American Bankruptcy Institute

Central States Bankruptcy Workshop

Great Debates

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PLENARY SESSION

2024

Outline for the Great Debates: The Role of the Examiner

Brief Background.

- Bankruptcy Courts appoint examiners in only a small number of cases. A study in the American Bankruptcy Law Journal looked at docket-level data from 1,225 large and small chapter 11 cases from 1991 to 2010 and found that examiners were sought 8.5% of the cases, and appointed in less than 4%.[1]
- The debate will summarize recent instances where parties in interest (notably a creditor or the US Trustee) have filed motions for the appointment of a chapter 11 examiner and the outcome of those motions and recent caselaw.[2]

Do examiners add value to complex chapter 11 cases?

- Reasons in favor of having an examiner
  - Examiners are independent and often have expertise relevant to the issues being examined
  - Findings are released publicly
  - Examiners can be granted investigative powers to subpoena evidence
  - Examiners are subject to court oversight
- Reasons against having an examiner
  - Costs are borne by the estate—both in terms of professional fees and time spent
  - Duplication of efforts
  - Delay of key case milestones
  - Reports cannot be used as evidence
  - Potential conflicts of interest

How can courts and professionals work to mitigate some of the issues associated with having an examiner appointed in a case?

- Scope of examination
- Budget
- Timing and deadlines for the examiner's reports
- Greater levels of engagement and negotiation with key stakeholders to head off some of these requests (if possible)

Now that the Third Circuit has ruled that Examiners are mandatory if the statutory requirements of section 1104(c)(2) are met, what will we see in practice? Will this be a positive development?

- Predictions on whether more motions for an examiner will be filed.

  Predictions on whether courts will be able to effectively rein in the expense and avoid duplication of efforts.

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1 *See* Jonathan C. Lipson & Christopher Fiore Marotta, Examining Success, 90 Am. Bankr. L.J. 1 (2016).

2 *See, e.g.*, *In re FTX Trading Ltd.*, 91 F.4th 148 (3d Cir. 2024).

PRECEDENTIAL

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 23-2297

In re: FTX TRADING LTD., et al.,
Debtors

ANDREW R. VARA, US Trustee for Region 3,
Appellant

On Appeal from the United States Bankruptcy Court
for the District of Delaware
(Case No. 22-11068)
Bankruptcy Judge: Honorable John T. Dorsey

Argued: November 8, 2023

Before: RESTREPO, BIBAS and SCIRICA, *Circuit Judges*.

(Filed: January 19, 2024)

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OPINION OF THE COURT

RESTREPO, *Circuit Judge*.

Sometimes highly complex cases give rise to straightforward issues on appeal. Such is the case here. Multi-billion-dollar company FTX Trading Ltd. ("FTX") filed for bankruptcy after a sudden and unprecedented collapse that sent shockwaves through the cryptocurrency industry. The issue before us is whether 11 U.S.C. § 1104(c)(2) mandates the Bankruptcy Court to grant the U.S. Trustee's motion to appoint an examiner to investigate FTX's management. We hold that it does, given both the statute's plain text and Congress's expressed intent in enacting this portion of the Bankruptcy Code. Accordingly, we will reverse the Bankruptcy Court's denial of the U.S. Trustee's motion, and remand for the appointment of an examiner consistent with this opinion.

I. Factual and Procedural History

Over the course of eight days in November 2022, the cryptocurrency company FTX suffered a catastrophic decline in value. The primary owner of FTX, Samuel Bankman-Fried, also owned most of Alameda Research, a cryptocurrency hedge fund. In early November, industry reports claimed that Alameda Research was financially compromised, and questions regarding a conflict of interest between the two allegedly independent companies began to arise. What followed were discoveries of multiple corporate failures, including FTX's use of software to conceal the funneling of FTX customer funds into Alameda Research to bolster its balance sheet. These discoveries caused FTX, a company that had been valued at $32 billion earlier in 2022, to face a sudden and severe liquidity crisis as customers withdrew billions of dollars over the course of a few days. Since the collapse, criminal investigations into FTX have unearthed evidence of widespread fraud and the embezzlement of customers' funds.[1]

Immediately following the crash, on November 11, 2022, Mr. Bankman-Fried appointed John J. Ray, III to replace him as CEO of FTX and its numerous affiliates ("FTX Group"). Over the next three days, Mr. Ray filed multiple voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code, 11 U.S.C. §§ 101 *et seq*. Mr. Ray, an experienced bankruptcy practitioner who claims to have supervised the restructuring of "several of the largest corporate failures in history," stated in his first report as debtor in possession that he had never before "seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information." JA 52. He deemed the situation at FTX Group "unprecedented," citing, *inter alia*, the compromised integrity of the companies' operating systems, the "faulty regulatory oversight" of FTX's operations abroad, and the "concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals." JA 52.

Mr. Ray further reported that many of the companies in FTX Group lacked "appropriate corporate governance," operating without a functioning board of directors and failing to produce audited financial statements. JA 59. He maintained that FTX Group "did not maintain centralized control of its cash" and kept no accurate list of its bank accounts or the accounts' signatories. JA 60. FTX Group companies were historically unable to produce accurate financial statements or a "reliable cash forecast." JA 60–62. As a result of these "cash management failures," Mr. Ray was unable to determine how much cash the companies had when the bankruptcy petitions were filed. JA 61. He also found that FTX Group had "billions in investments" in non-cryptocurrency assets, but these investments could not be completely accounted for due to the

[1] On November 2, 2023, Samuel Bankman-Fried was convicted of seven wire fraud, conspiracy, and money laundering charges. His sentencing is scheduled for March 2024. Other former FTX executives pled guilty to similar charges.

companies' failure to "keep complete books and records." JA 66.

In addition, Mr. Ray described how FTX Group failed to implement a corporate system to regulate cash disbursements. Employees would simply submit "payment requests through an on-line 'chat' platform where a disparate group of supervisors approved disbursements by responding with personalized emojis."[2] JA 64. Mr. Ray discovered that corporate funds were used to purchase homes and other personal items for employees in the Bahamas, where FTX was headquartered. For some real estate purchases, there was no documentation categorizing the transactions as corporate loans and the properties were recorded in the Bahamas under the names of the FTX employees or advisors.

Regarding the companies' cryptocurrency assets, Mr. Ray declared FTX Group engaged in "[u]nacceptable management practices" including, *inter alia*, "the use of an unsecured group email account" to access "critically sensitive data" and "the use of software to conceal the misuse of customer funds." JA 64–65. Mr. Ray claimed to identify $372 million of unauthorized cryptocurrency transfers initiated on FTX's petition date, and the subsequent unauthorized "minting" of $300 million in FTX's cryptocurrency tokens, FTTs. *Id*. The disordered state of FTX Group at the time it filed for bankruptcy, exacerbated by the failure of FTX founders to identify sources of supposed additional assets, meant that Mr. Ray and his team of professionals "located and secured only a fraction of the digital assets." *Id*.

Within weeks of the filing of the bankruptcy petitions, the United States Trustee moved for the appointment of an examiner pursuant to 11 U.S.C. § 1104(c). In so doing, the U.S. Trustee posited that a public report of the examiner's findings could reveal the "wider implications" that FTX's unprecedented collapse had for the cryptocurrency industry. JA 97. The U.S. Trustee also claimed an examiner could "allow for a faster and more cost-effective resolution" of the

[2] Mr. Ray revealed that there was no comprehensive list of FTX Group employees and only incomplete human resource records of the terms and conditions of employment.

bankruptcy proceedings because Mr. Ray could concentrate on his "primary duty of stabilizing the debtors' businesses" while the examiner investigated FTX's compromised pre-petition management, which was purportedly responsible for misappropriating $10 billion in customers' assets. *Id*.

Of greater significance for the purposes of this appeal, the U.S. Trustee argued that the Code mandates the Bankruptcy Court to grant their motion and order the appointment of an examiner. Section 1104(c) provides that, in instances like this where no trustee has been appointed, then:

> [O]n request of a party in interest or the United States trustee, and after notice and a hearing, the court *shall* order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor, if—
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> (1) such appointment is in the interests of creditors, any equity security holders, and other interests of the estate; or
>
> (2) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000.

11 U.S.C. § 1104(c) (emphasis added). The U.S. Trustee argued that, because they made the request and FTX Group's unsecured debts "substantially exceed" $5 million, appointment of an examiner was mandatory under the plain language of subsection (c)(2).[3] JA 98.

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[3] In addition, the U.S. Trustee advanced the argument that the appointment of an examiner would also be proper under subsection 1104(c)(1), claiming that an investigation would be "in the best interests of the Debtors' estates, their creditors, and

The Committee for Unsecured Creditors ("Creditors' Committee"), the Joint Provisional Liquidators of FTX Digital Markets Ltd., and the Debtors filed their objections to the U.S. Trustee's motion. At a hearing before the Bankruptcy Court, the U.S. Trustee reiterated their position that the appointment of an examiner in this instance is mandatory, and argued this interpretation is supported by legislative history that conveys Congress's intent to guarantee an independent investigation into any large-scale bankruptcy. The opposing parties argued the phrase "as is appropriate" in Section 1104(c) renders the appointment of an examiner subject to the Bankruptcy Court's discretion. JA 299, 307. They claimed such an appointment here would be highly inappropriate, given that an investigation would create an unjustifiable cost for creditors, interfere with their efforts to stabilize FTX Group, duplicate their findings of management wrongdoing, and pose a security risk to cryptocurrency codes.

The Bankruptcy Court agreed with those who opposed the motion and ruled the appointment of an examiner was discretionary under the Code. JA 17–18. The Court acknowledged FTX Group's unsecured debt far exceeded $5 million but found the phrase "as is appropriate" in Section 1104(c) allowed it to deny the U.S. Trustee's motion to appoint an examiner, despite the statutory requirements having been met. The Court supported its conclusion by citing Bankruptcy Court decisions and congressional records from the year before the revised Code was enacted.

II. Jurisdiction and Standard of Review

The U.S. Trustee appealed the Bankruptcy Court's decision to the District Court and moved to certify the order for direct appeal pursuant to 28 U.S.C. § 158(d)(2).[4] The District

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equity security holders" given the grounds to suspect "actual fraud, dishonesty, or criminal conduct in the management of the Debtors." JA 100 ¶ 35.

[4] The U.S. Trustee first moved for certification in Bankruptcy Court, and then renewed the motion when jurisdiction transferred to the District Court pursuant to Fed. R. Bankr. P. 8006(b).

Court granted the certification motion, and this Court authorized the direct appeal. We have jurisdiction over Chapter 11 cases under 28 U.S.C. § 158(d)(2)(A). This Court reviews questions of law decided by the Bankruptcy Court *de novo*. *In re Trump Ent. Resorts*, 810 F.3d 161, 166–67 (3d Cir. 2016).

III. Discussion

The issue before us is one of statutory interpretation: whether the plain text of Section 1104(c)(2) requires a bankruptcy court to appoint an examiner, if requested by the U.S. Trustee or a party in interest, and if "the debtor's total fixed, liquidated, unsecured debt" exceeds $5 million. We hold that it does. The Bankruptcy Court erred in denying the U.S. Trustee's motion to appoint an examiner to investigate FTX Group.

"Our interpretation of the Bankruptcy Code starts 'where all such inquiries must begin: with the language of the statute itself.'" *Ransom v. FIA Card Servs., N.A.*, 562 U.S. 61, 69 (2011) (quoting *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989)). In interpreting a statute, we are required "to give effect to Congress's intent." *In re Trump*, 810 F.3d at 167. We presume that intent is expressed through the ordinary meaning of the statute's language. *Id.* If the meaning of the text is clear, "the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce [the statute] according to its terms." *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) (internal quotation marks omitted). We therefore start by examining the plain text of Section 1104(c).

Congress made plain its intention to mandate the appointment of an examiner by using the word "shall," as in the Bankruptcy Court "shall" appoint an examiner if the terms of the statute have been met. 11 U.S.C. § 1104(c). The meaning of the word "shall" is not ambiguous. It is a "word of command," *Black's Law Dictionary* (5th ed. 1979), that "normally creates an obligation impervious to judicial discretion," *Lexecon Inc. v. Milberg Weiss Bershad Hynes & Lerach*, 523 U.S. 26, 35 (1998). We have held that "shall" in a statute is interpreted as "must," which means "shall" signals when a court must follow a statute's directive regardless of whether it agrees with the result. *Scott v. Vantage Corp.*, 64 F.4th 462, 477 (3d Cir. 2023). To interpret "shall" as anything but an obligatory command to appoint an examiner, when the conditions of subsection 1104(c)(2) have been met, would require us "to abandon plain meanings altogether." *Litgo N.J. Inc. v. Comm'r N.J. Dep't of Env't Prot.*, 725 F.3d 369, 397 n.17 (3d Cir. 2013) (citations omitted). Instead, the language of subsection 1104(c)(2) requires us to command the Bankruptcy Court to grant the U.S. Trustee's request for an examiner in this instance. *See Me. Cmty. Health Options v. United States*, 140 S. Ct. 1308, 1320 (2020) ("The first sign that the statute imposed an obligation is its mandatory language: 'shall.'").

Despite the mandatory language, the Bankruptcy Court found that the phrase "as is appropriate" controls the appointment of an examiner under Section 1104(c). Following this interpretation, the text "the court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate" means the Bankruptcy Court appoints an examiner only if it decides an investigation would suit the circumstances. 11 U.S.C. § 1104(c). According to this reading, context gives "shall" the meaning of "may." We disagree. Under the last-antecedent rule of statutory construction, "qualifying words, phrases, and clauses are to be applied to the words or phrase immediately preceding and not to others more remote." *Stepnowski v. Comm'r*, 456 F.3d 320, 324 (3d Cir. 2006) (quoting *United States v. Hodge*, 321 F.3d 429, 436 (3d Cir. 2003)). Applying the rule, the phrase "as is appropriate" modifies the words that immediately precede it—which are "to conduct such an examination of the debtor," not "shall order the appointment of an examiner." 11 U.S.C. § 1104(c).

Although instructive, the last-antecedent rule is not absolute and we therefore look to other indicia to discern the phrase's meaning. *Viera v. Life. Ins. Co. of N. Am.*, 642 F.3d 407, 419 (3d Cir. 2011) (citing *J.C. Penney Life Ins. Co. v. Pilosi*, 393 F.3d 356, 365 (3d Cir. 2004)). We need not look far. As the U.S. Trustee argued below, Section 1104(c) states "as is appropriate," not "*if* appropriate." JA 288 (emphasis added). While "if appropriate" indicates the Bankruptcy Court has a choice, the phrase "as is appropriate" indicates it is permitted to determine what is pertinent given the specific circumstances of each case. This interpretation—that "as is appropriate" refers to the nature of the investigation, not the appointment of the examiner—is further bolstered by the context. Immediately after the phrase "as is appropriate," the statute provides the word "including" and a list of topics that merit investigation: "allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor." 11 U.S.C. § 1104(c).

Under the Bankruptcy Court's interpretation, the appointment of an examiner under either subsection of Section 1104(c) would be subject to a court's discretion and a judge would have the final say as to whether an investigation was warranted. But this interpretation runs counter to the statute's plain language and established canons of construction. Whereas subsection 1104(c)(1) permits a court to consider "the interests of creditors, any equity security holders, and other interests of the estate," subsection (c)(2) allows for no such consideration. We agree with the Sixth Circuit's conclusion that "[t]he contrast" between the two subsections "could not be more striking." *In re Revco D.S., Inc.*, 898 F.2d 498, 501 (6th Cir. 1990). There is no weighing of interests in subsection 1104(c)(2); the court is only permitted to determine whether the unsecured debt minimum of $5 million has been met. *Id.* If we ignore the differences between the plain text of the two subsections, then subsection (c)(2) becomes discretionary and indistinguishable from subsection (c)(1). Such a reading would defy the "usual rules of statutory interpretation" by assuming that "Congress adopt[ed] two separate clauses in the same law to perform the same work." *United States v. Taylor*, 596 U.S. 845, 857 (2022). We make no such assumption here.

In addition to contravening rules of statutory construction, reading subsection (c)(2) as discretionary would require disregarding direct evidence of Congress's intent.[5] In

[5] The Bankruptcy Code was enacted after a "compromise bill" passed both houses of Congress in October 1978. *See* Leonard L. Gumport, *The Bankruptcy Examiner*, 20 Cal. Bankr. J. 71, 91 (1992). When proposing the bill to Congress, the sponsors

obtaining passage of the Bankruptcy Code, the Senate floor manager explained the "business reorganization chapter" ensures "special protection for the large cases having great public interest." 124 CONG. REC. 33990 (1978). Such protection comes from a provision guaranteeing an "automatically appointed" examiner in large cases, a measure designed to "preserve[] and enhance[]" debtors' and creditors' interests, "as well as the public interest." *Id.* The Code's sponsors agreed that, in cases where the "fixed, liquidated, unsecured debt" reached $5 million, the appointment of an examiner is required "to [ensure] that adequate investigation of the debtor is conducted to determine fraud or wrongdoing on the part of present management." 124 CONG. REC. 32403 (1978). To guarantee that "the examiner's report will be expeditious and fair," the sponsors forbade the examiner from acting as or representing a trustee in the bankruptcy and required that the investigation remain separate from the reorganization process.[6] *Id.* at 32406. In enacting Chapter 11, the sponsors adopted a revised approach where the needs of

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of that legislation, Representative Edwards and Senator DeConcini, made "nearly identical statements . . . to their respective chambers." *Id.* at 91–92. These statements are "persuasive evidence" of the legislation's intent. *See Begier v. IRS*, 496 U.S. 53, 64 n.5 (1990) ("Because of the absence of a conference and the key roles played by Representative Edwards and his counterpart floor manager Senator DeConcini, we have treated their floor statements on the Bankruptcy Reform Act of 1978 as persuasive evidence of congressional intent.").

[6] The Bankruptcy Code "prohibits an examiner from serving as a trustee or as counsel for the trustee in order to ensure that examiners may not profit from the results of their work." *In re Big Rivers Elec. Corp.*, 355 F.3d 415, 430 (6th Cir. 2004). Such independence distinguishes examiners from other participants in the Chapter 11 bankruptcies who may investigate wrongdoing but who also seek to benefit financially from the reorganization plan. *See, e.g.*, 11 U.S.C. § 1102(b)(1) (members of the creditors' committee "shall ordinarily" consist of either the seven largest creditors or those who organized before the filing of the petition).

security holders are balanced against "equally important public needs relating to the economy, such as employment and production, and other factors such as the public health and safety of the people or protection of the national interest." *Id.*; *see also Young v. United States*, 535 U.S. 43, 53 (2002) ("[T]he Bankruptcy Code *incorporates* traditional equitable principles."). Because subsection 1104(c)(2) was enacted to protect the public interest in larger bankruptcy cases, a "refusal to give effect to the mandatory language" regarding the appointment of an examiner would result in a failure "to give effect to the legislative intention." 7 Collier on Bankruptcy ¶ 1104.03[2][b] (16th ed. 2023).

Despite this clear intention to protect the public interest, Congress tempered the mandatory nature of subsection 1104(c)(2) by making both the request for an examiner and the scope of the investigation subject to acts of discretion. First, an examiner is not automatically appointed in cases where $5 million of unsecured debt exists. Rather, the U.S. Trustee or a party in interest must deem one necessary and motion the court. 11 U.S.C. § 1109(b). While the Debtors argue granting discretion to every party in interest is illogical and encourages abuse, they provide no evidence to support either position. That a party in interest may abuse its discretion by requesting an examiner is not grounds for deeming Congress's grant of such discretion absurd.[7]

[7] At argument, the government stated that during the fiscal year of 2022, the U.S. Trustee filed fewer than ten motions to appoint examiners. Transcript of Oral Argument at 6:20–23, FTX Trading Ltd. (Nov. 8, 2023) (No. 23-2297). He further noted that there has been no evidence of a "fallout" from the Sixth Circuit's decision in *In re Revco D.S., Inc.*, 898 F.3d at 501, which held the appointment of an examiner is mandatory under subsection 1104(c)(2) in 1990, over thirty years ago. *Id.* at 6:16–18; *see also* George M. Treister & Richard B. Levin, *Fundamentals of Bankruptcy Law* 369–71 (7th ed. 2010) ("Requests for an examiner are infrequent, in both large and small Chapter 11 cases."). In any case, courts must "give effect to [a] plain command, even if doing that will reverse the longstanding practice under the statute." *Lexecon Inc.*, 523 U.S. at 35 (citations omitted).

Second, while a bankruptcy court must appoint an examiner if the statutory requirements are met, the phrase "as is appropriate" in Section 1104(c) means the court "retains broad discretion to direct the examiner's investigation," including its scope, degree, duration, and cost. 5 Norton Bankr. L. & Prac. § 99:25 (3d ed. 2023); *see also* 11 U.S.C. § 330(a)(3). By setting the investigation's parameters, the bankruptcy court can ensure that the examiner is not duplicating the other parties' efforts and the investigation is not unnecessarily disrupting the reorganization process. Moreover, to the extent the mandatory nature of subsection 1104(c)(2) encourages parties in interest to invoke an investigation to tactically delay proceedings, the bankruptcy court has the discretion to continue with the confirmation process without receiving the examiner's findings or public report. 7 Collier on Bankruptcy ¶ 1104.03[2][b] (16th ed. 2023).

