

Who is Responsible Here? 'Responsible Persons' in Chapter 11 Cases

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While the underlying facts may vary somewhat, a familiar scenario occasionally plays out in bankruptcy courts across the United States. A company, usually either a corporation or limited liability company, is in dire straits. The unmistakable odor of fraud is in the air, as investors and others have commenced lawsuits against the company and its principals alleging widespread financial misdeeds and abuse. State and federal securities regulators are eyeing the company with increasing suspicion, and seem likely to commence enforcement actions and to seek the appointment of receivers. The principals of the company consult with bankruptcy counsel to determine if a chapter 11 filing will provide them with relief from their troubles.

Counsel advises the principals that they must bring in a new manager to navigate the case through chapter 11. To avoid the appointment of a chapter 11 trustee, the new manager must be given free rein to make all decisions in the chapter 11 case. Accordingly, the company files a chapter 11 petition, and immediately asks the court to approve a named individual as the “responsible person” for the debtor-in-possession. The responsible person will have all of the rights, powers, and duties of a chapter 11 trustee and will be subject to removal only by court order.

There is only one problem – the Bankruptcy Code does not support this result. This article will examine the rationales frequently advanced for the appointment of “responsible persons” and show that, under the circumstances outlined above or in any other circumstances where a chapter 11 debtor’s management cannot be trusted to serve as an estate fiduciary, the only Code-based remedy is the appointment of a chapter 11 trustee.

One of the major controversies during the legislative debates leading to the enactment of the Bankruptcy Code in 1978 was how debtors reorganizing under the new chapter 11 would be governed. Some argued that an independent trustee should be appointed in every case involving a public company. Others believed that chapter 11 debtors should generally be permitted to remain in possession and to control their own reorganization destinies. As enacted, the Bankruptcy Code reflected a compromise between these two views. By default, a chapter 11 debtor is a “debtor in possession,” 11 U.S.C. § 1101(1), and has virtually all of the rights, powers and duties of a trustee. 11 U.S.C. § 1107(a). If, however, the court finds that “cause” exists for the appointment of a trustee, or that such an appointment is in the interests of creditors, equity security holders, and other interests of the estate, the court is directed to order the appointment of a trustee. 11 U.S.C. § 1104(a)(1), (2).

Nowhere in the Bankruptcy Code does a “responsible person” appear as an alternative to a DIP or a chapter 11 trustee. The Bankruptcy Code is conspicuously silent on who has the power

to govern a non-individual DIP. For instance, while a corporation can be a debtor under chapter 11, the definition of “corporation” in 11 U.S.C. § 101(9) provides no hint regarding who controls a corporate DIP. This is by design. With very few exceptions, corporations and other artificial entities are creatures of state statutory law.

Whether a corporate debtor may irrevocably turn its affairs over to a responsible person must therefore be determined under state law. If such a permanent devolution of corporate management authority to an individual is permissible under state law, the bankruptcy court need not be involved in the selection or approval process. Because, however, few if any state statutes permit such a management structure, parties seeking the appointment of a responsible person to ward off a trustee appointment must enlist the aid of the bankruptcy court.

Does *Gaslight* Provide Illumination?

Parties seeking the appointment of a responsible person to perform the duties of a DIP usually base their argument on §§ 105(a) and 1107(a) of the Bankruptcy Code. They invite the bankruptcy court to follow the lead of the U.S. Court of Appeals for the Seventh Circuit in *In re Gaslight Club Inc.*, 782 F.2d 767 (7th Cir. 1986). A close reading of *Gaslight* demonstrates, however, that its unusual facts limit its precedential value.

The debtors in *Gaslight* were a series of related companies that operated private dining and drinking clubs throughout the United States. President and majority shareholder Robert Fredericks retained control of the companies after they filed chapter 11 petitions. Over time, the creditors’ committee became concerned about the debtors’ continuing operating losses and sought to compel a sale of excess property and the early filing of a plan. The creditors’ committee ultimately requested an order designating an individual to operate the *Gaslight* companies and to exercise their DIP rights. All parties in interest, including Fredericks and the U.S. Trustee, consented to the appointment. (While *Gaslight* was decided before the nationwide expansion of the U.S. Trustee Program under the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. 99-554, Oct. 27, 1986, 100 Stat. 3088, the cases arose in a district in which the U.S. Trustee system had operated as a pilot since the enactment of the Bankruptcy Code.) The responsible person quickly terminated Fredericks from his position as president. Fredericks began seeking to regain control over the *Gaslight* companies, asserting that his consent had been based upon a promise that he would remain employed.

