Multiple Debtors: Best Practices for Corporate Governance in Multi-Debtor Cases

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Tools Available for Dealing with Potential
Conflicts Where There Are Multiple Debtors

A. Introduction

There are many tools available to address potential conflicts in situations involving multiple debtors. This article addresses the appointment of a trustee, which would displace the debtors' existing management, or an examiner; the retention and employment of a chief restructuring officer who may have specific industry or restructuring expertise or the appointment of a responsible officer of the debtor(s); the appointment of an independent director(s) or special committee of a board of directors; the appointment by the Office of the United States Trustee of multiple official committees of unsecured creditors to advocate on behalf of different groups of creditors; the creation of a subcommittee of a creditors' committee; the creation and involvement of ad hoc groups of secured or unsecured creditors during the period leading up to and after the commencement of a bankruptcy case; and the appointment of a sale monitor or other estate neutral to ensure that actual or potential conflicts are handled appropriately.

B. Trustee

1. Standard for Appointment – 11 U.S.C. § 1104(a)

    a. Section 1104(a) of the Bankruptcy Code provides,

    > At any time after the commencement of the case but 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 a trustee—
    >
    > (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or
    >
    > (2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.

2. Preliminary Issues

    a. Only required if the court finds "cause" or that a trustee is in the interest of stakeholders.

    b. "Cause" can be difficult to prove

c. Court has broad discretion in determining whether facts constitute "cause." "Cause" is not limited to the examples listed in section 1104(a)(1); courts have found "cause" existed where the debtor engaged in self-dealing, commingled assets or made unauthorized payments

d. Overcoming presumptions that debtor in possession is better positioned to run business

3. Statistics for Trustees in Large Cases

a. Trustees appointed in 3.7% of cases

b. Motions rarely made (Lipson, Jonathan C. and Marotta, Christopher Fiore. "Examining Success" Working Paper. 2015. *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2568178*)

4. Trustee Appointment Under 11 U.S.C. § 1104(e)

a. The Bankruptcy Code directs the U.S. Trustee to move for the appointment of a chapter 11 trustee "if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting."

5. Reasons Trustee May Be Beneficial

a. Avoids conflicts in administration of the chapter 11 case

b. Allows for prosecution of certain claims/causes of action

c. Motion may lead to resolution of issues

d. Transparency in public process

6. Issues with Trustee

a. Interference with debtor operations

b. Constituent concern over loss of control

7. Illustrative Cases

a. *In re HII Technologies, Inc.*, Case No. 15-60070 (Bankr. S.D. Tex. 2015)

i. Ad Hoc Committee filed a motion to appoint a chapter 11 trustee for a subsidiary debtor, Apache Energy Services ("AES"). The committee argued that the sole-shareholder of its debtor parent, HII, was managing the bankruptcy for the benefit of HII's creditors at the expense of unsecured creditors of AES, and that AES had claims against HII and HII's officers that could not be asserted because of HII's control of AES. The committee also argued that DIP loan sought by parent was unnecessary for AES.

ii. The court ordered mediation, which resulted in a settlement between the Ad Hoc Committee and HII.

b. *In re Arabella Petroleum Company, LLC*, Case No. 15-70098 (Bankr. W.D. Tex. 2015)

i. The Official Committee of Unsecured Creditors filed a motion to appoint a chapter 11 trustee.

ii. The committee alleged that the debtor's 100% owner and managing owner made inappropriate prepetition transfers to non-debtor affiliates of the debtor.

iii. Court granted the motion to appoint a chapter 11 trustee.

c. *In re AIX Energy, Inc.*, Case No. 15-34245-BJH-11 (Bankr. N.D. Tex. 2015)

i. U.S. Trustee filed a motion to appoint a chapter 11 trustee on the grounds that an individual was principal of both debtors and could not pursue claims between the debtors and affiliated non-debtors.

ii. The U.S. Trustee sought the appointment of a chapter 11 trustee to pursue inter-debtor claims and claims of the debtors against non-debtor affiliates and the debtors' principal.

iii. The court granted the motion to appoint a chapter 11 trustee.

d. *In re JW Resources, Inc.*, Case No. 15-60831 (Bankr. E.D. Ky. 2015)

i. U.S. Trustee sought appointment of chapter 11 trustee where significant amount of debtor's assets were legal claims against Bayside, an entity which was the majority equity holder of debtor.

ii. Debtor's Board designated a "Designated Representative" to file bankruptcy petition and required filings.

iii. Once Designated Representative filed plan and disclosure statement, Board (which is controlled by majority equity holder, Bayside) adopted resolution requiring the Designated Representative to withdraw the plan and disclosure statement unless claims against Bayside were released.

iv. The trustee motion was filed February 16, 2016. The court has not ruled but avoided the issue by taking action to terminate exclusivity and allow the Committee to pursue plan.

e. *In re Family Christian, LLC*, Case No. 15-00643-jtg (Bankr. W.D. Mich. 2015)

i. Creditors that lost bid at auction sought appointment of a chapter 11 trustee, alleging the debtors' insiders ran a biased and closed auction process providing for improper releases to insiders, which resulted in a sale to debtors' previous owner.

ii. The creditors later withdrew the motion.

C. Examiner

1. Standard for Appointment – 11 U.S.C. § 1104(c)

a. Section 1104(c) of the Bankruptcy Code provides,

"…[A]t any time before the 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*, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor, if—

(1) such appointment is in the interests of creditors, any equity security holders, and other interests of the estate; or

(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.