In this instance, the Bankruptcy Court denied the motion for an examiner in part because it deemed Mr. Ray to be "completely independent" from FTX's founding members and that any remaining prior officers "have been stripped of any decision making authority." JA 9–10. On appeal, the debtors in possession and the Creditors' Committee argue an investigation would be duplicative and wasteful given their ongoing efforts to uncover all pre-petition mismanagement. Neither position is relevant, given our holding that the appointment of the examiner is mandatory under the Code. But nor is either position persuasive, given that Congress has guaranteed that an investigation under subsection 1104(c)(2) would differ from those conducted by the Appellees in several significant ways. [8]

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[8] The duties of an examiner are set forth in 11 U.S.C. § 1106(a)(3) and (4), which provide that an examiner shall, "except to the extent that the court orders otherwise," investigate "the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;" and then "file a statement of any investigation," which must include any fact "pertaining to fraud, dishonesty,

First, an examiner must be "disinterested" as defined by 11 U.S.C. § 101(14), which means a "creditor, an equity security holder, or an insider," or anyone with "an interest materially adverse to the interest of the estate" cannot be appointed to conduct a Section 1104(c) investigation.[9] *See* 11 U.S.C. § 1104(d). The Code also forbids a debtor in possession, the quintessential "insider," from performing the duties of an examiner and investigating itself. *See* 11 U.S.C. § 1107(a) (stating a debtor in possession "shall have all the rights . . . and powers" and "perform all the functions and duties" of a trustee, except the duties granted to trustees and examiners in subsections 1106(a)(2) through (4)). An examiner "is first and foremost disinterested and nonadversarial" and "answers solely to the Court." *In re Big Rivers Elec. Corp.*, 355 F.3d 415, 432 (6th Cir. 2004) (quoting *In re Baldwin United Corp.*, 46 B.R. 314, 316 (S.D. Ohio 1985)). This requirement of disinterest is particularly salient here, where issues of potential conflicts of interest arising from debtor's counsel serving as pre-petition advisors to FTX have been raised repeatedly. Moreover, the U.S. Trustee raised the concern that, given the reports of widespread fraud, officers or employees who may have engaged in wrongdoing could remain at FTX Group. JA 100 ¶ 35. In enacting subsection 1104(c)(2), Congress made certain that neither the Bankruptcy Court nor the Appellees could deem these issues unworthy of an outside investigation in this particular bankruptcy, which certainly qualifies as a

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incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate."

[9] Under the Bankruptcy Code, a "disinterested person" is defined as a person that "is not a creditor, an equity security holder, or an insider;" "is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor;" and "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason." 11 U.S.C. § 101(14)(A)–(C).

"large case[] having great public interest." 124 CONG. REC. 33990 (1978).

Second, an examiner appointed under subsection 1104(c)(2) must make their findings public, an obligation neither a creditor committee nor a debtor in possession shares.[10] *Compare* 11 U.S.C. § 1103(c)(2) *and* 11 U.S.C. § 1107(a), *with* § 1106(a)(4), (b). Requiring a public report furthers Congress's intent to protect the public's interest as well as those creditors and debtors directly impacted by the bankruptcy. Such protection seems particularly appropriate here. The collapse of FTX caused catastrophic losses for its worldwide investors but also raised implications for the evolving and volatile cryptocurrency industry. For example, an investigation into FTX Group's use of its own cryptocurrency tokens, FTTs, to inflate the value of FTX and Alameda Research could bring this practice under further scrutiny, thereby alerting potential investors to undisclosed credit risks in other cryptocurrency companies. In addition to providing much-needed elucidation, the investigation and examiner's report ensure that the Bankruptcy Court will have the opportunity to consider the greater public interest when approving the FTX Group's reorganization plan.[11]

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[10] The public report requirement is set forth in 11 U.S.C § 1106 (a)(4)(A) and § 107(a). Section 1106(a) sets forth the duties of an examiner. Subsection 1106(a)(4) directs an examiner to "file a statement of any investigation" which includes "any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate." 11 U.S.C. § 1106(a)(4)(A). Such a statement is deemed public under 11 U.S.C. § 107(a).

[11] At argument, counsel for the unsecured Creditors' Committee posited that examiners in large-scale bankruptcies are not appointed as a matter of course and cited three examples: *In re Genesis Global Holdco, LLC*., No. 1:23-bk-10063, ECF 1 *et seq*. (Bankr. S.D.N.Y. Jan. 19, 2023), *In re Voyager Digital Holdings, Inc*., No. 1:22-bk-10943, ECF 1 *et seq*. (Bankr. S.D.N.Y. July 5, 2022), *In re JCK Legacy Co*.,

IV. Conclusion

For the foregoing reasons, we reverse the decision of the Bankruptcy Court and remand with instructions to order the appointment of an examiner under 11 U.S.C. § 1104(c)(2).

No. 1:20-bk-10418, ECF 1 *et seq*. (Bankr. S.D.N.Y. Feb. 13, 2020). In searching the above-cited docket entries, it appears no motion requesting the appointment of an examiner pursuant to 11 U.S.C. § 1104(c)(2) was ever made. Transcript of Oral Argument 31:21–32:1, FTX Trading Ltd. (Nov. 8, 2023) (No. 23-2297).

Examining Success

by

Jonathan C. Lipson
and
*Christopher Fiore Marotta**

Chapter 11 of the Bankruptcy Code presumes that managers will remain in possession and control of a corporate debtor. This presents an obvious agency problem: these same managers may have gotten the company into trouble in the first place. The Bankruptcy Code thus includes checks and balances in the reorganization process, one of which is supposed to be an "examiner," a private individual appointed to investigate and report on the debtor's collapse.

We study their use in practice. Extending prior research, we find that examiners are exceedingly rare, despite the fact that they should be "mandatory" in large cases ($5 million+ in debt), and are recommended in any case if "in the interests of creditors." Using a hand-collected dataset (n=1225) of chapter 11 bankruptcies from 1991-2010, we find that they are sought in less than 9% of cases (104), and appointed in fewer than half of those (48, or 3.9% of the sample).

We make three observations about the use of examiners. First, regression modeling shows that the factors that predict when an examiner will be appointed appear to have little to do with the agency problems that concerned Congress, such as fraud or mismanagement. Rather, the timing of an examiner request and case venue appear to be the most important factors in the rare cases where they appear. Delaware's bankruptcy court, the nation's busiest, appears

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especially resistant to examiners. Our findings may support concerns that its bench has been captured by distress professionals. Second, governance in reorganization has changed significantly since Congress enacted chapter 11, yet agency problems persist. The reorganization of large companies is increasingly influenced by sophisticated investors (e.g., private equity funds), who often use pre-bankruptcy "turnaround managers" to manage the process. Examiners could tell us whether this change has net social costs or benefits—if they were used. Third, we offer preliminary evidence that examiners should be used more frequently, because a case with one is likely to be more "successful" in a variety of ways than a case without one.

Our findings inform looming fights about amending the Bankruptcy Code to alter or eliminate the examiner's position, and larger debates about how to define and achieve "success" in chapter 11 reorganizations. We borrow from literature on "experimentalism" in regulatory design to propose that bankruptcy courts use "mini-examinations" in order to learn more about examiners' effects on the reorganization process. Sensitive to concerns about cost, we propose that some or all of these mini-examinations be funded out of bankruptcy court filing fees, which according to a recent estimate averaged about $375 million per year between fiscal years 2010-2014.

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Introduction

Bankruptcy examination is a failure.

"Examiners" are private individuals appointed to investigate and report on alleged acts of pre-bankruptcy mal- or misfeasance when a company seeks protection under chapter 11 of the Bankruptcy Code.[1] Bankruptcy Code § 1104(c) sounds like examiners are mandatory in large cases,[2] and recommended in many of them: "[T]he court *shall* order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate . . . if . . . (1) such appointment is *in the interests* of creditors, equity security holders, and other interests of the estate; *or* (2) the debtor's fixed, liquidated,

[1] 11 U.S.C. § 1104(c). The Bankruptcy Code is the principal system for addressing corporate failure under U.S. law. The current version of the Bankruptcy Code was originally enacted in 1978, Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, and has been amended several times, *see, e.g.*, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11, 18, 28 U.S.C.).

[2] As explained further below, a "large" case is one for which data are reported in the Bankruptcy Research Database ("BRD"). *See* UCLA-LoPucki Bankruptcy Research Database, http://lopucki.law.ucla.edu (last visited Dec. 14, 2014). This database contains limited information on examiners, so we have supplemented the BRD data to provide greater insight into the use of examiners. We also collect data on "small" cases, that is, those too small to appear in the BRD. *See* explanation *infra* Parts 2, 3.

unsecured *debts . . . exceed $5,000,000.*"[3]

And yet, almost no one wants them. When it enacted the Bankruptcy Code in 1978, Congress presumed that operational managers of troubled companies would remain in possession and control of the debtor, in order to promote reorganizations that would save going concerns and jobs.[4] This, however, presented an obvious agency problem: these same managers may have gotten the company into trouble in the first place. Congress thus created a number of checks and balances in the reorganization process, chiefly to protect creditors—one of which would be the examiner.

Extending prior research,[5] we study their use in practice with hand-collected, docket-level data from 1,225 large and small chapter 11 cases from 1991 to 2010.[6] We find that they were sought in only 104 (8.5% of) cases, and appointed in 48, fewer than half of cases where requested, and less than 4% of the sample.[7] Even in the 661 large cases in the sample—where appointment would likely have been mandatory—they were sought in only 93 (14% of) cases, and appointed less than half the time sought, in 43 (or 6.5% of) large cases. The message is thus clear: Stakeholders in chapter 11 cases rarely want examiners.[8]

Ironically, Congress seems to have believed that examiners would be com-

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[3]11 U.S.C. § 1104(c) (emphasis added).

[4]*See* H.R. Rep. No. 95-595, at 220 (1977) ("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. . . . It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.").

[5]The first paper in this study was Jonathan C. Lipson, *Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies*, 84 Am. Bankr. L.J. 1 (2010) [hereinafter Lipson, *Examiners I*]. The data presented here are a larger and more comprehensive set than was used in *Examiners I*, which studied only "large" cases and focused on when examiners would be sought, rather than when they would be appointed or their implications for the chapter 11 system, the subjects of this paper.

[6]A case is "large" (n=661) if it has publicly traded securities and assets in excess of $100 million in 1980 dollars; otherwise (n=564) it is "small". *See infra* Part 2.

[7]*See infra* App. 1 for a list of cases in which they were appointed, along with the district and year the case was commenced.

[8]Judges appear to share this sentiment. Robert Gerber, a prominent bankruptcy judge in the Southern District of New York who later presided over the *General Motors* reorganization, has railed against the seemingly mandatory language of the Bankruptcy Code. "[M]andatory appointment [of examiners] is terrible bankruptcy policy," he noted in the *Lyondell Chemical* case, "and the [Bankruptcy] Code should be amended, forthwith, to . . . give bankruptcy judges (subject to appellate review, of course) the discretion to determine when an examiner is necessary and appropriate. . . ." *See* Transcript of Hearing Before the Honorable Robert E. Gerber at 35, *In re* Lyondell Chemical Co., No. 09-10023 (REG) (Bankr. S.D.N.Y. Oct. 26, 2009) (docket no. not available) (transcript on file with author). *See also In re* Dewey & LeBoeuf LLP, 478 B.R. 627, 639 (Bankr. S.D.N.Y. 2012) ("[T]his Court has already concluded and adheres to the view that it retains the discretion to deny a motion for appointment of an examiner."); *In re* Residential Capital, LLC, 474 B.R. 112, 121 (Bankr. S.D.N.Y. 2012) ("While section 1104(c) expresses a Congressional preference for appointment of an independent examiner to conduct a necessary investigation, the facts and circumstances of the case may permit a bankruptcy court to deny the request for appointment of an examiner even in cases with more than $5 million in fixed debts.").

mon—in some cases required—features of chapter 11 reorganizations. They would provide "special protection for the large cases having great public interest" and "determine fraud or wrongdoing on the part of present management."[9] Senator DeConcini, addressing the legislation that became chapter 11, stated that examiners would be appointed "automatically" in such cases.[10] The only U.S. appellate court to consider the question agreed, holding that examiners should be common features of all chapter 11 cases, and "mandatory" if requested in large ones.[11] While examiners have played important, sometimes controversial, roles in some of the nation's largest reorganizations, including *Enron,*[12] *Worldcom,*[13] *Lyondell Chemical,*[14] *Washington Mutual,*[15] *Lehman Brothers,*[16] *The Chicago Tribune,*[17] and *Caesar's Entertainment,*[18] they are vanishingly rare in most cases, large or small.

At first, resistance may have been understandable. System participants—creditors, managers, and judges—may have worried that the costs of an examination would exceed its benefits.[19] Creditors effectively pay for it, because examiner's fees have priority over general unsecured claims.[20] Other checks in the system—in particular creditors' committees, which would re-

[9]124 CONG. REC. S17, 403-34 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini) (quoted in COLLIER ON BANKRUPTCY, app. 14.4(f)(iii) (15th ed. rev. 2002) [hereinafter COLLIER]).

[10]*See id.* at 404 ("There will automatically be appointed an examiner in [large cases], but not a trustee .... I am convinced that debtor and creditor interests, as well as the public interest, will be preserved and enhanced by these provisions.").

[11]*See, e.g., In re* Revco D.S., Inc., 898 F.2d 498, 501 (6th Cir. 1990) ("When the total 'fixed, liquidated, unsecured' debt is greater than $5 million, the statute requires the court to appoint an examiner.").

[12]*In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Dec. 2, 2001).

[13]*In re* Worldcom, Inc., No. 02-13533 (Bankr. S.D.N.Y. July 21, 2002).

[14]*In re* Lyondell Chemical Co., No. 09-10023 (Bankr. S.D.N.Y. Oct. 26, 2009).

[15]*In re* Washington Mutual, Inc., No. 08-12229 (Bankr. D. Del. Nov. 1, 2008).

[16]*In re* Lehman Bros. Holdings, Inc., No. 08-13555 (Bankr. S.D.N.Y. Sept. 15, 2008). We note that neither *Lehman Brothers* nor *Washington Mutual* is in the dataset created for this study because the cases were pending as of 2010. This is likely fortunate, as their sheer size—*Lehman Brothers* was the largest case ever filed, with over $600 billion in pre-filing assets—would have skewed the data. Stephanie Gleason, *Lehman Bankruptcy Trustee Appeals Barclays Ruling to Supreme Court*, WALL ST. J., Dec. 15, 2014, http://www.wsj.com/articles/lehman-bankruptcy-trustee-appeals-barclays-ruling-to-supreme-court-1418659185.

[17]*In re* Tribune Co., No. 08-13141, *Agreed Order Appointing Examiner*, Dkt. No. 4120 (Bankr. D. Del. Apr. 20, 2010). The examiner's role in the *Tribune* bankruptcy is discussed in detail in Daniel J. Bussel, *A Third Way: Examiners As Inquisitors*, 90 AM. BANKR. L.J. 59 (2016).

[18]*In re* Caesars Entm't Operating Co., No. 15-01145 (Bankr. D. Del. filed Jan. 15, 2015) *transferred to* Bankr. N.D. Ill., 2015 WL 495259 (Bankr. D. Del. Feb. 2, 2015). *See also In re* Caesars Entm't Operating Co., 526 B.R. 265, 270-71 (Bankr. N.D. Ill. 2015) (discussing examiner's appointment).

[19]*See* Lipson, *Examiners I, supra* note 5, at 31, 51-52 (discussing concerns about costs). *See also* Bussel, *supra* note 17, at 62-63 ("If an examiner's role is to investigate, how exactly does introducing an entire new set of professionals (examiners routinely employ attorneys and financial advisors to fulfill their responsibilities) into a process already overrun with professionals conducting investigations help matters?").

[20]*See* 11 U.S.C. § 330(a)(1) (providing for expenses of examiners); 11 U.S.C. §§ 503(a)(1), 507(a)(2) (setting forth priority of expenses of administration, including examiners).

present them, and the power to appoint a trustee or convert or dismiss the case—would usually address agency problems caused by leaving managers in place. This would render an examination a redundant, potentially costly, fishing expedition, despite the seemingly mandatory language in the statute.

Today, however, observers increasingly worry that new kinds of governance problems plague the reorganization process. Sophisticated "distress investors"—hedge funds, private equity funds, and investment banks—may obtain control of troubled companies prior to or during bankruptcy.[21] So-called "turnaround managers" may replace operational managers at the behest of the distress investors calling the shots. These investors may sell—rather than reorganize—the debtor in order to earn a relatively quick profit on the investment. Yet, this profit may come at the expense of workers, taxing authorities, and the communities that have supported these companies.[22] Worse, distress investors sometimes fight amongst themselves, causing internecine battles that can be costly to the debtor, but of little benefit to the reorganization effort.[23] Because they may occupy (or dominate) creditors' committees, they can take advantage of a check meant to preserve systemic integrity.[24]

These changes have created an opaque "shadow bankruptcy" system, one that may undermine Congress' remedial goals in creating chapter 11—which was chiefly to preserve going (corporate) concerns and the jobs that they create.[25] Examiners could help assess the costs and benefits of this systemic change—if they were used. That they are not suggests that neither managers nor investors (creditors) want this sort of oversight of the process. Their

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[21] *See, e.g.*, Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703 (2008) (describing the activities of distressed debt investors); Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1640 (2009) (discussing problem of creditor control in bankruptcy committees) [hereinafter Lipson, *Shadow Bankruptcy*]; *See* Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. U. L. REV. 281, 282 (2009) ("What distinguishes hedge funds from other investors is that hedge funds tend to pursue active and aggressive investment strategies."); Jonathan C. Lipson, *Governance in the Breach: Controlling Creditor Opportunism*, 84 S. CAL. L. REV. 1035 (2011) (discussing creditor pre-bankruptcy effort to obtain debtor control) [hereinafter Lipson, *Governance*]; Jonathan C. Lipson & Christopher M. DiVirgilio, *Controlling the Market for Information in Reorganization*, 18 AM. BANKR. INST. L.J. 647 (2010).

[22] *See, e.g.*, Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 30-31 (2007).

[23] *See* Lipson, *Shadow Bankruptcy*, *supra* note 21.

[24] Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 VAND. L. REV. 749, 758-760 nn.46-59 (2011) (explaining history of creditors' committees in bankruptcy and providing citations to additional resources). In some cases, distress investors prefer to form unofficial "ad hoc" committees through which they influence the reorganization process. *See* Lipson, *Shadow Bankruptcy*, *supra* note 21.

[25] *See* Lipson, *Shadow Bankruptcy*, *supra* note 21.

reasons for eschewing examiners may differ—managers may fear scrutiny and creditors may worry about cost—but the net effect is the same: we know less about the chapter 11 process than we should. Our ignorance thus deprives us of the ability to make intelligent decisions about how to adjust the system to accommodate changes in the nearly forty years since the Bankruptcy Code was enacted—a question that is increasingly important as pressure grows to amend the Bankruptcy Code, including by replacing examiners with a more amorphous "neutral."[26]

Our study enables us to make three observations about examiners and their role in chapter 11.

First, since courts do not appear to apply the statute as written, system participants want to know when to expect them. We use our data to build a regression model, which shows that the factors Congress thought should matter to bankruptcy examination—in particular fraud, misconduct, or managerial incompetence—do not (at least in a statistical sense). Rather, bankruptcy examinations appear to be determined by the following factors:

- *Firm wealth.* An examiner is almost nine times more likely to appear in a large case than a small one, especially where the firm shows net-positive (unencumbered) assets at filing. The reported presence of unencumbered asset values may provide comfort to stakeholders who worry that the costs of an examination would otherwise outweigh benefits to creditors.
- *Timing.* The relative speed of a request for an examiner matters. The average successful examiner request was made a little over a quarter of the way into the case. A request that failed, by contrast, was probably made nearly halfway through, when important information might have been produced through other channels. This suggests that courts screen examiner requests based on their likely informational value.
- *Venue.* An examiner is 62% *less* likely to be appointed if sought in Delaware, a statistically significant effect.[27] This matters because Delaware is by far the most common district in which large cases are

[26]As a general proposition, bankruptcy laws in the "modern era"—since 1898, when the first "permanent" bankruptcy law went into effect—have been substantially amended at roughly 40-year intervals, in 1938 and 1978. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898), *amended by* Chandler Act, ch. 575, 52 Stat. 840 (1938), *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (2000 & Supp. V 2005)). There is a growing movement to overhaul chapter 11, including by replacing examiners with "estate neutrals." *See* AM. BANKR. INST., COMM'N TO STUDY THE REFORM OF CHAPTER 11, FINAL REPORT AND RECOMMENDATIONS 2012-14, 33-38 (2014), https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h [hereinafter ABI REFORM STUDY] (reporting on multi-year study to overhaul chapter 11). *See infra* Part 1.5 for a discussion of the recommendations of the ABI Reform Study.

