at 370 tbl.5.

185. *See* Matthew Wong, *Bankruptcy as a Risk Management Tool: Economic and Social Implications*, REV. OF BUS., Sept. 22, 2003, at 46, 49, 51 n.13 (citing a study finding that fifty-four percent of the companies' directors leave near the time of the bankruptcy filing); *see also* John D. Ayer, *The Role of Finance Theory in Shaping Bankruptcy Policy*, 3 AM. BANKR. INST. L. REV. 53, 78 n.99 (1995) (citing statistics regarding replacement of board of directors); Baird & Rasmussen, *Chapter 11 at Twilight*, *supra* note 138, at 697 & n.79 ("[D]irectors of these businesses do not survive."); Brian L. Betker et al., *"Warm with Sunny Skies": Disclosure Statement Forecasts*, 73 AM. BANKR. L.J. 809, 826 (1999) (estimating boards change seventy percent of members during reorganization); Gilson, *supra* note 177, at 386 ("On average, only 46% of incumbent directors and 43% of CEOs remain with their firms at the conclusion of the bankruptcy or debt restructuring.").

186. Terry Brennan, *Refco Spared Ch. 11 Trustee*, DAILY DEAL, Jan. 12, 2006, 2006 WLNR 618273.

187. S*ee In re* Adelphia Commc'n Corp., No. 02-41729, 2003 WL 22316543, at *1–5 (Bankr. S.D.N.Y. Mar. 4, 2003) (notwithstanding the financial scandals associated with the Adelphia Communications Corp. bankruptcy, senior management was not replaced until after the filing). Likewise, Ken Lay did not resign as CEO of Enron until January 23, 2002, more than a month after the bankruptcy petition was filed on December 2, 2001. Robert Schlesinger,

pany files for bankruptcy often lose their jobs before the Chapter 11 plan is confirmed.[188]

IV. THE NEW "PRIVATE" TRUSTEE

Congress rejected the Act's statutory trustee-controlled model[189] because of the view that managers did not create the firm's financial problems, and also because a public trustee would be unfamiliar with the debtor's business.[190] Though the Code makes it easier to appoint a trustee, appointments of public trustees remain rare and officers are not always forced to resign once the bankruptcy petition is filed.[191] However, managers increasingly are forced to share control of the business during the reorganization proceeding with court-appointed examiners and with a chief restructuring officer (CRO) or other entity that often lacks experience working in the firm's industry.[192] Indeed, perhaps the biggest change in manager control is the increasing trend by lenders to suggest that the company voluntarily[193] hire a turnaround or crisis manager or CRO immediately before or just after the bankruptcy filing.[194]

Enron Chief Executive Lay Resigns, BOSTON GLOBE, Jan. 24, 2002, at A2.

188. *See, e.g.*, *In re* Mortgage Inv. Co., 111 B.R. 604, 612 (Bankr. W.D. Tex. 1990) (refusing to find the manager of a company in Chapter 11 incompetent despite governmental investigation of his role in a savings and loan venture).

189. *See* SKEEL, *supra* note 47, at 177–78; Miller & Waisman, *supra* note 160, at 176.

190. *Cf.* Skeel, *supra* note 143, at 927 (noting that for the very same reasons creditors are hesitant to replace managers).

191. *See id.*

192. *See* Miller & Waisman, *supra* note 160, at 186–87 (suggesting that the "Chief Restructuring Officer" is the reincarnation of another entity that creditors sought to have appointed to control the firm, the "responsible officer").

193. *See* Mark V. Bossi, *Are CROs More Powerful than Turnaround Consultants? Creditors Drive Trend Toward New Title*, J. CORP. RENEWAL, Oct. 2006, at 1, *available at* http://www.turnaround.org/Publications/Articles.aspx?objectID=6588 (describing the processes creditors have used to influence companies to "voluntarily" retain turnaround professionals); Miller & Waisman, *supra* note 160, at 186–87 (discussing the ways in which lenders benefit from the appointment of a chief restructuring officer). Lenders likely will not overtly demand that debtors hire a specific person to be the CRO because of concerns with lender liability. *See, e.g.*, 1 WILLIAM L. WALLANDER & JEREMY B. COFFEY, LENDER LIABILITY LAW AND LITIGATION § 8.10[3][b] (1989 & Supp. 2008). For similar reasons, lenders will avoid dictating how the CRO should run the debtor's day-to-day operations. *See, e.g.*, Boyd v. Sachs (*In re* Auto Specialties Mfg. Co.), 153 B.R. 457, 478–81 (Bankr. W.D. Mich. 1993). *See generally* Baird & Rasmussen, *Missing Lever*, *supra* note 140, at 1235–36 (discussing concerns lenders would have with ordering companies to hire a specific CRO).

194. *See* William H. Henrich, The Role of the CRO in Debtor/Lender Com-

A. RETAINING THE PRIVATE TRUSTEE

The Code does not mention CROs, which are entities that are not exactly chief financial officers or chief executive officers.[195] Indeed, until recently, the term "CRO" was not even mentioned in published judicial opinions.[196] CROs play various roles in bankruptcy cases and have duties that are sometimes limited, like helping to secure future financing, but at other times are comprehensive, like running the company.[197] Despite their increased presence in bankruptcy cases since the early 2000s, neither the Bankruptcy Act nor the Code anticipated that debtors would be controlled by managers who were not hired as employees of the firm and were not appointed by the court as a public trustee. CROs and other privatized trustees now routinely serve as the debtor's representative during the bankruptcy case, oversee the development of financial projections, disseminate information to parties in interest, oversee the sale of assets, and prepare and negotiate the reorganization plan with creditor, bondholder, and equity committees.[198]

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munications in Bankruptcy, AM. BANKR. INST. J., July–Aug. 2004, at 20 ("Like the emergency room physician, the CRO seldom arrives on a cheerful scene.").

