Hearing Date: N.A. [(Local Rule 9023-1(a)]
Objection Deadline: February 6, 2006, 5:00 p.m.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	
Refco Inc., *et al.*,	:	Chapter 11
	:	Case No. 05-60006 (RDD)
Debtors.	:	(Jointly Administered)

MOTION OF UNITED STATES TRUSTEE UNDER FEDERAL RULE OF BANKRUPTCY PROCEDURE 9023 FOR RECONSIDERATION OF AMENDED ORDER DENYING IN PART, CONDITIONALLY GRANTING IN PART, AND ADJOURNING IN PART, MOTION OF THE UNITED STATES TRUSTEE PURSUANT TO 11 U.S.C. § 1104(a)(2)

Deirdre A. Martini, the United States Trustee for Region 2 (U.S. Trustee), hereby respectfully files her Motion Under Federal Rule of Bankruptcy Procedure 9023 for Reconsideration of the Amended Order Denying in Part, Conditionally Granting in Part, and Adjourning in Part Motion of the United States Trustee to Appoint Chapter 11 Trustee Pursuant to 11 U.S.C. § 1104(a)(2) (Denial Order), entered January 12, 2006.

BACKGROUND

On December 9, 2005, the U.S. Trustee filed her Motion to Appoint a Trustee Pursuant to 11 U.S.C. § 1104(a) (Trustee Motion), to which the Debtors stipulated. Shortly thereafter, the Court set a hearing on the Trustee Motion for January 10, 2006.

After the filing of the Motion, and at the insistence of the Official Committee of Unsecured Creditors (Committee), the Debtors appointed Harrison J. Goldin (Mr. Goldin) to serve as their Chief Executive Officer. Motion for an Order under 11 U.S.C. §§ 105 and 363

Authorizing the Employment of Goldin Associates, LLC as Crisis Managers for the Debtors, at p. 4. According to the Debtors, the appointment was intended, among other things, "to reduce the controversy over corporate governance, [and to] reduce the expense and uncertainty associated with an election." *Id.* Mr. Goldin began performing services for the Debtors on December 16, 2005 – one week after the filing of the Trustee Motion. *Id.* The Committee thereafter objected to the Motion, citing Mr. Goldin's employment as the principal reason why the appointment of a Chapter 11 trustee was not necessary in these cases.[1]

The Court held a hearing on the Trustee Motion on January 10, 2006. At the conclusion of the hearing, the Court announced its ruling and its underlying reasons from the bench.

On January 11, 2006, the Court entered its Order Denying Motion of the United States Trustee to Appoint Chapter 11 Trustee Pursuant to 11 U.S.C. § 1104(a)(2). The entry of this order was followed on January 12, 2006 by the entry of the Denial Order, which, pursuant to its own terms, replaces and supersedes the prior order.

The Denial Order sets forth alternative, contingent rulings. First, the Denial Order states that the relief requested in the Motion:

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[1]In addition to the Committee, the Moving Customer Group, an *ad hoc* group comprised of a number of parties in interest in the Refco Capital Markets, Ltd. (RCM) case, filed an objection to the Motion. Their principal objection to the Motion was that RCM should have a trustee different from the trustee for the remaining Debtors. The Moving Customer Group based this point of view on their contention that RCM has substantial claims against many of the Debtors that could not be both pursued and defended by the same trustee. The U.S. Trustee, after reviewing the Debtors' schedules and statements of financial affairs and considering the position of the Moving Customer Group, concluded that if the Court were to order the appointment of a trustee, she would exercise her discretion under Fed. R. Bankr. P. 2009(c)(2) to appoint a separate trustee for RCM. Before the hearing on the Motion, the U.S. Trustee so advised the Moving Customer Group, which thereafter at the hearing orally withdrew their objections to the Motion.

> is denied in its entirety, on the condition that, on or before January 13, 2006, and subject to further Order of the Court, (i) the members of the Refco Board (other than Bennett, whose removal will be addressed by the Bennett Removal Motion) tender their resignations and those resignations are accepted by Refco; (ii) at least one new director, who was previously unaffiliated with the Debtors and is independent, is appointed to the Refco Board; and (iii) the Bennett Removal Motion is granted by this Court . . . .

Denial Motion, p. 3.

