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DE Bankruptcy Court Denies Appointment Of Examiner Despite Statutory Mandate

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The United States Bankruptcy Court for the District of Delaware recently denied the appointment of an examiner in *U.S. Bank Nat'l Assoc. v. Wilmington Trust Co.* (*In re Spansion, Inc.*), notwithstanding the fact that the statutory threshold which arguably mandates the appointment of an examiner upon the request of a party in interest had been satisfied. In doing so, Chief Bankruptcy Judge Kevin J. Carey disagreed with the majority of courts that hold that the appointment of an examiner is mandatory if the statutory requirement is met.

Appointment of an Examiner

Section 1104(c)(2) provides that:

> (c) if the court does not order the appointment of a trustee under this section, then at any time 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 an examiner to conduct 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 best interests of creditors, any equity security holders, and other interest of the estate; *or*
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> (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)(2) (emphasis added).

The majority of courts, including the only circuit court to rule on the issue, have held that the use of the word "shall" indicates that the appointment of an examiner is mandatory if the $5 million threshold of debt is met. *See, e.g., In re Revco D.S., Inc.*, 898 F.2d 498, 500-01 (6th Cir. 1990); *Loral Stockholders Protective Comm. v. Loral Space and Commc'n, Ltd.* (*In re Loral Space and Commc'n, Ltd.*), 2004 WL 2979785, *5 (S.D.N.Y. Dec. 23, 2004); *In re Erickson Retirement Communities, LLC*, 425 B.R. 309, 312 (Bankr. N.D. Tex. March 5, 2010). However, this same provision provides courts with discretion to determine the scope of the examiner's investigation "as is appropriate." 11 U.S.C. § 1104(c); *see also Erickson Retirement Communities*, 425 B.R. at 312; Loral, 2004 WL 2979785 at *5; *In re UAL Corp.*, 307 B.R. 80, 84 (Bankr. N.D. Ill. 2004). Accordingly, in light of the apparent mandate of § 1104(c)(2), courts, when confronted with circumstances that arguably did not warrant the appointment of an examiner, have used the "as is appropriate" language to limit the duties of the examiner. *See, e.g., Erickson Retirement Communities*, 425 B.R. at 317 (stating that were there no standing problem for the requesting party, the court would appoint an examiner with no duties) (*citing In re Asarco, LLC*, No. 05-21207, D.I. 7081 (Bankr. S.D. Tex. March 4, 2008)); *Loral*, 313 B.R. at 587 (noting that it may be appropriate under certain circumstances to restrict examiner's investigation to a limited, prescribed role). Other courts have flatly declined to appoint an examiner, usually on grounds of laches, where such appointment would be wasteful and unproductive. *See, e.g., In re Bradlees Stores, Inc.*, 209 B.R. 36, 38 (Bankr. S.D.N.Y. 1997); *In re Schepps Food Stores, Inc.*, 148 B.R. 27, 30-31 (S.D. Tex. 1992). One of the most recent of these decisions, rendered by Judge Robert Drain in the Loral bankruptcy case, *In re Loral Space & Commc'ns, Ltd.*, 313 B.R. 577 (Bankr. S.D.N.Y. 2004), was ultimately reversed on appeal by the United States District Court for the Southern District of New York based upon the "plain" language and legislative history of the statute. *Loral*, 2004 WL 2979785, at *5. Nonetheless, the leading treatise on bankruptcy law maintains that:

> The mandatory nature of [§ 1104(c)(2)] was not intended and should not be relied on to permit blatant interference with the chapter 11 case or the plan confirmation process. Failure to make a timely request for the appointment of an examiner may provide the court with a basis for denying the request on the ground of laches. Alternatively, a court might grant the request of an examiner but so limit the role assigned to the examiner that substantial interference will be prevented.

7 Collier on Bankruptcy ¶ 1104.03[2][b] at 1104-39-40.

The *Spansion* Decision

Spansion, Inc. and its affiliates specialize in the manufacture and sale of flash memory products integrated into a broad range of electronics. The Spansion debtors filed a plan of reorganization that provided no recovery to equity security holders and only a limited recovery to convertible noteholders. Shortly before the confirmation hearing, an ad hoc committee of convertible noteholders filed an emergency motion seeking to vacate the order approving the debtors'

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disclosure statement and to direct the appointment of a trustee or examiner pursuant to §§ 1104(a)(1) and 1104(c)(2) of the Bankruptcy Code to investigate what they alleged were intentional misrepresentations regarding the valuation assumptions used by the debtors. An ad hoc committee of equity security holders filed a joinder to the emergency motion.

At the confirmation hearing, Judge Carey denied the motion to vacate the debtors' disclosure statement and refused to grant the appointment of an examiner. In denying the appointment of an examiner, the court acknowledged the majority line of decisions holding that appointment of an examiner is mandatory where the statutory debt threshold is met. However, the court noted that "it is well-established that the bankruptcy court has considerable discretion in designing an examiner's role." *In re Spansion, Inc.*, 426 B.R. 114, 126 (Bankr. D. Del. 2010) (citing *Loral*, 2004 WL 2979785, at *5). Judge Carey went on to cite decisions that "reconcile the mandatory appointment/discretionary duty conflict of § 1104(c)(2)" by appointing examiners with no duties. *Id.* at 127 (*citing Erickson Retirement Communities*, 2010 WL 881727, at *2). Specifically, the court quoted *Winston Indus., Inc. v. Lancer Homes, Inc.* (*In re Shelter Resources Corp.*), which stated that "to slavishly and blindly follow the so-called mandatory dictates of Section 1104(b)(2) [now § 1104(c)(2)] is needless, costly and non-productive and would impose a grave injustice on all parties herein." *Id.* (citing *In re Winston Indus., Inc.* (*In re Shelter Resource Corp.*), 35 B.R. 304, 305 (Bankr. N.D. Ohio 1983)).

