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Chapter 11, Corporate Governance and the Role of Examiners

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CHAPTER 11, CORPORATE GOVERNANCE AND THE ROLE OF EXAMINERS

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ABSTRACT

The debtor-in-possession model causes major corporate governance problems because the debtor's management has huge incentives to favor some parties over others before or in bankruptcy, e.g., through fraudulent conveyances or preference transfers. Control mechanisms, conversely, are weak. For instance, creditors' committees are often not appointed, ineffective, or conflicted. The bankruptcy court has, however, a strong instrument to detect and undo wrongdoing: the appointment of examiners. They can help to overcome many of these problems because they can neutrally investigate all potential violations of the law. On the other side, their appointment also has downsides, e.g., fees, potential delays, and disruptions in reorganization. Hence, the critical question is how courts can assess whether or not to appoint an examiner. There is no easy answer because the courts have little insight into the debtor's circumstances. To overcome this information asymmetry problem, I propose the appointment of preliminary examiners. They should be appointed in a majority of chapter 11 bankruptcy cases. They would conduct a summary investigation to detect potential violations of the law and report their findings to the bankruptcy court. On that basis, the court could make a more informed decision on the initial question of whether to appoint an ordinary examiner and, further, on the scope of her mandate. The main advantage compared to traditional examiners would be the substantially lower costs. This reform proposal would not only help to enrich the estate in the individual case but would also deter wrongdoing in the future. It hence can be understood as a tool to improve corporate governance in financially distressed or bankrupt companies.

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INTRODUCTION

Corporate governance does not have many advocates in bankruptcy proceedings. In chapter 11 actions, managers run the company and have to take many heterogeneous interests into account. However, they do not always have incentives to do so. Depending on the circumstances, management relies either on the shareholders or on the influential creditors.[1] The latter case is more common nowadays because of sophisticated creditors and activist turn-around investors such as hedge funds or private equity funds. Minor creditors and other stakeholders usually have little influence on the reorganization process. Consequently, they can be outsmarted not only through an unfavorable reorganization plan but also through actions taken by management, shareholders, and main creditors prior to or within bankruptcy. Potential discriminatory actions include fraudulent conveyances, preference transfers, and the non-enforcement of claims against management.[2] These claims can amount to hundreds of millions or even billions of dollars.[3]

Of course, many of these actions are illegal. But who should detect and correctly evaluate them? In theory, management is in the best position. However, since it was often the same management that violated the law in the first place, to favor one party over others, it will not (voluntarily) reveal and undo the action. The next potential institution is the creditors' committee. However, creditors' committees are often not even appointed.[4] When they are appointed, they are often criticized as being inactive or ineffective.[5] Further, they are not seldom conflicted, since some investigations might target their members.[6] Finally, the bankruptcy court can only discover wrongdoing, such as fraudulent payments or preference transfers, if it is obvious from the materials submitted to the court by the debtor or if insiders provide some indication. Because the management and perhaps even the main creditor as well as the debtor-in-possession lender might have incentives to cover up infringing actions, the bankruptcy court oftentimes will not detect violations of the law. Under-detection and under-prosecution of such actions are thus likely and will lead to under-deterrence.

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1 *See infra* Part I., pp. 416–33.

2 *See infra* Part I.B., pp. 421–25.(explaining incentives and potential violations in detail).

3 *See* Report of Richard J. Davis, as Examiner, *In re* Caesars Entm't Operating Co., Inc., No. 15-01145, 2016 Bankr. LEXIS 4529 (Bankr. N.D. Ill. May 18, 2016), https://online.wsj.com/public/resources/documents/CaesarsReport03-16-2016.pdf.

4 *See infra* notes 99–101 and accompanying text.

5 *See infra* notes 102–103.

6 *See infra* p. 437.

Only two possibilities remain: the appointment of trustees or examiners. Skepticism is great as to both. This is understandable with respect to trustees because their frequent appointment would undermine the legislature's decision for the debtor-in-possession model in chapter 11.[7] It should therefore be a last resort.[8]

For less evident reasons, bankruptcy courts, especially in Delaware,[9] are also very reluctant to appoint examiners. For a long time, mostly the downsides, such as costs and disruptions caused during the reorganization process and for the business, were emphasized.[10] The perception, however, has shifted because examiners can conduct valuable neutral investigations without replacing the management entirely.[11] Some scholars, such as Jonathan C. Lipson, Christopher F. Marotta, Daniel J. Bussel, and Lynn M. LoPucki, have therefore supported a more frequent use of examiners.[12] Likewise, the SABRE-Report from 2004 suggests a more flexible and more regular use of examiners.[13] The most prominent support has come recently from the American Bankruptcy Institute (ABI) Reform Proposal.[14]

This Article contributes to this ongoing discussion and to the literature on corporate governance in bankruptcy generally. Unlike the ABI Reform Proposal, it also addresses the crucial question of how courts can estimate whether or not they should appoint an examiner. It takes up and develops the idea of "mini-

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7 *See infra* Part I.C.2., pp. 427–29.

8 Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (*In re* W.R. Grace & Co.), 285 B.R. 148, 158 (Bankr. D. Del. 2002).

9 *See* Jonathan C. Lipson & Christopher F. Marotta, *Examining Success*, 90 AM. BANKR. L.J. 1, 27 (2016).

10 For a critical perspective on the arguments, *see infra* Part II.B.2., pp. 440–43.

11 For a much more detailed explanation of all benefits, *see infra* Part II.B.1., pp. 436–40

12 Jonathan C. Lipson, *Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies*, 84 AM. BANKR. L.J. 1, 43, 59 (2010); Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1626–27 (2009); Lipson & Marotta, *supra* note 9, at 50–51 (in favor of "mini-examiners"); Lynn M. LoPucki, *The Debtor in Full Control–Systems Failure Under Chapter 11 of the Bankruptcy Code? Second Installment*, 57 AM. BANKR. L.J. 247, 252–53 (1983); *see* Daniel J. Bussel, *A Third Way: Examiners as Inquisitors*, 90 AM. BANKR. L.J. 59 (2016) (advocating an inquisitorial model); *see also* Regina S. Kelbon, Ellen S. Herman & Richard S. Bell, *Conflicts, the Appointment of "Professionals," and Fiduciary Duties of Major Parties in Chapter 11*, 8 Bank. Dev. J. 349, 405–06 (1991).

13 Second Report of the Select Advisory Committee on Business Reorganization, 60 BUS. LAW 277, 307 (2004).

14 *See* AM. BANKR. INST., COMMISSION TO STUDY THE REFORM OF CHAPTER 11, FINAL REPORT AND RECOMMENDATIONS 2012–14, 32–38, https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h [hereinafter ABI Report].

examiners" by Lipson and Marotta.[15] I argue that "preliminary examiners"[16] should conduct a summary investigation to help the court to determine whether a more substantial investigation is warranted or not. Their short and timely report would put bankruptcy courts in the position to make more informed decisions on both questions of whether to appoint an ordinary examiner and the scope of her mandate. In contrast to Lipson's and Marotta's proposal, my concept is not experimental but focuses on the individual case to support the court in its decision-making process, and it thereby would increase payments to creditors. The main advantages of preliminary examiners as compared to ordinary examiners are substantially lower costs, a smaller disruption of the business, and fewer delays in the reorganization process. Their appointment would, at the same time, ensure the avoidance of violations of the law in the specific bankruptcy case and improve general deterrence.[17] As a result, their appointment would help to overcome many corporate governance problems.

I explain in this Article how preliminary examiners can be appointed under the Bankruptcy Code (the Code); further, I propose amendments to the Code in order to change the starting point: The appointment of preliminary examiners should be the rule and non-appointment the exception. I explain in detail the situations in which preliminary examiners should not be appointed due to the absence of any net benefit for the estate and reorganization process.

The remainder of the Article is organized as follows. The challenges for corporate governance in a bankruptcy setting are described in Part I. The focus is on conflicts of interest, which exist irrespective of whether the shareholders or the main creditors dominate the case through the management. In both scenarios, management has clear incentives to favor the influential parties over (other) stakeholders. In Part I.C., I outline possible solutions such as a sale of assets, the appointment of a trustee, or the appointment of creditors' committees. I concentrate on the appointment of examiners in Part II. Advantages, especially with respect to corporate governance, and disadvantages are discussed in Subsection B. This is followed by a comparative legal analysis. In Subsection E, I focus on the crucial question: How can courts know that an examiner should be appointed? I propose the use of preliminary examiners and discuss the concept in detail.

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[15] Lipson & Marotta, *supra* note 9, at 50–51.

[16] The label "mini-examiner" is being replaced with "preliminary examiner" as the latter term better reflects their role as an early-stage advisor to the court.

[17] *See infra* p. 449; *see also* Stefan Korch, *The Mandate and Authority of Examiners*, AM. BANKR. INST. L. REV. (forthcoming 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3133022.

I. CHALLENGES FOR CORPORATE GOVERNANCE IN CHAPTER 11

The implementation of good corporate governance is not an easy task. Managers' interests differ from those of shareholders. This constellation is referred to as the principal-agent problem.[18] Despite the practical problems, at least the objective is clear in theory: Managers must be induced to act in the best interest of the shareholders.[19]

The situation is distinctly more complex in a bankruptcy setting. When a company files for bankruptcy and is reorganized, many different and contrasting interests must be balanced.[20] The main interest groups are shareholders, creditors, and employees.[21] In chapter 11, the debtor remains in possession. It is therefore exclusively the debtor's management's task to consider the interests of shareholders, creditors, and other stakeholders and to balance them according to the priority set out in the Code.[22]

In a typical bankruptcy setting, the estate is not sufficient to pay off all creditors and still leave the shareholders' position unchanged. Shareholders often lose their investment entirely. The creditors themselves may have different seniority, and employees fear for their jobs and pension plans. The insufficiency of the estate adds to the complexity of the situation.

Consequently, the question arises whether the debtor's management has the ability, skills, and neutrality to balance the competing interests. After all, the old management might have been responsible for the debtor's poor performance

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[18] *See, e.g.*, Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON., 74 (1979); Nirvikar Singh, *Moral hazard: Economic meaning of the conditions justifying the first-order approach*, 15 ECON. LETT., 277 (1984); *see generally*, Stephen A. Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 AM. ECON. REV. 134 (1973).

[19] *See generally, e.g.*, Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939); Weinberger v. Uop, Inc., 457 A.2d 701 (Del. 1983); Thorpe by Castleman v. CERBCO, 676 A.2d 436 (Del. 1996); Broz v. Cellular Info. Sys., 673 A.2d 148 (Del. 1996).

[20] *See* Jochem M. Hummelen, *Shaping Bankruptcy: What Form Should it Take?*, 24 J. BANKR. L. & PRAC. 52, 88 (2015) (stating that agency problems continue in bankruptcy); Barry L. Zaretsky, *Trustees and Examiners in Chapter 11 Bankruptcy*, 44 S.C. L. REV. 907, 912 (1993).

[21] *See In re* Schepps Food Store Inc., 160 B.R. 792, 798; *see generally,* 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 (1993); Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is It Anyway?*, 70 N.Y.U.L. REV. 993 (1995).

[22] *See* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 382–83 ("If a debtor remains in possession . . . the debtor's directors bear essentially the same fiduciary obligations to creditors and shareholders as would a trustee for a debtor out of possession."); Wolf v. Weinstein, 372 U.S. 633, 649–52 (1963). *See also* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 709 (1993).

prior to the bankruptcy, which would cast doubt on its abilities and skills.[23] More relevant for this article, however, is the distrust in the managers' neutrality.[24]

In the following discussion, I will show that two main scenarios must be considered. In the first, the shareholders dominate the bankruptcy. In the second, one or some creditors are the dominating force. In the early years of chapter 11, shareholders were the most influential party.[25] Since then, the situation has changed. Nowadays the creditors more often dominate the bankruptcy process.[26] However, these situations are not mutually exclusive. Sometimes shareholders first dominate the case but later the management is replaced and the creditors exercise more influence.

Except for the few chapter 11 cases in which trustees or examiners were appointed, no comprehensive data exists on wrongdoing before or in bankruptcy. Empirical evidence on the scope of infringements would be very hard to gather because it would require investigations into a substantial number of bankruptcy cases. The effort would presumably cost millions or tens of millions of dollars.[27] The already mentioned proposal by Lipson and Marotta, which will be discussed in detail later,[28] tries to address this lack of data.[29] For now, the best approach that can be offered is a theoretical analysis that unveils incentives to the parties in the bankruptcy proceeding, discusses control mechanisms, and weighs the probability of detection of wrongdoing. The following analysis will show that corporate governance problems likely arise in both the shareholder-dominated and the creditor-dominated scenario.

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23 *See, e.g.*, Zaretsky, *supra* note 20, at 909; *see also* Evan D. Flaschen, *Independent Monitors in Chapter 11*, 4 AM. BANKR. INST. L. REV. 514 (1996) (being skeptical).

24 *See* LoPucki, *supra* note 12, at 264–65 (1983)*; see also* 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. 298, 315–16 (2006) (arguing that it is very difficult to determine whom managers owe their duty to in bankruptcy); Zaretsky, *supra* note 20, at 909; Christian Köhler-Ma, *Restructuring and Creditor Participation under the Proposed Reforms of the German Insolvency Code*, 2011 INT. INSOLVENCY L. REV. 22, 27.

25 *See infra* note 30.

26 *See infra* notes 32–64.

27 For a discussion about the costs of examiners *see infra* note 205 and accompanying text.

28 *See infra* pp. 451–52.

29 *See* Lipson & Marotta, *supra* note 9, at 1.

A. Shareholder-Dominated Cases

In the early years of chapter 11, shareholders often dominated the bankruptcy process,[30] and the process was therefore subject to various criticisms.[31] Many believed that the debtor's managers would excessively dominate the procedure.[32] My findings in the following analysis are consistent with this critique and add another layer.

The management has incentives to favor the shareholders because it was appointed by the shareholders. The management also needs to be reappointed by those same shareholders. The conflict of interest is most obvious in cases in which the shareholders run the company by themselves or have related representatives on the board.[33] This is especially likely if the bankruptcy follows a leveraged buyout. The conflict of interest, however, is by no means limited to the latter case.[34] Even a (formally) independent board is still controlled by the shareholders within bankruptcy. The board can be dismissed only by the shareholders, not by the creditors.[35] Hence, the board still relies on the shareholders' assent. However, in contrast to the situation of a solvent company, creditors have a higher priority than the shareholders.[36] The estate should be used primarily to fulfill their obligations.[37] This is especially obvious in cases of

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30 *See, e.g.*, Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1052 (1992); *cf. also* Laurence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority Claims*, 27 J. FIN. ECON. 285, 291 (1990).

