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Examiner Motions: Is Good Faith a Required Element?

TED A. BERKOWITZ AND VERONIQUE A. URBAN

Creditors and other parties-in-interest involved in bankruptcy proceedings have a variety of tools that they can utilize to obtain the best possible position in a debtor's bankruptcy case. One of the tools that provides great leverage for a creditor is a motion requesting the appointment of an examiner. The authors of this article explore the issue of whether an implicit good faith requirement should be considered by judges when they review examiner motions in bankruptcy cases.

Creditors and other parties-in-interest involved in bankruptcy proceedings have a variety of tools that they can utilize to obtain the best possible position in a debtor's bankruptcy case. One of the tools that provides great leverage for a creditor is a motion requesting the appointment of an examiner in a bankruptcy case pursuant to Section 1104(c) of Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code"). Historically, judges have interpreted Bankruptcy Code Section 1104(c)(2) as a mandatory provision pursuant to which a judge must appoint an examiner if certain thresholds are met. In recent years,

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however, some bankruptcy courts have exercised greater flexibility when deciding whether to appoint an examiner under Bankruptcy Code Section 1104(c)(2), ultimately determining that whether or not to appoint an examiner is within a court's discretion. Courts that view the appointment of an examiner under Section 1104(c)(2) as discretionary rather than mandatory have looked to a variety of factors in making that determination, not the least of which is the issue of whether the party filing the motion did so in "bad faith" as a means of disrupting the debtor's Chapter 11 case. The question that arises, therefore, is whether an implicit good faith requirement should be considered by judges when they review examiner motions.

SECTION 1104 OF THE BANKRUPTCY CODE ALLOWS FOR THE APPOINTMENT OF AN EXAMINER

Section 1104(c) of the Bankruptcy Code provides, in relevant part, that:

> [A]t any time before confirmation of a plan, on request of a party in interest or the United States Trustee, and after notice and a hearing, the Court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate…if — (2) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000.[1]

The controversy revolving around Section 1104(c)(2) of the Bankruptcy Code arises as courts interpret two seemingly opposite provisions of the statute. On its face, the statute provides that "the Court *shall* order the appointment of an examiner" if certain conditions are met, seeming to indicate that the appointment of an examiner in such a circumstance is mandatory. On a second look, however, the statute also provides that the "the Court shall order the appointment of an examiner…*as is appropriate*," which may indicate that the appointment of an examiner, even when certain thresholds are met, is discretionary rather than mandatory.

Courts that focus on the "shall" language of the statute generally hold that, based on the plain meaning of the statute, the appointment of an examiner is mandatory if all requirements, including the debt threshold, have

been met.[2] The view that the appointment of an examiner is mandatory has historically been the majority position of bankruptcy courts. These courts hold that to otherwise interpret the statute by relying on the "as is appropriate" language results in a grammatically incorrect reading of the statute.[3] Occasionally, however, courts have declined to appoint an examiner where the appointment would be inefficient and meaningless, such as on the ground of laches.[4]

Nonetheless, a certain minority of courts have focused on the phrase "as is appropriate" when determining whether to appoint an examiner. These courts argue that a bankruptcy court has discretion not to appoint an examiner if the circumstances of the case indicate that the appointment of an examiner would cause unnecessary delay or expense to the debtor's estate.[5] In other words, bankruptcy courts that have refused to appoint an examiner even when the requirements have been met seem to suggest that an examiner should not be appointed if the motion for the appointment of the examiner was brought for reasons other than the necessity of conducting an examination involving the debtor's case. In an era in which parties involved in bankruptcy cases have become more litigious, the request for an examiner has been one more arrow in parties' strategic quivers. Since a good faith requirement is not an explicit element of the statute, however, the question becomes whether bankruptcy courts should incorporate, and whether the Bankruptcy Code allows for, an implicit reading of a good faith requirement when determining whether to appoint an examiner pursuant to Section 1104(c)(2) of the Bankruptcy Code.

