

Debtor In Possession vs. Trustee

- Default Rule: a chapter 11 debtor is a “debtor in possession,” 11 U.S.C. § 1101(1).
In this chapter -- (1) “debtor in possession” means debtor except when a person that has qualified under section 322 of this title is serving as trustee in the case[.]” 11 U.S.C. § 1101(1).
- However, if the court finds that “cause” exists for the appointment of a trustee, or that such an appointment is in the interests of creditors, equity security holders, and other interests of the estate, the court is directed to order the appointment of a trustee. 11 U.S.C. § 1104(a)(1), (2).
- But why? – Why differ from the automatic appointment of a Trustee as seen in other chapters (i.e. 7, 12 & 13)
- The structure represents a compromise between those who wanted the automatic appointment of a trustee in all corporate chapter 11 cases and those who believes that a debtor-corporation should remain in possession during reorganization.

What is Cause?

- Section 1104(a)(1) provides for the appointment of a trustee in a Chapter 11 case for **cause**, “including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause.”
- In analyzing “cause”, courts have found cause based on the following factors:
 - Materiality of the misconduct;
 - Evenhandedness or lack of same in dealings with insiders vs. other creditors or customers;
 - The existence of pre-petition voidable preferences or fraudulent transfers to insiders
 - Management’s unwillingness or inability to pursue estate causes of action
 - Conflicts of interest that limit management’s ability to fulfill fiduciary duties to the debtor;
 - Self-dealing
 - Waste or squandering of corporate assets

§ 1107. Rights, powers, and duties of debtor in possession

(a) Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter.

Example: This includes the power to retain counsel, subject to the court's approval. See, e.g., In re Gaslight Club, Inc., 782 F.2d 767 (1986).

Hypotheticals

1. In December 2015, Lending Hand Bank loaned Spark Industries (a weapons manufacturer) \$50 million, secured by Spark's IP and manufacturing equipment. While on a sales trip in early summer 2022, Spark's CEO and brainchild, Tonya Spark, was abducted and held by insurgents. During her absence, Spark Industries struggled. After miraculously freeing herself, Tonya announced that Spark Industries will no longer manufacture weapons, but instead will make baby bottles. Shortly thereafter Spark Industries filed for bankruptcy since it was no longer receiving payments on its lucrative weapons contracts. By all accounts Tonya Spark is a genius and is not motivated by malice in her actions. As a creditor, does Lending Hand have grounds to seek the appointment of a Chapter 11 Trustee?

2. Same parties as No. 1, except assume that Tonya did not cease production of weapons. However, her absence still thrust Spark Industries into bankruptcy. It is well-recognized that Tonya's involvement in Spark Industries is essential to its successful functioning. However, Lending Hand has heard rumors of fraudulent conduct carried out by Spark Industries at the direction of another top executive, Jedidiah Pain. Lending Hand does not want to push Tonya out by having a Chapter 11 Trustee appointed but is concerned about some aspects of the company's operations. What other option does Lending Hand have in the bankruptcy context?

3. Prior to its bankruptcy filing, you represented Spark Industries as counsel. Six months prior to bankruptcy filing, Spark Industries executive Jedidiah Pain sought your advice on certain proposed transactions to Spark's affiliate, Ben-Ron, via email. You advised Jedidiah that you believed that the transactions were unsupported by appropriate consideration and could open Spark up to liability for fraudulent transfers. Unbeknownst to you, Jedidiah authorized Spark to go ahead with these transfers. Post-filing, Jedidiah wants to know whether these emails will come back to haunt either Spark or him. Will these communications be protected by the attorney-client privilege?

4. Assume that Lending Hand Bank was successful in having an examiner appointed under 11 U.S.C. § 1104. Dustin Jammer, CEO of competitor Jammer Co., sees an opportunity to get a “looksy” at Spark’s proprietary tech---which is involved in the matter the examiner is looking into. Jammer Co. purchases the claim of one of Spark’s raw materials suppliers valued at \$100,000. Jammer then files a motion to permit review of the examiner’s source materials for his report. Neither Lending Hand (because its claim is secured in part by IP) nor Spark want Jammer to have access to the materials.
- a. (i) Should the motion be granted?
 - b. (ii) What steps could Spark and/or Lending Hand take to protect the information?

5. Tonya Spark is the enigmatic, genius inventor and CEO of Spark Industries and Lending Hand Bank currently holds a \$50 million loan secured by stock in Spark. On January 1, 2022, Tonya announces that she is stepping down as Spark's CEO and her longtime assistant, Peter Pitts, is named as successor. Admittedly, Peter isn't the "genius" that Tonya is regarded as, and stock prices tumble in reaction to the announcement. Despite Peter's best efforts, Spark ultimately ends up filing for bankruptcy on December 1, 2022. Upset with the effect Peter's management role has on stock prices, Lending Hand files a motion to have a chapter 11 trustee appointed, although Lending Hand acknowledges that it cannot point to a specific act by Peter which would constitute "gross mismanagement." What are the arguments for and against the granting of the motion.

6. Assuming the court in No. 5 declines to appoint a trustee, would Lending Hand have better luck in getting an examiner appointed? Currently, Spark has filed against it \$100 million in secured claims, \$56 million in unsecured claims for goods & services, \$6 million in unpaid tax claims, and \$10 million in claims for unsecured loans. No plan of reorganization has been proposed.