Judge Carey held that there was "no sound purpose in appointing an examiner, only to significantly limit the examiner's role when there exists insufficient basis for an investigation," and that "[t]o appoint an examiner with no meaningful duties strikes [the court] as a wasteful exercise, a result that could not have been intended by Congress." *Id.*

The court stated that the record did not provide sufficient evidence of conduct that would make an investigation of the debtors "appropriate," but rather "reveal[ed] deep and heated differences of opinion about the value of the Debtor companies … ." *Id.* Moreover, the allegations of bad faith against the debtors' management for rejecting the plan's proposed rights offering provided "a classic confirmation dispute, rather than grounds for an investigation by an examiner." *Id.* at 128.

Importantly, the court noted that the creditors committee and the ad hoc committee of equity security holders had vigorously represented the interests of unsecured creditors and equity security holders, and all parties had ample opportunity to conduct extensive discovery and to investigate the Debtors prior to confirmation. *Id.* The court concluded that the appointment of an examiner was neither warranted nor appropriate and would cause undue cost to the debtors' estate and delay the administration of the Chapter 11 cases. *Id.*

Analysis

A request for the appointment of an examiner is often used as a strategic tool by various creditor constituencies to create leverage against the debtor. The appointment of an examiner can be viewed as uncorking an unknown quantity into the case, thereby creating some risk of uncertainty to constituents who believe they have a desired outcome negotiated and secured. This is especially true in cases such as *Spansion,* where the request is made on the eve of confirmation for the primary purpose of renegotiating the value of the estate.

Judge Carey's interpretation of the "as is appropriate" language of § 1104(c)(2) to provide discretion in the appointment of an examiner is controversial. Other courts have addressed this argument in the past and found that such a reading is both grammatically and contextually wrong. *See In re Schepps Food Stores, Inc.*, 148 B.R. 27, 30 (Bankr. S.D. Tex. 1992) (citing *Revco*, 898 F.2d at 501).

Nevertheless, this decision, and similar rulings, suggest an attempt by courts to develop a *de facto* "good faith" requirement as a predicate to the appointment of an examiner. Indeed, although the plain statutory language may mandate the appointment, both Judge Carey and Judge Drain in *Loral* found that either the timing and/or the circumstances surrounding the motion suggested improper ulterior motives that were not within the spirit of the Bankruptcy Code's intended purpose for the appointment of an examiner.

An examiner is most useful in situations where an investigation into the debtor's affairs is likely to preserve or create value for the estate and benefit all parties in interest. Accordingly, examination of the "good faith" of a movant for the appointment of an examiner will likely involve an analysis of the timing of the request, the proposed scope of duties that an examiner would be ordered to undertake, whether such duties would be duplicative of investigation that had already taken place (or if the requesting party had failed to take advantage of prior opportunity to conduct such investigation on its own), and whether the appointment of an examiner would benefit the estate as a whole instead of merely the party making the request. *See, e.g.*, Transcript of Hearing at 97:5-24, *In re Washington Mut., Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. May 5, 2010) (Walrath, J.) (Docket No. 3699).

Although there will often be merit to require "good faith" to appoint an examiner, that requirement is not in the plain language of the Bankruptcy Code. Indeed, § 1104(c)(2) of the Bankruptcy Code expressly uses the word "shall" when addressing the appointment of an examiner and "[i]t is well established that when a statute's language is plain, the sole function of the courts — at least where the disposition required by the text is not absurd — is to enforce it according to its terms." *Lamie v. United States Trustee*, 540 U.S. 526, 534, 124 S.Ct. 1023 (2004) (citations omitted). If the mandatory nature of the appointment is being exploited for improper (*i.e.*, bad faith) purposes, resolution of this issue may more appropriately lie in the hands of Congress to amend § 1104(c)(2) rather than the courts to adjudicate around it.

Conclusion

The *Spansion* decision highlights the struggle that some courts face when presented with a motion to appoint an examiner in circumstances where such appointment would be unproductive or wasteful under the specific circumstances of the case. The *Spansion* court resolved this issue by refusing to appoint an examiner absent any sound purpose to do so.

This approach seems to have gained momentum; within six weeks of Chief Judge Carey's decision in *Spansion*, Judge Mary Walrath of the United States Bankruptcy Court for the District of Delaware also found in three cases that no investigation was warranted and declined to appoint an examiner despite the statutory threshold having been satisfied. *See In re Magna Entm't Corp.*, Case No. 09-10720 (MFW) (Bankr. D. Del. April 20, 2010) (Walrath, J.); *In re HSH Delaware GP LLC*, Case No. 10-10187 (MFW) (Bankr. D. Del. April 23, 2010) (Walrath, J.); *In re Washington Mut., Inc.*, Case No. 08-12229 (MFW) (Bankr. D. Del. May 5, 2010) (Walrath, J.). Nonetheless, the "mandatory appoint/discretionary duty conflict" may be best resolved by amending § 1104(c)(2).