Statement to ABI Commission to Study the Reform of Chapter 11
Re Corporate Governance in Chapter 11

By Clarkson McDow, former U.S. Trustee for Region Four
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Thank you for your kind invitation to appear before you today to share some of my thoughts on chapter 11 and corporate governance. For eighteen of the best years of my legal career, I had the privilege of serving as the United States Trustee for Region Four. Since January I have been retired. For the first time in a long time, I do not have to say, "The views expressed are those of the speaker and not intended to represent the views of the Department of Justice, the EOUST or any other UST." While the views I express are not necessarily the views of the EOUST, my experiences during my time as UST have shaped my thoughts. This Commission has been rightly described as the "best and the brightest." I cannot add much knowledge but I hope to add some perspective.

The United States Trustee has a unique statutory role as administrator and enforcement "watchdog" of the bankruptcy system, which provides a broad public interest perspective that differs from the perspectives of debtors or creditors concerned with their economic interests. Congress has granted the United States Trustee, an independent party with no economic interest, standing to act and raise issues because the system needs an independent voice to protect those interests not present in the courtroom and the integrity of the system.

The Commission's mission statement provides that the study and potential reform of chapter 11 are warranted because of "the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code . . . ." In inviting me to appear, Sam Gerdano explained to me that the Commission would be writing on a blank slate. That is a good way to approach reform. Many people will press you on new things to write on that blank slate, but you also have to keep in mind the reasons the current Code was written in the manner in which it was written. In particular, the Commission should be wary of recommendations that might unwisely change things back to the way they used to be, thereby reviving problems that were ameliorated by earlier changes.

Some of the arguments for change that I have heard have reminded me of the arguments advanced during the tech bubble that the economy had changed and that the principles of investing were different. Similar arguments said that the real estate market would always rise and urged Americans to "let that equity in your home work for you." Many Americans have learned the hard way that certain principles do not change. In the bankruptcy context, I believe that one of those immutable principles is the importance of maintaining the separation of the court's judicial role from the administration of the bankruptcy case.

Recommendation Number 1. Maintain the separation of the court's judicial role from the administrative functions of appointing trustees, examiners and committees.

When Congress enacted the 1978 Act, it explained both the importance of bankruptcy and its difference from traditional civil litigation: "[T]here is a public interest in the proper administration of bankruptcy cases. . . . In contrast to general civil litigation, where cases affect only two or a few parties at most, bankruptcy cases may affect hundreds of scattered and ill-represented creditors. . . .Bankruptcy affects too many people to allow it to proceed untended by an impartial supervisor." H.R. REP. NO. 95-595, 88 (1977).

"Deeper problems arise because of the inconsistency between the judicial and administrative roles of the bankruptcy judges. The inconsistency places him in an untenable position of conflict, and seriously compromises his impartiality as an arbiter of bankruptcy disputes." *Id.* at 89. Congress further recognized that the combined administrative and judicial functions created an institutional bias, such that bankruptcy judges felt "personally responsible for the success or failure of a case," *id.,* which led to the appearance of bias . . . ." *Id.* But Congress did not blame the judges for this structural infirmity:

> None of these problems are the creation of the bankruptcy judges themselves. As a whole, they are fair-minded individuals who do the best they can to avoid the conflicts and institutional bias that exists in the bankruptcy system. Nevertheless, the structure of the system, written into the present Bankruptcy Act as law, necessitates the awkward position in which the bankruptcy judges find themselves, and brings disrepute on the whole system. The law must be changed to afford bankruptcy litigants the fair and impartial justice to which all other

litigants in the federal courts are entitled.

Id. at 91.

Some will respond to this by saying this is not 1978. In some respects they are correct. In those days the bankruptcy practice was not as widespread or as an important a part of our legal system as it is today. Then bankruptcy was run by a few people and it was easy to refer to them as a "ring." Today almost every major firm has a bankruptcy department. For several decades bankruptcy has attracted some of the best and brightest legal talent in the country. The practice is much more sophisticated than it was in 1978. The bankruptcy bench is strong and well respected. One of the reasons the bankruptcy bench is strong and well respected is because the 1978 Code freed them from their administrative duties and allowed the judges the freedom to focus on their judicial duties. Those administrative duties were taken on by the UST, which, of course has other significant enforcement activities. Because the reforms of 1978 broke the narrow "bankruptcy ring," the bankruptcy system has been able to attract a broader and better group of professionals.

Recommendation Number 2. The role of the court in selecting chapter 11 trustees should not be changed.

