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The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations

by

*Christopher W. Frost**

Governing a corporation during a Chapter 11 reorganization presents a special case of the age-old problem of the separation of ownership and control.[1] Critics of Chapter 11 have long pointed to the insulation provided by the automatic stay to managers of the business as one of the causes of bankruptcy inefficiency.[2] Protected from the normal contractual and market forces that restrain the behavior of managers of healthy companies, managers of firms in bankruptcy, the harshest critics charge, use delay and other strategies to enrich themselves and the shareholders at the expense of the firm's creditors.

These charges echo those leveled in corporate law debates about the responsiveness of managers to the concerns of shareholders[3] and, more recently, about the behavior of corporate managers of companies involved in leveraged buyouts.[4] Disputes over the constituencies that managers should serve and

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[1]The phrase "separation of ownership and control" was coined by Adolph Berle and Gardiner Means in their classic work, ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4 (1932).

[2]*See, e.g.*, Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1076 (1992) ("Filing a Chapter 11 petition, in effect, is a way to keep control of the firm free from the intrusive monitoring of creditors, thereby permitting management to extract wealth from the firm's various security holders.").

[3]*See, e.g.*, Victor Brudney, *Corporate Governance, Agency Costs and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1407 (1985) ("To be sure, there is room to debate the extent to which management engages in such diversion or shirking; but there is no doubt that the structural arrangements under which management is selected and governed permit it to do both more than trivially."). Classic articles examining this problem from an economic perspective include Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983), and Michael C. Jensen & William F. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[4]*See, e.g.*, William W. Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 165-70 (1989); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1662-64 (1989); Frank H. Easterbrook &

the efficacy of such institutional controls as fiduciary duties, contract, and the market in controlling managers' behavior continue unabated, resulting in a rich literature of corporate governance that accounts for a wide range of views. Drawing from this literature, many bankruptcy scholars have turned their attention to the unique corporate governance problems that Chapter 11 raises.[5] By examining the economic principles underlying the nonbankruptcy governance structure, these commentators have propounded theories that seek to align the Chapter 11 governance structure with its nonbankruptcy counterpart.

As compelling as such theories may seem outside of bankruptcy, they tend to fall apart in the context of a Chapter 11 case. The financial reverses precipitating the filing, the need to attend to the day-to-day business problems, and the desire for a speedy and inexpensive resolution of the problems often render the bankruptcy governance structure ineffective, resulting in a free-for-all in which strategic behavior is the order of the day. This specter is more likely in small bankruptcies where the creditors have so little at stake that the traditional methods of control—creditors' committees, motions to convert to Chapter 7 or to appoint a Chapter 11 trustee, termination of debtor exclusivity, and the like—are impractical. In many cases, there is no one with the time and the incentive to assure that managers are not milking the case for their own benefit.

Bankruptcy lawyers and judges are a pragmatic lot, however. Status conferences, expedited procedures in small bankruptcies, the judicious use of examiners and, perhaps most importantly, control over the fees awarded to debtors' attorneys are pragmatic responses to the difficulties inherent in governing a corporation undergoing a Chapter 11 reorganization. In addition, the recent report of the National Bankruptcy Review Commission[6] includes practical recommendations that are intended to reduce the managerial autonomy that has plagued small business cases.

Further complicating questions of bankruptcy governance, however, is the fact that governance questions are inextricably bound up in the broader

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Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1168-73 (1981).

[5]*See, e.g.*, Edward S. Adams, *Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results*, 73 B.U. L. REV. 581 (1993); Christopher W. Frost, *Running the Asylum: Governance Problems in Bankruptcy Reorganizations*, 34 ARIZ. L. REV. 89, 91-94 (1992); Thomas G. Kelch, *Shareholder Control Rights in Bankruptcy: Disassembling the Withering Mirage of Corporate Democracy*, 52 MD. L. REV. 264 (1993); Thomas G. Kelch, *The Phantom Fiduciary: The Debtor in Possession in Chapter 11*, 38 WAYNE L. REV. 1323 (1992); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993); David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992).

[6]*See* NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS (1997) [hereinafter NBRC REPORT]. The NBRC Report is available via the Internet at <http://www.nbrc.gov>.

policy question of what goals Chapter 11 should seek to promote. Leaving managers in control of reorganizing businesses not only benefits the managers and the shareholders, it may also provide indirect benefits to such noninvestor constituencies as employees, customers, suppliers, and the surrounding community. To the extent the Chapter 11 process introduces delay in the ultimate liquidation of businesses without a realistic chance of reorganization, the benefits are shared by these stakeholders. Thus a governance system that errs in favor of attempting reorganization may be justifiable as a means through which redistributions from creditors to these stakeholders might be effected.

We are far from a consensus on the appropriate goals underlying Chapter 11. In general, we seem to expect that the process of rehabilitation will serve both the goals of maximizing the value of the business assets, thereby maximizing creditors' returns, and restoring businesses to health so that they can continue to provide benefits to employees and other noninvestor stakeholders. The problem is that meeting both of these goals is impossible when liquidation is the choice that maximizes the value of the business assets. This conflict, coupled with the usual lack of clarity regarding the likelihood that the business does have a positive going concern value, forces us to choose between a governance system that is biased in favor of liquidation and one that is biased in favor of reorganization.

This Article addresses the financial economic theories of corporate governance and isolates some of the principles underlying the nonbankruptcy corporate governance structure that bear on the problem of corporate governance in Chapter 11. Having established those theories as a basis for discussion, the Article then examines the practical limitations on the bankruptcy process resulting from creditor indifference and a lack of consensus regarding the goals of Chapter 11. The Article next examines some of the ways courts have responded to the intractable problems of running a Chapter 11 debtor, focusing on courts' use of case management techniques, examiners, and control over attorneys' fees. The Article concludes with a discussion of the National Bankruptcy Review Commission's Report and Recommendations, discussing both the Commission's practical governance recommendations and the Report's evidence of a continued tension over the appropriate goals of Chapter 11.

I. THE THEORY OF BANKRUPTCY GOVERNANCE

In its broadest sense, the term "corporate governance" refers to the regulation of decisionmaking within the firm. Economic theory views the corporation as the central party to a set of contracts among providers of inputs to

production.[7] Corporate managers monitor compliance with these contracts and make decisions that fall within the inevitable gaps in the contracts.[8] Thus at this high level of generality, the basic principle of corporate governance is simply that managers control most of the decisions that are not the subject of explicit contract.[9]

It is here that the analysis starts to get interesting. Managers monitor the contractual relationships that comprise the firm, but they themselves are in a contract relationship with the firm and, therefore, must themselves be monitored.[10] This observation raises two fundamental questions. First, who is in the best position to monitor managers—that is, for whom do managers work? Second, how should that group accomplish and enforce its monitoring role? Passing familiarity with corporate law provides the commonplace answers. Managers owe their allegiance to the shareholders of the firm who effectuate their monitoring through their right to remove managers and through their enforcement of managers' fiduciary duties. This Part examines the reasons underlying these two propositions and then looks at the effect the bankruptcy process has on those rationales.

A. The Nonbankruptcy Corporate Governance Structure

The nonbankruptcy corporate governance structure is designed to resolve conflicts between the participants in the firm. The most basic of these conflicts arise from the differences in incentives that emerge once a corporation divides the claims to its assets between debt and equity. Issuing debt divides the claims on earnings and assets between fixed and residual claimants. Creditors trade a claim to the business' upside potential for a fixed, priority claim on the assets and the income stream. After the interest rate on the debt is fixed, creditors prefer that the corporation avoid projects that increase the risk of the income stream since they bear some of the risk of failure but receive none of the higher returns. Shareholders, on the other hand, prefer projects that increase the risk of the corporation because they will capture all of the higher returns and are protected on the downside by the limited liability doctrine.[11]

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[7]The seminal paper on this "nexis of contracts" theory is Jensen & Meckling, *supra* note 3.

[8]If parties could account for all contingencies in their contracts, there would be no need for discretion. It is because contracting is costly that managers must exercise discretion over some corporate decisions. *See* Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1199 (1984) ("Matters would be vastly simplified if firms were small and if contracts between the corporation and each of its constituencies satisfied the paradigm of contracting within discrete markets, where each exchange can accurately be described as 'sharp in by clear agreement; sharp out by clear performance.'").

[9]*See* DEL. CODE ANN. tit. 8, § 141 (1996); REV. MODEL BUS. CORP. ACT. §§ 8.01, 8.25 (1984).

[10]*See* Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y 671, 676-77 (1995).

[11]*See* Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 225-30 (1988) (providing an excellent summary of the literature discussing this phenomenon).

Managers play a central role in the mediation of this conflict. Their control over the selection of business projects enables them to choose between satisfying the shareholders' appetite for risk and observing the creditors' distaste for such projects. The nonbankruptcy corporate governance structure is designed to provide a mixture of contractual, market and fiduciary constraints on managers' choices. The following discussion examines this structure and the economic principles supporting it in an effort to illuminate the tensions and principles underlying the bankruptcy governance structure.

1. *Managerial Allegiance*

The differences in their respective claims on corporate income create inherent conflicts between creditors and shareholders. Thus, the question of managerial allegiance is of more than theoretical interest. The existing law provides an allocation of control and allegiance that forms the backdrop against which participants in capital markets develop expectations and negotiate contracts. As a general rule creditors derive their protection against managerial and shareholder opportunism solely through contract. Shareholders have protections that are less specific but occasionally more powerful than those granted the creditors.[12]

Historically, the allocation of control rights is most likely due to the differences in the legal source of claims of shareholders and creditors. Characterized as the true owners of the corporate enterprise, shareholders lay claim to the equitable principles that underlie trust law.[13] Since credit claims arise from contract, there is little room for a fiduciary analysis. Economic analysis of the firm provides an alternative explanation that better illuminates the special problems involved in translating general principles of corporate governance into the bankruptcy forum.

In the solvent corporation the allocation to shareholders of control rights and managerial allegiance is justified by the status of shareholders as the residual claimants on the corporation's cash flow. So long as the corporation is solvent, business decisions made by managers directly affect the income of the shareholders. Shareholders stand to gain or lose depending on the efficacy

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[12]This allocation of control rights has been the subject of substantial scholarly criticism. Commentators have questioned the wisdom of the shareholder wealth maximization principle that underlies the rules that direct managers to resolve conflicts between the interests of shareholders and creditors in favor of the shareholders. *See* Bratton, *supra* note 4, at 149-151; Rutheford B. Campbell, Jr., *Corporate Fiduciary Principles for the Post-Contractarian Era,* 23 FLA. ST. U. L. REV. 561, 599-606 (1996); McDaniel, *supra* note 11, at 265-309.

[13]*See* Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent And Insolvent Corporations,* 23 SETON HALL L. REV. 1467, 1473 (1993) ("This relationship of trust between directors and the corporation and its stockholders 'springs from the fact that directors have the control and guidance of corporate business affairs and property and hence of the property interests of the stockholders.'") (quoting Ashman v. Miller, 101 F.2d 85, 91 (6th Cir. 1939)).

of the managers. Thus, shareholders stand in the best economic position to monitor the decisions of managers. They have the most to gain or lose by managerial decisions.[14]

The beauty of this simple explanation of the managerial allegiance aspect of corporate governance is that it also provides an explanation of ways in which managerial allegiance shifts when the corporation becomes insolvent. In a growing number of cases, courts hold that managerial allegiance must shift to the creditors when the corporation approaches insolvency.[15] Upon insolvency, the residual claims of the shareholders become economically worthless.[16] Creditors who will go unpaid in the event of complete financial failure now occupy the position of residual owners. Thus, it is not surprising that managerial allegiance should depend upon the fortunes of the business.

2. *Enforcement of Control Rights*

Of course, it is one thing to require managers to pursue the business of the firm for the benefit of the shareholders but quite another to put such a guiding principle into practice. Again, passing familiarity with corporate law provides the commonplace methods of enforcing managers allegiance to the shareholders. Shareholders may enforce managers' fiduciary duties through derivative suits and retain the ability to oust managers through voting rights. But, while shareholder voting rights and fiduciary duties may constrain managerial behavior in the most egregious circumstances, these methods are unlikely to be effective in completely assuring managerial allegiance. In addition, these methods are inadequate to assure creditors that managers will not take actions that result in insolvency of the firm. To get a complete vision of the governance structure, therefore, one has to further examine the role of contract and the market in policing managers and mediating conflicts between creditors and shareholders.

The limitations of the fiduciary duty principle as a method of policing managerial misconduct are well known. The principle subsumes two related axioms. First, managers owe shareholders a duty of undivided loyalty. The duty of loyalty assures shareholders that managers will exercise their discre-

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[14]*See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67-70 (1991) (discussing the importance of residual claims in corporate governance).

[15]Two recent cases from the Delaware courts make clear that the fiduciary duties of managers extend to creditors when the corporation becomes insolvent or approaches insolvency. *See* Geyer v. Ingersoll Publications Co., 621 A.2d 784 (Del. Ch. 1992); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. Civ. A. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). The implications of this extension of fiduciary duties outside of the bankruptcy context are explored in Remesh K.S. Rao et al., *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially Distressed Firm*, 22 IOWA J. CORP. L. 53 (1996), and Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647 (1996).

[16]Although the bankruptcy system may provide shareholders with holdup value. *See infra* notes 76-81 and accompanying text.

tion free from the taint of self dealing. Second, managers owe shareholders a duty of care and diligence. In theory, these axioms should be sufficient to enforce shareholders' expectations of managerial allegiance. In practice, however, the business judgment rule limits the efficacy of the fiduciary duty principle in all but the most obvious cases of conflict.[17]

The limitations on the fiduciary duty principle relegate it to a secondary role in the corporate governance structure—effective in checking only the most egregious conflicts and management failures. Thus, the nonbankruptcy governance structure places relatively more reliance on the shareholders' contractual right to remove managers. Voting rights operate as the basic governance mechanism by giving shareholders the ability to replace managers who, through miscalculation, bad judgment, or shirking, have failed to maximize the value of the firm.[18] Again, however, shareholder voting rights may provide less than complete protection against managerial misbehavior. This is particularly problematic in large firms. The wide dispersion of shares necessitated by investors' desire for diversification[19] often results in individual shareholders having too little at stake to justify their monitoring managers to assure that they are doing a good job. This, coupled with managerial control over the proxy apparatus, enables managers to control the outcome of corporate elections.[20]

This problem leaves the market as the ultimate backstop against the limitations inherent in the fiduciary principle and shareholder voting rights. Given that the difficulty with voting rights is the wide dispersion of shareholders with each holding small claims, transactions that aggregate voting power in the hands of larger investors provide a remedy.[21] This is the typical justification for the merger and acquisition activity that became so rampant in the 1980s.[22]

As noted above, when a corporation is solvent, creditors do not enjoy a

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[17]*See* Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1361-62 (1989) ("Courts accord near-complete deference to corporate decisions untainted by interest."). Easterbrook and Fischel provide an explanation of the business judgment rule that highlights the likelihood that a negligence standard would result in managerial risk aversion that would be inconsistent with the goal of shareholder wealth maximization. EASTERBROOK & FISCHEL, *supra* note 14, at 98-100.

[18]Easterbrook and Fischel characterize shareholder voting rights as the second most distinctive feature (after limited liability) of corporate law. EASTERBROOK & FISCHEL, *supra* note 14, at 63.

[19]*See* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 17-20 (1986).

[20]*See* Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1079-82 (1990).

[21]*See* EASTERBROOK & FISCHEL, supra note 14, at 113-14; Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

[22]*See* Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 YALE J. ON REG. 119, 129-31 (1992).

claim to managerial allegiance enforced through the fiduciary duty principle or through voting rights.[23] Creditors do, however, need protection against actions that decrease the creditworthiness of their borrower.[24] Thus, a complete view of corporate governance must consider the contractual limitations on managerial conduct that are inherent in the firm's credit relationships.[25] Consider first the firm's long-term credit relationships. Such relationships are governed by contracts that often provide detailed protection against specific managerial actions that unduly increase the risk of the enterprise. These covenants strike a negotiated balance in the creditor/shareholder conflict. Actions that violate the covenants result in default and a consequent withdrawal of capital from the firm. In the absence of bankruptcy, such a withdrawal of capital would likely result in the replacement of the managers.[26]

Short-term lenders may also exercise a form of control over the behavior of managers. While short-term credit contracts do not usually contain the detailed covenants characteristic of longer term debt, the revolving nature of these arrangements can be a significant constraint. Managers who take actions that unduly increase the risk of the business may find their sources of short-term credit drying up, which in turn can result in a cash flow crisis that triggers defaults in other credit arrangements.