2. Preliminary Issues

   a. Only where a trustee is not appointed

   b. Appointment is (theoretically) mandatory if requirements of section 1104(c)(2) are met (*Loral Stockholders Protective Comm. v. Loral Space & Commc'n Ltd. (In re Loral Space and Commc'n Ltd.*), 2004 U.S. Dist. LEXIS 25681 (S.D.N.Y. Dec. 23, 2004))

      i. Appointment not made because of perceived delay, cost or adverse impact on administration of the case (*In re Spansion, Inc.*, 426 B.R. 114 (Bankr. D. Del 2010))

      ii. Appointment not made where party has waived rights through subordination agreement or otherwise (*In re Bradlees Stores, Inc.*, 209 B.R. 36 (Bankr. S.D.N.Y 1997; *In re Erickson Ret. Communities, LLC*, 425 B.R. 309 (Bankr. N.D. Tex. 2010))

      iii. Appointment not made where $5 million threshold not met

   c. Scope of the examiner is defined (and may be limited by courts)
      i. In *In re ASARCO LLC*, Case No. 05-21207 (Bankr. S.D. Tex. 2005), the Court determined the standard was met but there was no appropriate scope.

   d. Examiner may also be limited by time or budget (*In re New Century TRS Holdings, Inc.*, Case No. 07-10416 (Bankr. D. Del. 2007))

3. Statistics for Examiners in Large Cases (>$100 m publically traded debt)

   a. Examiners were only sought in 14% of cases and appointed in 6.5% of cases where debt threshold was met.

   b. Confirmation rate greater where examiner was appointed (97.9% as opposed to 89.7% where no examiner).

   c. Cases with public bond debt are more likely to have examiners (but bondholders are often not the party requesting the examiner).
   d. Examiners are 62% less likely to be appointed in Delaware than other jurisdictions.

   e. Bond prices appear to be materially higher (10.5%) in large cases with examiners. (Lipson, Jonathan C. and Marotta, Christopher Fiore.

"Examining Success" Working Paper. 2015 *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2568178*)

4. Reasons Examiners May Be Beneficial

    a. Evaluate conflicts in administration of the chapter 11 case

    b. Investigate prepetition transactions

    c. Value assets

    d. Provide a basis for settlement between or among parties

    e. Provide unbiased and independent evaluation of issues for the court

    f. Transparency in public process

5. Issues with Examiners

    a. Cost

    b. Timing of case

    c. May interfere with debtor operations

    d. May interfere (at least initially) with the negotiation of a compromise

6. Illustrative Cases

    a. *In re Enron Corp.*, Case No. 01-16034 (ALG) (Bankr. S.D.N.Y. 2001)

        i. U.S. Trustee sought appointment of an examiner to investigate the debtors' finances and determine the potential recoveries available to creditors.

        ii. Court granted appointment of examiner.

        iii. The examiner's report, issued on November 24, 2003, found that Enron, with the help of its former auditor, Arthur Andersen, violated accounting rules by creating complicated financial transactions that treated loans as sales that increased Enron's reported revenue, profit and cash-flow.

        iv. The effect of the report was to expose the lack of assets available to creditors.

b. *In re WorldCom, Inc.*, Case No. 02-13533 (AJG) (Bankr. S.D.N.Y. 2002)

   i. U.S. Trustee sought appointment of an examiner to investigate allegations of fraud by current and former management, including accounting irregularities. The debtors did not object.

   ii. Court granted appointment of examiner.

   iii. The examiner's report was filed on January 26, 2004. The examiner found that WorldCom had claims against former auditor, Arthur Andersen, and WorldCom's former chief financial officer for their role in developing an accounting fraud and against auditor, KPMG, which recommended and carried out a highly aggressive tax strategy to avoid paying hundreds of millions of dollars in state income taxes. Additionally, the report identified the relationship between WorldCom's chief executive and securities firm, Salomon Smith Barney, giving rise to breach of fiduciary duty claims.

   iv. Although the plan was confirmed prior to the filing of the final report, the report identified potential causes of action for the company to pursue.

c. *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555(JMP) (Bankr. S.D.N.Y. 2008)

   i. Creditor sought appointment of an examiner to investigate and report on the debtors' intercompany accounts, intercompany administrative claims, actions of officers and directors leading up to the chapter 11 filings and postpetition, and the use of assets by nondebtor subsidiaries.

   ii. Creditor questioned whether cash was transferred between debtors or to other Lehman entities giving rise to administrative claims for the benefit of creditors and whether directors and officers breached fiduciary duties in permitting such transfers to occur without receiving reasonably equivalent value.

   iii. Court granted appointment of examiner.

   iv. The examiner's report, filed on March 11, 2010, found that debtors utilized accounting tactic, Repo 105, to temporarily remove approximately $50 billion off of their balance sheet in the six months prior to their chapter 11 filings and that such tactics were in accordance with internal accounting policies

approved by executives and outside accounting firm, Ernst & Young

v. The report identified actionable claims against executives, shareholders and accounting firm.

d. *In re Dynegy Holdings, LLC*, Case No. 11-38111 (CGM) (Bankr. S.D.N.Y. 2011)

i. Indenture trustee sought appointment of an examiner to investigate and report on the debtors' prepetition actions that resulted in assets being transferred out of debtors' estates. The indenture trustee claimed that debtors transferred hundreds of millions of dollars in assets to their non-debtor parent two months prior to commencing the chapter 11 cases.

ii. Court granted appointment of examiner.

