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The Examiner – Back to the Future

Lloyd A. Palans*

The enactment of the Bankruptcy Code¹ formally introduced a new party to the Chapter 11 landscape – an examiner. Code section 1104(c) (formerly section² 1104(b)) codified the examiner role as a strategic tool to advance constituents' interests.³ However, the scope, use, timing and purpose of the role remained to be determined. This Article focuses on Judge Barry Schermer's creation, structure and innovative use of the examiner's role in the *Apex Oil Company et al.* case⁴ in a manner and scope that proved to be years ahead of its time.

I. BACKGROUND

The statutory predecessor of the Bankruptcy Code (the Bankruptcy Act of 1898, also known as the Nelson Act, hereinafter the "Act") was signed into law by President William McKinley on July 1, 1898.⁵ The Act was the first federal statute providing protections from enforcement of creditors' remedies while establishing a uniform bankruptcy system throughout the country. Because the Act did not adequately address the restructuring of a corporate capital structure, equity receiverships were often utilized to deal with corporate reorganizations.⁶ The amendments made to the Act in 1934⁷ and in 1938⁸ added Chapter X as a substitute for equity receiverships for the purpose of providing statutory authority to achieve corporate reorganizations, but these amendments failed to fully address the comprehensive reorganization of a corporate capital structure. Until the mid-1930s, corporate reorganizations were customarily pursued through use of equity receiverships.⁹ Ultimately, however, the Seventh

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1. 11 U.S.C. § 101 (1978), [hereinafter the "Bankruptcy Code" or "Code"].
2. Unless otherwise indicated, "section" or "sections" refer to the applicable section in the Bankruptcy Code.
3. See 11 U.S.C. § 1104(c) (1978).
4. See *In re Apex Oil Co.*, 91 B.R. 860 (Bankr. E.D. Mo. 1988); and see *In re Apex Oil Co.*, Case No. 87-03804 (Bankr. E.D. Mo filed Dec. 24, 1987) [hereinafter "Apex" or the "Apex Case"].
5. National Bankruptcy Act of 1898, Ch. 541, 30 Stat. 544.
6. See *S.E.C. v. U.S. Realty & Improvement Co.*, 310 U.S. 434, 448-49 (1940).
7. Act of June 7, 1934, Ch. 424, 48 Stat. 911, 912, 11 U.S.C. s203 (repealed 1949).
8. The Chandler Act of June 22, 1938, ch. 575, 52 Stat. 840 (repealed 1978).
9. See *U.S. Realty & Improvement Co.*, 310 U.S. at 448-49.

Circuit Court of Appeals held that a district court presiding over a corporate restructuring had inherent power to appoint persons to aid the court in performance of special administrative or judicial duties, utilizing services of auditors, investigators and examiners.¹⁰ And so, an examiner role was functionally created.

Today, sections 1104(c) and 1106(b) codify the appointment of a bankruptcy examiner and the scope of his or her duties. Code section 1104(c)(1) provides that the court “shall” order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate if (i) no trustee has been appointed; (ii) no plan has been confirmed; (iii) a party in interest or the United States trustee has requested an examiner; and (iv) “such appointment is in the interest of creditors, any equity security holders and other interests of the estate”¹¹ Code section 1104(c)(2) separately authorizes appointment of an examiner if the first three elements are met and if, in lieu of being in the interest of creditors or the estate, “the debtor’s fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed \$5,000,000.”¹²

Independence, disinterestedness and objectivity form the foundation of an examiner’s role.¹³ In practice, regardless of whether appointment of an

10. See *In re Utils. Power & Light Corp.*, 90 F.2d 798, 800-801 (7th Cir. 1937).

11. 11 U.S.C. § 1104(c)(1) (1978).

