

# **The Search for an Unbiased Fiduciary in Corporate Reorganizations**

AALS Workshop on Transactional Law Outline

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## **I. Introduction**

The parties around the negotiating table in the corporate reorganization context have changed. Traditionally, the distressed corporation, as a debtor in possession, sat at the head of the table and controlled the tenor and much of the substance of the negotiations. The other parties included the corporation's lenders and representatives of its unsecured creditors. These parties typically were financial institutions and trade creditors who had an existing business relationship with the corporation and a vested interest in the continuation of the corporation's business.

Although the distressed corporation remains at the table, it no longer automatically assumes the lead role in the negotiations, and it frequently deals with strangers rather than familiar business partners. Financial institutions and trade creditors are increasingly quick to sell their troubled credits. They often exit the credit before a corporation can design and implement a restructuring plan. The buyers of this distressed debt include hedge funds, private equity firms and claims traders. These institutions focus on profit generation, whether through the reorganization or liquidation of the corporation's business, and generally achieve their goals by seizing control of restructuring negotiations.

The goals of the corporation and its new set of creditors can and often do conflict. In addition, intercreditor conflict can develop as private funds compete for control of the corporation's restructuring. Consequently, the corporation's chapter 11 bankruptcy case can become a battle ground for resolving conflict rather than a neutral site for building consensus. This conflict can impair corporate value and potentially derail a corporation's restructuring efforts.

This article analyzes the increasing conflict in corporate reorganizations and whether the fiduciaries designated by the U.S. Bankruptcy Code—i.e., debtors in possession and statutory committees—are equipped to protect the corporation and its stakeholders generally.

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## II. Bankruptcy Fiduciaries and the Potential for Conflict

### A. The History of U.S. Corporate Reorganization Laws

Since the development of equity receiverships in the late 1800s, U.S. corporate debtors have exercised at least some control over their reorganization efforts.<sup>1</sup> Moreover, the corporate debtor and its key creditors largely determine the amount of creditors' recoveries and the extent of the debtor's discharge. The bankruptcy court and the U.S. trustee generally oversee the administration of the bankruptcy case, but rarely intervene in the substantive negotiations between the debtor and its creditors. In most cases, the bankruptcy court reviews and approves the results of the parties' negotiations and resolves disputes filed by the parties. Absent indications of fraud or illegal conduct, neither the bankruptcy court nor the U.S. trustee conducts, or orders an investigation of the debtor and its prepetition financial affairs.

This "hands-off" approach to corporate reorganization is an integral and considered component of U.S. bankruptcy laws, currently codified in chapter 11 of the U.S. Bankruptcy Code. A review of chapter 11's history reveals that politicians and academics periodically suggested a governmental gatekeeper to investigate debtors and monitor their bankruptcies and discharges. Notably, this type of governmental administrator underlies the U.K.'s corporate insolvency laws.<sup>2</sup> Nevertheless, the concept was consistently rejected by U.S. lawmakers, who also have been reluctant to expand the jurisdiction or powers of the bankruptcy courts.

### B. Bankruptcy Fiduciaries

The U.S. Bankruptcy Code and related case law rely heavily on fiduciary duty law to fill the void left by limited formal oversight. In most cases, the corporate debtor serves as a debtor in possession and, consequently, a fiduciary for the bankruptcy estate.<sup>3</sup> Similarly, the U.S. trustee may appoint one or more statutory committees of unsecured creditors in a chapter 11 case to serve as a fiduciary for those claimants represented by the committee.<sup>4</sup> Unlike the chapter

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<sup>1</sup> See, e.g., Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 22–23 (1995) (explaining that, in substance, equity receiverships "often resulted in old management retaining control of the enterprise, and dictating the terms of the sale" of the troubled railroad or other business). See also DAVID A. SKEEL, JR., *DEBT'S DOMINION* 49–69 (2001) (discussing origins of equity receiverships and corporate compositions and reorganizations).

<sup>2</sup> See generally VANESSA FINCH, *CORPORATE INSOLVENCY LAW* (2002) (providing an overview of U.K. insolvency laws).

<sup>3</sup> See 11 U.S.C. § 1107 (setting forth the rights, powers and duties of a chapter 11 debtor in possession). See also, e.g., *In re Cenargo Int'l*, 294 B.R. 571, 599 n.32 (S.D.N.Y. 2003) ("There is no question that a debtor in possession is a fiduciary, like a chapter 11 trustee, for the estate, creditors and shareholders.") (citations omitted); Rutherford B. Campbell, Jr., *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 IOWA J. CORP. L. 491, 493 & nn.85–87 (2007) ("[W]hen the company enters bankruptcy and is operating under Chapter 11, the cases hold or suggest that the obligation [of the debtor's management] is to maximize the total interests of creditors and shareholders as a whole.").

<sup>4</sup> See 11 U.S.C. § 1103 (setting forth the powers and duties of statutory committees). See also, e.g., Greg M. Zipes & Lisa L. Lambert, *Creditors' Committee Formation Dynamics: Issues in the Real World*, 77 AM. BANKR. L.J. 229, 231 (2003) ("Congress specifically allowed committees to 'consult with the trustee or debtor concerning the administration of the case,' to evaluate the debtor's financial dealings and current financial condition so the

7 context, chapter 11 does not routinely mandate the appointment of a bankruptcy trustee, examiner or other independent third party to act as a fiduciary for the bankruptcy estate.