3. *Summary: An Integrated Corporate Governance Structure*

As illustrated above, corporate governance is accomplished through a complex but integrated structure of contract, market and fiduciary principles. Each element of the structure complements the others, resulting in a system that attempts to mediate conflict between shareholders and creditors and that binds managers to behave in the interests of the stakeholders. The corporate governance system is also sensitive to the financial condition of the firm. During solvency, the system vests discretionary authority in managers and relegates creditors to the position of contracting parties. As the corporation begins to approach insolvency, the creditors' contractual controls become effective to grant them a larger voice in the management of the firm. Finally, when the firm reaches insolvency, creditors' contracts grant them more direct authority over managers and corporate law requires managers to shift their allegiance from the shareholders to the creditors.

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[23]Creditors may be granted voting rights, *see, e.g.*, DEL. CODE ANN. tit. 8, § 221 (1996), so this is more a matter of practice than an immutable corporate law rule.

[24]*See, e.g.*, Campbell, *supra* note 12, at 599-606.

[25]*See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073 (1995).

[26]*Id.* at 1084-85.

B. Translating Corporate Governance Principles to the Bankruptcy Forum

In theory, general principles of corporate governance should work well in the bankruptcy context. Both inside and outside of Chapter 11, governance issues present the basic problem of how to regulate the behavior of managers who might have an incentive to take actions that are not in the best interest of their constituents. This requires some method of determining who those constituents are and a system to bind the managers to pursue the interests of those constituents. Abstracting from the sense of urgency and heightened emotions of the participants, the basic decisions confronted in a bankruptcy case are not all that different from decisions encountered in running a solvent corporation. While some components of the nonbankruptcy system require adjustment to accommodate the particular needs of a collective judicial proceeding, the basic theory remains applicable inside bankruptcy.

1. *Evaluating Business Decisions in Chapter 11*

Governance in the reorganization context requires a decisionmaking structure capable of handling problems ranging from the mundane day-to-day decisions involved in running a firm to the basic liquidation/reorganization decisions that lie at the very heart of a Chapter 11 case. While the Code provides detailed standards for reaching such decisions, at bottom, these decisions should be judged by the standard applicable to all businesses. Most business analysts agree that the quality of decisions, big or small, is a function of the expected cost of the decision compared to the present value of the expected return from that decision. At first blush, this proposition appears unremarkable and unlikely to be particularly controversial. On further examination, however, the proposition raises two important points about business decisionmaking generally and its applicability to the reorganization context.

The first of these points is the fact that our general standard for business decisions says absolutely nothing about who should reap the gains or bear the losses of the decision. Thus, this standard adopts the goal of allocative efficiency which does not account for the distributional consequences of a particular decision. Thus, to the extent one sees the purpose of the reorganization process as the maximization of the value of the business assets,[27] the fact that a decision is being made in the bankruptcy context is irrelevant. All that insolvency does is change the beneficiaries of business decisions.

The second of these points is that decisions can be evaluated only on the basis of expected costs and expected returns. Business decisions of all sorts entail possibilities of gain and risks of loss. The fact that a loss instead of a

[27] The effect of the relaxation of this assumption is considered *infra* notes 71-82 and accompanying text.

gain materialized in a given case does not mean that the decision resulting in that loss was, at the time the decision was made, objectively wrong.[28] Perhaps more importantly, decisions made both inside and outside of bankruptcy involve such a wide array of competing possibilities and probabilities that it makes little sense to discuss business decisions in terms of their "correctness." Instead, the focus must be on the process through which such decisions are made—the governance structure. This proposition underlies the business judgment rule.[29] Courts recognizing the complexity of business decisions and their inherently subjective qualities require nothing more than that the decisionmaker be free of obvious conflict[30] and be well informed about the consequences of the decision.[31]

2. *Adjusting the Governance Structure to Account for the Special Needs of the Bankruptcy Process*

Of course, one cannot simply apply the nonbankruptcy governance structure in bankruptcy cases. The automatic stay and the need to deter strategic uses of the structure in an effort to achieve favorable treatment require that the structure be adjusted to account for the particular needs of the reorganization process. The automatic stay[32] deprives creditors of their contractual controls over managers by prohibiting them from withdrawing capital from the business. Shareholder meetings called in an effort to displace managers who are thought to have failed to adequately protect shareholder interests must be scrutinized closely to assure that they are not simply delay tactics.[33] Market discipline is not likely to be of much use. Markets for the securities of small bankrupt firms are likely to be thin. Even in those situations in

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[28]*See* EASTERBROOK & FISCHEL, *supra* note 14, at 98 ("To observe that things turned out poorly *ex post*, perhaps because of competitors' reactions, or regulations, or changes in interest rates or consumers' fickleness, is not to know that the decision was wrong *ex ante*.").

[29]*Id.* at 98-100. *See also* Palmiter, *supra* note 17, at 1373.

[30]*Id.* at 1361.

[31]*See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[32]11 U.S.C. § 362(a) (1994).

[33]*See* Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 52 B.R. 879 (Bankr. S.D.N.Y. 1985), *aff'd*, 60 B.R. 842 (S.D.N.Y. 1986), *rev'd*, 801 F.2d 60 (2d Cir. 1986), *on remand*, 66 B.R. 517 (Bankr. S.D.N.Y. 1986). In *Manville*, the bankruptcy court issued an injunction prohibiting a shareholders' meeting at the instance of the debtor's management and several creditor constituencies. The bankruptcy court found that the express purpose of the meeting would be to replace the existing board with one that would be more sympathetic to shareholders' interests. The district court affirmed, but the Court of Appeals for the Second Circuit reversed, stating that enjoining the meeting would require a showing that the equity committee was acting in bad faith by showing a "willingness to risk rehabilitation altogether in order to win a larger share for equity." 801 F.2d at 65. The court did, however, note that if Manville were insolvent, "denial of the right to call a meeting would likely be proper . . ." *Id.* at 65, n.6. On remand, the bankruptcy court supplemented its findings to include the required showing and again entered the injunction. 66 B.R. at 542. The *Manville* case, as well as other cases addressing this issue, are thoroughly discussed in Michael A. Gerber, *The Election of Directors and Chapter 11: The Second Circuit Tells Stockholders to Walk Softly and Carry a Big Lever*, 53 BROOK. L. REV. 295, 321-41 (1987).

which an active market exists, managers are unlikely to respond to the market when they are fighting for the very existence of the business.

This leaves the fiduciary principle as the sole surviving element of the nonbankruptcy corporate governance structure. Courts often note that the debtor in possession is a fiduciary. Moreover, because the corporation is usually insolvent in bankruptcy, that fiduciary duty extends to the creditors of the business. But, as noted above, the fiduciary principle works only as a backstop to the contractual and market components of the nonbankruptcy governance structure. The difficulty in evaluating business decisions leads courts to abstain from directly examining the quality of business decisions. Instead, outside of bankruptcy, the fiduciary principle is limited to an examination of obvious conflicts and egregious failures on the part of managers. Thus, the fiduciary principle alone cannot be expected to provide an answer to the difficult problems involved in governing a bankrupt entity.[34]

The Chapter 11 process is not without its own governance structure, however. The judicial controls over the entire process provide a replacement for the contractual and market controls that exist outside of Chapter 11. The court's authority to appoint a trustee,[35] end debtor exclusivity,[36] or convert or dismiss[37] a case can all be thought of as elements of the reorganization governance structure. In addition, the Code requires judicial approval of specific managerial decisions that can have the effect of prolonging or shortening the case.[38] Creditor committees[39] supplement this structure by assuring that widely dispersed creditors have a representative with enough at stake to justify the costs of monitoring the debtor and participating in bankruptcy decisionmaking.[40]

While this governance structure is facially complete, it provides a less than satisfactory substitute for the contract and market controls that are eliminated by the filing of a bankruptcy petition.[41] Outside of bankruptcy,

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[34]The business judgment standard governs the court's review of management's decisions in bankruptcy as well. *See* Frost, *supra* note 5, at 120. The fiduciary principle is further limited as a tool of bankruptcy governance by the fact that managers' duties run to both the creditors and to the shareholders. *See infra* notes 83-86 and accompanying text.

[35]11 U.S.C. § 1104(a) (1994).

[36]*Id.* § 1121(c).

[37]*Id.* § 1112(b).

[38]*Id.* § 363(b). Elsewhere I have analyzed the limitations of these elements of the bankruptcy governance structure. *See* Frost, *supra* note 5, at 120-29.

[39]11 U.S.C. § 1102(a)(1) requires the appointment of a creditors' committee in every case. In practice, however, creditors' committees are appointed in only about fifteen percent of all cases. *See* NBRC REPORT, *supra* note 6, at 642 (citing EXECUTIVE OFFICE OF U.S. TRUSTEES, SUMMARY BY CIRCUIT OF CREDITOR COMMITTEE DATA (1996) [hereinafter CREDITOR COMMITTEE DATA]).

[40]These collective action problems are similar to those facing shareholders in large, publicly held firms. *See supra* note 19 and accompanying text.

[41]Dissatisfaction with the bankruptcy governance structure is at the heart of the many calls for reform

managers are beholden to a group of claimants that has actual money at stake in the business decision under consideration. This economic incentive is nonexistent in a Chapter 11 since the ultimate decisionmaker is the bankruptcy judge.[42] In addition, the bankruptcy judge can only act on information and transactions that are presented to her. Managers' informational advantages coupled with their control over the initiation of business decisions may allow them to manipulate the decisionmaking apparatus to their benefit.[43]

But, by incorporating the economic principles underlying the nonbankruptcy governance structure, we can improve the performance of the reorganization process. Elsewhere I have suggested one potential solution.[44] When evaluating a particular decision, bankruptcy judges should attempt to discover the views of the group that stands at the margin of solvency—the economic residual claimants. This approach recognizes the fact that insolvency shifts the residual interest in business decisions from the shareholders to the creditors and is therefore consistent with nonbankruptcy decisions that extend fiduciary duties to creditors when the company approaches insolvency. This economic shift in the residual interest places creditors in the

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of Chapter 11. Much of the reform literature seems to be concerned with managers' use of the inadequate controls over them to prolong the bankruptcy case, benefitting shareholders and themselves at the expense of creditors. Many of these reform proposals call for market resolutions to the problems of financial distress in an effort to preclude this type of behavior. *See, e.g.*, Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J. L. ECON. & ORG. 523 (1992); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Bradley & Rosenzweig, *supra* note 2; Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983); David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994).

It seems fairly clear that these proposals are unlikely to garner support, however. Thus, the challenge is to work within the existing structure in an effort to improve corporate governance in Chapter 11. Several commentators have suggested ways in which the general principles of corporate governance might be further incorporated in Chapter 11 to improve results in Chapter 11. *See* authorities cited *supra* note 5.

[42]In the words of the Court of Appeals for the Seventh Circuit:

> [S]elf interest concentrates the mind, and people who must back their beliefs with their purses are more likely to assess . . . value . . . accurately than are people who simply seek to make an argument. Astute investors survive in competition; those who do not understand the value of assets are pushed aside. There is no similar process of natural selection among expert witnesses and bankruptcy judges.

In re Central Ice Cream Co., 836 F.2d 1068, 1072-73 n.3 (7th Cir. 1987).

[43]*See* Barry L. Zaretsky, *Trustees and Examiners in Chapter 11*, 44 S.C. L. REV. 907, 914 (1993) ("Although the Code requires that a court approve various business decisions made by the debtor-in-possession, the debtor maintains the ability to determine, to a considerable extent, which issues are placed before the court.").

[44]*See* Frost, *supra* note 5, at 135-38.

position of gaining or losing from the business decision. From a process perspective, this group of investors is likely to hold the correct incentives to make decisions that maximize the value of the corporation's assets.

This solution is subject to a conceptual difficulty. The accurate use of this method requires an answer to the very question that bankruptcy resolves—the value of the business assets. If the value of the business assets were readily ascertainable, there would be no need for a judicially supervised reorganization process. New claims to the assets could be generated automatically by an application of the absolute priority rule. It is therefore the vagaries of business valuation that create the need for the reorganization process.[45]

This problem presents an insurmountable obstacle to the full realization of such a theoretically neat solution. But residual claim analysis may still provide a means through which we can improve bankruptcy decisionmaking. Even in cases in which valuation difficulties preclude a precise location of the residual claimants, bankruptcy judges may be able to identify claimants that certainly are not residual claimants. For example, in cases in which the corporation is hopelessly insolvent, the judge may discount the claims of shareholders who have nothing at stake in the decision under consideration. Similarly, in evaluating the views of a senior creditor secured by collateral with a liquidation value far in excess of the creditor's claim, the bankruptcy judge should pay little heed to arguments that the business decision at issue should be decided in a way that would shorten the case. Thus, while residual claim analysis cannot provide a clear rule of decision, it can be used to evaluate competing positions. Rather than simply ask whether a proposed business decision is correct, this approach asks the judge to take account of the incentives of those advocating or contesting the decision.[46]

3. *An Example of Residual Claim Analysis: Litigation Settlements*

One category of cases that courts occasionally examine under this rubric consists of cases in which the principal asset of the estate is a lawsuit. The Seventh Circuit opinion in *In re Central Ice Cream Co.*[47] provides the best example. In *Central Ice Cream,* the court considered three appeals regarding the district court's decisions on sanctions and attorneys' fees. The heart of the case was the trustee's handling of a suit by the debtor against McDonald's Corp. Central Ice Cream had won a $52 million verdict against McDonald's. Pending the trial court's decision on the verdict, McDonald's offered Central Ice Cream $15.5 million to settle the case. The bankruptcy

[45]*Id.* at 137. Note also that valuation probably also requires an evaluation of the business decision itself leading to circularity in the decisionmaking process.

[46]*Id.*

[47]836 F.2d 1068 (7th Cir. 1987).

judge approved this settlement over the objection of the shareholders.[48]

After attorneys' fees, the settlement provided more than enough money to pay all of Central Ice Cream's creditors. The bankruptcy court approved the settlement stating, "To seek greater return for the shareholders at risk to the creditors would be most unfair."[49] While not called upon to overturn the bankruptcy court's approval of the settlement, Judge Easterbrook's opinion seemed to differ with the bankruptcy court regarding the appropriate resolution of the conflict:

> Central Ice Cream had assets sufficient to pay all creditors. This made the shareholders the residual claimants; each additional dollar would go to them. It is true, as the bankruptcy judge wrote, that spurning the settlement would expose the creditors to risk, but this parallels the risk creditors face outside of the bankruptcy process as firms try to maximize the expected value of the enterprise.[50]

The court also noted that, while creditors outside of bankruptcy are not entitled to challenge the corporation's decisions, inside of bankruptcy they may do so because "they are (presumed to be) the principally affected persons, the new residual claimants."[51]

The *Central Ice Cream* case is unusual, not only because the court presumed that the debtor was solvent, but also because the court so explicitly adopted an analysis focusing on the desires of the residual claimants. Other courts have considered settlement offers using a similar analysis, however. In *In re Bowman*,[52] for example, a Chapter 7 debtor sought to convert her[53] case to a Chapter 11 so that she could pursue litigation that the Chapter 7 trustee proposed to settle. The $500,000 settlement offer was sufficient to cover nondischargeable tax claims but was likely insufficient to provide a distribution to the debtor.[54] The court noted that the evaluation of a settlement offer in the context of an insolvent Chapter 7 estate is straightforward because the creditors take precedence. In a Chapter 11 case, or in a case in which there is a potential that the estate is solvent, however, the court

[48]The true status of the objecting parties was an issue in the case. The court noted that these objecting parties held more than 300 percent of the common stock of the debtor. *Id.* at 1069.

[49]*Id.* at 1070 (quoting *In re* Central Ice Cream Co., 59 B.R. 476, 487 (Bankr. N.D. Ill. 1985)).

[50]*Id.* at 1072.

[51]*Id.* at 1073.

[52]181 B.R. 836 (Bankr. D. Md. 1995).

[53]The fact that *Bowman* involved an individual debtor does not change the analysis. In this situation, the debtor occupies a role similar to that of a shareholder of a corporate debtor. In a subsequent opinion, the court rejected the debtor's claim that the suit was exempt. *In re* Bowman, No. 91-5-2533-SD, 1996 Bankr. LEXIS 925, 78 A.F.T.R.2d 96-5890 (Bankr. D. Md. July 11, 1996).

