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THE MYTH OF FIDUCIARY DUTIES IN CORPORATE REORGANIZATION CASES

Carlos J. Cuevas*

I. INTRODUCTION

In an ongoing debate concerning the desirability of Chapter 11, some commentators have advocated the repeal of Chapter 11, others

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2 See Bradley & Rosenzweig, supra note 1 (advocating the repeal of Chapter 11 and the creation of a "contingent equity"). Professor Adler has advocated the repeal of Chapter 11, and substitution of a "Chameleon Equity." Professor Adler has stated:

While no insolvency process is completely costless, a better solution to the problem of expensive insolvency exists. This solution, "Chameleon Equity," would not require an auction or a separate postinsolvency capital structure. Rather, it would give a firm the flexibility to issue a single set of unbundled residual and fixed obligations. A Chameleon Equity firm would
have recommended that Chapter 11 be modified, and others have staunchly defended the present Chapter 11 system. Corporate reorganization scholarship has recently focused on the effectiveness of Chapter 11; the empirical evidence, as reflected in this scholarship, shows that Chapter 11 has significant difficulties which are detrimental to creditors.

In 1994 Congress enacted various important amendments to the Bankruptcy Code (the "Code"); however, these amendments only implemented incremental modifications to Chapter 11. The 1994 amendments to the Code granted secured creditors greater rights and remedies in corporate reorganizations. Code § 362(d) provides a section that closely resemble a traditional firm, except that fixed-obligation Chameleon Equity holders would replace creditors. Such a Chameleon Equity holder would possess the same right as a creditor to set payments from the firm, but it would not be permitted to collect individually on an obligation in default. Instead, if the firm defaulted and remained in default on a fixed Chameleon Equity claim, the holder would gain a portion of the firm's residual claim and of voting control over the firm. Unpaid Chameleon Equity holders could then collectively decide to continue or to liquidate the firm, which would remain subject to any fixed claim not in default. In essence, a Chameleon Equity firm would retain the benefits of fixed obligations but would bear neither the costs that accompany a race to assets nor, in many instances, the costs of reintroducing fixed claims after insolvency.

Adler, supra note 1, at 323–24. Others have advocated replacing Chapter 11 with an auction of the debtor. See Jackson, supra note 1, at 209–24; Baird, supra note 1. See, e.g., Bebchuk, supra note 1; Roe, supra note 1.


5 For a general discussion of the problems with Chapter 11, see generally Bradley & Rosenzweig, supra note 1 and Lynn M. LoPucki, The Trouble with Chapter 11, 1993 Wis. L. Rev. 729. For example, it has been estimated that only between 10–12% of all public and private firms emerge out of Chapter 11 and that only seventeen percent have a reorganization plan confirmed. See Edward I. Altman, Comment, Evaluating the Chapter 11 Bankruptcy-Reorganization Process, 1993 Colum. Bus. L. Rev. 1; see also, LYNN M. LoPucki, STRATEGIES FOR CREDITORS IN BANKRUPTCY § 9.17 (1985) (illustrating that Chapter 11 has a poor success rate).


7 In 1994 Code § 362(d) was amended, and § 362(d)(3) was added to the Code. Section 362(d)(3) states:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay . . .

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in
secured creditor with a potent mechanism for protecting its interest and enforcing fiduciary duties in corporate reorganization cases. Section 362(d) permits a secured creditor to obtain relief from the automatic stay and foreclose on its collateral. This is a powerful inducement to make Chapter 11 debtors comply with their contractual and fiduciary duties to secured creditors.

Although much has been made of the significant overhaul which the 1994 amendments were supposed to accomplish, the amendments failed to address the plight of an unsecured creditor in a Chapter 11 case. The Code has granted unsecured creditors various remedies to enforce fiduciary duties in corporate reorganization cases. However, these remedies fail to achieve the desired results because they are inefficient and the bankruptcy courts are adverse to employing these remedies during the initial phases of a reorganization case. Moreover, the plight of unsecured creditors in insolvent corporate reorganization cases is exacerbated because Chapter 11 is premised on the erroneous notion that a debtor's management should remain in control of the debtor. Chapter 11’s failure to provide unsecured creditors with efficacious remedies to enforce fiduciary duties permits management to exploit Chapter 11 and disregard the interests of the unsecured creditors. The myth of fiduciary duties in corporate reorganizations is a fundamental issue which goes to the core of whether the current system of Chapter 11 is beneficial for unsecured creditors. The inability of unsecured creditors to enforce fiduciary duties renders corporate reorganizations inefficient and ineffectual for unsecured creditors because management usually has no incentive to maximize the distribution for unsecured creditors.8