12. 11 U.S.C. § 1104(c)(2) (1978). There is a split of authority whether appointment of an examiner is mandatory in cases where a debtor’s fixed debts exceed \$5,000,000, or whether a court has discretion to refuse to appoint an examiner. Clearly, Code section 1104(c) expressly states the court “shall” order appointment of an examiner if the statutory conditions are satisfied regardless of cost or need. *In re Revco D.S., Inc.*, 898 F.2d 498, 501 (6th Cir. 1990); *In re UAL Corp.*, 307 B.R. 80, 86 (Bankr. N.D. Ill. 2004). But, some courts view the appointment as discretionary based on a cost/benefit analysis for the estate or whether the request merely serves as a strategic litigation ploy. See *In re Lyondell Chem. Co.*, 445 B.R. 277 (Bankr. S.D.N.Y. 2011); *In re Residential Capital, LLC*, 474 B.R. 112, 115-16 (Bankr. S.D.N.Y. 2012) (“While [s]ection 1104(c) expresses a Congressional preference for appointment of an independent examiner to conduct a necessary investigation, the facts and circumstances of the case may permit a bankruptcy court to deny the request for appointment of an examiner even in cases with more than \$5,000,000 in fixed debts.”) *Id.* at 121.

13. See *In re Intercor, Inc.*, 127 B.R. 633, 638 (Bankr. E.D. Mo. 1991) (“[T]he Examiner’s role is by its nature disinterested and non-adversarial.”); *In re Southmark Corp.*, 113 B.R. 280, 284 (Bankr. N.D. Tex. 1990) (“[T]he court affirms . . . that the best interests of this estate compel the appointment of a disinterested, non-adversarial person with no connections to Southmark’s creditors or equity security holders to investigate Southmark’s pre-petition acts and conduct.”); *In re Hamiel & Sons, Inc.*, 20 B.R. 830, 832 (Bankr. S.D. Ohio 1982) (an examiner is a court fiduciary and is “amenable to no other purpose or interested party . . .”).

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examiner is mandatory or discretionary, the common thread for appointment arises when the debtor's prepetition conduct is under scrutiny and the appointment of an independent person in the Chapter 11 case is appropriate and in the best interests of the debtor's estate.

II. SCOPE OF APPOINTMENT

Over the years, the scope and duties of examiners have been somewhat limited or, perhaps better said, focused. The role in various cases has included review and reporting upon: (i) substantive consolidation as a settlement term proposed in a reorganization plan¹⁴; (ii) breach of fiduciary duty by directors and officers¹⁵; (iii) payment of asbestos claims¹⁶; (iv) intercompany claims and fraudulent conveyances¹⁷; (v) avoidable transfers, both pre-and post-petition¹⁸; (vi) claims against insiders and professionals¹⁹; (vii) fraud²⁰; (viii) accounting misstatements and SEC reporting issues²¹; (ix) securities fraud²²; and (x) going concern viability with respect to DIP financing facility.²³

However, the Code is not restrictive in defining the scope of an examiner's role. Code section 1106(a)(3) specifies that the scope of the examiner's duties broadly encompass investigating "the acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business,

14. *In re Am. Classic Voyages Co.*, No. 01-10954 (JWV), Examiner Report, filed Dec. 4, 2002; and see *Am. Classic Voyages Co. v. JP Morgan Chase Bank (In re Am. Classic Voyages Co.)*, 367 B.R. 500 (Bankr. D. Del. 2007).

15. *Troisio v. Poirier (In re U.S.A. Floral Prods.)*, Nos. 01-1230 (MFW), 03-52514, 05-00039-KAJ, 2005 U.S. Dist. LEXIS 38912 (D. Del. July 1, 2005); *In re Adelphia Commc'ns Corp.*, 336 B.R. 610 (Bankr. S.D.N.Y. 2006).

16. *In re Owens Corning*, 305 B.R. 175 (D. Del. 2004).

17. *In re Mirant Corp.*, 314 B.R. 555 (Bankr. N.D. Tex. 2004).

18. *In re Am. Rice, Inc.*, No. 98-21254-C-11, 2010 Bankr. LEXIS 6295 (U.S. Bankr. S.D. Tex. Apr. 27, 2010).

19. *Krys v. Sugrue (In re Refco Inc. Sec. Litig.)*, No. 07-md-1902 (JSR), 2010 U.S. Dist. LEXIS 33642, at *33 (S.D.N.Y. Mar. 1, 2010).