[54]181 B.R. at 840.

stated that the evaluation becomes more difficult.[55]

In making this more difficult analysis, the court adopted the approach of the bankruptcy court in the *Central Ice Cream* case without discussing Judge Easterbrook's analysis. The court stated:

> If creditors could be paid to a certainty, regardless of the outcome of litigation, there might be a strong argument for a debtor to proceed. In the instant case, however, there is no guaranty, just a potential for a larger sum of money that will only benefit the Debtor. The creditors do not benefit from pursuing the litigation further, although they have the most of the risk. The creditors may receive less than they would with the settlement, but there is no chance that they would receive more than they are owed. It would distort the bankruptcy process to permit the Debtor to shift the risk of loss to the creditors while retaining all the potential benefit for herself, particularly over the objections of creditors.[56]

Thus, the court in *Bowman*, like the bankruptcy court in *Central Ice Cream*, was unwilling to find that the continued pursuit of the litigation would not place creditor recoveries at risk.

In re Speilfogel[57] involved another individual debtor, this time in Chapter 11. The Chapter 11 trustee proposed to enter into a global settlement to which the debtor objected. The court distinguished *Bowman* stating that that case involved an insolvent debtor in a Chapter 7.[58] Instead, citing the Seventh Circuit opinion in *Central Ice Cream*, the court searched the record for some indication that the trustee had considered the interests of the debtor in the residuary interest in the settlement. Finding no such consideration, the court proceeded to "balance the equities," rejecting the settlement because "The Court believes that if the litigation proceeds, the creditors will ultimately receive a substantial portion, if not 100%, of their claims, whereas if the settlement is approved, the Debtor will receive nothing and lose any pos-

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[55] *Id.* at 844.

[56] *Id.* The court also considered the ability of Bowman as debtor in possession to act as a fiduciary for the estate, concluding that the conflict between her interests and the interests of her creditors could not be reconciled. *Id.* at 845. Accordingly, the court granted the debtor's motion to convert but immediately granted the motion of the IRS to reconvert the case to Chapter 7. The court also authorized the trustee to accept the settlement. *Id.* at 846-48.

[57] 211 B.R. 133 (Bankr. E.D.N.Y. 1997).

[58] *Id.* at 144-45. This reading of the *Bowman* opinion arguably renders it consistent with the Seventh Circuit's opinion in *Central Ice Cream*, but the reading is contestable. The *Bowman* court made no specific finding that the debtor was insolvent. Instead, the court simply noted that the settlement would result in a substantial payment to the creditors and that, while success in the litigation might result in a recovery for the debtor, all of the risk of loss would be borne by the creditors. 181 B.R. at 844.

sibility of a residual distribution."[59]

Both *Bowman* and the bankruptcy court's opinion in *Central Ice Cream* illustrate both the residual claim analysis and the limitations of that approach. In both cases, the continued prosecution of the litigation would not only potentially benefit the stockholders, but also would expose creditors to a risk of loss. The results in those cases show a sensitivity to the fact that the stockholders might not truly be the residual claimants. The question of who occupies that position turns on an analysis of the position of the creditors in the worst case scenario. If the debtor's rejection of the settlement creates a nontrivial chance of creditor losses, the process must account for their views.

Judge Easterbrook's opinion in *Central Ice Cream* recognized the difficult valuation problems that inhere in his approach but suggested an alternative approach to the problem. The opinion suggests that the risk to the creditors could be eliminated by putting the firm up for sale with a $15.5 million reserve price. If the settlement amount were less than the expected value of rejecting the settlement, the market (or perhaps the objecting shareholders) would recognize the value and would bid more than the settlement amount.[60]

4. *Summary: An Integrated Bankruptcy Governance Structure*

Because the bankruptcy process addresses the unique problems arising from financial disaster, the nonbankruptcy governance structure cannot simply be transferred into the bankruptcy context. Nonetheless, Chapter 11 sets out its own structure that, when supplemented by the residual claim approach to decisionmaking, appears calculated to achieve results that would be obtained outside of bankruptcy. This integrated structure replaces the nonbankruptcy contractual and market controls over managerial behavior with creditor representation and judicial oversight. Creditors' committees composed of large claimants and represented by counsel and other professionals, have both the wherewithal and the incentive to monitor managerial behavior. The Code's requirement that managers obtain judicial approval of significant transactions and the Code provisions allowing the court to appoint a trustee or examiner, or to convert or dismiss a case, provide ample opportunities to test managerial competence and loyalty.

Of course, the bankruptcy governance process generates controversies. Creditors' committees may not be fully representative of the broad array of their constituents. Managers and members of creditors' committees may take actions that violate their fiduciary duties to estates and their members. The point here is not that the process is self-executing and inevitably correct, but instead that the process seems calculated to isolate such problems and to respond to them in a rational way.

[59]211 B.R. at 146-47.

[60]*In re* Central Ice Cream Co., 836 F.2d 1068, 1072 n.3 (7th Cir. 1987).

II. THE REALITY OF BANKRUPTCY GOVERNANCE

Unfortunately, this well-intentioned and theoretically complete approach to governance in Chapter 11 unravels in many (perhaps most) cases. One of the principal culprits in this unraveling is the collective action problem facing widely dispersed creditors each holding small claims. Because small creditors have so little at stake in the bankruptcy process, they often adopt a posture of rational indifference toward the debtor, its management, and the bankruptcy case. Another problem which is easy to overlook is the possibility that a strict application of the bankruptcy governance structure may conflict with perceived normative commitments that underlie the Bankruptcy Code. This section addresses these two practical limitations on the ability of the bankruptcy governance structure to police adequately the behavior of managers of the debtor.

A. Creditor Indifference

Recent studies of large Chapter 11 cases have provided some cause for optimism that the governance structure established by the Code actually works to police management behavior. Several studies of large cases have provided evidence that bank creditors often are successful in ousting incumbent management.[61] In the most detailed of these studies, Professors LoPucki and Whitford concluded that the management's loyalty to creditors or shareholders was "clearly a function of the company's solvency. The managements of solvent companies never aligned with creditors, while the managements of insolvent companies did so frequently."[62] Thus, while Chapter 11 may not provide the best and cheapest means of governing an insolvent firm, one cannot say that managers are universally well entrenched.

In contrast, the few studies of small business bankruptcies tell a tale of virtual management autonomy.[63] In his 1983 study of small business bankruptcies, Professor LoPucki concluded that "the debtors studied were able to continue in complete control of their businesses while they were under the jurisdiction of the court."[64] This problem is exacerbated by the fact that in terms of numbers of cases, small cases far outweigh the cases involving large, publicly held debtors,[65] and the fact that the vast majority of such cases do

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[61]*See* Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms: Empirical Evidence*, 72 Wash. U. L.Q. 1005, 1011-15 (1994) (summarizing recent studies).

[62]LoPucki & Whitford, *supra* note 5, at 751.

[63]Jerome R. Kerkman, *The Debtor in Full Control: A Case for Adoption of the Trustee System*, 70 Marq. L. Rev. 159 (1987); Lynn M. LoPucki, *The Debtor in Full Control - Systems Failure Under Chapter 11 of the Bankruptcy Code?—First Installment*, 57 Am. Bankr. L.J. 99 (1983) [hereinafter *Debtor in Full Control I*]; Lynn M. LoPucki, *The Debtor in Full Control: Systems Failure Under Chapter 11 of the Bankruptcy Code?—Second Installment*, 57 Am. Bankr. L.J. 247 (1983).

[64]LoPucki, *Debtor in Full Control I*, *supra* note 63, at 120-21.

[65]*See* NBRC Report, *supra* note 6, at 632 (concluding that defining small business bankruptcies as

not result in a confirmed plan.[66]

One of the difficulties with small business bankruptcies is that the procedures set out in Chapter 11 are too costly and cumbersome to provide an effective reorganization framework for these cases.[67] While the governance difficulties encountered in these cases may to some extent be related to this problem, there is another important element that distinguishes small from large Chapter 11 cases. In small cases, creditors are unlikely to have an interest in closely monitoring managers.[68] The size of their claims and the remote chance that they will receive anything close to a full payout on their claims limit individual creditors' incentives to take an active interest in the case.[69] In the vast majority of cases it is difficult to find creditors with enough at stake in the case to be willing to serve on a creditors' committee. Studies indicate that creditors' committees are formed only in around fifteen percent of all Chapter 11 cases.[70]

This lack of creditor participation leaves the course of the reorganization to the debtor's management and to the secured creditors (if any). The views of the vast middle—who are likely to occupy the position of the residual claimants in the case—are likely to be effectively silenced in the process. In cases in which there is no significant secured creditor, the lack of a committee creates the conditions necessary for managerial entrenchment and delay.

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involving debtors with debts of less than $5,000,000 would include within that definition eighty-five percent of all of the Chapter 11 cases filed).

[66]*See id.* at 610-11 (citing studies that indicate that as few as ten to twelve percent of all Chapter 11 cases result in an effective reorganization).

[67]*Id.* at 614-15 (quoting Hon. Alexander L. Paskay & Frances Pilaro Wolstenholme, *Chapter 11: A Growing Cash Cow: Some Thoughts on How to Rein in the System*, 1 AM. BANKR. INST. L. REV. 331, 345-46 (1993) ("It takes no elaborate empirical study to justify the conclusion that the problems facing a publicly held corporation facing a mass-tort problem, are quite removed from a "mom-pop" corporation running a shoe repair shop . . . .")).

[68]The court in *In re Bayou Self, Inc.*, 73 B.R. 682 (Bankr. W.D. La. 1987), recognized this problem in the following passage:

> In most Chapter 11 cases, particularly the smaller ones, creditors, particularly unsecured creditors, are inactive. The debtor's obligations are so spread among a multitude of creditors that frequently no creditor, or creditors' committee if there is one, has a sufficient stake to pursue its interests. Yet, the creditors collectively over a number of cases can sustain substantial and needless losses if measures are not taken to insure that prompt efforts are taken to rehabilitate the debtor, if possible.

Id. at 684.

[69]In addition, unsecured creditors likely recognize that the benefits of any special interest that they take in the case will have to be shared with other unsecured creditors. This creates a classic free-rider problem that results in inadequate monitoring of management's actions. *See* Skeel, *supra* note 5, at 520-22.

[70]*See* NBRC REPORT, *supra* note 6, at 642 (citing CREDITOR COMMITTEE DATA, *supra* note 39).

B. The Connection Between Bankruptcy Policy and Governance

Apart from the cases involving claim settlement, there has been no trend in the reported decisions to adopt a residual claim approach to governance questions in Chapter 11. Of course, that does not mean that courts are insensitive to the solvency or lack thereof in the cases that they confront. There is every reason to believe that bankruptcy judges have always looked to the incentives that might underlie various claimants' positions—even if they do not memorialize that examination in their written opinions. Still, the lack of an explicit use of such an approach outside of the settlement context requires an explanation. As the following discussion suggests, one reason for the absence of such analysis may be found by examining the complex normative commitments underlying Chapter 11.

In addition to the practical problems resulting from creditor indifference, one of the primary difficulties in applying general principles of corporate governance in the reorganization context is the lack of a clear consensus regarding the goals of the bankruptcy process. For example, general governance principles dictate that the views of shareholders regarding the viability of the business enterprise be devalued in most cases. Shareholders of a hopelessly insolvent enterprise put nothing at risk in the business decision to reorganize rather than to liquidate. Since it is probably a safe empirical assumption that most bankruptcies involve hopelessly insolvent enterprises, it is tempting to go one step further and suggest that shareholders be completely disabled from participating in the Chapter 11 case. It is possible that a blanket rule that prohibited shareholders from participating in any Chapter 11 distribution would eliminate the holdup power shareholders exercise in the case.[71] While such an approach might create difficulties in retaining the continued involvement of shareholders who are critical to the viability of the business, it may well be that the losses from reorganizations that fail for lack of continued management involvement would be more than offset by the gains from improved governance.[72]

Commentators have advocated such proposals, but none have garnered

[71]*See* Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 Am. Bankr. L.J. 625, 633 (1991) (proposing a "preemptive cramdown" that would extinguish the claims of a class upon a showing that claims of the senior classes clearly exceed the value of the debtor); Skeel, *supra* note 5, at 510-13 (suggesting that shareholders be disabled from holding elections during Chapter 11 and proposing a relaxed "for cause" standard that would enable creditors to replace the board of directors in more cases).

[72]Various proposals for the repeal or radical reform of the process would create such a result. The simplest such proposal, first suggested by Professor Baird, is the repeal of the reorganization provisions of Chapter 11 and the use of Chapter 7 to conduct an auction for the business as a going concern. The proceeds from the auction could then be distributed among the claimants in accordance with the absolute priority rule. *See* Baird, *supra* note 41. The auction would end equity's participation in the case if the proceeds were insufficient to satisfy all of the claims.

widespread support. Perhaps one of the reasons for this lack of support is suspicion regarding the claimed efficiency gains of such proposals. A more fundamental reason is our national ambivalence regarding the purposes of Chapter 11. As a general matter, we see Chapter 11 as a means of maximizing creditor recovery through the preservation of going concern value. At the same time, Chapter 11 is hailed as a method of preserving jobs and communities that are affected by financial failure.[73] These goals are sometimes complimentary; but, perhaps more often, they are directly conflicting.

When a company has real going concern value—that is when the value of the company as an operating entity exceeds the liquidation value of the company—the goals of preserving jobs and communities and maximizing creditor values are entirely consonant. To the extent that the reorganization process keeps firms together that should be kept together everyone benefits.[74] Where the asset values that might be achieved in an orderly liquidation exceed those of the firm as a going concern, however, the interests of the creditors and those of the noncreditor stakeholders of the firm diverge.[75] Of course, if we could be certain regarding going concern value, or the lack thereof, the conflict would present a straightforward policy question that would be ripe for debate and resolution. But, in the real world of uncertainty, the system does not explicitly resolve the conflict and ambivalence reigns.

This ambivalence manifests itself in the reorganization governance structure. The continued participation of managers in the running of the corporation creates a bias in favor of reorganization.[76] Shareholders and managers of insolvent companies have every reason to desire an attempt at reorganization regardless of the efficiency of such an attempt.[77] The bias inures not only to

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[73]The legislative history of the Bankruptcy Code states, "The purpose of a business reorganization case, unlike a liquidation case, 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." *See* H.R. REP. No. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179. A number of commentators have stressed the importance of considering the effect of bankruptcy on constituencies other than the investors. *See, e.g.*, David Gray Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341 (1987); Karen Gross, *The Need to Take Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031 (1994); Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541, 545-547 (1993); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 766-768 (1991); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 352-360 (1993) [hereinafter *Imperfect World*]; Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 785-789 (1987).

[74]Warren, *Imperfect World*, *supra* note 73, at 354-56.

[75]*See* Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75, 94-99 (1995).

[76]*See* Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101, 133-36 (1997).

[77]*See* LoPucki & Whitford, *supra* note 5, at 685 ("The holders of underwater claims and interests often have reason to oppose liquidation until the distributions to them under the reorganization plan have

the benefit of the shareholders and managers, but also to the benefit of other corporate stakeholders. Employees, suppliers and the surrounding community benefit from the continued operation of the debtor[78] as well as from the possibility (albeit remote) of a turnaround in the business fortunes.[79]

While the Code does not explicitly take account of these stakeholder interests, the structural bias in favor of reorganization may reflect a normative commitment that goes beyond that of efficiency. Recall that the standard for judging business decisions set out above is neutral regarding the distributional effect of the decision.[80] In that economic analysis, business decisions are judged against a value maximizing standard. Distributional concerns such as the effect of the decision on noncreditor stakeholders find no place in such an inquiry.

Thus, the simple economic model of bankruptcy governance fails to capture what is really going on in bankruptcy cases. Rather than focusing solely on value maximization, there is a complex array of considerations including, perhaps first and foremost, a desire to maximize creditor recovery, but also including a general sense that every corporate debtor deserves at least a chance at reorganization—if not for the sake of the corporation itself, at least for the sake of the corporation's dependents. Regardless of the desirability of this policy,[81] the normative commitments underlying the approach seem to be reflected in the Code and therefore have a real effect on the governance structure.

This observation also provides an explanation for the use of residual claim analysis in the litigation settlement cases[82] and its absence in courts' analysis of other types of issues. In the abstract, the question of whether to settle litigation is no different from the decision to continue an attempt at reorganization, to invest in a new plant, or to make any other economic decision. A decision to forego a settlement offer represents an investment of the settlement proceeds in the litigation. A litigant seeking to maximize his or her wealth will reject a settlement only if the present value of the expected returns from the litigation exceed the present value of the settlement offer.