8 As the following discussion will reflect, many of the major problems associated with corporate reorganizations are directly related to the lack of enforcement of fidu-

such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90 day period)—

(A) the debtor has filed a plan or reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

(B) the debtor has commenced monthly payments to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien), which payments are in an amount equal to interest at a current fair market rate on the value of the creditor’s interest in the real estate.

11 U.S.C § 362(d)(3). Section 362(d)(3) was intended to address the problems caused by single asset debtors that seek to exploit Chapter 11. In addition, § 362(e) was amended to provide for more expedited hearings for motions for relief from the automatic stay. Consequently, the 1994 amendments did address some of the problems confronting secured creditors in Chapter 11 cases.
The purpose of this Article is to discuss the plight of unsecured creditors in insolvent corporate reorganization cases, and to recommend how Chapter 11 should be amended so as to ensure that unsecured creditors have efficient and efficacious remedies for the enforcement of fiduciary duties, thereby providing management with an incentive to manage the estate on behalf of the unsecured creditors. Part II of this Article discusses how unsecured creditors have ineffective and inefficient remedies to compel the enforcement of fiduciary duties. Part III proposes that, at the inception of a reorganization case concerning an insolvent debtor, unsecured creditors should be granted the option of either retaining current management or replacing existing management with a Chapter 11 trustee, by a "Vote of No Confidence". In essence, the Vote of No Confidence is a self-executing efficient and effectual means of enforcing fiduciary duties in insolvent corporate reorganization cases because it reduces transaction costs and permits the unsecured creditors to select a debtor's management without resorting to expensive and protracted litigation. In Part IV various rationales are given for adopting the proposed Vote of No Confidence, including: bankruptcy theory, efficiency, that unsecured creditors are the true parties-in-interest when a debtor is insolvent, and that the Vote of No Confidence will have a salutary impact on corporate reorganization cases.

II. THE PLIGHT OF UNSECURED CREDITORS IN AN INSOLVENT CORPORATE REORGANIZATION CASE

A. A Debtor-in-Possession Owes Fiduciary Duties to the Creditors

1. Commodity Futures Trading Commission v. Weintraub

In Commodity Futures Trading Commission v. Weintraub, the Supreme Court held that, with respect to pre-bankruptcy communications, a bankruptcy trustee controls the attorney-client privilege for a debtor-corporation. In reaching its conclusion, the Court observed that the commencement of a bankruptcy case causes fundamental transformations in corporate relationships. Therefore, a debtor-in-

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10 Id. at 358.
11 Justice Marshall wrote:
possession owes fiduciary duties not only to the equity security holders, but also to the creditors.12

Weintraub is significant because it established the proposition that a debtor-in-possession is a fiduciary for the unsecured creditors.13 The Court also noted that when a debtor is insolvent the interests of the shareholders must be subordinated to the interests of the creditors.14 In particular, Chapter 11 can function only if the debtor’s management is capable of exercising its fiduciary duties to the creditors in the same manner as a trustee.

2. Weintraub’s Progeny

Many lower federal courts have cited Weintraub for the proposition that a debtor-in-possession is a fiduciary to its creditors.15 These...
courts have employed *Weintraub* to develop a common law of fiduciary duties in bankruptcy. Some courts relying upon *Weintraub* have imposed liability upon directors, officers, and insiders because of breaches of fiduciary duties that occurred while these companies were operated as debtors-in-possession.