[27]p=0.039. *See infra* Table 1.1.

filed, accounting for 272 (41%) of all such cases in our sample. Yet, Delaware is a controversial venue because scholars divide sharply over whether its bench and bar are "captured" by insiders, in particular distress investors, turnaround managers, and their counsel.[28]

Second, there is an important debate over whether the transformation of chapter 11 reorganization—the rise of "shadow bankruptcy"—is good or bad. Some worry that private investors bleed troubled companies, sell their assets for a profit, then downsize or export jobs overseas, thus undermining a key remedial goal in creating chapter 11.[29] Others believe that the creative destruction of the new reorganization process—even the increase in asset sales rather than reorganizations "in place"—permits the redeployment of value to higher and better uses that may produce an overall gain in social welfare.[30] Bankruptcy examinations might shed light on these claims, if they occurred more frequently.

Third, the pattern in bankruptcy examinations is a window into debates about how to measure "success" in chapter 11.[31] Are cases "successful" if they maximize the wealth of financial creditors, even at the expense of other stakeholders?[32] Or do we take account of the interests of the "community"

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[28]*Compare* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (Univ. of Mich. Press 2005) [hereinafter LOPUCKI, FAILURE], *with* Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425 (2006) (reviewing LOPUCKI, FAILURE), *and* David A. Skeel, Jr., *What's So Bad About Delaware?*, 54 VAND. L. REV. 309 (2001). *See also* Robert K. Rasmussen & Randall S. Thomas, *Whither the Race? A Comment on the Effects of the Delawarization of Corporate Reorganizations*, 54 VAND. L. REV. 283, 306-07 (2001).

[29]*See, e.g.*, LoPucki & Doherty, *supra* note 22, at 30-31; Lipson, *Shadow Bankruptcy*, *supra* note 21.

[30]*See, e.g.*, Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 75 (2004); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 674 (2003) [hereinafter Baird & Rasmussen, *Chapter 11*]; Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 958 (2001) [hereinafter Baird & Rasmussen, *Control Rights*]; Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 784-85 (2002) [hereinafter Baird & Rasmussen, *End of Bankruptcy*].

[31]*Compare* Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1078-79 (1992) ("Chapter 11 should be repealed, abolishing court-supervised corporate reorganizations and, in effect, precluding residual claimants from participating in any reorganization of the firm."), *with* Lynn M. LoPucki & Joseph Doherty, *Bankruptcy Survival*, 62 UCLA L. REV. 970 (2015) [hereinafter LoPucki & Doherty, *Survival*], Lynn M. LoPucki, *Changes in Chapter 11 Success Levels Since 1980*, 87 TEMP. L. REV. 989 (2015) [hereinafter LoPucki, *Success Levels*], *and* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 355 (1993) ("[T]he [Bankruptcy] Code carries out a deliberate distributional policy in favor of all those whom a business failure would have hurt. The choice to make bankruptcy 'rehabilitative' represents a desire to protect these parties along with the debtor and creditors who are more directly affected."); Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 612-40 (2009) (describing value-creating aspects of Chapter 11) [hereinafter Warren & Westbrook, *Success*].

[32]The question is rooted in the work of Thomas Jackson. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 32-33 (1986) (developing "creditors' bargain" theory). *See also* Bradley &

affected by a corporate debtor's survival?[33] The former can be seen as expressing a preference for "private" (contractual) solutions, whereas the latter reflects a more "public" bias. Congress seems to have preferred the latter in enacting chapter 11, but the rise of shadow bankruptcy suggests that the former—financial creditor wealth—is increasingly the goal.

Confounding conventional wisdom, we find preliminary evidence that examinations correlate to "success" on both private and public metrics. Examiner cases tend to have higher bond prices, post-bankruptcy income, and headcounts, all evidence of "private" success. Moreover, there is little doubt that examiners' reports in cases such as *Enron*, *Worldcom*, and *Lehman Brothers* performed an important public service in explaining the spectacular and unanticipated collapses of these firms. Those who assume that examiners are a waste of money may simply be wrong.

While the evidence suggests that examiners are not used as Congress intended, and that there may be reason to use them more frequently, we are nevertheless sensitive to concerns about their costs. Drawing from recent literature on "experimentalism" in regulatory design, we propose that courts should experiment with "mini-examinations" in samples of chapter 11 cases in order to determine whether the better outcomes we observe here appear more broadly. Because bankruptcy examinations have important public attributes, we also propose that they be funded in whole or in part by bankruptcy filing fees—which, according to a recent estimate, averaged about $375 million per year for the fiscal years between 2010-2014[34]—and not exclusively from creditors' recoveries.

The paper has five parts. Part 1 presents the motivation for the study and reviews background literature. Part 2 describes our methodology. Part 3 summarizes the data and presents our findings on factors that influence examiner requests and appointments. Part 4 presents our findings on the relationship between examiners and "success" in large cases. Part 5 considers experimenting with "mini-examinations."

1. MOTIVATION AND BACKGROUND

If no one cares about examiners, why should we?

The short answer is that bankruptcy examination has the capacity to improve governance and transparency in corporate reorganization. Examiners could ameliorate the problems of agency cost and systemic integrity that con-

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Rosenzweig, *supra* note 31; Anthony T. Kronman & Thomas H. Jackson, *Secured Financings and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1818 (1998).

[33] *See, e.g.*, LoPucki, *Survival*, *supra* note 31.

[34] *See* Ed Flynn, *Is Bankruptcy the Red-Headed Stepchild of the Judiciary?*, 34 AM. BANKR. INST. J. 36, 37 (Oct. 2015).

cerned Congress when it created chapter 11, and that persist today in new but perhaps equally problematic forms. That they are not used as Congress expected—and that their underuse appears to correlate to worse outcomes—suggests that we may be missing an important opportunity to improve the operation of the chapter 11 system. Who wins and who loses from this failure is, in the broadest sense, the "success" we seek to study.

1.1 Governance in Reorganization

When Congress enacted the Bankruptcy Code of 1978, it changed the governance of companies in bankruptcy. While bankruptcy examiners were meant to be an important part of that change, it appears they have not been used as Congress envisioned.

Under prior law (the Chandler Act of 1938), trustees presumptively replaced the managers of large public companies that went into bankruptcy.[35] This was thought to hold managers accountable, thus containing agency costs. But it was also a problem because it deterred troubled companies from using bankruptcy: why would managers want to fire themselves?[36] This, in turn, was thought to dissuade corporate debtors from reorganizing. Reluctance to reorganize would tend to result in liquidations for the benefit of senior secured creditors, destroying going concern values, jobs, and potentially greater recoveries for junior stakeholders.[37] The system produced deadweight losses.

The solution required a change in the governance of corporate debtors, specifically to leave them presumptively in the possession and control of management (the so-called "debtor in possession").[38] Yet, this created obvious agency problems because the company would stay in the hands of operational managers, who may well have created the trouble in the first place. Congress thus created a series of checks and balances meant to protect the debtor's likely residual claimants, general unsecured creditors, and the integrity of the process.

The most important check would be one or more official committees that would represent the interests of widely dispersed creditors (and, occasionally, shareholders).[39] Creditors' committees have standing to investigate the debtor, and to challenge actions management might want to take in the

[35]Chandler Act § 156, 52 Stat. 840, 888 (codified as amended at 11 U.S.C. § 567 (1938)) (repealed 1978) (describing appointment of trustees in cases where debtors had liabilities of $250,000 or more). In smaller cases, managers could remain in possession and control. *Id.* at 888.

[36]Report of the Commission on the Bankruptcy Laws of the United States, Pt. 1, H.R. Doc. No. 93-137, 237, 248 (1973).

[37]*See supra* note 4.

[38]*See* 11 U.S.C. § 1101(1) ("'debtor in possession' means debtor . . .").

[39]*See, e.g.*, 11 U.S.C. §§ 1102(a), (b)(1). *See also* Harner & Marincic, *supra* note 24, at 794.

case.[40] They are expected to receive sensitive information about the debtor's performance, and to negotiate with the debtor's management about important matters, in particular a reorganization plan, which would reflect management's long-term goals for fixing the company. The plan process is, itself, also a check on management. Unless a sufficient amount and number of creditors vote for the plan, it will fail.[41] Plan voting can thus be seen as the ultimate check on corporate governance in chapter 11.[42]

While creditors' committees and plan voting can improve governance in chapter 11 cases, they are not the only checks Congress created. Chapter 11 sets forth a continuum of increasingly intrusive mechanisms to deter or remedy governance and informational problems that may arise in these cases. At the outer bound is the court's power to convert a case to a chapter 7 liquidation or to dismiss it under § 1112 for "cause," which can include "gross mismanagement" of the bankruptcy estate.[43] From a governance perspective, conversion or dismissal is one of the most drastic steps a bankruptcy judge could take: it effectively ends the reorganization effort, either causing the company to be liquidated promptly or ending the case, leaving the debtor's fate to other fora. It is a recognition that the reorganization process as such has failed.[44]

A somewhat less severe check is the power to appoint a chapter 11 trustee. The grounds to appoint a chapter 11 trustee overlap in important respects with grounds to convert or dismiss a case (or, for that matter, to appoint an examiner), including fraud, dishonesty, or incompetence by management.[45] The appointment of a chapter 11 trustee is not likely to be viewed as being as draconian as conversion or dismissal because it does not

[40]Among other things, the Committee may "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan" and "participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan." 11 U.S.C. §§ 1103(c)(2), (c)(3).

[41]*See* 11 U.S.C. § 1122(a) (classification of claims); 11 U.S.C. § 1126(c) (voting minima for plan acceptance); 11 U.S.C. § 1129(a)(8) (class voting requirements for plan confirmation). *See also* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987) (discussing voting rules in chapter 11).

[42]*See, e.g.*, David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994).

[43]*See* 11 U.S.C. § 1112. This section provides, in substance, that a case may be converted or dismissed, "whichever is in the best interests of creditors," provided there is "cause" to do so. 11 U.S.C. § 1112(b)(1). "Cause" includes "substantial or continuing loss to or diminution of" the value of the estate or "gross mismanagement of the estate." *Id.* at §§ 1112(b)(4)(A), (b)(4)(B).

[44]It is not, however, evidence that chapter 11 or the larger bankruptcy process is a failure. *See* Warren & Westbrook, *Success*, *supra* note 31 (arguing that prompt conversion or dismissal may be evidence of success when compared to possibility of protracted chapter 11 case with high reorganization costs and low reorganization returns).

[45]Bankruptcy Code § 1104(a) provides in pertinent part:

necessarily spell the end of the business—only of management. Unlike conversion or dismissal, the reorganization process can continue under a trustee, who is expected to promulgate a plan[46] and to report on misconduct by management.[47]

Examiners can be seen as the mildest point on this continuum, and one that implicitly trades information-forcing for a direct change in governance. Unlike conversion or dismissal, the appointment of an examiner does not end the reorganization effort.[48] Unlike a trustee, an examiner will not displace management (although in theory could do so[49]). An examiner will presumptively investigate and report on matters within the scope of her appointment.[50] Of course, this may indirectly affect governance in at least two ways: First, it may produce facts that lead to changes in the composition of, or causes of action against, managers (or others who allegedly harmed the debtor). Second, the examination process itself may take managers' time and energy (e.g., by requiring them to provide information or testimony), thus interfering with efforts to reorganize the debtor.

The legal standards for implementing any of these three mechanisms—conversion/dismissal, trustee, or examiner—also reflect a continuum, one that roughly reflects the severity of the sanction. Thus, while similar problems—in particular fraud or mismanagement—could trigger any of them,[51] conversion/dismissal and trustee appointment are doctrinally more difficult to obtain than an examiner, demanding a showing of "cause,"[52] implying that

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> (a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee—
>
> (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management . . .

11 U.S.C. § 1104(a). *See also* Clifford J. White III & Walter W. Theus, Jr., *Taking the Mystery Out of the Chapter 11 Trustee Appointment Process*, AM. BANKR. INST. J., July 2014, at 16 (discussing qualifications to serve as a trustee).

[46]11 U.S.C. § 1106(a)(5) (providing that a chapter 11 trustee shall "as soon as practicable, file a plan under section 1121 of this title, file a report of why the trustee will not file a plan, or recommend conversion of the case to a case under chapter 7, 12, or 13 of this title or dismissal of the case").

[47]11 U.S.C. § 1106(a)(4)(A) (providing that a chapter 11 trustee shall "file a statement of any investigation conducted under paragraph (3) of this subsection, including any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate . . . .").

[48]In three cases (0.85% of the sample), an examiner was appointed after which the case was converted or dismissed.

[49]According to subjects interviewed for this project, that has occasionally happened. *See* Lipson, *Examiners I*, *supra* note 5, at 50.

[50]As noted, a trustee will also do this.

[51]*Cf.* Paula D. Hunt, *Bankruptcy Examiners Under Section 1104(b): Appointment and Role in Complex Chapter 11 Reorganizations and Failed LBOS*, 70 WASH U. L.Q. 821, 829 (1992) (discussing overlapping standards).

[52]*See, e.g.*, 11 U.S.C. § 1112(b)(4) ("gross mismanagement of the estate").

management's reorganization effort has failed. By contrast, an examiner's appointment does not require statutory "cause" at all: appointment must either be "in the interests" of creditors or the debtor must have over $5 million in qualifying unsecured debt.[53] So far as the Bankruptcy Code is concerned, "cause" has no explicit role in decisions to appoint examiners.

1.2 Examining Political Compromise

While it may help to view these mechanisms as linked by some logic, it appears Congress was not so elegant. Rather, the role of the examiner was apparently the product of two political compromises involving governance.

The first involved the demotion of the bankruptcy trustee in reorganization. In the Senate's version of the bill that led to the Bankruptcy Code, trustees would have been mandatory in any case involving a "public" company, not unlike prior law.[54] The House's version, by contrast, would have made the appointment of a trustee discretionary, but it offered no appointment standards.[55] The compromise appears to have been to make the appointment of trustees discretionary and examiners mandatory in the chapter 11 cases of public companies.[56]

The second compromise reflected the demotion of the role of the Securities and Exchange Commission (SEC) in reorganization. Prior law (the Chandler Act) had contemplated an active role in corporate bankruptcy for the SEC, which was created around the same time (the late 1930s) for purposes of protecting investors in various settings.[57] Under Chapter X of the Chandler Act, the SEC had standing to act as a party in interest during the entire bankruptcy proceeding.[58] Any plan of reorganization for a debtor with more than $3 million in debt had to be submitted to the SEC for comment prior to

[53]11 U.S.C. § 1104(c).

[54]Section 1101(3) in S. 2266 originally provided as follows: "'public company' shall mean a debtor who, within twelve months prior to filing a petition for relief under this chapter, had outstanding liabilities of $5,000,000 or more, exclusive of liabilities for goods, services, or taxes and not less than 1,000 security holders." S. 2266, 95th Cong. § 1101(3) (2d Sess. 1978), *reprinted in* Collier, *supra* note 9, app. pt. 4(e), at app. pt. 4-1849. Section 1104(a) in S. 2266 originally provided as follows: "In the case of a public company, the court, within ten days after the entry of an order for relief under this chapter, shall appoint a disinterested trustee." S. 2266, 95th Cong. § 1104(a), (2d Sess. 1978), *reprinted in* Collier, *supra* note 9, app. pt. 4(e), at app. pt. 4-1850.

[55]*See* H.R. Rep. No. 95-595, at 402 (1977), *reprinted in* Collier, *supra* note 9, app. pt. 4(d)(i), at app. pt. 4-1550.

[56]124 Cong. Rec. H11, 102 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards), *reprinted in* Collier, *supra* note 9, app. pt. 4(f)(i), at app. pt. 4-2465; 124 Cong. Rec. S17, 419 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini).

[57]*See* Lipson, *Examiners I*, *supra* note 5, at 7-12 (discussing role of the SEC under pre-Code law).

[58]Chandler Act § 168, 52 Stat. 840, 890 (codified as amended at 11 U.S.C. § 567 (1938)) (repealed 1978).

confirmation.[59] At least initially, the SEC fulfilled its watchdog role, participating in meetings, challenging the appointment of trustees and trustees' administrations, opposing plans of reorganization, and criticizing compensation agreements.[60]

In practice, however, disaffection for the SEC's role in reorganization grew. By 1978, the SEC favored a mandatory trustee because he or she would protect investors in large public companies.[61] This would be important, as the SEC itself wanted to reduce its watchdog role in bankruptcy. Yet, if the Congressional compromise eliminated the mandatory trustee, only examiners would be a constant external check on management. Thus, as one attorney interviewed for this project who claimed familiarity with negotiations over the legislation observed, the role of the "mandatory" examiner was created as a "sop to the SEC."[62]

As the product of compromise, rather than any theory about governance (or information flow) in reorganization, it is not surprising that courts and commentators have struggled to understand when examiners would or should be appointed, how they should function in the process, and how their performance should be assessed. Thus, courts disagree about whether examiner appointments are "mandatory" if sought.[63] If they are not mandatory, they search to identify the factors that should matter.[64] As professionals paid from the estate—in effect, with money that would otherwise go to creditors—courts and system participants worry that examiners could simply be expensive fishing expeditions.[65] Because creditors' committees can undertake

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[59]Chandler Act § 172, 52 Stat. 840, 890-91 (codified as amended at 11 U.S.C. § 567 (1938)) (repealed 1978).

[60]*See* Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 65 (1997) ("In Chapter X the SEC challenged trustees who had connections with management, monitored their administration of the estate, and opposed any procedures and arrangements that did not meet its standard of fairness.").

[61]Aaron Levy, *The Role of the Securities and Exchange Commission and the Judicial Functions under the Bankruptcy Reform Act of 1978*, 54 AM. BANKR. L.J. 29, 29-30 (1980). *See also Bankruptcy Reform Act of 1978: Hearings on S.2266 and H.R. 8200 Before the Subcomm. on Improvements in Jud. Machinery*, 95th Cong. 622 (1977).

[62]Lipson, *Examiners I*, *supra* note 5, at 14 n.73 (quoting e-mail from L-3 to author, dated Nov. 16, 2009).

[63]*Compare In re* Spansion, Inc., 426 B.R. 114, 120 (Bankr. D. Del. 2010) (denying examiner appointment), *with In re* Residential Capital, LLC, 474 B.R. 112, 121 (Bankr. S.D.N.Y. 2012) (appointing an examiner). *See generally* Ryan M. Murphy, *Does the Recent String of Examiner Appointments Represent a Sea Change in Approach or Merely a Perfect Storm of Cases?*, PRATT'S J. BANKR. L. 2011.04-2.

[64]*See, e.g.*, Ted R. Berkowitz & Veronique A. Urban, *Examiner Motions: Is Good Faith a Required Element?*, PRATT'S J. BANKR. L. 2012.05-4.

[65]*See* Lipson, *Examiners I*, *supra* note 5, at 53 (discussing examiners' fees). As Professor Bussel observes, an examiner's "team of legal and financial professionals can be very expensive. Judges can fix budgets for examiners and their professionals, but a credible neutral investigation easily can cost tens of millions, and in the two largest cases (*Enron* and *Lehman Brothers*) examiners incurred more than $100 million in direct fees and costs." Bussel, *supra* note 17, at 112.

some or all of the investigation function, examiners may then be viewed as vestigial, a duplicative cost with an uncertain benefit.

1.3 The Changing Dynamics of Chapter 11—The Rise of Shadow Bankruptcy

The ink was barely dry on chapter 11 when the bankruptcy system began to change in three ways that would challenge its governance and informational features.

First, a new cadre of private "distress professionals" cropped up to guide, counsel, and manage failing firms. In addition to large law firms that would develop international reputations in bankruptcy (e.g., Weil Gotshal, Kirkland & Ellis,[66] and Jones Day), the "turnaround manager" or "chief restructuring officer" (CRO) would increasingly replace or supplement the chief executive of the failing firm prior to bankruptcy. Reorganizational managers such as AlixParters[67] and Alvarez & Marsal[68] would bring expertise in restructuring, a set of skills and insights operational managers were unlikely to have. Moreover, unlike statutory trustees appointed pursuant to the Bankruptcy Code, reorganizational managers might be selected and installed by powerful creditors prior to bankruptcy, perhaps charge less than a trustee (who is generally paid a percentage of assets distributed[69]), and—of greatest concern—perhaps have loyalties not to the reorganizing company or its larger body of stakeholders, but instead to the creditors at whose behest they were hired.[70]

The turnaround manager's incentives become even more clear when one considers a second development, which is the (roughly) simultaneous rise of professional distress investors, who can become important participants in the

[66]Full disclosure: Lipson was an associate in the bankruptcy group at Kirkland & Ellis from 1992 to early 1995.

[67]According to its website, AlixPartners has "been retained as restructuring advisor and/or interim management in some of the largest Chapter 11 reorganizations in history, including General Growth Properties, General Motors, and Kodak, to name only a few." *See AlixPartners, The Idea that Started an Industry—The History of AlixPartners*, http://www.alixpartners.com/en/About/History.aspx (last visited Jan. 6, 2016). AlixPartners claims to have invented the role of CRO. *Id.* ("The firm . . . pioneered a series of innovative concepts and practices . . . including: The role of Chief Restructuring Officer (CRO) . . . .").

