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BANKRUPTCY REORGANIZATION: LEGAL DYNAMICS ASSOCIATED WITH ECONOMIC DISCONTINUITY

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Introduction

In a competitive economic world, it is often the case that businesses fail and become insolvent. 1 If insolvent businesses are not protected by a specialized legal system, the creditors of the debtor will break the businesses up by liquidating them on the auction block according to the traditional non-bankruptcy law. If a business is liquidated, the value of the business as a productive whole will be lost; the workers and the managers are likely to lose their jobs. The creditors may find that the liquidation value of the debtor’s assets is insufficient to repay more than a fraction of their claims; unsecured creditors will often receive nothing. If the creditors are not paid in full in liquidation, there will be nothing left for the equity shareholders. The destruction of value caused by business liquidation will accordingly reduce the total wealth of society. 2 Keeping a failing business in operation, therefore, will often be, economically and socially, much more efficient and desirable than liquidating it.

For this reason, most legal regimes have their own legal rules dealing with the consequences of business failures even though the rules do not necessarily constitute a

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1 There are two kinds of insolvency: “balance sheet” insolvency and “equity” insolvency. A debtor is insolvent in the balance sheet sense if the sum of the debtor’s debts exceeds the value of the debtor’s assets. A debtor is insolvent in the “equity” sense if the debtor is unable to pay its debts as they become due regardless of the debtor’s ability to pay. In this article, the term “insolvency” is used in the balance sheet sense, unless otherwise identified.

2 In addition, the loss of jobs causes additional social costs such as increased unemployment insurance payments and decreased tax revenues. Although it is possible that other business entities with similar positions may eventually employ all or part of the workers and managers, this does not happen immediately, and it is not cost-free. In the long run, society will pay a price for the liquidation of a business. This view is
formal bankruptcy system. In 1978 Congress promulgated the United States Bankruptcy Code, which is also based on the premise that reorganization is often more desirable and economical than liquidation. When Congress created Chapter 11 of the Code, it envisioned that financially distressed businesses could use Chapter 11 as a tool to reorganize and to continue their operations as a viable concern. The House committee report emphasized that “[t]he purpose of a business reorganization case, unlike a liquidation, is to restructure a business’s finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders.”

However, business rehabilitation is not cost-free. First, the debtor needs additional resources to emerge from financial distress and continue its business as a viable concern. Before filing a bankruptcy petition, the debtor may have scaled back its operation and undertaken other internal restructuring, but may be failing nonetheless. It cannot increase cash flow any further from internal restructuring. Resources necessary for the debtor to survive then can only be obtained through an external infusion of capital. In most cases, except the rare cases where the security equity holders invest new capital, there are no sources other than the creditors that can bear the risks of new capital infusion. Under the

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7 Most of the economic resources necessary for debtor rehabilitation and the administration of a case are obtained in exchange for creditors’ losses. For example, the allowance of cross-collateral places financial risks on creditors. Case law shows that “major protections for secured and unsecured creditors in bankruptcy are being limited so that creditors can be forced involuntarily to infuse resources into troubled firms.” Paul B. Lewis, Bankruptcy Thermodynamics, 50 Fla. L. Rev. 329, 332 (1998). Such resource infusion is made possible by deviating from creditors’ expectations of their legal rights, either by changing contracts or limiting the creditors’ rights established under non-bankruptcy law. Id. The “automatic stay,”
Code, most such economic resources can, therefore, be obtained in exchange for creditors' losses. For example, discharge relieves the debtor of future financial burdens in exchange for creditors' financial losses, including the principal of the loan and its interest. Second, the administration of the case also involves costs. These costs include legal, accounting, investment banking, and debtor in possession fees and expenses. The administrative costs, which should be paid prior to secured credits, reduce the debtor's assets that would otherwise be available for distribution to the creditors. The total amount of these bankruptcy-related costs averages 10 to 20 percent of the debtor's prepetition value.

If a reorganization case ends up in success, keeping the debtor in operation as a viable concern, such costs eventually born by the creditors can be justified to some extent because the costs were contributed to promote social benefit. The reorganization scheme presupposes that the creditors' economic loss and attendant misuse of resources are inevitable for the purpose of debtor rehabilitation. The Supreme Court also recognizes the same consequence, stating that "[t]he fundamental purpose of reorganization is to

which was designed to give the debtor a breathing spell, also incurs lost opportunity costs to certain creditors. See, e.g., United Savings Association v. Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365 (1988) (holding that an undersecured creditor is not entitled to the compensation for its inability to seize and sell collateral). In Timbers, the Supreme Court held that an undersecured creditor is not entitled to the compensation for its inability to seize and sell collateral.

10 See generally, Lewis, supra note 8, at 359-64. Under the "social benefit view," business reorganization law has a special role distinct from that of state law, which is designed primarily to protect the creditors' interests. Id. at 359. The goals of bankruptcy reorganization law, while protecting creditors' interests, should also include enhancing or at least preserving the value of a debtor; protecting certain parties considered socially worth protecting, such as employees; establishing a means to collectivize debt collection; and determining how to allocate the debtor's existing value. Id. at 359-60. See also Douglas G. Baird, Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren, 54 U. Chi. L. Rev. 815, 816 (calling the "social benefit view" the "traditional view" of bankruptcy policy).
prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.”¹¹

If, however, the reorganization efforts fail to make the debtor emerge from financial distress, the time and money spent on the administration of the case would be considered merely wasted. The creditors must nonetheless bear such costs. The loss born by the creditors would, theoretically, be the difference between the liquidation value at the time of filing and the value actually distributed to the creditors group after the unsuccessful reorganization efforts. The amount of the costs incurred by a failing reorganization is up to 10 to 20 percent of the debtor’s prepetition assets. Moreover, according to an empirical study, fewer than 30 percent¹² of the cases filing for reorganization relief culminated in success.¹³ Indeed, the costs incurred by failing reorganizations and born by the creditors group are significant enough to damage not only the creditors but also the public trust in bankruptcy reorganization law.¹⁴ Creditor protection becomes much more crucial in cases where the reorganization efforts end up in vain.¹⁵

¹² According to the case statistics of the Executive Officer for the U.S. Trustee (EOUST), among the Chapter 11 cases of all sizes filed in 15 judicial districts from 1989 through 1995, fewer than 30 percent of the cases resulted in a confirmed plan of reorganization. David P. Bart & Scott Peltz, Rethinking the Concept of “Success” in Bankruptcy and Corporate Recovery, 17-May Am. Bankr. Inst. J. 1, 34 (1998).
¹³ This thesis considers a reorganization case to be successful if a plan of reorganization has been confirmed, unless otherwise specified. If “success” is defined as the achievement of the results sought or the avoidance of negative results, by the debtor at the time of filing, the success rate for Chapter 11 cases is different. Reorganization cases voluntarily dismissed after the debtor achieved its goals in filing average approximately 40 percent of the reorganization cases surveyed. Hon. Samuel L. Bufford, What is Right About Bankruptcy Law and Wrong About Its Critics, 72 Wash. U. L. Q. 829, 833 (1994). For various definitions of success, see Lynn M. LoPucki & William C. Whitford, Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies, 78 Cornell L. Rev. 597, 599-600 (1993).
This thesis attempts to discover the factors leading to such failures and to propose a cure. It argues that the basic structure of Chapter 11 of the Code, the debtor in possession structure, is one of the essential factors causing such a high rate of failure. The thesis further asserts that it is possible to reduce the rate of unsuccessful reorganization if the bankruptcy court exercises its power of case management more actively and expeditiously. For example, the court can screen the debtors' filing for relief before the reorganization case proceeds too far. The court can also order the appointment of a trustee unless it is convinced that such an appointment is useless. The debtor screening role of the court, if exercised appropriately, can prevent debtors that are not worth reorganizing from coming into the process, reducing the costs considerably. Appointment of a trustee, on the other hand, removes improper management while keeping viable businesses in operation, thereby also reducing the costs.

Chapter II of this thesis examines the basic structure of Chapter 11 of the Code, the debtor in possession construct, to discover the factors leading cases to failure. This chapter argues that most of the failing cases have resulted from problems connected to the debtor in possession structure. In the ordinary course of events in most Chapter 11 cases, while the debtor continues to operate its business and manage its property as an entity known as the debtor in possession, its creditors suffer, for example, a lack of necessary

have a going concern value worth saving. Theodore Eisenberg & Shoichi Tagashira, Should We Abolish Chapter 11? The Evidence From Japan, 23 J. Legal Stud. 111, 154 (1994).


This view emphasizing the bankruptcy courts' active role in the administration of a case is called the traditionalist's view, as compared to the proceduralist's view, which focuses on procedure and the function
information about the debtor’s financial conditions. Moreover, they are often apathetic to the reorganization of the debtor because of, in part, the relatively high cost of participation compared to their claims. Under Chapter 11, the debtor in possession not only exercises its wide discretion in operating the business, but also enjoys the exclusive right to propose a plan for at least 120 days.\textsuperscript{17} As a result, the debtor in possession has many incentives to take advantage of the process, such as abuses of the automatic stay and other strategies delaying the process. That, to some extent, explains why so many businesses filing for reorganization relief fail to reorganize or fail to survive the financial difficulties even after the plan has been confirmed.

Chapter III discusses the provisions restricting such discretion of the debtor in possession. Under the Code, there are several institutional devices restricting the debtor in possession’s seemingly absolute discretion. They include the court’s powers administrating the case and limiting the discretion of the debtor in possession;\textsuperscript{18} the creditors’ committee and the United States Trustee monitoring the debtor in possession;\textsuperscript{19} and the potential of the appointment of a trustee or an examiner. In addition, a debtor in possession is a fiduciary for the creditors of the estate;\textsuperscript{20} therefore, it has a duty to preserve and protect the assets of the estate\textsuperscript{21} while prosecuting the case expeditiously.\textsuperscript{22}

Among the restricting methods, Chapter III deals mainly with the mandatory creditors’

\textsuperscript{17} 11 U.S.C. Section 1121(b) (1994).
\textsuperscript{18} See 11 U.S.C. Section 1107(a); 5 Collier on Bankruptcy ¶ 1107.1-1107.3 (Lawrence P. King et al. Eds., 15\textsuperscript{th} ed. 1991); \textit{In re McClure}, 69 B.R. 282, 289-90 (Bankr. N.D. Ind. 1987).
committee and the fiduciary duties of the debtor in possession. Other restricting methods will be discussed in detail in the following chapters.

Promulgating the Code in 1978, Congress thought the mandatory unsecured creditors’ committee would curb the debtor in possession’s powerful discretion. However, the creditors’ committee has proved to be an inadequate safeguard. In order to achieve a balance between the debtor and its creditors and to make the reorganization procedure more efficient and fair, Congress granted the bankruptcy courts a stronger equity power than ever by revising Section 105 of the Code in 1986 and again in 1994. The purpose of the revisions was to eliminate the possibility of the debtor’s stratagems damaging the creditors.

The bankruptcy courts’ strong equity powers along with other statutory powers are the issues discussed in Chapter IV. Under the Code, the bankruptcy court is limited to its judicial functions, leaving the case management task to the United States Trustee. However, subsequent to the Code’s promulgation in 1978, the need for the court’s active participation in the process has been called for. Accordingly, the court’s decisions have recognized, for example, the debtor screening function of the court, such as the good faith filing requirement. Other methods testing the debtor’s eligibility for reorganization include, among others, creditors’ relief from the stay\(^\text{23}\) and the conversion and dismissal of a case for “cause.”\(^\text{24}\) These methods will, if exercised appropriately, prevent debtors not deserving reorganization from continuing futile yet expensive reorganization efforts, thereby reducing unnecessary costs. In addition, the court can order the appointment of a

\(^{22}\) \emph{In re Van Brunt}, 46 B.R. 29, 30 (Bankr. W.D. Wis. 1984).


\(^{24}\) 11 U.S.C. Section 1112(b) (1994).
trustee or an examiner. If appointed, the trustee normally replaces the debtor in possession and can redress the problems caused by the current management. An examiner, on the other hand, can help the court and creditors make appropriate decisions by giving them necessary information about the debtor’s management and financial conditions.

Chapter V of the thesis discusses the roles of the trustee and the examiner in the reorganization process. A trustee replaces the debtor in possession, managing the day-to-day operation of the debtor, and investigates the debtor’s management and financial situations with expertise, thereby helping the creditors and the court make appropriate decisions. It is often difficult to recognize the viability of a business apart from the management, especially in closely held small businesses. Therefore, the removal of incompetent or dishonest management, for instance, is crucial for the success of a reorganization case. It is likewise often the case that the appointment of a trustee brings about the conversion of the reorganization case to a Chapter 7 liquidation case. This implies either that the debtor should have been liquidated earlier or at least that the prior management was inappropriate to manage the business.

Chapter VI concludes that if the bankruptcy courts more actively exercise their equity power or discretion, the costs that creditors and the society eventually have to pay will decrease dramatically. Taking into consideration the results that failing cases would bring about, it is obvious that nonviable debtors and those abusing the automatic stay should be eliminated at an early stage of the procedure.

25 See generally Donald R. Korobkin, Vulnerability, Survival, and the Problem of Small Business
Chapter I

The Basic Structure of Chapter 11

A. Balancing Conflicting Interests

The Chapter 11 process represents "a remarkable conciliation of interests."26 In a reorganization case, for example, the debtor has an interest in its own effective rehabilitation,27 while its creditors have an interest in the recovery of their claims in proportion to the recovery of other creditors.28 A successful reorganization of the debtor is, in this context, directly connected to those of its managers, officers, and other employees as well as its equity shareholders. These interests are often contradictory; creditors' recovery against the debtor may, as a matter of course, detrimentally affect the possibility of successful debtor rehabilitation, for example. Chapter 11 attempts to reconcile these competing interests in a balanced manner under specialized collection rules.