195. *Cf.* Anthony Horvat, *Defining the Role of the CRO: The Strategic and Tactical Benefits of a Seasoned Professional*, AM. BANKR. INST. J., Sept. 2005, at 46–47 (noting that while "there is no consensus in the definition [of CRO]," one appropriate responsibility is managing the financial aspects of the company); Miller & Waisman, *supra* note 160, at 186 ("The CRO is vested with executive decision making powers and direct access to the debtor's governing body.").

196. A search of Lexis and Westlaw databases shows no opinions using the term prior to 2000. The earliest online decision that mentions a CRO appears to be *Clyde Bergemann, Inc. v. Babcock & Wilcox Co. (In re Babcock & Wilcox)*, No.00-1154, 2000 U.S. Dist. LEXIS 6448, at *17 (E.D. La. May 3, 2000). The first reported opinion to use the phrase "Chief Restructuring Officer" appears to be *Clyde Bergemann, Inc. v. Babcock & Wilcox Co. (In re Babcock & Wilcox Co.)*, 250 F.3d 955, 959 n.8 (5th Cir. 2001).

197. *See* James H.M. Sprayregen et al., *Chapter 11: Not Perfect, But Better Than the Alternatives*, J. BANKR. L. & PRAC., Dec. 2005, at 3, 24–25 (surveying the range of services CROs can provide and noting how this can vary on a case by case basis).

198. *See* Daniel F. Dooley, *CROs Can Be Driving Force for Good Corporate Governance*, J. CORP. RENEWAL, Oct. 2007, at 14, *available at* http://www.turnaround.org/Publications/Articles.aspx?objectID=8111 (explaining the issues CROs must address); Richard E. Mikels & Charles W. Azano, *"The More Things Change." Reflections on 34 Years of Practice*, AM. BANKR. INST. J., Oct. 2006, at 22, 70 (describing the expanding role of the CRO); Jonathan Berke, *For Interstate, Ch. 11 No Cakewalk*, DAILY DEAL, Sept. 23, 2004, 2004 WLNR 4656456 (stating that the manufacturer of Twinkies hired both its interim CEO and CRO from a crisis management firm and that the two will likely alter the company's distribution model); *Candy Corporation Crumbles*, BANKR.

Though they at times appear to serve as surrogates for a court-appointed trustee or examiner, they are predisposed to favor only one entity involved in the debtor's Chapter 11 reorganization: the creditor who was responsible for getting them hired.[199] Indeed, in most instances, the privatized trustee reports directly to the firm's board of directors, not to the CEO or other managers.[200]

While lenders likely would not force a firm to hire the lenders' chosen manager, the request to fire existing managers and hire new ones often is coupled with the lenders' refusal to continue to support financially struggling firms unless the firm complies with the request.[201] In addition, once the firm files for bankruptcy, creditors often insist that the DIP financing or cash collateral order require the debtor to appoint a CRO, who

CT. DECISIONS WKLY. NEWS & COMMENT, Feb. 10, 2004, at A2 (discussing comments of the CRO of Archibald Candy Corp.); *Firms' Teamwork Leads to Smooth Asset Sale for Piccadilly's*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, Apr. 27, 2004, at A7 (reporting that CRO of Piccadilly was a managing director of Phoenix Management Services); *IMPATH Reorganization Cooperation Culminates in Sale of Division*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, Jun. 1, 2004, at A8 (discussing Crossroads LLC, IMPATH's restructuring advisors, and its accomplishments, including the sale of business units and the stabilization of operations in the face of financial investigations); *Judge Barr Praises Professionals in Centis Bankruptcy*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, Jul. 27, 2004, at A5 (commending the work of bankruptcy professionals in formulating and enacting a liquidation plan); *Pathway Strategic Partners to Reorganize Waterman Industries*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, May 4, 2004, at A2 (announcing that principal of Pathway Strategic Partners LLC would serve as CRO of Waterman Industries); *Penthouse Publisher Goes Bust*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, Aug. 26, 2003, at A2 (announcing appointment of managing partner of Corporate Revitalization Partners LLC as CRO of General Media Inc.); *The Spiegel Group Sells Self-Named Catalog*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, June 9, 2004, at A2 (discussing CRO's role in the sale of a company's assets).

199. *See, e.g.*, *In re* Colad Group, Inc., 324 B.R. 208, 215 (Bankr. W.D.N.Y. 2005) (noting that the debtor selected the proposed consultant based on the secured creditor's recommendation); Mikels & Azano, *supra* note 198, at 70 (noting that lenders often require firms to employ a CRO and "obviously, it is more beneficial for creditors than for the debtor to have in place managers with less allegiance to shareholders and other management").