COURTS MAY NARROW THE SCOPE OF AN EXAMINER'S DUTIES

As a preliminary matter, once an examiner has been appointed, his or her duties will be prescribed under Section 1106 of the Bankruptcy Code, with his or her primary duties being those of an investigative nature. Section 1106(c)(3) of the Bankruptcy Code specifically provides that an examiner shall, "except to the extent that the court orders otherwise, investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the

continuance of such business, and any other matter relevant to the case or to the formulation of a plan."[6]

The phrase "except to the extent that the court orders otherwise" in Section 1106(d)(3) has provided great discretion to bankruptcy courts as to the nature and extent of an examiner's duties and responsibilities. Courts that argue that Section 1104(c)(2) of the Bankruptcy Code mandates the appointment of an examiner when the thresholds have been met, but that in certain cases the appointment of an examiner may not be appropriate or necessary, use Section 1106 of the Bankruptcy Code in order to reduce the examiner's role in the case. For example, it is not uncommon for a court to appoint an examiner in accordance with Section 1104(c)(2) but to then severely restrict the duties of the examiner in the case.[7] Alternatively, courts have also appointed examiners with no duties.[8] In this way, the bankruptcy court is able to protect the debtor and its estate from needless expenses or delays without running afoul of the mandatory appointment of the examiner. Of course, this leads to the elevation of form over substance. For example, loan documents that provide that an "Event of Default" occurs upon the appointment of a trustee might not prohibit the appointment of an examiner.

Collier on Bankruptcy, the leading treatise of bankruptcy law, recognizes this conflict, stating that

> the mandatory nature of [Section 1104(c)] was not intended and should not be relied on to permit blatant interference with the chapter 11 case or the plan confirmation process. Failure to make a timely request for the appointment of an examiner may provide the court with a basis for denying the request on the ground of laches. Alternatively, a court might grant the request of an examiner but so limit the role assigned to the examiner that substantial interference will be prevented.[9]

As further discussed below, at least one court has disagreed with such an approach, holding that there is "no sound purpose in appointing an examiner, only to significantly limit the examiner's role when there exists insufficient basis for an investigation. To appoint an examiner with no meaningful duties strikes [the court] as a wasteful exercise, a result that could not have been intended by Congress."[10]

THE MAJORITY VIEW — SECTION 1104(C)(2) IS MANDATORY

When interpreting Section 1104(c)(2), a majority of bankruptcy courts have held that, upon the request by a party-in-interest for the appointment of an examiner, the bankruptcy court has no discretion to deny such request if all of the requirements set forth in Section 1104(c)(2) have been met. The Sixth Circuit Court of Appeals, in *Morgenstern v. Revco D.S., Inc.* (*In re Revco, D.S., Inc.*),[11] is the only appellate court that has considered the question of whether Section 1104(c)(2) requires the mandatory appointment of examiners. In finding that Section 1104(c)(2) is mandatory, the court of appeals stated that "[t]he provision plainly means that the bankruptcy court 'shall' order the appointment of an examiner when the total fixed, liquidated, unsecured debt exceeds $5 million, if the U.S. trustee requests one."[12]

The *Revco* court, in coming to the conclusion that Section 1104(c)(2) is mandatory on its face, considered the meaning of that section in light of Section 1104 of the Bankruptcy Code as a whole. Section 1104(c)(1) of the Bankruptcy Code allows for the discretionary appointment of an examiner providing that the court shall order the appointment of an examiner "if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate."[13] As a result, the court in *Revco* found that "the contrast [between the two sections] could not be more striking…. Unless [§ 1104(c)(2)] requires the appointment of an examiner in such a case, it becomes indistinguishable from [§ 1104(c)(1)]."[14] Generally, however, such courts also recognize that the appointment of an examiner "should not cause "prejudicial delay, unnecessary expense or otherwise be undesirable."[15]

In *Loral Space & Communications Ltd.*, the United States District Court for the Southern District of New York reversed the bankruptcy court's refusal to appoint an examiner in the debtors' Chapter 11 case where the threshold requirements for the appointment of an examiner under Section 1104(c) had been met. In *Loral*, a group comprised of the debtor's stockholders sought a court order authorizing the formation of an official shareholder's committee. When the group's request was denied on two separate occasions by the bankruptcy court, the stockholder

group decided instead to file a motion requesting the appointment of an examiner in order to protect their interests. The bankruptcy court denied the examiner motion, in part because the bankruptcy court found that the requested appointment was "wholly inappropriate" and revolved around "an exercise that…is ripe for partisan abuse and, if not so abused, provides negligible benefit at high cost."[16] Such language seems to indicate that the bankruptcy court considered whether or not the examiner motion had been filed in good faith or for impermissible strategic reasons. Relying on *Revco*, however, the district court reversed the bankruptcy court's ruling and held that "[o]n its face, Section 1104(c)(2) mandates the appointment of an examiner where a party in interest moves for an examiner and the debtor has $5,000,00 of qualifying debt."[17] The district court clarified, however, that the bankruptcy court could "fashion the role of an examiner to avoid substantial interference with the ongoing bankruptcy proceedings," such as by limiting the scope of the examiner's investigation and/or the compensation and expenses available to the examiner.[18]