31 *See generally,* Bradley & Rosenzweig, *supra* note 30; David A. Skeel, *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465. *See also* Charles J. Tabb, *The Future of Chapter 11,* 44 S.C. L. REV. 791, 800, 858–59 (1993) (listing several critiques); Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 142–48 (1990) (showing massive deviations from the absolute priority rule, identifying potential reasons, and criticizing the practice).

32 *See* Edward S. Adams, *Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results*, 73 B.U. L. Rev. 581, 598–99 (1993) (arguing that debtor's directors should not make bankruptcy decisions); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 780–81 (1988); Bradley & Rosenzweig, *supra* note 30.

33 *See* LoPucki & Whitford, *supra* note 22, at 745–46; *see also* Sreedhar T. Bharath, Venky Panchapagesan & Ingrid Werner, *The Changing Nature of Chapter 11*, 27 (Indian Institute of Management Bangalore, Working Paper No. 461, 2007), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443248 (showing that management's equity positions correlate strongly with violations of the absolute priority rule).

34 *See* LoPucki & Whitford, *supra* note 31, at 150 (finding that in the majority of cases, managers were not identical with shareholders).

35 *In re* J.P. Linahan, Inc., 111 F.2d 590, 592 (2d Cir. 1940); *In re* Potter Instrument Co., Inc., 593 F.2d 470, 475 (2d Cir. 1979); *see In re* Johns-Manville Corp., 801 F.2d 60, 62–63 (2d Cir. 1986).

36 *See* LoPucki & Whitford, *supra* note 22, at 694–95 (similarly voicing skepticism).

37 Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 114 (1998); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy*

negative net assets. One could therefore argue that the creditors and not the shareholders should appoint the management.[38]

This debate, however, has been decided differently.[39] The courts' view is that the appointment is subject to (state) corporate law and is not overridden by (federal) bankruptcy law.[40]

> [T]he right of the majority of stockholders to be represented by directors of their own choice and thus to control corporate policy is paramount and will not be disturbed unless a clear case of abuse is made out. This has been the rule all along in equity receivership, in ordinary bankruptcy and in proceedings for reorganization under former section 77B of the Bankruptcy Act 11, U.S.C.A. § 207, where the corporate property was in control of receivers or trustees.[41]

Consequently, board members are appointed by the shareholders in the general meetings and not by the creditors or the bankruptcy court.

To address cases of obvious abuse, courts have granted the creditors an injunction to prevent the appointment or dismissal of the board for inappropriate reasons (*In re Johns-Manville*).[42] However, clear abuse is a high threshold. It covers cases in which shareholders "have an intent to jeopardize the reorganization" to prevent a reorganization plan that would largely dilute the

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Entitlements, and the Creditors' Bargain, 91 YALE L.J. 857, 860 (1982); Douglas G. Baird, THE ELEMENTS OF BANKRUPTCY 64 (rev. ed. 1993); *see also* LoPucki & Whitford, *surpa* note 22, at 683; Edward S. Adams, *note* 32, at 603; *cf. also* Barry L. Zaretsky, *supra* note 20, at 935; *but see* Mann, *supra* note 21; Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 VAND. L. REV. 741 (2004) (both arguing that the bankruptcy system should not primarily serve the creditors' interests).

38 It is therefore questionable whether the costs of equity committees are justified. *See*, *e.g.*, LoPucki & Whitford, *supra* note 31, at 185. *See also* LoPucki & Whitford, *supra* note 22, at 699. A counterargument could be that it might not be clear at the opening of the bankruptcy procedure that the estate is insufficient. If not, the risk and opportunities are on the shareholders. This should, however, only be true for a fraction of cases since the debtor or creditors usually do not unfoundedly file for bankruptcy.

39 *See In re* J.P. Linahan, Inc., 111 F.2d 590, 592 (2d Cir. 1940); *In re* Potter Instrument Co., Inc., 593 F.2d 470, 475 (2d Cir. 1979); *In re* Johns-Manville Corp., 801 F.2d 60, 62–63 (2d Cir. 1986). For a critical view on cases where a debtor holds insufficient assets, see David S. Kupetz, *Corporate Governance of Chapter 11 Debtors: The Impairment or Suspension of Shareholder "Democracy" Rights Taking into Account the Economic Realities of the Case*, NORTON BANKR. L. ADVISER, No. 7 (July 2005), at 8, 12.

40 *See In re* J.P. Linahan, Inc., 111 F.2d at 592; *In re* Potter Instrument Co., Inc., 593 F.2d at 475.

41 *In re* J.P. Linahan, Inc., 111 F.2d at 592.

42 *In re* Johns-Manville Corp., 801 F.2d at 65–69; *see also In re* J.P. Linahan, Inc., 111 F.2d at 592 (already indicating the exception for clear cases of misuse).

existing equity.[43] These cases are rare.[44] Courts do not consider strategic replacement of management by shareholders in order to prevent an unfavorable plan as a clear misuse of power. In other words, if shareholders do not like the outcome of the proposed plan, they can exchange the board as long as this behavior does not jeopardize the restructuring. This also applies to other management actions. Thus, the board, and ultimately also the management, still rely on the goodwill of the old shareholders, which gives an incentive to favor them over stakeholders.[45]

This situation favors certain behavioral patterns.[46] First, the management has little incentive to pursue claims against itself arising from mismanagement or other breaches of duties. Because of the business judgment rule, mismanagement will only lead to liability in severe cases or cases of conflicting interests.[47] Other types of infringements, such as insider trading, are unlikely to be unveiled.[48] Not only are managers unlikely to conduct an investigation, they may also prevent or sabotage any such attempt by the creditors' committee (or other parties).[49]

The second large risk in this situation are avoidable transfers made before the bankruptcy. Not seldom, shareholders receive payments or other benefits from the debtor, for example, payments that are made on claims which are secured by the shareholders through a guaranty. In groups of companies, fraudulent transfers and preference transfers are not uncommon, especially if only one or some of the subsidiaries are bankrupt.

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[43] *In re* Johns-Manville Corp., 801 F.2d at 66–67.

[44] It remains unclear whether the court would rule differently in cases of obviously insolvent companies. *See* LoPucki & Whitford, *supra* note 22, at 696 (arguing in this direction because of dicta found in a footnote in the decision).

[45] *See* Bruce H. White & William L. Medford, *Corporate Governance in Chapter 11 and Stockholder Voting Rights: Who's in Control?*, 22 AM. BANKR. INST. J. 34 (2003); *see also* Bradley & Rosenzweig, *supra* note 30, at 1076–77 (arguing that managers (mis)use bankruptcy to free themselves from creditors' control); Bharath et al., *supra* note 33 (citing several studies that show deviations from the absolute priority rule in more than 70% of the bankruptcy cases); Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANAL. 511, 526 (2009).

[46] *See* Zaretsky, *supra* note 20, at 916 (noting that "real parties in interest in the Chapter 11 case may in fact not be well served" if the old management remains in control).

[47] *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Francis v. United Jersey Bank, 87 N.J. 15 (N.J. 1981).

[48] *See* Bradley & Rosenzweig, *supra* note 30, at 1073–75 (showing an increase in insider trading after the 1978 reform).

[49] *See* LoPucki & Whitford, *supra* note 22, at 738–40 (stating that managers sometimes do not succeed in preventing investigations—in the cases cited because of SEC investigations or management turnovers—but suggesting that managers prevail in many cases).

The board of the subsidiary, which appoints the management, will itself have been appointed by the management of the parent company, and given the board's usual affiliation to the parent company, it will be unlikely to avoid fraudulent transfers that were previously ordered. These payments are not only against the law, they can also be quite substantial and make a real difference for the reorganization and the creditors. For example, in the *Caesars* bankruptcy, the examiner found transfers in a range of 3.6 to 5.1 billion dollars that are likely to be qualified as fraudulent.[50]

Lastly, there is a theoretical risk that shareholders will receive payments during bankruptcy. This would obviously violate the absolute priority rule and be a breach of existing duties. I therefore think that such benefits are not very common. A more likely scenario is the engagement of old shareholders as investors or creditors during bankruptcy. In this context, the imminent risk exists that shareholders will be overcompensated for their new contribution, e.g., by receiving excessive interest rates for DIP lending.[51] This would be a violation of the absolute priority rule.

B. *Creditor-Dominated Cases*

Over the last three decades, bankruptcy reality and critiques have notably changed.[52] Creditors have gained increasing influence over the decisions being made.[53] The main reason for this development is that creditors have become more sophisticated actors in bankruptcy.[54] Especially if well advised, they can strongly influence the process.[55] In early bankruptcy cases, commercial banks

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[50] *See* Report of Richard J. Davis, as Examiner, *In re* Caesars Entm't Operating Co., Inc., No. 15-01145, 2016 Bankr. LEXIS 4529 (Bankr. N.D. Ill. May 18, 2016), https://online.wsj.com/public/resources/documents/CaesarsReport03-16-2016.pdf (most of the claims arise from fraudulent transfers and have, according to the examiner, at least better than a 50% chance of succeeding in court); *see also* Hosking v. TPG Capital Management LP (*In re* Hellas Telecomms. (Luxembourg) II SCA), 524 B.R. 488 (Bankr. S.D.N.Y. 2015) (alleged fraudulent transfers of one billion dollars; eventually, the case was not subject to U.S. bankruptcy law).

[51] *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 North LaSalle St. P'ship, 526 U.S. 434; Tabb, *supra* note 31, at 846–48 (discussing the conflict between new value compensation and the absolute priority rule).

[52] For a critical discussion of modern bankruptcy, see Lipson, *supra* note 12 . *See also* George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 110–12 (2004).

[53] David A. Skeel, *Doctrines and Markets: Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 918–22 (2003); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1227–34 (2006); *see also* Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703 (2008).

[54] Ethan S. Bernstein, *supra* note 24, at 300–01.

[55] *See* LoPucki & Whitford, *supra* note 22, at 737 (assigning management turnover largely due to creditor pressure); *see also* Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms:*

were the main creditors. Nowadays they usually sell their claims to distressed debt investors, such as hedge funds and private equity funds.[56]

Creditors who also act as DIP lenders can often exercise influence on corporate governance in bankruptcy through the new loan agreement.[57] The covenants often provide lenders with veto power over payments and dividend decisions, new financing, investment decisions, and even the firing and hiring of managers.[58] Hence, DIP lenders can and actually do exercise control over the debtor in possession.

Creditors can also insist on the appointment of a chief restructuring officer before the filing for bankruptcy.[59] Such appointments influence the debtor's management before and in bankruptcy. Further, major creditors often have had the parent company pledge its stocks in the subsidiary or have had it give proxy control to a trustee, or the creditors have secured other control rights.[60] The creditors (or their trustees) can then act instead of the parent company as the original shareholder of the subsidiary. Since they can now exercise voting rights

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Empirical Evidence, 72 WASH. U. L.Q. 1005, 1017 (1994); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 544 (1983); Lipson, *supra* note 12 (for a critical view on professional/activist turn-around investors).

[56] Lipson & Marotta, *supra* note 9, at 6; Lipson, *supra* note 12, at 1614–16; *see also* Harner, *supra* note 53 (describing how distressed debt investors act in bankruptcy).

[57] Skeel, *supra* note 53, at 922–27; Jodie A. Kirshner, *Design Flaws in the Bankruptcy Regime: Lessons from the U.K. for Preventing a Resurgent Creditors' Race in the U.S.*, 17 U. PA. J. BUS. L. 527, 537 (2014–15); Baird & Rasmussen, *supra* note 53, at 1236–39; Kuney, *supra* note 52, at 46–57; *see also* Bharath et al., *supra* note 33, at 28–29; Sandeep Dahiya et al., *Debtor-in-possession financing and bankruptcy resolution: Empirical evidence*, 69 J. FIN. ECON. 259, 265–66 (2003) (showing an increase in DIP-financing from 7.41% in 1988 to 42.31% in 1997).

[58] Gilson & Vetsuypens, *supra* note 55, at 1007–10; *see also* Baird & Rasmussen, *Private Debt supra* note 53, at 1239 ("The typical debtor-in-possession (DIP) loan grants the lender virtually complete control over the reorganization process.").

[59] Hummelen, *supra* note 20, at 88; Skeel, *supra* note 53, at 918; Baird & Rasmussen, *supra* note 53, at 1233–34 (highlighting the powerful position of the CRO). A more subtle way of influencing the management is bonus payments, which are often agreed upon with the creditors' committee. *See* LoPucki & Whitford, *supra* note 22, at 710–12 (discussing employment contract incentives); *see also* Gilson & Vetsuypens, *supra* note 55, at 1015–19 (for empirical evidence). For debtor's Employee Retention and Severance Programs, see Mechele Dickerson, *Approving Employee Retention and Severance Programs: Judicial Discretion Run Amuck?*, 11 AM. BANKR. INST. L. REV. 93 (2003), Kuney, *supra* note 52, at 74–90. These payments may incentivize the management to lead the bankruptcy process in a certain direction. *See* Skeel, *supra* note 53, at 926–30. *See also* Bharath et al., *supra* note 33, at 28–29 (showing the increase in bonus payments and similar measures). They became common over the last decades but also have been criticized because of the risk of conflicting interests that they can create.

[60] Bernstein, *supra* note 24, at 300–01; Ayotte & Morrison, *supra* note 45, at 525–27; Baird & Rasmussen, *supra* note 53, at 1228–29 (noting the security interests in all debtor's assets but also the control through revolving credit facilities, which allow the creditor to heavily control the cash flow before bankruptcy).

in general meetings, they can also appoint or dismiss the management of the bankrupt company. In this case, the situation is totally different from the shareholder-dominated case. Even though the management was originally appointed by the shareholders, it now relies solely on the goodwill of certain creditors. They can and might replace management that, in their view, is not acting according to their interests. The shareholders' influence, by contrast, is diluted.[61]

Empirical evidence supports this hypothesis. In 2001, Ethan S. Bernstein found management turnover in about 48% of all bankruptcy cases (with a similar rate also found in non-bankruptcy cases, i.e., cases in which the companies were in financial distress but had not filed for bankruptcy).[62] Even higher turnover rates have been documented by Kenneth M. Ayotte and Edward R. Morrison, who found management turnover of 70% in bankruptcy cases,[63] along with other studies.[64]

At first glance, creditor dominance seems to be a positive development for corporate governance since it relaxes the conflicts of interest that arise from shareholder domination.[65] Liability claims against management and fraudulent transfers are less of a concern. If the management was replaced, there is less incentive for the new management to spare the old management, shareholders, or the parent company. Since the creditors are paid from the estate, the new management should try to enrich it by realizing claims against shareholders and former managers. However, the new management might not be willing to investigate prior actions by the old management. For instance, hedge fund managers may only want to concentrate on the turn-around. By being ignorant of the past, they may allocate their resources more efficiently.[66] Nevertheless,

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61 This assumes that the management is not itself holding shares of the company or is affiliated with the shareholders in any other way. However, in this situation, it is very unlikely that the creditors will not exercise their voting power to replace the management with neutral or creditor-friendly managers.