The most obvious issue in chapter 11 case governance is whether the debtor should remain in possession or whether a trustee should be appointed. Under the Bankruptcy Code, the court decides if "cause" exists for the appointment of a trustee, but the UST makes the actual appointment after consultation with the parties and subject to approval by the court. I submit that this system has worked well, and that, although judges could do a good job of selecting trustees, any effort to increase their involvement in the trustee selection process would come at a steep price.

While I have heard people question the utility of having an independent party without an economic interest involved in this process, I am not aware of a case wherein the United States Trustee failed to appoint a trustee who was not qualified to complete the assignment. Parties sometimes complain that their recommended person was not selected, but I do not know of a case where it has been argued that the selected person did not have the ability to perform the trustee duties.

A significant amount of due diligence is required in making trustee appointments. This due diligence is done in private for good reason. As UST, when I interviewed trustee candidates, the interviews were private and the candidates could be candid. The court probably does not have time to do the due diligence and even if it did, the nature of the information and the discussion could and likely would prejudice the parties. Trustee candidates must be fully vetted to determine if they have connections with creditors and others that would constitute disqualifying conflicts of interests or which would otherwise make their appointment unwise. If a party were to object that a trustee appointed by the court has a disqualifying conflict, the court would have prejudged this issue by appointing that person. Furthermore, persons being interviewed for trustee appointments generally explain how they will go about administering the estate. If the court were to make the appointment, it would then become difficult for the court to rule against the trustee if a party objected to the trustee's course of action disclosed during the interview.

Our bankruptcy system requires an unbiased judge and an independent trustee. The trustee must not only be independent, but must appear independent. The best way to ensure this independence is to divorce the judge from the trustee selection process. This is what Congress did with the Bankruptcy Code. The judge, who has a difficult enough job without this added responsibility, should not have to deal continually with the additional pressure of supporting or not supporting the trustee while deciding issues raised by the trustee he or she selected. Even though the judge is completely impartial and unbiased, the appearance to other parties may be that the deck is stacked against a party litigating against a trustee before the judge who selected the trustee.

Recommendation Number 3. The role of creditors in the selection of chapter 11 trustees should not be changed.

One advantage of the having the UST appoint trustees is that the trustee will be a more independent trustee not directly beholden to any particular creditor for his or her appointment. The UST, as is required by the Bankruptcy Code, consults with major creditors in a case when the court directs the appointment of a trustee. Often one major creditor who either sought or supported the trustee appointment will be quite vocal on who the trustee should be.

But there is no single creditor interest in bankruptcy; there is a multiplicity of creditor interests. The UST's job in the selection process is to consult with the parties and then to choose a trustee who can rise above individual creditor interests and can instead be a fiduciary advancing the interests of the entire estate for the entire creditor body. The trustee appointed by the UST can make the difficult decisions without worrying about the appearance that the trustee's actions were influenced by the party who advocated for his appointment.

Creditors can be quite candid with the UST in making trustee recommendations. Individual creditors often recommend multiple candidates to the UST, but the candidates do not usually know they are one of several recommendations. On more than one occasion of which I am aware, a UST was confronted by a disgruntled candidate who mistakenly believed that he or she was the major creditor's only candidate and then complained that the UST had ignored creditor interests by appointing someone else.

The distribution scheme of the Bankruptcy Code gives different incentives to various parties. Those on the top of the food chain with good security often favor a quick sale that provides a full recovery while leaving out those on the lower end of the distribution chain. On the other hand those on the lower end may want a more deliberative process that gives them some hope of a recovery. The trustee in administering the estate has to balance these competing interests. This is more easily accomplished by a trustee who is not indebted to a single creditor or group of creditors.

Recommendation Number 4. Although no method of selecting trustees and examiners could be perfect, the current method is better than any of the alternatives.

When I was the UST for R-4, I took seriously my duty to consult with parties in interest before making a trustee or examiner appointment. This consultation included not just seeking suggested names but also inquiring about the qualities that the trustee would need for the case. Seldom was there consensus on a trustee candidate. When there is such consensus the UST would give that candidate every consideration. Parties are often looking for a trustee to serve their narrow interests, rather than benefit the estate as a whole. While pleasing all of the parties is rarely possible, the consultation process is very valuable to the United States Trustee in making appointments. In making the decision I did not limit the search to those candidates suggested

by parties in interest. In smaller cases with less creditor interest or less sophisticated creditors sometimes no recommendations would be received.