Fredericks’ principal argument was that the bankruptcy court improperly circumvented the statutory procedures for appointing trustees by replacing him with the responsible person. The court of appeals, however, agreed with the district court that “on the very special facts of this case” the bankruptcy court’s order was appropriate and authorized by the statute. 782 F.2d at 770. The “very special facts” were the consent of all parties, including the U.S. Trustee, to the responsible person appointment. The appellate court found that §§ 105(a) and 1107(a) authorize the bankruptcy court to approve the replacement of the management of a DIP with a non-trustee responsible person so long as all parties agree to this course of action. *Id.* at 771.

The *Gaslight* court was troubled that Fredericks sought to renege on a deal that the parties had worked out and the bankruptcy court had blessed. It was loath to permit Fredericks to back out of the deal because his expectations might not have been met. The court itself sought to limit the precedential value of its opinion: “We would certainly question recourse to the present procedure as a means generally to avoid the appointment of a trustee. But we think the peculiar circumstances of the case before us as well as the consent on all sides to the procedure followed make this case different.” *Id.* at 772. While the *Gaslight* facts seemed to compel the result reached by the court, the *Gaslight* legal analysis was flawed and should not be followed.

“Responsible Persons” Not Authorized by § 105(a) or 1107(a)

The *Gaslight* court erred in concluding that it had authority to order the appointment of an independent responsible person to replace the management of a DIP. When “cause” exists, including fraud, dishonesty, incompetence or similar misconduct, Congress has established only one remedy that can supplant management while allowing the case to remain in chapter 11 – the appointment of a trustee pursuant to § 1104(a). Because § 1104(a) expressly sets forth a mechanism for the appointment of an independent fiduciary to replace management of a DIP, parties and bankruptcy courts cannot ignore this provision by writing alternative remedies into the Code. Courts must be faithful to the plain meaning of the Bankruptcy Code’s provisions, as drafted by Congress, and read them narrowly. *See, e.g., Lamie v. United States Trustee*, 540 U.S. 526, 533 (2004) (strictly interpreting 11 U.S.C. § 330(a)(1)). There is no “quasi-trustee” provision in the Code.

Parties seeking the appointment of responsible persons follow the lead of the *Gaslight* court by relying on 11 U.S.C. § 105(a) as authorizing the court to appoint a responsible person instead of directing the appointment of a trustee. Section 105(a) provides that “[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].” While this provision does grant bankruptcy courts broad equitable powers, it does not create substantive rights otherwise unavailable under the Bankruptcy Code. And it is universally accepted that a court cannot employ § 105(a) to ignore, supersede, misconstrue any bankruptcy statute or rule. As the U.S. Supreme Court has held, “Whatever equitable powers remain in the bankruptcy courts must and can be exercised [only] within the confines of the Bankruptcy Code.” *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988).

Parties seeking to support a responsible person appointment by invoking the bankruptcy court’s general equitable powers under § 105(a) never address the specific limitation on those powers contained in § 105(b): “Notwithstanding subsection (a) of this section, a court may not appoint a receiver in a case under this title.” Legislative history underlying this prohibition could not be more clear: “[T]he bankruptcy judge is prohibited from appointing a receiver in a case under title 11 under any circumstances. The Bankruptcy Code has ample provision for the appointment of a trustee when needed. Appointment of a receiver would simply circumvent the established procedures.” S. Rep. No. 989, 95th Cong., 2d Sess. 29 (1978). While a responsible person is not called a “receiver” by name, if she is given control over the debtor’s assets and

business, subject only to further orders of the court, she clearly is exercising the types of powers and performing the types of duties traditionally assigned to receivers.

The Bankruptcy Court for the Southern District of New York recently rebuffed efforts to have the court rely on § 105(a) to appoint a non-trustee fiduciary. In *In re Adelpia Comm. Corp.*, 336 B.R. 610 (Bankr. S.D.N.Y. 2006), the court pointed out that § 1104 calls for only two kinds of fiduciaries – trustees and examiners. *Id.* at 664. The movant had not shown grounds for a trustee appointment, and had not sought an examiner appointment. The bankruptcy court held that “[a]ppointing a trustee equivalent, under these circumstances, would be doing exactly what the Second Circuit told the lower courts *not* to do: using section 105(a) ‘to create substantive rights that are otherwise unavailable under applicable law’ and to ‘invent remedies that overstep statutory limitations.’” *Id.* (footnotes omitted)(emphasis in original).