iii. The report, filed on March 9, 2012 (three days before the debtors' disclosure statement hearing), found that transfer of coal assets from subsidiary to parent entity was a constructive fraudulent transfer and a breach of fiduciary duty by the board of directors of the debtor.

iv. The issuance of the report caused the debtors to request a two week standstill period to negotiate a new plan. The Court directed the examiner to mediate negotiations. The debtors' plan was confirmed six months later.

e. *In re Residential Capital, LLC*, Case No. 12-12020 (MG) (Bankr. S.D.N.Y.)

i. Bondholder sought appointment of an examiner to investigate and report on the debtors' prepetition transactions with Ally Financial Inc., any claims that the debtors may hold against their officers or directors, any claims the debtors may hold against Ally's officers and directors, and any claims that the debtors propose to release as part of their plan.

ii. Bondholder claimed that members of Creditors Committee were conflicted because they agreed to one or more plan support agreements that included support for non-debtor releases in favor of Ally and others.

iii. Court granted appointment of examiner.

iv. The report was filed under seal on May 14, 2013 and unsealed on June 26, 2013. The examiner found that the debtors had legitimate claims against Ally worth billions of dollars and stood to recover more than $3 billion, but Ally contributed $2.1 billion to debtor to settle claims.

v. The unsealing of the report is credited with driving a settlement. After approving the plan support agreement, the court ordered that the report be unsealed – noting that parties could still object to confirmation of the plan.

vi. The debtors' plan was confirmed less than six months later.

f. *In re Caesars Entertainment Operating Company, Inc.*, No. 15-01145 (ABG) (Bankr. N.D. Ill. 2015)

i. The Official Committee of Second Priority Noteholders filed a motion to appoint an examiner. The committee sought investigation of prepetition transactions that were subject to litigation to uncover avoidance claims and other claims of the estate, to have examiner determine scope of investigation and budget within 30 days of appointment, and authority for examiner to disclose privileged materials. The committee argued that immediate appointment of examiner would expedite global resolution of chapter 11 cases.

ii. Court granted broad scope regarding prepetition transactions, alleged insider transactions, and any other transactions involving the debtors to the extent such transactions suggest potential claims of the estates, self-dealing or conflicts of interest.

iii. The examiner's final report was issued on March 15, 2016. The examiner found material causes of action exist arising from the pre-petition transactions.

iv. The effect of the report remains to be determined.

g. *In re Molycorp, Inc.*, Case No. 15-11357 (CSS) (Bankr. D. Del. 2015)

i. Creditors filed a motion for the appointment of an examiner to investigate the value of the debtors' IP assets and transactions involving IP between debtor and non-debtor affiliates where disclosure was insufficient.

ii. Motion was filed on March 21, 2016. As of the date hereof, the court has not yet held a hearing on the motion.

iii. Court confirmed debtors' plan on March 30, 2016.

7. Beyond the Traditional Roles

a. Examiner as fiduciary (*In re Enron Corp.*, 326 B.R. 497 (S.D.N.Y. 2005))

b. Supervision of debtors (*In re Adelphia Communications Corp.*, 336 B.R. 610 (Bankr. S.D.N.Y. 2006))

c. Mediate plan negotiations (*In re UNR Indus., Inc.*, 72 B.R. 789 (Bankr. N.D. Ill. 1987))

D. Chief Restructuring Officer/Responsible Officer

1. Chief Restructuring Officer as a Tool for Dealing with Potential Conflicts?

A Chief Restructuring Officer ("CRO"), like other officers of a corporation, is hired with the approval of the Board of Directors of a corporation. The CRO typically either reports directly to the Board of Directors or to the Chief Executive Officer. A CRO is often retained to lead a restructuring process when a corporation is having financial and/or operational difficulties.[1] A CRO may be retained at the corporation's lenders' request. Alternatively, a CRO may also be retained when the senior management of a corporation and/or members of the Board of Directors own significant equity of the corporation in order to insure that the restructuring is led by a person who will focus on the interests of the corporation and not on the interests of the equity holders.[2] A CRO should identify potential situations where equity and corporate interests conflict.[3] Equity should be encouraged to secure its own counsel and abstain from voting at the Board level from all issues where it has a conflict of interest.[4] However, unless there are independent directors or a special committee of the Board of Directors comprised of directors without conflicts that the CRO reports to, the appointment of a CRO alone may not adequately address any such conflicts.

When there are multiple related debtors, the appointment of a CRO may be helpful when dealing with conflicts between related corporations if the CRO is appointed for only some of the

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[1] Carl S. Lane and Duncan S. Bourne, *Interim Officers: Critical Skills for Critical Situations*, ABI Journal, September 2013, at 38.

[2] *Id.*

[3] Kelly Beaudin Stapleton, John D. Penn, Andrew P. Vara, *Business Ethics: Maginot Lines? Examining and Enforcing the Duties Owed by Officers, Financial Advisors and Counsel*, 2010 ABI/UMKC Bankruptcy Institute and Consumer Forum, at 296.

[4] *Id.*

multiple related debtors or if the composition of the Board of Directors for the multiple related debtors differs such that there is oversight of the CRO from diverse Boards. Otherwise, the CRO may have conflicts similar to those of the other members of senior management and/or the members of the Board of Directors for the various corporations if the composition of the senior management and/or the members of the Board of Directors for the various related corporations are substantially the same.

