First Ruling: New Section 1104(e)
May Not Be a Ticking Time Bomb After All

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A fundamental premise of chapter 11 is that a debtor's prebankruptcy management is presumed to provide the most capable and dedicated leadership for the company and should be allowed to continue operating the company's business and managing its assets in bankruptcy while devising a viable business plan or other workable exit strategy. The chapter 11 "debtor-in-possession" ("DIP") is a concept rooted strongly in modern U.S. bankruptcy jurisprudence. Still, the presumption can be overcome. In cases involving demonstrated fraud, incompetence or gross mismanagement, or where the interests of the estate and the stakeholders in the chapter 11 case would be better served by designation of an impartial fiduciary to supplant the DIP, section 1104 of the Bankruptcy Code authorizes the court to direct the appointment of a bankruptcy trustee conferred with a broad array of powers and duties.

Ouster of a DIP is an extraordinary remedy. As a consequence, bankruptcy courts have traditionally been given considerable latitude in determining: (i) what degree of misconduct or incompetence qualifies as "cause" for the appointment of a trustee; and (ii) what factors should be considered in determining the "best interests" of the estate, creditors and shareholders. Even so, a perception that corporate executives have sometimes used chapter 11 as a means of deflecting allegations of fiduciary improprieties or illegality led Congress to amend the Bankruptcy Code in 2005 to expedite court consideration of misdeeds allegedly committed by

prebankruptcy management that could warrant replacing the DIP with a trustee. New section 1104(e) obligates the Office of the U.S. Trustee, an agency of the Justice Department entrusted with overseeing the administration of bankruptcy cases ("UST"), to move for the appointment of a trustee when it becomes aware of colorable allegations that a DIP's corporate executives or board engaged in actual fraud, dishonesty or criminal misconduct either before or after the bankruptcy filing.

Although greeted upon its enactment in April of 2005 with a significant amount of trepidation owing to its potential for derailing reorganizations or forcing companies to "clean house" in anticipation of filing for chapter 11 protection, section 1104(e) remained virtually untested in the courts for more than two years. That is no longer the case. In an apparent matter of first impression, a New York bankruptcy court recently considered what impact the new provision has on the standard applied to a trustee appointment motion. In *In re The 1031 Tax Group, LLC*, the court denied the UST's motion to appoint a trustee, or in the alternative, to convert the case to a chapter 7 liquidation, despite unrefuted allegations that the debtors' principal shareholder committed fraud, because control of the debtors had been subsequently transferred to new managers who had no material connection to either the bad actor or his misconduct. In doing so, the court concluded that the UST's duty to seek the appointment of a trustee under new section 1104(e) has no bearing on the standard customarily applied to determine whether a trustee should in fact be appointed.

The Statutory Background

Section 1104(a) of the Bankruptcy Code provides as follows:

> (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 —
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> (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor;
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> (2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or
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> (3) if grounds exist to convert or dismiss the case under section 1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate.

The examples of "cause" specified in section 1104(a)(1) are illustrative rather than exclusive. In keeping with its broad equitable mandate to protect all stakeholders involved in a chapter 11 case, the bankruptcy court has considerable latitude in determining what conduct or circumstances fit the definition. However, if the court finds that cause exists under section 1104(a)(1), "there is no discretion; an independent trustee must be appointed." A "cause" standard also governs dismissal or conversion of a chapter 11 case under section 1112, which provides that "cause" includes, among other things, substantial or continuing loss to or diminution of the estate, gross mismanagement, and failure to comply with court orders, reporting requirements or statutory fee obligations.

The "best interests" standard in section 1104(a)(2) has been described as "amorphous and necessarily involv[ing] a great deal of judicial discretion." Courts have considered several factors in determining whether the appointment of a chapter 11 trustee would best serve the interests of creditors and the estate, including: (i) the debtor's trustworthiness; (ii) the debtor's

past and present performance, and prospects for rehabilitation; (iii) confidence or lack of confidence of the business community and creditors in present management; and (iv) the benefits that can be derived from the appointment of a trustee balanced against the cost of appointment.

