

The Case for Congressional Intervention to Amend the Examiner Statute

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In several recent rulings, judges in the United States Bankruptcy Court for the District of Delaware have departed from the majority view that the appointment of an examiner is mandatory when the \$5 million threshold of 11 U.S.C. § 1104(c)(2) is satisfied and have refused to order appointment even though the threshold was met.¹ Recognizing the split among the courts both within and outside the Third Circuit regarding this issue, Judge Walrath certified a direct appeal of her denial of an examiner in the *Washington Mutual* case to the Third Circuit. In certifying that appeal, Judge Walrath determined, among other things, that the issue of whether the appointment of an examiner is mandatory is of great public importance because it arises so frequently.² Because of subsequent developments in the case, however, the Third Circuit will not have the opportunity to be the second court of appeals to address this issue, since an examiner was subsequently appointed on consent of all parties, thereby mooting the appeal.

With the number of motions for the appointment of an examiner steadily increasing, the time has come for Congress to amend § 1104(c)(2) of the Bankruptcy Code and provide a clear statutory basis to enable bankruptcy courts to exercise their discretion not to appoint an examiner when one is not warranted. Until the statute is amended, courts will continue to issue divergent opinions on the legal standard for the appointment of an examiner and undertake judicial contortions in complying with the statute's "plain meaning" in those instances where they do not believe that an examiner should be appointed. Such an amendment would likely decrease administrative costs that continue to escalate in today's large bankruptcy cases and would in no way prevent a court from appointing an examiner where one is warranted.

Section 1104(c)(2) of the Bankruptcy Code, which governs the appointment of examiners, provides in relevant part:

If the court does not order the appointment of a trustee under this section, then at any time before the confirmation of a plan, on request of a party in interest...the court *shall* order the appointment of an examiner to conduct such an investigation of the debtor *as is appropriate*...if:

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(2) The debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed \$5,000,000.³

Courts are divided about the meaning and application of the phrases "the court shall order" and "as is appropriate" under the statute. The legal standards applied to § 1104(c)(2) can be classified into three groups: (1) the term "shall" mandates the appointment of an examiner; (2) the phrase "as is appropriate" modifies the term "shall," which, in turn, provides the court with discretion in the appointment of an examiner; and (3) the statute mandates the appointment of an examiner but leaves the court with discretion to establish the parameters of the examiner's inquiry.

Majority View

The majority of courts hold that the appointment of an examiner is mandatory in cases involving over \$5 million in unsecured non-trade debt.⁴ According to the majority view, the statute's plain language and the legislative history support the proposition that § 1104(c)(2) mandates the appointment of an examiner.

The Sixth Circuit is the only court of appeals to address the issue of mandatory appointment. In *Revco*, 898 F.2d 498, 501 (6th Cir. 1990), the court of appeals held that in view of the phrase "the court shall order," a court is left with no discretion regarding appointment once the \$5 million threshold is satisfied. The Sixth Circuit reasoned that a discretionary interpretation of § 1104(c)(2) simply did not make sense because it would render 11 U.S.C. § 1104(c)(1), which gives the court discretion to appoint an examiner where the appointment would benefit the estate, "indistinguishable" from § 1104(c)(2).⁵ Interestingly, the Sixth Circuit noted that to curb abuse of the mandatory nature of § 1104(c)(2), bankruptcy courts are provided with "broad discretion to direct the examiner's investigation."⁶

Minority View and Recent Holdings

While the majority view may be appealing based on the exact wording of the statute, practical considerations have driven courts to interpret § 1104(c)(2)'s legislative history, as well as the statute's plain language, as discretionary. These courts generally hold that the appointment of an examiner is not mandatory because the clause "as is appropriate" in § 1104(c)(2) allows courts discretion not to appoint an examiner.⁷ The phrase "as is appropriate," under the minority interpretation, authorizes the court to weigh the benefits of an appointment against the burdens, which generally include the delay in the administration of the case and undue costs to the estate.⁸

For example, in *American Home Mortgage*, Judge Sontchi, in refusing to appoint an examiner because he did not believe the appointment was appropriate, stated:

I think the financial criteria are important, and obviously, they're met in this case, but that's only one piece of the puzzle, and the other piece of the puzzle is that there has to be an investigation to perform that's appropriate...I think that's a more nuanced approach than sort of saying it is what it is, and if you cry 'examiner' in a crowded case, you get one.⁹

More recently in *In re Spansion Inc.*, No. 09-10690, and *In re Washington Mutual, Inc.*, No. 08-12229, Judges Carey and Walrath addressed the split of authority regarding the extent of a court's discretion.