In addition, in a situation in which there are multiple related debtors, each of the debtors may have different interests in the outcome of a restructuring process. Their interests may conflict with respect to issues such as contractual arrangements, funding for capital projects, debt incurrence, debt repayment, business strategy, allocation of overhead, and intercompany claims. A CRO is often helpful with presenting the different concerns of the different debtor corporations to the senior management and /or the members of Board of Directors of the multiple related debtors. However, unless the CRO only acts for certain of the multiple related debtors or there are diverse Boards of Directors for the various multiple related debtors, the appointment of the CRO alone may not be able to resolve inter-debtor conflicts.

During Chapter 11, the employment of a CRO is subject to the approval of the Bankruptcy Court. New York, Delaware and various other jurisdictions have approved the appointment of a CRO pursuant to sections 105(a) and 363(b)(1) of the Bankruptcy Code.[5] The basis for the retention of the CRO under such sections of the Bankruptcy Code is that the CRO is being retained as an officer of the corporation and not as a "professional person" pursuant to section 327(a) of the Bankruptcy Code. Some Courts, however, have expressed concern about the lack of oversight of the allowance of fees for a CRO and the ability to insure that the professional is conflict free and impartial when the retention of a CRO is not pursuant to section 327(a) of the Bankruptcy Code.[6]

Where the scope of a CRO's authority has been determined to be too much like a Chapter 11 trustee, Bankruptcy Courts have denied the appointment of a CRO. *See In re BR Festivals LLC*, 2014 Bankr. LEXIS, 1276, (Bankr. N.D.Cal. 2014). The Bankruptcy Court held that the Debtor's proposal to have the CRO "oversee and manage the Debtor's compliance with its obligations as a [d]ebtor-in-possession, oversee and manage the litigation of avoidance actions undertaken by the Debtor, assist in the preparation and promulgation of a Chapter 11 Plan, and act as a disbursing agent for funds of the Chapter 11 Estate" was a Chapter 11 trustee's role. *Id.*

2. Responsible Officer as a Tool for Dealing with Potential Conflicts?

There are a few cases where courts have appointed a "responsible officer." The statutory bases for such appointment are sections 105(a) and 1107(a) of the Bankruptcy Code. Section 1107(a) provides that "[s]ubject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all functions and duties, except the duties specified in sections

[5] Timothy Brinkard and James R. Irving, *Emerging Trends and Living Criticisms: A CRO Retention Update*, ABI Journal, September 2013, at 18.

[6] *In re Blue Stone Real Estate, Constr. & Dev. Corp.*, 392 B.R. 897, 907 n.14 (Bankr. M.D. Fla. 2008).

1106(a)(2) (3) and (4) of this title, of a trustee serving in a case under this chapter." 11 U.S.C. §1107(a). The few courts that have appointed a "responsible officer" have relied on the court's authority to alter the powers of the Board of Directors or management based on the language "such limitations or conditions as the Court prescribes." *See Blue Stone,* 392 B.R. at 908; *In Matter of Gaslight Club, Inc.*, 782 F. 2d 767 (7th Cir. 1986).

Other courts have denied the request to appoint a non-statutory fiduciary to take over management of the debtor entities under sections 105 and 1107 of the Bankruptcy Code when there is an inter-debtor dispute. *In re Adelphia Communications Corp.,* 336 B.R. 610 (Bankr. S.D.N.Y. 2006). The *Adelphia* Court noted that the movant "is not looking for a turnaround expert to act under the supervision of a board; it is seeking the appointment of one or more "independent fiduciaries," to displace the board, with the power to make decisions on whether or not to commence or settle litigation, and to retain counsel to prosecute it. It may even include deciding whether the Arahova Debtors should try to make a go of it alone, as entities separated from the rest of the Debtors. Even without (but especially with) the latter, that is in substance if not name a trustee, and represents a back-door means of circumventing the statutory requirements, and case law, applicable to the appointment of trustees under section 1104." *Id.* at 668.

Even assuming that sections 105 and 1107(a) of the Bankruptcy Code provide a legal basis for the appointment of a "responsible officer," unless the responsible officer were only appointed for some, but not all, of the multiple related debtors, it is not clear that the appointment of a responsible officer alone would adequately address inter-debtor conflicts.

E. Independent Director(s) or Special Committee of a Board of Directors

1. Purposes of Appointing Independent Directors and Special Committees

An independent director, sometimes known as an outside or disinterested director, is a director who is not an employee or an executive officer of a company, and whose only compensation for his or her position consists of compensation for board or board committee service.[7] A company's current board of directors is responsible for appointing independent directors, and typically appoints independent directors to form special committees, as expressly authorized by Delaware law.[8] Special committees consisting of independent directors are usually formed for a particular purpose and the responsibilities of its member directors are typically tailored to achieve this purpose.[9] The appointment of a special committee is often seen as a precautionary measure, and is especially useful in situations where certain decisions are likely to be closely scrutinized and where there may be intercompany conflicts.[10]

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[7] NASDAQ Marketplace Rule 4200(a)(15) – Definition of "Independent Director."

[8] 8 Del. C. § 141(c)(1) ("The board of directors may . . . designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation.").

[9] *See* F. Lipman & L. Keith Lipman, Corporate Governance: Best Practices, 27 (2006).

[10] *See* G. Varallo, W. McErlean & R. Silberglied, *From Kahn to Carlton: Recent Developments in Special Committee Practice*, 53 BUS. LAW 397 (1998).

Two types of special committees are particularly common for dealing with conflicts in a multi-debtor situation: transactions committees and special litigation committees.