62 Bernstein, *supra* note 24, at 318. Bernstein calls the non-bankruptcy turnover a product of the "shadow at bankruptcy". *Id*. at 320–21.

63 Ayotte & Morrison, *supra* note 45, at 522–23.

64 LoPucki & Whitford, *supra* note 22, at 723–30 (finding 72% turnover during bankruptcy and even 91% when considering a timeframe of 18 months before filing and six months after confirmation); *see also* Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241, 246–47 (1989) (finding 52%).

65 *See also* Baird & Rasmussen, *supra* note 53, at 1250 (noting that the early replacement of unsuccessful management benefits the debtor and the creditors).

66 In cases of a replacement of management before filing for bankruptcy, usually some cooperation of the old management is needed. If a hedge fund has a reputation of suing the old management shortly after the replacement, the future cooperation of old management is less likely.

with regard to fraudulent transfers and management liability, the situation is at least slightly more favorable.[67]

On the other side, the new situation also weakens corporate governance. Major creditors now have a very large influence.[68] They not only control the composition of the board and the creditors' committee, but they also have a huge influence when it comes to voting on the reorganization plan.[69] The circumstances are even more one-sided if the debtor's management has been replaced prior to the filing for bankruptcy due to creditor pressure.[70] This kind of intervention can be observed in many cases, especially when claims are sold to hedge funds, and this can be a major source of conflicting interests.[71]

In this situation, the new management was installed and is now controlled only by the influential creditor(s). Especially in cases of activist turn-around investors such as hedge funds, which usually buy-out senior creditors and maybe even shareholders or junior creditors, the management is heavily dependent on this investor.[72] It therefore has a strong incentive to favor this investor. Smaller creditors and other stakeholders run the danger of being marginalized.[73] Conflicts of interest can also exist between larger creditors.[74]

The new management could favor the influential creditors in different ways. First, if installed before filing for bankruptcy, the new management could pay creditors off or supply collateral. This favor could be provided to either the new or the old creditors. If the new creditor, e.g., a hedge fund, bought the claim long in advance of the filing for bankruptcy, it might have received payments. Otherwise, the old creditor, typically a commercial bank, will have profited. In the first case, it is clear that the management has no incentive to undo the

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[67] More recent empirical data shows a sharp decline in violations of the absolute priority rule in the last decades. *See* Bharath et al., *supra* note 33, at 18–20.

[68] *See* Gilson & Vetsuypens, *supra* note 55, at 1024 (concluding that banks have more influence than other creditors); *see also* Ayotte & Morrison, *supra* note 45, at 525–28 (showing the very high concentration of secured debt and the high concentration of debt); Baird & Rasmussen, *supra* note 53, at 1239.

[69] *See* Gilson & Vetsuypens, *supra* note 55, at 1024.

[70] Creditors often give out revolving loans, which means that they can control the cash flow of the company. Hence, no management can survive without these creditors' approval. *See* Baird & Rasmussen, *supra* note 53, at 1228–29.

[71] *See* Ayotte & Morrison, *supra* note 45, at 522 (showing management turnover before filing for bankruptcy in 70% of all cases).

[72] *Cf.* Lipson, *supra* note 12, at 1616 (noting that investors might hold several positions in the debtor entity).

[73] *See, e.g.*, Gilson, *supra* note 64, at 246–47 (finding that public bond holders usually do not initiate management turnovers).

[74] *Cf.* Ayotte & Morrison, *supra* note 45, at 526–28 (finding a high objection rate in the creditors' committee – both from secured and unsecured creditors).

preference transfer or any other benefit. But even if the preference transfer was made to the bank that sold the claim before the management was replaced, the new management has little incentive to avoid this preference payment. It would not be consistent with the interests of the hedge fund that installed the new management. If a hedge fund or any other distressed debt investor obtains a reputation for frequently going after the old creditors following the sale of the claims, no future creditors will ever sell their claims to this hedge fund. Hence, if the new creditors are (potentially) repeat players, they have little incentive to have their management recover preference transfers or the like on behalf of the debtor.

Instead, the hedge fund might request a discount because of the preference transfers, as those have also reduced the value of the claim against the estate. Note, however, that this discount would be smaller than the benefit for the seller of the claim. This is because the illegal benefit harms all creditors, not only the hedge fund. In fact, the hedge fund would only partially benefit from the avoidance of a transfer. Hence, there is a large zone of potential agreement due to negative externalities that are caused by discriminating against other creditors.

C. Possible Solutions

As shown, conflicts of interest can be expected in many bankruptcy cases. I will now discuss potential solutions for these problems and will start with the possibility of selling the operating business as a whole. I will proceed with the appointment of bankruptcy trustees and conclude with a more extensive discussion of creditors' committees and their advisors.

1. The § 363 Sale

The establishment of a reorganization plan is still standard in U.S. bankruptcy law. However, an alternative is on the rise. In the last two decades, more and more businesses have been sold in the bankruptcy procedure.[75] Although § 363 does not cover these kinds of sales expressly, there is little doubt that they are valid. However, many details are still disputed.

A § 363 sale has a huge advantage: The operating business will not be affected by the bankruptcy after the sale.[76] Any disputes, delays, or reputational

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[75] ABI Report, *supra* note 14, at 203 (based on the UCLA-LoPucki Bankruptcy Database); *see also* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 170–71 (2005).

[76] 3 COLLIER ON BANKRUPTCY ¶ 363.02 [3] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2016).

damages can no longer affect the value of the business. This is not only favorable for employees but also for the creditors since the business is usually the main asset of the estate. The more value that is preserved, the higher the payment will be on each creditor's claim.

In this Article, I cannot take up the general discussion surrounding § 363 sales.[77] However, the aspect of better corporate governance can be emphasized.[78] The sale simplifies the situation. As soon as the business is no longer in bankruptcy, the management relies solely on the new shareholders. Since they now own the company, the corporate governance problems are reduced to the original principal-agent problem in corporations. The remaining conflicts are less disconcerting.

The positive effect is, however, limited to infringements that might otherwise occur during bankruptcy. The quick sale largely prevents illegal benefits from being provided to certain creditors or to shareholders during bankruptcy. After the sale, the business itself is no longer available as a source of payments. The distribution of the sale price is straightforward and hence is less vulnerable to manipulations. It is not as complex as the installment of the reorganization plan or the evaluation of DIP financing conditions. Creditors cannot easily be discriminated against. If a smaller creditor nevertheless feels disfavored, he can sue the debtor.

However, problems originating from the time before filing for bankruptcy are not resolved by the sale. Fraudulent and preference transfers are not avoided since these claims are usually not sold to the buyer.[79] Nor does the sale result in liability claims being brought against the management. Hence, the sale itself only stops infringements during bankruptcy; it does not provide a solution for violations that occurred before the sale. Regarding those issues, the sale might even complicate the situation.[80] Although the sale is favorable from a general

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[77] *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003) (both in favor of § 363 sales); John J. Hurley, *Chapter 11 Alternative: Section 363 Sale of All of the Debtor's Assets Outside of a Plan of Reorganization*, 58 AM. BANKR. L.J. 233 (1984) (one of the first authors to discuss the possibility of a total asset sale); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 11–15 (2007) (voicing criticism); Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy*, 56 STAN. L. REV. 645 (2003).

[78] *See, e.g.*, LoPucki & Whitford, *supra* note 22, at 755–66 (arguing that only a quick sale could improve corporate governance but not a sale after several months).

[79] *See infra* p. 455–56.

[80] *See infra* p. 455 (discussing complications for the enforcement caused by the sale).

corporate governance perspective, since it reduces conflicts of interest, it does not solve most of the problems caused by the DIP model.

2. *Appointment of a Bankruptcy Trustee*

An alternative to debtor-in-possession control in chapter 11 is the appointment of a trustee. Trustees are neutral administrators accountable only to the bankruptcy court. Therefore, they can address the different interests of shareholders and stakeholders without any disturbing influence. For this reason, among others, many foreign bankruptcy codes provide for the appointment of a bankruptcy trustee as the only model or as the standard model of bankruptcy procedure.[81] The reorganization is then planned and performed by the trustee. The appointment of a trustee should therefore not be misunderstood as a decision against reorganization.

[81] In Germany, for example, the appointment of a bankruptcy trustee is standard. INSOLVENZORDNUNG [INSO] [INSOLVENCY ACT], § 27 para. 1, http://www.gesetze-im-internet.de/englisch_inso/englisch_inso.html (Ger.). Nevertheless, the possibility of a self-administration of the debtor has existed since 1999. *Id.*, at §§ 270–285. It is comparable to the chapter 11 procedure. *See, e.g.*, Christian Tetzlaff, *in* 3 MÜNCHENER KOMMENTAR ZUR INSOLVENZORDNUNG Vorbemerkungen vor §§ 270 bis 285, Rn. 18 (3rd ed. 2014) (noting that chapter 11 was one illustrative example for the new sections in the bankruptcy code); *see also* Rainer Riggert, *in* INSOLVENZORDNUNG Vorbemerkung vor §§ 270 bis 285 InsO, Rn. 3–6 (Jörg Nerlich & Volker Römermann eds., 30th ed. Jul. 2016). Upon request of the debtor and if the court so orders, the management remains in charge. INSOLVENZORDNUNG [INSO] [INSOLVENCY ACT], § 270, para. 1 (Ger.). The bankruptcy court has discretion and no disadvantages for the creditors must be expected. *Id.* at § 270, para. 2. This is a manifestation of the stronger orientation towards creditor interests in Germany.

Despite the legal possibility, debtors remain in possession in only 2% of all cases (but in 50% of the larger cases). Holger Ellers, *in* BECK'SCHER ONLINE-KOMMENTAR INSO § 270 Rn. 6 (Alexander Fridgen et al., eds., 4th ed. Oct. 2016), Beck-Online, https://beck-online.beck.de/Home. This can be explained by the distrust in the capability of the old management compared to an experienced bankruptcy trustee but also by the discomfort with respect to the potential management conflicts of interest. To further promote the possibility of self-administration, the Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen [ESUG] [German Insolvency Law Reform], Dec. 07, 2011, BGBL. I at 2582 (Ger.), which came into force in 2012, simplified the requirements and the procedure. *See, e.g.,* Christian Tetzlaff, *in* 3 MÜNCHENER KOMMENTAR ZUR INSOLVENZORDNUNG Vorbemerkungen vor §§ 270 bis 285, Rn. 17 (3rd ed. 2014); Rainer Riggert, *in* INSOLVENZORDNUNG Vorbemerkung vor §§ 270 bis 285 InsO, Rn. 5 (Jörg Nerlich & Volker Römermann eds., 30th ed. Jul 2016); Volker Grub, *Überjustizialisierung und die Eigenverwaltung des Pleitiers*, 1994 WERTPAPIERMITTEILUNGEN 880, 880–81; Köhler-Ma, *supra* note 24, at 27.

For other countries, see, e.g., INSOLVENZORDNUNG [IO] [Insolvency Act], REICHSGESETZBLATT [RGBL] No. 337/1914, as amended, § 80 para. 1, https://www.ris.bka.gv.at/Dokumente/Bundesnormen/NOR40117937/NOR40117937.html (Austria); Loi sur les faillites [Bankruptcy Act] art. 11, of Aug. 8, 1997, MONITEUR BELGE [M.B.] [Official Gazette of Belgium], Oct 28, 1997, 28562, http://www.ejustice.just.fgov.be/cgi_loi/change_lg.pl?language=fr&la=F&cn=1997080880&table_name=loi (Belg.). For an overview see Ziad R. Azar, *A Review and Critique of Bankruptcy Statutes and Practices in Fifty Countries Worldwide*, 16 CARDOZO J. INT'L & COMP. L. 279, 289–92 (2008).

The obvious advantage of the trustee is her neutrality. The trustee is responsible to the court and can therefore balance the opposing interests better than the management.[82] Furthermore, bankruptcy trustees are typically very experienced persons possessing a legal and business background. After being appointed, they can quickly start with necessary measures. The management, by contrast, is usually not familiar with the specific legal framework[83] and needs extensive advice. One common way to reorganize a corporation is the sale of the whole business (if worth it) or, more often, the sale of profitable parts and the liquidation of the remaining parts.[84]

Obviously, both the DIP model and the trustee model have advantages and disadvantages. The U.S. system emphasizes the old management's familiarity with the company and the relevant market.[85] No transition is needed, which is important in bankruptcy since time is short.[86] Further, the appointment of trustees seems to delay the filing for bankruptcy, with adverse effects on the prospects of a successful reorganization.[87] Finally, in the U.S., bankruptcy is not automatically associated with failure and an inability of the management.[88] The perception is different in Germany and other European countries, for example, where bankruptcy is, to a certain extent, regarded as a disgrace for the management.[89]

This Article cannot address all aspects of the conceptual decision. I will instead take the choice made by the U.S. Congress in the 1978 reform as a given. Notwithstanding the conceptual decision in favor of the DIP model, the appointment of a trustee is still possible in U.S. chapter 11. According to § 1104(a), the bankruptcy court can appoint a trustee upon request of a party in

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82 *See supra* Part I.A.–B., pp. 418–25.

83 This can be explained by the small number of cases in which self-administration is ordered in Germany. *See supra* note 81. Turn-around management regularly takes place prior to the bankruptcy filing. It would be fair to argue, though, that more instances of self-administration would lead to more sophisticated turn-around managers being familiar with the bankruptcy procedure.

84 The trustee will later distribute the purchase price and other monetary assets to the creditors according to their priority.

85 *See, e.g.*, Skeel, *supra* note 53, at 927; Zaretsky, *supra* note 20, at 908.

86 *See* Skeel, *supra* note 53, at 927; Zaretsky, *supra* note 20, at 930; Tabb, *supra* note 31, at 856.

87 *See* ABI Report, *supra* note 14, at 28; Tabb, *supra* note 20, at 859; Christian Tetzlaff, *in* 3 MÜNCHENER KOMMENTAR ZUR INSOLVENZORDNUNG Vorbemerkungen vor §§ 270 bis 285, Rn. 6 (3rd ed. 2014); Holger Ellers, *in* BECK'SCHER ONLINE-KOMMENTAR INSO § 270 Rn. 1 (Alexander Fridgen et al., eds., 4th ed. Oct. 2016), Beck-Online, https://beck-online.beck.de/Home; Hummelen, *supra* note 20 (for the situation in the Netherlands).

88 *But see* J. Bradley Johnston, *The Bankruptcy Bargain*, 65 AM. BANKR. L.J. 213, 292 (1991).