Section 1104(a) provides that parties-in-interest or the UST may seek court intervention if they can either demonstrate by "clear and convincing" evidence that cause exists under subsection (a)(1) or show that the appointment of a trustee is in the best interests of stakeholders under subsection (a)(2), but it does not require them to take action. New section 1104(e), however, creates an affirmative duty for the UST to act in cases where there is a "reasonable" suspicion of wrongdoing by management:

> The United States trustee shall move for the appointment of a trustee under subsection (a) if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.

Section 1104(e) was added to the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). Unlike other provisions in the Act, section 1104(e) became effective immediately — it applies to chapter 11 cases commenced on or after April 20, 2005, instead of October 17, 2005.

Under prior law, the UST had the discretion to move for the appointment of a chapter 11 trustee. Now, the UST is obligated to do so under the circumstances specified in section 1104(e). The legislative history of the provision is scant. According to one commentator, a spokesperson for Senator Edward M. Kennedy, who introduced section 1104(e), indicated that the new provision

is designed to spur the UST to act quickly to redress malfeasance, instead of refusing to assume an aggressive posture, as had been the case previously. Other commentators have pointed to the provision as an indication of lawmakers' strong desire to ensure that corporate executives cannot seek refuge from their responsibilities to the investing public in a chapter 11 case.

Many commentators have criticized the provision's lack of clarity, some speculating that its ambiguity may force financially distressed companies to "clean house" before seeking chapter 11 protection, resulting in blameless executives with expertise crucial to the success of a reorganization effort being forced out (or choosing to seek alternate employment) along with the bad actors. Conjecture among bankruptcy professionals that the provision could seriously disrupt, complicate or even derail a chapter 11 reorganization by causing the unwanted departure of executives has not been borne out by the handful of section 1104(e) motions filed thus far by the UST. Moreover, judging by the only published ruling on the issue issued so far, apprehension that section 1104(e) could be a ticking time bomb may be overblown.

1031 Tax Group

The 1031 Tax Group, LLC, and 16 affiliated entities (collectively, "1031") were "qualified intermediaries" engaged in the business of providing custodial services to individuals and entities relying on section 1031 of the Internal Revenue Code to defer capital gains tax resulting from the sale of investment property through like-kind property exchanges. Until shortly before 1031 filed for chapter 11 protection in May 2007 in New York, Edward H. Okun, either directly or indirectly, was the sole principal of each of the entities involved. Beginning in 2005 and continuing through May 2007, Okun orchestrated a series of unsecured intercompany "loans"

that funneled money deposited by 1031's customers away from 1031 to other entities that he owned or controlled.

When 1031's financial woes ripened into a crisis in early May, the companies retained restructuring professionals. Shortly thereafter and, as the bankruptcy court subsequently noted, "[p]resumably, at least in part, to avoid the appointment of a chapter 11 trustee," Okun took the initial steps necessary to cede control of 1031 to independent management. 1031 informed the bankruptcy court of the ongoing process to select new management when it filed for chapter 11 on May 14, 2007, including the fact that Okun had arranged to retain a turnaround firm and a chief restructuring officer prior to the bankruptcy filings. The court subsequently approved 1031's application to continue employing the turnaround firm.

1031 sought authority to hire a new manager on June 21, 2007. The court provisionally approved the appointment of a new manager on July 17, specifying in its order that its approval was conditioned on 1031 taking all actions required under applicable state laws within 10 days to amend its organizational documents to effect the change in management for each of the debtors, and amending various agreements to make it clear that, without court approval, Okun could not fire the new manager or exercise management authority. Final approval of the management change came on July 27, after 1031 reported to the court that it had complied with the conditions.

Meanwhile, on May 29, 2007, the UST (later joined by various creditors and other interested parties), contending that Okun had engaged in fraud and other misconduct by diverting funds from 1031 to non-debtor entities he controlled, moved for an order directing the appointment of a

chapter 11 trustee or, in the alternative, converting 1031's bankruptcy cases to chapter 7 liquidations.

The Bankruptcy Court's Ruling

The bankruptcy court denied both of the UST's alternative requests for relief. At the outset of its discussion, the court observed that section 1104(e) "gave the U.S. Trustee an important but ill-defined role requiring vigilance and action where fraud, dishonesty, or criminal misconduct by 'current members' of management is suspected." Even so, the court explained, the "reasonable grounds to suspect" standard established in the provision was unquestionably satisfied in the case before it, given the uncontested facts surrounding Okun's "borrowings" from 1031.