Similarly, the United States District Court for the Northern District of Georgia, Gainesville Division, also decided that Section 1104(c)(2) is, on its face, mandatory when all requirements have been met.[19] The district court refused to accept the appellee's argument that the phrase "as is appropriate" allowed for the court to use its discretion over the appointment of an examiner under Section 1104(c)(2). Instead, the district court echoed the reasoning set forth in *In re Schepps Food Stores, Inc.*, in which the court stated that "[t]his reasoning is both grammatically and contextually wrong. In the provision, 'as is appropriate' modifies 'investigation.' The statute allows the court to determine the scope, length, and conduct of the investigation, rather than the appointment itself."[20]

THE MINORITY VIEW AND THE IMPLIED GOOD FAITH REQUIREMENT

Notwithstanding lengthy precedent holding that Section 1104(c)(2) of the Bankruptcy Code requires the mandatory appointment of an examiner, a minority of bankruptcy courts are breaking away from that traditional interpretation of Section 1104(c)(2). These minority courts have refused

to appoint an examiner, even when all of the threshold conditions set forth in Section 1104(c)(2) have been met, on the basis that "to slavishly and blindly follow the so-called mandatory dictates of Section 1104(b)(2) [now, §1104(c)(2)] is needless, costly and non-productive and would impose a grave injustice on all parties."[21]

In *U.S. Bank National Association v. Wilmington Trust Co.* (*In re Spansion, Inc.*), the bankruptcy court went against the majority rule and held that the language of Section 1104(c) of the Bankruptcy Code does not require the appointment of an examiner in those circumstances where no compelling reasons exist to grant such a request.[22] In *Spansion*, equity security holders, who were to receive nothing under the debtor's plan, and convertible noteholders, who were to receive a limited recovery under the plan, filed an emergency motion at the eleventh hour before the debtor's confirmation hearing. The motion sought to vacate the order approving the debtors' disclosure statement and to direct the appointment of a trustee or examiner so that the examiner could investigate potential intentional misrepresentations regarding the valuation assumptions used by the debtors in the disclosure statement.

Judge Carey, relying upon case law, the legislative history of Section 1104(c)(2) and *Colliers*, declined to appoint an examiner in the case, holding that the "[a]ppointment of an examiner at this time, based on this record, is neither warranted nor appropriate, and would cause undue cost to the estate, which would be harmful to the Debtors and would delay the administration of this chapter 11 case."[23] While the bankruptcy court acknowledged that certain bankruptcy courts had appointed examiners with no duties in other cases, the bankruptcy court declined to do, finding that appointing an examiner with no meaningful duties was wasteful and could not have been intended by Congress when it structured Section 1104(c)(2).[24]

The bankruptcy court in *Spansion* also emphasized that the parties moving for the appointment of an examiner had been vigorously represented in the Chapter 11 cases and that all of the parties had ample opportunity to conduct extensive discovery and investigate the debtors prior to the hearing on plan confirmation. The bankruptcy court seemed to indicate that the parties moving for the appointment of an examiner could have done so earlier in the cases rather than waiting until the last possible

moment before confirmation. As such, it appears that the bankruptcy court was implicitly reading a good faith requirement into Section 1104(c)(2) or, stated another way, rejecting the use of examiner requests made for strategic as opposed to investigatory purposes. The timing and circumstances of the filing of the examiner motion could potentially be seen as a bad faith filing, a tactic used solely to delay the case and cause havoc on the debtor as a means of strong-arming the debtor or other parties-in-interest into addressing the concerns of the moving party in the absence of otherwise available statutory remedies. The refusal by the bankruptcy court to appoint an examiner in the Chapter 11 case, despite the statutory thresholds of Section 1104(c)(2) having been fulfilled, sends a warning message to other creditors and parties-in-interest that an attempt to bully a debtor or other parties-in-interest by the filing of an examiner motion, where circumstances do not warrant such an appointment, will not be tolerated.

This implicit good faith requirement is similar to the analysis of Judge Stacey G. C. Jernigan in the case of *In re Erickson Retirement Communities, et al*., which also focused on whether the appointment of an examiner is mandatory under the Bankruptcy Code. In *Erickson*, the movants filed a motion for the appointment of an examiner after the debtors had already filed its proposed plan of reorganization. Arguing that all of the requirements set forth in Section 1104(c)(2) of the Bankruptcy Code had been met, the movants requested that the court appoint an examiner in order to determine whether the value of the debtor's property was being allocated properly pursuant to the plan. The bankruptcy court ultimately denied the motion on the basis that, as a threshold matter, the movants lacked the standing to bring the examiner motion.[25] Nevertheless, the bankruptcy court still provided its analysis with respect to Section 1104(c)(2) of the Bankruptcy Code.