89 This was even true for the UK. *See* BRUCE G. CARRUTHERS & TERENCE C. HALLIDAY, RESCUING BUSINESS 249, 284–85, 294 (1998).

interest or the United States Trustee.[90] The court shall, after notice and hearing, appoint a trustee for cause, which includes fraud, dishonesty, incompetence, and gross mismanagement, or if the appointment is in the interest of the parties.[91] In those severe cases of breach of duty, the management shall not remain in possession; however, these cases are rare.[92] Only in 3.6% of large chapter 11 cases does the debtor not remain in possession.[93] The ABI proposed in 2014 that trustees should, though still as an exception, be appointed more often.[94]

Following from the high threshold for the appointment and its rare use, it cannot be assumed that trustees are appointed in all cases involving major conflicts of interest. The use of a trustee is rather an expression of the bankruptcy court's deep concern and indicates that the management should, despite all the advantages of the DIP system, not stay in charge. However, this approach covers only very severe cases.

If a trustee is appointed, few of the bankruptcy related corporate governance problems persist. The trustee will investigate all matters that might enrich the estate. This includes claims against the old management as well as avoidable transfers. Moreover, the trustee will not effectuate any illegal payments to any of the parties. Only the general principal-agent problem remains, since the trustee administers the estate on behalf of the bankruptcy court and is only accountable to the court. This problem, however, is inevitable and substantially less concerning than all the other perverse incentives.[95]

3. *Creditors' Committees and Their Advisors*

In chapter 11 cases, the management is (or should be) monitored by the creditors' committee. The creditors' committee can employ advisors, such as lawyers.[96] These professionals can conduct investigations on behalf of the

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90 11 U.S.C. § 1104(a) (2012).

91 *See id*.

92 *See* Bernstein, *supra* 24, at 315.

93 Lipson & Marotta, *supra* note 9, at 26. In small bankruptcy cases, trustees were appointed only in 2% of the cases. *Id*. at 37.

94 ABI Report, *supra* note 14, at 29 (suggesting that the burden of proof should not be the clear and convincing evidence standard but the lower preponderance of the evidence standard).

95 Further, a reform of the fees could align the trustee's interest with the interest of the debtor and the creditors. *See infra* notes 203–06 and accompanying text.

96 11 U.S.C. § 1103(a) (2012). *See also* Kenneth N. Klee & K. John Shaffer, *Symposium on Bankruptcy: Chapter 11 Issues: Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 995, 1041–42 (1993).

committee and therefore demand access to the debtor's books.[97] Hence, the committee's advisors are generally enabled to detect wrongdoing. On the negative side, these investigations are often very costly, time-consuming, and might delay the bankruptcy process. There is also indication that, for various reasons, monitoring through the creditors' committee is insufficient in a significant number of cases.[98]

First, creditors' committees, although mandatory, are often not appointed because creditors are unwilling to serve as members.[99] In addition to the limited influence and relatively small expected payments, which cause a rational disinterest,[100] claims trading also leads to this reluctance.[101] In order to be able to sell their claims, creditors do not want to be constrained by insider information and hence are hesitant to participate in the creditors' committee.

Second, even if appointed, creditors' committees are often inactive for similar reasons.[102] Especially in cases with very limited assets, the engagement will likely not pay off. Conversely, creditors' committees might be more effective, and creditors less reluctant to serve if they could expect substantial payments from the debtor.

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[97] 7 COLLIER ON BANKRUPTCY ¶ 1103.03 [4][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2016).

[98] LoPucki, *supra* note 12, at 252–53.

[99] Empirical studies show that creditors' committees are often not appointed. *See* Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 VAND. L. REV. 749, 776–77 (in 48.6% of all cases, no committee was appointed); LoPucki, *supra* note 12, at 100 (finding creditors' committees in only 40% of all cases); *see also* Frost, *supra* note 37, at 120 (citing the NBRC report). For reasons, why creditors are unwilling to serve, *see generally* Johnston, *supra* note 88, at 270–71. *See also In re* Aspen Limousine Serv., Inc., 187 B.R. 989, 994 n.6 (Bankr. D. Colo. 1995) (stating that creditors' committees are often not appointed in smaller cases); *In re* Coast Carloading Co., 34 B.R. 855, 859 n.3 (Bankr. CD. Cal. 1983) (reporting unwillingness among creditors to serve as members); *In re* B&W Tractor Co., 38 B.R. 613, 615 (Bankr. E.D.N.C. 1984).

[100] *See, e.g.*, Brian A. Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. Small & Emerging Bus. L. 181, 200 (2000); Michael J. Herbert, *Business Reorganizations Under Chapter 13: Some Second Thoughts*, 10 OKLA. CITY U. L. REV. 603, 630 (1985).

[101] Klee & Shaffer, *supra* note 96, at 1063 (naming claims trading, insider information issues, and the lack of reimbursement).

[102] *See In re* ABC Auto. Prods. Corp., 210 B.R. at 442–43 (finding that members of creditors' committees are often inactive); *In re* Spruill, 78 B.R. 766, 772 n.14 (Bankr. E.D.N.C. 1987); *In re* B&W Tractor Co., 38 B.R. at 615 n.4 (calling creditors' committees inactive; from 250 pending cases in the district, only 5% had active creditors' committees); *In re* Gusam Rest. Corp., 32 B.R. 832, 834 n.1 (Bankr. E.D.N.Y. 1983) (stating that "creditors' committees exist in name only and are completely ineffectual"); *but see* Zaretsky, *supra* note 20, at 914.

Third, empirical findings indicate that committees are sometimes ineffective, especially because of internal fights.[103] In some cases, creditors' committees contribute to the delay of the case or even cause losses.[104] A recent empirical study by Lynn M. LoPucki and Joseph W. Doherty showed a correlation between the appointment of creditors' committees and lower rates of successful reorganizations.[105] Given these findings, it cannot generally be assumed that creditors' committees can satisfyingly solve corporate governance problems.[106]

To clarify, I do not argue that all creditors' committees are inactive, inefficient, and unable to fulfill their duties.[107] As noted, in very large cases, it is fair to assume that creditors actually have a rational interest in participating in the committee and influencing the process. However, in a substantial amount of cases, the committees are not able to conduct necessary investigations or supervise the management closely enough to implement good corporate governance.[108] Therefore, the outlined conflicts of interest may nevertheless result in undetected infringements of the law, even if a creditors' committee is appointed.[109]

In creditor-dominated cases, efficient monitoring through the creditors' committee is even less likely. The committee's composition reflects the relative value of the creditors' claims. Consequently, large creditors dominate the committee, which is supposed to monitor the management and investigate suspicious actions.[110] In this scenario, several members of the committee might

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[103] Lipson & Marotta, *supra* note 9, at 6; *see also* LoPucki, *supra* note 12, at 250–52.

[104] This could be seen in *In re* FiberMark, for example: The dispute of two main creditors—an original creditor and a hedge fund that bought claims of the debtor—and their representatives in the committee are believed to have caused delays and a loss of about $60 million in value for the estate. *In re* Fibermark, Inc., 330 B.R. 480, 489 (Bankr. D. Vt. 2005); *see* Report of Harvey R. Miller, as Examiner, *In re* FiberMark, Inc., No. 04-10463 (Bankr. D. Vt., Aug. 16, 2005) (Docket No. 1805), http://online.wsj.com/public/resources/documents/WSJ-HarveMiller_report.pdf; *see also* Lipson, *supra* note 12, at 43–44; Stephen W. Rhodes, *Eight Statutory Causes of Delay and Expense in Chapter 11*, 67 AM. BANKR. L.J. 287, 309–11 (1993) (noting that creditors' committees sometimes contribute to delay in the bankruptcy process).

[105] Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Survival*, 62 UCLA L. REV. 970, 983–84 (2015).

[106] *See* LoPucki, *supra* note 12, at 252–53 (pointing out that investigations by creditors' committees are rare).

[107] *But see, e.g.*, LoPucki & Whitford, *supra* note 22, at 688 (voicing considerable skepticism); LoPucki, *supra* note 12, at 250–53.

[108] *See* Johnston, *supra* note 88, at 292 (also arguing that creditors' committees leave unsecured creditors unprotected).

[109] *Cf.* Azar, *supra* note 81, at 295 (pointing out conflicts of interest).

[110] *See* Lipson & Marotta, *supra* note 9, at 6; *see also* LoPucki & Whitford, *supra* note 31, at 155 (stating that creditor committees mainly represent large creditors, especially banks); Regina S. Kelbon, Ellen S. Herman

not have any incentive to conduct an investigation, since this investigation could target themselves, the companies they work for, or their counter-party in claims trading. Theoretically, this problem could be solved by excluding conflicted members from the discussion and voting. However, it is not clear how other members can know about the conflicts of interest. If no one else knows, chances are low that the conflicted members will not influence the process. Additionally, other members might not always want to investigate actions that potentially favored certain members because they will try to avoid internal fights within the committee.

There is empirical evidence supporting this theoretical finding. Michelle M. Harner and Jamie Marincic found that the members of creditors' committees are often subject to conflicts of interest.[111] It has been observed, for example, that creditors use their position in the creditors' committee to gain insider information.[112] This of course goes one step beyond merely failing to disclose a conflict of interest. It is, therefore, at least doubtful that creditors' committees effectively monitor the management and initiate investigations.

D. *Concluding Remarks*

This section has described the main challenges for corporate governance arising from the DIP model. They can be classified as follows: First, claims against former or current managers may not be realized. Second, fraudulent conveyances and other avoidable transfers to shareholders or related persons are often unlikely to be detected or correctly evaluated and avoided. These two issues are most likely to arise in shareholder-dominated cases. Third, creditors may likewise profit from illegal benefits before the filing for bankruptcy, such as preference transfers. These are more likely to occur in creditor-dominated cases.

The whole situation could be best explained as a complex principal-agent-problem. If shareholders dominate the case, they can exploit the creditors through various actions taken by the management. In the creditor-domination scenario, some creditors can benefit at the expense of others if the management is captured. Subsequently, the latter is an intra-stakeholder conflict.

& Richard S. Bell, *Conflicts, the Appointment of "Professionals," and Fiduciary Duties of Major Parties in Chapter 11*, 8 BANKR. DEV. J. 349, 416–17 (1991) (showing that courts allow members on the committee who have potential conflicts of interest).

111 Harner & Marincic, *supra* note 99, at 790 ("Examples of these conflicts include members who held both secured and unsecured debt, held both equity and unsecured debt, or were controlled by alleged insiders of the debtor.").

112 *Id*. at 773.

Both scenarios have in common that the managers as agents lack incentives to value the interests of all principals. Disadvantaged parties often have no or very little insight—known as "information asymmetry." To detect and prevent wrongdoing, it is not sufficient to know about a wrongful action itself, e.g., that a payment was made. It is also necessary to have enough information to be able to evaluate its legality. Did the debtor, for example, receive a reasonable equivalent value in exchange?[113] Without this information, other parties cannot tell whether the transfer was a fraudulent conveyance or not.[114] Hence, information asymmetry may not only be caused by hidden actions but also by a lack of background information, which would be needed for the legal assessment.

Irrespective of who dominates the case, detection and efficient prosecution are often not very likely. Individual creditors have neither the authority nor the incentive to investigate. Creditors' committees often cannot fix this problem. If, as observed in almost half of all cases, no committee is appointed, or if it is appointed but inactive, no correction mechanism exists.[115] But even in all other cases, the resolution of the intra-stakeholder conflicts through an institution that represents the most influential creditors is doubtful.[116]

It is true that no comprehensive empirical evidence exists about wrongdoing in chapter 11. However, the absence of empirical evidence does not indicate that there is no reason to be concerned. Summarizing the theoretical study above, the setting is defined by massive management incentives not to comply with the law. In many cases, there is also minimal risk of detection because controlling mechanisms do not exist at all (e.g., creditors' committees are not appointed) or are weak (e.g., the committee is conflicted or inefficient). It is therefore reasonable to conclude that in a substantial number of cases, corporate governance principles and bankruptcy duties are not being fully respected by the debtor's management.

II. THE APPOINTMENT OF AN EXAMINER

The analysis so far has shown that serious agency problems and potential conflicts of interest exist in many bankruptcy cases. Only the appointment of trustees could substantially reduce the outlined problems. However, such an

113 11 U.S.C. § 548(a)(1)(B)(i) (2012).

114 *Id.*

115 *See supra* notes 96–109.

116 *See supra* notes 110–12 and accompanying text. *See also* ABI Report, *supra* note 14, at 37 (stating that the examiner is the only neutral person).

appointment would also take away all the advantages of the DIP model. In this section, I will argue that the appointment of examiners is often a promising solution. They can detect and reverse illegal actions and deter future infringements of the law. At the same time, they do not replace the management and thereby preserve the character of chapter 11.

A. Legal Framework and Legal Practice

In U.S. bankruptcy law, the appointment of an examiner is an alternative to the appointment of a bankruptcy trustee.[117] Examiners do not replace the debtor's management; rather, they investigate matters according to the court's decision on the scope of their mandate and report their findings to the court.[118]

Before the reorganization plan is confirmed, an examiner can be appointed upon request of a party or the U. S. Trustee after notice and hearing, if the court believes that an investigation is appropriate.[119] This addresses cases in which the management failed to run the company, or is not complying with corporate governance standards in the bankruptcy procedure, namely in cases of fraud, dishonesty, misconduct, or other irregularities in the management.[120] The appointment must be in the interest of the creditors.[121] Alternatively, the fixed

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[117] 11 U.S.C. § 1104(c) (2012). For the legislative history, *see* Lipson & Marotta, *supra* note 9, at 13–14 (2016); Zaretsky, *supra* note 20, at 917–27; *see also* Bussel, *supra* note 12, at 78–79.

[118] 11 U.S.C. §§ 1104(c), 1106(b), 1106(a)(4)(A) (2012).

[119] 11 U.S.C. § 1104(c) seems to require the request of a party or the U. S. Trustee to appoint an examiner. Nevertheless, a request is not a prerequisite of an appointment. Bankruptcy courts have long considered themselves to have authority to appoint an examiner even without a request. *See, e.g.*, *In re* First Am. Health Care of Ga., Inc., 208 B.R. 992, 994 (Bankr. S.D. Ga. 1996) (referring to 11 U.S.C. § 105(a)); *In re* Public Serv. Co. of N.H., 99 B.R. 177, 182 (Bankr. D.N.H. 1989); *In re* UNR Indus., Inc., 72 B.R. 789, 795 (Bankr. N.D. Ill. 1987) (also referring to 11 U.S.C. § 105(a)). They build on 11 U.S.C. § 105(a), which allows bankruptcy courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title" and provides that courts can take actions *sua sponte* even though the Bankruptcy Code "demands the raising by a party."