[68]According to its website, Alvarez & Marsal "is a leading global professional services firm that delivers performance improvement, turnaround management and business advisory services to organizations seeking to transform operations, catapult growth and accelerate results through decisive action." *About Alvarez & Marsal*, http://www.alvarezandmarsal.com/about-alvarez-marsal (last visited Dec. 18, 2014). The firm managed Lehman Brothers in its bankruptcy.

[69]*See* 11 U.S.C. § 326(a) (describing limits on compensation of bankruptcy trustees as a percentage of "all moneys disbursed or turned over" by the trustee to creditors or other stakeholders).

[70]*See generally* John Wm. Butler, Jr., et al., *Preserving State Corporate Governance Law in Chapter 11: Maximizing Value Through Traditional Fiduciaries*, 18 Am. Bankr. Inst. L. Rev. 337, 356 (2010) ("Employing turnaround professionals as CROs has become common in recent years. Often creditors insist that companies install third-party CROs in the midst of a dire financial situation."); A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 Minn. L. Rev. 875, 903 (2009).

reorganization process.[71] As with turnaround managers, distress investors are likely repeat players, and are often "activists" in the reorganization process.[72] They invest in troubled companies by lending to the firm prior to bankruptcy, purchasing defaulted claims against the company at a discount to face value, or both. As with reorganizational management, they view chapter 11 as a process in which to make money, not merely to salvage troubled companies. While their expertise and resources might enable them to help companies more effectively than the debtor's original, pre-bankruptcy lenders, they may also have incentives that run counter to those of the larger body of stakeholders of the debtor, in particular employees.

Third, and perhaps as a consequence of the first two, bankruptcy reorganization has become a faster process today than it was in the early 1980s. This is due chiefly to the development of "prepackaged" reorganization plans, and a growing emphasis on the sales of assets rather than "reorganization in place."[73] In a prepackaged bankruptcy, the debtor and major creditors negotiate a plan of reorganization before the case is commenced. Creditors commit to vote for the plan in a number and amount sufficient to satisfy the Bankruptcy Code's plan confirmation standards.[74] Based on this, the parties then expect the court will confirm the plan shortly after the case is commenced (thus the plan was "prepackaged" before case commencement). These cases tend to be much faster than traditional cases. In our sample, prepackaged cases lasted an average (median) of 176 (121) days.[75] Non-prepackaged plans, by contrast, were almost four times longer (lasting an average (median) of 564.2 (460) days in bankruptcy).[76]

Asset sales can also increase the speed of the process. Although chapter 11 was conventionally thought to promote reorganization "in place," it also provides for the sale of a corporate debtor's assets, in parts or as a whole, through Bankruptcy Code § 363.[77] These sales are increasingly common because, as Baird and Rasmussen explain, "[t]he ability to sell entire firms and

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[71]*See generally* Lipson, *Governance*, *supra* note 21 (discussing pre-bankruptcy activities of distress investors).

[72]Lipson, *Shadow Bankruptcy*, *supra* note 21, at 1644 ("Many distressed investors are activists, and activists cannot be wallflowers."); Harner, *supra* note 21 (describing the activities of distressed debt investors).

[73]*See* LoPucki & Doherty, *supra* note 22, at 30-31 (finding evidence of pressure to sell assets quickly). *See also* Baird & Rasmussen, *Chapter 11*, *supra* note 30, at 674; Baird & Rasmussen, *Control Rights*, *supra* note 30, at 958; Baird & Rasmussen, *End of Bankruptcy*, *supra* note 30, at 784-85. *See generally* Jacoby & Janger, *supra* note 22 (discussing view that chapter 11 requires speed because it is seen as a "melting ice cube").

[74]*See* 11 U.S.C. § 1126(b) (pre-bankruptcy voting rules); 11 U.S.C. §§ 1129(a)(7), (a)(8), (a)(10) (voting requirements for plan confirmation).

[75]n=202.

[76]n=432.

[77]11 U.S.C. § 363.

divisions eliminates the need for a collective forum in which the different players must come to an agreement about what should happen to the assets."[78]

Whatever the reason, the duration of large chapter 11 cases appears to be declining. In our data, a large case filed in 1991 was in chapter 11 for an average of 785 days; by 2009 (a year before our sample ends) such a case averaged 259 days. In the early years of chapter 11, participants worried that cases dragged on too long.[79] Speed has its virtues: it may stop the "ice cube" from "melting," as lawyers like to say. Yet, speed can also camouflage opportunism.[80] Now, observers worry that speed enables sophisticated distress investors to capture more "upside" reorganization value at the expense of widely-dispersed, small-dollar stakeholders, such as employees.[81]

One might wonder why creditors' committees have failed to address these problems. Harner and Marincic have studied creditors' committees, and found that they are often plagued by conflicts of interest.[82] "Key creditors," they note, "can use their committee membership to access information regarding the debtor's reorganization, obtain a seat at the plan negotiation table, and urge parties to pursue a reorganization that is beneficial to their own agendas."[83] They cite as one example *FiberMark*, a case in which disputes among distress investors on the committee paralyzed the reorganization process—and which led ultimately to the appointment of an examiner to explain (and to help resolve) these conflicts.[84]

These changes in the system—it is now more professionalized, profit-oriented, and faster than ever—have contributed to the ostensibly "shadow" character of reorganization: because the activities of distress investors are

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[78]Baird & Rasmussen, *End of Bankruptcy*, *supra* note 30, at 756.

[79]James J. White, *Harvey's Silence*, 69 AM. BANKR. L.J. 467, 474 (1995) ("[T]he largest and most palpable costs of Chapter 11 arise from delay. . . . Chapter 11—at least as practiced in large cases—appears to condone and even exaggerate delay and the attendant costs. For example, Eastern Airlines lost $600 million during the twenty-two months it lingered in Chapter 11. LTV continued in bankruptcy from July, 1986, to May, 1993, and during most of that time incurred losses. Countless other smaller and nameless Chapter 11's—as many as ninety percent—have this attribute; namely, they are businesses that must ultimately be liquidated, but it takes as long as eighteen months on average to accomplish liquidation. And during every one of those 550 days in bankruptcy, many, perhaps most, of these firms are experiencing losses and postponing the day when their assets can be allocated to better and more efficient purposes. The costs of delay are palpable and indisputable.").

[80]*See* Jacoby & Janger, *supra* note 22.

[81]John R. Graham, et al., *Human Capital Loss in Corporate Bankruptcy* (March 1, 2013), http://ssrn.com/abstract=2276753 or http://dx.doi.org/10.2139/ssrn.2276753 (last visited Dec. 10, 2014).

[82]Harner & Marincic, *supra* note 24, at 790 (finding that "at least one member of the creditors' committee held some interest or asserted some position that presented a potential conflict in thirty-five percent of the database cases with creditors' committees.").

[83]*Id.* at 753.

[84]*Id.* at 751-54, 751 n.5 (citing Report of Harvey R. Miller, as Examiner, at 4-5, 8, *FiberMark*, No. 04-10463 (Aug. 16, 2005)). *See also* Lipson, *Examiners I*, *supra* note 5, at 42 (discussing the *FiberMark* case).

largely private, it is difficult to know whether their activities hurt or help distressed firms and their larger body of stakeholders. It seems plausible that they could do either, although the logic of distress investing suggests that their gains will likely come at the expense of other, less sophisticated stakeholders. Examiners could reveal more about the real effects of these changes in the reorganization system—if they were used. That they are not bespeaks a larger turn toward "private" preferences in the reorganization process, discussed in the next sub-part.

1.4 Background Literature

In one sense, the rise of shadow bankruptcy marks the victory of one camp in an ongoing debate about the proper means and ends of bankruptcy policy—those with a preference for "private," as opposed to "public," ordering. Although the debate has not focused on examiners per se, they are necessarily part of it. Those who prefer private solutions ("contractarians") are likely more concerned about their costs, while those skeptical of free contract ("skeptics") are likely more sanguine about their benefits. Yet, the nature of bankruptcy examination and our findings about the actual use of examiners, suggest that public versus private is a false dichotomy: reorganization is a hybrid process, and will always require difficult alliances and compromises between "public" and "private" institutions.

Those with a preference for private ordering, such as Douglas Baird, Robert Rasmussen, and Thomas Jackson, tend to think that courts and Congress should give stakeholders—in particular financial creditors—maximum freedom to negotiate a debtor's fate, whether via reorganization or liquidation.[85] Under the hypothetical "creditors' bargain" posited by these commentators, courts should be neutral umpires in contests among stakeholders, with minimal public intrusion (presumably including examiners) into the negotiation process. This may be viewed as a "conservative" position in the sense that it tends to privilege the needs of capital over the interests of other stakeholders.[86] On this account, examiners are more likely to impede negotiations, adding cost and delay, but little benefit.

Skeptics are likely to worry that too much freedom of contract will lead

[85]Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. Legal Stud. 127, 128 (1986) ("In this paper I ask whether corporate reorganizations should exist at all."). *See also* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 Yale L.J. 857 (1982); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 Tex. L. Rev. 51, 53-54 (1992). Discussions of the different approaches are captured in, e.g., Susan Block-Leib, *The Logic and Limits of Contract Bankruptcy*, 2001 U. Ill. L. Rev. 503; Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. Rev. 75 (1995); Donald R. Korobkin, *The Role of Normative Theory in Bankruptcy Debates*, 82 Iowa L. Rev. 75 (1996).

[86]Jackson, *supra* note 32, at 32-33 (postulating that managers and employees "have no rights that need to be accounted for in [bankruptcy]").

to insider opportunism, including the shadow bankruptcy problem discussed above. Writers such as Lynn LoPucki, Elizabeth Warren, and Jay Westbrook, for example, worry that exuberance for private ordering may produce deadweight social costs in terms of excessive professional fees, lost going concern values, and doubts about the integrity of the system.[87] Congress' remedial goals for chapter 11—to preserve going concerns and jobs—have, on this account, been hijacked by preferences for a particular constituency: those who hold large, financial stakes.

To skeptics, examiners should play a greater role than they do, a check on the inmates who run the proverbial asylum. "Reading recent cases about examiners," Warren and Westbrook observed in 2005, "we were having trouble finding a standard by which to understand the analysis, so we cheated and looked at the relevant provisions of the statute. We came away thinking that the courts and the academics may have lost track of just what Congress said."[88]

A special case of this debate, with implications for the use of examiners that we discuss below, involves the question of venue.[89] Chapter 11 has loose venue rules, permitting a debtor to file its chapter 11 case in the bankruptcy court in any state in which it (or any member of its corporate group) has either a meaningful business presence or—more importantly—is incorporated.[90] The bankruptcy courts in the Southern District of New York and Delaware have come to dominate large chapter 11 case filings, the former because many large companies have activities in New York, the latter because many have one or more entities in the corporate group organized there.

Contractarians tend to see venue flexibility as just one more offering on the reorganizational menu.[91] Flexible venue rules maximize forum-selection options. If management and major creditors want the debtor's case in Delaware, and the debtor has a tenable connection to that state, who is to say that anyone would be better off if the debtor were forced to file somewhere else (e.g., near the headquarters and the bulk of employees), contractarians

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[87] *See, e.g.*, LoPucki, Failure, *supra* note 28; LoPucki & Doherty, *supra* note 22; Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Corporations*, 141 U. Pa. L. Rev. 669 (1993); Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 Harv. L. Rev. 1197, 1237-38 (2005); Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L.J. 499 (1999) [hereinafter Warren & Westbrook, *Business*]; Warren & Westbrook, *Success*, *supra* note 31.

[88] Elizabeth Warren & Jay L. Westbrook, *Examining the Examiners*, 24 Am. Bankr. Inst. J. 34 (May 2005).

[89] *Compare* LoPucki, Failure, *supra* note 28, *with* Ayotte & Skeel, *supra* note 28 (reviewing LoPucki, Failure, *supra* note 28).

[90] 28 U.S.C. § 1408(1) ("a case under title 11 may be commenced in the district . . . in which the domicile, . . . of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement . . .").

[91] *See* Skeel & Ayotte, *supra* note 28.

might ask? Skeptics, by contrast, would argue that the venue rules should change and would presumably support more aggressive judicial oversight across cases.[92] One mechanism by which Delaware courts could exert greater control over the reorganization process is through the use of bankruptcy examiners. Yet, perhaps not surprisingly, the data we present below shows Delaware distinctly resistant to their use.

Debates about chapter 11 often rest on deeper, but largely unexamined, differences about the merits of private versus public ordering in the distress context. The logic of the "creditors' bargain" depends heavily on private ordering.[93] Alan Schwartz is perhaps the best-known proponent of this view.[94] "Viewing bankruptcy through the lens of contract theory," he argued in a provocative 1998 paper, "reveals bankruptcy's anachronistic character: Bankruptcy is a government enterprise. The state runs the postal system and the bankruptcy system, and restricts competition with both by law. This Essay's central claim is captured in a variation on a trendy slogan: Privatize bankruptcy."[95] This does not necessarily mean eliminating bankruptcy, but instead promoting a much broader range of bankruptcy-related private ordering, and limiting the range of bankruptcy-related public commands (e.g., "thou shalt have an examiner"). On this view, total wealth would be maximized if capital is preserved for redeployment in other (profitable?) ventures.[96]

Skeptics, by contrast, worry about the larger social (and thus "public") effects of strong privatization.[97] Loss allocation—the effect of bankruptcy—inevitably has political consequences, so it is not surprising that politics (and

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[92]*See, e.g.*, LoPucki, Failure, *supra* note 28.

[93]Jackson, *supra* note 85. *See also* Baird, *supra* note 85, at 128 ("In this paper I ask whether corporate reorganizations should exist at all."); Rasmussen, *supra* note 85, at 53-54. Discussions of the different approaches are captured in, *e.g.*, Block-Lieb, *supra* note 78; Frost, *supra* note 85; Korobkin, *supra* note 85.

[94]*See, e.g.*, Schwartz, *supra* note 32.

[95]*Id.* at 1850-51. Lynn LoPucki has severely criticized Professor Schwartz's approach. *See* Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 Yale L.J. 317, 319 (1999) ("Schwartz's proof is defective. The model employs materially inconsistent assumptions and the proof reaches its goal only through miscalculations from those assumptions.").

[96]An interesting refinement of this appears in Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganization*, 113 Colum. L. Rev. 1, 5 (2013) ("Investors are free to place the critical assets of the same economic firm into whatever legal entities they want, and they frequently do.").

[97]Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 Wash. U. L.Q. 1031 (1994); Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 Nw. U. L. Rev. 919, 962 (1991) (bankruptcy law allocates losses "according to a set of principles, none of which is pre-eminent by definition."); Warren, *supra* note 31, at 354-56. Work focused specifically on employees includes Jean Braucher, *Bankruptcy Reorganization and Economic Development*, 23 Cap. U. L. Rev. 499, 517-18 (1994); Daniel Keating, *The Fruits of Labor*, 35 Ariz. L. Rev. 905, 907 (1993); Donald R. Korobkin, *Employee Interests in Bankruptcy*, 4 Am. Bankr. Inst. L. Rev. 5, 26-34 (1996).

thus public choices) inform the law that we have, and will have as long as Congress uses its power to enact bankruptcy laws. Elizabeth Warren (formerly a law professor; now a U.S. Senator), for example, has argued that bankruptcy policy necessarily embraces complex, "competing—and sometimes conflicting—values."[98] If legislative history is any indication, Congress designed chapter 11 to preserve going concerns and jobs, and believed that bankruptcy examiners would advance that goal.[99] Although practice has defied Congress' expectations, we show in Parts 3 and 4 both when examiners are likely to appear in a case and how their participation may add more value in both "private" and "public" respects than many believe.

1.5 Examining Reform

Given the changes in chapter 11 practice and ongoing debates about the proper goals of the system, it is not surprising that there is a movement toward reforming chapter 11. The most prominent of these efforts is the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 ("Commission").[100] The Commission makes three recommendations specific to examiners.

First, the Commission proposed replacing the position of "examiner," as such, with an "estate neutral."[101] Second, consistent with prior literature, the Commission recommended that the Bankruptcy Code be amended to eliminate the "mandatory" feature of the statute (i.e., that an examiner "shall" be appointed if the debtor has more than $5 million in qualifying unsecured debt).[102] Rather, appointment should be flexible, based on a "best interests" of creditors or "cause" test.[103] Third, the scope of a neutral's powers would presumptively be more limited than those of an examiner.[104] It appears that neutrals would be expected to report on certain problems in the reorganiza-

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[98]Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 777 (1987).

[99]*See supra* note 4.

[100]*See* ABI Reform Study, *supra* note 26.

[101]*Id.* at 32.

[102]*Id.* at 33 (citing and discussing Lipson, *Examiners I*, *supra* note 5).

[103]*Id.* at 32 (proposing that "estate neutral" be appointed "if (i) a trustee is not appointed and (ii)(a) the appointment is in the best interests of the estate, or (b) for cause"); *id.* at 37 ("[T]he Commission voted to eliminate the mandatory nature of the [examiner] appointment process and to permit the court to order the appointment of an estate neutral, upon request of a party in interest or the U.S. Trustee and after notice and a hearing, if such appointment would be in the best interests of the estate.").

[104]*Id.* at 32 ("an estate neutral should not . . . (i) propose a chapter 11 plan for the debtor; (ii) act as a mediator in any matter affecting the chapter 11 case, unless such action is the primary purpose of the individual's original appointment; (iii) initiate litigation on behalf of the debtor or the estate, unless such action is within the scope of the individual's original appointment and the individual was not previously engaged to investigate or examine matters relating to the litigation or the debtor's chapter 11 case; or (iv) except as provided in the principles for small and medium-sized enterprise cases, operate the debtor's business."). An examiner, by contrast, may do anything permitted in the case that the court forbids management from doing, including most of the foregoing. *See* 11 U.S.C. § 1106(b) (noting that examiners

tion process, but would not necessarily help to resolve them or—more important—report on the cause of the debtor's collapse in general.[105] According to the Commission an "estate neutral-like appointee [would be] the only party uniquely situated to provide an independent and neutral perspective in the case."[106]

Although the Commission recognized that there might be continued resistance to the use of an "estate neutral," as there has been to the use of examiners, it apparently believes that eliminating the mandatory element would induce parties to use a neutral more frequently. "The Commission . . . concluded that, with the elimination of the mandatory appointment provision, if the circumstances of the case warrant the appointment of an estate neutral, the potential benefit of the estate neutral to the estate would likely outweigh any additional costs to the estate."[107] The Commission thus "ultimately voted to provide more flexibility to the court and the parties in using estate neutrals . . . and to recommend use of estate neutrals in lieu of examiners."[108]

The Commission proposal has a refreshing realism about it, in the sense that it recognizes the reality that participants in chapter 11 often do not view examiner appointments as mandatory in large cases. It might be a good thing to bring the law (the Bankruptcy Code) in line with reality. There will also clearly be cases where an estate neutral of some sort—whether called an examiner or something else—could help to identify and resolve otherwise difficult problems.

Yet, the Commission recommendations suffer certain weaknesses. First, it is not clear why eliminating the "mandatory" feature of the statute would promote the use of a neutral (or examiner). If neutrals would be appointed on a "best interests" or "cause" basis, then one would have to ask whether the Commission has given stakeholders and courts any reason to see the value of neutrals or examiners that would satisfy these standards. Merely eliminating the word "shall" is not evidence of that value. As explained below, except in very large cases, parties appear to see their value only rarely.[109]

"shall perform . . . any other duties of the trustee that the court orders the debtor in possession not to perform").

[105]*See* ABI REFORM STUDY, *supra* note 26, at 36. On one hand, the Commission seems to recognize that a neutral could help resolve disputes among parties in the case. *Id.* ("[C]ertain matters in the case needed an independent assessment either because it was difficult for a debtor to investigate itself or because the debtor and stakeholders were too vested in their respective positions to identify areas of potential compromise."). On the other hand, as noted, a neutral presumptively would not mediate such disputes.

[106]*Id.* This seems obviously wrong. Both the judge and the U.S. trustee would, in most cases, also be in a similar position.

[107]*Id.* at 38.

[108]*Id.*

[109]To be sure, we do not object to eliminating the "mandatory" element of § 1104(c), as one of us has

Second, the Commission appears to downplay the concerns about agency cost that motivated the creation of the examiner position. A neutral might help to resolve disputes,[110] but is not necessarily likely to look routinely over the shoulders of either managers or investors, thus checking potentially problematic behavior. In theory, they could do so under the Commission proposal. But given the rise of shadow bankruptcy, it is unclear why those in control of the debtor would want a neutral to investigate their conduct. Because the bankruptcy court in Delaware—the busiest chapter 11 court in the nation—appears especially resistant to the use of examiners, there is little reason to think that judges in that court would embrace neutrals with greater enthusiasm than examiners.