The bankruptcy court in *Erickson* recognized that a bankruptcy court ordinarily has no discretion to appoint an examiner if the requirements of Section 1104(c)(2) are met and that, similarly to the holding in *Revco*, a court may exercise its discretion only when determining the scope and nature of the examiner's role.[26] Notwithstanding that fact, however, the court made a point in its opinion to state that the motion for the appointment of an examiner "in the context of these cases at this time (where

no allegations of fraud, dishonesty, misconduct, mismanagement and the like are involved) is unmistakably aimed at slowing down the confirmation process and gaining leverage to enhance or create recoveries for the [subordinated] creditors."[27] The court further discussed, in dicta, that the examiner motion may have been brought in bad faith by the movants, who wished for the appointment of an examiner for an investigation and report on the appropriate value allocation among the estates as to the sale proceeds. The court found, however, that such an investigation would not be in the best interests of the estates, and was puzzled as to why the numerous experts already retained in the case would not be able to successfully determine the valuation on their own without the need for the appointment of a separate examiner.[28] Especially in light of the fact that the debtors in the case had not been accused of any wrongdoing, the court expressed doubt as to whether the motion had been brought in good faith. The *Erickson* decision is another example of a bankruptcy court that questioned the interplay between good faith and the filing of an examiner motion under Section 1104(c)(2) of the Bankruptcy Code intended to tip the otherwise level playing field in favor of one party.

Since *Spansion* and *Erickson* were decided, Judge Walrath of the United States District Court for the District of Delaware declined to appoint an examiner in three cases in which she found that no investigation was warranted.[29] It appears that bankruptcy courts are reacting to attempts by parties-in-interest to utilize examiner requests for strategic purposes as a litigation tactic as opposed to investigatory purposes. As a result, more bankruptcy courts may, and should, begin to view examiner motions in the context of an implicit good faith requirement. The major hurdle that such bankruptcy courts will face, however, is the clear language in the statute that states that the bankruptcy court *shall* order the appointment of an examiner to conduct an investigation if all of the elements of the statute are met. As further case law develops, we will see whether bankruptcy courts will appoint examiners but limit the examiner's role and duties or whether they will refuse to indulge strategic requests for the appointment of an examiner. This is especially true in light of the fact that as more parties become disenfranchised with bankruptcy cases by virtue of valuations or subordination provisions, such parties will seek to use the provisions of

the Bankruptcy Code in a more strategic and creative manner.

If more bankruptcy judges begin to interpret Section 1104(c)(2) of the Bankruptcy Code with more flexibility and discretion, however, then it may be up to Congress to amend Section 1104(c)(2) in order to explicitly set forth a good faith requirement. Alternatively, Congress may decide to collapse Section 1104(c)(1), which, as stated earlier, provides for the discretionary appointment of an examiner, with Section 1104(c)(2). This type of modification would still allow bankruptcy courts to balance the needs of creditors and parties-in-interest in large Chapter 11 cases with the concerns and needs of debtors when appointing an examiner.

CONCLUSION

At its core, the use of examiner motions is a strategic tool that often packs a punch whether or not the motion for the appointment of the examiner is ultimately filed. The threat of filing a motion for the appointment of an examiner gives the moving party significant leverage over the debtor, who would prefer to negotiate with the creditor on its demands rather than expend money as would be required upon the appointment of an examiner. It is possible that implementing a good faith requirement into Section 1104(c)(2) would deter the use and filing of examiner motions as parties may be less willing to undertake the time and expense of filing the motion if a successful result could not be guaranteed.

Regardless of whether Section 1104(c)(2) is interpreted as being mandatory or discretionary, parties who attempt to use the threat or filing of examiner motions for their advantage in Chapter 11 case should be cognizant of the fact that Section 1104(c)(2) of the Bankruptcy Code does not allow for the blatant interference of a debtor's Chapter 11 cases. Even those bankruptcy courts that interpret Section 1104(c)(2) as requiring the mandatory appointment of an examiner may deny such motion on the ground of laches, or may appoint an examiner with limited or no duties. As such, parties should strive to adhere to a good faith filing of such motions, even if such requirement is not explicitly stated in the statute.