20. *In re SLI, Inc.*, No. 02-12608, 2005 BL 19967 (Bankr. D. Del. June 24, 2005).

21. *In re Global Crossing, Ltd.*, Nos. Chapter 11, 02-40187 (REG), 02-40241 (REG), 02-11982 (REG), 02-13765 (REG), 2002 Bankr. LEXIS 1903, at *5-6 (Bankr. S.D.N.Y. Aug. 7, 2002).

22. *In re Stage Stores, Inc.*, 269 B.R. 343 (Bankr. S.D. Tex. 2001).

23. *In re Geneva Steel Co.*, 236 B.R. 770, 803 (Bankr. D. Utah 2001).

and *any other matter relevant to the case or the formation of the plan[.]*”²⁴ As such, the court has considerable discretion in defining an examiner’s role.²⁵ The breadth of Code section 1106(b),²⁶ coupled with that old statutory catchall of section 105(a),²⁷ gives a court the ability to “design” an examiner’s mandate to suit the needs of the Chapter 11 case.

Rather than restricting the role of an examiner with limited duties answering limited inquires for a limited purpose in the *Apex* case, Judge Schermer used the designer approach creating the role of the Apex examiner in an expansive way to expedite resolution of the Chapter 11 proceeding, akin to creating a so-called roving referee with a whistle. Although the appointment of the Apex examiner was made nearly thirty years ago, the model adopted by Judge Schermer proved remarkably successful, and serves as a blueprint for every examiner in Chapter 11 business reorganizations today.

III. THE *APEX* CASE

By way of background, context and color, Apex activated its Chapter 11 process with the following attributes: (i) a twelve bank secured lender group (likely undersecured in its collateral position) asserting aggressive positions against Apex based upon a deteriorating collateral position; (ii) acrimony and distrust shared by and among the secured lenders and Apex; (iii) an emergency motion filed by the secured lenders concurrent with commencement of the Chapter 11 process seeking substantive consolidation of the assets of an off-shore, non-debtor affiliate owned and controlled by the Apex principals; and (iv) alleged diversions of Apex assets and working capital to the detriment of the secured lender group. Judge Schermer designed the examiner’s role with this litigious background in mind.

24. 11 U.S.C. § 1106(a)(3) (1978) (emphasis added).

25. See *In re Mirant Corp.*, 314 BR 555, 557 (Bankr. N.D. Tex. 2004) (“Though the wording of section 1106(b) of the Code is awkward, the courts have read it as permitting a designer approach to assignments given examiners.”).

26. 11 U.S.C. § 1106(b) (1978) (the section states that the examiner will perform “except to the extent the court orders otherwise, any other duties that the court orders the debtor in possession not to perform.”).

27. 11 U.S.C. § 105(a) provides “[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”

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On January 27, 1988, upon application of the Apex Unsecured Creditors Committee, Judge Schermer appointed an examiner who was directed to examine matters “designated by the court upon request of parties in interest.”²⁸ Judge Schermer designed the role to “allow the Court the flexibility necessary to place the Examiner in a variety of critical situations, thereby enabling the Examiner to make a substantial contribution to the completion of this bankruptcy and facilitation of settlements and issue resolutions.”²⁹ He authorized the examiner to take “any necessary and appropriate actions in furtherance of assisting the Court and parties in bringing these proceedings to a just, prompt and economic disposition.”³⁰ To enhance the examiner’s facilitator function, Judge Schermer prohibited the examiner from advocating for, or aligning himself with, the position of any party on any given matter. Rather, the examiner’s role was as that of investigator and mediator.

Critical to the Examiner’s fulfillment of this mission has been his conduct of investigations and mediations which provided economical alternatives to potentially expensive, protracted and divisive litigation. These investigations substantially benefited all parties by providing a disinterested participant who could assist in resolving the many conflicting and competing interests of the reorganization process.