The *Gaslight* court also cited § 1107(a) as a source of its power to appoint a responsible person. Section 1107(a) provides that the DIP will have most of the rights, powers, and duties of a chapter 11 trustee, “subject . . . to such limitations or conditions as the court prescribes. . . .” Reliance on § 1107 to support an order supplanting corporate management with a court-appointed quasi-trustee in circumvention of § 1104(a) is plainly wrong. The *Adelpia* court observed that the circumstances under which a bankruptcy court exercises its discretion to prescribe conditions and limitations on normal DIP status should be relatively limited, and that the court’s power to prescribe additional conditions and limitations restricting normal DIP rights and powers should be exercised with restraint. *Adelpia*, 336 B.R. at 665. The court concluded that it might be “altogether forbidden” from using § 1107(a) to impose limitations on the rights of a DIP that circumvented other sections of the Bankruptcy Code, such as § 1104(a). *Id.* at 666.

The *Adelpia* court correctly recognized that bankruptcy courts may not properly rely on § 1107(a) as a source of authority to appoint or supplant estate fiduciaries. While § 1107(a) clearly enables a court to place some limitations on the duties of a DIP, it does not even implicitly authorize the court to appoint a person to perform those duties.

The Bankruptcy Code expressly states who should perform duties that a DIP is ordered not to perform. Section 1106(b) states that an examiner appointed under § 1104(c) shall, in addition to conducting an investigation and filing a report, perform, “except to the extent that the court orders otherwise, any other duties of the trustee that the court orders the debtor in possession not to perform.” Sections 1107(a), 1104(c), and 1106(b) therefore provide courts with an explicit and flexible Code-based remedy to allocate trustee duties between the DIP and an examiner. Courts need not, and indeed should not, seek to divine from § 1107(a) an implied power to appoint a responsible person as a fiduciary. Instead, courts should direct the appointment of an examiner to perform those duties that the DIP has been ordered not to perform.

Gaslight was decided over 20 years ago, and has not been widely followed. Reported decisions almost universally reject its underlying premises or limit its holding to cases where all parties consent to the responsible person appointment. Accordingly, it is not surprising that

Collier On Bankruptcy pulls no punches in dismissing responsible person appointments as inappropriate:

It is really unnecessary to misinterpret the Code and look for ways to circumvent its provisions. In an appropriate case, section 1104 can be utilized to provide the proper persons to run the business and assist in the reorganization. When a court finds that management should be replaced, that should be sufficient cause under section 1104(a)(1) to order the appointment of a trustee.

7 *Collier On Bankruptcy* ¶ 1104.03[6][a], at 1104-50 (15th ed. rev.) (footnotes omitted) (emphasis added).

Conclusion – The Value of Following the Code

Parties seeking responsible person appointments advance a variety of practical rationales for why such an appointment is preferable to a trustee appointment: the suggested candidate is above reproach; a responsible person will cost less than a trustee; appointment of a trustee would terminate the DIP's exclusivity rights. These concerns are almost always overstated. U.S. Trustees take seriously their obligation to consult with parties in interest in selecting persons to appoint as chapter 11 trustees, and creditors may elect a trustee of their choice if they are unhappy with an appointment. 11 U.S.C. § 1104(b). A chapter 11 trustee's compensation must be reasonable, and must be determined under the same standards that govern compensation of professional persons. 11 U.S.C. § 330(a)(3). While a trustee appointment will terminate the debtor's exclusive right to file a plan, 11 U.S.C. § 1121(c)(1), there is no reason for exclusivity to continue when a responsible person with no prior relationship with the debtor assumes complete control of the DIP's affairs. That person is a trustee in all but name, and the Congressional intent to enable creditors and other parties to file plans to protect their interests upon the appointment of a trustee should not be so easily circumvented.

The ultimate consideration militating against responsible person appointments and in favor of trustee appointments is our duty as attorneys to respect the rule of law. Although chapter 11 governance provisions were tweaked in 1994 and 2005, they have remained largely unchanged since the 1986 reform act assigned the trustee appointment duty to U.S. Trustees. While many sections of the Code provide the parties and the courts with considerable discretion in maneuvering a case through chapter 11, the provisions dealing with the appointment of trustees are not discretionary. If grounds exist for the appointment of a trustee, a trustee must be appointed. Adherence to this legal requirement is the only *responsible* thing to do.