The courts' practice is convincing. The absence of a request does not actually indicate that neither the estate nor at least one of the involved parties would benefit from an investigation. It is also plausible that the parties are either biased or rationally disinterested. *See* Frost, *supra* note 37, at 120 (explaining why management does not need to fear close monitoring by small creditors). Favored creditors or shareholders would obviously not request the appointment of an examiner. Other stakeholders, although potentially benefiting from an investigation, might simply be rationally disinterested since participation and engagement in bankruptcy is costly. If their claims are small, the costs of an active participation likely exceed potential benefits. Further, information asymmetry is very common in this context. The absence of requests by the parties is therefore not a reliable indication of an absence of interest in or potential benefit from an examination.

[120] 11 U.S.C. § 1104(c) (2012).

[121] *Id.* § 1104(c)(1).

and unsecured debts must exceed $5,000,000.[122] In contrast to the appointment of a trustee, no "cause" is needed.[123]

The wording of § 1104(c)(2) seems clear: It is a mandatory rule.[124] Many courts follow this understanding.[125] However, some courts still think that they have discretion in this regard.[126] They will sometimes contend that they have full discretion over the scope of the appointment, which can lead to their appointing an examiner who is given very limited—or even no—power or who is given an inadequate budget.[127] Hence, they could also waive the mandatory appointment even in § 1104(c)(2) cases.[128] This approach has been criticized for good reasons.[129]

Examiners are only used in a fraction of cases. Lipson and Marotta found that bankruptcy examiners were appointed in only 6.5% of large bankruptcy cases between 1991 and 2010, and even less in small cases.[130] They also found huge differences among jurisdictions. Delaware courts, for example, were especially hesitant to appoint examiners: The appointment of an examiner by a

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[122] *Id.* § 1104(c)(2).

[123] *Id.* § 1104(c).

[124] *See* Kelbon et al., *supra* note 110, at 402; Lipson & Marotta, *supra* note 9, at 5–6; Zaretsky, *supra* note 20, at 937. *See also infra* note 125. 11 U.S.C. § 1104(c)(2) (2012).

[125] *See In re* Revco D.S., Inc., 898 F.2d 498, 501 (6th Cir. 1990); Morgenstern v. Revco D.S., Inc. (*In re* Revco D.S., Inc.), 898 F.2d 498, 501 (6th Cir. 1990); *In re* UAL Corp., 307 B.R. 80, 84–86 (Bankr. N.D. Ill. 2004); *In re* Mechem Fin. of Ohio, Inc., 92 B.R. 760 (Bankr. N.D. Ohio 1988); Walton v. Cornerstone Ministries Invs., Inc., 398 B.R. 77, 81–84 (N.D. Ga. 2008); *In re* The Bible Speaks, 74 B.R. 511, 514 (Bankr. D. Mass. 1987).

[126] *See, e.g.*, *In re* Loral Space & Communs., 313 B.R. 577, 585–86 (Bankr. S.D.N.Y. 2004); *In re* UAL Corp., 307 B.R. 80, 84–86 (Bankr. N.D. Ill. 2004); *In re* Rutenberg, 158 B.R. 230, 232–33 (Bankr. M.D. Fla 1993); *In re* Shelter Resources Corp., 35 B.R. 304, 305 (Bankr. N.D. Ohio 1983) (arguing that the mandatory appointment is not in the interest of the estate); *In re* GHR Companies, Inc., 43 B.R. 165, 170–76 (Bankr. D. Mass. 1984) (using historical arguments and distinguishing between publicly and privately held companies).

[127] *E.g.*, *In re* Loral Space & Communs., 313 B.R. at 585–86 (arguing similarly although not as bluntly); *but see* Loral Stockholders Protective Comm. v. Loral Space & Communs., Ltd. (*In re* Loral Space & Communs. Ltd.), No. 04 CIV. 8645 (RPP), 2004 U.S. Dist. LEXIS 25681, at 12–17 (S.D.N.Y. Dec. 23, 2004) (reversing the bankruptcy court's decision); *see also* Lipson, *supra* note 12, at 16; John W. Butler, Chris L. Dickerson & Stephen S. Neuman, *Preserving State Corporate Governance Law in Chapter 11: Maximizing Value Through Traditional Fiduciaries*, 18 AM. BANKR. INST. L. REV. 337, 350 (2010).

[128] *Id.*

[129] *See, e.g.*, Elizabeth Warren & Jay L. Westbrook, *Examining the Examiners*, 24 AM. BANKR. INST. J. 34, 74 (2005) (arguing that the court's discretion does not allow the court to define "these duties starting at zero"); Zaretsky, *supra* note 20, at 939 ("The statute could not be more clear in mandating the appointment of an examiner . . . ."); *see also* Loral Stockholders Protective Comm. v. Loral Space & Communs., Ltd. (*In re* Loral Space & Communs. Ltd.), No. 04 CIV. 8645 (RPP), 2004 U.S. Dist. LEXIS 25681, at 12-17 (S.D.N.Y. Dec. 23, 2004).

[130] Lipson & Marotta, *supra* note 9, at 37 (0.9% in small cases).

Delaware court is 62% less likely than by courts in other jurisdictions.[131] This disparity is important since Delaware courts try around 41% of all large bankruptcy cases.[132] Lipson and Marotta also found that allegations of fraud or mismanagement correlate with parties' requests for examiners.[133] However, little relationship could be found with appointment rates.[134] The main legislative considerations in § 1104(c) do not seem to be the relevant aspects in practice.

In the following discussion, I will elaborate on the benefits of examiners with respect to corporate governance and managers' compliance with the law. After a discussion of advantages and disadvantages, I will offer recommendations on the use of examiners under the Code. I will especially concentrate on the question of how courts can know whether or not to appoint an examiner.

B. Examiners' Impact on Corporate Governance

1. Arguments in Favor of the Appointment of Examiners

Examiners can improve corporate governance and management's compliance with bankruptcy law because they can investigate different measures taken by management before and after the bankruptcy filing.[135] Their findings may lead to a replacement of management or to the appointment of a trustee. Afterwards, legal actions against the old management may follow if investigations reveal major breaches of duties.

In the situation in which the old management is still in charge and runs the company,[136] investigations may concentrate primarily on managers' liability and transfers to shareholders prior to bankruptcy.[137] In cases of gross mismanagement or breach of the duty of loyalty, the managers might be liable to the company.[138] Further claims against managers might result from payments

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131 *Id*. at 35.

132 *Id*. at 25.

133 *Id*. at 29–32.

134 *Id*. at 32.

135 *See* Korch, *supra* note 17; Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1977–84 (pointing out the advantages of examiners if corporate governance fails); *see also* Warren & Westbrook, *supra* note 129, at 74–75.

136 *See infra* Part I.A., pp. 418–21.

137 *See* Lipson & Marotta, *supra* note 9, at 12.

138 However, pure mismanagement does not lead to liability because of the business judgment rule (assuming the absence of conflicts of interest). *See supra* note 47.

made to them shortly before the filing for bankruptcy, e.g., bonuses.[139] Given the bankruptcy, it is conceivable that these payments were unjustified or even fraudulent conveyances.[140] Without an examiner, it could be hard to detect and evaluate these payments at least in private companies. Further, even if public information is available, it would be hard for creditors or the court to evaluate the claim without any additional information. The fact that there was a payment does not say much about its voidability.

As LoPucki points out, such investigations can be performed more effectively by an examiner than by the creditors' committee or other parties.[141] The analysis above has shown that creditors' committees are often not appointed, ineffective, or conflicted.[142] Hence, neutral examiners are better suited to conduct an investigation.[143] LoPucki even claims that the appointment of creditors' committees might be detrimental since it could prevent courts from appointing a more effective examiner.[144]

Examiners can also investigate violations in favor of shareholders, such as fraudulent conveyances. Any payments to shareholders or any other benefits, such as a discharge of a guarantee, should be examined. This risk is especially present if the debtor was part of a group of companies. Not seldom, transfers without equivalent compensation are made between subsidiaries and between subsidiaries and the parent company.[145] The old management will be unlikely to avoid these payments.

There is also a potentially good use for examiners in the even more likely scenario that involves large influence by major creditors in the company's crisis. In cases of management turnover before the bankruptcy, the focus of the investigation shifts. Now, an investigation of any payments and other transfers made to certain creditors before the bankruptcy filing is clearly more important.[146] As some creditors will have gained (indirect) control over the

139 *See* Jonathan C. Lipson & Christopher M. Divirgilio, *The SEC in Bankruptcy: Past, Present and Future: Controlling the Market for Information in Reorganization*, 18 AM. BANKR. INST. L. REV. 647, 657–58 (2010).

140 *See* Skeel, *supra* note 53, at 946.

141 LoPucki, *supra* note 12, at 253; *see also* Robert C. Aronoff, *Appointing and Organizing Official Creditors' Committees with Model By-Laws*, 20 CAL. BANKR. J. 289, 290 (1992).

142 *See supra* notes 103, 111.

143 Kelbon et al., *supra* note 110, at 405–06.

144 LoPucki, *supra* note 12, at 253.

145 *See* Zaretsky, *supra* note 20, at 948.

146 *Id.*

company and acquired more information than others,[147] actions by the new management that benefit controlling creditors cannot be ruled out. Especially influential and sophisticated parties are often aware of the forthcoming bankruptcy and the potential losses they will incur.[148] Hence, sympathetic management might collaborate with these creditors to avoid or reduce their future losses in bankruptcy.

Existing cases of preference transfers and lender liability support this presumption. It is quite appealing for banks, for example, to gain a lien on accounts receivables if bankruptcy seems to be inevitable.[149] The new management is unlikely to avoid these payments later in bankruptcy for several reasons.[150] First, the management was installed and might now be controlled by the concerned creditor.[151] Harmful actions to creditors might result in the displacement of the management.[152] Second, since the management itself might have ordered these transfers, an investigation might also reveal managers' liability or even the commission of a criminal offence (e.g., fraud). Third, managers might want to ensure future employment by the debtor, which is only possible upon approval of the influential creditors.

Given the information asymmetry between large creditors and management on the one side and other stakeholders on the other, the chances are small that those other stakeholders or the bankruptcy court would know about avoidable actions.[153] The action itself might be unknown to other parties because it was hidden. But even if the action itself was not hidden and is known to other parties, they might not be able to evaluate whether it was illegal. A payment does not in itself indicate whether it was a fraudulent conveyance or not. Since only the

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[147] A large information asymmetry exists since the transparency mechanisms and protective provisions that are applicable to bankruptcy do not apply before the filing. *See generally* Lipson & Divirgilio, *supra* note 139, at 674.

[148] The testimony of the bank's loan officer in *In re Clark Pipe & Supply Co., Inc.*: "I just kept on trying to get out of the loan, you know. My attitude was bankruptcy is inevitable. I want to get in the best position I can prior to the bankruptcy . . . .". *In re* Clark Pipe & Supply Co., Inc., 870 F.2d 1022, 1029 (5th Cir. 1989).

[149] *Id*.

[150] *See* Zaretsky, *supra* note 20, at 948.

[151] This is the case if the creditor had the shares of the parent company pledged or had implemented any other proxy mechanism in the loan agreement in the event of default. *See supra* Part I.B., pp. 421–25.

[152] Given that the creditor also exercises shareholder rights, which is common in group bankruptcies. *See supra* note 60.

[153] *Cf.* LoPucki & Whitford, *supra* note 22, at 694 (naming information asymmetry as one source of power for management in bankruptcy). Other stakeholders, such as suppliers and employees, are not protected and have no insight and could not detect, prevent, or reverse opportunistic insider behavior. If they knew, they would call for an investigation. *See* Lipson & Marotta, *supra* note 9, at 51–52; *cf. also* Zaretsky, *supra* note 20, at 950.

creditors' committee can undertake investigations, other parties are often not positioned to detect and correctly evaluate wrongdoing. Individual creditors, for example, have no authority to examine the debtor's books and, further, have very little incentive to invest time and money since all the benefits would be shared with other creditors. As shown above,[154] the creditors' committee is, despite its legal capacity, often not helpful in investigating or avoiding preference transfers and other discriminatory actions.[155]

Examiners can investigate these potential infringements in an objective way and increase transparency.[156] Unlike the management, they will not suffer from any consequences and will therefore not favor any party. The appointment of an examiner combines the advantages of the DIP model and the appointment of a trustee. The concept follows the principle of proportionality since the management still runs the company.[157] Nevertheless, it also ensures a neutral investigation of potential violations of the law.[158] This solution fixes several problems associated with the DIP model without taking away its major benefits.

Beyond the positive impact on individual bankruptcy cases, achieved by enriching the estate and increasing payments to creditors, examiners can generally deter malpractice.[159] If managers know in advance that examiners are likely to be appointed and that they will commence an investigation, breaches of duties will become unattractive because it is likely they will be undone. Further, those actions might be sanctioned (e.g., by exposure to liability or equitable subordination). Therefore, the appointment of examiners has an important positive effect on corporate governance before and in bankruptcy.[160]

Moreover, the appointment of examiners would have another positive effect because examiners' investigations also serve the public interest by gathering information.[161] In most cases in which examiners were appointed, the

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154 *See supra* Part I.C.3., pp. 429–32.

155 *Cf.* Lipson & Divirgilio, *supra* note 139, at 658 (arguing that creditors and creditors' committees often oppose the appointment of examiners to protect their interests); Zaretsky, *supra* note 20, at 947–48.

156 *See* Warren & Westbrook, *supra* note 129, at 74–75; Zaretsky, *supra* note 20, at 947.

157 *See* Lipson & Marotta, *supra* note 9, at 12 (calling examiners the "mildest point"); *see also* Kelbon et al., *supra* note 110, at 406.

158 *See* Warren & Westbrook, *supra* note 129; Zaretsky, *supra* note 20, at 910.

159 For other possible impacts on corporate governance, *see* Lipson & Marotta, *supra* note 9, at 12.

160 In their study, Lipson and Marotta only found correlation and not causation between the appointment of examiners and better outcomes. *See* Lipson & Marotta, *supra* note 9, at 41. Still, this finding can give us some optimism since the cases in which examiners were appointed were more complex and more severe than others and still ended up having better overall results. *Id*. at 30, 44.

161 *See* Lipson & Marotta, *supra* note 9, at 9; *cf. also* Bussel, *supra* note 12, at 105–06.

circumstances of the bankruptcy could be better explained after the examiners issued their report. Citizens and policy makers understand better why companies become insolvent and how this affects jobs and the economy.[162] Moreover, prosecutors often use the information generated by examiners. Although this cannot be the main argument in favor of examiners, because the creditors and not the public eventually pay for the examiner[163] and hence the public interest must be secondary, it is a positive side effect that comes with their appointment.[164]

2. *Objections and Critical Discussion*

Despite all the benefits set forth above, the courts are hesitant to appoint examiners. Three concerns appear paramount.[165] First, examiners are believed to be quite costly. Second, they might delay filings for bankruptcy, and third, they might disrupt the reorganization process.