The Examiner’s contribution to Apex’s reorganization embraced three primary areas: (1) stabilization of the estate, (2) asset disposition, and (3) investigation³¹

IV. STABILIZATION

The acrimony, distrust and litigation which exploded upon commencement of the Apex Chapter 11 process required immediate stabilization to preserve going concern value. The examiner’s immediate focus was to create stabilization from chaos by: (i) monitoring budgeted

28. *In re Apex Oil Co.*, 101 B.R. 92, 93 (Bankr. E.D. Mo. 1989).

29. *In re Apex Oil Co.*, 111 B.R. 235, 237 (Bankr. E.D. Mo. 1990) (depublished).

30. *Id.*

31. *Id.*

expenditures and operating reports; (ii) facilitating exchange of financial and budgetary information between the warring parties on an ongoing basis; (iii) obtaining permission from the secured lenders for Apex to purchase and exchange oil futures contracts on the Mercantile Exchange thereby permitting resumption of commodity trading activities and acquisition of sweet crude oil for Apex refineries; (iv) expediting approval of government contracts; (v) monitoring retention of professionals; (vi) reviewing applications for compensation by professionals to determine compliance with court guidelines; (vii) assuring continuation of utility services for oil refineries and other members of the Apex family; (viii) preserving executory contracts and unexpired leases (particularly related to oil tankers and certain valuable options to purchase same); (ix) providing consolidated discovery for numerous reclamation litigants; and (x) creating a claims resolution procedure for all Jones Act, worker's compensation and tort claims pending against Apex throughout the country (which ultimately resolved over eighty-three percent of claims submitted through mediation and settlements).³²

In addition to the foregoing, the examiner mediated a settlement of the first-day emergency substantive consolidation litigation affecting assets of the off-shore, non-debtor affiliate owned and controlled by the Apex principals. Allegations abounded that Apex had deceived the secured lender group about the formation and ownership of its non-debtor affiliate, and had diverted Apex assets and corporate opportunities while not paying fair consideration for goods and services allegedly obtained from Apex. If permitted to proceed to trial, such litigation would have required discovery from twelve different lending institutions, many present and former employees of the secured lender group, officers and employees of fifty debtors and the off-shore non-debtor affiliate, principals of Apex, and numerous consultants and experts for all parties.

Pursuit of the substantive consolidation litigation to final judgment meant potential liquidation for Apex and loss of value for all parties. Nonetheless, the examiner's efforts produced a settlement that:

[E]liminated a major dispute between the Secured Lender Group and the Original Debtors which, if not settled, might have

32. *Id.*

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jeopardized prospects for a successful reorganization. In addition to resolving a dispute that otherwise would have resulted in time-consuming and expensive litigation, the settlement allowed the Original Debtors to share in net profits of (the non-debtor affiliate) and has resulted in payments to the Original Debtors' Estates aggregating \$11,560,000 as of August 31, 1989. As discussed in Section V-A of the Disclosure Statement entitled "General Description Of The Plan," up to 35% of the (non-debtor affiliate) Cumulative Net Profits will be available to the extent necessary after the Effective Date to help service Reorganized Apex's payment obligations under the Series B Notes.³³

With the court's guidance, the examiner role brought stabilization that, *in toto*, prevented further deterioration of debtor-creditor relationships between Apex and its secured lender group, restored use of working capital for Apex businesses, and resolved bitter litigation between the parties.

V. ASSET DISPOSITION

In addition to achieving stabilization of the estate, the examiner's role in asset dispositions also proved effective. Of primary importance, the examiner conducted a good faith and fair dealing investigation surrounding the proposed sale of Apex assets and businesses in satisfaction of the secured lenders' claims at a discount of approximately \$150,000,000. This discount created value for Apex unsecured creditors, which served as the basis for Apex to reorganize. Numerous objectors to the sale contended that the bid of the stalking horse buyer, AOC Acquisition Corp., constituted a lock-out, preventing other bidders to gain access to the \$150,000,000 discount earmarked to satisfy the secured lenders' claims. The objectors contended that the sale was actually a *sub rosa* plan, and that participation of Apex principals in the proposed sale constituted a breach of their fiduciary duties, self-dealing and bad faith. In