3. The Standard of Liability for Breach of Fiduciary Duty

   a. Intentional and Willful Conduct

   The Supreme Court has not determined the standard of liability for establishing a breach of fiduciary duty by either a trustee or debtor-in-possession. Some lower federal courts have held that in order to hold a trustee or debtor-in-possession personally liable for a breach of fiduciary duty it must be established that the trustee intentionally and willfully breached his or her fiduciary duty. For example, in *Sherr v. Winkler*, the United States Court of Appeals for the Tenth Circuit held that a trustee is not personally liable unless he or she acts willfully and deliberately in violation of his or her fiduciary duties. The court based its decision on the Supreme Court's decision that a trustee has a fiduciary duty to the creditors, and that fiduciary duty requires the trustee to refrain from pursuing courses of action that would solely benefit management. See *In re DN Assocs.*, 144 B.R. at 199. In the same vein, debtor's counsel may not be compensated from the estate for representing the interests of the debtor or the debtor's directors, officers, or shareholders in a manner that is detrimental to the creditors. See *id.* A debtor has a fiduciary duty to preserve the assets of the estate so as to maximize the return for unsecured creditors. See *Committee of Creditors Holding Unsecured Claims v. Citicorp Venture Capital, Ltd. (In re Papercraft Corp.)*, 187 B.R. 486, 498-500 (Bankr. W.D. Pa. 1995); *Bernstein v. Donaldson (In re Insulfoams, Inc.),* 184 B.R. 694, 703 (Bankr. W.D. Pa. 1995); *In re Harp*, 166 B.R. at 746.

   16 A debtor's management owes a fiduciary duty to the creditors, and that fiduciary duty requires management to refrain from pursuing courses of action that would solely benefit management. See *In re DN Assocs.*, 144 B.R. at 199. In the same vein, debtor's counsel may not be compensated from the estate for representing the interests of the debtor or the debtor's directors, officers, or shareholders in a manner that is detrimental to the creditors. See *id.* A debtor has a fiduciary duty to preserve the assets of the estate so as to maximize the return for unsecured creditors. See *Committee of Creditors Holding Unsecured Claims v. Citicorp Venture Capital, Ltd. (In re Papercraft Corp.)*, 187 B.R. 486, 498-500 (Bankr. W.D. Pa. 1995); *Bernstein v. Donaldson (In re Insulfoams, Inc.),* 184 B.R. 694, 703 (Bankr. W.D. Pa. 1995); *In re Harp*, 166 B.R. at 746.


   18 See, e.g., *Yadkin Valley Bank & Trust Co. v. McGee, 819 F.2d 74 (4th Cir. 1987); Ford Motor Credit Co. v. Weaver, 680 F.2d 451 (6th Cir. 1982); Sherr v. Winkler, 552 F.2d 1367 (10th Cir. 1977); In re Haugen Constr. Serv., Inc., 104 B.R. 233 (Bankr. D.N.D. 1989).*

   19 552 F.2d at 1367.

   20 *Id.* at 1375.
sion in *Mosser v. Darrow*, interpreting *Mosser* to require intentional and willful misconduct as a prerequisite for liability for breach of fiduciary duty.

The Court of Appeals for the Sixth Circuit in *Ford Motor Credit Co. v. Weaver* has also held that a trustee or debtor-in-possession can be held personally liable only for an intentional and willful breach of his or her fiduciary duties. The Sixth Circuit principally relied upon the *Sherr* decision, and it concluded that the intentional and willful standard was the correct standard for imposing liability. *Ford Motor Credit* is also significant because it held that trustee liability principles also extended to a debtor-in-possession.

The intentional and willful standard imposes significant obstacles for the enforcement of fiduciary duties. First of all, it is a difficult standard of proof to satisfy because mere negligence will not suffice. As a policy matter it is imprudent to have such a high standard for imposing liability because the standard of liability should encourage managers and directors of insolvent companies to be more cautious. Consequently, it is more prudent to impose a lower threshold for imposing liability so as to compel debtor’s management to act more

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21 341 U.S. 267 (1951). In *Mosser v. Darrow*, the Court ruled that a trustee of a common law trust could be surcharged for failing to take action when his subordinates engaged in intentional breaches of fiduciary duties by trading in the securities of the debtor’s subsidiaries.

22 The court stated:

*Mosser v. Darrow*, *supra*, established the rules that a trustee or receiver in bankruptcy is (a) not liable, in any manner, for mistake in judgment where discretion is allowed, (b) liable *personally* only for acts determined to be willful and deliberate in violation of his duties and (c) liable, in his official capacity, for acts of negligence.