In the alternative, the Denial Order provides that, if the foregoing conditions are not timely satisfied, the Trustee Motion would be granted –

> and the U.S. Trustee is directed to appoint a chapter 11 trustee for all the Debtors, on the condition that (i) the trustee so appointed shall have only the oversight functions of a board of directors and not the management powers of a chief executive officer; and (ii) shall not cause the removal or otherwise interfere with the actions of Harrison J. Goldin as the Debtors' Chief Executive Officer absent good cause and compliance with the requirements of 11 U.S.C. § 363(b).

Id.

On January 11, 2006, Refco filed its Debtors' Motion for Order Directing Removal of Phillip R. Bennett from the Board of Directors of Refco, Inc. The Debtors withdrew this motion at a hearing held January 13, 2006. At the hearing, the Debtors announced that Stephen M. Brecher had been appointed by the board of directors to serve as a new director of Refco, and further announced that all prior board members had resigned.

DISCUSSION

The Applicable Reconsideration Standards

Federal Rule of Civil Procedure 59, as made applicable to contested matters by Fed. R. Bankr. P. 9023, allows a bankruptcy court to vacate, set aside or modify a previously entered order. *In re Texlon Corp.*, 596 F.2d 1092 (2nd Cir. 1979); *In re Emergency Beacon Corp.*, 666 F.2d 754 (2nd Cir. 1981). Rule 59, in relevant part, states:

> On a motion for a new trial in an action tried without a jury, the court may open the judgment if one has been entered, take additional testimony, amend findings of fact and conclusions of law or make new findings and conclusions, and direct the entry of a new judgment.
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> Any motion to alter or amend a judgment shall be filed no later than 10 days after the entry of the judgment.

Fed. R. Civ. P. 59(a), (e).

In non-jury cases, a motion to alter or amend the judgment under Rule 59(e) is appropriate when the prior decision is based upon a manifest error of law or fact. *Ball v. Interoceanica Corp.*, 71 F.3d 73, 76 (2nd Cir. 1995) (*citing* 6A Wright and Miller, *Federal Practice & Procedure*, § 2804); *Bowers v. Andrew Weir Shipping, Ltd.*, 817 F.Supp. 4, 5 (S.D.N.Y. 1993). Rule 59(e) was adopted to enable the prompt correction of legal errors. *In re Hupton*, 287 B.R. 438, 445 (Bankr. N.D. Iowa 2002). Bankruptcy courts have broad discretion to grant motions for reconsideration under Rule 59(e). *Id.*

The Court's Conclusions Were Erroneous as a Matter of Law

1. In determining whether to order the appointment of a chapter 11 trustee, the Court erred by considering the candidates the U.S. Trustee might appoint.

Under 11 U.S.C. § 1104(d), after the court orders the appointment of a chapter 11 trustee, the U.S. Trustee is empowered, after consultation with parties in interest, to appoint, subject to the court's approval, a disinterested person to serve as trustee in the case. The Court has erred by allowing concerns over whom the U.S. Trustee might appoint to serve as trustee to color the Court's determination of whether grounds exist for the appointment of a trustee.

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In support of its Motion, the U.S. Trustee asserted that Refco's board of directors was fatally conflicted and could not, among other things, discharge its fiduciary obligations to direct an investigation into the financial affairs of the Debtors and to prosecute potential claims the estate might have against board members and others. The Court agreed with the U.S. Trustee's conclusion. (Transcript, at p. 115).[2] The Court, however, went on to state that notwithstanding the then-extant board's inability to carry out its fiduciary obligations, the appointment of a trustee would not be in the best interests of the estate because the trustee might interfere with Mr. Goldin's management of the debtor and because creditors might elect a trustee to replace the person whom the U.S. Trustee appoints.[3] (Transcript, at p. 123).

By the Court's rationale, a bankruptcy court may decide whether to appoint a chapter 11 trustee based upon its own assumptions about whom the U.S. Trustee might appoint. This basis for the Court's denial of the U.S. Trustee's motion turns the Bankruptcy Code's scheme for the appointment of a chapter 11 trustee on its head, and improperly interferes with the ability of the U.S. Trustee to exercise her independent authority to appoint a trustee after consultation with parties in interest and subject to later court approval. One of the fundamental changes wrought by the adoption the Bankruptcy Code in 1978, and the nationwide expansion of the United States Trustee Program in 1986, was to separate the bankruptcy courts from virtually all administrative

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[2] In support of this motion to reconsider, concurrently herewith the U.S. Trustee has filed relevant excerpts of the Transcript of the hearing on the Trustee Motion, held Jan. 10, 2006.