33. See *In re Apex Oil Co.*, 111 B.R. 235 (Bankr. E.D. Mo. Feb. 5, 1990) (quoting Apex Oil Disclosure Statement Supporting the Debtors' Joint Partially Consolidation Plan of Reorganization, at 58 (Dec. 14, 1989)).

order to expedite discovery and permit a full evidentiary hearing on the proposed sale, the examiner scheduled and enforced consolidated discovery for all objectors.³⁴ The court ultimately approved the sale and held that the secured lenders could not be compelled to sell their secured claims at discount to any other party.³⁵

In addition to procedurally and substantively addressing the bona fides of the section 363 sale of assets, the examiner mediated a settlement of substantial claims asserted by the United States Department of Energy (DOE) for which potential exposure risks to Apex aggregated \$354,000,000. These claims were ultimately resolved for the cash payment of \$15,000,000 by Apex to the DOE.³⁶

VI. INVESTIGATION OF CLAIMS AND CAUSES OF ACTION AVAILABLE TO THE ESTATE

Having stabilized the case and facilitated asset dispositions and resolution of claims objections, the examiner conducted an investigation of claims available to the estate against non-debtor affiliates and principals of the debtors. In doing so, the examiner faced litigation road blocks, including a motion to disqualify the examiner (eventually withdrawn) and numerous motions to quash various subpoenas and motions for Rule 2004 examinations.³⁷ The examiner conducted the investigation on an expedited basis over a three-month period, during which he interviewed over fifty witnesses including present and former Apex personnel, professionals and employees of third parties that represented or did business with, against or for Apex over the years. Further, the examiner completed over sixteen Rule 2004 examinations. The end result was a 249-page examiner report, as well as a two-volume appendix of exhibits, charts and other documents, concluding that Apex had several meritorious

34. The consolidated discovery included concurrent document production in three cities over two days followed by fifteen depositions in three cities in less than ten days to enable all parties to prepare for an evidentiary hearing and adhere to closing timelines.

35. *In re Apex Oil Co.*, 92 B.R. 847, 871 (Bankr. E.D. Mo. 1988).

36. *In re Apex Oil Co.*, 11 B.R. 235, 242 (Bankr. E.D. MO. 1990) (depublished)

37. FED. R. BANKR. P. 2004. Rule 2004 permits the court to order the examination of any party relative to the acts conduct, property, liabilities and financial condition of the debtor or to any matter which may affect administration of the debtor's estate.

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and substantial claims against certain non-debtor affiliates, including principals of the debtors. Shortly after filing the examiner's report, there was a significant increase in consideration paid to creditors of the Apex estates.

VII. EXAMINER AS DE FACTO "SPECIAL MASTER"

Although masters³⁸ are sanctioned under the Federal Rules of Civil Procedure (FRCP), masters are not permitted under the Bankruptcy Rules. FRCP 53 permits a district court to appoint a master with various powers including the power to "hold trial proceedings and make or recommend findings of fact on issues to be decided without a jury . . ." in certain circumstances, and to "conduct an evidentiary hearing, and exercise the appointing court's power to compel, take and record evidence"³⁹ Justice Brandeis characterized a court's inherent power to appoint persons unconnected with the court as special masters, auditors, examiners and commissioners as an "instrument for the administration of justice when deemed by [the court as] essential."⁴⁰

Rule 9031 of the Federal Rules of Bankruptcy Procedure entitled "Masters Not Authorized" provides that "Rule 53 [FRCP] does *not* apply in cases under the Code."⁴¹ Because of this prohibition, masters may not be appointed by bankruptcy judges. Yet, this rule conflicts with Code section 1106(a)(3), which provides that the scope of the examiner's duties broadly encompass "any other matter relevant to the case or the formation of the plan" This statutory provision, together with Code section 105(a), affords the bankruptcy court the ability to design an examiner's mandate to suit the needs of the Chapter 11 case.⁴²

In Judge Schermer's order appointing the Apex examiner, the examiner was authorized to take "any necessary and appropriate actions in furtherance of assisting the Court and parties in bringing these proceedings

38. A master is generally a court appointed official to make sure that judicial orders are followed or to make recommendations to the judge as to the disposition of a matter.