200. Baird & Rasmussen, *Missing Lever*, *supra* note 140, at 1234; Henrich, *supra* note 194, at 20.

201. *See* Bucki, *supra* note 146, at 392–93 (describing the wide range of powers a lender has over the debtor, including the power to insist upon the appointment of a CRO); Mikels & Azano, *supra* note 198, at 70 (describing the relationship between the debtor, CRO, and lender when the appointment of a CRO is required by the lender); Bert Weil, *Building Value Requires Addressing Host of Issues*, J. OF CORP. RENEWAL, Oct. 2004, at 4, 5.

often is selected or strongly recommended by the creditor and who meets privately with (and often reports to) the creditor. Advocates of this management structure contend that turnaround specialists who serve in the role of CRO can devise an objective strategic plan to guide a financially troubled company back to solvency while allowing existing managers to focus on the firm's day-to-day operations.[202]

Rather than seek the appointment of a public trustee, lenders and investors have embraced the concept of replacing managers with private turnaround specialists, ostensibly because of the specialists' expertise in operating financially distressed businesses.[203] Courts now routinely approve requests to hire turnaround specialists, crisis managers, and other professionals to serve as the CEO, CFO, or CRO of the company during the Chapter 11 proceeding.[204] For example, in 1995 and

202. Horvat, *supra* note 195, at 46; AM. BANKR. INST. J., SEPT. 2005, at 46, 46; *see also* AlixPartners, *Bankruptcy Reorganization*, http://www.alixpartners.com/EN/Services/BankruptcyReorganization/tabid/296/Default.aspx (last visited Dec. 2, 2008).

203. James H.M. Sprayregen et al., *Chapter 11: Not Perfect, But Better Than The Alternatives*, J. BANKR. L. & PRAC., 2005 , at 3, 24–25 (arguing that CROs are able to tailor their role to fit the circumstances of the bankruptcy, thereby increasing both efficiency and success). Some of these CROs have run companies with wildly different business operations. For example, Robert Dangremond of AlixPartners was the CEO of Refco (financial services company), CRO of Harnischfeger Industries (manufacturer, servicer, and distributor of surface mining products), CRO of Mirant (energy supplier), CFO of Zenith (home electronics), and CEO of Forstmann and Co. (private equity firm). AlixPartners, *Profile of Robert Dangremond*, http://www.alixpartners.com/EN/Professionals/ManagingDirectors/tabid/132/ModID/482/EmployeeID/30/Display/Bio/Default.aspx (last visited Dec. 2, 2008). John Boken of Kroll Zolfo Cooper is the CEO and CRO of TOUSA (homebuilder) and was the CRO of Collins & Aikman (auto parts supplier) and President and COO of NRG Energy (energy supplier). Kroll Zolfo Cooper, *Profile of John Boken*, http://www.krollzolfocooper.com/professionals/managingdirectors/boken/ (last visited Dec. 2, 2008). Of course, the availability of a pool of managers who have experience running or reorganizing distressed businesses casts into doubt the continued validity of the Code's antitrustee, manager-controlled presumption. The existence of these experienced turnaround specialists means that the replacement of managers might not delay the reorganization or deprive Chapter 11 debtors of experienced turnaround managers. *But cf. In re* Adelphia Commc'ns Corp., No. 02-41792, 2003 WL 22316543, at *4 (Bankr. S.D.N.Y. Mar. 4, 2003) (noting that installing senior management with extensive experience in the industry would help the debtor "chart a strategic direction and a long-term business plan around which a plan of reorganization may be structured").

204. Debtors who have used turnaround professionals include APS Holding Corp., Enron, Federated Department Stores, Harischfeger Industries, Kmart, Laidlaw, LTV Steel Company, Penn Traffic Co., Polaroid, Sunbeam, Wheeling Pittsburgh Steel Corp, and WorldCom. Robin E. Keller, *How to Get the Most*

1996 there was not a single CRO hired in any of the twenty largest Chapter 11 filings. Within the last ten years, however, hiring a CRO has become commonplace and CROs have been retained in approximately thirty percent of the largest Chapter 11 filings.[205]

CROs have been hired as officers, statutory trustees, and professionals.[206] Because professionals typically are required to report to the firm's officers or board of directors and to act at their discretion, however, creditors prefer to hire these managers as officers.[207] When asked to approve a debtor's request to hire a CRO as an officer rather than a professional who would be subject to court (and creditor) scrutiny, courts often ignore the turnaround manager's title and instead consider the substance of the manager's duties. In deciding whether a turnaround specialist is actually a disinterested professional whose retention and compensation must be approved by the court, courts have used both a qualitative and quantitative analysis. Courts generally consider the role the person would play in the reorganization case and will find the person to be a professional if she will play a central or significant role in the administration of the Chapter 11 proceeding[208] or will have discretion and autonomy in administering some aspect of the debtor's estate.[209]

An individual hired as senior management is often treated as a professional if the individual's primary employment is with a consulting or insolvency firm and the individual does not

From Crisis Manager Within the Limits of the Bankruptcy Code, BANKR. STRATEGIST, May 2001, at 1, 1; Elizabeth Douglass, *Worldcom Hires Turnaround Experts*, L.A. TIMES, July 30, 2002, at C3; Alison Maitland, *Clearing Up After the Visionaries*, FIN. TIMES (London), Jan. 30, 2003, at 12; Judith Schoolman, *Kmart May Fail Survival Test*, DAILY NEWS (N.Y.), Jan. 24, 2003, at 37; Tracy Turner, *Big Bear Parent Names Chairman*, COLUMBUS DISPATCH, Sept. 5, 2003, at E1.

205. *See* THE BANKRUPTCY YEARBOOK & ALMANAC (1995–2007), (5th to 17th eds. 1995–2007). The Almanac compiles data for the twenty largest bankruptcies, including trustee and examiner appointments and changes in management.

