AMERICAN BANKRUPTCY INSTITUTE
# JOURNAL
Issues and Information for the Insolvency Professional

## Chapter 11 - "101"

# Bad Words to a Debtor's Ear

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Chapter 11 debtors typically remain in control of their estates as debtors-in-possession (DIPs), often seeing their case to completion through confirmation of a chapter 11 plan. But it doesn't always go this way. The Bankruptcy Code also provides that the court may:

- appoint a trustee
- appoint an examiner
- convert the case to chapter 7
- dismiss
- end exclusivity.

Another "bad word" for many troubled companies, is "involuntary bankruptcy." We touch on that this month as well.

### Chapter 11 Trustees

The Bankruptcy Code says the court may order the appointment of a trustee "for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor" or "if such appointment is in the interests of creditors, any equity security-holders and other interests of the estate...." *See* Code §1104(a). Appointment of a trustee is mandatory in chapter 7, 12 and 13 cases. However, the appointment of a trustee in a chapter 11 case is an extraordinary remedy. A request for the appointment of a trustee must overcome the presumption that the debtor will continue to control the business. The basis for the strong presumption against appointing a trustee is two-fold. First, there is often no need for one; DIPs have a fiduciary duty to act in the best interest of creditors and other stakeholders, are typically motivated to maximize value and usually don't engage in significant wrongdoing or malfeasance. Second, the DIP is usually familiar with the business it had been managing pre-petition, often making it the best party to conduct operations during the reorganization. (It is worth noting that in many other countries there is not a presumption that current management will continue to run the business in bankruptcy, perhaps borne of a desire to get rid of the managers who ran the company into bankruptcy.)

The burden is on the moving party to demonstrate by clear and convincing evidence that appointment of a chapter 11 trustee is appropriate. Although the second part of the standard (best interest of creditors and other stakeholders) would seem somewhat easier to satisfy, as a practical matter it is very difficult to get a trustee appointed without showing some level of incompetence and/or malfeasance by the debtor's management.

Aside from the presumption in favor of current management and the high standard for appointment of a trustee, another reason you don't see many chapter 11 trustees is that where you really do need a trustee—such as where management has destroyed the business—the case may convert to chapter 7 first. If a chapter 11 trustee is appointed, he/she basically has the same obligations as the DIP, including running the business and filing a reorganization plan. *See* Code §1106. The trustee is typically appointed by the Office of the U.S. Trustee, usually after consultation with major creditors. There is, however, a provision that permits election of the trustee. *See* Code §1104(b).[1]

Even without forcing the appointment of a trustee, creditors may get control of the debtor by forcing a change of management. Indeed, in a great many public-company chapter 11s (including some of the most notorious), this is exactly what happens: Creditors force out the old management before the chapter 11 begins, and so the nominal "DIP" is someone in whom creditors have faith, sent in to clean up the mess that others left behind.

[1] There is a similar provision for chapter 7 trustees, although it is not commonly utilized under either chapter.

### Chapter 11 Examiners[2]

The Code states that a court may appoint an examiner after a party in interest or U.S. Trustee requests the appointment.[3] One reported decision has indicated that a bankruptcy court has authority to appoint an examiner *sua sponte.* An examiner is to be appointed if the court determines that such appointment is in the interests of creditors and other stakeholders *or* if the debtor's unsecured non-insider debts exceed $5 million. *See* Code §1104(c)(2).

Section §1104(c) provides that the court may order the appointment of an examiner "to conduct...an investigation of the debtor." In fact, courts have stretched the language of this rule a bit; several courts have used "examiners" in complicated cases to try to leverage out-of-court settlements. In other cases, examiners have been appointed to evaluate causes of action the estate may have. Cases with examiners are also uncommon, but are probably more common than chapter 11 trustees. In a complicated case where the court is reluctant to impose the costs and inconvenience of a trustee—but where the judge wants more comfort than he gets from the DIP—an examiner may be the ticket.

### Conversion and Dismissal

Code §1112 authorizes conversion or dismissal. On the motion of a party in interest, the court may order conversion or dismissal for any of 10 reasons itemized in Code §1112(b). These include:

- "continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation"
- "inability to effectuate a plan"
- "unreasonable delay by the debtor that is prejudicial to creditors."

[2] For a comprehensive discussion of trustees and examiners in chapter 11, *see* Friedland, Jonathan; Khokha, Tasneem and Nylen, Sven, "The Failure of Corporate Stewardship and the Rise of the Statutory Fiduciary: Examiners and Trustees in Chapter 11," *The Annual Survey of Bankruptcy Law* (2003).

[3] Section 1104(c). "Party in interest" is defined in §1109 as including the debtor, trustee, creditor's committee, an equity security-holder's committee or any indenture trustee.

Translated, we think this means: "Your honor, this case is going nowhere, and it is time to put a bullet through the poor beast." If nothing more can be accomplished in chapter 11—because of the debtor and its circumstances and/or because of the limits of what chapter 11 cases achieve—then dismissal may be warranted.

