

## CHALLENGES IN BANKRUPTCY & RESTRUCTURING

### The examiner in corporate restructurings – burden or benefit?

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As the credit market meltdown crashes over the US and international economies, the next major wave of corporate restructurings is in the queue, ready to go. With few remaining sources of readily available capital, and with the aggressive tactics of the hedge and distressed debt funds in restructuring cases, the next round of corporate restructurings promises to be contentious. In addition, questionable activities undertaken by some corporate management to disguise underperformance will undoubtedly be revealed in the blinding light that is the crucible of bankruptcy. There will be no shortage of finger pointing in this exercise.

#### Enter the examiner

A recent trend in corporate restructurings is the use of examiners. An examiner represents a middle ground between the debtor-in-possession management and a trustee in Chapter 11 cases. The legal standard for appointing an examiner is found in Bankruptcy Code 1104, which provides for the appointment of an examiner upon request of a party or the US Trustee to conduct investigations into the debtor's operations, at the court's direction, into such issues as allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor or by current or former management of the debtor. Appointment of an examiner is mandatory if either the debtor's fixed, liquidated unsecured debts (other than debts for goods, services or taxes or those owing to an insider) exceeds \$5m, or such an appointment is in the best interest of creditors, any equity securityholders and other interests of the estate.

Areas of inquiry for examiners have been varied. Examiners have been appointed and tasked with doing investigations to evaluate: (i) whether a debtor's employment of a consultant was appropriate; (ii) causes of action

available to the estate; (iii) the reasonableness of real estate broker fees; (iv) the proper interest rates of claims under a plan; (v) allegations of pre-bankruptcy fraud, dishonesty and other potential improprieties by management; (vi) complex tax issue; (vii) the proposed sale of debtor's assets outside of a plan; (viii) the condition of the debtor's real estate; (ix) the propriety of the debtor and outside lenders with respect to so-called off-balance sheet financings; and (x) whether a board properly discharged its fiduciary duties regarding restructuring proposals.

While the Bankruptcy Code talks in mandatory terms (the court 'shall' appoint an examiner if the one of the two conditions is met), in fact there is a gaping hole in practice. While appointment of examiners may be mandatory, the bankruptcy court retains wide discretion as to what duties are given to the examiner. For example, in a very recent order entered in the Chapter 11 of mining conglomerate ASARCO, LLC in Corpus Christi, Texas, the bankruptcy judge was faced with a motion for appointment of an examiner filed by ASARCO's parent based upon the mandatory debt amounts in the Bankruptcy Code. The parent company, itself the target of fraudulent conveyance and other attacks, asked the court to appoint an examiner to: (i) investigate the good faith of the ongoing plan negotiations among ASARCO and certain other constituents; (ii) conduct a valuation of the debtors; (iii) investigate the good faith of the settlements of claims reached by ASARCO with asbestos claimants; and (iv) investigate whether ASARCO has been properly fulfilling its fiduciary duties to the parent. It is abundantly clear from reading the judge's order that he was not happy with that request. Accordingly, while he ordered the appointment of the examiner, he further ordered that "the examiner shall not have any current duties". While the ASARCO examiner order is certainly an audacious exercise of judicial discretion,

it highlights the issue pointedly. In other cases, there is much negotiating and/or litigation over the scope of the examiner duties in such cases. For example, in the Chapter 11 proceeding of Dexter Distributing Corporation in Arizona, after much haggling, between the parties, the bankruptcy judge finally outlined 13 areas of specific inquiry for the examiner in that case.

While the ultimate decision under the Bankruptcy Code is left to the discretion of the US Trustee's office (which actually appoints the person to be the examiner), the US Trustee usually consults with the parties in the case to determine who would be a good candidate. The identity of the actual examiner usually depends upon the issues to be investigated. To the extent they are primarily legal in nature, examiners tend to be lawyers. To the extent they are financial, financial advisers and accountants are frequently used. To the extent the investigation involves operational issues or other specialised issues, turnaround consultants and other experts are brought in. Examiners have the right to retain lawyers and financial advisers to assist in their investigation, and almost always do. Those professionals, along with the fees and costs of the examiner him or herself, constitute administrative claims of the bankruptcy estate. The compensation for examiners, unlike trustees which is set by statute, is a matter of negotiation and can be anything from an hourly rate to a set fee.

In order to address the concern that the examiner might find impropriety in order to get another job – that is, the trustee position – the Bankruptcy Code provides that anyone who acts as an examiner in the case is not eligible, as a matter of law, to serve as a trustee subsequently appointed.

A veritable certainty with respect to an examiner is that someone will likely not be happy with the examiner's report and conclusions – this is particularly true in instances where the examiner is asked to look at allegations of ►►

misconduct or breaches of duty. The spectre of being sued looms large. The bankruptcy law provides that examiners enjoy quasi-judicial immunity, thereby insulating themselves for anything other than intentional misconduct or malfeasance.

#### To 'seal' or not to 'seal' – that is the question

It has become common practice in reorganization cases that an examiner report, once issued, is filed under 'seal'. This means simply that the report is filed but it is not accessible in the normal public records of the Bankruptcy Court. This is a clear exception to the general rule that all filings in bankruptcy cases are open to the public. The usual protocol is for the examiner to file a motion with the court requesting permission to file the report under seal. The court will generally order this with the proviso that it is without prejudice of any party to seek to have the report made public. If a matter is kept under 'seal', its use in the case is significantly limited since it cannot be attached to pleadings (although it can be referred to), and its use is otherwise awkward. Accordingly, it is also common for the party who wishes to use the examiner report to ask the court to make the report public. The party whose ox was gored in the examiner report will generally seek to keep the report sealed so it does not become public. Hence, the next wave of litigation begins.