Less than three weeks before the confirmation hearing in *Spansion*, the Ad Hoc Committee of Convertible Noteholders ("Convert Committee") petitioned the court for an emergency appointment of an examiner to investigate alleged misrepresentations in the debtors' disclosure statement and the debtors' valuation of the reorganized enterprise. The Convert Committee argued that § 1104(c)(2) mandated the appointment of an examiner because the statutory predicates were satisfied and the circumstances warranted the appointment.

The debtors argued that the Convert Committee's motion was merely a litigation tactic to derail the confirmation hearing and contended that § 1104(c)(2) mandates appointment only if the court deems the examination to be appropriate. Judge Carey agreed with the debtors, finding that the statute requires the appointment of an examiner "to conduct an investigation of the debtor *as is appropriate*."¹⁰ Judge Carey found that appointment was "neither warranted nor appropriate" because of the likely delay in the administration of the case, the costs to the estate, and the decidedly late-in-the-day timing of the emergency motion, and concluded that the Convert Committee's concerns could be adequately addressed in the context of plan confirmation without need for an independent third party weighing in on issues that were certain to be addressed by the litigants.¹¹

Judge Walrath reached a similar conclusion in the high-profile *Washington Mutual* case. Shortly after the commencement of the case, Washington Mutual Incorporated ("WMI") became embroiled in litigation with JPMorgan Chase and the Federal Deposit Insurance Corporation, among others, to determine the nature and extent of potential causes of action related to the seizure and sale of its subsidiary, Washington Mutual Bank. WMI halted its investigative efforts when the parties reached a global compromise that formed the cornerstone of WMI's plan of reorganization. That plan, as initially proposed, anticipated paying unsecured creditors substantially in full, but left no recovery for equity.

The Equity Committee in *Washington Mutual* was obviously not pleased with this outcome. According to the Equity Committee, WMI's abrupt abandonment of potential claims pertaining to WMI's collapse and its bank's seizure worth "billions of dollars" warranted an "independent, disinterested, objective evaluation" by an examiner.¹² The Equity Committee's legal arguments were straightforward. The Equity Committee argued that, "if the statute is to be applied as written, appointment [of an examiner] is mandatory."¹³

Contrary to the Equity Committee's assertion, the debtors argued that the plain language of § 1104(c)(2) provides a court with discretion not to appoint an examiner if it believes that the appointment would not be appropriate.¹⁴ Since a legion of entities, including government agencies, the Official Committee of Unsecured Creditors, and Congress, among many others, had already investigated the circumstances of the fall of Washington Mutual Bank, the commencement of another investigation was not "appropriate." The decision was a "very close call" for Judge Walrath.¹⁵ In the end, though, she found that appointment of an examiner was not appropriate because, among other reasons, the failure of Washington Mutual Bank

had been "investigated to death," the costs of the investigation would be burdensome to the estate, the appointment would lead to unnecessary delay, and the Equity Committee could prosecute its objection to the plan and the settlement embodied in it through the discovery process without need for a third party weighing in.¹⁶

The Equity Committee appealed Judge Walrath's decision and requested that the Third Circuit consider its appeal under direct certification. Having noted the absence of a controlling decision of the Third Circuit or of the Supreme Court of the United States, Judge Walrath certified the issue for direct appeal to the Third Circuit. Shortly thereafter, however, Judge Walrath reversed course. Frustrated by the Equity Committee's inability to obtain the discovery that it claimed that it needed due to alleged stonewalling by all parties, she invited the Equity Committee to file a new examiner motion. Considering the prospect of further delay and complication, WMI, the Equity Committee, and other interested parties consented to the appointment of an examiner, and Judge Walrath agreed that one had now become necessary to, among other things, limit further delay and reduce estate expenses.¹⁷

The appointment of an examiner in *Washington Mutual* and the dismissal of the appeal is significant. While the Third Circuit may in the end have departed from the majority and agreed with the lower court that § 1104(c)(2) gives judges discretion, a contrary ruling would have unnecessarily tied bankruptcy judges' hands or forced them to fashion wasteful remedies in trying to reach an equitable and correct result in those instances where an examiner is simply not warranted.