The costs of examiners are probably the main reason for this hesitation.[166] Examiners are paid from the estate[167] and enjoy priority over other creditors.[168] Depending on the complexity of the case, costs can rise into the millions of dollars. In the two largest cases, *Enron* and *Lehman Brothers*, the costs exceeded even $100 million.[169] However, both cases were multi-billion-dollar bankruptcies.[170] Despite the high costs, there is little doubt either that the examiners played a very favorable role in reorganizing both debtors or that the reports revealed important information.

In fact, examiners can also create monetary benefits. If they help the debtor to realize liability claims against the management or to avoid illegitimate pre-

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162 *See* Lipson & Marotta, *supra* note 9, at 9.

163 11 U.S.C. § 330(a)(1) (2012). *See also supra* note 37 (for a more comprehensive discussion about who pays what in bankruptcy).

164 If there is a public interest in investigating certain matters in bankruptcy, this investigation, as a matter of principle, should be conducted by other institutions, such as the SEC or public prosecutors.

165 Usually, the U. S. Trustee chooses the examiners, sometimes after consulting with main parties. There is hardly any criticism of these choices and the appointed examiners are highly respected. *See* Lipson, *supra* note 12, at 46.

166 *See* Bussel, *supra* note 12, at 112; Lipson, *supra* note 12, at 51 (presenting empirical and anecdotal evidence about the costs); Lipson & Marotta, *supra* note 9, at 5; *see also* Zaretsky, *supra* note 20, at 910, 935; A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875, 904–05 (2009).

167 11 U.S.C. § 330(a)(1) (2012). For a less doctrinal and more fundamental discussion about who pays what in bankruptcy, *see supra* note 37.

168 11 U.S.C. § 503(b)(1) (2012).

169 Bussel, *supra* note 12, at 112.

170 *Id.*

bankruptcy transfers or preferences, they enrich the estate and thereby also increase payments to the creditors.

Consequently, the costs of examiners should not prevent their appointment as long as the monetary benefits to the estate exceed the fees. If this is the case, it is in the best interest of the estate and hence the creditors to have examiners appointed. The crucial question for the courts should thus be whether the appointment is desirable under a cost-benefit analysis. Of course, neither the benefits nor the final costs are clear at the time of the appointment. Therefore, the courts must weigh the expected costs and benefits. Below, I will show how uncertainty about the benefits can be substantially reduced.[171]

Finally, examiners' investigations can also prevent costs. Other parties, such as creditors' committees, do not have to spend the debtor's money to investigate the same matter.[172] The creditors' committee's professional advisors are very costly.[173] They are usually also sophisticated experts with hourly rates similar to those of examiners. Hence, an investigation by the creditors' committee is usually not cheaper than appointing an examiner. Furthermore, the investigation is not conducted by an entirely neutral person. Creditors and other stakeholders who are not represented on the committee would likely prefer an examiner. Moreover, examiners' investigations may prevent duplicated investigations by other parties.[174] If a certain issue is of interest to more than one party or to a certain group, a centralized investigation through a neutral examiner is more efficient.[175] Further, examiners are preferable if the purpose of the investigation is to detect wrongdoing that benefited members of a creditors' committee. At best, the influence of the conflicted creditor on the investigation might not be clear. In addition to not revealing his conflict of interest, the creditor could even use his influence in the committee to prevent investigations of any actions from which he benefited. Lastly, the results might help to overcome legal disputes and prevent costly litigation.[176]

Taken together, these aspects might not justify appointments in every single case but at least they make the cost argument less convincing. Furthermore, as

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171 *See infra* Part II.E., pp. 449–50.

172 *See* Tabb, *supra* note 31, at 840 (criticizing the costs of creditors' committees).

173 *See id.*; Lynn M. LoPucki & Joseph W. Doherty, *Rise of the Financial Advisors: An Empirical Study of the Division of Professional Fees in Large Bankruptcies*, 82 AM. BANKR. L.J. 141, 147–48 (2008) (presenting empirical findings on the costs of creditors' committees' advisors).

174 Dickerson, *supra* note 166.

175 Flaschen, *supra* note 23, at 515.

176 *Id.*

general deterrence could be increased through a more frequent use of examiners, future investigations might be quicker and less expensive. Successful deterrence should reduce the number of issues that will arise and have to be investigated.

The second main concern is that the potential appointment of an examiner might be anticipated by the management and hence increase the incentive to delay a filing for bankruptcy.[177] The debtor's management could try to postpone the filing or entirely avoid bankruptcy to prevent any form of investigation, especially if the investigation were likely to target the management itself.[178]

Such a reaction cannot be ruled out. However, as long as there was no violation of the law, the management does not have to fear the examiner's investigation. Hence, the decision on the date of filing should not be affected in those cases. If the management actually delays the filing to avoid neutral investigations, then it seems especially preferable to actually have these investigations. The potential benefit from having the investigation would likely be large because the management's behavior indicates infringements of the law. In that case, the delay would be acceptable. Furthermore, the downsides of the delayed filing should be minimal. Cases in which the management not only mismanaged the company but actually violated the law are unlikely to be successful restructuring cases anyway. For example, if the shareholders benefitted from fraudulent transfers, the management obviously did not care much about the company's performance and prospects. It is therefore questionable whether the pure chance of an examiner's appointment would significantly impact the date of the filing and the chances for a successful reorganization.[179]

Third, examiners might delay or disrupt the reorganization process. The investigation does not only cost money but also binds resources, such as management's time.[180] This argument, although valid, seems quite overstated. If examiners only investigate specific matters, such as potentially voidable payments, the disruption should be negligible and not substantially hinder or delay negotiations on the plan. Even in solvent companies, minor delays and disruptions caused by yearly external audits are accepted.

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[177] *See supra* note 87.

[178] This is also true for controlling creditors if they fear being targeted and therefore prevent the management from filing.

[179] The potential loss of the managers' jobs is a more influential factor. *See* CARRUTHERS & HALLIDAY, *supra* note 89, at 265.

[180] Lipson & Marotta, *supra* note 9, at 12; *see also* Bussel, *supra* note 12, at 113.

Of course, there are major investigations as well, such as in the *Enron* and *Lehman Brothers* cases. It is fair to say that those cause larger distractions. However, in cases in which courts are willing to appoint examiners with such a wide mandate despite substantial costs, there is clear indication of massive violations of corporate governance, bankruptcy law, and other legal norms. Investigations in such cases are very important both generally and for the individual reorganization process specifically. Although the reorganization might have been somewhat smoother without the investigations, none of the massive infringements would have been disclosed and undone. Managers might not have been held liable and avoidable payments would not have been reclaimed. The estate will ultimately experience substantial losses. This, first of all, harms the creditors. The crucial question is therefore, again, whether the disruptions are severe enough to outweigh the benefits of the investigation. Finally, it should be considered that investigations by the creditors' committee would cause similar disruptions.

With regard to delays and disruptions, the considerations are substantially different in the situation of a § 363 sale. As soon as the operating business is sold, the disruptions no longer harm the business. In most cases, the old management has already been replaced or will be replaced after the sale. Hence, the new management has nothing to fear from the investigation and will be more likely to cooperate. On the other side, it will be harder for the examiner to gather information. Especially in quick sales, the period between appointment and sale might be so narrow that the examiner does not have enough time to detect wrongdoing. If the books and documents are not copied before closing, she will have difficulties accessing them. It is unclear whether the acquiring company is obligated to cooperate or not. Only the estate would benefit from the findings unless the claims are explicitly sold to the buyer. Hence, the acquiring company has no incentive to grant access or provide information to the examiner unless it is compensated for the effort. Such expenses would raise the overall costs of the investigation. Thus, the result of the analysis of the § 363 sale is ambiguous.

3. The Discussion in a Broader Context

The remarks above fit into the general discourse on the § 363 sales. The attitude towards examiners might be influenced by the general standpoint on how bankruptcy cases should be handled. Lipson and Marotta argue that the use of examiners may be less attractive for those authors who favor a private approach[181] in bankruptcy.[182] They are said to be concerned about the costs and potential disruptions. In contrast, skeptics of the § 363 sale, such as Lynn LoPucki, Elizabeth Warren, and Jay Westbrook,[183] are said to be less reluctant.[184]

I doubt that the contrast is as strong as Lipson and Marotta argue.[185] Presumably, those who fear insider opportunism and discrimination against certain stakeholders should support more frequent appointments of examiners since they can prevent such behavior or at least reverse the consequences.[186] However, even proponents of private orderings might not be generally opposed. Let us assume that large payments have been made from the debtor to some creditors or shareholders before or in bankruptcy. In many cases, an investigation of this matter would not substantially delay or distract the sale of the company unless the current management was heavily involved in illegal payments or similar activities. In such a case, however, all parties (except, of course, for the management and the favored party) could benefit from the management's replacement and the reclaiming of payments based on information produced by the examiner. It is not clear why the named authors would consider investigations to be harmful in this situation. Market orientation does not equate to the belief that markets work perfectly and that insider actions are not a problem. The appointment of an examiner could therefore even legitimize the sale and establish confidence on the part of other stakeholders. Many arguments and concerns against sales could be addressed by the appointment of examiners.

[181] *E.g.* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69 (2004); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992). For a critical analysis see also Jackson, *supra* note 37. For a general discussion see, e.g., Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75 (1995); Donald R. Korobkin, *The Role of Normative Theory in Bankruptcy Debates*, 82 IOWA L. REV. 75 (1996).

[182] Lipson & Marotta, *supra* note 9, at 18.

[183] Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1 (2007); LoPucki & Whitford, *supra* note 22; Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197 (2005).

[184] Lipson & Marotta, *supra* note 9, at 18–19.

[185] It is quite remarkable that most authors cited by Lipson & Marotta did not even mention examiners in their papers. This applies to contractarians and critics alike.

[186] Warren & Westbrook, *supra* note 129.

4. *Conclusion*

To summarize the discussion, examiners can add substantial value to the bankruptcy process. They can enrich the estate by avoiding transfers and asserting claims, and they also deter infringements of the Code and violations of corporate governance by increasing the chances of detection. There are downsides of an appointment, too. However, in many cases the disadvantages are unlikely to outweigh the benefits. Hence, I recommend a more frequent use of examiners.[187]

C. *Comparative Legal Insights*

At this point, I want to introduce some comparative legal insights. The comparison with Germany is especially interesting with respect to the appointment of examiners in self-administration procedures. Germany followed the U.S. example and created a DIP model that is similar to chapter 11. The debtor can select the self-administration procedure under certain conditions.[188] The legal transplant is, however, not pure. Although heavily influenced by the U.S. model,[189] the reforms in 1998 and 2012 differ in one major aspect: the German bankruptcy court has to appoint a supervisor in every self-administration procedure.[190] With very broad powers, this supervisor is comparable to a U.S. examiner. She is a neutral person who verifies the debtor's economic situation and monitors the management.[191] If the supervisor has any indication that the self-administration procedure puts creditors at a disadvantage, she must report her observations to the court and the creditors' committee.[192] The creditors' committee can then ask the court to end the self-administration

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[187] Lipson, *supra* note 12; Lipson, *supra* note 12, at 1626–27; Bussel, *supra* note 12 (advocating an inquisitorial model); LoPucki, *supra* note 12, at 252–53; *but see* Butler et al., *supra* note 127, at 350, 361.

[188] The situation is somewhat different in the Netherlands. The trustee can leave the management in charge. In that case, the management is supervised by a supervisory judge. This judge, however, mostly approves decisions within the bankruptcy process. *See* Hummelen, *supra* note 20.

[189] *See, e.g.*, Köhler-Ma, *supra* note 24.

[190] The statutory text reads as follows:

> Section 270c [sentence 1]: Appointment of an Insolvency Monitor
> In the event of the ordering of debtor-in-possession management, an insolvency monitor shall be appointed instead of an insolvency administrator.

INSOLVENZORDNUNG [INSO] [INSOLVENCY ACT], § 270c, *translation at* http://www.gesetze-im-internet.de/englisch_inso/englisch_inso.html#p1129 (Ger.).

[191] INSOLVENZORDNUNG [INSO] [INSOLVENCY ACT], § 274, para. 2, *translation at* http://www.gesetze-im-internet.de/englisch_inso/englisch_inso.html#p1142 (Ger.).

[192] INSOLVENZORDNUNG [INSO] [INSOLVENCY ACT], § 274, para. 3, *translation at* http://www.gesetze-im-internet.de/englisch_inso/englisch_inso.html#p1142 (Ger.).

and replace the management with a bankruptcy trustee.[193] Hence, the supervisor ensures the management's compliance with its legal obligations and good corporate governance during bankruptcy.

The mandatory appointment of supervisors reflects greater distrust in the debtor's management in Germany than in the U.S.[194] Coming from a trustee model, the self-administration procedure was politically easier to implement as long as the management was monitored. Severe infringements of the law and illegal benefits for some creditors or shareholders could largely be ruled out. This German legal framework tries to combine the advantages of both models. In particular, it leaves familiar and experienced managers in place, while also ensuring professional and neutral investigations of management's actions before and within bankruptcy.

Experience in Germany shows that investigations of liability and transfers prior to the filing for bankruptcy often lead to claims against the management or redemption of avoidable transfers and other similar actions.[195] As a result, the cost-benefit analysis in Germany mostly favors an appointment. To free courts from having to decide in every individual case, the German Bankruptcy Code provides for a mandatory appointment.

The subsequent question is whether the U.S. should have mandatory appointments of examiners as well. The picture in the U.S. is less clear. On the one hand, the estate might similarly benefit from an investigation of payments and transfers prior to bankruptcy since they might be voidable. On the other hand, liability is less important than in Germany, where the likelihood of managers' liability in bankruptcy is substantially higher. The main source of liability in Germany is a duty to file for bankruptcy if the company is materially insolvent.[196] A failure to file for bankruptcy in time leads to the personal liability of managers for any losses caused by the delay to the estate or to new

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193 INSOLVENZORDNUNG [INSO] [INSOLVENCY ACT], § 272, para. 1 (1), *translation at* http://www.gesetze-im-internet.de/englisch_inso/englisch_inso.html#p1133 (Ger.).

194 *See supra* note 81.

195 *See, e.g.*, Hans-Peter Kirchhof, *in* 2 MÜNCHENER KOMMENTAR ZUR INSOLVENZORDNUNG Vorbemerkungen vor §§ 129 bis 147, Rn. 2 (3rd ed. 2013) (pointing out the importance of the avoidance of pre-bankruptcy transfers because of the high frequency of their occurrence); Stefan Korch, *Wozu Sachwalter?*, 39 ZIP 109, 111–15 (2018).