Third, the Commission provides little guidance on when a neutral should be appointed, and what role they would serve.[111] Indeed, it appears that Congress explicitly rejected such amorphous standards when it chose to make examiner appointments mandatory based on the $5 million unsecured claim trigger.[112] Moreover, while the Commission claims to add "flexibility" to the role, a careful reading shows that its recommendations would actually narrow the range of possible functions a neutral possesses as compared to an examiner.[113]

Finally, the Commission did not take account of the role that examiners appear to play in the "success" of chapter 11 cases, however measured. This is unfortunate, as any proposed change in the reorganization process should consider whether the proposal will contribute to its success. We discuss "success" in bankruptcy examination in the next three parts of this paper.

2. SAMPLE CONSTRUCTION AND METHODOLOGY

To assess "success" in the use of examiners and their effect on case-level success, we construct a hand-collected dataset of 1,225 chapter 11 cases from 1991 to mid-2010. The dataset has two subsamples: (i) 661 "large" chapter 11 cases commenced from 1991 and concluded as of mid-2010;[114] and (ii) 564

proposed to replace its current $5 million trigger with a rebuttable presumption that an examiner would be in the "interests of creditors, equity security holders or the reorganization process." Lipson, *Examiners I*, *supra* note 5, at 77 (proposing an amendment to 11 U.S.C. § 1104(c)).

[110] We note that it appears that neutrals would have limited opportunities to do so. The Commission recommends that a neutral not "act as a mediator in any matter affecting the chapter 11 case, unless such action is the primary purpose of the individual's original appointment." *Id.* at 32.

[111] *Id.* at 32 (permitting appointment of a neutral "if (i) a trustee is not appointed and (ii)(a) the appointment is in the best interests of the estate, or (b) for cause.").

[112] *See* discussion *supra* notes 54-56.

[113] *See* discussion *supra* note 104.

[114] By "concluded" we mean the ending date indicated in the Bankruptcy Research Database. According to the protocols for this database, the end-date would be the date a plan was confirmed or the case was converted or dismissed. *See* Lynn M. LoPucki, *Protocols for the UCLA-LoPucki Bankruptcy Research Database*, at 33 (2013) [hereinafter *BRD Protocols*] (defining variable "XDaysIn").

"small" chapter 11 cases from 24 federal judicial districts commenced from 1991 and concluded as of the end of 2007.[115] A case is "large" if the debtor was a reporting company under the Securities Exchange Act of 1934 and had assets of at least $100 million in 1980 dollars (or $287 million in 2015 dollars);[116] otherwise, it is "small."

The availability (or not) of data required us to select cases in two different ways, depending on case size. Large case data comes initially from the Bankruptcy Research Database (BRD), supplemented by hand-collected information about examiners,[117] trustees, and attempts to convert or dismiss the case from publicly available dockets. Small-case data were entirely hand-collected. We selected the 564 small cases at random from 24 districts around the nation, replicating selection methods used by Warren et al.,[118] and discussed in greater detail in Appendix 2.

Using dockets and (where available) pleadings, we collected examiner-related information, as well as information on assets and liabilities, the presence of public bondholders, and plan confirmation, where available. Not surprisingly, small-case dockets present far less information than dockets from large cases. We nevertheless have sufficient data to offer observations and analyses about patterns in the use of examiners in cases across the chapter 11 spectrum that have important implications for those who use the system—

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[115]We start with cases from 1991 for two reasons. First, far fewer dockets are available electronically for cases prior to 1991. Second, the first (and only meaningful) circuit level published opinion on the use of examiners, *In re Revco,* was decided in 1990, holding (at least for the Sixth Circuit) that an examiner will be mandatory (if requested) when a debtor has more than $5 million in unsecured trade claims. *In re* Revco D.S., Inc., 898 F.2d 498, 500-01 (6th Cir. 1990) (holding that the Bankruptcy Code's examiner provision "plainly means that the bankruptcy court 'shall' order the appointment of an examiner when the total fixed, liquidated, unsecured debt exceeds $5 million, if the U.S. trustee requests one."). Since then, other circuit courts have mentioned examiners, but have not considered (in a published opinion) the circumstances under which they should be appointed. *See, e.g., In re* Smart World Technologies, LLC, 423 F.3d 166, 176 (2d Cir. 2005) (discussing the nature of examiners in considering whether creditors would have standing to negotiate settlement of derivative claims). Unlike large cases, we did not collect data on the "conclusion" date for small cases, because so few involved examiners.

[116]Basic data about such cases appear in the Bankruptcy Research Database (BRD) maintained by Professor Lynn LoPucki. *See* UCLA-LoPucki Bankruptcy Research Database, *supra* note 2. We supplement the data from the BRD with docket-level data on, e.g., requests for examiners, trustees, conversion/dismissal, and related matters.

[117]This produces two classes of cases: (i) those involving the sorts of examiners studied here (i.e., appointed under Bankruptcy Code § 1104), and (ii) so-called "fee examiners" sought and occasionally appointed to review the fees sought by professionals in large bankruptcy cases. Because fee examiners have little to do with the mandate of "real" examiners, those cases did not count as involving an examiner (unless a § 1104 examiner was also sought or appointed in that case). Both fee examiners and § 1104 examiners were sought in several cases, including *Adelphia Communications*, *Polaroid Corp.*, and *U.S. Airways* (2002).

[118]*See generally* Teresa A. Sullivan, Elizabeth Warren, & Jay Westbrook, Financial Difficulties of Small Businesses and Reasons for Their Failure 7 (1998).

debtors, creditors, judges, lawyers—and those who would reform it (Congress).

3. PATTERNS IN THE USE OF BANKRUPTCY EXAMINERS

To identify patterns in the use of examiners, we first describe and analyze the cases and companies in which they are involved, and the sample as a whole. In describing and analyzing the data, we split the discussion between large and small cases, for two reasons. First, it is generally recognized that the dynamics of a "large" and "small" case differ from one another.[119] This is supported by our findings about the use of examiners—they are nearly nine times more likely to be sought in a large case than a small one. Second, we have far more and richer information about large cases than small cases, in part because large cases involve companies that report their activities under the Securities Exchange Act of 1934.[120] We then compare the use of examiners and related governance mechanisms in large and small cases.[121]

3.1 Large Case Characteristics

The 661 large cases were from fifty-nine different judicial districts and were filed at an average rate of 33.1 cases per year. The peak years for case filings were 2000, 2001, 2002 and 2009, corresponding with the last two economic downturns, with 74 (11.2%), 93 (14.1%), 79 (12%) and 74 (11.2%) filings, respectively. The bulk of the cases (381 cases, 57.6%) were filed in the bankruptcy courts of one of the "big two" districts, Delaware (272 cases, 41%) and the Southern District of New York (SDNY) (109 cases, or 17%). Delaware had almost as many cases as all districts other than the SDNY combined.

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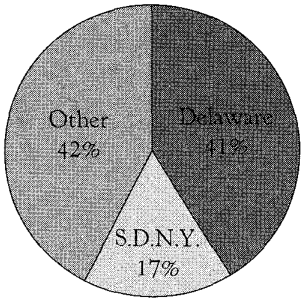
[119] *See, e.g.*, Warren & Westbrook, *Success*, *supra* note 31 (discussing different kinds of chapter 11 cases).

[120] For example, we were able to obtain asset information about 135 debtors (22.9%) in the small case subsample (n=589). For the large cases, by contrast, we have asset information for 421 debtors, or about 63.7% (n=661). Schedules of assets, liabilities, and financial affairs are required to be filed under 11 U.S.C § 521.

[121] *See infra* Appendix 3 for a summary of the statistical method.

Figure 3.1A Large Case Filings by Notable Districts



Debtors can commence a bankruptcy case voluntarily, or may be forced in by a statutorily defined number of creditors.[122] Most large cases were voluntary (637 cases, 96.4%). The median (mean) duration of large cases was 338 (441) days.[123] Two-hundred-two (202) cases (30.6%) used "quick" prepackaged plans, which had a median (mean) duration of 121 (176) days. A little less than half (ninety-four) prepackaged cases were filed in Delaware, which is to be expected given that practitioners frequently laud Delaware for its speed in processing chapter 11 cases.[124] As noted above, chapter 11 cases are resolving more rapidly today than when the Bankruptcy Code was first enacted in the early 1980s.

About ninety percent (593) of large chapter 11 cases resulted in a confirmed reorganization plan, although fifty-three debtors (8%) subsequently refiled. The checks on management discussed in Part 1 were rarely used in large chapter 11 cases. Chapter 11 trustees were appointed in twenty-four (3.6% of) large cases.[125] Motions to convert or dismiss were granted in sixty-five (9.8% of) large cases.[126] And, as noted, examiners were appointed in forty-three (6.5% of) large cases.[127] Examiners are thus more common than trustees, but less common than conversion or dismissal among large cases, a pattern different from the one we observe in small cases, discussed below.

Large debtors are, as the term implies, quite large in terms of assets and liabilities, with the top end skewing heavily. The sample had median (mean) scheduled assets of $542 million ($2.27 billion),[128] and median (mean) sched-

[122] 11 U.S.C. § 303.

[123] The longest was 2994 days. *In re* Molten Metal Technology, No. 97-21385 (Bankr. D. Mass. filed Dec. 3, 1997).

[124] *See* discussion *supra* Part 1.2.

[125] n=658.

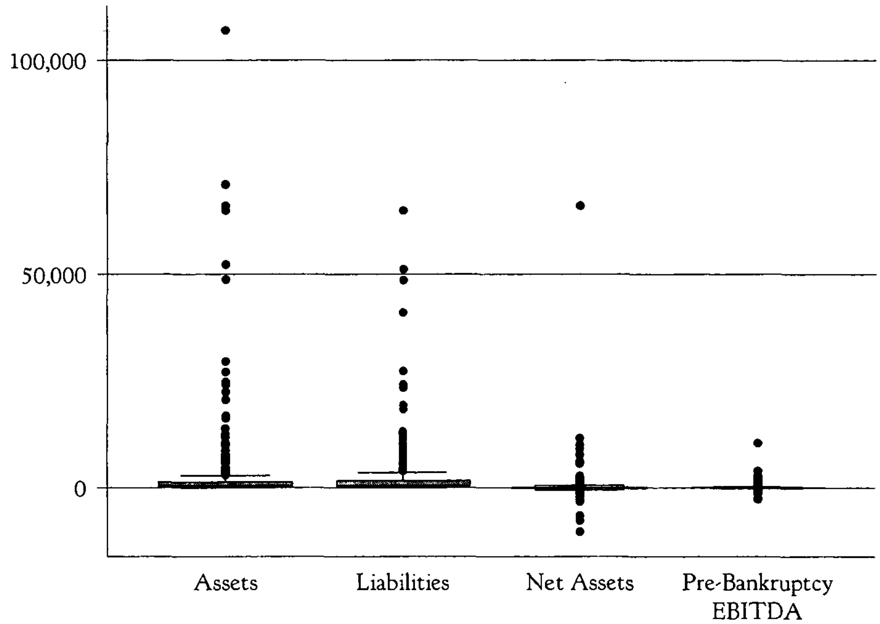
[126] n=658.

[127] Of these, three appointments were sua sponte, not on request of a party.

[128] n=421.

uled liabilities of $562.9 million ($2.3 billion).[129] If we net assets and liabilities, the median (mean) large debtor reported $13 ($354) million in assets, with a low end of -$10 billion[130] and a high end of $66 billion.[131] Pre-bankruptcy earnings before income, taxes, depreciation, and amortization (EBITDA) ranged from -$2.6 billion to $10.4 billion, with a median (mean) of $37 ($85) million.[132]

Figure 3.1B Financial Characteristics of Large Debtors ($000)



3.2 Examiner Requests (Motions) in Large Cases

An examiner should be required (if requested) in almost all large cases because these debtors almost always have qualifying unsecured debts greater than $5 million. Yet, requests for and appointments of examiners are rare, even in large cases. They were sought in ninety-three (14.1% of) large cases and appointed in forty-three (or 6.5%).[133] The vast majority of examiner

[129]n=322.

[130]*In re* Charter Communications, No. 09-11435 (Bankr. S.D.N.Y. March 27, 2009).

[131]n=319. The high value comes from *In re* Worldcom, Inc., No. 02-13533 (Bankr. S.D.N.Y. July 21, 2002).

[132]n=511.

[133]An examiner was appointed by the court sua sponte in three cases. *See In re* Baldwin Builders, No. 95-13057 (Bankr. S.D. Cal. July 18, 1995); *In re* El Paso Refinery, LP, No. 94-30051 (Bankr. W.D. Tex. Oct. 23, 1992); *In re* Bonneville Pac. Corp., No. 91-27701 (Bankr. D. Utah Dec. 5 1991).

motions were made in voluntary cases (89 cases, 95.7%). If an examiner motion was made, the bankruptcy was more likely to result in a confirmed plan of reorganization, with a 97.9% confirmation rate if an examiner motion was made versus an 89.7% confirmation rate for the subsample of large cases. In sixteen cases where an examiner was sought the bankruptcy used a prepackaged plan (17.2%). Cases where an examiner was requested were longer on average (570 with a request, 419 without), and had a greater number of docket entries on average (4245 with a request, 2086 without), consistent with a view that examiner cases may be more complex and/or contentious than the average case.[134]

Although examiners may be rare, lawyers and judges in large cases still want know when they are likely to be sought, independent of whether they will be appointed. Unfortunately, the rarity of examiners makes it difficult to offer a strong predictive model, although we identify factors that appear to matter, below:

3.2.1 *Economics*

Consistent with prior research, we find that the larger the pre-bankruptcy debtor by scheduled assets and liabilities, the more likely there will be a request for an examiner.[135] Cases with examiner requests were much larger by net assets[136] and pre-bankruptcy cash flow[137] than cases without such requests. If a debtor had more than $100 million in net scheduled assets, an examiner was 2.9 times more likely to be requested. This suggests that the larger the firm—and especially the larger the net (unencumbered) assets—the less costly an examination would appear to be to participants in the reorganization process, in relative terms. Interested parties may be more inclined to seek the (uncertain) benefits of an examination if there are surplus assets available.

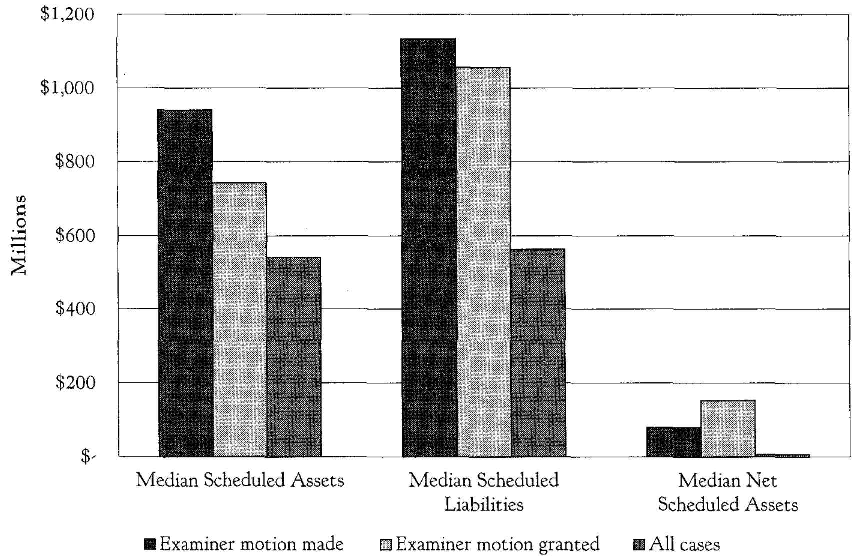
[134]*See* Lipson, *Examiners I*, *supra* note 5, at 32.

[135]*Id.* We recognize that the values indicated in pre-bankruptcy schedules may in hindsight prove to have been inaccurate. We nevertheless believe they are a valuable signal because practitioners are likely sophisticated enough to understand this, and to factor it in to whatever calculations they make when deciding whether to request an examiner.

[136]Median (mean) net assets in cases where an examiner motion was made were $79 million ($2.07 billion) as compared to -$300,000 ($12 million) in cases without (p=0.0003 using *ranksum*).

[137]Median (mean) pre-bankruptcy EBITDA (cash flow) in cases where an examiner motion was made were $52 ($201) million, as compared to $35 ($64) million in cases without (n=434). This was significant at p=0.0454 (*ranksum*).

Figure 3.2.1 Median Asset Values By Examiner Activity



3.2.2 *Venue*

One might think that courts with the largest cases would have the most examiner requests. The evidence is, however, mixed. There were more absolute examiner requests in Delaware than any other district (33, or 35.5% of requests) as compared to seventeen requests in SDNY (18.3%), the second largest venue by large-case filings and examiner requests. Yet, statistically, there is no meaningful relationship between filing a large case in Delaware and an examiner request.[138]

Because Delaware is viewed as the home of the prepackaged plan (about half of all such plans in our large-case sample, 94 of 202, were filed in Delaware), we also examine the relationship between this type of reorganization and examiner requests. While the presence of a prepackaged plan correlates significantly with requests for an examiner generally,[139] that is not the case in Delaware.[140] In other words, the chapter 11 cases likely to have the least judicial oversight are also unlikely to have an examiner independently assess the debtor's governance, its reasons for being in bankruptcy, or its pre-bankruptcy plan process.

3.2.3 *Governance Challenges*

Although venue does not correlate positively with examination requests,

[138]*Pearson's* x^2 =1.4347, p=0.231.
[139]*Pearson's* x^2 =9.0969, p=0.085.
[140]*Pearson's* x^2 =1.4347, p=0.231.

claims of pre-bankruptcy mismanagement do correlate to requests for them. Allegations of fraud or other misconduct,[141] and challenges to management's continued possession and control (e.g., through requests to appoint a chapter 11 trustee[142] or to convert or dismiss the case[143]), correlate significantly with requests for examiners in large cases.

3.2.4 *Case Complexity*

The complexity of the case itself, measured by the number of docket entries[144] and case duration,[145] also appear significant. This, too, is consistent with prior findings.[146] While statistically significant, its meaning is unclear: we cannot say whether an examiner request is the cause or the consequence of these observations. Given the disruption of an examination, either is possible. Nevertheless, if examiners are a response to informational failures, and case complexity is a proxy for information costs, then a request for an examiner is a plausible response to case complexity.[147]

3.2.5 *Movant Identity*

Because Congress created examiners to protect the "investing public" (in particular, bondholders), one might think that bondholders would most frequently seek an examiner.[148] While cases with public bondholders were more likely to involve an examiner than cases without public debt, bondholders themselves were not the party most likely to ask for one.[149] Examiners were requested in sixty-five out of 411 cases (15.8%) with public debt, com-

[141]*Pearson's* x^2 =6.0230, p=0.014. We use the "XTortCause" field from the BRD. The BRD Protocols indicate that this is likely over-inclusive. It codes for "bankruptcies caused principally by fraud claims (includ[ing] securities fraud claims) against the company," as well as other torts (e.g., products liability). *See BRD Protocols*, *supra* note 114, at 34.

[142]*Pearson's* x^2 =56.3380, p=0.000.

[143]*Pearson's* x^2 =4.5544, p=0.033.

[144]*Ranksum*, p=0.0000.

[145]*Ranksum*, p=0.0000.

[146]Lipson, *Examiners I*, *supra* note 5, at 41.

[147]As discussed below, we construct regression variables that show that *when* one requests an examiner, relative to case duration, relates significantly to judicial decisions to appoint one. We note that trustee requests may be a confounding variable because examiners and trustees often appear to be sought as alternative forms of relief in the same motion. *See* Lipson, *Examiners I*, *supra* note 5, at 42 (discussing requests for examiners as a "fallback" to trustee requests).

[148]*See* Lipson, *Examiners I*, *supra* note 5, at 2 (discussing legislative history).

[149]Of 411 large cases with public debt, examiners were sought in 65 (15.82% of) cases, as opposed to 346 public debt cases in which no examiner was sought. Examiners were nearly three times more likely to be appointed in cases with public debt, than cases without (29 appointments in public debt cases; 11 appointments in cases without public debt). Of course, debtors with public debt tended to be larger than average, suggesting that the mere presence of public debt alone is unlikely to contribute significantly to requests for or appointments of examiners, a point we develop further below. Median (mean) scheduled assets where the debtor had public debt were $736 million ($5.64 billion), compared to $366 million ($807 million) where the debtor did not have public debt. Median (mean) scheduled liabilities where the debtor had public debt were $784 million ($6.66 billion), compared to $370 million ($760 million) where the debtor did not have public debt. Median (mean) net scheduled assets where the debtor had public debt

pared to examiners requested in 14.1% of cases in the entire large-case subsample.[150] Perhaps this is because bondholders were not the party most likely to ask for an examiner.[151] Rather, individual creditors who were not bondholders were far more likely to file or support an examiner motion, and did so in 39 cases (41.9%).

3.2.6 *Regression Model—Examiner Motions*

Using the foregoing, we construct a regression model to predict when an examiner will be sought. Consistent with prior research, factors such as a debtor's pre-bankruptcy size and problems of governance seem to matter the most, although neither is especially illuminating. Specifically, we find that net positive assets and the request for a trustee most strongly predict that an examiner may be sought.[152]

Yet, as shown in Table 1.1, neither is dispositive because examiners are not sought in many very large cases.[153] Moreover, lore among lawyers suggests that an examiner should be sought in the alternative to a trustee, and so the requests will be conjoined. While either could indicate trouble in governing the reorganization process, the request for the trustee could be a red herring, bait for the real goal (an examiner)—or vice versa. Thus, while we take comfort in the fact that the data support both intuition and prior research, we cannot say with great confidence exactly which (and only which) of these factors will lead a party to request an examiner.

