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Congress Should Rewrite The Bankruptcy Examiner Mandate

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Originally enacted in 1978, and largely unmodified since, Section 1104(c)(2) of the Bankruptcy Code mandates the appointment of an examiner when a debtor has over $5 million of unsecured debt.

Today, that threshold is routinely met, particularly in the context of the large retail bankruptcies that have been filed since the onset of the COVID-19 pandemic.

While the appointment of an examiner in Chapter 11 cases is not an extraordinary remedy, it is certainly not a common one. This infrequency is likely caused by two factors: (1) Courts have inconsistently interpreted the mandate contained in Section 1104(c)(2); and (2) creditors' committees, in many cases, are well-equipped to conduct the requisite investigation into prepetition conduct.

The questions become then: What is the utility of the current mandate if the appointment of an examiner under Section 1104(c)(2) is left to the discretion of the bankruptcy court, and if in fact there is no discretion, is it time for Congress to rewrite the statute to reflect what is a growing, and perhaps more importantly, pragmatic approach to the use of examiners in Chapter 11?

Title 11 of the U.S. Code, Section 1104(c)(2) provides that

> 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 ... the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000.

Multiple courts, including the U.S. Court of Appeals for the Sixth Circuit, the only circuit court to decide the issue, have held that the use of the word "shall" mandates the appointment of an examiner if the $5 million unsecured debt threshold is satisfied.[1]

The minority view, primarily coming from the bankruptcy court in Delaware, holds that Section 1104(c)(2) does not automatically require the court to appoint an examiner if the $5 million unsecured debt threshold is met.[2]

These decisions note that the statute requires the appointment of an examiner "to conduct an investigation of the debtor as is appropriate." Under these cases, the bankruptcy court always retains the discretion to refuse to appoint an examiner if there is no appropriate investigation to be conducted.

However, even courts that hold that examiner appointment is mandatory when the debt threshold is met acknowledge that the bankruptcy court has considerable discretion in designing — or constraining — the examiner's role.[3]

Bankruptcy courts in Texas have reconciled the seemingly mandatory language "shall order" with the discretionary language "as is appropriate" and found that examiners with no duties may be appointed.[4] Those cases hold that the appointment of an examiner is mandatory where the $5 million unsecured debt threshold is satisfied, but the scope of the examiner's duty, i.e., what is appropriate, is discretionary.

Accordingly, the scope of an examiner's authority can vary widely, depending on the order of the appointing court. The Bankruptcy Code provides substantial latitude for the court to either expand or contract the examiner's authority, and the courts should take advantage of this to fit the needs of each case.

In some instances, the estate may be best served by the examiner's investigation being limited to particular topic areas, such as potential avoidance actions, specific transactions involving the debtor or insiders, solvency analysis, valuation, or evaluation of proposed settlements.

For example, In re: Lyondell Chemical Co., the court approved an examiner request but limited the scope of the examiner's investigation to focus only on a proposed rights offering.[5] After the examiner's report was filed, the court determined that the rights offering posed no cause for concern and denied a request filed by unsecured creditors who sought to expand the examiner's role.[6]

Courts can also limit the duration or budget for the examiner's investigation where an extensive examination would be an unnecessary drain on estate resources.

In the U.S. District Court for the Southern District of New York case In re: Parmalat USA Corp., the court appointed an examiner but limited the investigation to two weeks and provided only a $5,000 budget.[7]

More recently, in In re: Neiman Marcus Group Ltd., Chief Bankruptcy Judge David Jones of the Southern District of Texas stated that he found no merit for an examiner, but, after a six-hour hearing, was ready to appoint one under Section 1104(c)(2) because he felt it was mandatory.[8] However, he stated that he would give the examiner a budget of only $100,000 and limit the investigation to three weeks.[9] In response, the motion was withdrawn.[10]

The reluctance to appoint an examiner illustrated above likely flows from a concern for the conservation of estate resources. The creditors' committee, which is appointed in every Chapter 11 case, almost always is, or should be, well-equipped to conduct its own investigation, using, inter alia, Rule 2004, into

any prepetition misconduct that may lead to a recovery for the estate.

As noted by one court, "[t]he appointment of an examiner would be inappropriate if ... an appropriate and thorough investigation has already been conducted (or is nearly complete) by a creditors committee or a governmental agency."[11]

Courts have recognized that in such cases, an examiner would be duplicative and constitute a waste of estate resources, particularly where the examiner is permitted to retain her own professionals.

The Southern District of New York's decision In re: Loral Space & Communications Ltd. provides an example of how a court reconciled work that had already been completed by the creditors' committee with a motion requesting an examiner to be appointed to duplicate that work. There, the court ordered that an examiner should be appointed to review the valuations already conducted by the debtors and the creditors' committee to determine whether appropriate procedures were followed in their valuations.[12]

Another possibility is to put the examiner in an oversight role, as the U.S. Bankruptcy Court for the Southern District of New York did in In re: Cenveo Inc., allowing the creditors' committee or independent committee of the debtors' board to conduct an investigation with the examiner supervising to ensure that the investigation is thorough and conducted in good faith.[13]

There, the examiner was tasked with filing a report at the conclusion of those investigations regarding whether the respective examinations were comprehensive and whether the resulting assessments and conclusions were reasonable.[14]

Examiners have also been utilized in noninvestigatory roles. For example, examiners have been appointed to both investigate potential avoidance actions and to actually file and prosecute actions to recover avoidable transfers;[15] to provide closer supervision of the debtors in the course of their dealings;[16] and to serve as mediator between the debtor and creditors in plan negotiations.[17]

There should be no debate that in the right circumstance, the appointment of an examiner can aid in maximizing the return to the debtor's creditors. The question is whether the appointment of an examiner is mandatory in all cases where the $5 million unsecured debt threshold is satisfied, which would be in almost every retail Chapter 11 case, or whether the appointment is left to the discretion of the bankruptcy court.