Sherr, 552 F.2d at 1375.

23 680 F.2d at 451.

24 *Id.* at 461.

25 The Sixth Circuit stated:

A trustee in bankruptcy may be liable for violations of his fiduciary duties. A trustee in bankruptcy can be liable in his official capacity or individually. A bankruptcy trustee is liable in his official capacity for acts of negligence. The applicable standard is the exercise of due care, diligence and skill both as to affirmative and negative duties. The measure of care, diligence and skill required of a trustee is that of “an ordinarily prudent man in the conduct of his private affairs under similar circumstances and with a similar object in view.” Mistakes in judgment cannot be the basis of a trustee’s liability in his official capacity. . . . A bankruptcy trustee is liable personally only for acts willfully and deliberately in violation of his fiduciary duties.

*Id.* (citations omitted).

26 *Id.* at 461–62.
carefully. Establishing a lower threshold for imposing liability should facilitate the enforcement of fiduciary duties, and thus compel some managers to act more prudently. Equally as important, the lower threshold of liability should compel managers to act in the unsecured creditors' best interests and maximize the value of the estate, thereby deterring officers and directors from making decisions that will exclusively benefit the equity security holders or themselves.

Litigation as the means of remedying or rectifying breaches of fiduciary duties is inefficient, especially in the context of an insolvent corporate reorganization case. In general, litigation is expensive and time consuming, and an insolvent estate may lack the resources to prosecute actions for breach of fiduciary duty against debtor's former management. A trustee might be deterred from commencing litigation because of the cost of the litigation and the high threshold of proof. There is also the important issue of whether the estate will be able to enforce and collect its judgment. If the debtor is a closely-held corporation, and its principal has also filed for bankruptcy because of personal guarantees, then the principal might also be insolvent. Although the judgment might be nondischargeable, the judgment might be worthless. Under these circumstances, litigation as the principal means of enforcing fiduciary duties is an inefficient and ineffectual remedy.

With all due deference, the Tenth and Sixth Circuits misconstrued Mosser v. Darrow. The Supreme Court never discussed the issue of what was the standard for imposing liability on a trustee for breach of fiduciary duty. Thus, as a matter of law, these courts have misinterpreted the law, and made the enforcement of fiduciary duties against a debtor-in-possession more difficult.

b. Negligence

Some lower federal courts have held that a trustee, and thus a debtor-in-possession, can be held liable for negligent as well as intentional breaches of his or her fiduciary duty to the estate. In In re

27 The filing of a Chapter 11 petition means that the Titanic is in trouble, and the ship's crew should exercise more caution in Chapter 11 so as to avoid ramming into another iceberg. The fact that a company has filed for Chapter 11 should dramatically alter the rules of engagement. Management should act with greater prudence, and its decisions should be held to higher scrutiny.

Cochise College Park, Inc., the Ninth Circuit Court of Appeals held that a trustee could be held liable for negligent breaches of fiduciary duty. The court rejected the reasoning employed by the Tenth and Sixth Circuit Courts of Appeal because it thought that the Tenth Circuit had misconstrued *Mosser v. Darrow*.

Although the negligence standard is less onerous than the intentional and willful standard, it is still fraught with problems. The principal difficulty with the negligence standard is that the only means of enforcing it is through litigation. As previously discussed, litigation is an inefficient means of enforcing fiduciary duties, especially within the context of a bankruptcy case. The fact that the estate is insolvent will usually mean that the trustee and his or her counsel will be adverse to commencing litigation because there are no funds to pay legal fees or disbursements. Moreover, it is unlikely that individual unsecured creditors will have the financial incentives or inducements to finance the litigation. Consequently, even with a less rigorous standard there are still significant impediments to the enforcement of fiduciary duties in corporate reorganization cases.