NOTES

[1] 11 U.S.C. 1104(c)(2) (2011).
[2] *See, e.g., In re Revco D.S., Inc.*, 898 F.2d 498, 500-01 (6th Cir. 1990); *In re UAL Corp.*, 307 B.R. 80, 86 (Bankr. N.D. Ill. 2004); *In re Loral Space Commc'ns*, 2004 WL 29797856, * 5 (S.D.N.Y. Dec. 23, 2004).
[3] *See In re Schepps Food Stores, Inc.,* 148 B.R. 27, 30 (Bankr. S.D. Tex. Dec. 8, 1992) (finding that it is contextually and grammatically wrong to read the phrase "as is appropriate" as modifying the term "shall").
[4] *See, e.g., In re Bradlees Stores, Inc.,* 209 B.R. 36, 38 (Bankr. S.D.N.Y. 1997) (waiver of right to appoint an examiner by delay in seeking appointment); *In re Schepps Food Stores, Inc.,* 148 B.R. 27, 30-31 (S.D. Tex. Dec. 8, 1992).
[5] *See*, *e.g.*, *In re Bradlees Stores, Inc.*, 209 B.R. 36, 39 (Bankr. S.D.N.Y. 1997); *In re Magna Entm't Corp.*, Case No. 09-10720 (MFW) (Bankr. D. Del. April 10, 2010) (Walrath, J.); *In re Spansion Inc.*, 426 B.R. 114, 128 (Bankr. D. Del. April 1, 2010) (Carey).
[6] 11 U.S.C. § 1106(c)(3).
[7] *In re Loral Space Commc'ns*, 2004 WL 29797856, * 5 (S.D.N.Y. Dec. 23, 2004) (noting that it may be appropriate under certain circumstances to restrict examiner's investigation to a limited, prescribed role).
[8] *In re Asarco, LLC*, No. 05-21207, docket entry 7081 (Bankr. S.D. Tex. March 4, 2008) (ordering the appointment of an examiner due to Section 1104(c)(2)'s mandatory nature but also ordering "that the examiner shall not have any current duties.").
[9] 7 Collier on Bankruptcy ¶ 1104.03[2][b] at 1104-39-40.
[10] *In re Spansion*, 426 B.R. 114 (Bankr. D. Del. April 1, 2010).
[11] 898 F.2d 498 (6th Cir. 1990).
[12] *In re Revco D.S., Inc.*, 898 F.2d 498, 500-01 (6th Cir. 1990).
[13] 11 U.S.C. 1104(c)(1).
[14] *In re Revco*, 898 F.2d at 501.
[15] *In re Adelphia Commc'ns Corp.*, 336 B.R. 610, 646 n.61 (Bankr. S.D.N.Y. 2006), aff'd, 342 B.R. 122 (S.D.N.Y. 2006).
[16] *In re Loral Space Commc'ns*, 313 B.R. 577 (Bankr. S.D.N.Y. Sept. 2, 2004).
[17] *In re Loral Space Commc'ns*, 2004 WL 29797856, * 13 (S.D.N.Y. Dec. 23, 2004)
[18] *Id.* at *15; see also *In re Revco D.S., Inc.*, 898 F.2d 498, 501 (6th Cir. 1990) (holding that "the bankruptcy court retains broad discretion to direct the

examiner's investigation, including its nature, extent and duration").

[19] *In re Donald F. Walton,* 398 B.R. 77 (N. D. Ga. Dec. 5, 2008).

[20] *In re Schepps Food Stores, Inc.*, 148 B.R. at 30.

[21] *In re Shelter Res. Corp.*, 35 B.R. 304, 305 (Bankr. N.D. Ohio 1983).

[22] *In re Spansion*, 426 B.R. 114 (Bankr. D. Del. April 1, 2010).

[23] *Id.* at 128.

[24] *Id*. at 127.

[25] *In re Erickson Retirement Communities, LLC*, 425 B.R. 309, 316 (N.D. Tex. Mar. 5, 2010).

[26] *Id*. at 312. ("This court agrees with such courts that, where the $5 million threshold is met, a bankruptcy court ordinarily has no discretion. The only judicial discretion that comes into play is in defining the scope of the examiner's role/duties.")

[27] *Id.* at 315.

[28] *Id.*

[29] *See In re Magna Entm't Corp.*, Case No. 09-10729 (MFW) (Bankr. D. Del. April. 20, 2010); *In re HSH Delaware GP LLC*, Case No. 10-10187 (MFW) (Bankr. D. Del. April 23, 2010); *In re Washington Mut., Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. May 5, 2010).