Strategic Use of Bankruptcy Examiner Requests

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Seeking to have an independent examiner investigate a debtor or its management can be a powerful tool available to creditors and other interested parties in a bankruptcy case. Typically, a party might request that an examiner be appointed if the debtor or its management is suspected of fraud or other misconduct. The low cost associated with making the request, together with recent positive outcomes for requesting creditors, may help to increasingly popularize the use of examiner requests by parties seeking leverage in bankruptcy plan negotiations.

From the perspective of a debtor in possession, an examiner's investigation can be intrusive or disruptive to the management of its bankruptcy case. Additionally, examiners are often expensive and drain valuable estate assets. But when an interested party requests that an examiner be appointed, the court has little or no discretion to refuse – the appointment is likely mandatory under the Bankruptcy Code. As a result, when an examiner request is filed or threatened, the only practical way a debtor can avoid the appointment is by convincing the party to withhold or withdraw its request. This can force debtors to deal with parties who might otherwise lack significant negotiating leverage.

Statutory Basis for Examiner Appointments

The Bankruptcy Code mandates that an examiner be appointed upon the request of an interested party and if certain basic criteria are met. Bankruptcy Code section 1104(c) provides that, as long as a court has not already appointed a trustee or confirmed a plan of reorganization, any interested party may request that an examiner be appointed.[1] After the request is made, "the court shall order the appointment of an examiner…if… the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000," a fairly low threshold in most corporate bankruptcy cases.[2] Additionally, examiner appointments are mandatory under section 1104(c)(1) if the appointment "is in the interests of creditors, any equity security holders, and other interests of the estate."

Once the court directs the appointment to be made, the United States trustee is actually charged with making the appointment of the examiner pursuant to section 1104(d). The trustee's appointee must be a disinterested person and cannot be the trustee himself.

<u>Interpretations of Section 1104(c) in Case Law</u>

Although some published opinions hold that courts retain discretion to refuse appointment requests, by interpreting "shall" to mean "may" in section 1104(c)[3], many courts disagree, and have found that "shall" means "must."[4] The only circuit-level opinion to address this issue refutes this conclusion.[5] In *Revco*, the Sixth Circuit reversed a bankruptcy court's refusal to appoint an examiner to investigate the debtor's prepetition leveraged buyout, holding that "the statute requires the court to appoint an examiner" when more than $5 million of unsecured debts are involved. The majority of examiner requests today are granted based on the same plain language reasoning as the *Revco* court employed.[6]

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[1] 11 U.S.C. § 1104(c).
[2] 11 U.S.C. § 1104(c)(2).
[3] *See, e.g., In re Rutenberg*, 158 B.R. 230 (Bankr. M.D. Fla. 1993); *In re Shelter Resources Corp.*, 35 B.R. 304, 305 (Bankr. N.D. Ohio 1983).
[4] *See, e.g., In re Mechem Financial of Ohio, Inc.*, 92 B.R. 760, 761 (Bankr. N.D. Ohio 1988); *In re The Bible Speaks,* 74 BR 511, 514 (Bankr. Mass 1987).
[5] *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498 (6th Cir. 1990).
[6] *See, e.g., In re Loral Space & Communications Ltd.*, (S.D.N.Y. 2004) (district court found that bankruptcy court had no discretion to deny equity holders' request to appoint an examiner because the debt threshold was met).

Federal bankruptcy statutes have long provided for bankruptcy examiners. The current language in section 1104(c) is rooted in Chapter X of the pre-1978 Bankruptcy Act, and was largely designed to protect stakeholders of large publicly traded debtors. Despite the long history behind the current provision's language, employment of bankruptcy examiners has become significantly more prominent over the past 10 years or so.

Creditors and other parties favor the use of examiners partly because they are relatively inexpensive to the requesting party. The mandatory language of 1104(c)(2) often results in estate-paid examiners being appointed at the request of parties who must come out of pocket for little more than drafting and filing the request. Courts have appointed examiners in a number of recent notable cases. Some examples include *In re Lyondell Chemical Co., et al.,* Case No. 09-10023 (Bankr. S.D.N.Y.), *In re Fontainebleau Las Vegas LLC, et al.*, Case No. 09-21482 (Bankr. S.D. Fla.), *In re TCI 2 Holdings LLC, et al.*, Case No. 09-13654 (Bankr. N.J.), *In re DBSI Inc., et al.*, Case No. 08-12687 (Bankr. Del.), and *In re UAL Corp., et al.*, Case No. 02-48191 (Bankr. N.D. Ill.).