In promulgating Chapter 11 of the Code in 1978, Congress intended to balance these two competing interests of the parties by giving them an arena in which the parties negotiate and bargain. Therefore, whatever the eventual outcome of the bargain, the debtor and its creditors themselves ultimately determine the deployment of the assets of

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28 See, e.g., In re Whitman, 101 B.R. 37, 38 (1989). Creditors in general are not necessarily interested in maximizing the debtor's viability. Mark J. Roe, Bankruptcy and Debt: a New Model for Corporate
the estate and produce the plan.\textsuperscript{29} Chapter 11 adopted the idea that, with appropriate oversight and an effective committee of creditors, the debtor itself would be best suited to reorganizing the failing business. With the leading role assigned to the debtor in possession, Chapter 11 devised the mandated statutory committee of unsecured creditors. The committee is the primary counterpart to the DIP, having the right and duty to negotiate a reorganization plan with the DIP. Chapter 11 is thus based on the assumption that the dynamics between the creditors' committee and the DIP would produce the necessary resources and incentive to effect the efficient and successful reorganization of the debtor.

Under Chapter 11, while the DIP and its creditors negotiate and bargain over a reorganization plan, the bankruptcy court, by and large, loosely oversees the lengthy bargaining process. In principle, the court cannot be actively involved in the administration of the cases. Rather, the court's role is limited to that of an adjudicator of actual controversies requiring judicial intervention. Reorganizations are not assumed primarily to be the outcome of the judicial process,\textsuperscript{30} but reflect the persuasive power in the negotiation process held by the disputing parties themselves. As a result, the role of the bankruptcy court or the judge can be reduced to that of a bystander if the negotiating parties mutually agree on the terms of the reorganization plan.\textsuperscript{31} Congress thought that the dynamics between the DIP and creditors, but not the court, would work best in balancing


the competing interests, thereby achieving the policies underlying Chapter 11 of the Code.

Unexpectedly, however, since 1978, the need for efficiency in Chapter 11 cases has called for the court’s more active involvement in the administration of the cases. This trend has arisen partly because creditors were often apathetic in overseeing the DIP. The bankruptcy court thus had to participate in the process actively in order to complement the creditors’ supervisory deficiencies. In United Savings Association v. Timbers of Inwood Forest Associates, Ltd., 32 The United States Court of Appeals for the Fifth Circuit stated that bankruptcy judges are, to a certain extent, required to be involved in the management of Chapter 11 cases:

Early and ongoing judicial management of Chapter 11 cases is essential if the Chapter 11 process is to survive and if the goals of reorganizability on the one hand, and creditor protection, on the other, are to be achieved. In almost all cases the key to avoiding excessive administrative costs, which are borne by the unsecured creditors, as well as excessive interest expense, which is borne by all creditors, is early and stringent judicial management of the case. We recognize that Congress, in 1978, amended the bankruptcy laws with the intention of removing bankruptcy judges from the administration of the debtor’s estate. The purpose of this amendment was to insure the impartiality of the bankruptcy judges. We do not believe, however, that Congress thereby intended to relieve the bankruptcy judge of the responsibility of managing the cases before him in such a way to promote the objectives and goals of the Bankruptcy Code. 33

Beside the court’s role in case management to expedite the process and reduce the costs, the abuse of the process by the DIP calls for the court’s active participation in the process. According to an empirical study, 34 corporate managers, in most cases surveyed, abused bankruptcy law to protect their positions and the wealth of the insider

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32 In re Timbers of Inwood Forest Associates, Ltd. 808 F.2d 363 (5th Cir. 1987), aff’d, 484 U.S. 365 (1988).
33 Id. at 373 (footnotes omitted).
shareholders of a corporation.\textsuperscript{35} Even though what the study shows may not be a universal phenomenon and leaves "large areas of uncertainty and contention,"\textsuperscript{36} it sheds some important light on the cost and effectiveness of business reorganization. The study demonstrates how much the DIP structure of Chapter 11 is susceptible to abuse by the debtor's management.

As discussed above, the basic scheme of Chapter 11 is analogous to the civil adversary system.\textsuperscript{37} The goals of the adversary system are to discover the facts (in reorganization cases the "facts" can be "value maximization") on which the dispute is based and, if appropriate, redress losses.\textsuperscript{38} The system relies upon two fundamental attributes: party control and an independent decision-maker.\textsuperscript{39} Under the system, the parties weave the process out of their actions and responses, with the expectation that a vigorous interchange (the "interchange" is analogous to "negotiation" in reorganization cases) between them will lead to an optimal result.\textsuperscript{40} The traditional decision-maker, the court, instead remains relatively passive.\textsuperscript{41} In order for the adversary system to succeed, the adversaries should be equally able to obtain information and to present the case to the court.\textsuperscript{42} In reorganization cases, however, the creditors are many in number, and their interests are diverse. They are often apathetic to the case and, more importantly, unable to

\begin{footnotes}
\footnotetext{35}{Id. at 1076.}
\footnotetext{36}{Donald R. Korobkin, The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenweig, 78 Iowa L. Rev. 669, 735 (1993).}
\footnotetext{37}{The adversary system is a principle deeply rooted in Anglo-American law and originated from the concepts of ordeal, battle, and wager of law. Zipes, infra note 38, at 1113 & n. 14.}
\footnotetext{38}{Greg M. Zipes, Discovery Abuse in the Civil Adversary System: Looking to Bankruptcy's Regime of Mandatory Disclosure and Third Party Control over the Discovery Process for Solutions, 27 Cumb. L. Rev. 1107, 1112 (1996-1997) n. 13.}
\footnotetext{39}{Id., at 1112.}
\footnotetext{40}{See id.}
\footnotetext{41}{See id.}
\footnotetext{42}{Id. at 1113.}
\end{footnotes}
obtain needed information about the financial or economic situation of the debtor. In contrast, under the DIP structure of Chapter 11, in which the controlling power in reorganization is assigned to the DIP, the DIP can exercise its wide discretion while operating the ordinary businesses of the debtor and making bankruptcy decisions. The wide discretion of the DIP and unbalanced access to information are the main factors that often lead a case to failure and as a result waste time and money.

B. The Debtor in Possession Construct and Its Efficiency

1. The Debtor in Possession Concept

In most Chapter 11 cases, the debtor, as DIP, remains in possession of the business and continues to oversee operation of the ongoing business. Bankruptcy courts also have recognized a strong presumption that the debtor is entitled to remain in possession of the estate. In addition to operating the business, the DIP retains the exclusive right to propose a reorganization plan for at least 120 days after the commencement of the case. The DIP retains significant control over both the business and the reorganization of the business.

With respect to legal status or entity, the DIP is regarded as the same entity as the debtor. In other words, the DIP is the preexisting debtor with modified rights and

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44 See, e.g., Committee of Dalcon Shield Claimants v. A.H. Robins Co., 828 F.2d 239 (4th Cir. 1987).
46 The courts’ opinions have been divided on whether the DIP is a separate entity or the same entity as the debtor. Recently, courts’ decisions seem to reject the “separate entity theory” at least as a universally applicable concept. See In re Chapel Gate Apartments, Ltd., 64 Bankr. 569, 576 (Bankr. N.D. Tex. 1986); N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984); In re Triangle Chemicals, Inc., 697 F.2d 1280, 1290 (5th Cir. 1983); In re Unishops, Inc., 543 F.2d 1017, 1018-19 (2d Cir. 1976). See generally Stephen McJohn, Claims & Opinions: Person or Property? On the Legal Nature of the Bankruptcy Estate, 10 Bankr. Dev. J. 465 (1994).
obligations. Section 1101(1) defines the DIP as the debtor unless a trustee has been appointed,\textsuperscript{47} and Section 101(12) defines the debtor as “the person or municipality concerning which” a Chapter 11 case has been filed.\textsuperscript{48} In the question of who controls the business and the direction of the proceedings, the DIP refers to the management of the business including managers, directors, and other officers.\textsuperscript{49}

2. Historical Background

Prior to the Bankruptcy Reform Act of 1978, a DIP was allowed only in small businesses. Under the Bankruptcy Act of 1898,\textsuperscript{50} reorganization law included two different forms of relief: Chapter X and Chapter XI. Chapter XI had a relatively simple procedure for restructuring unsecured debts, primarily intended for use by smaller businesses.\textsuperscript{51} Under Chapter XI, the current managers, often the owners of the business, retained control of the company and had substantial autonomy in operating the business and creating the terms of a reorganization plan. In contrast, Chapter X was intended for use by corporations with more complex capital structures.\textsuperscript{52} It represented a more complicated procedure, which restricted the influence of former management and afforded substantial protections to the creditors both in the administration of the estate

\textsuperscript{48} See id. Section 101(12).
\textsuperscript{50} The Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (repealed in 1978) [hereinafter the “Act”].
and in the formulation of a plan.53 Under Chapter X, a trustee was always appointed, replacing the current management. The trustee had broad powers to investigate past fraud and mismanagement in addition to the power to operate the business.54 In 1978, Congress unified the aspects of Chapter X and XI of the Act into Chapter 11 of the Code.55 Chapter 11 of the Code adopted the rule of Chapter XI, which generally allowed corporate managers to remain in possession of the business and have the right to formulate a plan.

This ability of management to retain control of the business during a reorganization case is part of an effort to increase the effectiveness of the reorganization under Chapter 11. When Congress promulgated this Chapter, it presumed that managers were basically honest, competent, and familiar with the business and its constituencies, which in general made them more qualified than a trustee in operating the business.56 Congress also thought that the rule requiring appointment of a trustee in Chapter X cases brought about undesirable results. Managers of larger corporations, losing confidence in remaining in their positions, often tried to file for bankruptcy relief under Chapter XI instead of Chapter X, or delayed filing for relief altogether until the corporation lost its viability and therefore became unable to reorganize.57 By allowing managers to remain in control of the business under Chapter 11, Congress wanted to encourage managers to file for bankruptcy reorganization earlier while the business was viable and thus offer the failing business a better chance for survival. Moreover, some commentators have suggested that even the creditors will often prefer to deal with managers they are familiar with in order

54 Id.
55 The Code also reflects aspects of Chapter XII of the Act, which was applied to real property arrangements of non-corporate debtors. House Report, supra note 51, at 223-24.
to save the time and expenses necessary to educate a trustee or other third party about the business and the problems involved.\textsuperscript{58}

3. Roles of the Debtor in Possession

Upon commencement of proceedings for reorganization under Chapter 11 of the Code, current management continues to operate its business as a DIP unless a trustee is appointed.\textsuperscript{59} For most purposes, the managers of the business control.\textsuperscript{60} With some exceptions,\textsuperscript{61} the DIP has all the rights and powers, and performs all the functions and duties, of a trustee appointed in a case under the Code.\textsuperscript{62} Unlike a trustee, however, there is a strong presumption in favor of the DIP continuing to operate the business unless management is incompetent or dishonest.\textsuperscript{63} The DIP thus not only continues the ongoing operation of the business, but it also is the driving force behind the negotiation and formulation of the reorganization plan.\textsuperscript{64}

The DIP continues to engage in the transactions that arise in the ordinary course of the debtor's business unless the bankruptcy court orders otherwise.\textsuperscript{65} The transactions include

\textsuperscript{56} Id. at 233.
\textsuperscript{57} Id. at 233-34.
\textsuperscript{58} See Peter F. Coogan et al., \textit{Comments on Some Reorganization Provisions of the Pending Bankruptcy Bills}, 30 Bus. L., 1149, 1156 (1974).

\textsuperscript{59} 11 U.S.C. Sections 1104(a), 1107(a) (1994). \textit{See also WWG Industries, Inc. v. United Textiles, Inc. (In re WWG Industries, Inc.), 772 F.2d 810, 811 (11th Cir. 1985)} (upon the filing of the Chapter 11 petition, the debtor obtains the title "debtor-in-possession").

\textsuperscript{60} For purposes of this thesis, both the officers and the directors are considered to be part of the management of the debtor. Nimmer & Feinberg, \textit{supra} note 49, at 21 (describing management as "the officers, directors, retained professionals and business managers").

\textsuperscript{61} The exceptions are related principally to the right to compensation and the investigative functions of a trustee. \textit{See} 11 U.S.C. Section 1107(a) (1994). \textit{See also Practising Law Institute, Reorganization Under the Bankruptcy Code-Chapter 11, 776 PLI/Comm 925, 928 (1998)}.

\textsuperscript{62} 11 U.S.C. Section 1107(a) (1994). The Code prescribes a trustee's rights, powers, and duties first and then, for convenience, quotes the provisions regarding a trustee to the DIP.


\textsuperscript{65} 11 U.S.C. Section 363(c)(1) (1994).
the use, sale, or lease of the property of the estate.\(^{66}\) Only those actions arising outside the ordinary course of business require the bankruptcy court’s approval in advance. A DIP’s business decisions, if they are based on the exercise of rational business judgment, will not be intervened.\(^{67}\) Under the business judgment test, a DIP will be found to have exercised proper business judgment when its act involves a business judgment made in good faith on a reasonable basis, within the scope of its authority.\(^{68}\) Keeping the business in operation is essential for the debtor in reorganizing the business successfully because it gives the DIP time to reorganize and preserves the going concern value of the business while the case lasts.