In order to keep an examiner report under seal, the parties seeking to do so must establish either that the report contains confidential or trade secrets type of information, or alternatively that the report needs to remain sealed in order to "protect a person with respect to scandalous or defamatory matter contained in [the examiner report]." (See Bankruptcy Code 107(b)(1), (2); Bankruptcy Rule 9018.) The circumstances where a report is deemed to contain confidential or trade secret information is usually not that contentious. Courts can, for example, opt to redact those aspects of the report that might disclose such confidential information, or may opt to keep the entire report under seal.

The area which generates more controversy is the alternative standard regarding potentially defamatory and scandalous materials. The Bankruptcy Code and rules do not provide any definition of what exactly is 'defamatory' or 'scandalous.' In the cases that have looked at this, the courts are clear that because this is an exception to the presumption that matters filed in bankruptcy court should remain available to the public, the party asserting this

must show that the material at issue would alter the effected party's reputation in the eyes of a reasonable person, *and* that the material is untrue or potentially untrue *and* irrelevant or included for an improper end. It is apparent that it is difficult to meet this standard if one was trying to keep an examiner report private. Even if it can be shown that the material at issue would damage a person's reputation, and that the material was untrue or potentially untrue, to the extent that its inclusion in the examiner report was relevant to the examiner's conclusion (even if the effected person vehemently disagreed with the examiner's conclusions or findings), the report would be made public. It is clear that keeping an examiner report from the public arena is, at best, a difficult challenge.

#### So how does one use an examiner report?

As discussed below, examiner reports are usually not inexpensive. Examiner reports in commercial cases tend to be quite lengthy and detailed. It is a truism that someone in the case will be happy with an examiner report, and someone will not be happy with the examiner report, depending upon the examiner's conclusions. It is clear from a review of some of the more noteworthy examiner reports that examiners don't pull any punches (nor should they), and the examiner report has created serious vehemence in cases. So how can the examiner report be used in the case? That is an interesting conundrum in practice. Can an examiner report be used as evidence of wrong doing based on the examiner's conclusions? The answer is a resounding maybe.

An examiner report is in the strictest form classic hearsay – it is an out of court statement by the examiner regarding facts and legal conclusion drawn from those facts (again depending upon the mandate of the examiner when appointed). Since it is clear that the examiner report does not bind the court in the case, how does one get an examiner report into evidence? Interestingly, there have been few reported decisions on this very important issue in question. There are at least two theories to get an examiner report into evidence. The first is that the facts being determined would constitute 'investigative findings', and therefore would be an exception to the hearsay rule. So are an examiner's factual findings 'investigative findings' such that they are admissible as evidence in court? Perhaps. At least one court has found that the legal conclusions in an examiner report under no circumstances would meet the hearsay exception of the rules, but

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rather the factual findings may qualify. The problem may be further exasperated by the fact that examiner reports may contain 'hearsay within hearsay.' For example, an examiner report will usually be based upon witness interviews. The examiner may say, for example: "John Doe told me as follows..." Accordingly, not only is the examiner report hearsay, but it contains hearsay with respect to the statement of John Doe. Courts that have looked at this problem have held that unless there is an independent basis in the evidentiary rules to admit the hearsay contained in the examiner report, even the factual findings may be kept out of an evidentiary record.

The second theory used is that the examiner is in the nature of a court-appointed expert under Federal Rule of Evidence 706. Under the Federal Rules of Evidence, a court can appoint its own expert to assist the court with certain defined areas. It has been suggested in at least one case that an examiner is in the nature of a court-appointed expert on the areas that he or she is examining. While that is fine as far as it goes, that would also subject the examiner to complete discovery obligations that would be incumbent upon any expert (such as depositions, requests for production of documents, etc.). This may run counter to the examiner's ►►

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wishes as the examiner may not simply wish to become an expert for a litigant in the case. (In the Enron case, for example, in order not to 'chill' the examiner's activities, the bankruptcy court specifically limited discovery of the examiner.) In addition, if it is not stated clearly at the outset of the appointment that the examiner will be in the nature of a court-appointed expert, trying to anoint the examiner with this title after the examiner report comes out may be a bit strained.

**The cost / benefit analysis for examiners**

In contentious cases, examiners and the discharge of their duties can come with a hefty

price tag. For example, in the Fibermark case, the examiner report costs the estate \$1.75m. In the Dexter Distributing case it was \$825,000. In the Enron case, the bill exceeded \$100m. So if the examiner report is not evidence or binding on the court, is it worth it? At least one bankruptcy court has addressed this head on. As the bankruptcy court in the Fibermark decision opined, the report is still a benefit to the estate because it provides a 'road map' for parties to follow in the case and otherwise provides an objective and independent view with respect to rights and liabilities of parties. The fact that an examiner's report may be more of

a beginning rather than a conclusion was not deemed to be the issue as far as benefit. It is hoped that an examiner report can spur parties to settlement discussions.

We believe the use of examiners in contentious cases in the next wave of corporate restructurings is a certainty. How effective a tool it will prove to be is still an open question. ■

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Bridge Associates LLC (Bridge), is a nationally known restructuring boutique with offices located in New York, Cleveland, Tampa, Chicago, Tulsa and Houston. Bridge handles in and out of court restructurings and post confirmation wind downs nationwide. Bridge's six members and more than 25 associates and contractors provide crisis management, advisory, negotiating, restructuring and wind down services to middle market companies with assets from \$50m to several billion dollars.

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