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been fixed."). *See also* Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1496 (1993) ("Shareholders [of an insolvent firm] are highly motivated to overinvest in risky propositions and to underinvest in stable ones. Shareholders also are likely to delay liquidation, even if this strategy causes further loss to the firm.").

[78]*See What Constitutes Success in a Chapter 11? A Roundtable Discussion*, 2 AM. BANKR. INST. L. REV. 229, 233-37 (1994).

[79]The company could strike oil. The point here is not that companies often strike oil during a reorganization, however. Instead, the point is that the possibility of some huge business success, however remote, is of value to the stakeholders.

[80]*See supra* note 27 and accompanying text.

[81]I have stated elsewhere that I find this more expansive view of the reorganization process flawed. *See* Frost, *supra* note 75, at 112-38.

[82]*See supra* notes 47-60 and accompanying text.

The settlement cases generally do not implicate any concerns about noninvestor stakeholders in the business, however. Thus, the residual claim approach provides a way in which the court may analyze the settlement offer towards the end of maximizing the value of the estate without concern over how the decision might affect those interests.

In sum, the principal effect of the complex normative commitments underlying Chapter 11 is to make impossible the distillation of bankruptcy governance to a single principle. The competing concerns the bankruptcy process addresses create conflicts that cannot be resolved by a simple rule of decision. Instead, bankruptcy governance involves a flexible structure that includes the allocation of responsibility for conflict resolution coupled with a respect for local customs and judicial attitudes. The structure is adaptable—changing to meet the facts of the situation at hand. It is also pragmatic—responding to problems using the resources at hand.

III. THE PRAGMATISM OF BANKRUPTCY GOVERNANCE

Expanding the range of constituencies, the interests of whom the bankruptcy system must consider, exacerbates the governance problems inherent in Chapter 11. Reconsider the question of fiduciary duties. To the extent that the Chapter 11 process is intended to benefit the shareholders of the company as well as the creditors, one cannot take too literally the notion that fiduciary duties should benefit creditors when the corporation is insolvent. Shareholders are also worthy of managers' consideration. The need to serve two masters with conflicting interests requires managers to strike some balance between the two.[83] One commentator has suggested that the underlying principle of bankruptcy governance is that the debtor in possession may, and perhaps must,[84] make an effort to reorganize the debtor (notwithstanding the contrary desires of the creditors) *unless* that attempt appears to be hope-

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[83] While a conflict of obligation creates an uncomfortable legal environment that lacks clarity, the officers, directors, and managers of the DIP owe obligations of care, honesty, and reason to both the creditors of the bankrupt and its owners. The DIP thus operates in an inherent conflict. The DIP's obligation is to resolve that conflict in a reasoned, balanced and honest manner.

Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1, 33 (1989). Professor Campbell points out that outside the bankruptcy context managers often represent "multiple masters, including majority common shareholders, minority common shareholders and preferred shareholders." *See* Campbell, *supra* note 12, at 593.

[84] Congress intended to make it clear that, even if insolvency may render the shareholders' continued economic interests in the corporation problematical, shareholders nevertheless retain their ownership interest. Therefore, it would be anomalous to interpret the Bankruptcy Code to mean that once a corporation is insolvent directors no longer owe any fiduciary duty to shareholders.

Miller, *supra* note 13, at 1494 n.119.

less.[85] While this principle appears to provide a standard against which managerial actions might be judged, in practice the idea, standing alone, grants managers broad discretion that is very difficult to limit.[86]

As noted above,[87] outside of bankruptcy, the fiduciary principle is but a component of a broader governance structure that includes contract and market elements. The special problems addressed by bankruptcy require that the contract and market elements of the nonbankruptcy structure be curtailed. In addition, the expansion of the scope of beneficiaries to whom managers owe duties of care and loyalty further weakens the fiduciary principle as a means of control over managerial misbehavior. Our normative commitments preclude an approach to the supervision of management that focuses simply on the interests and desires of the residual claimants to the assets. Add in a dash of rational disinterest from a widely dispersed creditor body, and you have a recipe for nearly unfettered discretion by possibly opportunistic managers.

Of course, one must not forget that bankruptcy decisions take place in the context of a judicial proceeding. Bankruptcy judges serve as the ultimate defense against managerial self-aggrandizement. Most important decisions require judicial approval.[88] Bankruptcy judges have the power to displace managers through the appointment of a trustee.[89] They can declare futile an attempt to reorganize through their authority to convert or dismiss the case.[90] They can move cases along by shortening (or refusing to extend) the exclusivity period.[91] But, their ability to completely control the case is subject to an inherent limitation caused by the very source of their authority. Bankruptcy judges are judges and thus are by nature limited to a judicial role. They decide disputes that are brought before them. They can act only on the information submitted to them. They are required to be above the fray, not in the middle of it.

Notwithstanding this limitation, bankruptcy judges have devised ways in which managerial discretion might be checked. Judges have taken a more

[85]*Id.* at 1496 ("[I]t seems that when the financial condition of a corporation is hopelessly insolvent, such that there is little or no chance that stockholders would have any equity interest in the corporation, a debtor's directors no longer have any duty to pursue actions that may prejudice the debtor, its business, and the interests of senior classes.").

[86]This problem has plagued advocates of corporate constituency statutes that enable managers to consider the interests of nonshareholder constituencies in responding to takeover attempts. *See* Campbell, *supra* note 12, at 622 ("Constituency statutes . . . provide an obfuscation opportunity that facilitates [managerial opportunism].").

[87]*See supra* notes 16-17 and accompanying text.

[88]*See* 11 U.S.C. § 363(b) (1994) (requiring judicial approval of transactions outside of the ordinary course of business).

[89]*Id.* § 1104(a).

[90]*Id.* § 1112(b).

[91]*Id.* § 1121(d).

active role in case administration. They have made use of examiners and mediators in an effort to resolve conflicts over plan development. Perhaps more significantly—at least to debtors' counsel—courts have placed some of the burden on the attorneys involved in the case to monitor the actions of managers and to exercise some control over the reorganization process. The following discussion addresses these methods and some of the problems that they create.

A. Case Management

Bankruptcy judges have shown a remarkable creativity in developing case management techniques that preserve their role as impartial adjudicators while insuring that Chapter 11 cases do not languish. These solutions range from the systematic application of a "fast track" procedural system for small Chapter 11's to the ad hoc use of status conferences and scheduling orders and *sua sponte* hearings designed to move parties swiftly toward resolution of the case.

In 1987, Bankruptcy Judge Small of the Eastern District of North Carolina introduced a fast track procedure for small bankruptcy cases.[92] The approach involves an accelerated schedule for the filing of the plan, and conditional approval of the disclosure statement with the court approving both the plan and the disclosure statement in one hearing.[93] If the debtor fails to comply with the deadlines, the Bankruptcy Administrator[94] files a motion requiring the debtor in possession to show cause why the case should not be dismissed. Other judges have followed Judge Small's lead in instituting fast track procedures.[95]

While the fast track system is widely touted as a method of reducing the costs of Chapter 11, thus making reorganization available to small debtors, the approach also has significant governance benefits. Managers recognizing that a day of reckoning is close at hand will have less incentive to delay the case in hopes of a turnaround in the debtor's business fortunes. The data regarding fast track procedures certainly shows that the procedure moves cases through Chapter 11 more quickly. A study of Chapter 11 cases before and after Bankruptcy Judge Mund of the Central District of California instituted a fast track procedure show a substantial reduction in the median time to confirmation (24.1 percent), conversion (44.1 percent), dismissal (53.5 per-

[92] *See generally* Hon. A. Thomas Small, *Small Business Bankruptcy Cases*, 1 Am. Bankr. Inst. L. Rev. 305 (1993) (discussing the fast track procedure).

[93] *Id.* at 309.

[94] The Bankruptcy Administrator is counterpart to the trustee in the judicial districts in Alabama and North Carolina.

[95] *See* NBRC Report, *supra* note 6, at 615 n.1569.

cent), and in the total days in Chapter 11 (45.4 percent).[96]

We cannot always equate acceleration of the process with improved governance, however. Managers still retain information and initiation advantages that allow them to continue to exercise wide discretion. Nevertheless, the fast track procedures do reduce the ability of managers to use delay to perpetuate their employment and to extract concessions from creditors. The stricter requirements of the fast track procedures provide creditors with some assurance that there will be an outside limit to the delay they will experience.

The 1994 amendments to the Bankruptcy Code added provisions that permit a business with debts under $2 million to elect fast track treatment.[97] These provisions limit the exclusivity period to 100 days and require that all plans be filed within 160 days. An increase in the 100-day period requires that the debtor show that the need for an increase is "caused by circumstances for which the debtor should not be held accountable."[98] In addition to the limitation on the exclusivity period, the small business amendments allow the disclosure hearing to be combined with the confirmation hearing[99] and grant the court discretion to dispense with the requirement that a creditors' committee be appointed.[100]

As an approach to corporate governance, the 1994 statutory incorporation of the fast track approach leaves much to be desired, however. While the small business definition captures a majority of Chapter 11 cases,[101] small business treatment is only applicable to those debtors who elect such treatment.[102] The procedures adopted by Judge Small and Judge Mund are not so limited. Neither approach employs a dollar limitation. Instead, these judges base their decision regarding fast track status on their own experience with bankruptcy cases.[103]

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[96]Hon. Samuel L. Bufford, *Chapter 11 Case Management and Delay Reduction: An Empirical Study*, 4 AM. BANKR. INST. L. REV. 85, 101 (1996).

[97]*See* 11 U.S.C. § 101(51C) (1994) (defining "small business" as having noncontingent unliquidated debts of less than $2 million).

[98]*Id.* § 1121(e)(3)(B).

[99]*Id.* § 1125(f).

[100]*Id.* § 1102(a)(3).

[101]Statistics compiled by the NBRC indicate that seventy-two percent of all debtors fall within the $2 million debt limitation. NBRC REPORT, *supra* note 6, at 630-31.

[102]*See* 11 U.S.C. § 1121(e). The only real incentives to elect such treatment are the streamlined procedures for approval of the disclosure statement and the elimination of the mandatory creditors committee. These incentives are likely to be inadequate to ensure a widespread election of small business treatment for two reasons. First, the combination of the disclosure statement and plan approval processes may serve only to compress the time within which the debtor is expected to confirm a plan. Second, statistics indicate that creditors' committees are rarely appointed in small bankruptcies without regard to the mandatory language of 11 U.S.C. § 1102(a). *See supra* note 70 and accompanying text.

[103]Bufford, *supra* note 96, at 99; Small, *supra* note 92, at 307. Judge Small also seeks the recommendation of the Bankruptcy Administrator. *Id.*

In addition to this structural approach to case management, the 1994 amendments explicitly grant bankruptcy judges the authority, on their own motion or on motion of a party in interest, to hold a status conference and to enter detailed scheduling orders.[104] Bankruptcy Judge Fenning of the Central District of California recently authored an article in which she noted:

> Two kinds of chapter 11 cases come through the bankruptcy judge's door: Debtors that may be able to confirm a plan, and those that are hopeless. The two types call for different case management approaches. The problem is telling them apart at the beginning of the case. No simple litmus test is available, but most experienced bankruptcy judges find it relatively easy to sort about 90 percent of all chapter 11 cases into those two categories after just one or two hearings.[105]

Judge Fenning believes that early status conferences provide a method through which she can identify "zombie cases" and terminate them quickly.[106] In a similar vein, Bankruptcy Judge Clark of the Western District of Texas has written of the practice of judges in Texas who enter scheduling orders that respond to motions for relief from the automatic stay in single asset real estate cases.[107] These orders require the debtor to achieve confirmation of a plan by a date certain or face foreclosure or case dismissal.[108]

One potential concern with this more active role for bankruptcy judges is that it may conflict with their role as impartial adjudicators.[109] The 1978 Code went to some lengths to remove bankruptcy judges from the day-to-day administration of cases.[110] Prior to the enactment of the Code, bankruptcy judges took an active role in supervising and administering cases—a role that Congress believed placed the judge in an "untenable position of conflict, and seriously compromise[d] his impartiality as an arbiter of bankruptcy

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[104] 11 U.S.C. § 105(d). Many judges held conferences and entered such orders before the enactment of the statutory authorization. Of course, one benefit of the explicit authority of the court to enter into detailed scheduling orders is that it validates one of the key components of the fast track approach.

[105] Hon. Lisa Hill Fenning, *Judicial Case Management Is No Hostile Takeover*, 15-SEP AM. BANKR. INST. J. 35 (1996).

[106] Judge Fenning also suggests that bankruptcy judges should use their authority to mediate fundamental disputes in an effort to arrive at a consensual plan. *Id.* at 36-37.

[107] Hon. Leif M. Clark, *Chapter 11—Does One Size Fit All?*, 4 AM BANKR. INST. L. REV. 167, 191 (1996).

[108] *Id.* at 191-92.

[109] *See* John D. Ayer, *How to Think About Bankruptcy Ethics*, 60 AM. BANKR. L.J. 355, 397 (1986) ("The extent to which a judge may, in fact, act *sua sponte* is a measure of how much he is a participant, and how much a mere decider, of issues.").

[110] *See id.* ("It seems clear that a dominant purpose of the 1978 Code was to reduce the judge's *sua sponte* role."). *See also* Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. LJ 431, 433-34 (1996).

disputes."[111]

Active case management is a far cry from the administrative duties formerly placed on bankruptcy judges, however.[112] Federal and state judges have increasingly taken an active role in managing cases to assure that they move toward completion.[113] Also, as one commentator has pointed out,[114] Congress evidenced an intent to provide judges more latitude in controlling cases when it added language to § 105 in 1986 making explicit the authority of bankruptcy judges to issue *sua sponte* orders.[115] This change has increased substantially the ability of bankruptcy judges to actively manage cases.

Prior to the 1986 amendments, § 1112(b) allowed only a "party in interest" to move for a conversion or dismissal of a Chapter 11 case. The legislative history surrounding the enactment of the Bankruptcy Code shows that the restriction of § 1112(b) to parties in interest was a conscious choice on the part of the Code's drafters that evidenced their concern with "excessive judicial entanglement in administrative matters."[116] This history, coupled with the plain meaning of § 1112(b), led most courts considering the question to conclude that they were without the power to dismiss or convert cases *sua sponte*[117] unless there was a showing that the case was filed with an "intent to abuse the judicial process in the hope of delaying creditors."[118]

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[111]H.R. REP. No. 95-595, at 89 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6050.

[112]Of particular concern was the bankruptcy judges' involvement in the appointment and supervision of trustees who were involved as litigants in the cases. *See* Miller, *supra* note 110, at 434.

[113]*See, e.g.*, MANUAL FOR COMPLEX LITIGATION THIRD 14-15 (1995) (characterizing effective judicial management as active, substantive, timely, continuing, firm but fair, and carefully prepared). The Fifth Circuit has drawn a similar analogy:

> 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 as to promote the objective and goals of the Bankruptcy Code. Our conclusion in this respect is strengthened by the fact that the bankruptcy court is an adjunct of the district court. District court judges function under Fed. R. Civ. P. 16 with full power and responsibility to manage their cases and with the directive to move their cases in such a way as to promote fairness to the parties and judicial economy.

United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd. (*In re* Timbers of Inwood Forest Assocs, Ltd.), 808 F.2d 363, 373-74 (5th Cir. 1987) (en banc) (footnote omitted), *aff'd*, 484 U.S. 365 (1988).

[114]Miller, *supra* note 110, at 435-36.

[115]*See* 11 U.S.C. § 105(a) (1994) ("No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process."). This language was added by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 203, 100 Stat. 3088, 3097.

[116]Gusam Restaurant Corp. v. Speciner (*In re* Gusam Restaurant Corp.), 737 F.2d. 274, 277 (2d Cir. 1984). The *Gusam* opinion collects the legislative history underlying § 1112(b) as originally enacted. *Id.* at 276-77. *See also In re* Moog, 774 F.2d. 1073, 1076 (11th Cir. 1985).

[117]*See Gusam*, 737 F.2d at 277. *See also* Warner v. Universal Guardian Corp. (*In re* Warner), 30 B.R. 528 (B.A.P. 9th Cir. 1983).

[118]*See Moog*, 774 F.2d at 1076-77 (collecting cases).