196 INSOLVENZORDNUNG [INSO] [INSOLVENCY ACT], §§ 15a, 17, 19, *translation at* https://www.gesetze-im-internet.de/englisch_inso/englisch_inso.html#p0101 (Ger.).

creditors.[197] These claims are easier to pursue than claims of mismanagement.[198] It is easy to see how the absence of a supervisor in the German self-administration procedure would lead to a loss for the estate and creditors since the management would not voluntarily pay for the damages it caused if it were still in charge. Hence, the appointment of supervisors makes sense in so many cases that the German legislature chose a mandatory rule to avoid (costly and time-consuming) case-by-case decisions by the bankruptcy courts.

By contrast, there is no similar duty to file for bankruptcy and hence no corresponding liability in the U.S.[199] It is thus less likely than in Germany that management is liable. Mismanagement alone is not sufficient since officers and directors are protected by the business judgment rule.[200] Realistically, directors are only liable for breaches of loyalty and other severe acts of wrongdoing, such as fraud or insider trading, which cannot be expected in most cases.

Although many corporate governance concerns are similar in the U.S. and in Germany, the major differences with regard to the management's liability explain why a mandatory supervisor makes more sense in Germany than in the U.S.[201] Considering the variance in benefits and costs, U.S. bankruptcy courts rightly have discretion with respect to the appointment of examiners. However, the analysis supports the finding that examiners should be appointed more often. Germany, while mostly copying the U.S. system, introduced a mandatory supervisor to address the concerns about infringements in and before bankruptcy. The current legal practice in the U.S. does not sufficiently consider the incentives and the lack of control mechanisms. Moreover, comparative legal analysis supports my concept of mandatory preliminary examiners, which I will

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197 Lars Klöhn, *in* 3 MÜNCHENER KOMMENTAR ZUR INSOLVENZORDNUNG § 15a Rn. 140–321 (3rd ed. 2014). In some cases, managers have also had to file for private bankruptcy because their estate was not sufficient to pay for the caused damage. *See* STATISTISCHES BUNDESAMT, FACHSERIE 2 REIHE 4.1, UNTERNEHMEN UND ARBEITSSTÄTTEN—INSOLVENZVERFAHREN 4 (Oct. 2016), https://www.destatis.de/DE/Publikationen/Thematisch/UnternehmenHandwerk/Insolvenzen/Insolvenzen2020410161104.pdf (listing private bankruptcy broken down to former or current jobs, including directors of companies).

198 German corporate law also embraces the business judgement rule: AKTIENGESETZ [AKTG] [STOCK CORPORATION ACT], § 93, para. 1, sentence 2, https://www.gesetze-im-internet.de/aktg/__93.html, *translation at* http://docplayer.net/4833637-German-stock-corporation-act-aktiengesetz.html (Ger.).

199 Delayed filing for bankruptcy was also a problem in the U.S. before the 1978 reform. *See* Lipson & Marotta, *supra* note 9, at 10.

200 *See supra* note 47.

201 Korch, *supra* note 195, at. 110–15; *But see* Flaschen, *supra* note 23, at 515 (arguing in favor of a mandatory appointment of an independent "monitor," which would be similar to an examiner, in every chapter 11 case); Tabb, *supra* note 31, at 861.

introduce later in this Article,[202] because it can serve as a compromise between the mandatory appointment of examiners and the current legal practice.

One further aspect of German law could contribute to the debate in the U.S. Specifically, the supervisor's (and trustee's) fees are in part performance-based.[203] The larger the estate, the higher the supervisors fee.[204] This fee structure aligns the economic interests of the creditors and the supervisor. There is thus little risk that supervisors would act against the interest of the estate and the creditors or even purposely take any action that would reduce the estate. Although it is beyond the scope of this Article to generally discuss the fees of advisors in U.S. bankruptcies,[205] I want to note that a revision of the fee structure in chapter 11 seems worth considering also from this perspective.[206] Many concerns about examiners could be addressed by such a revision.

D. The ABI Reform Proposal

The analysis so far leads to the following picture: The mandatory appointment of an examiner does not seem appropriate for the U.S. The bankruptcy courts rightly have discretion. However, the status quo is not satisfactory either, especially with respect to the mandatory rule of § 1104(c)(2).[207] Although conflicts of interest are easy to predict, examiners are rarely appointed. In situations in which the management has clear incentives to violate the law, the absence of an examiner is unsatisfactory.

The ABI reform proposal reaches a similar conclusion. Its authors propose a more flexible standard when it comes to the appointment of examiners.[208] However, it is hard to see how more flexibility would help to promote more

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202 *See infra* Part II.E.1., pp. 450–53.

203 See INSOLVENZRECHTLICHE VERGÜTUNGSVERORDNUNG [INSVV] [BANKRUPTCY COMPENSATION ACT], § 1–2, 12, https://www.gesetze-im-internet.de/insvv/index.html#BJNR220500998BJNE001000311 (Ger).

204 *Id*.

205 *See, e.g.*, ABI Report, *supra* note 14, at 56–67; Lynn M. LoPucki & Joseph W. Doherty, *Routine Illegality in Bankruptcy Court, Big-Case Fee Practices*, 83 AM. BANKR. L.J. 423 (2009); Lynn M. LoPucki & Joseph W. Doherty, *Professional Overcharging in Large Bankruptcy Reorganization Cases*, 5 J. EMP. LEG. STUD. 983 (2008); LoPucki & Doherty, *supra* note 173.

206 *See* ABI Report, *supra* note 14, at 56–67 (discussing fees in bankruptcy and alternative fee arrangements).

207 *See supra* notes 130–34 and accompanying text.

208 ABI Report, *supra* note 14, at 36–38.

frequent appointments of examiners.[209] On the contrary, increased flexibility would likely lead to even less appointments,[210] whereas more appointments would be helpful and beneficial.[211] In the next section, I address the crucial question of how bankruptcy courts can know when the appointment of an examiner would be beneficial.[212]

E. How Can Courts Know That They Should Appoint an Examiner?

The crucial question is how bankruptcy courts can know that an examiner would be beneficial in the case before them. Since bankruptcy judges are outsiders and rely on information provided by the debtor, its employees, or a creditor, this is not an easy task.[213] As discussed above, certain types of infringements can be expected in a given situation. Some of the infringements can be inferred from the documents the debtor's management must provide, such as the statement of affairs.[214] In other cases, creditors or their advisors may indicate to the court that they suspect or know of certain infringements. However, in some further cases the documents may not reveal much and other sources may not be available. For instance, creditors may not have any knowledge because they either do not have information about an action itself or they may lack the background information that is necessary for an accurate legal evaluation. In such cases, the court needs another source of information that is neutral and reliable. To address this need, I introduce the concept of preliminary examiners, basing it on Lipson's and Marotta's "mini-examiner" proposal.[215]

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209 Considering the current practice of many bankruptcy courts (especially in Delaware), it is unlikely that these courts would appoint substantially more examiners if the Bankruptcy Code granted them more flexibility. *See* Lipson & Marotta, *supra* note 9 (who found that, in large bankruptcy cases, examiners were appointed in 43 cases following 93 requests); *see also* Lipson, *supra* note 12, at 27 (who earlier found 39 appointments and 87 requests).

210 *See* Lipson & Marotta, *supra* note 9, at 22–23.

211 *See* Second Report, *supra* note 13, at 307, 316–17, *see also* Warren & Westbrook, *supra* note 129, at 74–75; Zaretsky, *supra* note 20, at 935–36.

212 *See infra* Part II.E., pp. 449–50.

213 The experience should not be overstated here. Since courts get comprehensive feedback only if they appoint an examiner and only fragmented and infrequent information if they do not, their experience from past cases is limited.

214 *See Form B 207: Statement of Financial Affairs for Non-Individuals Filing for Bankruptcy*, UNITED STATES COURTS, http://www.uscourts.gov/sites/default/files/form_b_207.pdf (last visited Feb. 25, 2017).

215 *See infra* notes 216–22 and accompanying text.

1. *Preliminary Examiners*

I take up a proposal by Lipson and Marotta in a recent paper.[216] They suggest the appointment of "mini-examiners".[217] The "mini-examiner's" task would be to conduct a general investigation of the circumstances surrounding the bankruptcy.[218] They would not investigate any details. Their report should rather put the court in the position to decide whether further and more detailed investigation is necessary.[219] However, Lipson and Marotta want to introduce "mini-examiners" mainly on an experimental basis to gather information and to give better policy recommendations.[220] They want to explore cases which would otherwise be in the "shadows"[221] in order to see whether, as a general matter, more examiners should be appointed.[222]

The costs of mini-examiners would be substantially lower than those of examiners having broad authority,[223] which makes the concept interesting. The risk of exorbitant costs and minimal benefits would be significantly reduced. Further, disruptions or delays due to such a limited investigation should not be very significant.

Although based on Lipson's and Marotta's proposal, my concept is not meant to be experimental; it rather focuses on the individual case to increase the net benefit for the creditors and to improve the general deterrence of infringements of the law.[224] Preliminary examiners should be appointed to support bankruptcy courts in conducting their cost-benefit-analysis of the examiner-appointment decision. Their investigation should not be detailed or comprehensive and should be understood as an initial observation. Because of this function, I call these individuals preliminary examiners or, in short, "pre-examiners." Ultimately, a frequent use of pre-examiners could also make more information available so as to improve policy recommendations. It is, however, not the main purpose of the concept.

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216 Lipson & Marotta, *supra* note 9.

217 *Id*. at 50–51.

218 *Id*. at 50.

219 *Id*. at 50–51.

220 *Id*. at 47–52.

221 *See Id*. at 51; Lipson, *supra* note 12, at 1611, 1614, 1627 (using the words "shadow" and "shadow bankruptcy" to express concern about the many unknown circumstances of bankruptcies).

222 Lipson & Marotta, *supra* note 9, at 50–51.

223 *See* Frost, *supra* note 37, at 137 (pointing out that courts can reduce costs substantially by narrowing the mandate, which is similar to the approach here).

224 *See infra* pp. 456.

The second main difference to the Lipson and Marotta proposal relates to the funding. They do not want to pay the "mini-examiners" from the estate.[225] Instead, bankruptcy fees should be used to pay them.[226] Lipson and Marotta claim, citing Ed Flynn's study on bankruptcy fees and costs from 2015,[227] that the fees could cover the additional costs of "mini-examiners".[228] However, as they acknowledge,[229] bankruptcy fees do not even entirely cover the current costs of the bankruptcy court system.[230] Hence, it remains unclear how "mini-examiners" could eventually be paid from these fees. It is much more likely that U.S. taxpayers would cover their cost.[231]

I strongly disagree with this approach. Although I see some benefits of this (partly academic) experiment, the costs seem to be prohibitive.[232] Since examiners are appointed in the interest of the creditors, and creditors benefit from most of their work (e.g., avoidance of preference transfers and fraudulent conveyances), they should also pay examiners and "mini-examiners". As a matter of principle, I think the costs of corporate bankruptcy should not even partly be shifted to the public.

As mentioned, my proposal for preliminary examiners is not designed as an experiment but rather to support courts in their decision-making process, and to provide them with a helpful tool. I believe that in many situations, in which the courts cannot assess whether they should appoint an examiner, it would be useful to have a cursory review. By appointing a pre-examiner, the bankruptcy court can make a more informed decision.[233] The pre-examiner would estimate whether there is any indication of legal violations, such as disproportionate payments to shareholders, managers, or certain creditors prior to bankruptcy. If this was the case, she would recommend the appointment of an examiner. If the

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225 Lipson & Marotta, *supra* note 9, at 52–53.

226 *Id*.

227 *See* Ed Flynn, *Is Bankruptcy the Red-Headed Stepchild of the Judiciary?*, 34 AM. BANKR. INST. J., Oct. 2015, at 36.

228 Lipson & Marotta, *supra* note 9, at 52–53.

229 *Id*. at 52.

230 *See* Flynn, *supra* note 227, at 36, 36–37, 58 (finding that about 25% of the costs are not covered and are hence borne by taxpayers).

231 *Id*. And even if the fees were too high, the alternative to a multi-million dollar research project would be to reduce bankruptcy fees and thereby help to minimize losses of creditors and increase the chances of a successful reorganization of the debtor by also reducing the costs for the debtor. This seems preferable to me.

232 It is also not entirely clear to me how such general findings could be implemented. If Lipson & Marotta were, for example, to find out that an examiner should be appointed in 7% (or 15%) of all cases instead of 3%, this would not really help the bankruptcy judge in deciding her individual case.

233 *See* Lipson & Marotta, *supra* note 9, at 50–51.

pre-examiner could not find any signs of infringement, the court would not appoint an examiner. This would help to reduce costs in cases in which an examiner would otherwise have been appointed (e.g., mandatorily upon request of a party in a large case) or where the scope of the mandate would have been unnecessarily broad due to the court's lack of information. Further, after the pre-examiner's report, the bankruptcy court would be better positioned to evaluate which professional fees should be approved (e.g., for a creditors' committees' investigation).

The appointment of pre-examiners would lead to a higher exposure rate of violations of corporate governance and bankruptcy duties. Consequently, those violations could be reversed more often. This would not only undo violations in the specific case but would also generally deter malpractice. The effect would hence be similar to the appointment of ordinary examiners.[234] Creditors, shareholders, or managers, all of whom may fear investigations, would have fewer incentives to illegitimately favor one party over others, especially if such actions were not only undone but also sanctioned, e.g., by equitable subordination, liability claims, or even criminal charges. Overall, a regular appointment of pre-examiners would have a positive effect on corporate governance in bankruptcy.

One could reply that the pre-examiner, due to her limited mandate, could also miss some evidence. This, however, is distinctly less likely than the current risk of a false negative by the court. In accepting that a targeted, if limited, investigation may not reveal enough evidence to warrant a more thorough inquiry, it becomes plainly apparent that a bankruptcy court on its own has little realistic chance of identifying the need for a full investigation.

Further, it could also be said that pre-examiners may be biased towards finding indications for wrongdoing if they are usually appointed as examiners. However, there are certain limitations to this argument. First, the court has to make an independent decision to appoint the examiner and will not just blindly follow the pre-examiner's recommendations. It will rather critically study the report and reach its own judgment. Second, pre-examiners will also likely want to be appointed again in the future, especially if that is the usual way to be appointed as an ordinary examiner later in the case. Hence, they cannot simply exaggerate facts because courts would refrain from appointing them a second time. And third, even if the pre-examiner might have a slight bias towards finding irregularities, this would not necessarily be detrimental. In an

[234] *See supra* notes 158–59 and accompanying text.

environment in which all other informed parties not only lack an incentive to reveal information but might even be willing to hide facts, it could be helpful to have one person with an incentive to bring to light all infringements. Finally, the fee structure for examiners could again be changed to a more performance-based fee, which would make investigation unattractive when there was little prospect of finding infringements.[235] The pre-examiner would know that he could not earn high fees as an examiner and therefore would have less incentives to exaggerate wrongdoing.