In addition to engaging in the day-to-day business, the DIP has rights and powers related to enhancing or preserving the value of the bankruptcy estate. For instance, parties holding property of or owing money to the debtor’s estate must turn it over to the debtor,\(^{69}\) and the DIP may void certain unperfected transfers and transfers for less than reasonably equivalent value.\(^{70}\) The DIP may also seek to recover certain payments or security interests that were made before the bankruptcy filing, on the ground that one creditor would be unfairly preferred over others.\(^{71}\) In addition, the DIP may assume and perform advantageous executory contracts and unexpired leases and may reject those that are burdensome,\(^{72}\) including collective bargaining agreements.\(^{73}\)

\(^{66}\) *Id.*  
\(^{67}\) See, e.g., *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1311 (5th Cir. 1985) (ruling that the bankruptcy court did not clearly err by finding that the assumption of the amended lease was a proper exercise of the debtor’s business judgment).  
\(^{70}\) *Id.* Sections 544, 548.  
\(^{71}\) *Id.* Section 547.  
\(^{72}\) *Id.* Section 365.  
\(^{73}\) *Id.* Section 1113.
While continuing to operate the business and enhancing the value of the estate, the DIP also negotiates the reorganization bargain with its creditors and other participants in the procedure. In the course of the negotiation, the DIP makes decisions that involve choices about whether to proceed with the negotiation or liquidate the business. In addition, the DIP makes decisions about the manner in which the assets and losses of the business will be allocated. Such decisions should be included in the reorganization plan.74

The DIP furthermore has the right and power to sell all or part of the assets outside the ordinary course of business after meeting certain requirements.75 It has the power to appoint professionals to perform functions for the estate76 and the standing to sue or be sued in the same manner as a trustee under Section 323 of the Code.77 The DIP is also subject to the duty to disclose the financial condition of the debtor by periodic reporting to interested parties;78 the duty to protect and preserve the assets;79 and the duty to prosecute the case in an expeditious manner.80

4. Efficiency of the Debtor in Possession Construct

In designing Chapter 11, Congress recognized the need for the debtor to remain in control to some degree in order to encourage the debtor to file for bankruptcy relief in

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74 Id. Section 1322.
75 Id. Section 363 (b). Under section 363 of the Code, the DIP can sell the assets outside the ordinary course of business if it has an “articulated business justification,” In re Continental Air Lines, 780 F.2d 1223, 1226 (5th Cir. 1986), and provides adequate notice to all creditors, and if a hearing is held on the sale.
77 Id. Section 323.
78 See 11 U.S.C. Section 704(7)(8).
79 See id. Section 704(2); In re Nautilus of New Mexico, Inc., 83 B.R. 784, 789 (Bankr. D. N.M. 1988).
time while the business still had a going concern value.\textsuperscript{81} The benefits inherent in the DIP concept were described by Congress:

The public and the creditors will not necessarily be harmed if the debtor is continued in possession in a reorganization case . . . . In fact, very often the creditors will be benefited by continuation of the debtor in possession, both because the expense of a trustee will not be required, and the debtor, who is familiar with his business, will be better able to operate it during the reorganization case. A trustee frequently has to take time to familiarize himself with the business before the reorganization can get under way. Thus, a debtor continued in possession may lead to a greater likelihood of success in the reorganization.\textsuperscript{82}

The DIP construct is thus based upon the assumption that a debtor can be reorganized most effectively when the management of the debtor retains control of the business during a reorganization case. The managers are more likely to attempt to reorganize the debtor earlier, while the business is still viable and therefore capable of being reorganized, if they have some confidence in remaining in their positions.\textsuperscript{83} The managers are also expected to be able to control the ongoing operations of the business, utilizing their experience and contacts.

However, the DIP construct is not free from defects.\textsuperscript{84} In general, the DIP construct has provided a ground for questioning the credibility of the Chapter 11 process. Managers whose conduct likely contributed to and precipitated the debtor's financial difficulties continue to manage the debtor in bankruptcy. These same individuals, therefore, may not best be entrusted with protecting the interests of creditors and equity shareholders and rehabilitating the business they had mismanaged. Indeed, there are reorganization cases caused by fraudulent, inept, inefficient, and poor management. Nevertheless, Congress, in

\textsuperscript{81} House Report, supra note 51, at 231.
\textsuperscript{82} Id., at 233.
\textsuperscript{83} Id. at 231.
designing the 1978 Code, responded that “the need for reorganization of a public company today often results from simple business reverses, not from any fraud, dishonesty, or gross mismanagement on the part of the debtor’s management.”\textsuperscript{85} Obviously, however, there are many businesses whose management has caused such financial difficulties.

In addition to these problems attributed to the DIP, one could argue that the DIP concept is flawed because there is no independent party responsible for advancing the reorganization on an expeditious basis.\textsuperscript{86} On this point, some commentators have contended that the DIP concept has proven to be pragmatically superior to requiring the appointment of a trustee and in the best interests of rehabilitation and reorganization.\textsuperscript{87} Moreover, in the 1994 Amendment, Congress vindicated the DIP concept adopted in 1978 despite such criticism.\textsuperscript{88}

Real problems arise when a DIP makes decisions about the evaluation of the debtor. The DIP is often inclined to choose reorganization over liquidation even if the debtor is unfit for reorganization. Regardless of whether or have been retained after the commencement of the case or have been newly hired, the management of the DIP would be apt to exaggerate the viability of the debtor because they want to retain their jobs. If a DIP elects to reorganize a business that is not economically viable and should be

\textsuperscript{85} Id. at 233.
\textsuperscript{88} See 11 U.S.C. Section 1107(a) (1994).
liquidated, such reorganization efforts are very likely to be unsuccessful. All the parties in interest, mostly the creditors, will bear the resulting costs incurred by the useless attempts of reorganization. Similarly, the DIP will face the difficult task of allocating losses among the various claimants. It serves as an arbitrator in a zero sum game. Deciding who wins and loses, the game involves choices between a number of competing interests. For example, equity holders have the lowest priority in bankruptcy and thus are unlikely to receive anything in a liquidation. Accordingly, they have a strong incentive to encourage keeping the business in operation despite economic realities. Unsecured creditors with lower priority have a similar incentive to prefer reorganization to liquidation. By contrast, secured creditors are likely to choose the liquidation of the business regardless of whether the business has a going concern value, because the going concern value of the debtor has nothing to do with the secured creditors. The secured creditors may nevertheless bear the costs caused by even a failing reorganization case. Therefore, the most crucial issues related to unsuccessful reorganization cases would be the following: how to restrict the DIP’s seemingly absolute discretion in operating the business; how to evaluate the debtor’s business without influence of the DIP; and how to access exact information that is under the control of the DIP.

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89 According to the zero sum game, dollars allocated to one group in a reorganization case are lost by another.
Chapter II

Restricting the Debtor in Possession

There are several sources restricting the DIP’s seemingly uncontrollable discretion and powers. They include the creditors’ committee monitoring the DIP;\(^90\) the bankruptcy court’s power limiting the discretion of the DIP;\(^91\) the conversion or dismissal of the case;\(^92\) the appointment of a trustee or an examiner;\(^93\) and the court’s order prohibiting the DIP from operating the business.\(^94\) In addition to these restricting sources, a DIP is a fiduciary for the estate, including the creditors of the debtor.\(^95\) The fiduciary duty of a DIP is derived from the fact that a DIP represents the estate. Among the sources enumerated above, fiduciary duties and the creditors’ committee are discussed below, while others are examined in Chapter IV as part of the courts’ roles.

A. Fiduciary Duties

The creation of a DIP engenders new rights, duties, and powers for the debtor, which are defined by the Code.\(^96\) Section 1107(a) of the Code places a DIP in the shoes of a trustee appointed in a case under Chapter 11 of the Code in virtually every way. The DIP

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\(^93\) Id. Sections 1104-1106.
\(^94\) Id. Section 1108.
therefore must perform the functions and duties, including the fiduciary duty, of a trustee, with a few exceptions such as investigative duties.\(^97\) "[I]f a debtor remains in possession—that is, if a trustee is not appointed—the debtor’s directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession . . . . Indeed, the willingness to leave debtors in possession ‘is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.'"\(^98\)

The term fiduciary duty is generally used to describe a relationship involving confidence, trust, and good faith.\(^99\) The relationship that creates such a fiduciary duty in the bankruptcy context is built between the DIP and the constituents of the estate. The DIP owes a fiduciary duty to the bankruptcy estate and all parties who hold an interest in the estate.\(^100\) In a solvent corporation, the managers owe fiduciary duties of care and loyalty to the debtor and, in most states, to its shareholders,\(^101\) but not to its creditors. In contrast, under the DIP concept the directors and managers of the DIP have an expanded responsibility to all parties that comprise the bankruptcy estate,\(^102\) including the

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\(^{97}\) Id.


\(^{99}\) Restatement (second) of Trust Section 2 cmt. B (1959) (“A person in a fiduciary relation to another is under a duty to act for the benefit of the other as to matters within the scope of the relation.”).


creditors. Some commentators assert that such “expanded fiduciary duty of the trustee (the debtor in possession) . . . stems from the notion that a corporate entity should be operated to respond to the interests of those who hold an immediate financial stake in the entity. In the solvent corporation, the shareholders hold such a stake. In an insolvent corporation, however, because the firm’s assets are inadequate to pay off all of its debts, the claims of the creditors take on a significance akin to those of the shareholders.”

The majority of bankruptcy courts have required that a DIP justify its actions under the corporate fiduciary standard. Under this rule, the DIP is held to the same standards of care and loyalty that corporate directors and officers owe to their corporation and its shareholders. The duty of loyalty, for example, prohibits directors from using their positions of trust and control for self-dealing. The duty of care requires directors to use reasonable efforts and procedures to make an informed and knowledgeable decision. In contrast, an uninformed decision is made when the DIP is grossly negligent in its decision-making process and, as a result, makes a bad decision in light of the goals of Chapter 11, estate preservation and creditor protection. Under the business judgment rule,

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103 See, e.g., In re Central Ice Cream Co., 836 F.2d 1068 (7th Cir. 1987) (addressing that the debtor in possession has a duty to maximize the value of the estate); Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.), 52 B.R. 879, 885 (Bankr. S.D. N.Y. 1985) (stating that the debtor in possession is “bound to act in the best interest of the corporation [and] as fiduciary[y] of the estate”).
105 Id.
106 See, e.g., Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1311 (5th Cir. 1985).
107 See, e.g., In re Schipper, 933 F.2d 513, 515 (7th Cir. 1991).
which is the core of corporate fiduciaries’ duty of care, the DIP has a duty to be informed before making a decision, but it has no duty to reveal the information to any of the interested parties.111 Under the rule, as long as the DIP articulates a reasonable basis for its decision,112 and the decision is not arbitrary or capricious, the court will not blame its judgment.113

The corporate fiduciary standard thus gives the DIP much leeway in its decision-making. Its decision can pass the court’s review unless it is, for example, “tainted by fraud, illegality, self-dealing, or is uninformed.”114 The reasons that courts have given debtors this enlarged discretion include expediting the administration of a case and minimizing the cost to the estate,115 promoting the negotiating process,116 relieving the court of administrative duties,117 and allowing the DIP to operate the business more actively.118

Another fiduciary standard that a DIP may be held to is the common law trustee standard. The nature and extent of the powers and duties of a common law trustee are determined by the terms of the trust.119 In the absence of any provisions in the terms of the trust, they are determined by rules such as those stated in section 169-96 of the

113 Id.
115 See, e.g., Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1311 (5th Cir. 1985).
117 Id.
118 Id.
119 Restatement (Second) of Trusts Section 164 (1959).
Restatement (Second) of Trusts. In comparison with the corporate fiduciary obligations, those of a common law trustee are more stringent duties of loyalty and care. A common law trustee bears a duty to furnish information within a reasonable time, a duty to preserve the trust, a duty to defend and enforce claims, a duty to exercise reasonable care and skill, and a duty to deal impartially with the beneficiaries.

Although the majority of the courts abide by the business judgment rule in the areas of duty of care, some bankruptcy courts implicitly have held not only bankruptcy trustees but also DIPs to the fiduciary duties of a common law trustee. In In re Frankel, the Bankruptcy Court of the Western District of New York State held the DIP to a more stringent standard of fiduciary duty. The court held that the corporate officer had a duty to exercise the quantum of care that a person of ordinary intelligence and prudence would exercise in caring for creditors’ collateral. Further, the court stated, “[a] breach of this duty, whether knowing or negligent, could result in liability attaching.” Moreover, some other courts have held that the most important fiduciary duty of the DIP is to keep the courts and creditors informed of the status of the business under reorganization.

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120 Id.
121 Id. Sections 170, 174.
122 Id. Section 173.
123 Id. Section 176.
124 Id. Sections 177-78.
125 Id. Section 174.
126 Id. Section 183.
127 See, e.g., In re Frankel, 77 B.R. 401 (Bankr. W.D. N.Y. 1987) (holding that the DIP has a duty to exercise the same care that a person of ordinary intelligence and prudence would exercise); In re Roblin Indus., Inc., 52 B.R. 241 (Bankr. W.D. N.Y. 1985); In re Cochise College Park, Inc., 703 F.2d 1339 (9th Cir. 1983).
129 Frankel, 77 B.R. at 404.
The bankruptcy court in *In re McClure* held that the disclosure of the debtor’s financial condition by periodic reporting to interested parties is high on the list of fiduciary duties of the DIP and is to be excused only for justifiable cause. These cases can be analyzed in the context of two categories: that a DIP may be held liable for negligent decisions and that the obligations of the DIP include the duty to reveal necessary information. Taken together, these cases basically hold the DIP to the fiduciary duties of a common law trustee.

The bankruptcy courts have held the DIP to more stringent fiduciary standards than those typically imposed upon non-bankruptcy corporation fiduciaries. The Chapter 11 trustee’s fiduciary obligations are almost identical to those of a common law trustee, and a DIP is in the shoes of a trustee in almost every event. Thus a DIP is subject to fiduciary obligations similar to those of a common law trustee. There are some differences, however, between the two fiduciary duties. A common law trustee may be held liable for mere negligence, but, under the business judgment rule, a DIP is liable only for gross negligence. In addition, while a common law trustee traditionally has a duty to disclose to the beneficiaries all material facts that might affect the value of the assets, a DIP has only the duty to be properly informed before making a decision. The courts’ holdings

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132 *Id.* at 289.
133 See the cases cited in *supra* note 130. See also *Restatement (Second) Section* 173 (1959).
135 See *In re Schipper*, 933 F.2d 513, 516 (7th Cir. 1991); *Restatement (Second) of Trust Section* 170(2), Section 173 (1959).
in many cases indicate that there is at least a trend among some bankruptcy courts toward the need for more stringent fiduciary duties on the part of the DIP.