206. *See, e.g.*, *In re* Metro. Elec. Mfg. Co., 295 B.R. 7, 9 (Bankr. E.D.N.Y. 2003); *In re* Bartley Lindsay Co., 120 B.R. 507, 512 (Bankr. D. Minn. 1990).

207. *See* Bossi, *supra*, note 193, at 1.

208. *In re* Federal Mogul-Global, Inc., 348 F.3d 390, 404 (3d Cir. 2003); *In re* CNH, Inc., 304 B.R. 177, 179 (Bankr. M.D. Pa. 2004); *In re* Seatrain Lines, Inc., 13 B.R. 980, 981 (Bankr. S.D.N.Y. 1981).

209. *In re* ACANDS, Inc., 297 B.R. 395, 402 (Bankr. D. Del. 2003); Bicoastal Corp. v. Clear (*In re* Bicoastal Corp.), 149 B.R. 216, 218 (Bankr. M.D. Fla. 1993).

work full time for the debtor; if the individual is retained by the debtor contemporaneously with or immediately following the bankruptcy filing; if the individual's compensation is paid to the consulting firm; or if the individual has been hired on an interim basis to work through the debtor's immediate financial problems.[210] Thus, though firms, their primary creditors, and the privatized trustees themselves may resist labeling the new manager as a professional, some courts conclude that even when new managers are hired to serve as officers of a debtor firm, they are professionals who may be paid only after the court approves their application for compensation.[211]

Even if CROs or other privatized trustees provide value, other parties in interest have the right to full information about their employment status, the amount of control they have over the business reorganization, and any potential agency conflicts created by their relationship with other parties in interest in the case.

B. BENEFITS, COSTS, AND AGENCY CONFLICTS

The Code does not explain what debtors must show to warrant hiring a CRO or any other private trustee, what procedures must be used to hire one, to whom the private trustee must report, or whether shareholders or creditors have the right to vote to replace a private trustee during the reorganization proceeding.[212] Who has the right to replace managers and professionals during the bankruptcy case is critical, since the replacements will have an incentive to favor the position of the party who controls their retention even if the manager understands that the Code imposes on her ethical obligations to other parties involved in the case.[213] Courts have allowed entities

210. *In re* Madison Mgmt. Group, Inc., 137 B.R. 275, 283–84 (Bankr. N.D. Ill. 1992); *In re* Bartley Lindsay Co., 120 B.R. 507, 512 (Bankr. D. Minn. 1990).

211. *See, e.g.*, *Madison*, 137 B.R. at 284; *Bartley*, 120 B.R. at 512–13; *see also* Keller, *supra* note 204, at 1. Some courts have concluded that turnaround specialists who were hired before the bankruptcy filing and who serve as officers and make all relevant business decisions for the firm are not professionals whose retention must be approved by the court. *See, e.g.*, *In re* Phoenix Steel Corp., 110 B.R. 141, 142 (Bankr. D. Del. 1989).

212. *Cf. Turnaround Managers Discuss Lessons from Merry-Go-Round*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, Dec. 18, 2001, at A1 (discussing that the role of the CRO is not clearly defined by the Code and that the engagement letter needs to clearly define the CRO's authority and responsibility).

213. While the case law is mixed, there is strong support for the argument that shareholders retain the right to call meetings even after the Chapter 11

that are hired as professionals to serve as the debtor company's CEO even though the professionals typically are not employees of the debtor. Indeed, privatized trustees almost always are referred to as independent contractors and they often are employed by other entities.[214] CROs who are members of turnaround firms almost always retain their affiliations with those entities,[215] and typically are paid through their turnaround firms (or other related entities) even as they serve as CRO or CEO of a Chapter 11 debtor. For example, the motion to hire the CRO in the Enron bankruptcy requested the court to enter an order pursuant to § 363 of the Code authorizing Enron to "[e]nter into an [a]greement to [e]mploy Stephen Forbes Cooper, LLC as an [i]ndependent [c]ontractor to [p]rovide [m]anagement [s]ervices for the [d]ebtor."[216]

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filing. *See* Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 801 F.2d 60, 64 (2d Cir. 1986); Official Bondholders Comm. v. Chase Manhatten Bank (*In re* Marvel Entm't Group, Inc.), 209 B.R. 832, 838–40 (D. Del. 1997); *In re* Heck's Props., Inc., 151 B.R. 739, 757–60 (S.D. W. Va. 1992). Other courts have found that allowing a stockholder meeting may interfere with a bankruptcy case and should be enjoined. *See, e.g.*, *In re* Potter Instrument Co., 593 F.2d 470, 475 (2d Cir. 1979); *In re* Quail Aero Service, Inc., 755 N.Y.S.2d 103, 105 (App. Div. 2002); *In re* Bicoastal Corp., No. 89-8191-8P1, 1989 WL 607352 (Bankr. M.D. Fla. Nov. 21, 1989); *see also* Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 68–73 (1990) (arguing that shareholder meetings should routinely be enjoined). *See generally* Mark E. Budnitz, *Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, or Should the Meeting Be Cancelled Altogether?*, 58 GEO. WASH. L. REV. 1214 (1990) (tracing the case law concerning shareholder meetings in the bankruptcy context and proposing a new test to determine if meetings should be enjoined or permitted).