3.3 Regression Model—Examiner Appointments in Large Cases

Ultimately, system participants and observers are more concerned with whether an examiner will be appointed than whether one will be sought. Using the foregoing factors, we find that two dominate examiner appointments in large cases: (1) motion timing and (2) venue.[154] The sooner one

were $500,000 ($136 million), compared to $20 million ($128 million) where the debtor did not have public debt.

[150]This was statistically significant. *Pearson's* x^2 =3.5704, p=0.059.

[151]Individual investors were coded as such if, from the docket or the pleadings, it appeared the movant had purchased securities (equity or debt) of the debtor or claimed to be a plaintiff in securities fraud litigation involving the debtor. Individual investors filed or supported an examiner motion in eighteen cases (17.6%).

[152]Table 1.1 shows that net assets and the request for a trustee meaningfully predict when an examiner will be sought. Other factors—in particular the presence of fraud or public bondholders—do not. *See also* Lipson, *Examiners I*, *supra* note 5, at 33 (making similar findings with preliminary data).

[153]Although an examiner was sought in *Worldcom*, the largest case by scheduled assets in our sample ($107 billion), an examiner was not sought in the next two largest, *CIT Group*, which listed $71.2 billion, or *Conseco*, which listed $52.29 billion.

[154]Factors that were identified as significant according to our threshold determination ($p<0.05$) using a Wilcoxon rank-sum test or Pearson's chi-squared test were included in a logistic regression for both examiner motions and grants of examiner motions. For simplicity and to address multicollinearity, we

requests an examiner—and doing so in a case in a venue *other than* Delaware—the more likely the request will succeed.

3.3.1 *What is—and is Not—in the Model*

The first thing to notice about our regression model is what it lacks: None of the factors Congress identified as salient to a bankruptcy examination correlate to examiner appointments.[155] Factors such as pre-bankruptcy fraud[156] and public debt[157] bear little relationship to whether an examiner will be appointed. Neither governance nor information flow—Congress' concerns in creating bankruptcy examinations—appear to matter.[158]

In this sense, we can say that Congress' articulated aspirations for bankruptcy examinations are a failure. With the exception of notable outlier cases such as *Enron* and (possibly) *Worldcom* and *Lehman Brothers*, examiners are not "automatically" appointed to ferret out and report on the mal- or misfeasance that may have contributed to the debtor's distress.[159] Rather, like comedy and real estate, the factors that matter to the use of examiners in large cases will be timing and location. The earlier in the case an examiner was sought, the more likely it was to be granted; and an examiner appointment is about three times less likely to occur in a case in Delaware.[160]

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omitted redundant financial variables. Scheduled assets, scheduled liabilities, and net scheduled assets all relate to the size of the debtor. We deemed it sufficient to include net scheduled assets instead of all three measures.

[155] *See infra* Table 1.2.

[156] *Pearson's* x^2 =0.6397, p=0.424 (n=93).

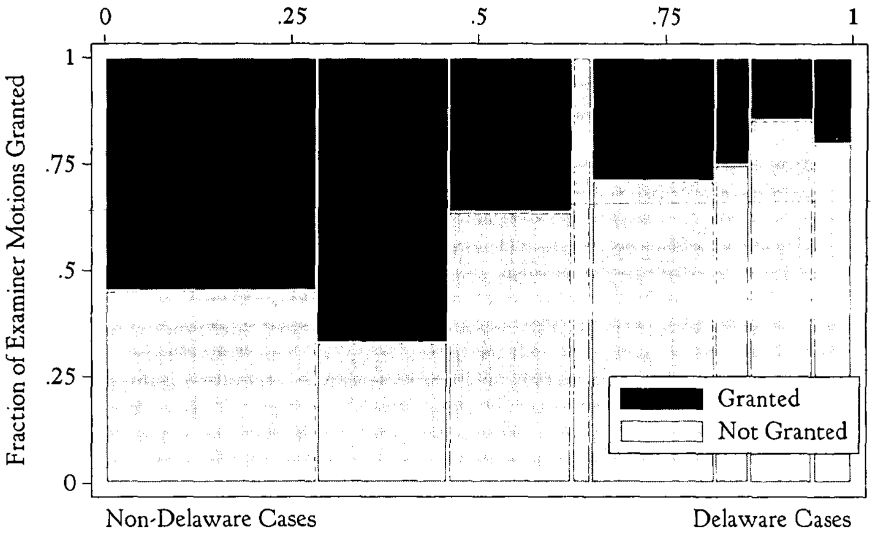
[157] *Pearson's* x^2 =0.0001, p=0.991 (n=89).

[158] Nor does the size of the debtor matter; while movants may care about the presence of net assets when deciding whether to ask a court to appoint an examiner, courts do not, as there appears to be no relationship between the amount of net assets and the appointment of an examiner. We note that, in this regard, the distinction between appointment on motion and appointment sua sponte matters. When examiners are appointed on motion, we find no statistically significant relationship between net assets and examiner appointments. *Ranksum*, p=0.6474. Yet, if we add the three cases in which examiners were appointed sua sponte, we find net assets do correspond significantly with examiner appointments. *Wilcoxon ranksum*, p=0.0234. Given the small sample size, and outlying nature of the values—these are unusually large cases—we are not sure what to make of this statistic, so do not emphasize it.

[159] *See* discussion *supra* note 10.

[160] *See infra* Table 1.3. We also perform a probit regression, which produces substantially the same results. Note that we test separately for New York and Delaware, as they are the chief venues for large cases.

Figure 3.3.1 Relative Effect of Timing and Venue on Examiner Appointments in Large Cases



This shows the relative likelihood of success in motions to appoint an examiner as functions of the combined effects of timing and venue. The motion filed early in a case in a court outside Delaware is about 40% more likely to be granted than one made later and in Delaware.

3.3.2 *Timing*

Consider first motion timing. We find an examiner motion was made an average of 174.8 days into a case,[161] and an examiner motion was ruled on by the court an average of 76.5 days from when the motion was made.[162] Comparing the timing of the motion to the length of the bankruptcy case (the end point being confirmation or conversion/dismissal), examiner motions that were made faster were more likely to be granted. This was statistically significant in our regression model.[163] Motions that were granted were made an average of 28.2% of the way through the case.[164] Motions that were not granted were made an average of 40.4% through the case.[165]

Timing likely matters for two, related reasons. First, asking for an examiner sooner in a case may appear less strategic than making the same request later, because (most likely) the longer the case lasts the more information will have come out about the debtor, thus reducing the need for an examiner.

[161] n=86.
[162] n=41.
[163] p=0.048.
[164] n=35.
[165] n=50.

The court in *In re Residential Capital,* for example, granted a motion to appoint an examiner in part because it reasoned that "the motion was filed early."[166]

Concerns about strategic behavior are understandable. We found evidence that courts actually denied examiner requests in only sixteen cases (17.8%). What happens to motions that are neither denied nor granted? In sixteen cases, the examiner motion was mooted by subsequent events (17.8% of requests), such as confirmation of a plan (fourteen cases), or the appointment of a chapter 11 trustee (two cases). In sixteen cases (17.8% of requests), the examiner motion was withdrawn. While we do not know why a given movant would withdraw an examiner request, absent some major change in the information available to the movant, withdrawal tends to suggest that perhaps the motion was originally filed for strategic, not information-seeking, reasons.[167]

Second, examiner requests made closer to the commencement of a chapter 11 case may also indicate that they were motivated by a more plausible need for information about the debtor. The passage of time seems likely to result in the production of more information, from whatever sources. Moreover, relationships among the parties—e.g., a creditors' committee and the debtor in possession—may have developed to the point where there are reliable, informal ways to produce information. We find anecdotal support for this in the fact that examiner motions in "freefall" cases were made within days of commencement. In *Worldcom*, for example, the examiner was sought and appointed the first day of the case.[168] These cases were commenced with virtually no planning, and so the need for an orderly approach to telling the story of these failures may have been manifest at the outset.

Worries about strategic requests in turn bespeak equally legitimate concerns about examiner costs. A prior study has shown that examiner costs can range from the hundreds of millions of dollars (as in *Enron*) to very little, depending on the nature and scope of the examination.[169] A request that is seen as strategic is doubly offensive. Not only does the motion itself gum up the process, but if an examiner is appointed without good reason, its cost will,

[166] *In re* Residential Capital, LLC, 474 B.R. 112 (Bankr. S.D.N.Y. 2012).

[167] *See* Lipson, *Examiners I*, *supra* note 5, at 16 (discussing strategic use of examiner motions).

[168] *In re* WorldCom, Inc., Case No. 02-13533, Order Granting the Motion of the United States Trustee for the Appointment of an Examiner (Bankr. S.D.N.Y. July 22, 2002). Interestingly, in *Lehman Brothers*—the epitome of "freefall" cases—the examiner was not appointed until January 2009, nearly four months after the case was commenced. *Compare* Voluntary Petition (Chapter 11), Docket No. 1, Lehman Bros. Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. Sept. 15, 2008), *with* Order Approving Appointment of Examiner, Docket No. 2583, Lehman Bros. Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. Jan. 20, 2009). This may be because the early days of the case were consumed with efforts to sell assets in order to raise cash. *See* Jacoby & Janger, *supra* note 22, at 891-92 (discussing speed of sales in *Lehman Brothers*).

[169] *See* Lipson, *Examiners I*, *supra* note 5, at 31.

as explained above, go straight to the bottom line of all unsecured creditors. Thus, early requests for examiners would seem more consonant with legitimate goals of improving governance and transparency at relatively lower cost. The later the request, by contrast, the more likely the values invert, so that questions about governance and information flow will likely have been addressed in other ways, and yet the cost of an examination may not decline. Timing may be a plausible proxy for sound decision-making about the appointment of examiners.

3.3.3 *Location—Anywhere but Delaware*

The same cannot be said for venue. Although Delaware had more examiner motions than any other district (33), it appointed only eight examiners (24.2% of requests in Delaware). The regression model shows that an examiner is about 62% *less* likely to be appointed in Delaware than any other district. Specifically, an examiner appointment is about three times less likely to be present in a case in Delaware as opposed to another jurisdiction (9% of large cases filed outside of Delaware, 2.94% of large cases filed in Delaware). While an examiner motion is also unlikely to be granted in New York, if we analyze them separately, we find that the relationship between examiner appointments and venue in New York is not statistically significant. As indicated in Table 1.2, Delaware venue correlates significantly and negatively with examiner appointments.[170]

The reasons for Delaware's reluctance to appoint an examiner are not difficult to surmise: the judges there may have little confidence that an examiner would add much value to a process run largely by lawyers and other distress professionals. This may support the view of those who prefer private ordering, who believe that the system runs reasonably well and does not need the intrusion of examiners. Or, it may support the concerns of skeptics that the Delaware judiciary has been captured by the bar and distress professionals who fear external scrutiny. In any case, it is clear that Delaware judges do not want to be told that they "shall" do something—appoint an examiner—if they believe doing so has no value.[171]

Given preliminary evidence (below), that examiners correlate to better outcomes along both private and public metrics, Delaware's strong resistance to appointing them is systemically problematic, because it deprives us of data about their actual effect that would enhance long-term decision-making about their use. Delaware hosts many of the largest chapter 11 reorganizations in

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[170] $p=0.012$.

[171] *In re* S.A. Telecomms., Inc., Nos. 97-2395 (PJW) through 97-2401 (PJW) (Bankr. D. Del. Mar. 27, 1998) ("I'm going to point out that this Court has for years consistently viewed [§ 1104(c)(2)] as not being a mandatory provision . . . . My view doesn't turn on the word 'shall' and I've ruled a number of times to this effect, Judge Balick has, and I think I'm not going to change this Court's view of that section.").

the nation (41% of large cases in our sample). If the Delaware bench is not captured by the bar and bankruptcy professionals, one might think that more limited examinations, controlled in scope to limit cost, might be a way to determine their potential value, and to learn more about the cases in Delaware. Indeed, Delaware invented a related and experimental technique in the use of "fee examiners," whose task is to review and (presumably) challenge (excessive) fees requested by estate professionals.[172] Ironically, unlike the examiners we consider, the Bankruptcy Code does not explicitly provide for the "fee examiners" Delaware uses. Thus, fee examiners are arguably *ultra vires,* although no sane professional in Delaware is likely to make that argument.[173] Nevertheless, the takeaway point is simple: Delaware courts could alleviate concerns about the integrity of their process by using examiners more frequently. That they have not bespeaks either evidence of capture (we hope not) or that judges there have not yet fully internalized examiners' potential benefits (our preferred explanation). We develop both points more fully in Parts 4 and 5.

3.4 Characteristics of Small Cases

Before doing so, we consider the pattern in the use of examiners in "small" cases (those without both public securities and assets exceeding $100 million in 1980 dollars). While "small" cases are less notorious than large ones, they are in fact the bulk of all chapter 11 filings.[174] Examiners may be appointed in any chapter 11 case where a court finds the appointment to be in the "interests" of creditors.[175] Thus, while examiners may (in theory) be mandatory (if sought) in large cases, they could be used in "small" chapter 11 cases, too, if parties and courts thought they had value. In order to more fully assess the pattern in the use of examiners, we also gathered data on 564 small cases from 24 different judicial districts commenced from 1991 to 2007.

Following Warren and Westbrook, we drew small cases based on the venue of filing rather than by debtor size, as is the case with the large-case subsample.[176] Thus, although Delaware and the SDNY dominate the large case subsample, they represent only small fractions of the small cases: twenty-six cases (4.6%) are from Delaware, and 19 (3.4%) from the SDNY. The jurisdiction with the most small cases was the Western District of Washing-

[172] *See* Lipson, *Examiners I*, *supra* note 5, at 2.

[173] *See* Lois R. Lupica & Nancy B. Rapoport, *Best Practices for Working with Fee Examiners*, Am. Bankr. Inst. J., June 2013, at 20 (2013).

[174] Warren & Westbrook, *Businesses*, *supra* note 87 (reporting data from five-year longitudinal study of 23 bankruptcy districts in the 1990s).

[175] 11 U.S.C. § 1104(c)(1).

[176] *See generally* Sullivan, *supra* note 118, at 7. Cases in our sample were filed at an average rate of 34.7 per year. The peak years for case filings were 2003 and 2007, with 43 (7.6%) and 47 (8.3%) filings, respectively.

ton (39 cases, 6.9%). More information about how we selected small cases appears in Appendix 2.

As mentioned above, the vast majority of small debtors have fewer than $100 million in assets. They had median (mean) scheduled assets of $1.0 million ($14.9 million),[177] and median (mean) scheduled liabilities of $1.9 million ($16.8 million).[178] Small debtors were likely to have net negative assets, with a mean (median) of -$1.9 million (-$320,000).

Reorganization plans were confirmed in 303 small cases (53.7%). Chapter 11 trustees were appointed in twelve cases (2%). Motions to convert or dismiss were granted in 287 cases (50.9%).[179] As noted, while examiners are rare in both kinds of case, they were almost nine times more likely in large cases (43 or 6.5%) than in small ones (5 or 0.9%).[180]

3.5 Comparing Large and Small Cases

The data show a distinct pattern as between large and small chapter 11 cases, which likely affects not only the use of examiners, but also the other governance choices under chapter 11. While almost 90% of large cases confirmed reorganization plans, barely half of small cases did. Although rare in all cases, trustee motions and appointments were also more likely in large cases compared to small cases. Trustees were nearly twice as likely to be sought in large cases (7.6% of small cases; 12.6% of large cases), and were over 1.7 times more likely to be appointed in large cases (2.1% of small cases; 3.7% of large cases).

The action in small cases is in motions to convert or dismiss the case. A motion for conversion or dismissal was more than twice as likely to be made in a small case (64.5% of small cases; 23.6% of large cases), and small cases were more than five times more likely to be converted or dismissed (50.9% of small cases; 9.9% of large cases). Motions to convert or dismiss are far more likely to succeed in small cases than in large: 71% of conversion/dismissal motions (259) succeeded in small cases, as compared to 42% (65) in large cases.

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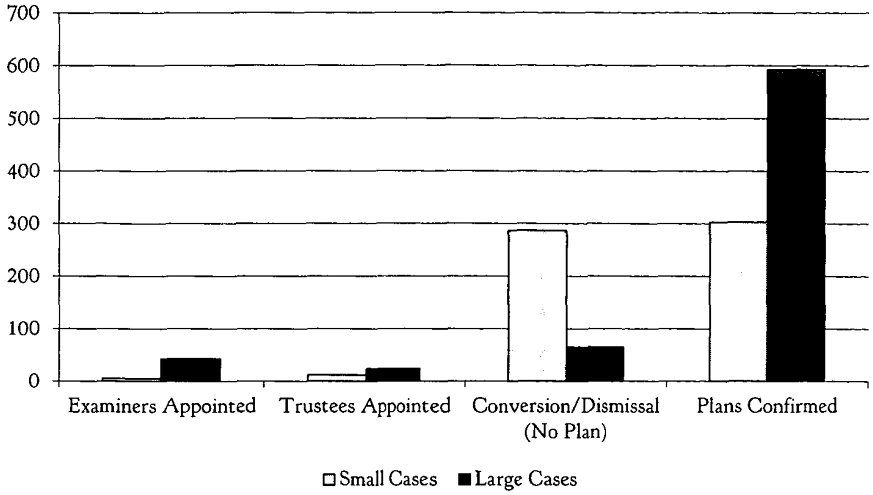
[177] n=130.

[178] n=130.

[179] Obviously, some cases in which a plan was confirmed were also dismissed or converted.

[180] Consistent with large cases, examiner motions were more commonly mooted or withdrawn rather than explicitly denied. In two cases the examiner motion was explicitly denied, in two cases was withdrawn, and in three cases was mooted by a subsequent event (e.g. confirmation of a plan, appointment of a trustee).

Figure 3.5.1 All Outcomes by Case Size



This shows that conversion or dismissal is a far more common outcome in small cases than in large ones, and that examiners are slightly more common in large cases than are trustees, an unpopular choice regardless of case size. Plan confirmation is the most likely outcome in all cases, although much more likely in a large case.

While it is not possible to know all of the reasons for the variation, net asset values likely matter. Small cases are materially constrained in this way, reporting negative mean and median assets (-$1.9 million and -$320,000, respectively).[181] In large cases, by contrast, net assets were positive at both the mean ($354 million) and median ($13.1 million).[182] Among other things, this suggests that the average large company in chapter 11 probably has unencumbered assets, which would give it financing capacity and perhaps sources of liquidity unavailable to small debtors. The absence of net-positive assets (and thus, potentially, liquidity) doubtless reduces patience with the threat of added process. If the debtor cannot make a go of it early, then it may be better to flush the whole affair promptly.

This suggests that Congress got at least part of the governance story right when it enacted chapter 11: creditors do not want trustees, and courts do not want to appoint them. Instead, in smaller cases, creditors either want to go long—confirm a plan—or cut their losses quickly, by converting or dismissing the case. In large cases, plan confirmation and bankruptcy examination are more

[181]n=130.
[182]n=319.

common, suggesting that net assets increase the tolerance (and perhaps demand) for process.

4. EXAMINING SUCCESS—THE RELATIONSHIP BETWEEN EXAMINERS AND COMMON MEASURES OF SUCCESS

While we have a good sense when examiners will be sought and the factors that appear to matter to their appointments in large cases, we still have a more basic question to consider: So what? Who cares whether examiners are sought or appointed, especially if they are so rare? Haven't bankruptcy system participants voted with their feet, in declining to request (or, in the case of judges, to approve) examiners?

One answer—perhaps the most important answer—turns on the second sense in which we study success and bankruptcy examinations: That is, whether examiners contribute to the success of specific chapter 11 cases, or the chapter 11 process as a whole?

4.1 Defining Success

This, of course, begs the question what constitutes "success" in chapter 11? This is a question many have pondered and none has answered definitively.[183] As Warren and Westbrook observe:

> Even if a company does not soon return to the bankruptcy court, the definition of 'success' in this context is subject to considerable debate. How long does a company have to exist post-reorganization before it is deemed a 'success'? Must it be alive for ten years? Five years? Two years? What if it shrinks in size? Must it be profitable all or part of that time to be a success? What if it is purchased in year three? These and many similar questions make it difficult to pinpoint what constitutes success following confirmation.[184]

And, of course, one could consider a case "successful" in relative terms if the debtor is liquidated promptly rather than dragging out an ultimately fruitless reorganization effort.

A recent study by LoPucki and Doherty defines "success" as business

[183] *Compare, e.g.*, Bradley & Rosenzweig, *supra* note 31, at 1078-79 (1992) ("Chapter 11 should be repealed, abolishing court-supervised corporate reorganizations and, in effect, precluding residual claimants from participating in any reorganization of the firm."), *with* Warren, *supra* note 31 ("[T]he [Bankruptcy] Code carries out a deliberate distributional policy in favor of all those whom a business failure would have hurt. The choice to make bankruptcy 'rehabilitative' represents a desire to protect these parties along with the debtor and creditors who are more directly affected."), *and* Warren & Westbrook, *Success*, *supra* note 31, at 612-40 (describing the value-creating aspects of chapter 11).