The functions of the fiduciary duties of the DIP are twofold: they represent the logical grounds for statutory duties of the DIP, and they provide the basis for the DIP’s liabilities to the estate and its constituencies. If the managers of a DIP fail to meet the duties, they are personally responsible for the damages caused by their intentional or negligent activities. The courts ultimately decide the scope of the duties and the degrees of care and loyalty through interpretation of the Code. If the courts expand the scope of the fiduciary duty of the DIP, its discretion in reorganization would accordingly be restricted.

B. The Creditors' Committee

1. General Description

Chapter 11 created several methods designed to oversee the DIP and to prevent its indiscretion. Committees of several kinds, such as the creditors' committee and the equity shareholders' committee, are some of the methods. Most importantly, Congress established a mandatory creditors’ committee to represent unsecured creditors and “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 . . .”

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138 The role of a creditors' committee is not limited to such a supervisory role. "A well-functioning creditors' committee can contribute to building consensus around sound and fair solutions to business problems more effectively through its mediative power than as an advocate for a particular interest." Daniel J. Bussel, Coalition-Building Through Bankruptcy Creditors' Committees, 43 UCLA L. Rev. 1547, 1550 (1996).
Secured creditors, unsecured creditors, and equity owners in Chapter 11 have substantially different channels of control or influence on a case. The main control source for secured creditors is based on their lien or property interest in collateral. The DIP can use the assets of the estate in the ordinary course of business, but its rights to use the property are ultimately limited by the secured creditors' interests.\textsuperscript{140} In addition, a reorganization plan cannot be confirmed unless secured creditors receive under the plan at least the value of their collateral.\textsuperscript{141} Unlike secured creditors, unsecured creditors and equity owners have no rights in specific property. Instead, they can individually respond to issues presented for a vote, file claims, raise issues for litigation, and exercise informal persuasion. The creation of such representative committees thus helps the creditors and equity owners systematically and effectively protect their interests. Among the various possible committees, an equity shareholders' committee has a strong incentive to reorganize the debtor, often regardless of the debtor's viability. In particular, in cases of closely held companies, such a committee shares the same interests as the DIP. It would therefore suffice for the purposes of the thesis to discuss the creditor committee alone because this thesis attempts to discover some methods that are appropriate for restricting the DIP's discretion in order to reduce the rate of unsuccessful reorganization. For similar reasons, the secured creditors' committee is also not a main focus of this thesis.


\textsuperscript{141} 11 U.S.C. Section 1129(b) (1994).
2. The Unsecured Creditors’ Committee

Under section 1102(a)(1), the United States Trustee must appoint at least one unsecured creditors’ committee in every Chapter 11 reorganization case unless the court orders for cause that one not be appointed in a small business case.\(^{142}\) The court may also order the appointment of additional committees it deems appropriate to represent an interest adequately.\(^{143}\) However, in practice, multiple committees are uncommon, except in mega cases.\(^{144}\) Whether the bankruptcy court has the power to review and alter the United States Trustee’s creditors’ committee appointments is controversial. In light of policies underlying Section 105 of the Code, which grants the courts a significant discretionary power in managing a case, it can be said that the court may order the United States Trustee to alter committee membership only when it finds that the original appointment was clearly erroneous.\(^{145}\)

The unsecured creditors’ committee ordinarily consists of persons willing to serve and selected from the debtor’s seven largest unsecured creditors.\(^{146}\) There are no requirements

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\(^{142}\) Dispensing with the appointment of a creditors’ committee in a small business case pursuant to Section 1102(a)(3) does not depend on the debtor’s decision to be treated as a small business under Section 1121(e). See In re Haskell-Dawes, Inc., 188 B.R. 515 (E.D. Pa 1995).


\(^{144}\) See Ronald W. Goss, Chapter 11 of the Bankruptcy Code: An Overview for the General Practitioner, 4 Utah B.J. 8, 10 (1991)


\(^{146}\) 11 U.S.C. Section 1102(b)(1). Although the Code provides that the unsecured creditors’ committee shall ordinarily consist of those persons who are willing to serve and holding the seven largest unsecured claims
for a person or entity to qualify to sit on the committee. The person or entity can hold the unsecured deficiency portion of a secured claim, can be a trade creditor, or can be the union representative. The committee members are reimbursed for the actual expenses incurred in connection with their participation on the committee. These expenses are considered administrative expenses. The creditors’ committee is a separate legal entity, distinct from its members or any specific creditor sitting on the committee. The committee protects the interests of its constituents by monitoring the DIP’s activities and negotiates a plan with the DIP. The committee may employ professionals to assist in the reorganization process. The employment of the committee professionals is subject to court approval, and approved professionals are entitled to reasonable compensation as administrative expenses.

The responsibilities and rights of the committee are diverse: to consult with the DIP concerning the administration of the case, to investigate the financial condition and the conduct of the DIP, to participate in the plan negotiation, and to perform other


147 11 U.S.C. Section 503(b)(3)(d). Committee members’ expenses are to be reimbursed from the estate without their having to prove that the individual members substantially contributed to the case. John D. Penn, Controlling the Composition and Creation of Creditors’ Committees, 16-May Am. Bankr. Inst. L.J. 40, 40 (1997).


151 Id. Section 1103(a). The counsel for the unsecured creditors’ committee has a fiduciary relationship to all unsecured creditors, not just to the committee members. E.g., In re General Homes Corp., 181 B.R. 870 (S.D. Tex. 1994); In re Barney’s Inc., 197 B.R. 431 (S.D.N.Y. 1996).


153 Id. Section 1103 (c)(1). See also In re Jefley, Inc., 219 B.R.88 (E.D. Pa. 1998) (The court directed the creditors’ committee to participate in attempted bargaining with the union so that the creditors’ interests could be directly negotiated.)


155 Id. Section 1103 (c)(3).
services in the interest of those represented.\textsuperscript{156} Thus, in theory, the unsecured creditors' committee should exert significant influence on the outcome of the reorganization proceeding by preventing the DIP's indiscretions. In practice, however, it rarely influences the proceeding.\textsuperscript{157} The committee has fallen short of Congress's expectations. In smaller cases, the committee sometimes does not even exist because of the absence of creditors' concerns.\textsuperscript{158} Even in cases where a committee is formed, it may not work properly.\textsuperscript{159} In larger cases, even though the committee has broad powers, the powers are not always utilized.\textsuperscript{160} Sometimes the attorney of a committee actively monitors the case and incoming reports about the business,\textsuperscript{161} thereby in part curbing the DIP's indiscretions.

Criticisms about the unsecured creditors' committee are abundant because of the substantial cost to the estate\textsuperscript{162} and its ineffectiveness. Most of the costs incurred are agency costs, and they can be significant if the case is prolonged. The ineffectiveness of the committee is due to several factors. First, the lack of compensation beyond expenses discourages the committee members to be active in committee matters because of the

\begin{footnotesize}
\begin{enumerate}
\item[156] Id. Section 1103 (c)(5); see In re George Worthington Co., 921 F.2d 626, 633 (9th Cir. 1990) (citing In re GHR Energy Corp., 35 B.R. 539, 543 (Bankr. D. Mass. 1983)).
\item[158] Karen Gross & Matthew S. Barr, Bankruptcy Solutions in the United States: An Overview, 17 N.Y.L. Sch. J. Int'l & Comp. L. 215, 232 (1997). Under the Bankruptcy Reform Act of 1994, in small cases, on request of a party in interest, the court may order, for cause, not to appoint a creditors' committee (11 U.S.C. Section 1102 (a)(3)). A "small business" is defined by the Code as a person engaged in commercial or business activities (other than a person whose primary activity is owning or operating real property) whose aggregate noncontingent liquidated secured and unsecured debts do not exceed $2,000,000 (11 U.S.C. Section 101 (51C)).
\item[159] Gross & Barr, supra note 158, at 232.
\item[160] Id.
\end{enumerate}
\end{footnotesize}
considerable time they have to spend.\textsuperscript{163} Second, the committee members rarely have the expertise necessary to perform their expected duties.\textsuperscript{164} Few of the committee members have experience with reorganization proceedings; still fewer of them have the skills necessary to evaluate or investigate a debtor’s business\textsuperscript{165} because few of them may have been involved in bankruptcy cases. Third, perhaps most importantly, the ineffectiveness of the committee is caused by the fact that it cannot directly control the activities of the DIP.\textsuperscript{166} The unsecured creditors' committee can influence the DIP’s decision making, but cannot compel it.\textsuperscript{167}

\textsuperscript{163} Adams, supra note 157, at 615.
\textsuperscript{164} Id.
\textsuperscript{165} Id.
\textsuperscript{166} Id.
\textsuperscript{167} Id.
Chapter III
Roles of the Bankruptcy Courts

According to the basic scheme of the Code, the bankruptcy court’s roles are limited to those of a disinterested adjudicator who functions only when a legal controversy has arisen. However, because the creditors’ committee, the counterpart of the DIP, and the mere existence of the fiduciary duty of the DIP have proved to be not enough to ensure fair and efficient proceedings, the bankruptcy courts’ active involvement in the process has been required to make reorganization proceedings more expeditious and efficient.168

The Code, however, does not provide specific ways for the court to make the process efficient. Because the practical realities and necessities involved in a case vary, a narrowly defined provision cannot meet such a variety of circumstances. Therefore, Section 105 of the Code grants a comprehensive power to the courts to meet the various demands of cases. The language of the section appears to give the courts unlimited discretion. It is thus said that the bankruptcy court is a court of equity.169 This does not

168 This view is based on the assumption that although the current provisions of Chapter 11 of the Code have not proved successful in practice, the goals underlying those provisions are laudable. There are those commentators who argue that Chapter 11 should be abolished in its entirety. See Michael Bradley & Michael Rosenberg, The Untenable Case for Chapter 11, 11 Yale L.J. 1043, 1078 (1992); James W. Bowers, Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing among Bankruptcy Hypotheses, 72 Wash. U. L. Q. 955, 976-77 (1994). Some others question whether the underlying premises of Chapter 11 have been justified. See, e.g., Thomas H. Jackson, The Logic and Limits of Bankruptcy Law, 209-24 (1986); Douglas G. Baird, The Uneasy Case for Corporate Reorganizations, 15 J. Legal Stud. 127 (1986).
mean, however, that the bankruptcy court is a traditional court of equity.\textsuperscript{170} It means, instead, that the court is “a specialized court of limited jurisdiction applying statutory law that embodies a particular, often changing, social objective.”\textsuperscript{171} Because bankruptcy reorganization law should meet such changing circumstances, the courts accordingly have much discretion in interpreting and applying the law.\textsuperscript{172} In this sense, the bankruptcy court can be referred to as a court of equity, but its discretion in interpretation should be kept within the generally accepted limitations of jurisprudence.\textsuperscript{173}

The scope of the court’s powers in making a reorganization case efficient by, for example, filtering out nonviable debtors from the relief will thus be defined through the interpretation of the statutory language of the relevant provisions, such as Section 105 and Section 1112 of the Code. In order to discuss the scope of the court’s powers, it would be helpful to examine the historical background of the court’s powers in advance.

\section*{A. Evolution of the Courts’ Equitable Power}

\subsection*{1. Separation of Functions}

As mentioned above,\textsuperscript{174} Chapter 11 of the Code basically relies on the bargain between the DIP and its creditors for a successful reorganization; this cannot be achieved,

\begin{flushleft}\textsuperscript{170} Hon. Marcia S. Krieger, “The Bankruptcy Court Is a Court of Equity”: What Does That Mean?, 50 S.C. L. Rev. 275, 310 (1999).\\\textsuperscript{171} Id.\\\textsuperscript{172} See id. at 297 (asserting, in relevant part, that the phrase “court of equity” is used in three different ways. First, it is and has been used to define the scope of the court’s jurisdiction and authority. Second, the phrase has been used to legitimize the social policy underlying bankruptcy law and to justify a conclusion or result where the result is not that of application of statutory law. Third, the powers of an equitable court are invoked by parties who want to get a result that seems fair to them but may not be consistent with the law).\\\textsuperscript{173} The court’s discretion in interpretation is allowed not because the court is a court of equity but because bankruptcy law concerning reorganization should meet the varieties and changing needs of society. Many of the Code’s provisions are also comprehensive enough to invoke the court’s considerable discretion in interpretation. See, e.g., 11 U.S.C. Section 105(a) & (d).\\\textsuperscript{174} See Chapter II-B of this thesis.\end{flushleft}
however, without the bankruptcy court’s supervision and intervention. Then the question becomes to what extent the bankruptcy courts should be involved in the case management. Under the Bankruptcy Act, bankruptcy courts or judges were actively involved in the case management and in the ordinary affairs of reorganization cases. In other words, under the Act, the courts played important roles in performing administrative, supervisory, and clerical functions in addition to their judicial duties. The Act required that the courts be actively involved in the procedure because creditor participation was below congressional expectation and offered insufficient guarantee that creditors’ interests were protected and that the reorganization case would proceed fairly and efficiently. This in part led to the perception that lawyers and trustees, instead of creditors and equity owners, controlled bankruptcy cases and that judges were biased because of their involvement in the debtor’s affairs and business. This perception was grounded upon “the direct involvement of the bankruptcy judges in the administrative aspects of bankruptcy cases, selection and appointment of trustees and subsequent decisions by the judges on legal issues that arose out of or referenced information obtained by the judges during the administrative processes.”

In designing the Code, Congress recognized the negative impacts of the court on the credibility of the reorganization procedure. Congress thus removed a wide range of administrative matters from the bankruptcy judge. The 1978 Bankruptcy Code, accordingly, transferred many of the supervisory functions from the judge to a case

175 The Bankruptcy Reform Act of 1938, Stat. 840 (1938) (repealed in 1978)
trustee and to the United States Trustee. The Code involves the judge only when a dispute has arisen. Under the Code, therefore, "the bankruptcy court should become a forum that is fair in fact and in appearance as well" since the judge no longer is obliged to take an active role in managing bankruptcy cases. In addition to the creation of the United States Trustee, the Code prohibits the bankruptcy judges from attending creditors' meetings. The Federal Rules of Bankruptcy Procedure also prohibits ex parte communications between the court and parties in interest.