7. After Spark's bankruptcy filing, Jedidiah Pain (a maligned executive of Spark) also filed a chapter 11 bankruptcy case for his separate entity, Pain Enterprises. Lending Hand had loaned \$20 million to Pain to support the development of his "Mechanical Man Supersuits." Due to allegations of fraudulent conduct by Pain, a chapter 11 trustee was appointed and it was discovered that Pain Enterprises has transferred its supersuit patents to Jammer Co. in the lead-up to filing. Lending Hand and fellow creditors argue that the consideration received for the patent was well below market value. The trustee, who is suspicious of the transfers, nonetheless declines to institute a fraudulent transfer action due to lack of funds to support litigation. What option does Lending Hand and Pain Enterprises' other creditors have to seek avoidance of the transfers?

8. Assume the prepetition transfers of the supersuit patents discussed in No. 7 occurred, but no trustee has been appointed. Pain Enterprises is owned 60% by Jedidiah Pain and 40% by Gold Dust Twins Investments. As such, two of Gold Dust's representatives, sisters Helen & Ellen Husk, sit on Pain Enterprises' board of directors. The Husks also own StarFlight Projects. As part of Pain's Board of Directors, the Husks learn that the Debtor will be seeking to avoid the prepetition transfers of the supersuit patents and return them to the bankruptcy estate. StarFlight itself is very interested in purchasing the patents, but the Husks also learn from their position that both the Debtor and the creditors committee, would prefer a reorganization plan without a sale. Before the avoidance actions are filed, the Husks direct StarFlight to purchase any creditor claims it can, which it does at 33 cents on the dollar. With these claims, StarFlight seeks to use its position to force a plan which would either include a sale of the patents or an all-out liquidation. Are there any issues with StarFlight's plan?

9. One year prior to Pain Enterprises' bankruptcy, Lending Hand Bank foreclosed on certain equipment used in Pain's research & development department. Despite the foreclosure, Pain and Lending Hand negotiated a rental agreement by which it would retain physical possession of Lending Hand's equipment and pay a monthly rental fee. The current rental agreement expired two days before Pain's bankruptcy filing. Post-bankruptcy filing, a chapter 11 trustee is appointed and takes possession of Pain Enterprises' assets. In the meantime, Lending Hand finds a buyer for the equipment and sends representatives to remove the equipment from Pain's facility. The chapter 11 trustee refuses admittance and informs Lending Hand's representatives that before turning over any equipment, the trustee needs to review Pain's records and seek a determination of ownership (apparently, there are conflicting documents in Pain's records as to which of the equipment was actually owned by Lending Hand.) Not wanting any part of an ownership dispute, Lending Hand's buyer backs out of the deal. Lending Hand wants to sue the trustee. Is the trustee protected by qualified immunity?

10. Same facts as 9. Lending Hand and the chapter 11 trustee litigate ownership of the equipment before the bankruptcy court and the bankruptcy court determines that ownership lies with Lending Hand. This ruling is confirmed on appeal to the district court, but no appeal of the district court order is timely taken. Nonetheless, the chapter 11 trustee argues that the equipment is absolutely necessary to the reorganization of the debtor and refuses Lending Hand access to the building to take possession, nor will it turn over the equipment itself. Litigation ensues for three months in the bankruptcy court before Lending Hand is finally able to take possession. During the three months, Pain, at the chapter 11 trustee's direction, continued to use the equipment and in doing so, some of the most valuable pieces were damaged. Lending Hand wants to sue the chapter 11 trustee for damages. Assuming Lending Hand would receive permission from the court to do so, will the chapter 11 trustee be protected by qualified immunity.

Faculty: abiLIVE: Litigating a Motion to Appoint a Chapter 11 Trustee Pursuant to 11 U.S.C. 1104(A)

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Hon. Jeffery A. Deller is a U.S. Bankruptcy Judge for the Western District of Pennsylvania in Pittsburgh, appointed in 2005. Prior to his appointment, he was a shareholder in the bankruptcy and insolvency practice group at Klett Rooney Lieber & Schorling, P.C. While in private practice, some of his representations included representing the University of Pittsburgh Medical Center Health System (UPMC) in connection with its \$100 million acquisition of the assets of St. Francis Hospital, serving as counsel to the unsecured creditors' committees of various chapter 11 cases (including the cases filed by National Record Mart and Arcadia Energy Corp.), and serving as advisor to most of the Pittsburgh region's banks and financial institutions with respect to bankruptcy and loan workout matters. Judge Deller is a prior recipient of the Allegheny County Bar Association's Young Lawyer of the Year Award. He authored Looking Before You Leap Into an Involuntary Bankruptcy Case, 171 N.J. L. J. 446 (2003), and Examining the Examiner: Waiver Of the Attorney-Client Privilege and the Outer Limits of an Examiner's Powers in Bankruptcy, 43 Duq. L. Rev. 187 (2005), and co-authored "Putting Order to the Madness: BAPCPA and the Contours of the New Pre bankruptcy Credit Counseling Requirements," 16 J. Bankr. L. & Prac. 1 Art. 5 (2007). He is also a contributing author to West's Pennsylvania Forms: Debtor-Creditor, a forms guide and treatise for practitioners. Judge Deller received his B.A. in economics and political science from the University of Pittsburgh and his J.D. cum laude from Duquesne

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