- **Transactions committees**: Transactions committees are usually formed to review, approve, and/or recommend the terms of various transactions that a debtor might be contemplating. From a practical standpoint, a transactions committee can aid the board by offering an unbiased opinion of the contemplated transaction. From a legal standpoint, the approval of an independent transactions committee serves to insulate the board from a suit arising from the transaction by shifting the burden of proof from defendants to the potential plaintiff to show that the debtor did not satisfy the deferential business judgment rule. Where, on the other hand, the board is conflicted and no special committee is appointed, the transaction proponent will bear the burden of demonstrating the transaction satisfies the stricter "entire fairness" standard.[11]

- **Special litigation committees:** Oftentimes, a board must decide whether or not to pursue litigation arising out of possible wrongdoing by the corporation, or against the company's officers or directors, or a closely related party. A similar conflict of interest may arise in a multi-debtor restructuring, when one debtor must investigate whether it has claims against another, or against a parent entity. This inherent conflict sometimes prompts creditors to seek derivative standing to pursue claims on the debtor's behalf. In these situations, companies wishing to avoid a derivative suit will often appoint a special litigation committee to investigate the claims instead.[12]

2. Role of Independent Counsel in Other Cases

A special committee's decision to retain its own independent counsel has a noticeable effect on the persuasiveness of its findings, so much so that a litigation committee's use of independent counsel with no prior relationship with the company has become "standard practice."[13]

Although few courts have specifically examined the importance of independent counsel in aiding a special litigation committee's investigation, an examination of several case studies illustrates the potential value of retaining independent counsel:

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[11] *See In re Los Angeles Dodgers LLC*, 457 B.R. 308, 313 (D. Del. 2011) (applying entire fairness standard to DIP loan).

[12] *See Zapata v. Maldonado*, 430 A.2d 779 (Del. 1981) (holding that defendant board of directors which had lost control over litigation due to lack of independence could reassert control and terminate derivative suit by appointing a special committee of uninterested directors).

[13] *See* Hazard, Geoffrey C. Jr. and Rock, Edward B., "A New Player in the Boardroom: The Emergence of the Independent Directors' Counsel" (2004). *Faculty Scholarship.* Paper 6. Available at http://scholarship.law.upenn.edu/faculty_scholarship/6.

- **Cengage**: In 2013, Cengage Learning, Inc. ("Cengage"), a leading publisher of textbooks in the United States, filed Chapter 11 bankruptcy to restructure approximately $5.8 billion in debt in the face of declining revenues and its inability to pay its obligations as they became due.[14] Prior to bankruptcy, Cengage's board of directors appointed Richard D. Feintuch as an independent director to analyze possible restructuring alternatives. Later on, when Feintuch was informed that Apax Partners LLP ("Apax") had purchased over $1 billion of Cengage debt prior to filing, he began an independent investigation as to whether the company had any claims against Apax or the Cengage directors who approved the transaction.[15] Feintuch hired an independent outside law firm, Willkie, Farr, & Gallagher LLP, to investigate the claims and produce a report.[16] Despite initial opposition by the Creditors Committee to Feintuch's role, the parties agreed to allow Feintuch to complete his investigation. Ultimately, Feintuch reviewed the report prepared by Willkie in their capacity as his independent counsel, and concluded that the company had no viable claims against Apax or its directors.[17] Cengage subsequently proposed a plan, with the creditors' support, under which Apax would give up a mere $12 million in distributions to other creditors.[18]

- **Edison Mission Energy:** In 2012, Edison Mission ("Edison"), a California-based energy development firm and holding company, filed for chapter 11 bankruptcy.[19] The board appointed two independent directors, but no independent counsel to investigate whether the company had any claims against its parent company, Edison International, in connection with a series of prepetition transfers whereby Edison transferred $183 million to Edison International and terminated a valuable tax sharing agreement. When the unsecured creditors committee sought standing to bring claims against Edison International,[20] it was ultimately able to secure a settlement by which Edison International would make payments to Edison totaling approximately $625 million and assume various tax and employee-related obligations.[21]

- **Energy Future Holdings:** In April 2014, Energy Future Holdings ("EFH"), a Texas power company, entered chapter 11, seven years after being purchased in

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[14] *In re Cengage Learning, Inc*., No. 13-44106 (ESS), Docket No. 181, Declaration of Richard D. Feintuch (Bankr. E.D.N.Y. July 30, 2013).

[15] *Id.*

[16] *Id.*

[17] *In re Cengage Learning, Inc*., No. 13-44106 (ESS), Docket No. 553, Disclosure Statement for Debtors' Joint Plan of Reorganization, 41-42 (Bankr. E.D.N.Y. Oct. 3, 2013).

[18] *In re Cengage Learning, Inc*., No. 13-44106 (ESS), Docket No. 1225, Order Confirming Debtors' Amended Joint Plan of Reorganization, 35 (Bankr. E.D.N.Y. March 4, 2014).

[19] *In re Edison Mission Energy*, No. 12-49219 (JPC), Docket No. 1, Edison Mission Energy Voluntary Petition for Chapter 11 Bankruptcy (Bankr. N.D. Ill. Dec. 17, 2012).

[20] *In re Edison Mission Energy*, No. 12-49219 (JPC), Docket No. 1054, Notice of Motion of Unsecured Creditors' Committee for Order Granting Standing to Prosecute Claims (Bankr. N.D. Ill. Jul. 31, 2013).