2. The Need for Efficiency

However, since Congress enacted the Code in 1978, the principle of separation of judicial and administrative functions has been eroded continuously because the need for efficiency in the prosecution of Chapter 11 cases has increased. Partly due to creditor apathy and partly because of the uniform performance in administrative rules and practices by the United States Trustee, bankruptcy judges have become increasingly involved in the administration of bankruptcy cases.

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178 Miller, supra note 162, at 434.
179 House Report, supra note 51, at 4. See generally Paul N. Silverstein & Harold Jones, The Evolving Role of Bankruptcy Judges Under the Bankruptcy Code, 51 Brook. L. Rev. 555 (1985). See also In re Gusam Restaurant Corp., 737 F.2d 274 (2nd Cir. 1984), rev'd 32 Bankr. 832 (Bankr. E.D.N.Y. 1983) (concluding that Congress's expressed intent to curtail excessive judicial involvement in administrative matters and the Code's legislative history prohibiting the sua sponte conversion of cases made clear that Section 1112(b) requirement of a request by a party in interest should be read literally).
182 Miller, supra note 162, at 435.
3. Amendments to Section 105

To meet this increased need for active case management on the part of the bankruptcy courts, Congress amended Section 105 of the Code in 1986. The amendment was intended to authorize the courts to take any action and make any determination necessary to enforce a court order or rule on a *sua sponte* basis to prevent abuses of the reorganization process. Since the effective date of the amendment, the courts have frequently issued broad sweeping orders to control or manage a case. In addition, before the status conferences were codified in Section 105(d) of the Code in 1994, the courts often used Bankruptcy Rule 7016, which applies Rule 16 of the Federal Rules of Civil Procedure to adversary proceedings in reorganization cases. Under Bankruptcy Rule 7016, the judge could organize and conduct a pretrial conference in order to, for example, expedite the case, prevent wasteful pretrial activities, and facilitate the settlement of the case.

In 1994, Congress again amended Section 105 of the Code, authorizing bankruptcy judges to hold status conferences *sua sponte* or on a motion of a party in interest. The status conference can be held in any reorganization case or proceeding after notice to parties in interest. At the conferences, unless it is inconsistent with another provision of the Code or Bankruptcy Rules, the court can issue an order prescribing limitations and conditions as the judge deems appropriate to ensure that the case proceeds expeditiously.

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and economically.\textsuperscript{189} Such orders include, among others, setting a date by which the debtor must file a disclosure statement and a reorganization plan; setting a date by which the debtor must assume or reject an executory contract or unexpired lease; and setting a date by which a party in interest other than a debtor may file a plan.\textsuperscript{190} By amending Section 105 of the Code, Congress formally acknowledged that active case administration by bankruptcy courts often benefits all parties and increases the efficiency of the bankruptcy process.\textsuperscript{191}

4. Scope of the Courts' Equitable Power under Section 105

Even if one admits that Section 105 of the Code grants a wide range of equity or discretionary power to the bankruptcy court, the question of whether the court has the power to "fill the gaps left by the statutory language" still remains unanswered. For example, unlike most other courts, the Eleventh Circuit Court of Appeals disallowed the use of cross-collateralization in \textit{Shapiro v. Saybrook Manufacturing Co., Inc.}\textsuperscript{192} Cross-collateralization alters the general distribution scheme mandated in bankruptcy reorganization. Despite the lack of express authorization, many courts have permitted cross-collateralization, using the courts' equitable powers to effect a result consistent with the rehabilitation of the debtor, which these courts considered to be the primary goal of

\textsuperscript{189} \textit{Id.} Section 105(d)(2).
\textsuperscript{190} \textit{Id.} Because the enumerated items of Section 105(d)(2) are not exclusive, the court may order the DIP, for example, to combine the plan and disclosure statement into one simple and precise document. Such an order will contribute to reducing time and money in the reorganization process. \textit{See} Hon. Leif M. Clark, \textit{Keeping It Simple: A Case Study}, 17-Jan Am Bankr. Inst. J. 28, 43 (1998).
\textsuperscript{191} Miller, \textit{supra} note 162, at 439.
\textsuperscript{192} \textit{In re Saybrook Manufacturing Co., Inc.}, 963 F.2d 1490, 1496 (11th Cir. 1992).
Chapter 11 of the Code. The courts denying the bankruptcy court the power to fill the gap left by the statutory language consider that the application of Section 105(a) of the Code is limited to a furtherance of expressly delineated Code sections. Other courts allow such payments by utilizing the courts’ equitable powers under Section 105(a) to move beyond the strict statutory mandates.

However, some commentators argue that the bankruptcy courts have the powers to fill the gap left by the statutory language because Section 105 of the Code grants such equitable powers to the courts. This opinion emphasizes that “[e]quity developed out of a recognition of a need for flexibility, a realization that strict reliance on the written law will lead to unjust and inefficient results, and a belief that special remedies should be judicially devised in appropriate circumstances.” This opinion may, however, be confused about the distinction between the nature of bankruptcy law and the bankruptcy courts’ power. The Code indeed includes many equitable provisions, and, therefore, the

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195 Leepson, supra note 169, at 776 (quoting 2 Collier on Bankruptcy, ¶ 105.01, at 105-04 (15th ed.))


197 Leepson, supra note 169, at 807.

198 Id. at 777.

199 E.g., automatic stay, the broad definition of the estate, strong-arm powers to marshal assets, avoidance of liens, sale of estate assets free and clear of liens or interests, equitable subordination of claims, and coercing debtors to explain their past financial affairs are all like equitable relief that can be obtained in non-bankruptcy courts. Krieger, supra note 170, at 295.
courts can exercise a broad discretionary power in interpreting or applying such provisions to a specific case. The fact that the courts have discretionary power does not mean that the bankruptcy courts are courts of equity. It means, instead, that the courts can fill the gaps left by the statutory language, but they cannot move beyond the expressed mandates of the Code.  

5. Use of Section 105 for ADR

In conjunction with Section 105 of the Code, the bankruptcy courts are increasingly utilizing alternative dispute resolution methods to manage bankruptcy cases effectively. One of the prime examples is the use of the mediation process in Chapter 11 cases. Mediation is a non-binding process, in which an independent person is introduced “to induce rationality among the parties and avoid expensive, vexatious, and protracted pursuit of litigation tactics or stalemated negotiations.” Section 105 of the Code has been used in several cases to solve claims disputes. This section offers many potentials for the efficient execution of reorganization cases.


202 Id.

203 Id. at 438 n. 25.
B. The Courts' Debtor Screening\textsuperscript{204} Role

In order to reduce the costs incurred during reorganization cases, it is necessary to administer a case expeditiously and efficiently. In particular, preventing debtors not deserving reorganization efforts from coming into the process is most important.\textsuperscript{205} Under the Code, debtors abusing the automatic stay and those without a going concern value do not deserve reorganization efforts.\textsuperscript{206} Should such debtors come into the process, they must be expelled as early as possible to protect creditors from unnecessary costs.

There are several methods developed by theory or expressly provided by the Code provisions to which the courts can resort to prevent debtors not deserving reorganization from entering the process, or to oust them. First, various courts and commentators are in agreement that, under the Code, there is an implied good faith requirement in filing a case even though the Code does not explicitly provide such a requirement.\textsuperscript{207} Second, according to Section 362(d) of the Code, the court can grant relief from the stay to a party in interest for cause, including lack of adequate protection of the party in interest.\textsuperscript{208} If such relief is granted for a creditor, the case often loses its merit and the process stops. Third, pursuant to Section 1112(b) of the Code, the court can convert a reorganization case to Chapter 7 liquidation or dismiss a case for cause if such conversion or dismissal is

\textsuperscript{204} In this thesis, "debtor screening" is used to mean both the effort to select debtors eligible for reorganization immediately after the filing and the effort to expel debtors without eligibility from the reorganization process by either dismissing the case or converting it to a liquidation case.

\textsuperscript{205} Debtors not deserving reorganization include those without going concern or economic viability and those whose management is abusing the process in order to thwart the creditors.

\textsuperscript{206} However, if a debtor is viable despite the management of the debtor being incompetent or dishonest, such a debtor can be reorganized. In such a case, the DIP should be replaced with a trustee, and the case should not be dismissed.

\textsuperscript{207} Carlos J. Cuevas, Good Faith and Chapter 11: Standard That Should Be Employed to Dismiss Bad Faith Chapter 11 Cases, 60 Tenn. L. Rev. 525, 525 (1993).

\textsuperscript{208} 11 U.S.C. Section 362(d) (1994).
in the best interest of creditors.\textsuperscript{209} Fourth, the court may apply Section 305 of the Code to dismiss a case or suspend all proceedings if the court deems that such dismissal or suspension would better serve the interests of creditors and the debtor.\textsuperscript{210} However, Section 305 of the Code has rarely been used to dismiss a case. Where there is no explicit provision of the Code that can be utilized under certain circumstances, the court sometimes resorts to Section 105 of the Code to screen or expel some kinds of debtors from the process. Section 105 expressly gives the court the authority to take any action or make any determination necessary or appropriate to prevent an abuse of process.

The relationships among the various debtor screening methods are rather complicated. The dismissal of a case under Section 305 is rarely used because such dismissal cannot be reviewed by appeal.\textsuperscript{211} Section 105 has been used by several courts in conjunction with Section 1112(b), while some courts have used Section 105 as a ground for protecting the courts' integrity\textsuperscript{212} when dismissing a case with prejudice. Further, Section 1112(b) is used as a ground for recognizing the implied requirement of good faith filing. The difference is that the implied threshold requirement, unlike Section 1112(b), is applicable at the preliminary stages of a reorganization case. According to this view, bad faith, the counterpart of good faith, is one of the indications that constitutes the "cause" of Section 1112(b) of the Code. In other words, "bad faith" is a version of the cause on the side of the debtor.

\textsuperscript{209} \textit{Id.} Section 1112(b).
\textsuperscript{210} \textit{Id.} Section 305(A).
1. Good Faith Filing Requirement

Unlike the Bankruptcy Act of 1898, Chapter 11 of the Code does not explicitly require that a reorganization case be filed in good faith. However, the threshold good faith test has been adopted among the courts. With respect to the meaning of “good faith,” various courts are in disagreement. The divergent opinions about the question of what constitutes good faith stem from the different views about the goals and policies of reorganization law.

Some courts’ decisions focus exclusively on the debtor’s ability to reorganize as an indication of good faith. Under this test, the debtor’s motive for filing for Chapter 11 is irrelevant to good faith. This view, the objective test, asserts that because the subjective test relies on the debtor’s speculative inner motive, it allows the court to exercise too much discretion in determining whether to dismiss a case. The objective test is consistent with the purpose of business reorganization, which is to provide a vehicle for the rehabilitation of a distressed business. The weakness of this test is that it ignores the importance of the subjective purpose or intent of the DIP, which is an

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212 The bankruptcy crimes statute is also designed to ensure the integrity of the bankruptcy court by criminalizing intentional and fraudulent abuse of the process. Tamara Ogier & Jack F. Williams, Bankruptcy Crimes and Bankruptcy Practice, 6 Am. Bankr. Inst. L. Rev. 317, 329 (1998).

213 The Bankruptcy Reform Act of 1898. It governed all bankruptcy cases filed prior to October 1, 1979.

214 See, e.g., In re Cohoes Indus. Terminal, 931 F.2d 222 (2d Cir. 1991); Carolin Corp. v. Miller, 886 F.2d 693 (4th Cir. 1989); Phoenix Piccadilly, Ltd. v. Life Insurance Co. (In re Phoenix Piccadilly, Ltd.), 849 F.2d 1393 (11th Cir. 1988); Little Creek Development Corp. v. Commonwealth Mortgage Co. (In re Little Creek Dev. Co.), 779 F.2d 1068 (5th Cir. 1986).

215 The objective test is premised upon the notion that a debtor must have a realistic possibility of reorganizing. See, e.g., In re Ionosphere Clubs, 98 B.R. 174, 177-78 (Bankr. S.D.N.Y. 1989); In re Winshall Settlor’s Trust, 758 F.2d 1136, 1137 (6th Cir. 1985); N.L.R.B. V. Bidisco & Bildisco, 465 U.S. 513, 527 (1984). If it is evident from the commencement of a case that reorganization is unlikely, then courts will find objective bad faith. If so, courts probably will find subjective bad faith, too, if the only reason that the case was filed was to thwart the creditors. Cf. Carolin Corp. v. Miller, 886 F.2d 693 (4th Cir. 1989).

important concept in commercial law.\textsuperscript{219} In a sense, reorganization law is an extension of commercial law because it is a mechanism created to deal with a debtor who has committed defaults. Moreover, subjective good faith insures that the DIP honestly intends to reorganize and will treat its creditors with good faith, and that it will not use Chapter 11 only to evade its obligation to creditors.\textsuperscript{220} The objective test is insufficient in that it ignores the debtor’s motive.

In contrast, the subjective test regards the bankruptcy system as an equitable process. In order to receive equity, the debtor must have clean hands. This test looks for evidence of motive.\textsuperscript{221} The viability of the debtor is immaterial to keep the case proceeding. Thus, under this test, once subjective bad faith is established by showing that the debtor has attempted to use the bankruptcy process to thwart the creditors’ rights, the case should be dismissed despite the prospect of a successful reorganization.\textsuperscript{222} In \textit{In re Phoenix Piccadilly, Ltd.}, the United States Court of Appeals for the Eleventh Circuit held that “the prospects of a successful reorganization do not override, as a matter of law, the finding of bad faith . . . .”\textsuperscript{223} This view, however, also has some flaws. This test in part contradicts the policy of the Code that intends to provide open access to distressed businesses.