**B. Creditors' Committee**

In Chapter 11 the presumption is that the debtor's management will remain in control and manage the debtor's affairs. Unsecured creditors participate in a reorganization case principally through a statutorily created device called a "creditors' committee." A credi-

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29 703 F.2d 1339 (9th Cir. 1983).
30 *Id.* at 1357.
31 The Ninth Circuit stated:

Given that the term "surcharge" itself means to impose "personal liability on a fiduciary for wilful or negligent misconduct in the administration of his fiduciary duties," ..., we find this interpretation to be incorrect. Properly construed, the language quoted from *Mosser* indicates merely that the sort of personal liability which may be imposed on a trustee for the acts of his employees is not strict liability but rather liability depending at least on a showing of the trustee's own negligence; *Mosser* does not "hold" in any sense that personal liability does not obtain if such a showing of negligence is made. *Id.* at 1357 n.26. (citation omitted).


Except as provided in paragraph (3), as soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall ap-
tors' committee is the entity that represents the unsecured creditors in a corporate reorganization case, and it owes a fiduciary duty to the unsecured creditors.\textsuperscript{34} Code §1103(c)\textsuperscript{35} specifies the powers of a creditors' committee, which include conducting an investigation of the debtor's affairs and negotiating a consensual plan of reorganization. Although some might deem the authority of a creditors' committee to be expansive, it lacks the authority to operate the estate.\textsuperscript{36}

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\textsuperscript{34} Members of a creditors' committee are fiduciaries for those whom they serve. See In re Grant Broad., Inc., 71 B.R. 655, 661–62 (Bankr. E.D. Pa. 1987); In re Mesta Mach. Co., 67 B.R. 151, 156–57 (Bankr. W.D. Pa. 1986). A creditors' committee fulfills its fiduciary duties to its constituency by advising the creditors of their rights and by advising the creditors of the proper course of action to pursue. See In re REA Holding Corp., 8 B.R. 75, 81 (Bankr. S.D.N.Y. 1980). A primary goal of a creditors' committee is to preserve the debtor's estate so as to either preserve or enhance the distribution that unsecured creditors will receive. See In re Charter Co., 50 B.R. 57, 62 (Bankr. W.D. Tex. 1985).

\textsuperscript{35} Code §1103(c) states:

A committee appointed under section 1102 of this title may—

1. consult with the trustee or debtor in possession concerning the administration of the case;
2. investigate 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, and any other matter relevant to the case or to the formulation of a plan;
3. participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
4. request the appointment of a trustee or examiner under section 1104 of this title; and
5. perform such other services as are in the interest of those represented.


\textsuperscript{36} Although a creditors' committee may consult with a debtor-in-possession concerning the administration of the case, a creditors' committee was not intended to have day-to-day input concerning the debtor's business decisions. See In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey, 85 B.R. 15, 17 (Bankr. S.D.N.Y. 1988); David G. Epstein et al., Bankruptcy §§ 10–13 (1993). An example of a creditors' committee lack of authority to make day-to-day business decisions for a debtor is reflected in In re Calvary Temple Evangelistic Ass'n, 47 B.R. 520 (Bankr. D. Minn. 1984). There, the bankruptcy court held that a creditors' committee lacked the authority to make a motion to sell some of the debtor's property free and clear of liens. The court concluded that Code §§ 1109(b) and 1103(c)(5) failed to grant a creditors' committee the authority to make business decisions on behalf of
Consequently, the function of a creditors' committee in a corporate reorganization case is advisory rather than supervisory.37

A creditors' committee might be unable to protect the interests of its constituents for various reasons. A creditors' committee is not appointed in every case, which weakens the effectiveness and utility of this device.38 Some committee members might lack experience in dealing with insolvent companies, and some members might lack sophistication concerning insolvency law.39 Even though a creditors' committee has been appointed, it might be inactive, and thereby provide no protection for the unsecured creditors.40 The estate, moreover, might be insolvent and lack the funds necessary to retain

the estate. In the same vein, in In re UNR Industries, Inc., 30 B.R. 609 (Bankr. N.D. Ill. 1983), the trade creditors' committee sought an order that would restrict the debtor's ability to make certain business decisions. The court denied the trade committee's request. The caselaw and the Code made it clear that Congress intended to allow debtors-in-possession to manage their affairs without day-to-day input from creditors. Moreover, if the trade creditors are dissatisfied with current management, then they can seek the appointment of a trustee.