214. *See, e.g.*, Sea Containers, Ltd., Current Report (Form 8-K), exhibit 10.1 at 13 (Apr. 18, 2007); McLeodUSA, Inc., Current Report (Form 8-K), exhibit 10.4 at 1 (Aug. 12, 2005); Integrated Health Servs., Inc., Current Report (Form 8-K), exhibit 10.3 at 6 (July 27, 2000); Final Order Pursuant to 11 U.S.C. § 363 Authorizing the Continued Employment of AP Services, LLC as Crisis Managers to the Debtors and the Designation of Ted Stenger as Chief Restructuring Officer of the Debtors, *In re* Dana Corp., No. 06-10354 (Bankr. S.D.N.Y. Mar. 29, 2006) (all creating an independent contractor relationship between the debtor and the consulting firm).

215. The Mirant Corporation bankruptcy provides a standard illustration of CRO compensation. Mirant paid AlixPartners, LLC directly for an AlixPartners principal's service as Chief Restructuring Officer. Mirant Corp., Annual Report (Form 10-K), at 105 (Mar. 15, 2005).

216. Order Pursuant to 11 U.S.C. § 363 Authorizing the Debtors to Enter Into an Agreement to Employ Stephen Forbes Cooper, LLC as an Independent Contractor to Provide Management Services for the Debtors Nunc Pro Tunc to January 28, 2002, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Apr. 4, 2002), 2002 WL 32150520.

Mr. Cooper was hired as the CRO and CEO of Enron but remained a principal of Kroll Zolfo Cooper, a "risk consulting firm" that provides turnaround consulting and risk and crisis management. He also served as a CRO for other companies while serving as Enron's CRO.[217] Ironically, while the CRO in Enron was not an Enron employee,[218] the CRO and the others hired to assist the CRO were entitled to indemnification under Enron's directors' and officers' liability insurance policies. Other large firms that also agreed to provide indemnification to a CRO (or the CRO's consulting firm) include Integrated Health Services, Inc., American Business Financial Services, Inc., and Dana Corporation.[219] In effect, these private trustees had all the powers of a corporate officer, had control of the business during the restructuring proceeding, and had limited liability as a result of those powers—but had no explicit fiduciary duties to other creditors or parties with interests in the bankruptcy case.[220]

Allowing a firm to hire a private trustee when the firm already has hired other professionals or when an examiner has been appointed by the court is also problematic because it can dramatically increase costs. For example, Enron had an ex-

217. Maitland, *supra* note 204; Paul Nowell, *Krispy Kreme Ousts CEO in Turnaround Bid*, WASH. POST, Jan. 19, 2005, at E3 (announcing Cooper's installment as CEO of Krispy Kreme while he continued to serve as CEO of Enron).

218. Stephen Cooper, Enron's CRO, was paid by his limited liability company, SFCooper, LLC. Order Pursuant to 11 U.S.C. § 363 Authorizing the Debtors to Enter Into an Agreement to Employ Stephen Forbes Cooper, LLC as an Independent Contractor to Provide Management Services for the Debtors Nunc Pro Tunc to January 28, 2002, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Apr. 4, 2002), 2002 WL 32150520.

219. *See* Sea Containers, Ltd., Current Report (Form 8-K), exhibit 10.1 at 13 (Apr. 18, 2007); McLeodUSA, Inc., Current Report (Form 8-K), exhibit 10.4 at 1 (Aug. 12, 2005); Am. Bus. Fin. Servs., Inc., Current Report (Form 8-K/A), exhibit 10.2 at 5–6 (Mar. 10, 2005); Integrated Health Servs., Inc., Current Report (Form 8-K), exhibit 10.3 at 7 (July 27, 2000); Letter from Ted Stenger, Managing Director of AP Services, LLC to Michael L. DeBacker, Vice President, Dana Corporation (Mar. 2, 2006), *reprinted in* Application of the Debtors and Debtors in Possession Pursuant to 11 U.S.C. § 363 for Entry of (I) An Interim Order Authorizing the Employment of AP Services, LLC as Crisis Managers to the Debtors and the Designation of Ted Stenger as Chief Restructuring Officer of the Debtors and Scheduling Final Hearing on Proposed Employment Agreement, and (II) A Final Order Authorizing Same, *In re* Dana Corp., No. 06-10354 (Bankr. S.D.N.Y. Mar. 3, 2006)

220. The CRO and CFO in WorldCom also remained members of the same consulting firm even as they served as officers of WorldCom. Elizabeth Douglass, *Worldcom Hires Turnaround Experts*, L.A. TIMES, July 30, 2002, at C3.

aminer and a CRO, both of whom helped to investigate and unravel Enron's complex financial transactions and its use of business partnerships to conceal debt.[221] Enron's examiner was paid $90 million to investigate Enron's prepetition activities with its managers, lawyers, banks, and accountants.[222] The original contract to hire the CRO obligated Enron to pay $1.32 million annually for the CRO's services, $1.2 million annually for the services of up to fifteen other members of a turnaround firm, and a minimum $5 million "success fee."[223] After objections by the SEC and other creditors, this amount was reduced to $1.2 million annually for the CRO and $800,000 for the associates. The turnaround firm had been paid $63.4 million in fees when it requested a $25 million success fee for the CRO's and associates' work in the case.[224] While this compensation may be comparable to fees paid to consultants who provided management services to nondebtor businesses, the motion to employ the CRO in Enron as an independent contractor to provide management services did not provide proof that the proposed compensation was market-based. Moreover, it is not clear whether the CRO, examiner and creditors committee performed similar functions or tasks during the bankruptcy.[225]

Having the privatized trustee report to and be controlled by only one secured creditor exacerbates agency problems since the trustee has little incentive to protect the interests of the parties who face the greatest losses in bankruptcy cases, namely, the unsecured creditors. In addition, in some instances, the amount of fees the private trustee (and the associates she hires) receives from the debtor directly impacts the profitability

221. *Firm Requests 'Success Fee' in Enron Case*, N.Y. TIMES, Sept. 4, 2004, at C2; Carrie Johnson, *Interim Chief At Enron Asks for $25 Million*, WASH. POST, Sept. 4, 2004, at E1.