Moreover, debtor rehabilitation is one of the goals of Chapter 11 and is at least as

\begin{enumerate}
\item \textsuperscript{217} \textit{Id.} at 26.
\item \textsuperscript{218} \textit{See In re Coastal Cable T.V., Inc.}, 709 F.2d 762,765 (1\textsuperscript{st} Cir. 1983).
\item \textsuperscript{219} \textit{U.C.C.} Section 1-203 (1990) (“Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.”). For the definition of good faith, \textit{see U.C.C. Sections 1-201, 2-103.}
\item \textsuperscript{220} \textit{In re HBA East, Inc.}, 87 B.R. 248, 258-59 (Bankr. E.D. N.Y. 1988); \textit{In re Southern Communities, Inc.}, 57 B.R. 215, 218 (Bankr. M.D. Fla. 1986).
\item \textsuperscript{223} \textit{In re Phoenix Piccadilly, Ltd.}, 849 F.2d 1393, 1394 (11\textsuperscript{th} Cir. 1988).
\end{enumerate}
important as creditor protection. In addition, the subjective test also seems to be contrary to the language of Code section 1112(b), which protects creditors against a debtor who is unable to reorganize.  

There is another view that requires both objective futility and subjective bad faith to dismiss a case. In Carolin Corp. v. Miller, the United States Court of Appeals for the Fourth Circuit noted that because dismissal of a case at a preliminary stage was an extraordinary remedy, it should be exercised only “with great care and caution.” The Fourth Circuit stated that, therefore, “something more than even the most obvious likelihood of ultimate futility should be required to justify threshold dismissals . . . .” The Fourth Circuit concluded that “both objective futility and subjective bad faith should be shown in order to warrant dismissals for want of good faith in filing.” The Fourth Circuit Court rationalized this high standard by stating that if there is no question of subjective bad faith, the ultimate futility issue is better left to post-petition development. Conversely, if the reorganization is not objectively futile, the debtor’s original motive or intent should not warrant dismissal. This view is based on a presumption that the implied threshold requirement should be different from the requirements of Section 1112(b) because there is a risk of premature dismissal of viable cases in the preliminary dismissal. However, there is no justification for such different treatment, and it would be a pure waste of resources to attempt to reorganize an

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224 See, e.g., In re Koerner, 800 F.2d 1358, 1368 (5th Cir. 1986); In re Fossum, 764 F.2d 520, 521-22 (8th Cir. 1985). Absence of a reasonable likelihood of rehabilitation is one of the “causes” provided by Section 1112(b) of the Code. 11 U.S.C. Section 1112(b)(1) (1994).

225 Carolin Corp. v. Miller (In re Carolin Corp.), 886 F.2d 693 (4th Cir. 1989).

226 Id. at 700.

227 Id.

228 Id. at 700-701.

229 Id. at 701.
absolutely nonviable debtor even if the case has been filed in subjective good faith. If the
case is destined to be dismissed by the application of Section 1112(b) of the Code, it
would be better to dismiss the case earlier before it incurs costs hurting the creditors. The
standard of this view is too rigid to apply under the Code\(^{231}\) in that this view makes it
difficult for dismissal to occur.

Courts employing the totality of the circumstances test view the good faith
requirement as an important instrument for maintaining the integrity of the bankruptcy
system.\(^ {232}\) Under this test, a court examines all the facts and circumstances of the case,
using some factors to determine whether the petition has been filed in good faith.\(^ {233}\) This
test is often used to dismiss single asset real estate cases.\(^ {234}\) For example, in \textit{In re Little
Creek Development Co.},\(^ {235}\) the Fifth Circuit discussed the good faith requirement not only
for Code section 362(d),\(^ {236}\) but also for Code section 1112(b).\(^ {237}\) The court noted that the
good faith standard performed an important role in preventing a debtor from abusing the

\(^{230}\) \textit{Id.}

\(^{231}\) While insisting that the objective-subjective test adopted by the Fourth Circuit Court in \textit{Carolin Corp. v.
Miller}, supra note 225, is the preferable good faith test, one commentator argues that in order for a debtor
to survive a motion for dismissal, the debtor must demonstrate both that it can reorganize and that the case
has not been filed in subjective bad faith. Carlos J. Cuevas, \textit{Good Faith and Chapter 11: Standard That
Should be Employed to Dismiss Bad Faith Chapter 11 Cases}, 60 Tenn. Rev. 525, 530 (1993). However, the
test adopted in \textit{Carolin} requires that the movant demonstrate both objective and subjective bad faith in
order to dismiss the case. Therefore, according to \textit{Carolin}, if the reorganization is not objectively futile, the
debtor’s subjective original intent does not warrant dismissal. \textit{Carolin} 886 F.2d at 701. In contrast, under
the commentator’s view, if a case has been filed in subjective bad faith, the case should be dismissed even if the
reorganization is not objectively futile.

E.D. N.Y. 1988).

\(^{233}\) \textit{In re Village Green Realty Trust}, 113 B.R. 105, 115-16 (Bankr. D. Mass. 1990); \textit{In re Sherwood Enters.},

\(^{234}\) \textit{See In re McCormick Rd. Assocs.}, 127 B.R. 410 (Bankr. N.D. Ill. 1991); \textit{In re Castleton Assocs.}, 109

\(^{235}\) 779 F.2d 1068 (5th Cir. 1986).

\(^{236}\) 11 U.S.C. Section 362(d) (1994). Section 362(d)(1) permits a creditor to seek relief from the automatic
stay for cause, and courts have held that bad faith constitutes cause for relief from the stay. See \textit{id.}
362(d)(1).

\(^{237}\) \textit{Little Creek}, supra note 214, at 1071-74.
reorganization process and in protecting the integrity of the bankruptcy system.\textsuperscript{238} It also stated that to determine whether a case had been filed in good faith required an evaluation of the totality of the circumstances, including the debtor's financial condition, motives and the local financial realities.\textsuperscript{239} This view is appropriate under the Code because it is adjustable to any circumstances.\textsuperscript{240} It can also take into consideration the goals and policies underlying the bankruptcy law. Nevertheless, this view has been criticized for its relying on particular, predetermined factors for determining bad faith and because it has usually been applied in single asset debtor cases.\textsuperscript{241} Indeed, the totality of the circumstances test has been developed from single asset cases, but use of the test is not exclusive.\textsuperscript{242} Moreover, even though findings of lack of good faith in proceedings have been predicated on certain recurring patterns, the patterns are only the results of case analysis and are not exclusive.\textsuperscript{243}

\textsuperscript{238} \textit{Id.} at 1072
\textsuperscript{239} \textit{Id.}
\textsuperscript{240} This view is a dynamic one because the meaning of "totality of circumstances" is so flexible that it can take into consideration varied and ever-changing social circumstances regarding bankruptcy policies. In this sense, the implied good faith filing requirement is not a fixed institution that concerns itself with the need for a procedural mechanism to abort obviously futile cases straightaway, but it is rather a dynamic device founded on the desirability of forestalling filings aimed at achieving an objective beyond the accepted purposes of the bankruptcy process. See Lawrence Ponoroff & F. Stephen Knippenberg, \textit{The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy}, 85 \textit{Nw. U. L. Rev.} 919, 946-47 (1991).
\textsuperscript{242} For example, in \textit{In re Sharon Steel Corporation}, 871 F.2d 1217 (3rd Cir. 1989), the United States Court of Appeals for the Third Circuit stated that "[u]nder the discretionary determination of cause required by \textit{11 U.S.C. Section 1104(a)(1) and the flexible standard embodied in (a)(2), the court acted within its discretion in concluding that the totality of the circumstances signaled the need for a trustee.}" \textit{Id.} at 1228.
\textsuperscript{243} \textit{See Little Creek, supra} note 214, at 535 n. 70.
2. Relief from the Stay

In a voluntary reorganization case, a debtor triggers the automatic stay upon the filing of a bankruptcy petition.²⁴⁴ The automatic stay functions as a stay against a variety of acts affecting the debtor and the property of the estate.²⁴⁵ Because of the conveniences afforded by the automatic stay, some debtors tend to abuse it. If a debtor files a petition solely to trigger the automatic stay, for example, the debtor without intention of reorganization achieves its principal purpose simply by obtaining the stay. Later the case may be dismissed by the court for such abuse or may be terminated by granting a creditor relief from the stay. However, once the process proceeds, it incurs cost. Abusive filings waste significant resources. Not only the debtor’s creditors but also the entire bankruptcy system, such as the courts, trustees, and other creditors, shares the cost.

Thus, Section 362(d) of the Code provides that on request of a party in interest, the court may grant relief from the stay.²⁴⁶ The relief includes termination, annulment, or modification of the stay, and conditioning on the stay.²⁴⁷ The court may grant a moving creditor such relief from the stay in three situations. First, it can be granted to the creditor for cause, which includes the fact that the creditor’s interest in its collateral is not adequately protected.²⁴⁸ Therefore, when there is an “equity cushion” in the collateral

²⁴⁵ H. Rep. No. 95-595, 1978 U.S. Code Cong. & Admin. News 6296-97. (“The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy.”).
²⁴⁶ 11 U.S.C. Section 362(d).
²⁴⁷ Id.
²⁴⁸ Id. Section 362(d)(1).
providing sufficient protection to the creditor, relief will be denied.\textsuperscript{249} In deciding whether to grant relief from the stay for "cause" other than lack of adequate protection, the courts apply a balancing approach.\textsuperscript{250} When the prejudice the creditor would suffer if the relief from stay were denied is more than the damage the debtor and other creditors would sustain if the relief were granted, the court will lift the stay.\textsuperscript{251} Second, if the debtor does not have any equity in the collateral and the collateral is not necessary to an effective reorganization,\textsuperscript{252} the relief will be granted.\textsuperscript{253} Third, in single asset cases, a moving creditor whose claim is secured by an interest in the real estate may be granted relief from the stay if, within 90 days from the order for relief, the debtor has not either filed a plan that has a reasonable possibility of being confirmed in a reasonable time or commenced monthly payments at a market rate of interest to each such creditor.\textsuperscript{254}

The relief from automatic stay functions in part as a method of creditor protection, and, in some cases, such as single asset real estate,\textsuperscript{255} it plays a debtor screening role by


\textsuperscript{250} Therefore, according to this balancing approach, the equity cushion can be considered as only one factor in determining whether to grant relief from the automatic stay. Lawrence J. Dash, The Equity Cushion Analysis in Bankruptcy, 10 Hofstra L. Rev. 1149, 1191 (1982).

\textsuperscript{251} See In re Continental Airlines, Inc., 152 B.R. 420, 424 (Bankr. D. Del. 1993) (balancing the prejudice that would be suffered if the stay were lifted, the relative hardship of the parties, and the probable success of debtor rehabilitation).


\textsuperscript{253} 11 U.S.C. Section 362(d)(2). See, e.g., In re Canal Place Ltd., Partnership, 921 F.2d 569 (5th Cir. 1991).


\textsuperscript{255} An analysis based upon 510 chapter 11 cases during the early 1990s in Los Angeles, California, shows that 56\% to 64\% of the cases were filed primarily to protect real property from impending foreclosure. Lisa Hill Fenning & Craig A. Hart, Measuring Chapter 11: The Real World of 500 Cases, 4 Am. Bankr. Inst. L. Rev. 119, 120-22 (1996).
leading the case to termination, dismissal or conversion. In a case of single asset real estate, for example, if a secured creditor is granted relief from the stay and can continue the foreclosure, the debtor will lose the merit of the case and will be ousted from the process.

However, these remedies are easily circumvented by debtors. Debtors, in the case of a dismissal or stay relief, can commence a new case, or in the case of dismissal with prejudice, can convey all or a portion of the legal title of their assets to another person. Then the different person can, in turn, file a new case. The debtor of the new case automatically obtains the protection of the stay. Recognizing the limitations of the remedies provided by the Code, various courts have developed "prospective relief" or in rem orders to prevent future abuse. These orders grant the creditor relief from the stay and prospectively prohibit any parties from using the automatic stay. With respect to future repeat filings, the Bankruptcy Review commission has recently proposed an amendment to the Code to authorize the courts "to issue in rem orders that would bar the application of a future automatic stay to identified property of the estate for a period up to six years when a party could show that the debtor had transferred such real property . . . to avoid credit foreclosure or eviction."

258 Id. at 6.
259 National Bankruptcy Review Commission Final Report, Consumer Bankruptcy Proposal No. 1. 5. 6., In Rem Orders, at 281-87 (Oct. 1997). For pending bankruptcy legislation about in rem relief, see H.R. 3150
3. Dismissal or Conversion under Section 1112(b)

The bankruptcy court may convert a reorganization case to a Chapter 7 case or dismiss a case for “cause.” Section 1112(b) of the Code enumerates ten grounds for such conversion or dismissal. The listed ten grounds are not exclusive. They are only examples of the “cause.” The Code, however, does not provide a definition of the term “cause.” According to the doctrine developed by case law soon after Congress enacted the Code, lack of good faith on the part of the debtor constitutes the “cause.” Lack of good faith, that is, bad faith, means that the reorganization case is futile or filed in subjective bad faith. The lists in Section 1112(b) also involve both the futility and bad faith of the debtor. Consequently, it has been said that “good faith . . . is an implicit prerequisite to the filing or continuation of a proceeding under Chapter 11 of the Code.”

The problem with Section 1112(b) is that this section’s debtor screening role arises too late and is therefore inefficient. For example, the creditors entitled to raise the same issue both under Section 1112(b) and 362(d) usually prefer to raise the issue by a motion to lift the stay. The law governing a motion to lift the stay favors an early determination of the reorganizability of the debtor, while a motion to dismiss or convert a case discourages an early determination.