When considering whether to appoint a trustee for "cause," the bankruptcy court explained, "a court's focus is on the debtor's current management, not the misdeeds of past management." According to the court, fraud, dishonesty, incompetence or gross mismanagement by prior management "does not necessarily provide grounds for the appointment of a trustee under § 1104(a)(1), as long as a court is satisfied that the current management is free from the taint of prior management."

By challenging "whether new management may be tainted by an association with, or selection or appointment by, the governing body," the court explained that the UST fulfilled its obligation under section 1104(e). The court then addressed the new provision's impact on the standard governing trustee appointment motions. Acknowledging the absence of any rulings to date on the issue, the court concluded that the statutory requirements in section 1104(e) have no bearing

on the standard applied. Sections 1104(a)(1) and (a)(2) and cases interpreting the provisions, the court emphasized, "continue to control whether a trustee should be appointed."

Even so, the court concluded that section 1104(e) does impact the burden of proof in connection with a trustee appointment motion made in cases where tainted old management appoints new management:

> While prior case law establishes that the U.S. Trustee as the moving party bears the burden of proving "cause" by clear and convincing evidence, the Court believes that where the U.S. Trustee establishes a *prima facie* case that a tainted current member of the governing body has selected or appointed new management shortly before or after a chapter 11 filing, a court should apply heightened scrutiny in reviewing whether new management is also tainted, thereby requiring appointment of a chapter 11 trustee for "cause." Once a *prima facie* showing is made by the U.S. Trustee, the burden then shifts to the debtors, or other parties opposing the appointment of a chapter 11 trustee, to demonstrate that the new management is unconflicted by any association with the tainted members of the governing body that made the selection or appointment. If the parties opposing appointment meet this burden, the ultimate burden of establishing cause shifts back to the moving parties.

The court ruled that 1031 had satisfied this shifting burden. The postpetition agreement appointing a new manager, who was not in any way associated with or beholden to Okun or complicit in his alleged misdeeds, implemented a complete, irrevocable, authorized and legally binding change in control during the pendency of 1031's chapter 11 cases. Taken together, the court explained, these measures not only were adequate to overcome the UST's *prima facie* showing under section 1104(e) and to shift the ultimate burden of establishing "cause" back to the UST, but ruled out any finding that cause existed under section 1104(a)(1).

The court concluded that the appointment of a trustee would not be in the best interests of creditors and other stakeholders. Standing alone, the court noted, "a well-founded distrust and a lack of confidence" expressed by some creditors, even with new management, would point to the appointment of a trustee. Still, the court emphasized, "there are additional factors to consider," including: (i) the existence of an active creditors' committee functioning effectively and working well with the debtors; (ii) significant progress achieved in the chapter 11 case, as demonstrated by the filing of a disclosure statement jointly proposed by the committee and 1031; and (iii) the shared interest of all constituents in confirming a viable chapter 11 plan as expeditiously as possible, given the 180-day deadline established by the tax laws for completing like-kind exchanges. According to the court, "ordering the appointment of a chapter 11 trustee now would threaten these positive developments." Finally, citing substantially the same reasons, the court denied the UST's motion in the alternative to convert 1031's chapter 11 cases to chapter 7 liquidations.

Analysis

1031 Tax Group provides useful guidance in determining what impact section 1104(e) has on the criteria traditionally applied to trustee motions under sections 1104(a)(1) and (a)(2), but it leaves several important questions unanswered. For example, the bankruptcy court's burden shifting paradigm apparently applies only to situations where tainted old management appoints new management that is allegedly unsullied and independent. Moreover, unlike *1031 Tax Group*, other cases are likely to involve contested allegations of wrongdoing. How is the burden of proof to be allocated in cases where the UST's "suspicions" of wrongdoing are refuted, or where control has not been transferred to new management? Presumably, the burden would then rest

squarely on the shoulders of the UST to demonstrate the existence of “cause” by clear and convincing evidence, as was the law prior to section 1104(e)’s enactment. Proving that management engaged in fraud, dishonesty or criminal conduct, moreover, may be more difficult than establishing what would otherwise amount to “cause” under section 1104(a)(1), especially in light of management’s heightened stake in the outcome and the possibility of facing criminal liability based upon the bankruptcy court’s determination.