[3]The Court also suggested that it may broadly consider an appointed trustee's "skill set" in deciding whether to approve the U.S. Trustees's appointment under 11 U.S.C. § 1104(d). (Transcript, at p. 104). While the U.S. Trustee believes that the Court's discretion to deny the approval of a trustee appointment is more narrowly circumscribed by law than the Court suggests, this issue is not ripe for decision.

matters, including, notably, the decision of who should serve as trustee in a bankruptcy case. *See* H.R. Rep. No. 595, 95th Cong. 1st Sess., at 88-99 (1977). This change was designed largely to address problems of cronyism and favoritism that existed under prior law. *Id.*

In both the Denial Order and its oral ruling, the Court has inserted itself substantially into the determination of who should serve as the independent fiduciary in these cases. The issue of whether a chapter 11 trustee should be appointed is addressed to the court, and may be referred to colloquially as a "what" issue. In other words, the bankruptcy court, based on the law and the facts of the case, is called upon to determine whether a chapter 11 debtor should remain in possession or a chapter 11 trustee should be appointed. After the court makes this determination, the U.S. Trustee is required, after consultation with parties in interest, to appoint a disinterested person to serve as trustee. 11 U.S.C. § 1104(d).

By engaging in judicial speculation over whom the U.S. Trustee might appoint and over what role Mr. Goldin might play under a trustee, the Court converted the "what" issue into a legally-impermissible "who" issue. The Court, based upon the Committee's preference for Mr. Goldin, made it abundantly clear that, if the answer to the "who" question was not "Harrison J. Goldin," then it was going to tailor its order to assure that Mr. Goldin remained in effective control of the Debtors' estates. The Court thereby usurped the role of the U.S. Trustee to determine who should be appointed as an independent fiduciary to manage the affairs of the Debtors.[4]

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[4] 7 *Collier on Bankruptcy*, ¶ 1104.02[6] (15th ed. 2005), states in relevant part:

> The thrust of the rules for the appointment of a trustee is to remove the court from the selection process in order to protect the court's appearance of impartiality in subsequent proceedings. The court should not use its approval power to force the choice of a candidate that the court favors.

2. The Court erred in finding that the hiring of Mr. Goldin as CEO, coupled with a last-minute resignation by the board of directors after appointing a single successor director, obviated the need for a Chapter 11 trustee.

In its Denial Order, the Court found that the Trustee Motion would be denied, so long as the members of the Debtors' board of directors resigned by close of business on January 13, 2006, and at least one independent director previously unaffiliated with the Debtors was appointed to the board. The Debtors apparently fulfilled these conditions.[5] They announced on January 13 that, effective January 12, Stephen M. Brecher had been appointed to the board by the board of directors, and the remaining members had resigned their memberships on the board.

While bankruptcy courts may take into account changes in a debtor's management team in determining whether to order the appointment of a Chapter 11 trustee under 11 U.S.C. § 1104(a)(2), last-minute management changes designed to fend off a trustee appointment have been found to be unavailing. *See In re Microwave Products of America, Inc.*, 102 B.R. 666 (Bankr. W.D. Tenn. 1989); *In re Sharon Steel,* 871 F.2d 1217 (3rd Cir. 1989). In this vein, the relevant sequence of events is noteworthy. Even though the U.S. Trustee had made it abundantly clear for weeks that she would ultimately seek the appointment of a chapter 11 trustee in these cases, the Debtors did not bring Mr. Goldin on board until a week after the U.S. Trustee filed her Trustee Motion,[6] and even then only at the Committee's insistence. But the conflicted board of

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[5] The Court concluded that the appointment of a single director by the conflicted board of directors to exercise the full authority of the board is sufficient under Delaware law. The U.S. Trustee is not addressing here whether this conclusion is warranted.

[6] The Court stated in its bench ruling that Mr. Goldin's authority had been called into question by the Trustee Motion, and that Mr. Goldin had been reluctant to undertake necessary actions pending a determination of the Trustee Motion. (Transcript, at pp. 122-123). Because Mr. Goldin accepted the CEO position after the Trustee Motion was filed, it is difficult to see how the Motion called Mr. Goldin's authority into question. Furthermore, the U.S. Trustee is

directors remained in office, exercising control over Mr. Goldin as CEO. After the U.S. Trustee argued that the board composition prevented Mr. Goldin from exercising independent control over the Debtors' affairs, the Court permitted the Debtors to continue to reshuffle management by replacing the board of directors. These management changes, having been made only during the pendency of the Trustee Motion, are clearly "too few and too late." *Microwave Products* at 676.