In order to constitute grounds for dismissal or conversion under Section 1112(b)(1), for example, the loss must be “continuing,” and the delay must be “unreasonable.” In addition, the provision requiring “denial or confirmation of every proposed plan and denial of a request made for additional time for filing another plan or a modification of a plan,” Bankruptcy Code Section 1112(b)(5), suggests that the debtor will be given every opportunity to reorganize before the case is dismissed or converted.
4. Dismissal Pursuant to Section 105

Several bankruptcy courts have used their equitable power under Section 105 of the Code to dismiss a case with prejudice in order to prohibit commencement of a new case within a specified period of time. Some courts have used this power to protect the courts' integrity by dismissing a case with prejudice, overriding other sections of the Code that appear to set limits on the effect of dismissal. Courts dismissing a case by using Section 105 have used Section 1112(b) in conjunction with that section. By and large, Section 105 has been used as a supplemental authority to other provisions such as Section 362(d) and 1112(b) of the Code.

5. Timing of Screening

Screening or filtering of debtors should occur as early as possible in the reorganization process to reduce costs and save time. However, in reality, it takes place at any time throughout the reorganization process before the court confirms the plan. As a result, most cases that will fail in the end continue the costly procedure for a long time. Moreover, the courts are "extremely hesitant to either terminate the reorganization attempt or permit creditors to remove significant assets from the debtor." In most cases, the courts protect the debtor's exclusive right to file a plan for at least 120 days.

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265 Chaves, supra note 257, at 9.
266 Id. at 10.
267 See, e.g., In re Geller, 96 B.R. 564 (E.D. Pa. 1989) (The court awarded sanctions for abusive filings, putting a limitation on future filings altogether for 6 months and requiring the court’s permission for a future filing for 2 years).
268 Section 105 of the Code has been used to invoke the court's equitable powers to allow limited payments of pre-petition debt under the "doctrine of necessity." Donald S. Bernstein & Regina E. Shannahan, An Introduction to Chapter 11, 577 PLI/Comm 7, 34 (1991).
after the commencement of the case. The courts have routinely extended the exclusivity period\(^{270}\) without placing a considerable burden on the debtor to show that the business has a going concern worth saving.\(^{271}\) The average time spent on Chapter 11 cases appears to be between 18 and 21 months, and fewer than a third of the plans are confirmed within a year.\(^{272}\)

C. **Comparison with the Bankruptcy Law of Canada**

This problem of inefficiency in screening debtors not deserving reorganization efforts arises because of the courts’ attitude toward the reorganization rather than from the provisions of the Code. For example, the implied threshold requirement of good faith filing and Section 1112(b) and 105 of the Code provide the courts a wide range of discretion. If the courts appropriately exercise their discretion granted by the Code, debtors not eligible for reorganization will be filtered out from the process in time. In this regard, Canadian bankruptcy law\(^{273}\) and its practices provide important insights on the reorganization system and practices of the United States. For example, the debtor screening mechanisms of Canadian law suggest an important solution to the prosecution of Chapter 11 of the Code.

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\(^{271}\) Triantis, *supra* note 269, at 103.

1. Threshold Screening

The Canadian system examines the debtor's eligibility for reorganization at the very early stage of the process. Under the Companies' Creditors Arrangement Act (CCAA) of Canada, in order for the debtor to have the opportunity to reorganize, the debtor must show that it is viable or otherwise eligible for reorganization immediately after or at the time of filing. The court holds an *ex parte* hearing upon filing and makes a preliminary determination on the debtor's eligibility for reorganization, including viability. If the debtor is recognized to be eligible for rehabilitation, the court enters an order granting the application and staying the collection activity of the creditors. A case under the Bankruptcy and Insolvency Act (BIA) may be initiated by the filing of a proposal, or, as is much more common, by the filing of a notice of intention to make a proposal. The notice of the filing is sent to creditors within five days. Creditors then may move to terminate the case on the grounds that the debtor is not eligible for reorganization. The grounds can be abuse of the stay or non-viability of the debtor. In addition, under the BIA, the debtor must retain a licensed trustee, who has a continuing obligation during the case to report on the financial condition and prospects of the debtor. If there is no possibility of successful reorganization, the trustee will probably refuse to be hired. The trustee's refusal also functions as a means of debtor screening. After the notice of

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273 Canada has two statutory regimes for the formal reorganization of insolvent companies: the Companies' Creditors Arrangement Act (CCAA) and the Bankruptcy and Insolvency Act (BIA).
274 R.S.C. ch. C-25 (1985) (Can.) [hereinafter CCAA]. The CCAA is used primarily for the reorganization of larger debtors with complicated capital structures, while the BIA is a less expensive alternative for smaller debtors with less complicated capital structures.
proposal, the debtor must file a projected cash flow statement together with the trustee’s report certifying the reasonableness of that statement.\textsuperscript{279}

2. Information Disclosure

Under both the CCAA and BIA, because of the threshold screening mechanism mentioned above, not only the court but also the creditors, at the inception of the case, can get needed information about the financial and economic conditions of the debtor.\textsuperscript{280} The information helps the court and creditors correctly evaluate the debtor’s business. In addition, the creditors can use such relatively credible information\textsuperscript{281} during the negotiation. On the other hand, the debtor’s management consequently has the incentive to provide early in the reorganization stage as much credible information about its business as possible, including the information that has caused the financial distress.\textsuperscript{282} This early-acquired information plays another role in successful reorganization in Canada. It subsequently improves the efficiency of a liquidation auction by removing the advantages the managers may have and reducing uncertainty over the value of the company.\textsuperscript{283}

\begin{itemize}
\item \textsuperscript{278} Id.
\item \textsuperscript{279} Id.
\item \textsuperscript{280} Under the Code, the creditors usually obtain the financial information of the debtor through the disclosure statement submitted by the DIP. For the debtor’s strategies regarding the disclosure statement, see Glenn W. Merrick, \textit{The Chapter 11 Disclosure Statement in a Strategic Environment}, 44 Business Lawyer 103 (1988).
\item \textsuperscript{282} Triantis, \textit{supra} note 269, at 111.
\end{itemize}
3. Termination of a Case

The Canadian bankruptcy courts are more flexible and active in terminating a pending case. In both the United States and Canadian regimes, there are debtor monitoring systems that often lead a pending case to termination. Once the court has noticed that the case is inappropriate for reorganization, the court may terminate the formal reorganization efforts or convert the case to a liquidation proceeding. The laws of both countries focus on the same four factors: (1) whether the debtor is acting in good faith; (2) whether the case is proceeding quickly enough; (3) whether the debtor has the capacity to reorganize; and (4) whether the debtor's act in question is prejudicial to creditors. In both countries, the bankruptcy courts have considerable discretion in determining both how to combine such factors to terminate the reorganization effort and what kinds of circumstances warrant such termination. Despite such similarities of factors leading to termination of a case, there appear to be substantial differences in the judicial attitudes of both countries. Unlike the Code, the Canadian system routinely brings cases before the court for evaluation and possible termination even without a formal move on the part of the creditors. Under the CCAA, for example, the court’s initial order specifies the time, typically a few months, within which the debtor must propose a

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283 Id.
284 LoPucki & Triantis, supra note 277, at 311.
285 11 U.S.C. Section 1112(b) (1994); BIA Section 50.4(11) (Can.).
286 E.g., 11 U.S.C. Section 1112(b); BIA Section 50.4(9) and (11) (Can.)
287 E.g. 11 U.S.C. Section 1112(b)(3). Under the BIA (Can.), lack of “good faith” or “due diligence” are grounds for refusing to extend the time for filing a proposal, BIA Section50.4(9), or for terminating the time for filing a proposal, BIA Section 50.4(11).
288 E.g. 11 U.S.C. Section 1112(b)(1), (2), (4), (5), and (7); BIA Section 50.4(9), (11) (Can.).
289 E.g. 11 U.S.C. Section 1112(b)(1), (3); BIA Section 50.4(11) (Can.).
290 LoPucki & Triantis, supra note 277, at 311.
plan. The automatic stay is given for only that period. To continue in reorganization beyond that period, the debtor must present a plan or apply to the court for extensions at intervals not longer than forty-five days. While considering the application for extension, the CCAA court can check the debtor’s eligibility again. The bases for the extension are the four factors described above.
A. The Need for a Trustee or an Examiner

When Congress consolidated Chapter X (Corporate Reorganization), Chapter XI (Arrangements), and Chapter XII (Real Property Arrangements) of the Bankruptcy Act (Act) into a unified reorganization chapter of the Code, it presumed that pre-bankruptcy management would continue to operate the business following the filing for relief. Congress then also recognized the need for displacing the dishonest or grossly incompetent DIP by creating a mechanism by which interested parties could seek the appointment of a trustee. If, as is often the case, the managers of a debtor are so untrustworthy that the reorganization case is unlikely to succeed, it would be desirable to oust the managers from the management. On this occasion, the appointment of a trustee is proper because the debtor itself is economically viable. On the other hand, there are some instances in which the current management needs to be retained even though some activities of the management are problematic. For these occasions, the appointment of an examiner is provided by the Code.

If a trustee is appointed, it can often solve problems associated with the DIP construct of the Code. First, when the debtor has engaged in fraud or has incompetently managed

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the business, for example, a trustee can honestly and effectively investigate the prior managers’ conduct and can take over the management of the business. Second, even when the debtor does not have such problems, a trustee may be able to soothe the possible tensions between the current management and creditors. Third, a trustee also can more convincingly resolve issues regarding the corporate governance and the fiduciary duty of the DIP, because the trustee is not elected by the shareholders and has no special relations with the various constituencies. The benefits of the appointment of a trustee result from the fact that a trustee is an independent third party who is relatively familiar with reorganization cases.

The appointment of an examiner is also beneficial in some instances. An examiner can help in determining early in a case whether there is any meaningful chance that the debtor can emerge from the financial difficulties. An independent, impartial examination may have more credibility than an investigation by a committee, which likely has an interest in the conclusions reached after the investigation. An examiner may provide other benefits available from the intervention of an independent third party without incurring as much cost as a trustee does. An examiner also can help diffuse possible tensions among the various constituencies by performing its tasks independently.

298 Id.
299 Id.
B. Appointment of a Trustee or an Examiner

The United States Trustee and any party in interest may request the court to order the appointment of a trustee or an examiner at any time after the commencement of a case but before the confirmation of a plan. If the court orders such an appointment, the United States Trustee shall appoint the trustee or examiner, "after consultation with parties in interest." The appointment is subject to the court's approval. However, there is neither a statute nor a legislative history that defines the scope of the court's discretion regarding the approval.

1. Trustee Appointment

There are two instances where the court can order the appointment of a trustee: where the "for cause" standard is satisfied and where the "best interest" standard is satisfied. Pursuant to section 1104(a)(1), a party in interest or the United States trustee may seek the appointment of a trustee "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." The grounds listed in section 1104(a)(1) are not exclusive, but it is arguable that the "cause" includes some of the grounds listed in section 1112(b) of the Code. Among the nonexclusive ten factors enumerated in section 1112(b), from (1) to (5) and (10) provide an arguable basis for seeking the appointment.

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300 11 U.S.C. Section 1104(a) & (b) (1994).
301 Id. Section 1104(c).
304 According to the rules of construction, the words "includes" and "including" are not limiting. See 11 U.S.C. Section 102(3) (1994).
305 See id. Section 1112(b) (1994).
of a trustee. The courts are in agreement that the time frame in which the court can review current management’s actions embraces activities both before and after the commencement of the case.

The particular kinds of conduct that have been found to satisfy the "for cause" standard include: inadequate accounting records and controls; failure to obtain proper insurance either for the employees or for its property; commingling of assets; conflicts of interest; failure to pay tax; fraud; and dishonesty. The courts have also ordered the appointment of a trustee where the current management failed to garner the confidence of major secured creditors, unsecured creditors, and prospective buyers.

306 See, e.g., In re Horn & Hardart Baking Co., 22 Bankr. 668, 671 (Bankr. E.D. Pa. 1982) (The bankruptcy court ordered the appointment of a trustee after the debtor in possession experienced continuing and unexplained losses following the filing for relief).
309 See, e.g., In re Brown, supra note 308, at 585; In re Caroline Desert Disco, Inc., 5 Bankr. 536, 537 (Bankr. C.D. Cal. 1980) (failure to maintain necessary casualty, public liability and worker’s compensation insurance).
311 See, e.g., In re L. S. Good & Co., 8 Bankr. 312, 315 (Bankr. N.D. W. Va. 1980) (stating that “the magnitude of the number of inter-company transactions places current management . . . in a position of having grave potential conflicts of interest and . . . the current management will be unable to make the impartial investigations and decisions demanded in evaluating and pursuing inter-company claims. . . .”); Dardarian v. La Sherene, Inc. (In re La Sherene, Inc.), 3 Bankr. 169, 176 (Bankr. N.D. Ga. 1980) (commingling of the affairs of the debtor in possession and a related corporation).
312 See, e.g., Brown, supra note 308, at 585 (repeated failure to pay real estate taxes, resulting in additional penalties); In re Great N.E. Lumber & Millwork Corp., 20 Bankr. 610, 611 (Bankr. E.D. Pa. 1982) (failure to file and pay sales tax).
314 See, e.g., In re Deena Packaging Indus., Inc., 29 Bankr. 705, 707-08 (Bankr. S.D. N.Y. 1983) (failure to disclose relevant financial information in schedules); La Sherene, supra note 311, at 175-76 (general dishonesty exemplified by desperate conduct in desperate situations).
315 See, e.g., In re Brown, 31 Bankr. 583, 585 (D. D.C. 1983) (an instance where the debtor’s litigious personality dissuaded interested parties from closing on sale or lease of the debtor’s property); Smith v.
In addition, the appointment of a trustee has been ordered where the debtor in possession either has failed to pay to a secured party or has made unauthorized payments including, for example, payments on account of prepetition indebtedness.