222. *Firm Requests 'Success Fee' in Enron Case*, *supra* note 221.

223. The CRO eventually petitioned the court to hire even more employees from the turnaround firm. Eric Berger, *Enron Finds Bills Pile Up as Cash Drains*, HOUS. CHRON., Oct. 25, 2002, at Bus. 1 (reporting that the bankruptcy judge approved a request to hire fifteen more restructuring experts).

224. Pacelle, *supra* note 131.

225. WorldCom also had an Examiner, a CRO, a CEO, and an active creditors committee. The CRO in WorldCom, though not paid as handsomely as Enron's CRO, also asked for a $7 million "success" bonus for the CRO and CFO (who were both employed by the same risk management firm). *See* Jonathan D. Glater, *In Scandals, Another High Price to Pay*, N.Y. TIMES, Dec. 13, 2002, at C1.

of the turnaround firm.[226] This creates yet another agency conflict. It also gives the private trustee an incentive to pursue its own economic interest to the detriment of other parties involved in the bankruptcy case.

Creditors and the Office of the United States Trustee have objected to the retention of these private trustees, citing private trustees' conflicts and the amount of money the trustees and their firms have charged in Chapter 11 cases. Some critics have argued that private trustees cannot be disinterested if members of the private trustee's consulting firm have been hired both as professionals and as officers of the debtor, or if members of the firm served as officers of the debtor before the bankruptcy case was filed. Objections also have been filed where the debtor had employed the consulting firm before the filing, or because the private trustee's actual employer (the consulting firm) sought an equity interest in the debtor.[227] Parties also have objected because the debtor did not propose to hire the private trustee either as a professional or an officer but instead sought to employ the person in a manner not recognized by the Code.[228]

The potential conflicts and the uncertainty created when members of a turnaround firm are hired to serve as CROs or CEOs in bankruptcy cases caused the United States Trustee in one region to negotiate a protocol with a major turnaround firm that prevents that firm from serving in more than one capacity or switching roles in a case, and from being retained by the debtor if anyone affiliated with the turnaround firm sat on the debtor's board within the preceding two years.[229] Under the protocol, the turnaround firm may not be retained as both a professional under § 327 and as an officer under § 363.[230] It also gives the court the explicit authority to review the private trustee's compensation and fees under a reasonableness standard, but it does not impose any explicit duty on the turna-

226. For example, media reports suggest that increasing the number of associates from the CRO's turnaround firm who worked for Enron helped bolster the turnaround firm's profit targets and ultimately would increase the CRO's bonus from the turnaround firm. *See* Barboza, *supra* note 127.

227. *See, e.g.*, *In re* Bidermann Indus., U.S.A., Inc., 203 B.R. 547, 549, 553–54 (Bankr. S.D.N.Y. 1997).

228. *See* Keller, *supra* note 204, at 1.

229. *See* U.S. Trustee Program, Protocol for Engagement of Jay Alix & Associates and Affiliates, at 1–2, *available at* http://www.usdoj.gov/ust/r02/docs/chapt11/manhattan_retention/Jay_Alix_Protocol.doc.

230. *Id.* at 1.

round expert to consider the interests of all parties in the bankruptcy case.[231]

V. CLARIFYING PRIVATE TRUSTEES' ETHICAL DUTIES

The private trustee model that firms are now using is inconsistent with the Code's presumption that prepetition managers will be allowed to control the firm during the bankruptcy proceeding. If, as seems to be the case, creditors have lost confidence in the managers' ability to run the firm, if they feel managers are unable to fulfill their fiduciary duties to all parties in interest, or if they believe the firm's prebankruptcy managers are incompetent, they can exercise their right under the Code to have those managers replaced by a public trustee.[232] Creditors' circumvention of the Code's presumption that either existing managers should be allowed to control the firm or a public trustee should be appointed to replace unfit managers creates inherent conflicts of interest and gives private trustees an incentive to ignore the interests of all parties involved in the case, with the notable exception of the interests of the party that cause it to be retained.

While serving as CROs or CEOs, privatized trustees often control the daily operations of many debtor firms but remain principals of their consulting firms, commonly serving in conjunction with existing management (i.e., the debtor's CEO) or with a court-appointed examiner.[233] This overlapping management structure is not consistent with Chapter 11's statutory provisions, which anticipate that there will be one of the following: a DIP (and perhaps an examiner), or a public trustee (and not an examiner). Moreover, having a DIP and a private trustee or a private trustee and an examiner unnecessarily increases the costs associated with the reorganization.

Because the use of private trustees is a relatively new phenomenon, and because they are retained under circumstances that fail to give other parties an adequate opportunity to question the retention, the fiduciary duties of private trustees are murky and agency problems are rampant. While some courts

231. *Id.* at 3.

232. 11 U.S.C. § 1104 (2000 & Supp. 2006).