The 1986 amendment to § 105(a) frees bankruptcy courts from the constraints imposed by § 1112.[119] The legislative history is sparse, however; Senator Hatch's statement in support of the amendment indicates that the change was intended to allow bankruptcy judges more latitude in managing their cases.[120] As further support for a more active bankruptcy judiciary, several cases have cited the admonition of the Fifth Circuit in *United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd. (In re Timbers of Inwood Forest Associates, Ltd.)*:

> 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.[121]

The court's opinion in *In re Tax Shop, Inc.*[122] provides an example of such judicial management in the context of a fast track case. In *Tax Shop*, the court refused to reinstate a case that had been dismissed for the debtor's failure to comply with the court's fast track scheduling order. As in many small cases, the creditors showed no interest in the case.[123] *Tax Shop* illustrates the efficacy of the *sua sponte* motion for dismissal for these small cases.

In re Great American Pyramid Joint Venture,[124] provides an example of the use of a *sua sponte* order in a more complex case. *Great American Pyramid* involved the Chapter 11 cases of six entities that were involved in the development of an entertainment and sports arena (in the shape of a pyramid) in Memphis. Despite the involvement of creditors and other parties in inter-

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[119]*See, e.g.*, Finney v. Smith (*In re* Finney), 992 F.2d 43, 44 (4th Cir. 1993); *In re* Argus Group 1700, Inc., 206 B.R. 757 (E.D. Pa. 1997); Pleasant Pointe Apartments, Ltd. v. Kentucky Hous. Corp., 139 B.R. 828 (W.D. Ky. 1992); *In re* Petit, 189 B.R. 227 (Bankr. D. Me. 1995); *In re* Tax Shop, Inc., 173 B.R. 605 (Bankr. E.D. Mich. 1994); *In re* B & B West 164th Street Corp., 147 B.R. 832 (Bankr. E.D.N.Y. 1992); *In re* Great Am. Pyramid Joint Venture, 144 B.R. 780 (Bankr. W.D. Tenn. 1992); *In re* Daily Corp., 72 B.R. 489 (Bankr. E.D. Pa. 1987).

[120]"This bill also allows a bankruptcy court to take any action on its own, or to make any necessary determination to prevent an abuse of process *and to help expedite a case* in a proper and justified manner." 132 CONG. REC. S15,096 (daily ed. Oct. 3, 1986) (statement of Senator Hatch) (emphasis added).

[121]808 F.2d 363, 373 (5th Cir. 1987) (en banc), *aff'd*, 484 U.S. 365 (1988). *See Tax Shop*, 173 B.R. at 608 (quoting *Timbers*); *In re* Public Serv. Co., 84 B.R. 1, 2 (Bankr. D.N.H. 1988) (same); *In re* Bayou Self, Inc., 73 B.R. 682, 684 (Bankr. W.D. La. 1987) (same); *Daily Corp.*, 72 B.R. at 494 (same). *See also* Miller, *supra* note 110, at 435.

[122]173 B.R. at 605.

[123]The court held a status conference at which no creditors appeared, *id.* at 606, and held a show cause hearing that no one attended. *Id.* at 607.

[124]144 B.R. at 780.

est, the court issued a *sua sponte* order to show cause why the cases should not be converted or dismissed.[125] Before the hearing was held on the court's order, the City and County filed their own § 1112(b) motions.[126] While it is difficult to determine what would have happened absent the court's order, it is likely that the order had the effect of spurring the creditors to action.[127]

This case illustrates one of the benefits of a *sua sponte* order. Motions to dismiss or convert require the debtor to provide some evidence of the likelihood of a reorganization. They provide a means through which the reality of the debtors efforts to reorganize may be examined. Making such a determination can be a complex undertaking, however, and creditors may be reluctant to bring a § 1112(b) motion prematurely. *Sua sponte* orders might act as a form of judicial signal to the parties in interest that the judge would be receptive to a § 1112 motion, which signal might in turn overcome creditors' reluctance to place the issue squarely before the judge.

Short of outright dismissal, several bankruptcy courts have used their authority under § 105(a) to order the appointment of a bankruptcy trustee. In *Fukutomi v. U.S. Trustee (In re Bibo, Inc.),*[128] the Ninth Circuit approved the bankruptcy court's use of its *sua sponte* authority to appoint a trustee when, on a motion to approve management fees, the court found documentation that established a kickback scheme involving a principal of the debtor.[129] The Ninth Circuit held that "[t]he statute plainly gives the bankruptcy judge authority to appoint a trustee *sua sponte*,"[130] and further held that the evidence established cause to appoint a trustee.[131] Finally, the Ninth Circuit rejected the principal's claim that the bankruptcy court denied him due process by denying him a continuance prior to the hearing on the court's motion.[132] The Ninth Circuit held that the notice and hearing the principal received were "appropriate in the circumstances" given the clear evidence of

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[125]Id. at 782.

[126]*Id.* at 782 n.2.

[127]The court converted five of the six cases under consideration and placed the remaining case on a "fast track." *Id.* at 792.

[128]76 F.3d 256 (9th Cir. 1996).

[129]*Id.* at 257.

[130]*Id.* at 258.

[131]*Id.*

[132]Upon the bankruptcy court's discovery of the documentation and examination of one witness, the court granted a short recess so that the principal could consult with counsel for the debtor. *Id.* at 257. After consulting with counsel, the debtor requested a continuance. The court denied the request, stating:

> I want someone to take over all the assets of the debtor today. I do not want Mr. Fukutomi or Ms. Fukutomi to have access to any of the assets of this estate hereinafter from the moment they walk out the door until all this case is resolved one way or another.

Id.

fraud and the consequent threat to the estate.[133]

Of course, such judicial management techniques only have the effect of enabling the judge to consider the substantive issues involved in the case. They provide no indication of how to resolve those questions. In *Great American Pyramid*, the court recognized the difficult substantive problems involved in the case as it framed the issue:

> Query, what is a reasonable breathing spell and fair opportunity for a chapter 11 debtor to seek to rehabilitate before pulling the reorganization plug? The ultimate questions for judicial determination here, considering the realities of these case administrations at this time, is whether reorganization is now visionary only or hopeless and whether liquidation or dismissal is the only appropriate solution under the existing circumstances?[134]

Case administration provides no answer to this dilemma and our ambivalence over the purposes of Chapter 11 precludes an easy answer.

This observation points to one of the principal dangers of active judicial case management. While status conferences, fast track procedures and *sua sponte* orders may be efficacious means of framing issues and assuring that management is not using the protection of Chapter 11 merely to perpetuate itself in office, quick resolution of bankruptcy cases should not be an end in and of itself. Take for example the decision in *In re Petit.*[135] Petit involved an individual Chapter 11 debtor whose principal asset was a cause of action against Key Bank. All of the counts in the complaint had been dismissed or disposed of through summary judgment against the debtor. One count remained on appeal, however, and at least one expert testified that the debtors damages were in excess of $30 million.[136] Despite the fact that the debtor, the creditors, the trustee, and the United States Trustee believed that the issue on appeal should keep the reorganization alive,[137] the court *sua sponte* converted the case to a Chapter 7.[138] It is difficult to tell from the opinion precisely why the *Petit* court was determined to convert the case in the face of opposition from every constituency. The court indicates its belief that the debtor may have duped the creditors by holding out the possibility of such a large return.[139] This reading of the case is cause for concern. To the extent

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[133] *Id.* at 259. *See also In re* Embrace Systems Corp., 178 B.R. 112 (Bankr. W.D. Mich. 1995) (lack of disinterestedness of sole employee of debtor in possession is basis for *sua sponte* appointment of a trustee).

[134] *In re* Great Am. Pyramid Joint Venture, 144 B.R. 780, 789 (Bankr. W.D. Tenn. 1992).

[135] 189 B.R. 227 (Bankr. D. Me. 1995).

[136] *Id.* at 228.

[137] *Id.*

[138] *Id.* at 229.

[139] *Id.* at 228 ("It is a fact of life, however, that while there is no statutory requirement that creditors

bankruptcy courts use judicial case management to substitute their judgment for that of the interested parties, they may step beyond the bounds of impartial decisionmaker and into the role of active participant in the case.[140]

The court's opinion in *In re Mother Hubbard, Inc.*[141] is an example of the sensitivity required when a bankruptcy court is exercising its authority to act *sua sponte.* In *Mother Hubbard,* the president and sole shareholder of the debtor proposed a plan that sought to contribute a late filed unsecured claim as new value.[142] After denying the president's motion to deem the claim timely filed and after permitting an unsecured creditor to file a competing plan, the court considered *sua sponte* whether to hold a hearing to consider the appointment of a Chapter 11 trustee.[143] In its discussion of the issue, the court noted the danger of involvement with administrative matters and stated its belief that the impetus for such a motion must come from the record.[144] While the court expressed its concern regarding the goals and motives of the debtor's president and sole shareholder, it noted that both the unsecured creditor, who was also the proponent of a competing plan, and the creditor's committee had "sufficient incentive to monitor the Debtor's business activities (and [the president's] business judgments)."[145] Accordingly, the court declined to order a hearing but admonished the president regarding the conduct of the business during the confirmation process[146] and invited parties in interest with knowledge of facts constituting cause to file a motion.[147]

In sum, while case management alone cannot provide substantive solutions to the complex questions presented in a Chapter 11 case, it can assure the parties that the court will address the question in a timely manner. A necessary prerequisite to improved governance in Chapter 11 is a system that periodically frames the issues for the ultimate decisionmaker. As studies of

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be realistic or reasonable in their expectations of success, the Court does not enjoy such latitude and neither may we permit the Debtor to fantasize indefinitely.").

[140]It is possible that the court's decision might be justified on the grounds that the Chapter 11 process could achieve nothing that could not be achieved more expeditiously in a Chapter 7. If this were the case, considerations of judicial economy coupled with a lack of benefit from judicial efforts might warrant conversion. The opinion is devoid of such analysis, however.

[141]152 B.R. 189 (Bankr. W.D. Mich. 1993).

[142]*Id.* at 191.

[143]*Id.* at 196-97.

[144]*Id.* at 197 ("This judge also strongly believes it is improper to sua sponte raise such an issue unless persuasive evidence comes to the court's attention on the record which may lead to a conclusion that cause exists or an abuse of process is occurring.").

[145]*Id.*

[146]*Id.* ("Van Zoeren shall act in accordance with his fiduciary obligations, as contrasted to his personal desires, to assure a 'level playing field' is maintained until the conclusion of the confirmation hearings on the competing plans.").

[147]*Id.* at 198.

small business reorganizations have found, small business bankruptcy cases often leave managers in full control of the process because creditors have little incentive to become actively involved in the cases.[148] Active case management can provide a counterbalance to the control managers assert over these cases.

B. Flexible Use of Examiners

Even with active case management, bankruptcy judges suffer an informational disadvantage vis-a-vis managers which impairs the ability of the bankruptcy governance structure to provide adequate checks on managers. The caseload of bankruptcy judges is ever increasing as new bankruptcy filings reach record heights.[149] The resulting time limitations, coupled with the limits of the adjudicative role, allow managers to restrict the information available to the parties and to the judge.

Of course, the Code requires that managers provide some information to the other participants in the case. The Code requires the debtor in possession to file periodic reports and summaries of operation of the business with the court, the United States Trustee, and the taxing entities, and to respond to requests for information by parties in interest.[150] In addition, creditors' committees, in those cases in which they are appointed, are charged with consulting with the debtor in possession concerning the administration of the case and investigating the debtor and its management.[151]

While these provisions assure that the debtor's managers are subject to broad oversight, they may be inadequate to highlight more subtle information that managers hold about the prospects for reorganization. Only involvement in the day-to-day operations of the debtor will provide the detail required to make an accurate assessment of those prospects. In addition, the acquisition of knowledge about alternatives to reorganization requires that one take the initiative to explore those alternatives. While an active creditors' committee in a large case may take that initiative,[152] in smaller cases there may be no-

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[148]*See supra* notes 61-70 and accompanying text.

[149]Total bankruptcy filings reached a record high of 1,178,555 in 1996. New Generation Research, 1997 Bankruptcy Yearbook and Almanac 32 (1997). Thus, even though the Chapter 11 caseload is about half of what it was during the peak years 1985-86 and 1990-93, *see id.*, the bankruptcy system is strained.

[150]11 U.S.C. §§ 704(8), 1106(a)(1) (1994).

[151]*Id.* § 1103(c).

[152]Even in large cases, the creditors' committee may be at a severe disadvantage. Professor Zaretsky questioned the ability of creditors' committees to control the management of the debtor:

> [A] committee is not involved in the day-to-day operations of the debtor and is often in the position of responding to initiatives generated by the debtor. Its information comes primarily from the debtor and may reflect the debtor's sometimes unduly optimistic assessments. Accordingly, a committee usually cannot set the direction of the business or the tone of the operations.

one to do so but the judge who, of course, must look to managers for suggestions.

Commentators have suggested that courts make flexible use of the provisions of Chapter 11 allowing the court to appoint an examiner to counteract this difficulty.[153] Traditionally, examiners have been appointed in cases in which there has been some need to investigate the prebankruptcy conduct of the firm's managers or shareholders. But, in several large cases, courts have charged examiners with mediating disputes, bringing suits, and operating the debtor's business.[154] Courts could use examiners to provide the court with an unbiased review of specific decisions, thus alleviating somewhat the information monopoly held by the managers.[155]

Section 1104 provides the necessary authority for such a flexible use of examiners. The statute authorizes the court to appoint an examiner to "conduct such an investigation of the debtor as is appropriate" if the appointment is in the best interests of the creditors, equity holders and other interests in the estate.[156] Section 1104(c) provides a list of the subjects of such an investigation that seems to require that there be some allegation of fraud, dishonesty, or incompetence, but the provision makes clear that the list is illustrative only.[157]

A few courts have made use of this flexible authority, typically coupling specific informational charges with a general charge to mediate the case. For example, the court's charge to the examiner in the Apex Oil Company Chapter 11 case included taking "any necessary and appropriate actions in furtherance of assisting the Court and parties in bringing these proceedings to a just, prompt and economic disposition."[158] This broad charge required the examiner to undertake, for example, extensive monitoring of the debtor's efforts to stabilize its business postpetition;[159] mediation of a number of disputes;[160]

Zaretsky, *supra* note 43, at 915.

[153]*Id.* at 940-61; Frost, *supra* note 5, at 132. Professor Adams has proposed the more radical solution under which an appointed trustee would share decisionmaking authority with prepetition managers. *See* Adams, *supra* note 5, at 620-23.

[154]*See* Zaretsky, *supra* note 43, at 940-61 (discussing the various uses to which courts have put examiners).

[155]*Id.* at 955 ("[S]ome bankruptcy courts have employed examiners as the 'eyes and ears' of the court . . . .").

[156]11 U.S.C. § 1104(c) appears to require the court to appoint an examiner when the debtor's debts exceed $5 million. Several courts have denied appointment of examiners in such cases, however. *See* Zaretsky, *supra* note 43, at 938-39. The National Bankruptcy Review Commission has recommended that the mandatory language in § 1104(c) be deleted. NBRC REPORT, *supra* note 6, at 23.

[157]11 U.S.C. § 102(3) (1994) (stating tht the terms "includes" and "including" are not limiting). *In re* Public Serv. Co., 99 B.R. 177, 182 (Bankr. D.N.H. 1989) ("The Debtor's strict interpretation of examiner as merely an investigator of fraud and other irregularities is unwarranted.").

[158]*In re* Apex Oil Co., 111 B.R. 235, 237 (Bankr. E.D. Mo. 1990), *rev'd*, 132 B.R. 613 (E.D. Mo. 1991), *aff'd in part, rev'd in part*, 960 F.2d 728 (8th Cir. 1992).

[159]*Id.* at 238.

and an investigation into the good faith of asset purchasers for purposes of § 363(m).[161]

The court in *In re Public Service Co.*[162] appointed an examiner to resolve a somewhat more specific problem. The parties in *Public Service* had reached a difficult point in negotiations that revolved around the arcana of utility rate-making. In addition to the desirability of a third-party mediator, the court noted that it needed assistance "in understanding some of the rather arcane concepts employed in the utility rate-setting regulatory world in order to properly perform its duties."[163]

Finally, in *In re Big Rivers Electric Corp.*,[164] the court appointed an examiner specifically to address allegations that management was violating its fiduciary duty to maximize the value of the estate regarding a long-term lease of substantially all of its income-generating assets.[165] The examiner's investigation revealed the existence of a "No Shopping" clause in the lease and concluded that the debtor had "failed to develop bids submitted by parties other than [the proposed lessee]."[166] The court, noting its duty to maximize the value of the estate[167] as well as the duty of the debtor to do the same,[168] subsequently ordered an auction of the assets resulting in a binding commitment for $50 million more than was offered by the original proposed lessee.[169] Thus, through the use of an examiner, the court was able to penetrate the informational monopoly held by management.