Irrespective of the answer, the debate over whether the appointment is mandatory or discretionary can waste valuable time and precious resources.

It is thus time for Congress to clarify the circumstances under which an examiner must, or should, be appointed, and in so doing, amend the statute to reflect the realities of today's corporate Chapter 11 practice — i.e., where rigidity in the application of Section 1104(c)(2) can lead to duplication and waste, and discretion enables the bankruptcy court to enact the creative solutions that are key to maximizing value for the estate.

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[1] See In re Revco D.S., Inc., 898 F.2d 498, 500-501 (6th Cir. 1990); In re Loral Space & Commc'ns Ltd., 2004 WL 2979785, at *5 (S.D.N.Y. Dec. 23, 2004); In re UAL Corp., 307 B.R. 80, 84 (Bankr. N.D. Ill. 2004); In re Big Rivers Electric Corp., 213 B.R. 962, 965-966 (Bankr. W.D. Ky. 1997); In re The Bible Speaks, 74 B.R. 511, 514 (Bankr. D. Mass. 1987); In re 1243 20th Street, Inc., 6 B.R. 683, 685 n.3 (Bankr. D.D.C. 1980); In re Lenihan, 4 B.R. 209, 211 (Bankr. D.R.I. 1980).

[2] See In re Spansion, Inc., 426 B.R. 114, 127-28 (Bankr. D. Del. 2010); In re Visteon Corp., No. 09-11786(CSS) (Bankr. D. Del. May 12, 2010), ECF. No. 3145, Hr'g Tr. at 170:16-20 (holding that "it would be an absurd result to find that in every case where the financial criteria is met and a party-in-interest asks, the Court must appoint an examiner. There has to be an appropriate investigation that needs to be done."); In re Am. Home Mortg. Holdings, Inc., No. 07–11047(CSS) (Bankr. D. Del. Oct. 31, 2007), ECF No. 1997, Hr'g Tr. at 76:09–12 (holding that even when the threshold in section 1104(c)(2) is met, "the other piece of the puzzle is that there has to be an investigation to perform that's appropriate"); In re Washington Mutual Inc., No. 08-12229 (MFW) (Bankr. D. Del. May 5, 2010), ECF No. 3699, Hr'g Tr. at 97:9–13 (holding that "if the Court determines that there's no appropriate investigation that needs to be conducted, the Court has the discretion to deny the appointment of an examiner"); see also In re Residential Capital, LLC, 474 B.R. 112, 120 (Bankr. S.D.N.Y. 2012) (appointing an examiner, but noting that "[t]he 'as is appropriate' language permits a bankruptcy court to deny appointment of an examiner in limited circumstances even if the debtor has $5 million in fixed debts.")

[3] See Revco, 898 F.2d at 501 ("the bankruptcy court retains broad discretion to direct the examiner's investigation, including its nature, extent, and duration"); Loral, 2004 WL 2979785, at *5 ("[I]t is well established that the bankruptcy court has considerable discretion in designing an examiner's role.") (quotations and citation omitted).

[4] See In re Erickson Retirement Communities, LLC, 425 B.R. 309, 317 (Bankr. N.D. Tex. 2010); In re Asarco, LLC, Case No. 05-21207 (Bankr. S.D. Tex. Mar. 4, 2008), ECF. No. 7081.

[5] In re Lyondell Chemical Co., Case No. 09-10023 (Bankr. S.D.N.Y. Oct. 28, 2009), ECF No. 3148.

[6] Id., ECF No. 3705 (Jan. 27, 2010).

[7] See In re Parmalat USA Corp., Case No. 04-11139 (Bankr. S.D.N.Y. May 17, 2004), ECF No. 383.

[8] In re Neiman Marcus Group Ltd., Case No. 20-32519 (Bankr. S.D. Tex. May 29, 2020), ECF No. 827, Hr'g Tr. at 188:21-189:24.

[9] Id. at 194:12-17.

[10] Id. at 196:8-15.

[11] In re Residential Capital, LLC, 474 B.R. 112, 121 (Bankr. S.D.N.Y. 2012) (citing Washington Mutual,No. 08-12229 (MFW), ECF No. 3699, Hr'g Tr. at 98:12–100:21 (examiner motion denied where the debtor had been "investigated to death," and where the cost would be high with little ascertainable benefit to parties in the case)).

[12] Loral, 2004 WL 2979785 at *5.

[13] In re Cenveo Inc., Case No. 18-22178 (Bankr. S.D.N.Y. March 15, 2018), ECF No. 203.

[14] Id.

[15] See In re Patton's Busy Bee Disposal Service Inc.,182 B.R. 681 (Bankr. W.D.N.Y. 1995).

[16] See In re Adelphia Communications Corp., 336 B.R. 610, 652-53 (Bankr. S.D.N.Y. 2006).

[17] See In re Enron Corp., 326 B.R. 497, 499 n.5 (S.D.N.Y. 2005); see generally 7 Collier on Bankruptcy ¶ 1104.03[1] (16th ed. 2020).