3. Implicit in the Denial Order is an improper limitation on the board of directors to manage the affairs of the debtors in possession.

Additional problems may now exist with the new management structure of the Debtors. There is substantial doubt whether, in light of the Court's bench rulings and later Denial Order, Mr. Brecher has in fact been vested with the full authority of a board of directors under Delaware law.

In the Court's bench ruling, the Court stated that it would find that any chapter 11 trustee appointed by the U.S. Trustee would breach his or her fiduciary duties if that trustee did not retain Mr. Goldin in the management of the Debtors' affairs. (Transcript, at p. 129). Such judicial constraints would substantially limit the independent business judgment with which trustees and debtors in possession are vested in operating debtors' businesses under section 1108 of the Bankruptcy Code. *See, generally, In re Curlew Valley Associates*, 14 B.R. 506 (Bankr. D. Utah 1981). The "business judgment rule" applicable in bankruptcy cases to trustees and debtors in possession is directly analogous to the corporate law "business judgment rule" applicable to boards of directors. The corporate rule presupposes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that

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aware of no evidence, in the record or otherwise, that Mr. Goldin refrained from taking any action as the CEO of the Debtors during or because of the pendency of her Trustee Motion.

the action taken was in the best interests of the company." *Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984).

The Court's preemptive limitation of a chapter 11 trustee's authority to exercise his or her business judgment – by determining whether and in what role Mr. Goldin would be retained – raises substantial questions regarding whether the Debtor's newly reconstituted board is operating subject to a similar implied judicial limitation of its business judgment. The Denial Order creates a false dichotomy between board oversight on the one hand, and management on the other hand. Under Delaware law, the board of directors is responsible for management of a corporation's affairs: "The business of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ." 8 De.C. § 141(a). The officers of a corporation are agents of the board, but the board is ultimately responsible for their actions. *Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co.*, 34 Del. 567, 156 A. 350 (1931). Under Delaware corporate law, directors may not irrevocably delegate their duty to manage the corporate enterprise. *Adams v. Clearance Corp.*, 35 De. Ch. 459, 121 A.2d 302 (1956). Clearly, when a debtor is in possession, bankruptcy courts are not to involve themselves in issues of corporate governance absent evidence of clear abuse. *In re Johns-Manville Corp.,* 801 F.2d 60 (2nd Cir. 1986). In fact, the Debtors' prior board replaced the chief executive officer twice since the cases were filed, without Court approval of those changes.

Because a corporate officer is merely an agent of the board of directors, exercising management powers delegated by the board of directors, the principles of agency law apply to the relationship between the officer and the board. A fundamental principle of agency is that the principal at all times retains the power to revoke the authority of the agent. Restatement

(Second) of Agency, § 118. Even if the principal and agent have entered into a contract under which certain authority is delegated to the agent, the principal may revoke that authority at will, subject only to the right of the agent to seek damages for breach of contract. *Id.* Under these principles, a corporate board at all times retains the right to terminate the corporation's CEO or to limit the CEO's authority.

The Court has nowhere expressly limited the authority of the Debtors' newly reconstituted board to exercise its full powers under Delaware law. Nevertheless, there is no logical way to justify an order that would severely limit the authority of any chapter 11 trustee appointed to exercise his or her business judgment with respect to management, while simultaneously allowing the board of directors full authority over the management of the Debtors. Certainly a disinterested chapter 11 trustee who has publicly disclosed all connections to the Debtors, their creditors, and other parties in interest, and who has been appointed by an official of the U.S. Department of Justice after due consultation with parties in interest, should be given at least as much deference as a sole director elected by an outgoing conflicted board of directors. In any event, to the extent that the Court's Denial Order implicitly limits the authority of the current board of directors to exercise full management authority over the Debtors, including the authority to replace the current management team, the Denial Order is contrary to law.

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4. The Court cannot legally limit the authority of a chapter 11 trustee to exercise the powers and perform the duties of a trustee under the Bankruptcy Code.