[184] Warren & Westbrook, *Success*, *supra* note 31, at 611.

"survival" after bankruptcy.[185] In their model, a debtor's survival is a Coasean concept, determined by "the relationships among the company's employees and the relationships of those employees with outsiders and firm assets."[186] Even if a debtor, or its assets, are sold in reorganization, "if the structure of those relationships survives and remains distinguishable from its owner, we regard the company as surviving."[187] They use as an example the reorganization of General Motors, which technically involved a sale of the operating company, but nevertheless "survived" as such, as compared to retailers that may sell off individual locations, where the local employees may continue to work in the same business, but under different ownership and a different name.[188] The former "survived"; the latter did not.

Their approach to success accepts Congress' stated remedial goals in chapter 11: to preserve jobs and going concerns.[189] Although they recognize that survival tends to undercut a contractarian approach to reorganization, they think it is nevertheless a more accurate expression of Congressional intent and a better overall predictor of success because it accounts for the interests of all of a firm's stakeholders, and not merely those holding large financial contracts.[190] Overall, they find that of the 634 large cases they observed from the Bankruptcy Research Database, 70% survived.[191] This approach to success thus tends to support "public" measures of success, in the sense that the reference point is the public policy behind the law.

Examiners are insufficiently frequent in large chapter 11 cases to influence survival in the LoPucki-Doherty model. We nevertheless find evidence from our data (combined with theirs) that bankruptcy examiners appear to correlate with "success" in both "private" and "public" ways. We differentiate the two this way because it reflects the two dominant preferences in debates over reorganization policy, namely private versus public, discussed in Part 1. We recognize, however, that the distinction is artificial and, indeed, runs counter to our intuitions about the interaction between public and private in reorganization. Nevertheless, differentiating success this way focuses the analysis, and maps well onto what we perceive to be significant ambiva-

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[185] LoPucki & Doherty, *Survival*, *supra* note 31, at 4 ("[W]e have chosen to predict and explain 'success' defined as business survival.").

[186] *Id.* at 10 (citing Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy*, 56 STAN. L. REV. 645, 671 (2003) ("Baird and Rasmussen's view of the bankrupt firm as merely an asset-owning entity misses the firm's essence. Coase's view of the bankrupt firm as a relationship among people captures it.")).

[187] *Id.* at 10.

[188] *Id.*

[189] *Id.* at 3.

[190] *Id.* ("We believe that if all stakeholders' interests are taken into account, survival is virtually always economically preferable to liquidation whenever survival is achievable.").

[191] *Id.* at 11 tbl.2.

lence about the public/private nature of reorganization in general, and the use of examiners in particular. The data bear this out.

4.2 "Private" Success

One way to measure success is in terms of financial wealth, akin to the "creditors' bargain" model noted in Part 1. To assess examiners' effect on this kind of success, we look at three post-reorganization economic performance metrics: (1) bond price changes; (2) net income; and (3) change in employee numbers. We consider these outcomes in large cases from four different perspectives: (1) whether an examiner was appointed; (2) whether a trustee was appointed; (3) whether the case was converted or dismissed; and (4) whether none of the foregoing happened, and the case proceeded to a confirmed reorganization plan, generally considered a sign of success. We use these states of cases because they describe the four major outcomes against which we can assess the success (or failure) of examiner cases.

A word of caution is in order. In the same way that consensus about defining success is difficult, we worry that it would be easy to over-read available data on the relationship between examiners and case outcomes. Despite evidence that bond prices, net income and headcounts are all better in examiner cases, we remain skeptical. How could something as seemingly tangential as an examiner "cause" a case to succeed? Debtor size or net assets may be stronger predictors of success, which would suggest that firms that already are more "successful" are more likely to succeed in chapter 11. Moreover, there are insufficient observations to create a regression model. Thus, while we have data sufficient to show plausibly that examiners correlate with better outcomes, we do not have sufficient data to show "causation." This is not for want of trying, but instead precisely because examiners are so rare.

4.2.1 *Bond Prices*

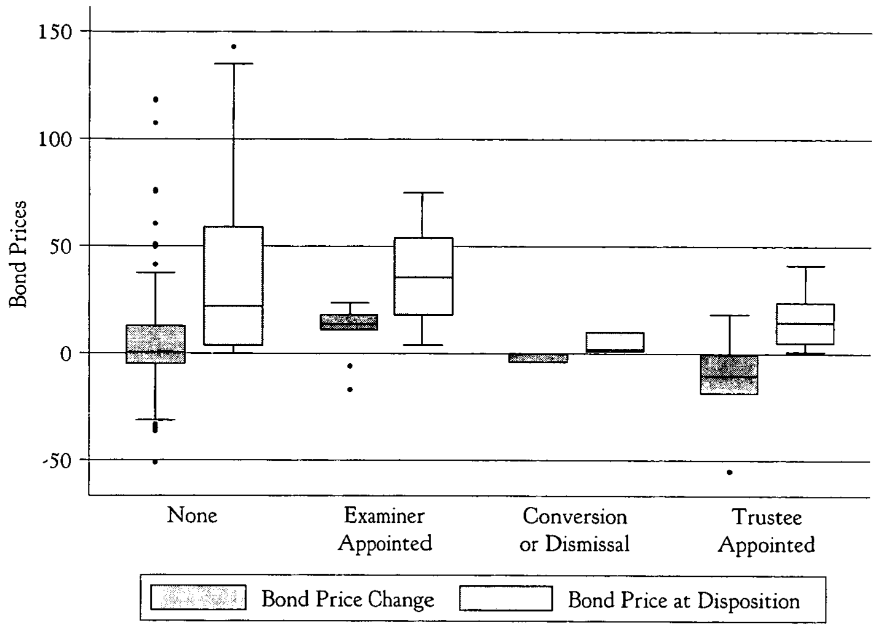
Private distress investors will often invest in a chapter 11 reorganization by purchasing bonds issued before bankruptcy by the debtor. For purposes of measuring "private" success, bond prices would seem to be an especially valuable metric, because they are real-time information about market responses to the debtor's reorganization. In general, bond prices will rise if the market believes the reorganization will increase payouts on the bonds; otherwise it is declining.

Bond price movement data are limited by virtue of the small number of examiner cases. Thus, only one observation is statistically significant, and then offers highly indirect evidence: large cases that convert or dismiss will suffer significant declines in bond prices (no surprise).[192] No other test of

[192] *Ranksum* $p=0.0414$ (n=126).

bond price data against these events is sufficiently robust to tell us much about their effect on case outcomes. Yet, bond prices are an average of 10.5% higher for examiner cases, as compared to 6.6% higher for all large cases in the sample[193] (we have no bond price data for small cases). Thus, if we relax assumptions of strict statistical significance, and look instead at the pattern, it would appear that bond prices fare better when an examiner is appointed than in all other states of affairs.

Figure 4.2.1 Bond Prices and Examiner Cases



This shows that bond prices—in relative and absolute terms—appear better when an examiner is appointed than in any other state of a case.

Does this necessarily mean examiner cases are more successful than others? The answer has to be equivocal, both because of the small sample size and because, as one bankruptcy judge on the SDNY bench told us, distress investors may seek an examiner to provoke small movements in the bond market.[194] When asked why one would lead to the other, this judge surmised that it was due to the fact that the hearing itself may produce valuation or similar

[193]As noted, given the number of examiners appointed in these cases (9 of 126), it is not surprising that we find no statistical significance (p=0.1284).

[194]Telephone Interview with J-2 (Oct. 10, 2007).

information of interest to investors.[195] If true, private investors would seem to think that they would benefit from an examiner request even if they may be reluctant to pay for one themselves.

This, however, is puzzling: If distress investors believe that requesting an examiner will produce information that can move the bond market, and they are becoming more common features of large cases, why is the number of examiner requests not increasing? As noted above, examiner requests are rare, and appear to have declined in large cases over time, more or less commensurate with the rise of professional distress investing.

The answer may lie in the "mandatory" language of the statute: distress investors may want information that would come out in a hearing on a motion to appoint an examiner, but only if they cannot get that information elsewhere. Because they understand that the statute's use of the term "shall" creates the possibility that a court will grant the motion, they worry that they would get what they asked for—an examiner. But, they do not want an examination, assuming (perhaps incorrectly) that an examination is not cost-justified. Moreover, in some cases they may worry that the examiner's investigation will turn to them. If our data on bond prices are any indication, then perhaps they are mistaken: an examiner appointment may actually produce greater recoveries, and so perhaps they should seek examiners more frequently.

4.2.2 *Post-Bankruptcy Net Income*

Post-bankruptcy net income presents better direct evidence of the relationship between an examination and "success" outcomes. Unlike an examiner's effect on bond prices, which is positive but not statistically significant, cases in which an examiner was appointed were positive and statistically significant.[196] Companies with examiners emerged with mean net income of about $5.2 billion, as compared to an average of $371 million for companies without. Yet, here, too, we counsel caution: Only 14 of the 216 companies for which data were available had examiners.

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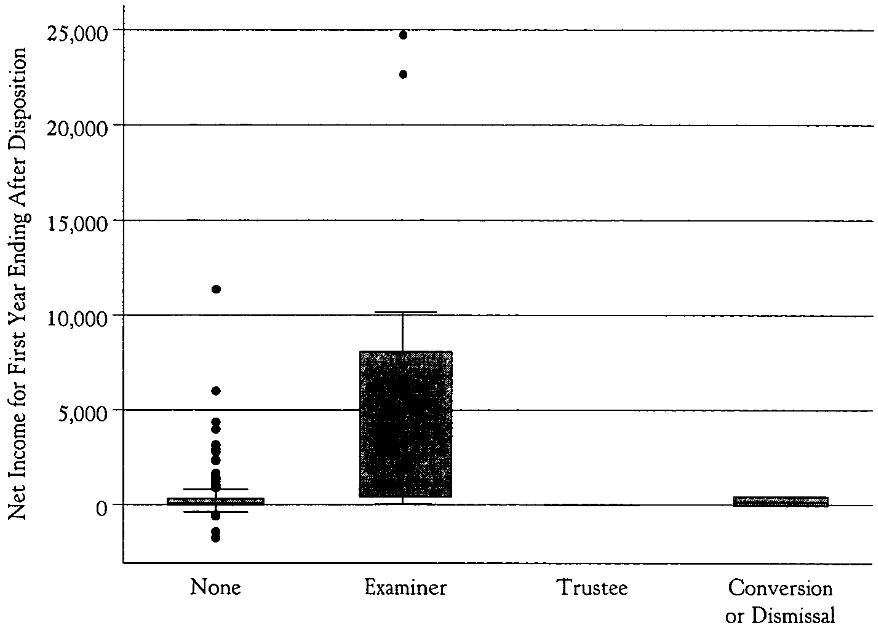
[195] *Id.* (Distress investors are "just following what everyone else says, so there it is. Some guy issues a quote from courtroom X that some witness's gotten up and said the company is really worth 25% more than everyone else is saying it is. . . . It'd be interesting to see whether the bonds start trading at 10% more the next day. I'll bet they do.").

[196] *Ranksum* $p=0.0$ (n=216).

Figure 4.2.2 Net Income and Examiner Cases



This shows that post-bankruptcy income appears to be greater in cases that had an examiner than in cases that did not.

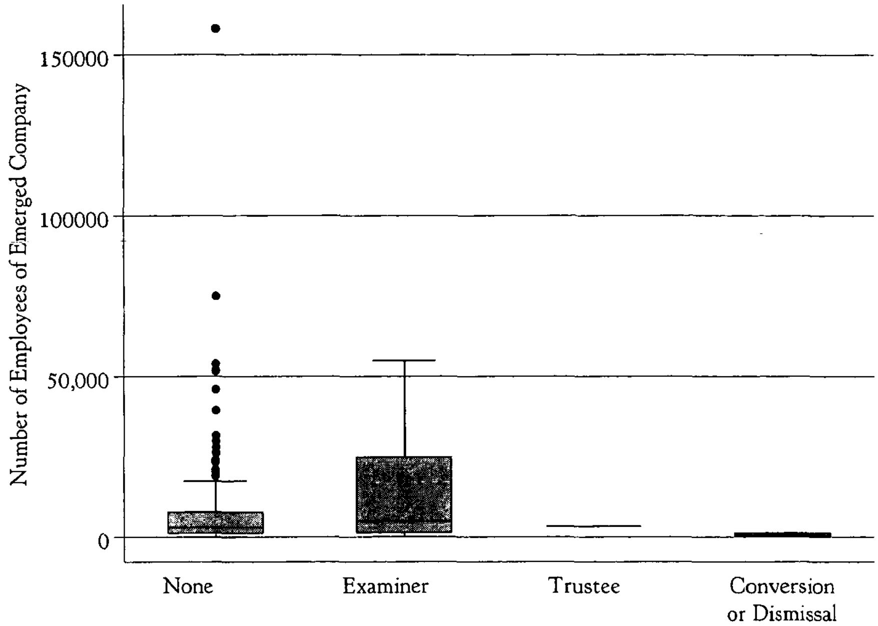
4.2.3 *Post-Bankruptcy Headcount*

Although more ardent contractarians may dismiss the interests of employees, it would seem that another useful measure of success (one with admittedly both "private" and "public" features) is an emerging debtor's number of employees. After all, as noted above, Congress believed that chapter 11 would be an important mechanism for saving jobs. Do examiners advance that goal?

Subject to prior caveats about causation, it appears that they do. Companies that had a bankruptcy examination emerged with a mean (median) headcount of 15,474 (5,000). By contrast, companies that emerged from chapter 11 without having had a bankruptcy examiner had a mean (median) headcount of 7,302 (2,983). This was statistically significant in bivariate analysis.[197]

[197] *Ranksum p*=0.04 (n=227).

Figure 4.2.3 Headcount and Examiner Cases



This shows that post-bankruptcy headcounts appear to be higher when an examiner is appointed than in any other state of a case.

As with other success measures, it is difficult to see how an examiner could *cause* companies to emerge from chapter 11 with more employees, on average. As with the other measures, caution is warranted because examiners were appointed in only fifteen—about 6.5%—of 227 cases for which we have employment data. Several of these cases were true outliers: United Airlines had 55,000 employees; Owens Corning had over 19,000 employees; and Lyondell Chemical had 14,000. That all had examiners may simply be coincidental.

Yet, as discussed in the next part, this may be evidence of the conflation of "public" and "private" in reorganization, exemplified by the use of bankruptcy examiners. While we might say that preserving jobs is a private benefit, in the sense that it secures private employment, it is also generally viewed as a public good by politicians, including those who enacted chapter 11 in order to promote just that.[198] The examination may not have caused these debtors to have more employees, but the examiner may have preserved the

[198] *See* discussion *supra* Part 1.

integrity of the process involving these otherwise very large and (to some) controversial cases. Preserving the integrity of the process may, in turn, have improved the outcome in some way that is difficult to quantify but nevertheless important.

4.3 "Public" Success

The Bankruptcy Code's legislative history shows that Congress did not intend examiners to produce exclusively private (financial) benefits. Instead, as explained in Part 1, Congress viewed examiners as responsive to both private and public problems. "Public" problems would include agency concerns created by a system that permitted managers to remain in possession and control of a debtor while ultimately discharging debts. It would also reflect broader concerns about investor confidence in the public securities (in particular bond) markets.

In the wake of the financial crisis, scholars in various fields have begun to rethink the boundary between the "public" and the "private."[199] One iteration of this appears in recent scholarship on the role of "publicness" in securities and corporate governance,[200] a field with a direct historical connection to bankruptcy examiners. In the words of Langevoort and Bratton, "publicness" in securities regulation "follows from an effort to create more accountability of large, economically powerful business institutions that is only loosely coupled with orthodox (and arguably more measurable) notions of investor protection."[201] Publicness in securities regulation is "what society demands of powerful institutions, in terms of transparency, accountability, and openness, in order for that power to be legitimate."[202]

Hilary Sale makes this point concretely: "Publicness" in the regulation of corporations cannot merely reflect legislative or regulatory decisions about the boundary between public and private. Instead, many social institutions, in particular the media, affect the "public" status of corporations. "Public corporations are not just creatures of Wall Street. They are creatures of Main Street, the media, bloggers, Congress, and the government."[203] As such, disclosure obligations are intimately bound up with substantive regula-

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[199]Perhaps the most notable examples appear in Richard A. Posner, A Failure of Capitalism: The Crisis of '08 and the Descent into Depression (2009); Richard A. Posner, The Crisis of Capitalist Democracy (2010). *See also* Jonathan C. Lipson, *Against Regulatory Displacement: An Institutional Analysis of Financial Crises*, 17 Penn. J. Bus. L. 673 (2015).

[200]Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 Geo. L.J. 337, 339 (2013) ("[T]he public-private divide has long been an entirely under-theorized aspect of securities regulation.").

[201]*Id.* at 340.

[202]*Id.*

[203]Hillary A. Sale, *The New "Public" Corporation*, 74 Law & Contemp. Probs. 137, 137 (2011).

tory goals.[204]

These observations provide a helpful frame of reference for assessing the "public" role of examiners. To this point, the value of bankruptcy examination has been assessed largely from a private perspective: will an examiner put dollars in the pockets of private creditors? Because creditors appear to presume that the answer to that question is likely to be "no" we then never ask the next question, which is: are the interests of private creditors the only interests the system serves?

Framed this way, the answer seems clear. Bankruptcy, in general, and chapter 11 reorganization in particular, represents a series of complex normative and economic tradeoffs. While it is possible to understand scholarship about bankruptcy in terms of a "public-private" distinction, bankruptcy scholars almost never approach it in this way. The insights of securities law scholars have yet to permeate the world of bankruptcy theory.

This is especially ironic in the case of bankruptcy examiners, because they are in part an outgrowth of larger political moves to regulate securities markets. As explained above, the examiner position was created in part as a compromise over the role of the Securities and Exchange Commission; protecting public investors was a rationale for having bankruptcy examiners. Thus, as Professor Bussel observes, "[f]ostering a public perception that justice has been done in the context of catastrophic business failures is an important independent value advanced by the transparency afforded by an [examiner's] independent, fully disclosed investigation."[205]

5. EXPERIMENTATION IN EXAMINATION—"MINI-EXAMINATIONS"

One might think from the foregoing that we advocate greater use of examiners. This is correct, but incomplete. In fact, our findings tell us that there is reason to believe greater use of examiners would improve outcomes, but constraints inherent in the problem we study—the infrequency of examinations—mean we cannot be certain. Thus, we suggest a pragmatic alternative: "mini-examinations" on an experimental basis. In doing so, we draw from recent literature on experimentalism in regulatory design.[206]

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[204] *Id.* at 143 ("[T]he regulations are about the power of disclosure to force substance. The theory of this information-forcing-substance regime is that companies will create systems and policies in order to fill in all of the regulatory disclosure blanks and answer the questions posed.").

[205] *See* Bussel, *supra* note 17, at 111.

[206] Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267 (1998); *see also* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 4-7 (1992) (discussing responsive regulation); Gra'inne de Bu'rca & Joanne Scott, *Introduction: New Governance, Law and Constitutionalism*, *in* LAW AND NEW GOVERNANCE IN THE EU AND THE US 1, 2-3 (Gra'inne de Bu'rca & Joanne Scott eds., 2006) (defining the concept of new governance).

5.1 EXPERIMENTALISM IN REGULATORY DESIGN

Charles Sabel and William Simon explain that experimentalism envisions systems of governance that are both distributed and dialectical.[207] They are distributed because they resemble hub-spoke systems, in which a central authority provides guidance—but not strictly command and control—over local units that have both opportunities for discretion and obligations to identify and implement local variations. They are dialectical because they require a constant flow of information among elements of the system, to permit real-time updating and revision—"experimentation" based on relatively good information. Experimentalist institutions in the United States have emerged in sectors such as nuclear power, food safety, and child welfare.[208]

Legal institutions can be experimentalist, in the words of Sabel and Simon, "to the extent that they are designed to achieve local adaptation and aggregate learning by combining discretion with duties to report and explain, and by pooling information."[209] Although experimentalism as a form of governance is still in its early stages, it has four basic components: (1) "framework" (overall) goals; (2) local discretion in how to realize these goals; (3) a reciprocal obligation on the part of local groups to report program progress to the central authority, evaluated against performance metrics and/or peer review and feedback; and (4) iterative updating of the performance metrics by the central authority, based on local feedback.[210]

An example from the child welfare context involves the development of the "quality service review" (QSR) undertaken in certain states as part of an effort to reform these systems in the wake of litigation challenging their ability to deliver basic services.[211] The QSR requires caseworkers and managers to review random samples of child-welfare (e.g., abuse and neglect) cases for various outcome metrics, to present their findings, and to meet and discuss ongoing performance as indicated in the QSR.[212] The QSR is experimentalist because it "seeks to induce continuous reconsideration of a system's norms in the course of monitoring compliance with them."[213]

The most important contribution experimentalism makes to the project of bankruptcy reorganization is, as suggested by the example of the QSR, an ongoing commitment to gather and share information about the system's per-

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[207]Kathleen G. Noonan, Charles F. Sabel & William H. Simon, *Legal Accountability in the Service-Based Welfare State: Lessons from Child Welfare Reform*, 34 L. SOC. INQUIRY 523, 545 (2009); Charles F. Sabel & William H. Simon, *Minimalism and Experimentalism in the Administrative State*, 100 GEO. L.J. 53 (2011).