Where the grounds exist, the judge has the choice of dismissal or conversion, so which one should one ask for? If you go for conversion, you are still stuck with the bankruptcy process—a chapter 7 trustee, notice to creditors, all that sort of thing. On the other hand, you have the benefit of judicial supervision and you preserve avoidance actions that may bring money into the estate. If you go for dismissal, you get to shed of all that encumbrance—but so does the debtor. So you save the costs and inconvenience of bankruptcy, but you also lose the protections. There isn't any general rule here. The point is that in an individual case, you are going to have to weigh the costs and benefits of staying in versus getting out.

## Exclusivity

Finally, a background note: Underlying all these issues is the question of who (if anyone) may propose a chapter 11 plan. Code §1112 provides that *only the debtor* may propose a plan in the first 120 days of a chapter 11 case. In a corporate case, "debtor" means the managers of the debtor corporation, controlled ultimately by the shareholders. We think this rule is a linchpin of chapter 11 that is often underappreciated; it allows old equity-owners to use chapter 11 as a "second bite at the apple" to give them one last chance before they lose control to the creditors.

The immediate relevance is that the rule goes away if conversion, dismissal or the appointment of a trustee occurs, so this critical power of "debtor exclusivity"—a linchpin of the chapter 11 case—vanishes if any of these events comes to pass.

## Involuntary Bankruptcy

Now, a word about *involuntary bankruptcy*. There is an irony here. Five hundred years ago, when bankruptcy was young, the idea of "voluntary bankruptcy" was pretty much of an oxymoron: Bankruptcy was a creditor's remedy, and a debtor wouldn't volunteer for it. Bankruptcy began to look attractive to the debtor only after the introduction of the first primitive discharge rule in 1705. And indeed, it wasn't until after World War II that we observe large numbers of debtors voluntarily filing for bankruptcy with the discharge in view.

The Code still permits creditors to begin an involuntary case (*see* Code §303). Only a very small number of involuntary cases show up on the docket—and if anything, we suspect this tiny number is larger than it should be. We think that involuntary bankruptcy, in keeping with its antiquarian roots, is pretty much like a muzzle-loading weapon: occasionally lethal and as likely as not to blow up in your face.

The first problem is the threshold: It's not easy to start an involuntary case. You need three or more creditors holding claims that "aggregate at least $11,625 more than the value of any lien." This means that before you begin, you have to find at least two other creditors just as motivated as you are.[4] An involuntary case cannot be commenced against a nonprofit business.

In a voluntary case, the filing of the petition begins the bankruptcy. In an involuntary case, the filing just begins a contested matter. That is, if the debtor challenges the petition, then the creditor has to prove either one of these bankruptcy predicates:

- The debtor is generally not paying such debtor's debts as such debts become due; or
- Within 120 days before the date of the filing of the petition, "a custodian...was appointed or took possession."

Translated, this means that if the debtor makes an assignment for the benefit of creditors at state law, then you can put him into an involuntary bankruptcy. Code §303(h). As a plaintiff in the involuntary case, you get your involuntary order if and only if you win this contested matter—and that may not be the end of it. Because of the potency of involuntary bankruptcy, the Code affords businesses protection against creditors that seek to improperly invoke its power. For example, Code §303(i) sets out remedies in cases in which an involuntary petition is dismissed other than on consent of all petitioners and the alleged debtor.

Until the court enters an "order for relief" finding that the grounds for involuntary bankruptcy have been satisfied, the "alleged debtor" is in what's known as the "gap period." During this period, the debtor is allowed to operate its business and use, sell or lease its assets as if it were not in bankruptcy. (If there is a risk of loss to the estate during this period, the court may appoint a trustee during the gap period.)

So filing an involuntary petition is chancey and potentially hazardous. But even ignoring chance and hazard, there is a more fundamental question: Do you need it?

4 The Code does say that if the debtor has fewer than 12 creditors in total, you can get away with just one petitioner—but most debtors have more than 12 creditors, so in the usual case you will need three petitioners.

Consider this classic case: Your client is one of many creditors of the debtor and is morally certain that the debtor is dissipating assets.

On the one hand, there are non-bankruptcy remedies available that may enable you to collect your debt and prevent dissipation of assets. These may be quicker and cheaper than bankruptcy and may enable you to collect amounts owed in full without sharing with other creditors.

On the other hand, once you file the involuntary petition, you've bought yourself a whole new set of enemies. The involuntary case is a bell you can't un-ring: Once you file, you can't dismiss without giving notice to all other creditors. If you win the involuntary adjudication, there will be a trustee who may or may not act as your ally, and there will be lots of other creditors who will want to share *pro rata* anything that is available—and some of whom may have a statutory priority in bankruptcy.

The cases where involuntary bankruptcy is most worthy of consideration are those where (1) the debtor is mishandling or dissipating assets and there does not appear to be any quick and effective way to stop it other than the court supervision that comes with bankruptcy, or (2) cases where a significant transfer has been made that would be avoidable if the transferor were put into bankruptcy. Consequently, there are cases where involuntary bankruptcy can be effective, but it is a weapon of last resort, and you'd better think it through carefully before you take your client's bad situation and make it worse. ■

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