39. FED. R. CIV. P. 53(a)(1)(B), (c)(1)(C) (2017).

40. *Ex parte* Peterson, 253 U.S. 300, 312 (1920).

41. FED. R. BANKR. P. 9031 (emphasis added).

42. *See* 11 U.S.C. § 105(a) (1978); *and supra* Scope of Appointment discussion section.

to a just, prompt and economic disposition.”⁴³ Although the Apex examiner was not afforded the power to hold trial proceedings, nor conduct an evidentiary hearing, nor exercise the court’s power to compel, take and record evidence, a review of the examiner’s role in *Apex* served as the functional equivalent of a “de facto” special master. A special master may be appointed to assist a district court to further the administration of justice. The appointment of the Apex examiner functionally accomplished the same purpose.

A successful plan confirmation achieved by proactive mediators recently received notoriety in the Chapter 9 bankruptcy proceeding of the City of Detroit, Michigan.⁴⁴ Comparing the Apex examiner engagement with the work of the mediators in the City of Detroit’s Chapter 9 bankruptcy proceedings, Judge Schermer was well ahead of his time.⁴⁵

The Supreme Court has long recognized that bankruptcy courts “are essentially courts of equity, and their proceedings [are] inherently proceedings in equity.”⁴⁶ This is a residual power given to bankruptcy courts in Bankruptcy Code Section 105(a) and is consistent with the confines of Bankruptcy Code Section 1106(a)(3). A strong case may be made that Federal Rule of Bankruptcy Procedure 9031 should be abrogated to permit bankruptcy courts as a court of equity to appoint special masters to promote the administration of justice.⁴⁷ Rule making should not trump an express statutory entitlement.

CONCLUSION

When Judge Schermer appointed an examiner in the *Apex* case in

43. *In re Apex Oil Co.*, 111 B.R. 235, 237 (Bankr. E.D. Mo. 1990).

44. *In re City of Detroit, Michigan*, No. 14-CV-14872, 2015 WL 5697702, at (E.D. Mich. Sept. 29, 2015), *aff’d* 838 F. 3d. 792 (6th Cir. 2016), *cert. denied sub nom.* Ochadleus v. City of Detroit, Mich. 137 S. Ct. 1584, 197 L. Ed. 2d 707 (2017), and *cert. denied sub. nom.* Quinn v. City of Detroit, Mich. 137 S. Ct. 2270 (2017).

45. See Donald Swanson, *A Proactive Mediator Role: Special Settlement Master*, MEDIATBANKRY.COM, May 9, 2017, <https://mediatbankry.com/2017/05/09/mediation-ish-roles-part-1-the-special-master/> (“my sense is that proactive mediation (like that of a settlement master under Fed. R. Civ. P. 53) is on its way to becoming standard practice for large bankruptcy cases – and for smaller cases as well.”).

46. See *Local Loan Co. v. Hunt*, 292 U.S. 234, 240 (1934).

47. See Paulette J. Delk, *Special Masters in Bankruptcy: The Case Against Bankruptcy Rule 9031*, 67 MO. L. REV. 29 (2002).

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January 1988, no party fully appreciated the significance or impact of that role. With the benefit of hindsight, what was accomplished with the efficient administration of justice nearly thirty years ago proved to be years ahead of its time. Then, as today, Code sections 1104 and 1106 together with 105(a) substantively provide for that which Rule 9031 taketh away. As we reflect upon the Apex examiner role created in 1988, Dr. Emmett “Doc” Brown, Marty McFly’s friend in the 1985 science-fiction-comedy movie, *Back to the Future*,⁴⁸ comes to mind. Doc Brown’s time machine invention built from a DeLorean automobile sent Marty McFly back in time thirty years to repair damage to history. History has now come full circle. The Apex examiner role crafted by Judge Schermer long ago proved to be years ahead of its time, and serves as a blueprint for proactive examiner roles for years to come.

48. BACK TO THE FUTURE (Universal Pictures 1985).