The combination of the investigative functions of the examiner with a mediation function provides governance benefits in addition to the expected economies associated with alternative dispute resolution.[170] The requirement that the examiner/mediator file a report with the court may deter managers or shareholders from taking strategic positions in the negotiations simply to delay the ultimate resolution of the case.[171] In addition, involve-

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[160] *Id.* at 241.
[161] *Id.*
[162] 99 B.R. 177 (Bankr. D.N.H. 1989).
[163] *Id.* at 182.
[164] 213 B.R. 962 (Bankr. W.D. Ky. 1997).
[165] *Id.* at 965-67.
[166] *Id.* at 968.
[167] *Id.* at 970.
[168] *Id.* at 971.
[169] *Id.*
[170] The requirement that the examiner file a report may, however, impair the ability to reach a settlement because the parties cannot be assured that their communications with the examiner will remain confidential. Mabey, Tabb, and Dizengoff note that, "an examiner as mediator is not classic mediation. Rather, the examiner is clothed with judicial authority . . . ." Ralph R. Mabey et al., *Expanding the Reach of Alternative Dispute Resolution in Bankruptcy: The Legal and Practical Bases for the Use of Mediation and the Other Forms of ADR*, 46 S.C. L. Rev. 1259 (1995). Thus, the use of an examiner as an "investigative mediator" may involve a tradeoff between governance and alternative dispute resolution benefits.
[171] 11 U.S.C. § 1106(a)(4) (1994).

ment in the negotiations may provide the examiner with an opportunity to obtain information about the prospects of the business and the managers' operation of the business that would not otherwise come to light.

Of course, examiners are not without costs and the economics of many small cases will not support the luxury of third-party involvement. Thus, it is not surprising that most of the reported cases in which courts have used examiners, as described here, have involved large debtors with active creditors' committees and complex issues. But, if the task of the examiner is narrowly defined to the investigation of the viability of the enterprise or the desirability of a particular course of action, the court may keep the costs in check. In addition, examiners need not be bankruptcy attorneys.[172] If the examiner's task is to evaluate a business decision, the analysis might be most appropriately accomplished by someone knowledgeable in the field.

In addition to cost, the flexible use of examiners may give rise to concerns regarding the adjudicative function of the bankruptcy judge. To the extent bankruptcy judges use examiners as a surrogate judge with the ability to achieve results that they themselves might be prohibited from accomplishing, their role as impartial adjudicators of disputes might be called into question. As noted above,[173] the Bankruptcy Code was intended to relieve bankruptcy judges from the duty of administering cases in an effort to assure that the judges could exercise their adjudicative powers free from any appearance of partiality. To this end, Bankruptcy Rule 9003 prohibits *ex parte* communication by an examiner unless otherwise authorized by applicable law.[174] This prohibition assures that the judge remains above the fray as an adjudicator of facts developed through the normal operation of the adversary system.

C. Attorney Compensation

One way that bankruptcy judges have found to improve governance is to look to the professionals already involved in the case for assistance in policing managers. In large reorganizations, this burden is shared by the wide range of professionals employed by the debtor in possession, the committees, and other significant creditors.[175] In smaller cases, which are marked by the absence of committee and large creditor involvement, a large share of the governance burden often rests with the attorney for the debtor in possession. In what is doubtless an alarming trend for bankruptcy debtor's counsel, bank-

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[172]*See* NBRC Report, supra note 6, at 658 (discussing the Licensed Insolvency Officer concept used in the United Kingdom in which accountants are used to administer insolvency cases).

[173]*See supra* notes 109-111 and accompanying text.

[174]Fed. R. Bankr. P. 9003(a). In *Big Rivers*, the court held that its earlier uncontested final order authorizing *ex parte* communications by the examiner constituted "applicable law" for purposes of Rule 9003(a). 213 B.R. at 975-76. In addition, the court held that the failure to object to the order rendered subsequent motions to disqualify the judge and to remove the examiner untimely. *Id.* at 972-73.

[175]*See supra* notes 39-40 and accompanying text.

ruptcy courts have increasingly used their authority over fee applications as a method of policing managerial and shareholder behavior in Chapter 11 cases.

Outside of bankruptcy, the Model Rules of Professional Conduct enjoin attorneys retained by "organizations" (including corporations) to remember that they represent "the organization acting as through its duly authorized constituents"[176] and require that conflicts between their client and the individuals running the client (including the person who signs the attorney's check) are to be resolved in favor of the client.[177] The Model Rules provide some guidance to attorneys regarding the appropriate response to actions by corporate officers and employees that the lawyer believes are not in the best interest of the corporation—including, as a last resort, resignation from the relationship.[178]

While corporate representation sometimes results in some discomfort for attorneys, the ethical obligations of an attorney representing the debtor in possession[179] present difficulties that go well beyond those facing corporate lawyers outside of the bankruptcy or insolvency context. The attorney's obligation to the "estate" requires more vigilance than is required of corporate attorneys outside of bankruptcy.[180] In bankruptcy, as one court put it, "the duty to advise the client [the DIP] goes beyond responding to the client's request for advice. It requires an active concern for the interests of the estate, and its beneficiaries."[181] This enhanced obligation, coupled with the role of counsel for the debtor in possession as an officer of the court, ensures that the attorney is at the center of Chapter 11 governance controversies. Not only do an attorney's fiduciary obligations extend to all who are interested in the estate, the attorney has a duty to preserve the integrity of the

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[176] Model Rules of Professional Conduct Rule 1.13(a) (1983).

[177]

> If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization. . . .

Id., Rule 1.13(b).

[178] *Id.*, Rule 1.13(c).

[179] Counsel for the debtor in possession is herein referred to as "counsel for the debtor in possession," rather than "counsel for the debtor." This reference is used to draw attention to the fact that the attorney technically represents an entity that has duties to the estate. Neither the Code nor courts are scrupulous about the distinction between the debtor and the debtor in possession because, when a Chapter 11 trustee has not been appointed, there is no distinction. 11 U.S.C. § 1101(1) (1994).

[180] *See* Ayer, *supra* note 109, at 387-90.

[181] *In re* Wilde Horse Enters., Inc., 136 B.R. 830, 840 (Bankr. C.D. Cal. 1991).

bankruptcy process.[182] The obligations of counsel for the debtor in possession include a duty to "carefully monitor each case and encourage conversion or dismissal without delay when it becomes apparent that reorganization is no longer feasible or that wrongdoing is taking place."[183] Not only must counsel be vigilant in advising the debtor in possession's managers regarding their fiduciary obligations, counsel has an affirmative duty to inform the court of the managers' lapses.[184]

Of course these enhanced duties create what Professor Westbrook has referred to as "unavoidable conflicts inherent in the representation of DIPs."[185] The essence of this conflict lies in the divergence of incentives held by the various participants in the case. Because the shareholders and managers are likely to have interests that differ radically from those of the creditors, a conflict is unavoidable. The attorney for the debtor in possession is therefore thrust into the eye of the storm and must avoid the urge to view the shareholders and managers as her principal constituency.[186]

By far the most notorious case addressing these inherent conflicts is *In re Kendavis Industries International, Inc.*[187] *Kendavis* involved a large reorganization in which the creditors' committee and certain individual creditors moved for disgorgement of fees paid to counsel for the debtor in possession (Locke, Purnell, Boren, Laney and Healey).[188] The gravamen of the movants' allegations was that Locke Purnell had represented both the debtor in possession and its controlling shareholders (the Davis family) and had taken actions designed to benefit only the Davis family.[189] The court noted that correspon-

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[182]Zeisler & Zeisler, P.C. v. Prudential Ins. Co. of America (*In re* JLM, Inc.), 210 B.R. 19, 26 (B.A.P. 2d Cir. 1997).

[183]*In re* Pacific Forest Indus., Inc., 95 B.R. 740, 744 (Bankr. C.D. Cal. 1989).

[184]*JLM*, 210 B.R. at 26 (collecting cases).

[185]Jay Lawrence Westbrook, *Fees and Inherent Conflicts of Interest*, 1 AM. BANKR. INST. L. REV. 287 (1993). *See also* Ayer, *supra* note 109, at 387-95 (discussing the overlapping roles of all of the attorneys in the case); C. R. Bowles, Jr. & Nancy B. Rapoport, *Has the DIP's Attorney Become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Cases?*, 5 AM. BANKR. INST. L. REV. 47 (1997) (discussing the inherent conflicts involved in representing a debtor in possession). *Cf.* Bruce A. Markell, *The Folly of Representing Insolvent Corporations: Examining Lawyer Liability and Ethical Issues Involved in Extending Fiduciary Duties to Creditors*, 6 J. BANKR. L. & PRAC. 403 (1997) (discussing the conflicts involved in representing insolvent corporations outside of bankruptcy and concluding that "no ethical or rational lawyer should ever willingly represent an insolvent corporation outside bankruptcy").

[186]"It is to ensure [the] integrity of the bankruptcy process where, by definition, a debtor in possession is not disinterested, that counsel for the debtor in possession must be disinterested, free of any adverse entanglements which could cloud its judgment respecting what is best for the estate." *JLM*, 210 B.R. at 26.

[187]91 B.R. 742 (Bankr. N.D. Tex. 1988). *See also* Diamond Lumber, Inc. v. Unsecured Creditors' Comm. of Diamond Lumber, Inc., 88 B.R. 773 (N.D. Tex. 1988); *In re* Chapel Gate Apts. Ltd., 64 B.R. 569 (Bankr. N.D. Tex. 1986). Professor Westbrook refers to all of these cases as the *Kendavis* trio of cases. Westbrook, *supra* note 185, at 290.

[188]91 B.R. at 744.

[189]*Id.* at 745-46.

dence among Locke Purnell, the Davis family, and other professionals involved in the case indicated that the Davis family believed that Locke Purnell represented them.[190] In addition, the court looked to the actions of Locke Purnell during the proceeding.[191] The court stated that the activities of Locke Purnell "were designed to further the interests of the Davis family"[192] and concluded that the totality of the evidence could lead only to the conclusion that Locke Purnell represented the interests of the Davis family.[193] The court awarded Locke Purnell only $2,000,000 of the $4,000,000 in fees previously awarded—requiring disgorgement of the balance.[194]

In the course of the *Kendavis* decision, the court engaged in a detailed analysis of conflicts of interest in the bankruptcy process. The court set the stage for this broader inquiry by stating that the case "demonstrates the problems inherent in a popular theory regarding representation of Debtors in bankruptcy, the concept of the 'potential' conflict of interest . . . ."[195] In its discussion, the court noted that the history and statutory language of the disinterestedness requirement of § 327[196] creates no room for allowing representation of multiple entities in one or a series of related cases on the basis that the conflicts created are only "potential."[197] The court's broad holding is that "whenever counsel for a debtor corporation has any agreement, express or implied, with management or a director of the debtor, or with a shareholder, or with any control party, to protect the interest of that party, counsel holds a conflict."[198]

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[190]*Id.* at 750-51. One of these items clearly demonstrates the nature of the conflict. One of the family members wrote "As Barb [apparently a member of Locke Purnell] continues to repeat and everyone agrees there is no shareholder equity—so we've got nothing to loose [sic]—The banks have it all on the line now—not us." *Id.* at 765.

[191]*Id.* at 749-751. Specifically, the court examined the debtor's new value plan finding that it was unconfirmable because it did not propose a substantial contribution, *see id.* at 749, and Locke Purnell's vigorous opposition to the committee's plan which called for 100 percent payment to all nonbank and noninsider creditors. *Id.* at 750.

[192]*Id.* at 752.

[193]*Id.* at 751.

[194]*Id.* at 762-3. *See* 11 U.S.C. § 328(c) (1994) (allowing the court to deny allowance of compensation if "at any time during such professional person's employment . . . , such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate . . . ." In addition, the court ordered disgorgement of a $500,000 retainer that had been paid to Locke Purnell by a related Debtor but that had not been disclosed to the court. 91 B.R. at 762. *See* 11 U.S.C. § 329(a) (requiring attorneys to file a statement of compensation paid or agreed to be paid).

[195]91 B.R. at 744.

[196]Section 327(a) of the Code requires that professionals employed by the trustee not "hold or represent an interest adverse to the estate" and that such persons be "disinterested." 11 U.S.C. § 327(a). Section § 101(14)(E) further defines disinterested person as a person who, "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders . . . ." *Id.* § 101(14)(E).

[197]91 B.R. at 752-57.

[198]*Id.* at 754.

Courts considering similar situations often note the difficulties that a rigid interpretation of the disinterestedness requirement would create, usually concluding that the *Kendavis* result should be limited to egregious conflicts such as those considered in that case.[199] For example, the court in *In re Howell*[200] approved counsel for the debtor's application for compensation even though the attorney represented the bankruptcy estates of both a closely held corporation (a beauty school) and its individual shareholders. The court distinguished *Kendavis* on its facts citing the egregious nature of the Kendavis attorney's behavior.[201] The court also rejected the reasoning of the *Kendavis* court, applying instead a potential conflicts analysis.[202] Ultimately, the court in *Howell* concluded that "The unity of interest and interdependence that exists between the debtors and the school exemplify the 'mom & pop' nature of the present situation so that Archer's dual representation was both economically reasonable and legally appropriate."[203] Thus, the cost of separate counsel may be one factor that limits strict adherence to the disinterestedness analysis.

The court in *In re Office Products of America, Inc.*[204] provided another rationale for limiting the holding of *Kendavis* to its facts. In *OPA*, the trustee, joined by creditors and an unofficial creditors' committee, objected to the fee application of counsel for the debtor in possession (Gresham Davis). Among their arguments was that Gresham Davis represented the interests of OPA's management in fighting a conversion of the case to Chapter 7.[205] Upon a review of the detail of the fee application, the court agreed that "at some point in the representation, the interests of the officers and directors of OPA may have become elevated above those of the estate."[206] In particular, the court focused on the fact that management's proposed plan of reorganization "could redound only to the benefit of the owners of the enterprise and not to its creditors . . . ."[207] The court refused, however, to find a conflict based solely on the fact that management had proposed a cramdown plan benefitting only the shareholders:

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[199]*See, e.g., In re* Spanjer Bros., Inc., 191 B.R. 738, 754 (Bankr. N.D. Ill. 1996) (noting lack of evidence that the attorney for the debtor in possession represented management, directors, or shareholders); *In re* Howell, 148 B.R. 269, 271 (Bankr. S.D. Tex. 1992) (limiting the *Kendavis* result to egregious behavior); *In re* Office Prods. of America, Inc., 136 B.R. 983, 988 (Bankr. W.D. Tex. 1992) (limiting application of *Kendavis* to cases with "compelling facts").

[200]148 B.R. at 269.

[201]*Id.* at 271.

[202]*Id.* at 271-72.

[203]*Id.* at 272. *See also In re* Roberts, 75 B.R. 402, 406 (D. Utah 1987) (citing client's choice of counsel and the economic realities as reasons to permit joint representation).

[204]136 B.R. at 983.

[205]*Id.* at 986.

[206]*Id.*

[207]*Id.*

> There are serious policy ramifications to such a holding . . . which auger against deciding the case on that basis. The cramdown provisions of the Code are an expression of congressional intent regarding the importance of reorganization values even in the face of considerable creditor opposition, provided those creditors' interests are appropriately protected.[208]

The court also noted that a strict application of *Kendavis* would create an inevitable *in terrorem* effect that would discourage competent counsel from accepting responsibility for such cases in the first place and from diligently discharging their duties.[209]

Thus, the widespread use of the principles enunciated in *Kendavis* is subject to the cost and normative concerns that limit the effectiveness of the bankruptcy governance structure. In small cases, courts are reluctant to find that dual representation constitutes a *per se* disqualification on the basis of disinterestedness. In addition, courts are averse to holding that actions of counsel for the debtor in possession which benefit managers and shareholders of the debtor necessarily should be taken as an indication that the attorney has abandoned her broader duty to the estate in favor of a particular group.

This is not to say, however, that an attorney's compensation plays no role in the bankruptcy governance structure. In contrast to the fairly broad approach taken in the disinterestedness cases, courts are increasingly examining attorneys' fees and governance issues in a somewhat more targeted way by examining how the work provided a benefit to the estate as is required under § 330(a)(3)(C).[210] These cases require attorneys to exercise independent judgment regarding the continued viability of a debtor or to risk losing their fees for work done beyond the point at which the reorganization appears to be hopeless.[211]

In re Office Products of America, Inc. provides an example of this approach. In this case, after concluding that actions by counsel for the debtor in

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[208]*Id.*

[209]*Id.* at 988.