233. *2 AlixPartners Specialists Will Oversee Turnaround at WorldCom*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, Aug. 13, 2002, at A1, *available at* Westlaw, 39 No. 21 BCD (LRP) 1. (reporting that WorldCom hired two principals of a turnaround firm as its CRO and CFO, that these individuals reported to the CEO, and that an examiner had been named in the case).

and commentators have suggested that a turnaround specialist who also serves as the CEO or other top-level manager should have some type of fiduciary duties,[234] private trustees do not appear to have the same obligations as public trustees despite their apparently unlimited powers to control the firm. That is, they typically have limited liability and may have a right to be indemnified for their actions,[235] yet have no clear duties to either the debtor or any creditor other than the one who may have insisted that they be hired.

Agency problems exist because other parties in interest cannot effectively supervise or monitor the managers' performance or routinely object to their compensation. Indeed, if managers are not required to disclose their relationships with other parties in interest, the court cannot adequately supervise a manager to evaluate her loyalty to the estate. Likewise, without requiring managers to disclose their relationships with others involved in the case, courts are less likely to be able to prevent improper conduct or to determine whether the manager's request for compensation is reasonable. Because private trustees usually avoid being hired as professionals under § 327, once the court approves the motion to retain their services and to pay the compensation provided in their contract, creditors and other parties in interest typically cannot object to their compensation or to the fees that the debtor firm pays for additional consultants.

Perhaps the easiest way to eliminate the agency costs and conflicts of interest associated with privatized trustees would be to prevent them from exercising any control over business debtors. This ban could be justified on the theory that the agency conflicts these private trustees have when they are allowed to control the reorganization proceeding will be greater than the conflicts managers already have when they are balancing the interests of shareholders or certain creditors (like trade creditors or suppliers) who are likely to support keeping the firm intact (and retaining the current managers) with those of other creditors (like distressed debt traders or hedge funds) who might prefer liquidating the firm.[236] While preventing

234. *In re* Bidermann Indus. U.S.A., Inc., 203 B.R. 547, 551–52 (Bankr. S.D.N.Y. 1997); *Ethical Decisions About Cash May Result in Lawsuits*, BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, Dec. 18, 2001, at A3 (noting problems involved when the CRO is also an officer or fiduciary of the firm).

235. *See supra* notes 179–80 and accompanying text.

236. *See* Bienenstock, *supra* note 76, at 544–47 (discussing incentives that affect managers' and trustees' negotiations during Chapter 11 reorganiza-

firms from hiring private trustees might reduce agency costs and eliminate conflicting loyalties, this ultimately may not be in the best interest of the debtor because it might prevent businesses from hiring professionals with the expertise and talent needed to help the business reorganize in Chapter 11. Moreover, *all* managers face some conflicts because they must balance the interests of creditors and shareholders.

Instead, debtors should be allowed to retain existing managers—including managers recently appointed at the insistence of creditors—if the debtor proves by clear and convincing evidence that (1) it is in the best interest of all parties in interest to allow those managers to retain control of the debtor during the reorganization process and (2) the managers are neutral and have no personal interest that would affect their ability to protect the interests of all parties involved in the Chapter 11 proceeding. Courts should allow a creditor to force a firm to hire a private trustee only if the individual is disinterested as defined by § 327, is not controlled by (and does not report to) the creditor, and has the power to make decisions for the debtor without seeking creditor approval.[237] Unlike the partial disclosure some private trustees are required to make in at least one bankruptcy district,[238] private trustees should be required to make a full disclosure that explains the relationships they have with all other parties involved in the case.

Applying this test would not prevent firms from hiring private trustees during or immediately before the Chapter 11 filing. It would just require that those managers have clear fiduciary duties to all parties in interest and not have relationships with creditors that would prevent them from making impartial and independent decisions. Requiring debtors to retain private trustees as professionals should both decrease the number of people who are paid to exercise control over the Chapter 11 debtor and also place the proposed compensation of these entities under greater scrutiny. In addition to reducing these direct costs, simplifying the management structure should help reduce the likelihood that debtors will be forced to provide indemnification to private trustees, existing managers, other pro-

tions).

237. *See* Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 827 (2004) (suggesting that "bankruptcy neutrality is essential to the management of a general default," because bankruptcy involves competing interests).

238. *See* U.S. Trustee Program, *supra* note 229.

fessionals, or examiners for claims filed against them as a result of their employment by the DIP.[239]

Of course, there will be costs associated with a bankruptcy system that increases disclosure requirements, requires firms to prove that private trustees are independent and unbiased, and potentially disqualifies some competent turnaround specialists. Those costs[240] should be offset by the savings that will result from reducing the number of managers, private trustees, examiners, outside financial advisors, mediators, and potentially other professionals[241] working simultaneously in the same case and often on the same matters. An early determination

239. Mark Ribbing, *Turnaround Firms Watch Merry-Go-Round Suit*, BALT. SUN, Dec. 7, 1997, at 1D. These demands for indemnification are similar to those routinely made by investment bankers. *See* COLLIER COMPENSATION, EMPLOYMENT & APPOINTMENT OF TRUSTEES AND PROFESSIONALS IN BANKRUPTCY CASES ¶ 1.15 (2007). Indeed, the retention agreements proposed by investment bankers typically seek indemnification against their own negligence. *Id.* Not all courts have been always willing to approve such agreements, though. *See, e.g.*, *In re* Mortgage & Realty Trust, 123 B.R. 626, 631 (Bankr. C.D. Cal. 1991).

240. For example, while requiring the DIP to prove that its managers are both competent and do not hold or represent interests that are adverse to the estate may require parties to participate in one additional hearing, it is likely that this will become part of the first day matters that are routine in large bankruptcy filings.