[208]*See* Noonan, *supra* note 207.

[209]Sabel & Simon, *supra* note 207, at 78.

[210]*Id.* at 79.

[211]*See* Noonan, *supra* note 207, at 542-46.

[212]*Id.*

[213]*Id.* at 525.

formance, thus creating the possibility of updating practice in the light of that information. Under traditional child-welfare regimes, information would flow largely in one direction, from those in control to those in the field. The exception to this would involve "event notification"—a child death, for example. Experimentalist approaches to public system reform, by contrast, involve a distinctive form of monitoring. Whereas event notification is triggered by unexpected disruptions, "core monitoring in experimentalist service provision is part of the organizational routine."[214] Continuous evaluation via mechanisms such as the QSR results in a stream of information that is likely to be more representative, more fine-grained, and thus more useful to managers and caseworkers who seek to improve the system.

Bankruptcy examination has been treated as a kind of event-notification, triggered by unexpected disruptions. Examinations seem in the legal imagination to be more closely associated with spectacular, outlier cases such *Enron*, *Worldcom*, and *Lehman Brothers* than more carefully planned cases that have become the routine of chapter 11. Yet, this is not what Congress expected, and may not in fact be in the interests of system participants given virtually any measures of success. By abjuring more regular and independent investigation of the causes of a debtor's collapse and potential claims against those who caused it, we deprive ourselves of information about the operation of the system, and who wins and who loses in it. Experimentalism teaches that more regularized feedback in the process is likely to improve outcomes; our evidence about bankruptcy examinations suggests that this may be true in chapter 11 reorganization.

Adapting experimentalism to bankruptcy reorganization generally, and in the use of examiners in particular, presents at least two challenges. First, experimentalism has largely focused on traditionally public systems, such as those involving child welfare. Would its key components—such as feedback loops, distributed decision making, peer review—work in a company's reorganization? While it is not difficult to imagine that Congress had something like this in mind when it created the role of examiner (at least for large cases), system participants seem not to want it. Perhaps this is because a public system is likely to have access to resources (such as the public fisc) unavailable to corporate debtors. As noted above, creditors are reluctant to spend "their" money on examinations, unless they are confident that the benefits will exceed the costs.

Second, experimentalism presumes that we acknowledge and agree on systemic goals. "The key influence in the move toward experimentalism is the view that services need to be tailored to the needs of beneficiaries," Sabel

[214]Sabel & Simon, *supra* note 207, at 91.

and Simon observe.[215] While this demands respect for local variation, it also takes as largely noncontroversial the important question of what the "needs of beneficiaries" might be. In the case of many of the administrative and regulatory systems they observe—e.g., nuclear power, child welfare—the identities and needs of beneficiaries are not strongly contested. The same cannot be said for reorganization under chapter 11. As explained in Part 1, this system of addressing corporate failure has been disputed almost since inception, in large part because there are disagreements over who should benefit (financial creditors or larger groups of stakeholders?) and how to measure benefit (dollars or dollars plus something else, such as "integrity"?).

Experimentalism nevertheless holds the promise for reconceiving the role of examiners in chapter 11. If, as the evidence suggests, examiners may improve both public and private outcomes, then a helpful next step would be to design mechanisms to experiment with their use. This seems especially important where private distress investors increasingly influence the outcomes of cases, given that their motives, tactics, and the effects of their participation, are often opaque.

5.2 Experimenting with Mini-Examinations

Experimentalism with examiners could, for example, take the form of "mini-examinations." A "mini-examination" could be a chapter 11 examination of very limited duration and scope, with commensurately limited cost. Like the QSR discussed above, judges would draw from a random sample of chapter 11 cases and perhaps use examiners to assess the cases with specific inquiries in mind (e.g., is the creditors' committee leaving causes of action unprosecuted?). A single lawyer, preferably with expertise in chapter 11 reorganization, should undertake the mini-examination; the lawyer's firm or a larger group of professionals (e.g., forensic accountants) that might be appropriate in a full-blown examination should not undertake the mini-examination. This would significantly limit costs.

If the mini-examination reveals information that warrants further investigation—for example, plausible grounds to believe there are causes of action against managers or controlling creditors that might enhance estate recoveries, or misconduct by managers or system participants—the court would then have a choice. It could either expand the examination, or refer the matter for further development by the creditors' committee, the United States Trustee, the Securities and Exchange Commission, or the Justice Department, depending on the nature of the examiner's preliminary findings. In the process, courts would increase the overall number of examiner appointments, which would in turn provide greater evidence about their efficacy (or not).

[215] Sabel & Simon, *supra* note 207, at 90.

To enhance neutrality and limit the temptation to undertake needless "fishing expeditions," the examiner who undertakes the initial, limited investigation should ordinarily not be eligible to conduct a full examination.

We would hope that in most cases, mini-examinations turn up little evidence of problems of the sort we note. But if in fact a reasonable number show problems—and there is reason to believe these problems would not otherwise have come to light—then greater use of full-blown chapter 11 examinations may be warranted. It may be that courts continue to use examiners only in this exploratory fashion; or they may conclude that concerns about efficiency and integrity warrant a more fulsome examination by the preliminary examiner.

Key questions about mini-examinations will involve their triggers. Courts appear to have the capacity to appoint examiners sua sponte, so failures to request examiners need not be a problem.[216] The questions then become when and how much more frequently should courts appoint examiners for mini-examinations? Should mini-examinations be truly random (perhaps more obviously "experimental") as in the QSR, or should there be certain threshold criteria? Should they strive for appointments in 10-20% of cases, thereby doubling or tripling their current use? Or should it be more or less? To what extent should size generally, and the presence of net assets in particular, matter? These factors appear to influence examiner requests currently. It is unlikely a judge would appoint an examiner in a case indifferent to them. But how "rich" should the reorganizing company be to be part of this experiment? As discussed below, we propose a public funding mechanism that may alleviate some of these concerns.

We think the criteria Congress enacted are good enough to start with. Thus, if after an independent assessment, the court believes there are potential problems with governance or information flow in a case, then a mini-examination would be warranted. This may last no more than a week, and have only one goal: to determine whether further inquiry is warranted. Cases that experience significant pre-petition (or post-petition) claims trading, that propose hurry-up sales, or that sell assets for below book-value—shadow bankruptcy cases—may all be viable candidates as they suggest potential problems of governance or transparency that may, in turn, affect outcomes. Any case that proposes to retain the debtor as a going concern but outsources jobs or otherwise impairs employees may also warrant a mini-examination. In all such cases, the potential to determine whether insiders have behaved opportunistically would be in the "interests" of the debtor's larger community of stakeholders, whose interests may no longer be pro-

[216] *See supra* discussion note 133.

tected by the governance and informational mechanisms conventionally used (e.g., creditors' committees).

Any effort to advance this proposal must consider many more questions than can be answered here. The most we can hope is that judges concerned about agency and similar problems in the reorganization process recognize that they have the tool to deal with them, even if it (examination) is one that many have historically resisted.

5.3 Funding Mini-Examinations

One potential way to reduce resistance would be to change the funding mechanism for bankruptcy examinations. The costs of bankruptcy examinations—even "mini-examinations"—may not be trivial. While all expenses of administering the estate are borne by creditors,[217] it appears that creditors find the costs of examiners more problematic, presumably because the material (financial) benefits to them of an examination are so uncertain. This is likely exacerbated by the fact that examination is justified in part by its public attributes—attributes that private creditors understandably do not want to fund. Why, creditors might ask themselves, should we reduce our recoveries to educate the investing public or promote systemic integrity?

One way to address this is through cross-subsidies from bankruptcy filing fees. Ed Flynn has recently observed that "[t]otal bankruptcy case filing fees averaged about *$375 million* per year between Fiscal Years 2010-14."[218] Although Flynn notes that "the cost of operating the bankruptcy courts averaged $767 *million per year*"[219] in the same period, he also reports that "more than $100 million per year in bankruptcy fees are diverted into a general government fund."[220] It is highly unlikely that mini-examinations of the sort we propose would come anywhere near $100 million per year, especially if (as we recommend), courts limit these mini-examinations to a single professional (and not the professional's entire firm) and impose clear and limited budgets.

If a fee-funded mini-examination turned up evidence that warranted a deeper investigation, the question of additional expense would then arise. While there are too many unknowns to warrant a detailed proposal, it would seem that at that point, creditors should bear some or all of the costs of the examination. Thus, the balance of the examination might become an expense of administration, as is currently the case. This would not, of course, eliminate creditor concerns about cost. But if the mini-examination has generated

[217] *See* 11 U.S.C. §§ 330(a)(1), 507(a)(2) (setting forth expenses of administration, and priority over general unsecured claims).

[218] Flynn, *supra* note 34, at 37 (emphasis in original).

[219] Flynn, *supra* note 34, at 36 (emphasis in original).

[220] *Id.* at 58.

information sufficient to justify additional examination, one hopes that creditors agree that the benefits will likely exceed the costs.

To be sure, there are other funding possibilities. One could consider funding from the Federal Reserve System, which is generally outside the ordinary federal budget process.[221] One could simply include funds for this in the federal budget (although that seems improbable in the near term). One could imagine special surcharges in larger chapter 11 cases (e.g., those qualifying as "large" in this study). We choose bankruptcy filing fees simply because they align the "public" benefits of examinations to a source of funding closely associated with those who use the system. But, we do not mean to suggest that this is the only way to ameliorate concerns about the costs of bankruptcy examinations.

CONCLUSION

Bankruptcy examiners are unusual characters. "An examiner's legal status is unlike that of any other court appointed officer which comes to mind," the court noted in the *Baldwin United* case.[222] Examiners perform both public and private functions in a system that seeks to manage agency costs through controls on governance and information flow. While their rarity is not surprising—creditors do not want to subsidize others' education—they nevertheless appear to offer important and underappreciated benefits. We find that they correlate to better outcomes in both "private" and "public" respects in the cases in which they appear. At the same time, we recognize that the limited use of examiners leaves us without sufficient data to know with great certainty how valuable they can be. We have gathered, presented, and analyzed data that lead us to conclude there is good reason to use examiners more frequently, and so have proposed a relatively painless way to do so. While we believe examiners can contribute to success in reorganization, we also believe that further study is warranted.

[221] In 2012, for example, the Federal Reserve System had earnings of about $81 billion and net expenses of about $3.7 billion. BD. OF GOVERNORS OF THE FED. RESERVE SYS., ANNUAL REPORT: BUDGET REVIEW 2013, http://www.federalreserve.gov/publications/budget-review/files/2013-budget-review.pdf.

[222] *In re* Baldwin United Corp., 46 B.R. 314, 316 (Bankr. S.D. Ohio 1985).

APPENDIX 1 *Sample Cases in Which Examiners Were Appointed*

	Name of Debtor	District	Year filed
1.	American Classic Voyages Co.	DE	2001
2.	American Rice, Inc.	TX SD	1998
3.	ATA Holdings Corp.	IN SD	2004
4.	B-E Holdings Inc./Bucyrus-Erie Company	WI ED	1994
5.	Baldwin Builders/Baldwin Building Contractors, L.P.	CA CD	1995
6.	Best Products Company, Inc. (1991)	NY SD	1991
7.	Bonneville Pacific Corporation	UT	1991
8.	Brunos, Inc.	DE	1998
9.	Cenvill Development Corp.	FL SD	1992
10.	Cityscape Financial Corp.	NY SD	1998
11.	Costilla Energy, Inc.	TX WD	1999
12.	divine, inc.	MA	2003
13.	DVI Inc.	DE	2003
14.	El Paso Refinery, LP	TX WD	1992
15.	Enron Corp.	NY SD	2001
16.	FiberMark, Inc.	VT	2004
17.	Geneva Steel Company	UT	1999
18.	Global Crossing Ltd.	NY SD	2002
19.	Grand Court Lifestyles, Inc.	NJ	2000
20.	Gulf USA Corp.	ID	1993
21.	Interco, Inc.	MO ED	1991
22.	IT Group, Inc. (The)	DE	2002
23.	Koger Properties, Inc.	FL MD	1991
24.	Loral Space & Communications Ltd.	NY SD	2003
25.	Megafoods Stores, Inc.	AZ	1994
26.	Metropolitan Mortgage & Securities Co., Inc.	WA ED	2004
27.	Mirant Crop.	TX ND	2003
28.	NewPower Holdings, Inc.	GA ND	2002
29.	Nu-kote Holding, Inc.	TN MD	1998
30.	Owens Corning	DE	2000
31.	PG&E National Energy Group	MD	2003
32.	Polaroid Corp.	DE	2001
33.	Polymer Group, Inc.	SC	2002
34.	Refco Finance, Inc.	NY SD	2005
35.	SpectraSite Holdings, Inc.	NC ED	2002
36.	Sun HealthCare Group, Inc.	DE	1999
37.	UAL Corporation (United Airlines)	IL ND	2002
38.	Washington Group International, Inc.	NV	2001
39.	Worldcom, Inc.	NY SD	2002
40.	Fremont General Corporation	CA CD	2008
41.	Syntax-Brillian Corporation	DE	2008
42.	Lyondell Chemical Company	NY SD	2009
43.	Trump Entertainment Resorts, Inc. (2009)	NJ	2009
44.	Capital ASAM*	MD	1996
45.	Integra Realty Resources*	CO	1992
46.	Kinlaw Finance Co. of Lumberton NC, Inc.*	NC ED	1998
47.	Potomac Iron Works*	MD	1993
48.	Praestar Health*	MA	1996

* "Small case" (assets less than $100 million in 1980 dollars and/or not a reporting company under the Securities Exchange Act of 1934). Otherwise, cases are "large."

APPENDIX 2 *Small Case Sample Selection Methodology*

Our small-case-selection methodology was adapted from that used by Professors Sullivan, Warren and Westbrook for their Business Bankruptcy Project.[223] They selected cases from twenty-three judicial districts—two from each circuit plus one extra, as explained below.[224] Using data published by the Administrative Office of the United States Courts, they identified the districts with the most and fewest[225] business bankruptcy filings in each circuit.[226] The twenty-third district was the Western District of Washington, which would have been the district with the most filings in the proposed Twelfth Circuit.[227]

We selected cases filed in the same districts identified by Professors Sullivan, Warren and Westbrook (the "Selection Districts").[228] We endeavored to randomly select three cases from each Selection District for each year between 1991 and 2007, which would have resulted in a dataset consisting of 1173 cases. Unfortunately, however, the availability of electronic dockets for cases filed in the early- and mid-1990s is limited. For years for which we were unable to obtain dockets for three cases from each Selection District, we obtained dockets for as many cases as were available for that Selection District, up to three.

In order to randomly select three cases per year from those Selection Districts for which more than three cases per year were available, we used Excel to generate three random numbers (the "Selection Numbers") for each Selection District and year. We then obtained a list of chapter 11 cases filed in each Selection District and year,[229] and obtained dockets for those cases that corresponded with the Selection Numbers. For instance, if the Selection Numbers for cases filed in the District of Delaware in 2007 were 1, 35 and 106, we obtained dockets for the first, thirty-fifth and one-hundred-sixth cases on our list of cases filed in the District of Delaware in 2007. If a Selection Number corresponded with a chapter 11 case filed by an individual debtor (as opposed to a business entity) we generated a new Selection Number that corresponded with a case filed by a business entity.

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[223]*See generally* SULLIVAN, ET AL., *supra* note 118, at 7 (1998).

[224]*Id.* Sullivan et al. point out that representing each circuit equally leads to a good geographic distribution of cases and mitigates the effect of differences in precedent between circuits. *Id.*

[225]The district with the absolute fewest filings was not always selected. Rather, the district with the fewest filings that contained at least fifty chapter 11 cases was chosen.

[226]*Id.*

[227]We decided to include the Western District of Washington as well because proposals to split the Ninth Circuit have been made as recently as 2007.

[228]*See infra* note 229 (explaining that no cases filed in the District of New Jersey were included).

[229]This list was obtained from Westlaw. At the time of selection, Westlaw's docket search tool did not contain information for every case filed in a particular district. Thus, the cases in our dataset were randomly selected from the set of cases for which information was available on Westlaw, which, at the time, was a subset of all chapter 11 cases filed.

APPENDIX 3 *Statistical Methodology*

In order to construct the regression model, we tested certain variables for significance in bivariate analysis with motions for an examiner and grants of examiner motions. Wilcoxon non-parametric tests were used to test the difference of medians for continuous variables (due to the skewedness of the distributions).[230] Pearson's chi-squared tests (χ^2)[231] were used to test the association of categorical variables (e.g., whether or not the case involved allegations of fraud).

Second, variables that were trending significant from bivariate analysis (p-value$<$0.05) were then added to logistic regression models to predict the likelihood that an examiner would be requested and/or appointed. Certain variables were omitted despite trending significantly from a bivariate analysis because of theoretical assumptions or redundancy. One of the continuous variables was also transformed using a square root transformation to satisfy the linearity in the logit assumption.[232]

Factors that were examined in this two-part analysis included:

(1) assets (as listed in the bankruptcy schedules);

(2) liabilities (as scheduled);

(3) net scheduled asset values;

(4) whether the case was filed in a "big district" (Delaware or the SDNY);

(5) allegations of fraud;

(6) days in bankruptcy (commencement through confirmation or conversion/dismissal);

(7) relative speed an examiner motion was made;

(8) number of docket entries;

(9) the presence of public bondholders;

(10) the use of a prepackaged plan;

(11) motions for appointment of a trustee;

(12) trustee appointments;

(13) motions for conversion or dismissal; and

(14) orders for conversion or dismissal.

Due to the non-parametric distribution of the continuous variables, linear-

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[230]This is a non-parametric test of significance between two groups (e.g., the assets or liabilities of cases with and without a request for an examiner). *See generally* GREGORY W. CORDER & DALE I. FOREMAN, NONPARAMETRIC STATISTICS FOR NON-STATISTICIANS: A STEP-BY-STEP APPROACH (Wiley 2009).

[231]*See* R.A. Fisher, *On the interpretation of x^2 from contingency tables, and the calculation of P*, 1 J. ROYAL STAT. SOC. 85, 87-94 (1922).

[232]R.K. Elswick, Jr., Pamela F. Schwartz & Josephine A. Welsh, *Interpretation of the Odds Ratio From Logistic Regression After a Transformation of the Covariate Vector*, 16 STAT. IN MED. 1695, 1695-96 (1997).

ity in the logit was tested.[233] A transformation was applied to the relative speed of an examiner motion after determining that it was inconsistent with the linearity assumption. We applied a square root transformation, which was consistent with the density of the distribution.

We also recoded the net scheduled assets categorically to make the data more easily interpretable. We recoded the net scheduled assets into three categories: (1) debtors with net negative assets, (2) debtors with net assets between $0 and $100 million and (3) debtors with net assets in excess of $100 million.

TABLES

Table 1.1 Examiner Requests—Expected Factors

Examiner Motion (Request)	Odds Ratio	Std. Err.	z	P>|z|	[95% Conf.	Interval]
Net Assets	1.66716	.3422797	2.49	0.013	1.114858	2.493073
Trustee Motion	8.535191	3.313852	5.52	0.000	3.987749	18.26832
Pre-bankruptcy Fraud	.6721429	.4826661	-0.55	0.580	.164518	2.746059
Public Bondholders	1.432873	.5340714	0.96	0.335	.6901463	2.974912
Delaware Venue	.9780058	.3464399	-0.06	0.950	.4884493	1.958229
Constant	.0574808	.0241662	-6.79	0.000	.025215	.1310349

Table 1.2 Examiner Appointments—Expected Factors

Examiner Appointment	Odds Ratio	Std. Err.	z	P>|z|	[95% Conf.	Interval]
Net Assets	.7847537	.3128133	-0.61	0.543	.3592801	1.71409
Trustee Motion	.3874626	.287581	-1.28	0.201	.0904595	1.659607
Pre-bankruptcy Fraud	13.52761	20.54662	1.71	0.086	.6892241	265.5106
Public Bondholders	.291433	.2362829	-1.52	0.128	.0594862	1.427779
Delaware Venue	.1506449	.1130062	-2.52	0.012	.0346279	.655364
Constant	5.924478	6.055049	1.74	0.082	.7992609	43.91487

Table 1.3 Examiner Appointments—Salient Factors

Examiner Appointment	Odds Ratio	Std. Err.	z	P>|z|	[95% Conf.	Interval]
Delaware Venue	.2673365	.1476916	-2.39	0.017	.090533	.7894227
Gap Between Filing and Examiner Request	.1446788	.1415438	-1.98	0.048	.0212641	.9843785
Constant	2.223416	1.034323	1.72	0.086	.8933992	5.533448

[233] *Id.*

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