[210]11 U.S.C. § 330(a)(3)(C) (1994) directs the court in reviewing a fee application to consider, among other things, "whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title." In addition, 11 U.S.C. § 330(a)(4)(A)(ii) (1994) prohibits the court from allowing compensation for services that were not "reasonably likely to benefit the debtor's estate" or that were not "necessary to the administration of the case."

Section 330 was substantially rewritten in the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 224, 108 Stat. 4106, 4130-31. In large part, the change appears simply to codify the lodestar method of determining attorneys' fees used by many bankruptcy courts.

[211]"Chapter 11 cases which lack viable chances of reorganization may place the fees of counsel at risk." *In re* Offield, 128 B.R. 548, 550 (Bankr. W.D. Mo. 1991).

possession did not warrant a finding of disinterestedness,[212] the court went on to consider whether the firm's efforts to avoid a conversion of the case provided a benefit to the estate.[213] Again, the court noted that the plan of reorganization filed by the debtor in an effort to avoid conversion of the case was unconfirmable,[214] and stated that the fee detail filed in the case suggested "that there was a point in time when the debtor knew or should have known that pursuit of [the] plan flew in the face of [the plan confirmation standards] . . . ."[215] The court concluded that "[a]t that point, the services of the counsel were no longer 'necessary.'"[216] The court denied allowance of the request for $10,315.00 in fees that related to the plan, stating that that work "served primarily to maintain then-current management in control of the enterprise, at significant risk to the creditor body."[217]

In *Rubner & Kutner, P.C. v. U.S. Trustee (In re Lederman Enterprises, Inc.)*,[218] the Tenth Circuit made clear that in evaluating fee applications, benefit to the estate is a threshold concern which the court must determine before conducting any review into the reasonableness of the attorneys' fees.[219] *Lederman* involved an appeal of a bankruptcy court order disallowing attorneys' fees that related to plan confirmation and disclosure. The bankruptcy court held that the debtor's petition was not filed in good faith and, therefore, that the work did not benefit the estate.[220] The firm appealed the order, arguing that the bankruptcy court erred in treating lack of benefit to the estate as a basis for denial of all fees related to particular work. Instead, the firm argued, benefit to the estate is merely a factor that the court should consider in determining the amount of the fees.[221] The *Lederman* court also rejected the firm's argument that the bankruptcy court's denial of compensation amounted to punishment for the debtor's decision to file the petition, citing a number of cases in which courts have denied fees for work completed when it is obvious that there is no reasonable prospect for a successful

[212]*See supra* notes 187-209 and accompanying text.

[213]136 B.R. at 988-91.

[214]*Id.* at 990.

[215]*Id.*

[216]*Id.* at 990-91.

[217]*Id.* at 991.

[218]997 F.2d 1321 (10th Cir. 1993).

[219]*Id.* at 1323.

[220]*See id.* at 1322.

[221]*Id.* at 1323. The firm also appealed the bankruptcy court's reduction of its fees based on inadequate information in the fee application. The district court found that the bankruptcy court erred in imposing a twenty percent across the board reduction in the fees, and remanded the case for a recalculation of fees. *See* Rubner & Kutner, P.C. v. United States Trustee (*In re* Lederman Enters., Inc.), 143 B.R. 772, 775 (D. Colo. 1992). The district court affirmed the portion of the bankruptcy court's opinion reducing the fees for lack of benefit to the estate, however. *Id.*

reorganization.[222]

Not all courts have followed the lead of cases such as *Lederman* and *OPA*. These two cases place the counsel for the debtor in possession in a unique role. Normally when representing a corporation, an attorney is entitled to look to the corporation's management for direction regarding business judgments. The comments to Rule 1.13 of the Model Rules of Professional Conduct evidence this traditional allocation of authority:

> When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province. However, different considerations arise when the lawyer knows that the organization may be substantially injured by action of a constituent that is in violation of law.[223]

The court in *In re Spanjer Bros., Inc.*[224] cited this commentary in its consideration of a creditors' committee's challenge to the allowance of fees to counsel for the debtor in possession incurred in the unsuccessful opposition to the committee's motion for the appointment of a trustee.[225] The court noted that the debtor's management's opposition to the motion was not a violation of law and therefore it was counsel's duty to follow the instructions of management and defend against the committee's motion.[226]

Of course, one cannot take the Model Rules standard of illegality too literally in the bankruptcy context. It is not illegal to take actions such as filing plans that violate the absolute priority rule, appealing confirmation orders, or opposing conversion, yet taking such actions may place counsel for

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[222]997 F.2d at 1323-24 (collecting cases). *See also In re* Ogden Modulars, Inc., 207 B.R. 198 (Bankr. E.D. Mo. 1997) (denying fees of attorney for opposing the revocation of an order of confirmation); *In re* Parke Imperial Canton, Ltd., 1995 Bankr. LEXIS 259, No. 93-61004 (Bankr. N.D. Ohio Feb. 27, 1995) (reducing fees related to the preparation of unconfirmable plan and disclosure statement and appeal of confirmation of creditor plan); *In re* Mflex Corp., 172 B.R. 854 (Bankr. W.D. Tex. 1994) (disallowing all compensation and requiring disgorgement of retainer where counsel filed plan with little chance of confirmation and failed to disclose compensation and conflicts of interest); *In re* Automobile Warranty Corp. 138 B.R. 72 (Bankr. D. Colo. 1991) (fees disallowed for preparation of plan that was filed as delay tactic); *In re* S & E Oil Co., Inc., 66 B.R. 6 (Bankr. W.D. La. 1986) (reducing fees where it should have been obvious that reorganization would not succeed).

[223]MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13 cmt.3 (1983). Professor Ayer has noted that such pronouncements of the ethical obligations of attorneys are based on a litigation model and on a model of negotiation that includes a basic supposition that a lawyer is a person who tries a case. Ayer, *supra* note 109, at 378-84. He further points out that bankruptcy does not fit within the models represented by the Code of Professional Responsibility or the Model Rules. *Id.* at 392.

[224]191 B.R. 738 (Bankr. N.D. Ill. 1996).

[225]*Id.* at 751-52.

[226]*Id.* at 752.

the debtor in possession at risk of losing fees if the court determines that the actions did not benefit the estate. Cases in which courts deny fees on this basis revolve around the fuzzy standards imposed by the fiduciary principle, not some hard-edged notion of illegality. Still, cases such as *Spanjer* remind us that in examining those fiduciary standards, the Code requires the debtor in possession, and thus its counsel, to represent all of the interests in the estate—not just those of creditors seeking a quick liquidation.

Casco Northern Bank, N.A. v. DN Associates (In re DN Associates)[227] makes clear that this broad duty plays an important role in the determination of fee disputes. The court rejected a creditor's argument that counsel for the debtor in possession represented interests that were materially adverse to the estate. The creditor argued that counsel's opposition to the creditor's plan and the proposal of three plans under which the limited partners would retain an interest in the reorganized debtor warranted a disallowance of fees. The First Circuit Court of Appeals quoted the bankruptcy court with approval, stating that:

> [i]t would be unfortunate if courts, looking only at plan provisions removed from context, concluded as a matter of law that a conflict of interest existed whenever a debtor and its counsel, in the face of creditor opposition, pursued a reorganization strategy that, while providing for creditors in a fashion consistent with Chapter 11 priorities, sought to adjust the rights and relations of parties-in-interest so that the interests of equity interest holders could be preserved.[228]

The legitimacy of the equity holders' desire to preserve their interests also carried over to the court's analysis of how the work benefitted the estate. The court approved the bankruptcy court's discussion of the intangible benefits the plans provided. Among these benefits was the attempt to protect "all interested parties, including creditors and debtor's investors"[229] and the constructive competition that arose among the plans.[230]

The ability of debtors to retain counsel willing to undertake such an expansive role naturally is impaired by the risk that the court will deny fees to attorneys who err in favor of managers and shareholders. In *In re Garrison Liquors*,[231] the court noted that a rule that penalized attorneys for failed reorganization efforts "would not merely chill the enthusiasm for debtors' representation but would prejudice the bankruptcy system itself by promoting the

[227] 3 F.3d 512 (1st Cir. 1993).
[228] *Id.* at 516 (quoting *In re* DN Associates, 144 B.R. 195, 200 (Bankr. D. Me. 1992)).
[229] *Id.* at 516.
[230] *Id.*
[231] 108 B.R. 561 (Bankr. D. Md. 1989).

filing of liquidation cases rather than reorganizations."[232] In somewhat stronger language, the court in *In re City Mattress*[233] rejected the notion that attorneys should act as watchdogs over the viability of the reorganization, noting that "[l]egal services are the very lifeblood of a debtor in reorganization."[234] The court seemed to reject the benefit to the estate standard, substituting instead a good faith requirement stating, "To the extent that a Chapter 11 debtor is incapable of reorganization, the Trustee's Office may move for conversion or dismissal. So long as the debtor is permitted to continue in Chapter 11, however, this court will not penalize counsel for its good-faith representation."[235]

These cautionary notes notwithstanding, the trend seems to be to treat counsel for the debtor in possession as a critical component of the Chapter 11 governance system. The unique nature of debtor practice requires the attorney to monitor continually not only the legal aspects of the case but also the business decisions made by management. This unique status arises not only from the broad fiduciary duties owed by the debtor in possession, and thus by its counsel, but also from purely pragmatic considerations. As the court in *In re Pacific Forest Industries, Inc.*[236] so aptly pointed out, the governance structure that Congress envisioned for the Bankruptcy Code does not work in a world of ever increasing filings.[237] The courts and the United States Trustee's office are hopelessly overburdened[238] and thus the process must turn to counsel for the debtor in possession as the one person who is familiar with both the debtor and the practical constraints on the reorganization process.[239]

D. SUMMARY: MAKING THE BEST OF A BAD SITUATION

Bankruptcy courts have shown a remarkable resourcefulness in respond-

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[232]*Id.* at 564. *See also In re* James Contracting Group, Inc., 120 B.R. 868, 873 (Bankr. N.D. Ohio 1990) (stating that "counsel should not be penalized merely for the lack of a successful reorganization").

[233]174 B.R. 23 (Bankr. W.D.N.Y. 1994).

[234]*Id.* at 26.

[235]*Id.* The *City Mattress* case did not, however, involve a challenge to the fees of the counsel for the debtor in possession based on lack of benefit. Instead, the case considered the United States Trustee's challenge to an application for interim compensation.

[236]95 B.R. 740 (Bankr. C.D. Cal. 1989).

[237]*Id.* at 743-44.

[238]*Cf.* NBRC REPORT, *supra* note 6, at 26 (recommending an expansion of the role of the United States Trustee in small business reorganizations).

[239]In *Pacific Forest Industries,* the court examined what counsel for the debtor in possession referred to as an application to sequester his attorneys' fees. The plan called for the monthly payment of attorneys' fees which counsel would place in his client trust account pending court approval of his fee application. 95 B.R. at 741. The attorney argued that attorneys for a debtor in possession should not be forced to finance the case and risk losing their fees if the reorganization failed. *Id.* The court noted that the risk of nonpayment provided the attorney an incentive to monitor the debtor in possession and to assure that estate assets were not wasted in a futile attempt at reorganization. It then denied the application. *Id.* at 743.

ing to the problem of governing managerial behavior within a legislative framework that is theoretically sound but practically unworkable.[240] Through active case management, courts have placed outside limits on the ability of managers and shareholders to delay the ultimate demise of hopeless debtors. Courts have successfully used examiners to overcome managers' informational advantages and to assist in plan negotiations. Finally, through their control over fee awards, courts have conscripted attorneys for debtors in possession into a governance role. Each of these methods are subject to difficulties that limit their effectiveness, however. The nature of the judicial role may be inconsistent with some forms of case management. This problem, combined with concerns over costs, limit the widespread creative use of examiners. The need to attract high-quality attorneys to debtors' practice, coupled with the inherent conflicts such a practice entails, causes courts to be reluctant to rely too heavily on counsel for the debtor in possession. On balance, however, these approaches seem to be reasonably calculated to respond to the intractable problems native to the reorganization process.

IV. THE NATIONAL BANKRUPTCY REVIEW COMMISSION REPORT: PRAGMATISM MEETS POLICY

Established by the Bankruptcy Reform Act of 1994,[241] the National Bankruptcy Review Commission has recently completed an exhaustive study of all aspects of the bankruptcy process.[242] The Commission's 1,000-plus page Final Report includes more than 170 recommendations covering the entire range of bankruptcy problems from individual bankruptcies to large corporate reorganizations. Although, the Commission chose not to draft an all-encompassing bankruptcy reform bill, perhaps reducing the likelihood of prompt legislative consideration, it is likely that the Report will dominate discussions of bankruptcy policy for years to come.

While the Commission's Report recommended a number of changes to Chapter 11, by far the most significant proposals for changes in the reorganization governance structure attempt to address the unique problems of small business reorganizations. As noted above,[243] small business cases not only dominate Chapter 11,[244] but also present unique problems that have led some commentators to question the wisdom of including large and small cases

[240] Clark, *supra* note 107, at 200.

[241] Pub. L. No. 103-394, §§ 601-610, 108 Stat. 4106, 4147-50.

[242] The Commission's Report was presented to Congress, the President, and the Chief Justice on October 20, 1997.

[243] *See supra* notes 61-70 and accompanying text.

[244] The Commission estimated that approximately eighty-five percent of Chapter 11 filings would fall within the $5,000,000 debt limit that the recommendations use to define "small business." *See supra* note 65.

under the same statutory framework.[245] The Commission noted two fundamental problems relating to small business Chapter 11's. First, some Chapter 11 requirements are so costly and cumbersome that relief under the chapter is out of reach for certain businesses wishing to reorganize.[246] Thus, the Commission's recommendations included proposals to streamline several Chapter 11 procedures for these cases. Second, the Commission noted that the majority of small businesses seeking relief have no reasonable likelihood of rehabilitation.[247] With respect to this latter category of cases, the Commission attempted to craft rules to identify more quickly hopeless debtors and to move them out of the reorganization process.

Solutions to these two problems create a tension, however. Provisions that are designed to eliminate those cases languishing in Chapter 11 without hope of reorganization will necessarily increase the cost of the process.[248] Conversely, cost-cutting and simplification measures carry the risk of reducing the effectiveness of the governance structure. The Commission's Report appears sensitive to this tension—generally erring on the side of improved governance.[249]

A. The Small Business Proposals

The small business proposals attack the problem of governing these cases from two directions. First, the proposals provide standards regarding the debtor in possession's conduct of both the case and the underlying business. These proposals provide shortened deadlines for both plan filing and confirmation and provide that the failure of the debtor to comply with either the deadlines or a number of other requirements constitute cause for dismissal, conversion, or the appointment of a trustee. Second, the proposals enhance

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[245]*See* Paskay & Wolstenholme, *supra* note 67, at 345-56. *Compare* Clark, *supra* note 107, at 200 (examining the question, but concluding that well-trained bankruptcy judges can tailor the single chapter to fit a variety of debtors), *with* David Arthur Skeel, Jr., *Markets, Courts and the Brave New World of Bankruptcy Theory*, 1993 Wis. L. Rev. 465, 510-517 (1993) (suggesting that Congress should enact separate reorganization chapters for public and closely held corporations).

[246]NBRC Report, *supra* note 6, at 614.

[247]*Id.* at 609.

[248]*See id.* at 640 (noting the additional cost and burden of proposed reporting requirements).

[249]The principal cost cutting measures will likely have little effect on the governance structure. Piggybacking off of the existing provisions on small business bankruptcies, the proposals eliminate the mandatory appointment of creditors' committees for a larger number of cases. *See* 11 U.S.C. § 1102(a)(1) (1994). This provision is likely to have a negligible effect on bankruptcy governance, since creditors' committees are currently appointed in only around fifteen percent of all Chapter 11 cases. The other cost cutting measure is the proposal to simplify the disclosure requirements by allowing the use of form disclosure statements and allowing courts the discretion to combine the hearing on approval of the disclosure statement with the confirmation hearing. The Commission noted that small cases cannot support the fees required to draft the elaborate disclosure statements required under current law. NBRC Report, *supra* note 6, at 637. It is therefore likely that simplifying the disclosure statement requirements will result in better disclosure than is currently available.

oversight of the debtor in possession and the conduct of the case. The proposals expand the reporting requirements, require the court to conduct status conferences and increase the role of the United States Trustee's office in overseeing the case. The following discussion examines these approaches in more detail.