37 See Daniel R. Cowans, Cowans Bankruptcy Law and Practice § 20.8 (1994); Epstein et al., supra note 36, §§ 10–11.

38 Professor LoPucki has observed:

The Bankruptcy Code provides that “the court shall appoint a committee of creditors holding unsecured claims.” Based upon this provision, Congress had naively predicted that “[t]here will be at least one committee in each case.” The Bankruptcy Court for the Western District of Missouri, however, appointed a creditors’ committee in only 19 (40%) of the cases studied. The trend over the year studied appeared to be away from the appointment of committees. Committees were appointed in the first five cases under the new Code. During the last four months of the year committees were appointed in only four of the eighteen cases filed (22%) and in only one of five that were destined for success.

Lynn M. LoPucki, The Debtor in Full Control-Systems Failure Under Chapter 11 of the Bankruptcy Code?, 57 Am. Bankr. L.J. 247, 250 (1983). The low percentage of cases in which a creditors’ committee is actually appointed weakens the protections offered to the general creditor body by this mechanism.


Second, the members of creditors’ committees are seldom qualified for the task they are asked to undertake. At least in the Western District of Missouri, few have had any experience with reorganization proceedings and even fewer are equipped by training or experience to evaluate the debtor's business or negotiate a plan.

LoPucki, supra note 38 at 252.

committee counsel or to compel the counsel to act zealously. More importantly, as previously discussed, there are structural impediments that prevent creditors' committees from adequately protecting the interests of its members in a corporate reorganization case when a debtor is insolvent. The major premise of Code § 1103(c) is that a creditors' committee's primary obligation is to negotiate a consensual reorganization plan. There are three important assumptions involved underlying this premise: 1) that current management should remain in control of the debtor; 2) that the debtor is capable of successfully reorganizing; and 3) that the creditors favor reorganization rather than liquidation. In some reorganization cases, these assumptions might be incorrect and operate to the detriment of the unsecured creditors. Code § 1103(c) fails to grant a creditors' committee any authority concerning the day-to-day operations of the debtor, the development of a business plan, or the debtor's restructuring. A creditors' committee's inability to have any input concerning the preceding matters not only places it in a powerless position, but also places the unsecured creditors in a similar position concerning the debtor's daily operations and the debtor's business plan. The estate might not have the funds necessary to compensate creditors' committee counsel for litigation concerning the enforcement of fiduciary duties. Consequently, debtor's management is at liberty to proceed

41 See Blain & Erne, supra note 39, at 491–92; LoPucki, supra note 38, at 250.
43 Under these circumstances, the only constraint upon the debtor is that some transactions will have to be approved by the bankruptcy court. For example, sales outside of the ordinary course of business require bankruptcy court approval. See 11 U.S.C. § 363(b) (1) (1994). But the unsecured creditors might not be adequately represented in these hearings because the estate might lack the resources to compensate creditors' committee's counsel. Therefore, creditors' committee's counsel might be adverse to vigorously representing the interests of the unsecured creditors. Absent specific transactions which require court approval, a debtor-in-possession is at liberty to operate and manage the business as it prefers. Thus management is at liberty to advance the interests of the shareholders and of itself to the detriment of the unsecured creditors.

Congress has failed to provide a creditors' committee with effective remedies to enforce management's fiduciary duties to the unsecured creditors. Although some might contend that a creditors' committee can enforce fiduciary duties through the plan process, that might be deceptive. First, it ignores that a significant amount of important activity can occur in a reorganization case without the input of a creditors' committee. Equally significant, it assumes that a debtor will be in a position to proffer a plan of reorganization. In addition, some might posit that a creditors' committee has the option of converting or dismissing a case or seeking the appointment of a
as it desires concerning the debtor's day-to-day management, the
debtor's business plan, and the debtor's restructuring, and thus ig-
nore the interests of the unsecured creditors.

C. The Appointment of a Trustee

The appointment of a trustee is supposed to be a major creditor
protection device. Nevertheless, as the following discussion will
demonstrate, the appointment of a trustee is an illusory remedy be-
cause: 1) there are significant transaction costs in seeking the appoint-
ment of a trustee; 2) there is a high burden of proof needed to secure
the appointment of a trustee; and 3) courts are adverse to granting
motions to appoint a trustee.