Uncertainty also remains regarding the meaning in section 1104(e) of “reasonable grounds to suspect,” a phrase that appears nowhere else in the Bankruptcy Code. Other provisions of the Bankruptcy Code contain the phrase “reasonable cause to believe,” but we are left to speculate whether the language in section 1104(e) establishes a lower standard triggering the UST’s obligation to act than what is commonly understood to be reasonable belief.

The bankruptcy court’s concern regarding the potential for derailing a reorganization by displacing a DIP based solely upon creditor distrust or lack of confidence is notable. It demonstrates the difficulty in balancing the important public interests in ensuring that chapter 11 not act as a smokescreen to conceal the misconduct of corporate fiduciaries against the equally important policy favoring a presumption that existing management has the best chance to steward a company successfully through chapter 11. Finally, *1031 Tax Group* indicates that, consistent with the purpose of the provision, the scope of section 1104(e) should extend beyond CEOs, CFOs or “governing body” members of corporate debtors — a limitation that the provision’s language could be interpreted to impose — to encompass any individual or entity in control of a chapter 11 debtor.

The 2005 BAPCPA amendments added numerous provisions to the Bankruptcy Code designed to augment management accountability and provide greater protection to creditors, shareholders and the public. In addition to section 1104(e), the reforms placed new limitations on a chapter 11 debtor's exclusive right to file and solicit acceptances for a chapter 11 plan, and severely curtailed the circumstances under which a debtor can win approval of key employee retention plans that had been perceived to provide overly generous stay-on benefits and incentives to existing management. In addition, section 1112(b) was amended to limit the court's discretion to refuse to order conversion of a chapter 11 case to a chapter 7 liquidation if the debtor fails to move expeditiously toward confirmation of a plan. These changes are one of the latest salvos in a wave of corporate accountability reforms that began in 2002 with passage of the Sarbanes-Oxley Act. Among other things, Sarbanes-Oxley amended the Bankruptcy Code to add section 523(a)(19), which makes non-dischargeable in an individual's bankruptcy case debts based upon violations of securities laws if there has been a judgment, order, consent order or decree in a federal or state judicial or administrative proceeding entered against the debtor.

Epilogue

Just over two months after bankruptcy judge Martin Glenn issued his ruling in *1031 Tax Group*, the UST, joined by various creditors and with the support of the official unsecured creditors' committee, renewed her motion to appoint a chapter 11 trustee for the 17 affiliated debtors. This time Judge Glenn granted the motion.

Developments in the chapter 11 cases had been anything but positive after Judge Glenn denied the UST's trustee motion on August 13, 2007. Among other things, the proposed cash infusion promised by Okun that was to be drawn from non-debtor affiliates controlled by him proved to be much less than anticipated, especially after three of the companies filed for chapter 11 protection in early October. With little or no prospect for a finalized plan funding agreement on the horizon and a continuing lack of creditor confidence in management, Judge Glenn reconsidered his previous determination that the appointment of a chapter 11 trustee would not, on balance, best serve the interests of the estate and its stakeholders.

Given the changed circumstances in the case, Judge Glenn concluded that a trustee should be appointed under section 1102(b)(2):

> The factors that weighed heavily in denying the earlier trustee motions either no longer apply at all or are now greatly attenuated. Any hope for a prompt exit from chapter 11 has seemingly vanished. Okun has proven that he is unreliable (or worse) in delivering in any timely way on the promises he made at the start of these cases and many times since. If there are benefits to the estate from the proposed new agreement with Okun, the chapter 11 trustee should be the one in the first instance to reach that conclusion. . . . The level of distrust between the Debtors, on the one hand, and the objecting creditors, on the other hand, already high earlier in the case, has only increased.

In re The 1031 Tax Group, LLC, 374 B.R. 78 (Bankr. S.D.N.Y. 2007).

In re The 1031 Tax Group, LLC, No. 07-11448(MG) (Bankr. S.D.N.Y. Oct. 23, 2007) (unpublished amended memorandum opinion and order granting motions for appointment of chapter 11 trustee).

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