Debtors in possession and creditors' committees are subject to influence by self-interest and outside pressures. Board members and corporate management may aggressively pursue a reorganization of the business to, among other things, preserve their jobs or attempt to salvage value for shareholders. They may in turn cede to the demands of private funds to obtain postpetition or exit financing for the corporation. Creditors' committees may support a plan that allows one or more of its members to obtain control of the reorganized corporation. Committee members also have access to and may use the corporation's confidential information to achieve their own business agendas.

The potential vulnerability of debtors in possession and creditors' committees raises the question of who is or should be protecting the bankruptcy estate. The estate is formed upon the corporation's filing for chapter 11 protection and includes, among other things, all of the corporation's legal and equitable interests in property.<sup>5</sup> In many respects, the estate is equivalent to the concept of the corporate entity. The estate includes the corporation's postpetition business operations, and its value is the basis of stakeholders' recoveries in the chapter 11 case. If existing bankruptcy fiduciaries are unable to protect and maximize the value of the estate, then an alternative fiduciary or approach to formal oversight should be explored.

### III. Balancing Competing Interests in Reorganizations

As explained above, the general rule in U.S. corporate reorganizations is that the corporate debtor stays in possession of its property and in control of its restructuring efforts with relatively little interference from the bankruptcy court or the U.S. trustee. This approach is commonly referred to as a U.S.-style or chapter 11-style reorganization. Although some countries like the United Kingdom, France and China recently adopted aspects of a chapter 11-style reorganization, most countries balance the control retained by the corporate debtor with more intrusive governmental or judicial oversight. Moreover, many countries mandate the appointment of an administrator, receiver or other trustee upon the commencement of any corporate bankruptcy.

The prominence of administrators in non-U.S. corporate insolvency schemes and the periodic calls in the United States for more governmental oversight of corporate reorganizations suggest that further study is warranted. Specifically, evaluating the strengths and weaknesses of different approaches to corporate reorganizations and the entities serving as fiduciaries in that context may identify ways to improve the chapter 11 process. For example, France recently implemented a safeguard procedure that is designed to allow nearly-insolvent corporations to restructure their financial affairs without initiating a formal

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committee can evaluate the case's viability and the prospects for a plan, to negotiate plan terms, and to seek the appointment of a trustee or examiner.") (citations omitted).

<sup>5</sup> See 11 U.S.C. § 541(a) (defining the scope of the bankruptcy estate).

insolvency proceeding.<sup>6</sup> Under the safeguard procedure, the corporation continues to operate its business but the supervising court appoints a judicial administrator to, among other things, assist the corporation in its restructuring efforts and inform the court of the corporation's progress. The judicial administrator is not a receiver or trustee in the traditional sense; rather, it serves more as a facilitator and liaison for the corporation, its constituents and the supervising court.

Although a chapter 11-style bankruptcy and, in particular, the debtor in possession concept can significantly enhance a corporation's restructuring efforts, potential conflicts of interest, self-dealing and moral hazard may diminish the value of those efforts. In some cases, the creditors' committee may protect the estate and, in others, it may compound the problem. In either case, aspects of certain non-U.S. insolvency laws may offer solutions to the bankruptcy fiduciary dilemma.

#### IV. An Alternative Bankruptcy Fiduciary: An Estate Representative

This article suggests an alternative fiduciary in the chapter 11 context: a disinterested party appointed specifically to protect and act in the interests of the bankruptcy estate. I refer to this party here as an "estate representative." Under this proposal, the estate representative would be appointed in lieu of any statutory committees, and it would be available to both assist and monitor the debtor in possession and its stakeholders in achieving a successful restructuring. The underlying purpose of the estate representative would be to reduce conflict and the costs of conflict in chapter 11 cases, thereby better protecting corporate value for the benefit of all stakeholders generally.

The estate representative proposal discussed here draws on elements of existing U.S. bankruptcy laws, as well as concepts incorporated into U.K. and French insolvency laws. For example, the estate representative would, like a chapter 7 trustee under the U.S. Bankruptcy Code, owe its primary fiduciary duties to the bankruptcy estate. The specific duties and the priority of these duties would be delineated in a manner similar to the statutory guidance provided to administrators in U.K. administrations. The proposal also would contemplate the estate representative consulting with the debtor in possession regarding its restructuring objectives and reporting on the debtor's progress to the bankruptcy court—a role similar to judicial administrators under the French safeguard procedure.

#### V. Conclusion

The estate representative proposal would not eliminate conflict in chapter 11 cases. It would, however, identify a disinterested party to help balance and mitigate competing interests in the chapter 11 case and to provide objective reports to the bankruptcy court. Debtors in possession and most individual

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<sup>6</sup> See France's Commercial Code, art. L.620-1. See also *DOING BUSINESS IN FRANCE* §§ 18.01–18.03 (2006) (explaining safeguard procedure).

creditors and equity holders serving on statutory committees have the resources to participate in the chapter 11 case to protect their own interests. They nonetheless may be ill equipped to represent and protect the interests of the corporation's stakeholders generally. The estate representative would give the often under-represented bankruptcy estate and stakeholders a more meaningful voice in the chapter 11 process.