One challenge of the consultation process is to ensure that everyone understands that the process is open and that recommendations should not be limited by some preconceived notions of how the United States Trustee appoints trustees. For example in some places there was historically an assumption that the chapter 11 trustee would come from the chapter 7 panel or there may be an assumption that the trustee should come from the district or at least the state in which the case is filed. Such mistaken assumptions can discourage recommendations that do not fit those narrow criteria and make the UST's selection more difficult. At times I heard complaints from parties and members of the bankruptcy bar about my going out of the district for a trustee or examiner or for my not selecting a member of the chapter 7 trustee panel. Not all judges were comfortable with a trustee who was not from their district or the local chapter 7 panel. Sometimes a local trustee who knows the locality is the best candidate but in more complicated cases sometimes the best candidates are not the local candidates. The EOUST currently makes it clear that USTs are expected to have an open system of trustee selection and that the guiding principle is to find the most qualified individual who will best serve the case and the public interest.

During my eighteen years with the United States Trustee Program, the interview and vetting process evolved significantly. The process has become more rigorous and more uniform across regions. The interview and vetting processes followed by the UST would be difficult for the court to follow. The candidates share ideas about how the case should proceed and usually give some idea of the direction they will take as trustee. Much of this information should not be heard by the court outside the courtroom, but there is no way to vet candidates effectively in public.

In many cases speed is important in the selection of the trustee, because if the appointment is for "fraud, dishonesty, incompetence or gross mismanagement" time becomes of the essence in getting new management in place. Any changes in the process should keep this in mind and avoid unnecessary delay. We did not always get a candidate selected as quickly as I would have liked but speed is an important consideration.

Sometimes the very parties that were consulting with me about trustee selections were obviously going to be litigating with the trustee selected. That

does not mean that that party might not have some valuable insights that would aid the process, but is an important factor to be considered in making the selection. All of the parties consulted are going to have a major interest in the trustee's actions. Sometimes the parties want a trustee that will maximize value or bring about a speedy reorganization. At other times a party may simply want a trustee who will rubber stamp a sale without asking too many questions. All trustees have a fiduciary duty, not to any one creditor or any group of creditors, but to the estate. This may include the duty to investigate matters such as the secured status of the very creditors who are being consulted.

Recommendation No. 5. The burden of proof for the appointment of a trustee should be a preponderance of the evidence.

There is probably a correct perception that too few trustees are appointed. I have heard people say that this is due to the appointment process. However, it is difficult to evaluate, and attaching a cause is even more difficult. There is no empirical evidence to show that the appointment process discourages parties from seeking a trustee. Nor is there anecdotal evidence from specific cases.

The expense of the litigation and the expense of the trustee are often cited as reasons for not seeking the appointment of a trustee. Another reason that parties fail to seek and other times actively oppose a trustee is the misconception that the appointment of a trustee displaces operational employees. If appropriate, there is no reason a trustee cannot maintain current staff and keep the business running. The debtor's attorney would be in the perfect position to seek such a trustee appointment, but often is reluctant to do so, because the appointment may mean she is out of a job as the trustee will seek new professionals. At times this seems unfair, but usually new professionals untainted by relationships with prior management are necessary. The Unsecured Creditors Committee often anticipates a lesser role for the committee when there is a trustee. This may leave the UST as the party making the motion. At times parties actively encourage the UST to make such motions rather than making the motions themselves. This was always fine with me so long as our investigation found sufficient grounds for a trustee, but sometimes the motions placed a strain on our limited resources.

While as noted above, it is difficult to ascribe a causal reason for the lack of trustee appointments, there is one clear and potentially easy partial solution.

The Commission could propose that the Code be amended to clarify the burden of proof for the appointment of a trustee. A preponderance of the evidence showing "fraud, dishonesty, incompetence or gross mismanagement" or any other cause for appointment of a trustee should be sufficient for the appointment of a trustee.

The burden of proof for the appointment of a trustee should be uniform from district to district. While some cases hold that the burden is "clear and convincing," the better view is that the burden of proof is and should be a "preponderance of the evidence." See *In re Tradex Corp.*, 339 B.R. 823 (D. Mass. 2006). *Tradex* cited *Grogan v. Garner*, 498 U.S. 279 (1991), a Supreme Court case holding that the burden of proof in a case seeking as exception to discharge was the preponderance of the evidence because there is no indication that Congress sought to impose a higher standard. Just as there is no reason for a heightened standard for the burden of proof in an exception to discharge, there is no reason for a higher standard in a motion for a trustee.

A number of courts hold that clear and convincing evidence is needed to overcome a "strong presumption" in favor of the debtor remaining in possession. These courts sometimes refer to the appointment of a trustee as a drastic remedy. This perpetuates the myth that a trustee appointment is bad and leads to the failure of the business. Many cases with trustees fail, because as a practical matter trustees are generally appointed in the cases with the worst pre-petition management.