[21] *In re Edison Mission Energy*, No. 12-49219 (JPC), Docket No. 1424, Order Approving (I) Entry into Plan Sponsor Agreement, (II) Sponsor Protections, and (III) Related Relief (Bankr. N.D. Ill. Oct. 13, 2013).

one of the largest leveraged buyouts in history.[22] Prior to the bankruptcy, debtors retained Sidley Austin LLP as special counsel to handle a broad range of corporate and litigation matters, including the task of investigating intercompany claims and estate causes of action against the equity sponsors.[23] EFH also had independent directors appointed at the parent company (EFH) and the two main subsidiaries in its bifurcated capital structure (EFIH and TCEH), although those disinterested directors did not retain independent advisors and the company was represented by single counsel. After a prepetition RSA was abandoned and efforts to commence an auction were derailed, the disinterested directors ultimately retained separate counsel and financial advisors who were tasked with negotiating "conflict" matters between the estates. The Sidley investigation and the disinterested director negotiations and ultimate settlement became the basis for the court's approval of a settlement that resolved approximately billions of dollars of potential litigation arising out of the LBO by and among the estates, key creditors, and the equity sponsors.[24]

- **Verso**: Like EFH, Verso had a bifurcated capital structure following the consummation of a merger with NewPage approximately one year before the combined company filed for bankruptcy in January 2016.[25] A key issue in the Verso bankruptcy was a Shared Services Agreement between NewPage and Verso under which NewPage made monthly payments to Verso for certain shared corporate services and for realized synergies arising out of the merger. Whether the Shared Services Agreement could be assumed or rejected, and the value of the services being provided under that agreement, were highly contested among Verso and NewPage creditors prior to the bankruptcy. Disinterested directors at NewPage and Verso—represented by independent conflicts counsel at Latham & Watkins and Quinn Emmanuel—negotiated a protocol that avoided costly and destructive litigation at the beginning of the case, paving the way towards a consensual bankruptcy.[26]

F. Multiple Creditors' Committees

1. What is the authority *not* to appoint a statutory creditors' committee for every affiliated debtor under Bankruptcy Code section 1102(a)(1)?

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[22] Mike Spector, *Energy Future Holding Files for Bankruptcy*, THE WALL STREET JOURNAL, April 29, 2014 http://on.wsj.com/1VKh2zu

[23] *In re Energy Future Holdings*, No. 14-10979 (CSS), Docket No. 665, Motion to Employ/Retain Sidley Austin LLP as Special Counsel (Bankr. D. Del. May 29, 2014).

[24] *In re Energy Future Holdings*, No. 14-10979 (CSS), Docket No. 7204, Order Approving Settlement Among Debtors, U.S. EPA, and Certain Other Parties (Bankr. D. Del. Dec. 2, 2015); *In re Energy Future Holdings*, No. 14-10979 (CSS), Docket No. 7204, Order (Amended) Confirming the Sixth Amended Joint Plan of Reorganization (Bankr. D. Del. Dec. 9, 2015).

[25] *In re Verso Corp*., No. 16-10163 (KG) (Bankr. D. Del. Jan. 26, 2016).

[26] *In re Verso Corp*., No. 16-10163 (KG), Docket No. 92, Order (I) Approving Interim Shared Services Agreement Protocol and (II) Granting Related Relief (Bankr. D. Del. Jan. 27, 2016).

2. In the name of efficiency and not allowing chapter 11 cases to be prosecuted for the benefit of professionals, has the pendulum swung too far against appointing more than one statutory creditors' committee, such as in Lehman where many subsidiaries were each among the largest debtors in history?

3. Derivative Standing

    a. *Smart World Technologies, LLC v. Juno Online Services, Inc. (In re Smart World Technologies, LLC)*, 423 F.3d 166 (2d Cir. 2005): Did the bankruptcy court "err in granting Smart World's creditors standing to settle the adversary proceeding between Smart World and Juno, without Smart World's participation and over Smart World's objections? 423 F.3d at 174.

    b. "[W]hile authority to pursue a Rule 9019 motion may, in certain limited circumstances, be vested in parties to the bankruptcy proceeding other than the debtor-in-possession, those circumstances are not present here." 423 F.3d at 174. "We do not rule out that in certain, rare cases, unjustifiable behavior by the debtor-in-possession may warrant a settlement over the debtor's objection, but this is not such a case." *Id*. at 177.

    c. Bankruptcy Rule 9019 and Bankruptcy Code section 323 show that only the trustee and debtor in possession are authorized to bring a settlement motion and be the estate representative. *Id*. at 174. Bankruptcy Code section 1106(a) holds the debtor in possession accountable to maximize value. *Id*. at 175. Derivative standing is available when the debtor in possession unjustifiably fails to bring suit, *In re STN Enterprises*, 779 F.2d 901 (2d Cir. 1985), or the debtor consents, *Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.)*, 262 F.3d 96, 100 (2d Cir. 2001). Bankruptcy Code section 1109(b) allows creditors to intervene in adversary proceedings, not to take ownership of the debtor's claims. *In re Smart World*, 423 F.3d at 182. "[T]he bankruptcy court's power to act pursuant to § 105(a) does not provide an independent basis upon which to grant appellees standing." *Id*. at 184.