If, despite all these arguments, there is still a concern, one could appoint other persons as examiners and thereby eliminate the incentive.[236] This, however, would come at a price; the examiner would have to start the investigation all over again. This would increase costs and cause further delays, and it is therefore not preferable.

2. *Pre-examiners under the Bankruptcy Code*

Although the Code does not mention pre-examiners anywhere, their appointment would still be possible. Courts have huge discretion over the scope of an examiner's mandate.[237] They could, therefore, appoint an ordinary examiner and effectively make him a pre-examiner just by narrowing his mandate.[238] It would make sense to have a time-limit so as to avoid lengthy investigations that would thwart the objective of the concept. Further, the budget should be limited and only provide reasonable compensation for a preliminary investigation. The pre-examiner would thus have no incentive to turn the preliminary investigation into a detailed one.

This understanding is in line with the wording of § 1104(c), which allows the court to order "an investigation of the debtor as is appropriate."[239] In a situation in which it is unclear whether or not a larger investigation is needed, a preliminary investigation is "appropriate" to answer this question. Further, it is the general understanding that the bankruptcy court has great discretion when it comes to the scope of the mandate.[240] It follows that the authority to order a

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235 *See supra* notes 203–06 and accompanying text.

236 *See* Lipson & Marotta, *supra* note 9 ("mini-examiners" should not conduct the full investigation).

237 Bussel, *supra* note 12, at 80; Korch, *supra* note 17.

238 *Cf.* Warren & Westbrook, *supra* note 129.

239 11 U.S.C. § 1104(c) (2012).

240 *See supra* note 126.

limited investigation is embedded in the authority to order investigations generally.

If the pre-examiner finds any indication or evidence of infringements, the courts could expand the mandate.[241] This could be an appealing compromise for courts that are currently very reluctant to appoint an ordinary examiner (upon request). The costs of a pre-examiner would be comparatively low, and the court could decide later on the regular appointment. This approach should thus help to overcome the current practice of some courts not appointing examiners, although it is mandatory under § 1104(c)(2), on the grounds that their discretion over the scope of the investigation also allows them to not appoint an examiner.[242] At least a preliminary investigation should be ordered so as to facilitate a more informed decision.

3. Reform Proposal

Given the current practice of some bankruptcy courts,[243] an amendment to the Code could still be helpful. The Code should explicitly allow courts to appoint pre-examiners to gather all necessary information relevant to the actual appointment decision. It should further require the appointment of pre-examiners in most cases.[244] Conversely, a mandatory appointment of ordinary examiners would no longer be necessary.

Above, I have shown that a pre-examiner could improve the bankruptcy courts' decision making at relatively low cost and without causing major distractions to the business. I therefore suggest that the appointment of a pre-examiner should be a standard measure unless the court initially decides to appoint an examiner.[245]

The change in the statute would be advisable because of the current hesitation of many bankruptcy courts, especially in Delaware, to appoint examiners.[246] Although pre-examiners might not face the same opposition, as they would be cheaper and less disruptive, I still believe that this or the "mini-examiner" proposal alone would not convince Delaware courts. Since the

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[241] *Cf.* Lipson, *supra* note 12, at 43, 52 (explaining similar approaches by bankruptcy courts).

[242] *See supra* note 126.

[243] *See supra* notes 126–34 and accompanying text.

[244] *See infra* in this sub-section.

[245] In this case, a pre-examiner is obviously redundant because the court already has decided the critical question.

[246] *See supra* note 130.

debtors can largely choose the bankruptcy jurisdiction, a race to the bottom would be likely.[247] In particular, debtors with well-founded fears would be likely to opt for Delaware to avoid any investigation.

This problem could also be partly solved by other reform proposals, such as the one made by LoPucki, to stop forum shopping.[248] However, although there are good reasons for such attempts,[249] these reform proposals are so far-reaching that there is little hope that Congress would pass them in the near future. In the meantime, my proposal would force all courts, also the more reluctant ones, to make an informed decision. The appointment of pre-examiners would be the rule, and exceptions would be defined by the Code. This would reduce the courts' discretion.

To address cases in which pre-examiners are not desirable, the statute should provide for exceptions. The exceptions should reflect circumstances where even pre-examiners seem to be too costly or situations in which few benefits could be expected. Useless appointments could thereby be prevented.

Which cases should be covered by the exceptions? As noted above, there are mainly two reasons why even pre-examiners could appear unnecessary. First, pre-examiners, as with ordinary examiners, would have to be paid from the estate. Although they would not have a comprehensive mandate and hence would cost substantially less than ordinary examiners,[250] the fees could be a reason not to appoint a pre-examiner. This could be relevant especially in small bankruptcy cases in which the fees would be too large in proportion to the overall costs of the case.[251] In smaller cases, even modest fees could reduce the estate significantly. The first exception should therefore be for such cases. A small case could be defined either by the amount of debt or the value of the estate. It seems

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247 *Cf.* Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom"*, 54 VAND. L. REV. 231, 255–65, 270–71 (2001).

248 LOPUCKI, *supra* note 75, at 137–81, 243, 247.

249 *Id.* at 249–54; Lynn M. LoPucki & Joseph W. Doherty, *Delaware Bankruptcy: Failure in the Ascendancy*, 73 U. CHI. L. REV. 1387 (2006); LoPucki & Doherty, *supra* note 205, at 425–27; LoPucki & Kalin, *supra* note 247. *But see* Robert K. Rasmussen & Randall S. Thomas, *Whither the Race? A Comment on the Effects of the Delawarization of Corporate Reorganizations*, 54 VAND. L. REV. 283 (2001); Kenneth Ayotte & David A. Skeel, *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425 (2006); David A. Skeel, *What's So Bad About Delaware?*, 54 VAND. L. REV. 309 (2001); *see also* Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U.L. REV. 1357 (2000) (making a reform proposal that could serve as compromise).

250 *See supra* note 223 and accompanying text.

251 *See* Frost, *supra* note 37, at 137 (doubting the benefit of ordinary examiners in small-cases); *see also* Bussel, *supra* note 12, at 79–80.

plausible to follow the legislative decision in § 1104(c)(2) and reverse the formulation into an exception for cases in which the "debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, *sum up to a maximum of* $5,000,000."[252] To relate the exception to the amount of debt seems preferable although it does not directly indicate the size of the estate from which the pre-examiner needs to be paid.[253] It would, however, be easier for the courts to estimate the amount of debts than the value of the assets, which would be time-consuming and costly. Consequently, it seems reasonable to base the exception on the wording of § 1104(c)(2). To avoid disproportionate appointments, one could further allow courts to refrain from making an appointment if the costs would obviously exceed the benefits. Cases of debtors in a particularly bad condition could be captured by this more flexible exception.

The fact that cases are small does not mean that the likelihood of infringements is smaller than in larger cases. The conflicts of interest are exactly the same. The risk of a breach of duties might even be higher than in larger cases, as the public could be less interested in the case. It is therefore necessary to have a counter-exception. If there was any indication of fraudulent conveyances, preference transfers, or of a basis for liability, the court should be able to appoint either a pre-examiner or an ordinary examiner. The crucial question would then be whether the benefits for the estate and the creditors would likely exceed the costs of the investigation. If this were the case, the court should appoint an examiner or pre-examiner.

The second exception should cover cases in which no or almost no benefits could be expected from an investigation. To identify these situations, it is helpful to again look at the potential benefits of examiners. Examiners, after being appointed upon recommendation of the pre-examiner, might investigate managers' liability resulting from gross mismanagement, insider trading, or fraudulent behavior. Further, they could detect fraudulent conveyances made to the shareholders and voidable transfers made to creditors. In these situations, a pre-examiner would not be necessary only if there were no signs of larger transfers in the relevant period and no collateral was given. Then, there would be little risk that other creditors were harmed. A pre-examiner's screening would thus not be necessary. Of course, smaller payments might be hidden. However,

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[252] *See* 11 U.S.C. § 1104(c)(2) (2012) (for the current mandatory appointment requirement).

[253] It could be, for instance, that a debtor in a very bad condition has very few resources and a huge debt load and nevertheless does not qualify for the exception.

if they were small enough, they might not justify the costs of an examiner or pre-examiner.

To this proposal, one could respond that courts would not be in a position to know which transfers were made. However, there is a huge difference from the original situation because courts would now have a good source of information: the debtor and its management. As shown, the management of the debtor, old or new, has an incentive to avoid the appointment of both an examiner as well as a pre-examiner.[254] The burden of proof should therefore be shifted to the management. This shift would incentivize the management to provide necessary information. For instance, the management could submit the relevant documents to the court, such as bank statements, to check whether uncommon or larger payments were shown to be made in the preceding year. Further, accountants and senior management of the debtor should be heard as witnesses. The same standard should apply to the creation or extension of a lien. Except as otherwise allowed under § 547(c), such creation or extension shortly before filing for bankruptcy (90 days)[255] would suggest avoidable transfers and a violation of the absolute priority rule. To justify an exception from a mandatory appointment of a pre-examiner, the management should declare under oath, or prove, that no such collateral was furnished or extended in favor of a certain creditor.

All conditions should be fulfilled cumulatively to justify an exception. It is only where liability claims, voidable payments, and preference transfers are all unlikely that a pre-examiner should not be appointed. It is worth mentioning that even if no pre-examiner were appointed, the court's basis of information would be significantly better compared to the current situation. The debtor would have a strong incentive to provide information. My proposal would thus not only improve decision making when a pre-examiner is appointed, but would improve decision making in all bankruptcy cases.

In summary, the appointment of a pre-examiner should be the general rule. This is not necessarily an extension of oversight compared to the current situation, but rather a narrower standard than the current mandatory rule in § 1104(c)(2), which requires, upon request, the appointment of an ordinary examiner in basically all large cases. Compared to this rule, the mandatory appointment of a pre-examiner would be less rigorous, especially with the allowed exceptions for small bankruptcy cases and other cases in which no

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[254] *See* CARRUTHERS & HALLIDAY, *supra* note 89, at 249–50.

[255] *See* 11 U.S.C. § 547(b)(4)(A) (2012).

breach of duties by the management could be expected.[256] At the same time, it would enable the bankruptcy courts to make much more accurate decisions.

CONCLUSION

Examiners can fill a gap in bankruptcy. As the debtor remains in possession, agency problems and conflicts of interest arise. This Article has shown that infringements of the law are likely to appear irrespective of the circumstances of the bankruptcy. The debtor's management has incentives to favor some parties over others. The analysis has revealed that the favored parties could be the shareholders or, more commonly, influential creditors, depending on the influence they were able to exercise on the management.

Additionally, it has been shown that control mechanisms do not satisfactorily detect and deter infringements. Creditors' committees are often not appointed, ineffective, or conflicted. Only in some, especially very large cases, do they effectively monitor the debtor and investigate potential wrongdoing. Further, the bankruptcy courts usually do not have enough insight to ascertain an indication of violations because they receive their information mainly from the management and creditors. Both could be conflicted. Consequently, good corporate governance is not sufficiently ensured in and before bankruptcy.

To overcome these problems, the bankruptcy court can appoint either a trustee or an examiner. The obvious advantage of the latter is that she does not replace the management. In practice, however, examiners are only rarely appointed. This Article has shown that they could add great benefits to the bankruptcy process because they would be able to investigate potential infringements and also deter wrongdoing. Given the management's incentives and the lack of control, examiners should be appointed more often, especially in Delaware, where the bankruptcy courts are currently particularly reluctant. This proposal is also supported by a comparative legal analysis of the German self-administration procedure, for which the U.S. chapter 11 was used as a role model, but which nevertheless envisions a mandatory supervisor in every case to ensure enforcement of the law.

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256 The proposal made here has some similarity to a proposed amendment of 11 U.S.C. § 1104(c) advanced by Lipson, *supra* note 12, at 77 appx. 3: Lipson has suggested that "the appointment of an examiner shall be presumed" in three cases. *Id*. The first provision covers cases of breach of duty by the management, the second large bankruptcy cases, and the third has a rather open formulation that covers other benefits of examiners. *Id*. The main differences are that the appointment is only presumed if the elements of the provisions are met. In my proposal, the appointment is the standard and non-appointment is the exception. Furthermore, in 2010, Lipson did not yet propose the appointment of "mini examiners". *Id*. Since the appointment of ordinary examiners is a more important decision, the wording of Lipson's draft is more modest. *Id*.

To address the bankruptcy courts' difficulties in assessing whether to appoint an examiner or not, I propose the use of preliminary examiners, whose sole purpose would be to conduct a preliminary investigation and help the court to decide the question of whether an ordinary examiner should be appointed. Pre-examiners should mainly look for indications of voidable transfers, liability on the part of managers, and other violations of the law. By using pre-examiners, courts could improve their decisions both on the appointment of examiners and the scope of their mandate. Since pre-examiners would not have a comprehensive mandate, their costs would be significantly lower than those of ordinary examiners. Further, pre-examiners would not substantively disrupt or delay the reorganization process because they would only conduct a very limited investigation. Hence, this proposal addresses two major concerns about the appointment of ordinary examiners.

Although pre-examiners are not explicitly mentioned in the Code, courts could institute the position because they have vast discretion on the scope of the mandate of ordinary examiners. Pre-examiners would simply be examiners with a very limited mandate. If there was no indication for a beneficial investigation, the appointment would not be extended to a "full" examination. By contrast, if the summary investigation revealed the need for a more in-depth investigation, the court could and should expand the mandate.

The Code should be amended to explicitly provide for the appointment of pre-examiners. Their appointment should be the rule and not the exception. Hence, courts would have to justify why they would not appoint a pre-examiner. Exceptions would be conceivable for very small cases and cases in which the management could prove to the satisfaction of the bankruptcy court that no indication of any wrongdoing existed. Since the management has access to the books and all documents, this could be responsibly demanded. By altering the Code in this way, incentives to prove conformity with the law and the burden of proof would be aligned given that the management (i) could easily provide the information to the court and (ii) would also have an incentive to do so to prevent the appointment of a pre-examiner. Even if no pre-examiner was appointed, this amendment would make more information available to the bankruptcy court.

In summary, examiners are a great tool for detecting and remedying wrongdoing without fundamentally changing the bankruptcy system. They can fix flaws in the chapter 11 procedure without turning it into a trustee system. They can not only enrich the estate in the individual bankruptcy case, but also generally deter wrongdoing. Higher prospects of detection would, in the future, lead to more compliance with the law and better corporate governance both before and in bankruptcy. Assessed in light of the benefits, current bankruptcy practice has yet to fully appreciate the potential of examiners.