“There are few situations which come to mind where grounds will exist for the appointment of a trustee under subsection (a)(2) where 'cause' for such appointment will not exist under subsection (a)(1) because the difference between the two subsections results from a difference in point of view. While the former is understood from the perspective of potential problems stemming from current management, the latter is viewed from the perspective of other parties that can be damaged by the conduct of the management. Thus, the same activity of the management will usually satisfy the two standards at the same time. The courts’ decisions that have applied either of the two standards would not, therefore, mean that the standard applied is exclusive. Indeed, it is not uncommon to find that courts’ decisions ordering the appointment of a trustee rest upon both the "for cause" and the "best interests" standards at the same time. Some courts, however, have ordered the appointment of a trustee only under the "best interests" standard to investigate whether reorganization is possible. Some other courts have ordered the appointment of a trustee, for cause, where the debtor in possession failed to


See, e.g., In re McCall, 34 Bankr. 68, 69 (Bankr. E.D. Pa. 1983) (the debtor’s failure to make monthly payments for two years constituted gross mismanagement or incompetence).


5 Collier on Bankruptcy ¶ 1104. 01, at 1104-22 to 23 (15th ed. 1982).


maintain the confidence of the secured parties,\textsuperscript{321} where the debtor was confined in prison,\textsuperscript{322} and where the individual debtor died after the case had commenced.\textsuperscript{323} The bankruptcy courts have placed the burden of proof for the appointment of a trustee on the party moving for a trustee and have repeatedly ruled that the movant must prove the need for a trustee by "clear and convincing evidence."\textsuperscript{324}

The courts, however, have been reluctant to order the appointment of a trustee under the "best interests" standard in marginal cases. For example, the courts have declined to order appointment of a trustee where current management had a needed expertise in a complex industry or where it was unclear whether a trustee was more likely to successfully rehabilitate the debtor than the DIP. Similarly, the courts have sometimes declined to order the appointment of a trustee where the intermediate option of appointing an examiner under section 1104(b) proved to be more acceptable.\textsuperscript{325}

2. Examiner Appointment

According to Section 1104(c) of the Code, if the court does not order the appointment of a trustee, it "shall order the appointment of an examiner to conduct such an investigation of the debtor . . . ."\textsuperscript{326} The statutory standard, "the interests of creditors, any

\textsuperscript{322} See, e.g., In re New Haven Radio, Inc., 23 Bankr. 762, 767 (S.D. N.Y. 1982).
\textsuperscript{325} See, e.g., In re Hamiel & Sons, Inc., 20 Bankr. 830, 832-33 (Bankr. S.D. Ohio 1982) (because of the costs of a trustee and the fact that the estate was not depleted, the court decided to order the appointment of an examiner to investigate the potential liabilities of principal officers and shareholders under alter ego doctrine); In re American Bulk Transport Co., 8 Bankr. 337, 340-41 (Bankr. D. Kan. 1980) (a trustee would not be needed, although it would be in 'best interests' of creditors to appoint an examiner).
\textsuperscript{326} 11 U.S.C. Section 1104(c) (1994).
equity security holders, and other interests of the estate, mirroring the standard for the appointment of a trustee. The movant must prove the need for the appointment of an examiner by clear and convincing evidence. The collective interest of all of the constituencies should be considered in the appointment of an examiner. Among such interests, the interest of the estate is the primary concern. Like the standard for trustee appointment, this standard also requires a comparison of the costs and the benefits of an examiner appointment. The costs of an examiner are generally significantly lower than those of a trustee because an examiner does not manage the business and therefore does not need to be compensated for a management role.

C. Roles of Trustees and Examiners

The statutory language of Section 1104(a)(1) and (c) suggests that the appointed trustee or examiner should first investigate allegations of fraud, dishonesty, incompetence, and so on. An independent third party is often well suited to investigate issues regarding the conduct of the DIP and to provide an impartial, credible report. An impartial report helps the interested parties resolve disputed issues and reach an agreement on a reorganization plan by bringing to light facts and issues of concern to the

327 Id.
329 A few courts have granted examiners the authority to run the business or otherwise to control the reorganization. E.g., In re John Peterson Motors, Inc., 47 B.R. 551 (Bankr. D. Minn. 1985); In re Liberal Market, Inc., 11 B.R. 742 (Bankr. S.D. Ohio. 1981). Even though an examiner, except to the extent that the court orders otherwise, performs the duties of a trustee, 11 U.S.C. Section 1106(a)(3) and (b), such duties should be interpreted not to include the operation of the debtor’s business under the DIP structure of the Code. Section 1106(b) authorizes an examiner to investigate and report, and to perform “any other duties of the trustee that the court orders the debtor in possession not to perform.”
330 Zaretsky, supra note 297, at 946.
parties. Such investigation by a trustee or an examiner can reach not only the debtor's current business but also its management before the commencement of the case. The investigative function of a third party is particularly important in smaller cases because, in a smaller case, there may not be an active creditors’ committee and professionals who can help supervise the DIP.

When there is substantial evidence that the DIP has been involved in fraud, gross mismanagement, or other conduct inconsistent with its role as fiduciary for the estate, the appointment of a third party is mandatory. In Chapter 11 cases, creditors and shareholders have a strong interest in the operation of the business of the debtor and in the honest formulation of a reorganization or liquidation plan. If the DIP is engaged in fraud or gross mismanagement, it cannot provide its various constituencies with comfort and confidence. As a result, the negotiation process will likely come to a deadlock leading the case to failure. Appointment of a trustee can be the proper solution to such a problem.

In particular, if there are conflicts of interest, the need for an independent third party increases. In a reorganization case, there is considerable potential for conflicts of interest. The managers of the DIP may be the beneficiaries of avoidable transfers or may otherwise be in a position to benefit at the expense of the estate. Members of the creditors’ committee may also have in mind their own interests. The debtor may have affiliates with whom it deals on unfair terms. When the appearance or fact of conflict becomes an issue, the intervention of a third party may alleviate such difficulties. In addition, a trustee can

331 Id.
333 Id. See also, e.g., In re U.S. Communications of Westchester, Inc., 123 B.R. 491, 495 (Bankr. S.D. N.Y. 1991).
often pursue litigation on behalf of the estate more effectively than the DIP or a creditors' committee.

The advantages associated with the appointment of a third party often outweigh the drawbacks that undeniably exist in such appointment.\textsuperscript{334} A trustee will seek to benefit all the creditors and will bring a refreshing air of objectivity and impartiality to a business. Specifically, the trustee will probably keep accurate and trustworthy records and try to cooperate with the creditors in the pursuit of a plan.\textsuperscript{335} In addition, the trustee's objective management of the business may make it possible to cut off loyalties to favored suppliers, customers, or employees and sell off unprofitable or marginal divisions or product lines. The trustee, through objective management, can also reduce the overhead by cutting off inefficiencies, wastes, and excesses, thereby garnering the confidence in the creditors and equity shareholders. The appointment of a third party may also prove to be particularly advantageous in cases where the court has an opportunity to appoint an individual or firm with unique expertise or to counterbalance an otherwise ineffective creditors' committee.\textsuperscript{336} Most importantly, the trustee may be more experienced than the current management in dealing with the complexity of the reorganization process,\textsuperscript{337} thereby maximizing the chances of a successful reorganization for the benefit of all parties to the proceeding.

\textsuperscript{334} The expenses related to a trustee, the trustee's being unfamiliar with the business, and the possibility of discouraging the debtor from filing for relief would be some of the disadvantages. See generally A & P H. R. Rep. No. 95-595, 95\textsuperscript{th} Cong., 1\textsuperscript{st} Sess. (1977) at 233.


\textsuperscript{336} \textit{Id.} at 249.

\textsuperscript{337} In some bankruptcy districts, such as Columbus, Ohio, and San Antonio, Texas, Chapter 13 standing trustees run extensive credit-education, counseling, and re-establishment programs for consumer debtors. These programs might increase the rate of successful reorganization. Jean Braucher, \textit{Bankruptcy Reorganization and Economic Development}, 23 Cap. U. L. Rev. 499, 499 (1994) n. 2.
The court can limit the roles of a trustee in operating the debtor’s business. In other words, a trustee may completely replace the management of the DIP or may be assigned a more limited role. If the court deems that the current management is important to the ongoing business operations, it can order the trustee to serve only an oversight role, retaining the current management for day-to-day operations.  

Except for being unable to replace the operation of the debtor’s day-to-day business, an examiner performs the same duties as a trustee unless the court orders otherwise. One of the distinctive roles of an examiner is that an examiner with expanded powers may be appointed to mediate in deadlocked plan negotiations. Mediation by an examiner appears to be particularly useful when the period within which the DIP can exclusively propose a reorganization plan has expired. Once the exclusive period has expired, any party can file a plan and attempt to obtain the agreement of other constituencies. Under this circumstance, an independent third party’s plan is more likely to obtain other parties agreement.

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338 See, e.g., In re Madison Management Group, 137 B.R. 275 (Bankr. N.D. Ill. 1992) (a trustee was appointed to investigate causes of action available to the debtor and to pursue viable actions).
341 Zaretsky, supra note 297, at 957.
343 Zaretsky, supra note 297, at 958.
Chapter V

Conclusion

When Congress promulgated Chapter 11 of the Code in 1978, it thought that the operation of a business was best left to existing management. The current management possesses the most familiarity with the business. Retention of existing management will therefore enhance the effectiveness of the debtor’s business operations and reduce the cost of administration. Accordingly, the Code contemplates that the debtor will remain in control of its business while negotiating the terms of a reorganization plan.

In order to support the efficacy of the debtor in possession concept, Congress created several participants who would balance the conflicting interests of the debtor and its creditors. The mandatory creditors’ committee is one of them. The committee is designed to oversee, monitor, and investigate the business operation by the debtor in possession and to negotiate a plan. If the committee is not enough to protect creditors’ interests, the bankruptcy court may order the appointment of an independent third party, a trustee or an examiner. A trustee or an examiner investigates not only the conduct of the existing management but also the debtor’s economic and financial situations. The third party is expected to restore the confidence of other parties in interest by impartial investigation and objective evaluation of the debtor. The United States Trustee also plays a supervisory role along with its case administration function. The bankruptcy courts’ equity power is
one of the most influential methods controlling the conduct of the debtor in possession even though the courts’ role is principally limited to the judicial function.

However, the realities of bankruptcy practice have proved to be different from what Congress contemplated. Despite Congress’s original intention, both the creditors’ committee and the appointment of a third party have not functioned well. Creditors are often apathetic to the reorganization process. Moreover, in many small cases, the creditors’ committee does not even exist. The appointment of a third party is rare because the courts regard the appointment of a trustee or an examiner as an extraordinary remedy. Absent extraordinary circumstances, the courts consider that such an appointment is counterproductive and against the policies underlying the DIP construct of the Code. As a result, in the majority of cases the DIP can enjoy its exclusivity for at least 120 days from the inception of the case without much intervention. Moreover, the exclusive period can be extended easily. The courts’ deep-rooted respect for the DIP concept gives many incentives to a debtor to file for reorganization relief even though the debtor does not have a going concern value. The result is that after a lengthy and expensive reorganization effort, the case still fails. Empirical studies show that less than 30 percent of the Chapter 11 cases have managed to get a confirmed plan and that about half of the debtors whose plans have been confirmed have again experienced financial difficulties.

One of the important factors contributing to such unsuccessful reorganizations has been that businesses not eligible for reorganization efforts nonetheless attempt to reorganize. Debtors without going concern value and those that abuse the automatic stay do not deserve rehabilitation efforts. If a reorganization case fails, considerable costs remain without any desirable outcome. The costs are borne by the creditors, and in the
long run society as a whole shares them. Unlike successful business rehabilitation, a failing case has no ground to justify such expenses. The costs incurred by debtors not deserving reorganization cannot be justified even though the presupposed "possible misuse of resources"\textsuperscript{344} is taken into account.

The thesis suggests that bankruptcy courts more actively manage reorganization cases in order to reduce the costs incurred by the filings of ineligible debtors. Provided that the courts adequately utilize the existing legal devices established under the Code, the costs would be reduced dramatically. First, the court can use the threshold requirement of good faith filing. This requirement has been developed by some courts to prevent abusive or non-viable debtors from taking advantage of the reorganization relief. Second, the court can utilize Section 1112(b) (conversion or dismissal) and Section 362(d) (relief from the stay). These sections can help terminate some pending cases on the grounds of abuse or futility of the case. Third, the appointment of a trustee or an examiner should be used more frequently. Section 1104 of the Code provides some circumstances under which the appointment of a trustee or an examiner is mandatory. Fourth and most importantly, the utilization of Section 105 of the Code is a useful method to expedite reorganization cases. Under this section, the courts may take any action and may make any determination necessary to enforce a court order or rule to prevent an abuse of the process on a \textit{sua sponte} basis. Many courts are now using Section 105 as a ground for creating new methods that would help them administer a case more efficiently and expeditiously. Mediation based on Section 105 is a good example.

There are many provisions and doctrines that suggest the courts participate in the reorganization process more actively to protect creditors’ rights. Nevertheless, the courts are extremely reluctant to get out of their deep-rooted respect for the debtor in possession construct of the Code. Compared to the bankruptcy practice of Canada, that of the United States overprotects the debtors at the expense of the creditors.

Such lukewarm attitudes of the courts may result from a fear that a premature decision would cause mistakes. In most cases, because the DIP is aware of the courts' attitudes, it submits information regarding its business as late as possible. Then the courts, for example, can use Section 105(d) of the Code to order the DIP to file the disclosure statement before a plan is ready. It is possible and necessary for the courts to make the DIP reveal its financial and economic realities at the early stage of the process because the debtor's managers may have been preparing for bankruptcy for a long time before they finally file the petition. If credible financial information of the debtor comes to the creditors immediately after the filing, a substantial portion of debtors not worth saving would be kept out of the reorganization process, as shown in the bankruptcy practice of Canada. The bankruptcy courts of the United States should more actively administer reorganization cases. No one believes in preserving businesses destined to fail, and a debtor that abuses the rehabilitation scheme does not deserve to be called an honest debtor eligible for survival.
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