The Denial Order provides that if the U.S. Trustee appoints a chapter 11 trustee for these Debtors, that trustee "shall have only the oversight functions of a board of directors and not the management powers of a chief executive officer." The Denial Order further provides that a Chapter 11 trustee "shall not cause the removal of or otherwise interfere with the actions of Harrison J. Goldin as the Debtors' Chief Executive Officer absent good cause and after compliance with the requirements of 11 U.S.C. § 363(b)." Just as the Court may not limit the authority of the board of directors over management of the debtors in possession, the Court may not limit the authority of a chapter 11 trustee over the management of the Debtor's estates. These provisions of the Denial Order are therefore fundamentally inconsistent with the Bankruptcy Code and with general principles of corporate governance.

The United States Supreme Court has spoken unequivocally about the authority of a bankruptcy trustee over the debtor:

> [T]he Bankruptcy Code gives the trustee wide-ranging authority over the debtor. In contrast, the powers of the debtor's directors are severely limited. Their role is to turn over the corporation's property to the trustee and to the creditors. Congress contemplated that when a trustee is appointed, he assumes control of the business, and the debtor's directors are "completely ousted."

CFTC v. Weintraub, 471 U.S. 343, 352-3 (1985). The Supreme Court also has observed that, because the authority of corporate officers is legally derived from that of the board of directors, no meaningful distinction exists between the two vis-a-vis a trustee. *Id.* at 348, n. 4.

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The duties of a chapter 11 trustee are set forth in 11 U.S.C. § 1106. It is noteworthy that, with the sole exception of the duty to investigate under § 1106(a)(3), the statute nowhere

empowers the Court to relieve the trustee of these duties. In addition to these duties, the chapter 11 trustee has broad powers under numerous other sections of the Code. Among these powers are: the power to avoid certain transfers under §§ 544 – 550; the power to assume or reject executory contracts under § 365; the power to use, sell, or lease property of the estate under § 363; the power to retain professionals under § 327; and the authority to operate the debtor's business under § 1108. While a trustee's exercise of many of these powers is subject to court approval, nowhere in the Bankruptcy Code is the bankruptcy court empowered to divest a trustee of any of these powers and to vest them in another entity so long as the trustee is serving.

The Denial Order would clearly hamper the chapter 11 trustee in the performance of these duties and the exercise of these powers. For instance, under section 1106(a)(5), the trustee is required, as soon a practicable, to file a plan of reorganization, to file a report of why the trustee will not file a plan, or to recommend conversion to another chapter of the Code. Under the management structure imposed by the Denial Order, however, it is highly doubtful that a trustee exercising only "the oversight functions of a board of directors and not the management powers of a chief executive officer" would have sufficient information to perform this duty in a meaningful way. While it might be argued that Mr. Goldin would perform these duties and exercise these powers in the trustee's name, the chapter 11 trustee would lack meaningful input into what Mr. Goldin did, and would have the burden to demonstrate "cause" to the Court before the trustee "interferes" with Mr. Goldin's actions. The trustee would be a figurehead, exercising even less control over the Debtors' affairs than the conflicted board of directors that all parties in interest acknowledged had to be replaced. By the terms of the Denial Order, the chapter 11

trustee would have all of the statutorily-based fiduciary duties of a trustee, but would be judicially-hamstrung in the performance of those duties.

If a chapter 11 trustee is appointed, the Denial Order will strip the trustee of most of the powers and duties of a trustee and vest those powers and duties in a legally subordinate individual effectively appointed by the Court – Mr. Goldin. The Denial Order and the Court's bench ruling demonstrate the Court's determination to assure that Mr. Goldin retains virtually unfettered authority to manage the Debtors' affairs. Clearly, however, bankruptcy courts have no authority under the Bankruptcy Code to dictate who should exercise the powers of a trustee. (*See* law cited at p. 6, *supra*). Because the Denial Order contemplates the appointment of a toothless trustee who will have little or no control over the Court's designated CEO, Mr. Goldin, the Denial Order contravenes both the letter and spirit of the Bankruptcy Code.

WAIVER OF MEMORANDUM

Because the legal points and authorities upon which this motion is based are incorporated herein, the U.S. Trustee respectfully requests that the requirement of Local Rule 9013-1(b) that a separate memorandum of law be filed and served be deemed satisfied by this motion.

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CONCLUSION

Based upon the foregoing, the U.S. Trustee respectfully requests that this Court: (a) reconsider the Denial Order; (b) enter an order directing the appointment of a trustee under 11 U.S.C. § 1104(a)(2), without any express or implied limitations on such trustee's powers and duties; and (c) providing such additional relief as might be proper.

Dated: New York, New York
January 20, 2006

Respectfully submitted,

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UNITED STATES TRUSTEE

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