4. Is bankruptcy standing different than constitutional and prudential standing?

    a. As opposed to constitutional and prudential standing, in title 11 cases and SIPA proceedings, statutory committees and other parties in interest are routinely granted rights to appear and be heard, which do not always carry with them the right to prevent a settlement among the real parties.

        i. Constitutional standing refers to the need to make sure there is a case and controversy because Article III, section 2 of the U.S. constitution only authorizes the Article III judicial power to be used to resolve cases and controversies. *Valley Forge Christian*

College v. Americans United for Separation, 454 U.S. 464, 475-476 (1982). For lack of lifetime tenure and irreducible compensation, Bankruptcy Courts do not exercise Article III judicial power. Constitutional standing would require a showing of an "injury in fact" that is "concrete," "distinct and palpable," and "actual or imminent." *Whitmore v. Arkansas*, 495 U.S. 149, 155 (1990). The litigant must also establish that the injury "fairly can be traced to the challenged action and is likely to be redressed by a favorable decision." *Id*. "[T]he opposing party also must have an ongoing interest in the dispute, so that the case features 'that concrete adverseness which sharpens the presentation of issues.'" *Camreta v. Greene*, 131 S. Ct. 2020, 2028 (2011) (quoting *Los Angeles v. Lyons*, 461 U.S. 95, 101 (1983)).

ii. The initial standard is met as long as the party alleges a "specific, identifiable trifle of injury," *United States v. Students Challenging Regulatory Agency Procedures*, 412 U.S. 669, 686-90, 690 n.14 (1973), or a "personal stake in the outcome of [the] litigation," *The Pitt News v. Fisher*, 215 F.3d 354, 360 (3d Cir. 2000).

iii. In addition to "injury in fact," the party seeking standing must demonstrate that it has prudential standing requiring the litigant to assert its own, non-abstract, legal rights or interests intended to be protected by the statute, regulation, or constitutional guarantee in issue. *Valley Forge Christian College v. Americans United for Separation of Church and State, Inc.*, 454 U.S. 464, 474-75 (1982).

A. Statutory committees own no claims and are powerless to bind the actual claimholders. There do not appear to be any decisions barring a statutory committee from appearing and being heard on behalf of its constituency on the ground that it did not own or have the right to bind the entities it was representing. But, the bankruptcy courts do impose prudential standing requirements on entities attempting to assert other parties' rights. This has not been used against statutory committees.

b. The Bankruptcy Code, the Bankruptcy Rules, and the jurisprudence recognize two other types of standing. *See, e.g., In re Caldor*, 303 F.3d 161 (2d Cir. 2002) (section 1109 grants right to appear and be heard in any contested matter or adversary proceeding) and *Smart World Technologies LLC, v. Juno Online Services, Inc.*, 423 F.3d 166, 182-83 (2d Cir. 2005) (right to control and settle cause of action distinguished from right to appear and be heard in *Caldor*).

i. There is (a) standing to prosecute or defend, and control settlement of, a cause of action, and (b) standing to intervene, appear, and be

heard. The latter standing is (i) grantable "generally" to "any interested entity" for cause shown pursuant to Bankruptcy Rule 2018(a) in title 11 cases outside chapter 11 and SIPA proceedings removed to the Bankruptcy Court, and (ii) granted specifically by section 1109(a) to parties in interest in chapter 11 cases.

5. Standard for Reviewing United States Trustee's Appointment or Refusal to Appoint Additional Committee

    a. Courts have applied differing standards to reviewing the United States Trustee's appointment of, or refusal to appoint, an additional committee of creditors. *Bodenstein v. Lentz (In re Mercury Fin., Corp.),* 240 B.R. 270 (N.D. Ill.1999) (abuse of discretion); *In re Voluntary Purchasing Groups, 1997 U.S. Dist. LEXIS 4227* (E.D. Tex. 1997) (abuse of discretion or arbitrary and capricious); *In re McLean Indus. Inc.*, 70 B.R. 852, 858-9 (Bankr. S.D.N.Y. 1987) (*de novo* basis); *In re Texaco Inc.*, 79 B.R. 560 (Bankr. S.D.N.Y. 1987) (disbanding additional statutory committee appointed under section 1102(a)(1) on *de novo* basis); *In re Sharon Steel Corp.*, 100 B.R. 767, 774 (Bankr. W.D. Pa. 1989) (vacating UST's appointment of additional statutory committee based on *de novo* review).

G. Subcommittee of a Creditors' Committee

1. Is the creation of a subcommittee solely an internal committee matter, similar to a statutory committee's practice of adopting its own bylaws?

2. Can subcommittees retain separate professionals if their purpose is to advocate for a constituency of the full committee that is adverse to another constituency of the full committee? Would the new professionals qualify under section 328(c)?

H. *Ad Hoc* Groups of Creditors

1. Derivative standing can be granted to *ad hoc* creditor groups, the same as to statutory committees.

2. Debtors can be recused from interdebtor disputes. *In re Adelphia Communications Corp.*, 336 B.R. 610 (Bankr. S.D.N.Y. 2006), *aff'd*, 342 B.R. 122 (S.D.N.Y. 2006).

3. Is Bankruptcy Rule 2019 serving its intended purpose?

    a. Are groups of creditors circumventing Rule 2019 by causing the indenture trustee to retain their chosen law firm, while the *ad hoc* group does not have to appear in court?

4. Does derivative standing carry with it the exclusive power to settle?

I. Sale Monitor / Estate Neutral

1. The Use and Role of a Sale Monitor

Though never mentioned in the Bankruptcy Code, there have been a handful of cases in which a sale monitor or similar entity has been used by the various constituencies to be an independent voice to oversee a sale process.