<u>Examiner Appointments Generate Results</u>

Another reason examiner requests have gained popularity is because examiners are often effective in furthering the agendas of interested parties. Famously, the examiner appointed in *Enron* produced four separate reports which cost the estate nearly $90 million in examiner fees. Some argue that the examiner fees were money well spent, as the reported finding provided part of the basis for criminal charges against ex-management and opened the door for the recovery of billions of dollars to the estate in so-called "mega-claims" litigation.

In *Loral Space and Communications* (*In re Loral Space & Communications Ltd.*, (S.D.N.Y. 2004)), shareholders petitioned the court unsuccessfully several times to appoint an official committee of equity holders, arguing that the debtors' valuation was too low. Each time, the court rejected their request, reasoning that the equity was worthless and holders had no interests to protect. When equity holders shifted their strategy and requested instead that an examiner be appointed, the bankruptcy court still refused. The holders appealed to the district court, which ordered the appointment.

The resultant examiner's report suggested a much higher valuation than the debtors' financial advisors had proposed. In response to this higher possible valuation, an official shareholder committee was appointed. Ultimately, shareholders did not recover anything under the plan, but the examiner request had provided them an opportunity to protect any interests they might have had.

In early 2010, the examiner appointed in *Lehman Brothers* (*In re Lehman Brothers Holdings, Inc., et al.*, Case No. 08-13555 (Bankr. S.D.N.Y.)), filed a report that numbers well over 2,200 pages in nine volumes. The examiner's findings included evidence that potentially misleading accounting methods were partially to blame for Lehman's swift collapse. The report could result in civil or even criminal charges being brought against Lehman or members of its pre-bankruptcy management. After the examiner's report is more fully analyzed by the bankruptcy court, creditors and other parties-in-interest, and regulatory authorities, its full impact will begin to emerge.

Using Examiner Requests Strategically

Examiner requests can be effective even when they are not granted, but instead are threatened or filed and withdrawn. In *FairPoint Communications* (*In re FairPoint Communications, Inc., et al.*, Case No. 09-16335 (Bankr. S.D.N.Y.)), senior noteholders used the threat of an examiner appointment to improve their treatment under the plan of reorganization.

The noteholders had been negotiating an out of court debt-for-equity exchange prior to the debtors' bankruptcy filing. This plan would have left the debtors' secured credit facility in place and shifted ownership of the company to noteholders.

The debtors significantly revised their projections and instead negotiated a prepackaged bankruptcy with senior lenders, which proposed granting 2% ownership of the reorganized company to unsecured creditors and 10% to management. The noteholders filed a motion seeking appointment of an examiner to investigate a leveraged buyout, stock dividend and other prepetition transactions involving the debtors. After the examiner request was withdrawn, the debtors filed a revised plan which would allocate 8% of the reorganized company and warrants to purchase additional stock to unsecured creditors and the remainder to senior lenders. It appears that the noteholders used the threat of an examiner request in part to improve their negotiating position with the debtors.

Although examiner appointments are usually considered mandatory, the Bankruptcy Code does provide the court discretion to check the breadth of the examiner's investigation. The Sixth Circuit explicitly recognized this in *Revco*, noting that under section 1104(c) "the bankruptcy court retains broad discretion to direct the examiner's investigation, including its nature, extent, and duration." Once an examiner is appointed, sections 1106(a) and (b) describe certain duties, but for every one includes the qualifier "unless the court orders otherwise."

In *Lyondell*, the court approved an examiner request, limiting the scope of the examiner's investigation to focus only on a proposed rights offering. After the report was filed, the court determined that the rights offering posed no cause for concern and denied a request filed by unsecured creditors who sought to expand the examiner's role. In theory at least, a court could order the appointment of an examiner and then fully limit the scope of its duties.

Conclusion

Given the recent uptick in such motions and the results they appear to have generated, expect to see more of these as this current bankruptcy cycle plays out. It is reasonable to expect that as the frequency of examiner requests increases, so too will resistance from courts in the form of scope limitations.