241. Creditors sometimes ask courts to appoint a responsible party—instead of a trustee—who would be paid by the debtor, would report to the creditor, and would make all major executive decisions. *See In re* Commc'n Options, Inc., 299 B.R. 481, 482 (Bankr. S.D. Ohio 2003) (appointing a "responsible party" to act for the DIP); *In re* SunCruz Casinos, LLC, 298 B.R. 821, 830–32 (Bankr. S.D. Fla. 2003) (rejecting suggestion to appoint a responsible person to perform the duties of a DIP or trustee); *In re* NRG Res., Inc., 64 B.R. 643, 646–47 (W.D. La. 1986) (stating that DIP no longer exists once trustee is appointed); *In re* FSC Corp., 38 B.R. 346, 350 (Bankr. W.D. Pa. 1983) (describing the powers of a responsible party). A responsible party also was appointed in the bankruptcy of Livent, Inc. *See* THE 2004 BANKRUPTCY YEARBOOK & ALMANAC, *supra* note 109, at 332–33. Some courts also have approved the appointment of a "limited purpose trustee" that does not displace the DIP and, instead, shares the status of estate representative with the DIP. *See, e.g.*, *In re* Madison Mgmt. Group, Inc., 137 B.R.275, 282–83 (Bankr. N.D. Ill. 1992). Having a limited purpose trustee who shares control of the company with the DIP is problematic because the Code mandates that the trustee assume control of all the property of the estate and serve as *the* representative of the estate. 11 U.S.C. §§ 323, 521(4) (2000 & Supp. 2006). Moreover, the Code does not provide for trustees with limited powers and it is unclear how a trustee could thoroughly investigate the debtor's financial transactions if it shares management duties with the managers who may have participated in the improper transactions. Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (*In re* Sealed Air Corp.), 285 B.R. 148, 157 (Bankr. D. Del. 2002) (refusing to appoint limited purpose trustee).

about the qualifications of the firm's managers should decrease the costs associated with having too many managers performing substantially similar tasks. It also should eliminate challenges to the management structure that hedge funds or other distressed debt investors might make after purchasing creditors' claims (or equity's interests) early in a case, when the late entrants then seek to increase their leverage in the case by challenging the professional's fees.

Critically examining the debtor's management structure early in the case would have other benefits. For example, it should decrease the amount of satellite litigation concerning whether the managers breached their fiduciary duties to shareholders or creditors prebankruptcy while the firm was insolvent or in the zone of insolvency, or whether the managers' prepetition activities deepened the firm's insolvency. Requiring managers to be unbiased should also decrease the number of challenges to management's decisions to restructure or liquidate the firm, to discontinue certain business operations, to retain certain employees or pay key employees bonuses to remain with the business, or to alter the firm's relationship with certain employees or favored creditors.[242]

Ensuring that managers are neutral should decrease the disputes involving pay-to-stay or incentivizing bonus plans. If

242. Courts often give managers wide discretion to determine which creditor is "critical" and rarely require creditors to attest in writing or orally at the hearing that they will refuse to do business with the debtor in the future if their prepetition claims are not paid. *See* Order Authorizing Payment of Prepetition Claims of Critical Vendors at 1–2, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Dec. 3, 2001) (allowing managers to pay critical-vendor claims "in their discretion"); *see also* Stephen Cousings et al., *First Day Orders: An Examination*, 11 J. BANKR. L. & PRAC. 213, 215 (2002). At least one judge ordered all critical venders to come to court and state that they would refuse to do business with the debtor unless the court approved the critical-vendor motion. *See* Soma Biswas, *Kmart Ruling Claws Back Payments*, DAILY DEAL, Mar 1, 2004, 2004 WLNR 17771888. A system that presumptively utilizes impartial managers should reduce the number of creditor contentions that managers are paying favored vendors. *See* Patricia L. Barsalou & Zack Mosner, *Preferential First-Day Orders: Same Question, Different Look*, AM. BANKR. INST. J., Feb. 2003, at 8; Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 MARQ. L. REV. 1, 24–26 (1989); Margaret Newkirk, *Courts Compete to Bag Big Cases*, ATLANTA J.-CONST., Feb. 29, 2004, at E1 (contending that managers use first-day orders "to take care of friends and award themselves hefty retention bonuses or severance"). Once the court either has determined that the managers should be replaced *or* agrees that the managers are presumptively neutral and qualified to remain in control of the debtor, creditors should be less skeptical of critical-vendor motions.

firms must prove that it is in the best interest of the reorganization to allow existing managers to control the reorganization process, this proof should be sufficient to satisfy the Code's requirement that the employee is essential to the survival of the business. Thus, the court's finding that managers should be allowed to remain in control of the debtor should also resolve many of the issues that would be raised in a hearing on a motion to approve a key employee retention plan.

CONCLUSION

Congress adopted the DIP manager-controlled model based on the assumptions that existing managers had valuable experience and expertise and that the managers were not responsible for the firm's financial distress. The current practice of displacing managers just before or after the firm files for bankruptcy and replacing them with creditor-controlled private trustees suggests that the underlying premises for Chapter 11's manager-controlled presumption may no longer be sound. However, even if it is better as a normative matter to replace managers with a privatized trustee, a creditor should not be allowed to give control of the debtor to an entity that is not an employee of the firm, that reports to an individual creditor or creditor group, and that may have irreconcilable conflicts of interests. Instead, privatized trustees should be allowed to control firms in bankruptcy only if they can prove that they are independent and unbiased and are willing and able to protect all parties' interests in the bankruptcy case, not just the interest of the person who got them hired.