Effect of the Ongoing Controversy

Without a resolution regarding the scope of a judge's discretion under the examiner statute, courts are going to continue to expend limited judicial resources on examiner motions that threaten to needlessly delay the administration of bankruptcy cases and burden bankruptcy estates with unnecessary costs. Indeed, courts on both sides of the divide have acknowledged that mechanical application of the statute may lead to undesirable results and may invite abuse in cases where the appointment of examiner is not warranted.¹⁸ Even those courts that believe that they have no choice but to appoint an examiner when the \$5 million threshold is met have fashioned creative remedies that, while perhaps mitigating the problem, nonetheless saddle bankruptcy estates with additional costs and increase the court's workload without good reason.

For example, in *In re Asarco LLC*, No. 05-21207, the United States Bankruptcy Court for the Southern District of Texas ordered the appointment of an examiner but gave the examiner no duties. Instead, the court allowed "any party [] the right to ask the [c]ourt to assign specific duties to the [e]xaminer at any time."¹⁹ Similarly, in *In re Erickson Ret. Cmty., LLC*, 425 B.R. 309, 315 (Bankr. N.D. Tex. 2010), Judge Jernigan, in denying the examiner motion because a subordination agreement did not permit the movant to seek such relief, noted in dictum that had she otherwise been obligated to appoint an examiner, she would have appointed one with no duties.

Judge Wedoff of the United States Bankruptcy Court for the Northern District of Illinois suggested a somewhat different approach in *In re UAL Corp.*, 307 B.R. 80

(Bankr. N.D. Ill. 2004). Agreeing with the majority that courts lack discretion to deny appointment when the \$5 million threshold is met, Judge Wedoff suggested that the examiner could be simply directed to investigate whether there is good cause to undertake the examination proposed by the movant, somewhat akin to the finding of a chapter 7 trustee under Federal Rule of Bankruptcy Procedure 2002(e) that a debtor has no assets worth administering.²⁰

These solutions fail to avoid wasteful motion practice, incurrence of unnecessary estate expenses, and a burden of judicial resources that were noted by Judge Carey as a reason not to appoint an examiner.²¹ Indeed, it is the bankruptcy court itself that is best positioned to determine if and when an examiner is necessary, as evidenced in *Washington Mutual* where Judge Walrath used her discretion to first deny appointment and then invite a second motion when it became apparent to her that an examiner would be appropriate after further developments in the case. Why go through the charade of appointing an examiner with no duties or an examiner to examine whether an examination is appropriate if the court believes based on the facts before it that an examiner is simply not warranted? The absurdity of an outcome where an examiner is appointed without any duties merely for compliance purposes conflicts with the Bankruptcy Code's goal of prompt, expeditious, and cost-effective administration of bankruptcy cases. The courts' and debtors' resources can be put to better use.

Judge Gerber of the New York Southern District Bankruptcy Court perhaps said it best in his recent bench ruling in *In re Lyondell Chemical Company* when he stated:

I and other bankruptcy judges around the country have seen the ways in which the mandatory appointment language has been abused. *And it's obvious, to anyone with any large case experience, that mandatory appointment is terrible bankruptcy policy, and that the [Bankruptcy] Code should be amended.*²²

The authors wholeheartedly agree with Judge Gerber.

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¹ See, e.g., *U.S. Bank Nat'l Assoc. v. Wilmington Trust Co. (In re Spansion, Inc.)*, 426 B.R. 114, 128 (Bankr. D. Del. 2010); *In re Washington Mutual, Inc.*, No. 08-12229 (MFW) (Bankr. D. Del. May 5, 2010) [Dckt. No. 3663]; and *In re HSH Delaware GP LLC*, No. 10-10187 (MFW) (Bankr. D. Del. May 3, 2010) [Dckt. No. 258].

² *In re Washington Mutual, Inc.*, No. 08-12229 (Bankr. D. Del. June 3, 2010) [Dckt. No. 4639].

³ 11 U.S.C. § 1104(c) (emphasis added).