One example of how trustees can work involved a case in Maryland a few years back. The DIP tried to sell its racetrack by a quick sale. The proposed sale would have allowed no distribution to unsecured creditors and would have only paid the secured debt which was held by an insider. The UST's objection to the sale was sustained. The evidence at the hearing on the sale demonstrated that the DIP was not living up to its fiduciary duties. As a result a motion was made for a trustee and was granted. The trustee sold the racetrack for a sufficient price to pay all unsecured creditors and make a return to equity. This was hardly the drastically bad result which parties frequently predict.

Recommendation No. 6. The Commission should resist efforts to create court-appointed alternative parties to perform functions of the Debtor-in-Possession.

We are all familiar with cases in which the DIP is underperforming. In many of the mid-sized and smaller cases, debtors desperately need professional help beyond debtor's attorney and an accountant. There is nothing to prevent the debtor's board from hiring a Chief Restructuring Officer or a consultant if one is needed, and in many cases this would improve the chances of success. Debtors should be encouraged to seek such help, but they should stop short of having this person assume the powers of the debtor or reporting independently to creditors or the court. The board of the debtor should be left in full control unless and until a trustee is appointed. Dividing the responsibilities is, more often than not, a bad idea. When a Chief Restructuring Officer is hired, the CRO should report to the debtor's board of directors and the duties should be clearly defined. Those duties should be clearly to the debtor and not the creditors.

On more than one occasion as UST, I allowed the major constituencies to talk me into an examiner as a lesser remedy to the appointment of a trustee. This can work if the examiner has a limited role such as ensuring that proper financial controls are in place, but when the role is expanded to a quasi-trustee the record is more mixed.

Any half measure will be used by debtors to avoid losing complete control to a trustee. It will give some parties a false sense of security that a court appointed officer is on the job. If this person is allowed to have professionals, they will duplicate the debtor's professionals. But without professionals, it is difficult to see how this person will be effective. If the role is plan negotiations, how will this role differ from the debtor's attorney? If the court appointed this officer and he or she reported to the court, or if the court directed the officer's role, the court would be getting back into the business of day to day case administration. The parties would have the impression that the court appointed officer was representing the court in the negotiations. This could easily lead to abuse or a lessened respect for the process.

Some encourage the expansive use of court-appointed mediators in bankruptcy cases. Mediation in bankruptcy, if properly done, can be helpful in developing consensus and advancing the reorganization process. But one of the current problems with mediation is the growing practice of sitting judges

appointing other sitting judges as mediators, who then conduct those mediations in secret. Just last week, however, the federal Third Circuit Court of Appeals roundly criticized a similar secret process as unconstitutional when the court invalidated a Delaware law providing for secret arbitration before Delaware judges. In any event, any mediator in bankruptcy should be independent and should not report, formally or informally, to the court.

I also would not want examiners to fill a mediation role for the same reasons they cannot serve as trustees. The examiner's function is to investigate and report. Tasking an examiner with doing more may call into question his or her independence.

But ultimately, if the debtor is not capable of performing the duties of a DIP, the answer is a trustee. Anything short of that will ultimately be ineffective. Any suggestions of such remedies buy into the concept that a trustee is a drastic remedy. If courts were empowered to appoint officers with some but not all DIP duties and functions, trustee appointments would become rare indeed. Such a remedy would protect the fraudulent and the incompetent by enabling them to remain involved with the debtor, but would do little to advance the interests of the estate. Most cases can succeed or fail on their own merits without a trustee; the DIP model, while not perfect, is a good one. In those cases in which the DIP cannot function properly the answer is a trustee. I submit that overall results in chapter 11 would be better if more trustees were appointed. Attempts to avoid this appropriate remedy will neither reduce costs nor lead to more successful reorganizations.

Conclusion

The foregoing recommendations have focused primarily on the importance of the continued role of an independent party in the selection of replacement fiduciaries in cases in which the debtor is not able to fulfill its duties as DIP. But I want to reemphasize the overall importance of having an independent watchdog of the bankruptcy system. During my tenure as UST, I was always aware that some believed that only judges and those with a pecuniary interest should play a meaningful role in a case. But the legislative history and experience establish quite clearly that an independent actor who is willing and able to challenge all parties is necessary to uphold the integrity of the bankruptcy process. Any significant recalibration of the balance present in the current system—whether by further entrenching current management, allowing creditors more control, or restoring case administration duties to the

judge—would, in my view, constitute a giant step backward towards the flawed system that was reformed in the modern bankruptcy code adopted in 1978.