1. *Standards of Conduct*

The heart of the standards of conduct governing small business reorganizations is the Commission's proposal to amend § 1112(b).[250] The proposal provides particularized benchmarks for the conduct of the business and the Chapter 11 case and shifts the burden to the debtor to show its entitlement to continue in Chapter 11 if the benchmarks are not met. Among these benchmarks are a failure to maintain insurance or to pay taxes or bankruptcy fees or charges, continued loss to or diminution of the estate, and failure to file reports in the case or to attend § 341 meetings or Rule 2004 examinations or to comply with the United States Trustee's reasonable requests for meetings or information.[251] Failure of the debtor in possession to meet these benchmarks constitutes cause for dismissal, conversion or the appointment of a trustee. The proposed revisions to § 1112 represent the Commission's attempt both to add teeth to the Code's procedural requirements and to identify objective factors that have a high correlation with a likelihood of a failed reorganization.[252]

Where cause is established, the burden shifts to the debtor to show an entitlement to continue in Chapter 11. Not only must the debtor show that it is more likely than not that a plan will be confirmed within the time set by the court, but, if the cause was an act or omission of the debtor, the debtor must show a reasonable justification for the act or omission and must cure the problem within thirty days or less if the court so orders.[253] The Commission's Report explains that the intent of this proposal is to adopt a burden of proof "halfway between existing Chapter 11 practice and the burden of proof imposed on nondebtor litigants seeking injunctive relief against creditor action."[254] The proposals continue to place the burden on the party seeking dismissal or conversion until the debtor fails to meet one of the benchmarks. At that point, the burden shifts to the debtor to show a likelihood of success.

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[250]It is unclear from the text of the recommendations for revision of § 1112 whether the proposal is intended to apply only to small business reorganizations. The proposal itself recommends a replacement for 1112(b) which appears to apply to all Chapter 11 cases. NBRC REPORT, *supra* note 6, at 30-31. The Report's discussion of the proposal makes several references to small business cases, however. *Id.* at 652-56.

[251]*Id.* at 31.

[252]*Id.* at 653.

[253]*Id.* at 30.

[254]*Id.* at 652-63.

In addition to the proposed changes to § 1112, the Commission has recommended shortened deadlines for filing and confirming a plan of reorganization. Under the proposal, all plans[255] and disclosure statements must be filed within ninety days and a plan must be confirmed within 150 days. The proposal would permit extensions only if the extension hearing is conducted and ruled upon within the deadline and only if the debtor proves "by a preponderance of the evidence that it is more likely than not to confirm a plan of reorganization within a reasonable time."[256] The proposal includes a requirement that the United States Trustee actively participate in the extension hearing and requires the court to set a new deadline at the time the extension is granted.[257] While the Commission Report justifies this requirement as a cost saving measure that is beneficial to the debtor,[258] it is perhaps more appropriately viewed as providing assurance to the creditors that there will be an outside limit on management's ability to maintain control over the business in Chapter 11.

2. *Oversight*

Of course, these standards would be ineffective to counteract the control of managers in cases in which no one raises the debtor's failure to meet the standards. Thus, as a complement to the standards, the Commission's recommendations combine enhanced powers of the United States Trustee, and a requirement that the court hold at least one "on the record" scheduling conference,[259] with increased debtor reporting requirements to provide a structure of oversight of the debtor in possession. These provisions represent the Commission's effort to counteract the governance problems associated with creditor apathy in small Chapter 11 cases.

The centerpiece of the Commission's oversight proposal is enhancement of the role of the United States Trustee. The proposals require the United States Trustee to conduct an initial debtor interview (IDI) soon after the initiation of the case. The purpose of the IDI is twofold. First the IDI is intended to provide debtor education. The proposal requires the United States Trustee to inform the debtor of its reporting and other obligations under the Code. Second, the IDI allows the United States Trustee to begin learning about the debtor's business and likely prospects for reorganization.

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[255]The recommendation retains the exclusivity period for the entire ninety days but allows the court to lift exclusivity. *Id.* at 28.

[256]*Id.* at 29.

[257]*Id.*

[258]*Id.* at 644.

[259]*Id.* at 29. The court may dispense with the scheduling conference if the debtor and the United States Trustee present an agreed scheduling order to the court for approval on notice and a hearing. *Id.* The proposals contemplate that, in most cases, such an order will be agreed to at the initial debtor interview. *See infra* note 260 and accompanying text.

In addition to the IDI, the United States Trustee is given the authority to visit the debtor's business premises to examine the debtor's books and records. Finally, and perhaps most significantly, the proposals require the United States Trustee to review and monitor cases with a view toward identifying those cases in which the debtor's prospects appear hopeless and to move for relief under § 1112 where material grounds exist.[260]

The Commission's proposed enhancements to the Chapter 11 reporting requirements are conceptual rather than specific. The proposal calls upon the Advisory Committee on Bankruptcy Rules to develop nationwide standards for small business reporting that achieve a balance between reasonably complete information and affordability and simplicity. Elaborating on what constitutes reasonably complete information, the proposal states that the reporting requirements should, at a minimum, include information regarding profitability, including projections of receipts and disbursements and a comparison of actual versus projected results, and information regarding the debtor's compliance with the Code's requirements and tax obligations.[261]

B. Evaluation of the Commission's Proposals

The Commission's proposals obviously draw heavily from the positive experiences of bankruptcy judges who have used active case management techniques in an effort to reduce the delay and consequent waste of assets in small business cases. The oversight function of the United States Trustee responds directly to the creditor indifference problem that many commentators have identified in these cases. In addition, the shortened deadlines for plan filing and confirmation coupled with the changes in the substantive standards for dismissal or conversion provide creditors with some assurance that some outside limits are placed on both the length and the breadth of managerial discretion. Overall then, the recommendations represent a positive step toward improved governance in Chapter 11.

This conclusion is subject to a few caveats, however. The Commission's general proposals regarding Chapter 11 may limit somewhat the effectiveness of the small business proposals. By a 5-4 vote, the Commission proposed the codification of the new value exception (corollary?)[262] to the absolute prior-

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[260]NBRC Report, *supra* note 6, at 32.

[261]*Id.* at 26-27.

[262]Whether the new value rule is an exception or corollary to the absolute priority rule turns on the appropriate interpretation of § 1129(b)(2)(B) of the Bankruptcy Code, which provides that, in a cramdown plan, junior classes may not "receive or retain under the plan *on account of such junior claim or interest* any property" unless senior classes are paid in full. *See* 11 U.S.C. § 1129(b)(2)(B)(ii) (1994) (emphasis added). The correct characterization may also turn on which side of the new value debate one finds him or herself. *Compare* NBRC Report, *supra* note 6, at 104 (discussing the Commission's recommendation to codify the new value "corollary"), *with* Hon. Edith H. Jones, *Dissent from Certain Commission Recommendations on General Issues in Chapter 11*, at 19, *published in* NBRC Report, *supra* note 6, at

ity rule[263] in all cases, large and small.[264] The effect of this proposal on the governance concerns discussed in this Article is somewhat indirect, but may be substantial.[265] Both the substantive and oversight aspects of the small business proposals have as their goal the identification of cases in which a confirmed plan is unlikely. The effort, of course, is to eliminate the ability of managers and shareholders to use the delays inherent in Chapter 11 to remain in control of the debtor, and perhaps to extract concessions from the creditors.[266] Small business debtors may remain in Chapter 11 beyond the deadlines only upon a showing that it is more likely than not that they will confirm a plan within a reasonable time. To the extent that the new value rule makes it easier to propose a confirmable plan, the deadlines may lose some of their effectiveness.[267]

In addition, it may be that the proposals do not go far enough in resolving the governance problems in small business cases. In its deliberations over how oversight should be conducted, the Commission considered and rejected proposals to require the appointment of an independent business expert to examine the viability of the business and to oversee the debtor's management.[268] Critics of this approach cited the duplication of functions already served by the courts, United States Trustees, and panel trustees: the likelihood that such agents would be perceived as "stereotypical government bureaucrats," and, the cost of such professionals.[269] In the end the Commission

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ch.5 (discussing the Commission's proposal to codify a new value "exception"). The dissenting views of the individual Commissioners are available via the Internet at <http://www.nbrc.gov/report/24commvi.pdf>.

[263]NBRC Report, *supra* note 6, at 24.

[264]In fact, the Report makes specific reference to the needs of "mom and pop" businesses in its new value discussion. *See id.* at 564.

[265]The proposal does, however, include a provision terminating the debtor's exclusive right to propose a plan on motion by a party in interest when the debtor moves to confirm a nonconsensual new value plan. *Id.* at 24. This aspect of the proposal ameliorates somewhat the imbalance created by granting the debtor an exclusive option to propose such a plan. *Id.* at 562. The lifting of exclusivity may not be sufficient, however, to counteract the negotiating leverage created by the ability to delay the case by proposing a new value plan and the informational advantage held by the debtor's management. *See* Jones, *supra* note 262, at 24-27 (pointing out the inadequate protection provided by competing plans).

[266]The NBRC Report recognizes the concern that the ability of equity to propose a new value plan may create additional opportunities for equity to exercise "hold-out leverage," but concludes that "in the context of the widely held publically traded debtor, this proposal is unlikely to change negotiating positions based on hold-out powers." NBRC Report, supra note 6, at 565. The Report does not respond to this concern in the context of smaller cases.

[267]*See* Jones, *supra* note 262, at 28 (arguing that the proposal undercuts the small business proposals). Judge Jones also argues that the proposal does not include the requirements for new value contributions set out in *Case v. Los Angeles Lumber*, 308 U.S. 106 (1939), and may overrule the Supreme Court's holding in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988). *Id.* at 23. These deficiencies would make it even easier to confirm a new value plan.

[268]NBRC Report, *supra* note 6, at 658. The Report refers to the success of such an approach in the United Kingdom. *Id.*

[269]*Id.* at 658-59.

decided to allocate this function to the United States Trustees.

The Report's discussion of this decision provides an unsatisfactory explanation. Duplication is a function of the allocation of authority. Presumably, the presence of an independent monitoring agent would alleviate the governance burden placed on others in the process.[270] Furthermore, it is unclear what problems are created by a perception that the monitor is a bureaucrat. Even if such a perception would create difficulties, it is unlikely that the perception of a monitoring agent as a "stereotypical government bureaucrat" is reduced by the allocation of oversight authority to a governmental entity.

The Commission's reference to the cost of an additional professional in the case raises what is perhaps the most disturbing aspect of the small business proposals. While the Report uses cost as a means of justifying its decision not to use an independent monitoring agency, the Report is nearly devoid of any discussion of the likely cost of the expanded duties allocated to the United States Trustee. The only reference to the cost of expanding the duties of the United States Trustee is a brief passage expressing concern over whether Congress will appropriate the necessary funds for the United States Trustee to fulfill its new role.[271]

Of course, inadequate funding would cripple the oversight provisions. The problem with the Commission's approach to the cost issue is more fundamental, however. Increasing oversight comes only at a cost—no matter whether the role is assigned to a governmental or to a private entity. It may be that the United States Trustee can perform this role more efficiently than can a private monitoring agent, but the Report provides no evidence that this is true. Aside from the relative efficiency of government versus private monitors, there is the question of who should bear the cost of oversight. By assigning the oversight role to the United States Trustee, the proposal places this burden on the government, creating an additional subsidy for the reorganization process. Such a subsidy may be defensible in light of the public benefits of the reorganization process. At a minimum, however, the question raises substantial policy issues that the Report's treatment of the cost issue obscures.

C. The Commission Proposals and the Continued Debate over the Goals of Chapter 11

Like most of the Commission's recommendations, the small business proposals are not entirely free of controversy. Two of the Commissioners dissented from the small business proposals noting that "the Commission's

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[270]In addition, the Report's reference to a duplication of the panel trustee's function is somewhat mystifying.

[271]NBRC Report, supra note 6, at 657.

Recommendation sets up a requirement-laden, inflexible program aimed primarily at removing cases from the system that cannot confirm plans in the limited time permitted."[272] The dissent cites the benefits of Chapter 11 to employees, customers and suppliers, and taxing authorities, and argues that the proposals would make those benefits more difficult to achieve.[273] In its conclusion, the dissent states, quite clearly, the deep-seated policy issues that the proposals raise:

> The Recommendation thus reveals an unmistakable sense that it is not the failing business lingering aimlessly in Chapter 11 that is the target so much as it is Chapter 11 itself. If that is the message of the Recommendation, then a more fundamental debate about Chapter 11 must be resolved—or at least the clear policy choices identified—before large scale case management proposals can be realistically considered.[274]

These Commissioners' comments illustrate a point made earlier. There exists no clear consensus regarding the appropriate goals of Chapter 11.[275] This lack of consensus surfaces elsewhere in the Report and in the dissents. In her dissent from the Chapter 11 proposals, Commission Member Judge Jones complained that the majority's proposals included a number of unstated assumptions that include the debtor's need for added negotiating leverage and control and that there are too few cases with confirmed plans.[276] She further expressed concern that there was a lack of attention paid to "concrete proposals to get the creditors paid more quickly and certainly."[277] Sharply divided votes on proposals such as the new value recommendation may simply reflect differences of opinion regarding the appropriate means to an agreed end. It is more likely, however, that the differing views reflect a more fundamental disagreement on the appropriate ends.

A common refrain in discussions of Chapter 11 is that it is intended to rehabilitate businesses "for the benefit of both debtors and creditors [and] to preserve jobs and other ties within communities."[278] Successful reorganizations can do both. But this well-worn maxim obscures an important fact—the separate goals of benefitting creditors and saving jobs and ties within communities conflict anytime the business has a liquidation value that ex-

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[272]Babette Ceccotti & Hon. Robert Ginsberg, *Dissent From Recommendation Regarding Small Business Chapter 11 Cases*, at 7, *published in* NBRC REPORT, *supra* note 6, at ch.5.

[273]*See id.* at 2-3.

[274]*Id.* at 3.

[275]*See supra* notes 71-82 and accompanying text.

[276]Jones, *supra* note 262, at 1222.

[277]*Id.* at 1223.

[278]NBRC REPORT, *supra* note 6, at 566-67.

ceeds its value as a going concern.[279] These are the cases that present the most fundamental policy questions regarding the goals of Chapter 11. The Commission's Report shows that the resolution of such questions will continue to undergird the debate over bankruptcy reform.

CONCLUSION

In theory, the problem of controlling managerial behavior in Chapter 11 presents no real challenge. Chapter 11 provides a structure of investor representation and judicial oversight that facially addresses the governance problems inherent in running an insolvent corporation. By looking to the principles of financial economics that support and illuminate the nonbankruptcy governance structure, analysts have developed a number of suggestions regarding ways to apply nonbankruptcy governance principles in Chapter 11 to assure that managerial decisions maximize the value of the business assets.

The theoretical solutions to governance problems in Chapter 11 do not provide answers in the real world, however. Small bankruptcies present unique governance problems that arise from the fact that creditors do not individually have enough at stake to justify monitoring the debtor's management and challenging actions that do not maximize the value of the debtor's assets. The most fundamental of such actions relate to efforts to continue an attempt at reorganization that appears, to an objective observer, to be hopeless. A delay in liquidation may place creditor recoveries at risk in an effort that may only benefit shareholders and managers. Bankruptcy courts have developed three somewhat related approaches to combat managerial autonomy in these cases. Through active case management, the flexible use of examiners, and control over the fees of counsel for the debtor in possession, some courts have attempted to counteract managerial autonomy. The National Bankruptcy Review Commission has incorporated some of these approaches in its proposals for reform of the provisions governing small business bankruptcies.

But lurking under the surface of the both the cases and the Commission's Report is a more fundamental problem—a lack of consensus regarding the goals of Chapter 11. Everyone can agree on what we want bankruptcy to do—it should rehabilitate companies in order to maximize creditor returns, preserve jobs, and assure continuing support for communities surrounding the business. Sometimes Chapter 11 can do this, but most of the time it cannot. The question is not whether we should save the businesses that can be saved and quickly liquidate the rest, however. It is instead a question of in which direction the process should err. Since our approach to governance will nec-

[279]*See supra* note 75 and accompanying text.

essarily have an effect on the direction of error, it is unlikely that a fully functioning governance structure will emerge until this fundamental question is answered.