There is a strong presumption that in a Chapter 11 case a debtor
should remain in control and in possession of its business. In a cor-
porate reorganization case the appointment of a trustee is an extra-
ordinary remedy. The party seeking the appointment of a trustee
in a Chapter 11 case bears the burden of demonstrating by clear and

trustee. The preceding remedies are illusory because they are seldom granted during
the initial phases of a corporate reorganization case. It is during the initial phases of
a reorganization case that creditors are vulnerable because this is the period when
losses are being accumulated. Indeed, by the time a court is willing to appoint a
trustee the damage has been done and it is impossible to resuscitate the debtor. See,
e.g., In re Ionosphere Clubs, Inc., 113 B.R. 164 (Bankr. S.D.N.Y. 1990).

44 Code § 1104(a) states:

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—

(1) for cause, including fraud, dishonesty, incompetence, or gross mis-
management 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; or

(2) if such appointment is in the interests of creditors, any equity secur-
ity 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.


46 See In re Tahkenitch Tree Farm Partnership, 156 B.R. 525, 527 (Bankr. E.D. La.

1992); In re Microwave Prods. of Am., Inc., 102 B.R. 666, 670 (Bankr. W.D. Tenn.
1989).
convincing evidence that the appointment of a trustee is necessary; a high burden of proof. It is expected that there will be some form of mismanagement in every Chapter 11 case, but mere mismanagement is insufficient to justify the appointment of a trustee.

A case that exemplifies the ineffectualness of Code § 1104(a) as currently devised is Committee of Dalkon Shield Claimants v. A.H. Robins Co. There, the district court had found the debtor in civil contempt for various violations of a court order, and it also found that the debtor had taken action in violation of both the letter and the spirit of the Code. The Committee of Dalkon Shield Claimants (the “Committee”) made a motion for the appointment of a trustee, and the motion was denied. The Fourth Circuit Court of Appeals affirmed the district court, holding that the record was barren of mismanagement or fraud, and thus, the appointment of a trustee was not warranted.

A motion to appoint a trustee is one of the few instances in which a bankruptcy court will employ clear and convincing evidence as the standard of proof. Even when allegations of fraud are involved concerning the nondischargeability of a debt, the burden of proof is a preponderance of the evidence. See Grogan v. Garner, 498 U.S. 279 (1991). The employment of the clear and convincing standard places a movant at a significant disadvantage.

Chief Judge Lifland has written:

The language of § 1104(a)(1) of the Code represents Congressional recognition that some degree of mismanagement exists in virtually every insolvency case. The philosophy of chapter 11 is to give the debtor a "second chance" and, consistent with such philosophy, current management should be permitted to identify and correct its past mistakes.


One case has stated:

One case . . . has attempted to define incompetency and gross mismanagement. The court stated, "incompetency has its roots in mismanagement, requiring a showing of a lack of business acumen and ability . . . Gross mismanagement suggests some extreme ineptitude on the part of management to the detriment of the organization. But it must rise above simple mismanagement to achieve the level envisioned by the Code."


The Fourth Circuit stated:

We find that a careful reading of the court’s opinion reveals that the court did not find cause to appoint a trustee within the meaning of Section 1104(a)(1). The court noted specifically that it had not found fraud or mismanagement. Further, it stated that the concepts of incompetence and dis-
Equally significant, the court reasoned that Code § 1104(a) had to be interpreted flexibly, and that a court had discretion to determine whether conduct constituted incompetence or dishonesty for purposes of § 1104(a).\textsuperscript{55} \textit{A.H. Robins} reflects the difficulties with § 1104(a)(1) because a bankruptcy court has an enormous amount of discretion in determining whether conduct constitutes cause. Instead of strictly construing the language of the Code, courts engage in a cost-benefit analysis to determine whether the appointment of a trustee will be beneficial. Decisions such as \textit{A.H. Robins} undermine the policy underlying Code § 1104(a), which is predicated upon creditor protection and the enforcement of fiduciary duties.