⁴ See, e.g., *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498, 500-01 (6th Cir. 1990) ("[Section 1104(c)(2)] plainly means that the bankruptcy court 'shall' order the appointment of an examiner when the total fixed, liquidated, unsecured debt exceeds \$5 million if the U.S. trustee requests one."); *In re Loral Space & Communications Ltd.*, Civ. A. No. 04-8645 (RPP) (S.D.N.Y. Dec. 20, 2004) [Dckt. No. 14] (reversing the bankruptcy court's decision denying appointment of examiner where the \$5 million debt threshold was met and the parties seeking appointment had standing to do so); *In re Walton*, 398 B.R. 77, 80-83 (Bankr. N.D. Ga. 2008); *In re UAL Corp.*, 307 B.R. 80, 83-86 (Bankr. N.D. Ill. 2004); *In re Mechem Fin. of Ohio, Inc.*, 92 B.R. 760, 761 (Bankr. N.D. Ohio 1988); *In re The Bible Speaks*, 74 B.R. 511, 514 (Bankr. D. Mass.1987); *In re 1243 20th Street, Inc.*, 6 B.R. 683, 685 n.3 (Bankr. D.C. 1980); *In re Lenihan*, 4 B.R. 209, 211 (Bankr. D.R.I. 1980).

⁵ *Revco*, 898 F.2d at 501.

⁶ *Id.*

⁷ See, e.g., *Spansion, Inc.*, 426 B.R. at 128; *Washington Mutual, Inc.*, No. 08-12229 (MFW) [Dckt. No. 3663]; *HSH Delaware GP LLC*, No. 10-10187 (MFW) [Dckt. No. 258]; *In re Am. Home Mortgage Holdings, Inc.*, No. 07-11047 (CSS) (Bankr. D. Del. Nov. 5, 2007) [Dckt. No. 1779]; *In re Refco, Inc.*, No. 05-60006 (RDD) (Bank. S.D.N.Y. March 7, 2006) [Dckt. No. 1682], Hr'g Tr. 57; *In re ACandS, Inc.*, No. 02-12687 (Bankr. D. Del. Dec. 19, 2002) [Docket No. 234]; *In re Bradlees Stores, Inc.*, 209 B.R. 36, 39 (Bankr. S.D.N.Y. 1997); *In re Rutenberg*, 158 B.R. 230, 233 (Bankr. M.D. Fla. 1993); *In re Winston Indus., Inc. (In re Shelter Resources Corp.)*, 35 B.R. 304, 305 (Bankr. D. Ohio 1983).

⁸ *Spansion, Inc.*, 426 B.R. at 128.

⁹ *American Home Mortgage*, No. 07-11047 (CSS) (Bankr. D. Del.), Hr'g Tr. 76:9-16.

¹⁰ *Spansion, Inc.*, 426 B.R. at 126 (Bankr. D. Del. 2010) (original emphasis) (citations omitted).

¹¹ *Id.* at 128.

¹² *Washington Mutual, Inc.*, No. 08-12229 (MFW) (Bankr. D. Del. Apr. 26, 2010) [Dckt. No. 3579].

¹³ *Id.* at 19.

¹⁴ *Washington Mutual, Inc.*, No. 08-12229 (MFW) (Bankr. D. Del. May 4, 2010) [Dckt. No. 3626].

¹⁵ *Washington Mutual, Inc.*, No. 08-12229 (MFW) (Bankr. D. Del.), Hr'g Tr. 97:25.

¹⁶ *Washington Mutual, Inc.*, No. 08-12229 (MFW) (Bankr. D. Del.), Hr'g Tr. 98:14-15.

¹⁷ *Washington Mutual, Inc.*, No. 12229 (MFW) (Bankr. D. Del. July 22, 2010) [Dckt. No. 5120].

¹⁸ See, e.g., *Revco D.S., Inc.*, 898 F.2d at 501 (explaining that the court has discretion to direct the scope of an examiner's role that may deter unnecessary investigations); *Spansion, Inc.*, 426 B.R. at 127.

¹⁹ *In re Asarco LLC*, No. 05-21207 (RSS) (Bankr. S.D. Tex. Mar. 4, 2008) [Dckt. No. 7081]. The examiner was later assigned duties by the court after additional motion practice.

²⁰ *In re UAL Corp.*, 307 B.R. 80, 86-87, n.5 (Bankr. N.D. Ill. 2004).

²¹ *Spansion, Inc.*, 426 B.R. at 127 (the appointment of an examiner with no duties is "a wasteful exercise...that could not have been intended by Congress.").

²² *In re Lyondell Chemical Co.*, No. 09-10023 (REG) (Bankr. S.D.N.Y. Oct. 26, 2009), Hr'g Tr. 35 (emphasis added).