A good example of this was *In re Philadelphia Newspapers, LLC, et al*., Case No. 09-112047 (SR) (Bankr. E.D. Pa). The selection of the Sale Monitor in that highly contentious case (which raised the issue of whether a lender can credit bid its debt in a sale under a plan of reorganization vs. a 363 sale) arose by way of stipulation among the debtor, the agent for the lending syndicate, the lending syndicate, the creditors' committee and the U.S. Trustee. The terms of the stipulation provided for the U.S. Trustee to select and appoint the Sale Monitor, but when the stipulation was approved by the court, the U.S. Trustee's selection of the Sale Monitor was removed and left to the parties in interest to decide. The selection of the Sale Monitor was done by joint application of those parties in interest under sections 327 and 328 of the Bankruptcy Code and the order granting the joint application "authorized the Parties, through the Debtors and for the benefit of the estate, to employ… the Sale Monitor." The stated services of the Sale Monitor included, without limitation, the monitoring of:

- Due diligence investigation
- Debtors' evaluation and determination of "Qualified Bidders"
- Debtors' evaluation and comparison of bidders, bids, and bid terms
- Debtors' determination of the highest and best bid during the Sale Process and auction
- Debtor's determination and declaration of the Successful Bidder
- All other aspects of the sale and interaction with bidders and prospective bidders

The appointment of the Sale Monitor in *Philadelphia Newspapers* was the result of the distrust of the lenders and Creditors' Committee for the Debtors' sale process and whether the Debtors' investment banker was running a real sale process or being purposely restrained by management in favor of an insider sale.

In another newspaper case, *In re Freedom Communications*, Case No. 8:15-bk-15311-MW (Bankr. C. D. Cal.), the Debtors filed an application to employ an "Independent Sale Representative" under section 327 of the Bankruptcy Code. The Independent Sale Representative was sought by the Debtors due to a pending insider offer to acquire substantially all of the Debtors' assets -- the *Orange County Register*, the *Press Enterprise* and *Unidos*. The application states that the Independent Sale Representative "will serve as the representative of the Debtor's estates and will act on the Debtors' behalf with respect to all aspects of the sale process, including, without limitation, the marketing of the Debtors' assets, the selection of bidders and most favorable bid, the decision making process is connection with such matters…"

The major distinction between the *Philadelphia Newspapers* and *Freedom Communications* cases was that there was already an investment banker for the debtors in the former case, and the Sales Monitor's job was the oversee the sale process. In the *Freedom*

Communications case, however, the Independent Sale Representative *was* the investment banker for the Debtors, but was given the authority to make decisions and bind the debtors – more akin to the role of a Chief Restructuring Officer.

In both cases, the roles of the Sale Monitor and Independent Sale Representative were as estate fiduciaries that answered only to the bankruptcy court. Such is the statutory role of an examiner appointed under section 1104(c) of the Bankruptcy Code, but the independent estate fiduciary appointed to oversee or run a going-concern sale process is not an examiner, and the role is completely different.

2. The Estate Neutral

The concept and role of the independent estate fiduciary is not codified in current bankruptcy law and has led the ABI's Commission to Study the Reform of Chapter 11 to propose, in its Final Report issued in 2014, that a new position be created in chapter 11 cases where appropriate – the Estate Neutral.

The Commission has proposed the following recommended principles for the appointment of an Estate Neutral:

a. The Bankruptcy Code should be amended to delete any reference to an "examiner" and to incorporate the concept of a more flexible "Estate Neutral," as described below.

b. Section 1104(c) of the Bankruptcy Code should be amended to set forth the standards for, and potential authority and duties of, an Estate Neutral, as described below.

c. Section 1104(c) should not mandate the appointment of an Estate Neutral in any circumstances.

d. The court should be permitted to order the U.S. Trustee to appoint an Estate Neutral if (i) a trustee is not appointed and (ii) (a) the appointment is in the best interests of the estate, or (b) for cause.

e. An order directing the U.S. Trustee to appoint an Estate Neutral should specify the scope of the Estate Neutral's duties and the duration of the appointment. The court may direct the U.S. Trustee to appoint more than one Estate Neutral in any given case to serve different functions if necessary or warranted by the circumstances of the case. Nevertheless, the Bankruptcy Code should include a presumption against the appointment of more than one Estate Neutral in any given case.

f. An order directing the U.S. Trustee to appoint an Estate Neutral should not permit the individual to: (i) propose a chapter 11 plan for the debtor; (ii) act as a mediator in any matter affecting the chapter 11 case, unless such action is the primary purpose of the individual's original appointment; (iii) initiate litigation on behalf of the debtor or the estate, unless such action is within the scope of the individual's original appointment and the individual was not previously engaged to investigate or examine matters

relating to the litigation or the debtor's chapter 11 case; or (iv) except as provided in the principles for small and medium-sized enterprise cases, operate the debtor's business.

g. Upon the entry by the court of an order directing the U.S. Trustee to appoint an Estate Neutral, the U.S. Trustee should, in conformity with the procedures established for appointment of a chapter 11 trustee, appoint a disinterested person to serve as the Estate Neutral. A party in interest should have the ability to object to the person appointed as the Estate Neutral under the same procedures and subject to the same standards established in the principles governing objections to the person appointed as the chapter 11 trustee.

These recommendations are practical and would allow the Estate Neutral to be employed in any number of ways in a chapter 11 case, including to oversee a sale process.

The question becomes who should pick and appoint the Estate Neutral. Should it be the U.S. Trustee's office or could it be the debtor or other parties in interest or all of the above? An argument could be made that the U.S Trustee's office should select the Estate Neutral. A similar argument could be made that the parties in interest should select the Estate Neutral as they have a better idea of what each individual expert brings to the table as the independent estate fiduciary. Common ground can be found which provides for the selection of the Estate Neutral by the U.S. Trustee after consultation and approval by the parties in interest.

The concept of the Estate Neutral is a flexible way to insert an independent voice into a situation where the parties in interest in a chapter 11 cannot seem to work together productively for the overall benefit of the estate.