Another consideration is that a motion to appoint a trustee involves substantial transaction costs. There could be major discovery taken by both parties, and a hearing could last for a few days. Unless an unsecured creditor has obtained a sizable judgment, an individual unsecured creditor might lack the financial incentive or resources to seek the appointment of a trustee because the legal fees and costs often make the motion cost prohibitive. Usually, it will be incumbent honesty cover a wide spectrum of conduct and that the court has broad discretion in applying such concepts to show cause. The court examined the entire situation, including the consequences of appointing a trustee, and determined that the debtor had not given the court cause to appoint a trustee. The Committee misconstrues the court’s statement regarding its discretion, given in a finding of cause, to appoint a trustee. We believe that the court’s statement can only be construed to be a general assertion by the court of its discretionary authority in the event, not present here, that it were to find cause.

\textit{Id.} at 241.

\textsuperscript{55} The court stated:

Like the district court, we recognize that Robins’ conduct was improper and warranted a civil contempt sanction. But a policy of flexibility pervades the bankruptcy code with the ultimate aim of protecting creditors. A determination of cause, therefore, is within the discretion of the court and due consideration must be given to the various interests involved in the bankruptcy proceeding. “The concepts of incompetence, dishonesty, gross mismanagement and even fraud all cover a wide range of conduct. . . . Implicit in a finding of incompetence, dishonesty, etc., for purposes of section 1104(a)(1), is whether the conduct shown rises to a level sufficient to warrant the appointment of a trustee.” Obviously, to require the appointment of a trustee, regardless of the consequences, in the event of an act of dishonesty by the debtor, however slight or immaterial, could frustrate the purpose of the Bankruptcy Act. Section 1104(a)(1), therefore, must be construed, if possible, to make it harmonious with the Act in its entirety. Such construction requires that the courts be given discretionary authority to determine whether conduct rises to the level of “cause.”

\textit{Id.} at 241–42 (citation omitted).
upon the creditors’ committee to make the motion to appoint a trustee. The strong presumption against the appointment of a trustee, and the transaction costs associated with a motion to direct the appointment of a trustee, render Code § 1104(a) an inefficient and ineffectual means of protecting creditors and enforcing fiduciary duties in corporate reorganization cases.

D. A Motion Pursuant to Code Section 1112(b) to Dismiss or Convert

1. Bad Faith Dismissal

Code § 1112(b) authorizes a bankruptcy court for cause to dismiss a Chapter 11 case or convert a Chapter 11 case to Chapter 7. A bankruptcy court will dismiss, at its inception, a Chapter 11 case if it

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56 Robins was a mega case, and there were sufficient funds to finance litigation by the Committee. But in some Chapter 11 cases involving an insolvent debtor, there might not be sufficient funds to finance an aggressive litigation by a creditors’ committee.

57 Code § 1112(b) states:

Except as provided in subsection (c) of this section, on request of a party in interest or the United States trustee or bankruptcy administrator, and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 7 of this title or may dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, for cause, including—

(1) continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation;
(2) inability to effectuate a plan;
(3) unreasonable delay by the debtor that is prejudicial to creditors;
(4) failure to propose a plan under section 1121 of this title within any time fixed by the court;
(5) denial of confirmation of every proposed plan and denial of a request made for additional time for filing another plan or a modification of a plan;
(6) revocation of an order of confirmation under section 1144 of this title, and denial of confirmation of another plan or a modified plan under section 1129 of this title;
(7) inability to effectuate substantial consummation of a confirmed plan;
(8) material default by the debtor with respect to a confirmed plan;
(9) termination of a plan by reason of the occurrence of a condition specified in the plan; or
(10) nonpayment of any fees or charges required under chapter 123 of title 28.

establishes that the case was a bad faith filing.\footnote{See, e.g., In re Phoenix Piccadilly, Ltd., 849 F.2d 1393 (11th Cir. 1988); Pleasant Pointe Apartments, Ltd. v. Kentucky Hous. Corp., 139 B.R. 828 (Bankr. W.D. Ky. 1992); In re Campus Hous. Developers, Inc., 124 B.R. 867 (Bankr. N.D. Fla. 1991).} Bad faith corporate reorganization cases are usually single asset cases, which usually involve real property.\footnote{See, e.g., In re Phoenix Land Corp., 164 B.R. 174 (Bankr. S.D. Fla. 1993); In re Punta Gorda Assoc., 143 B.R. 281 (Bankr. M.D. Fla. 1992); In re Denver Inv. 141 B.R. 228 (Bankr. N.D. Fla. 1992).}

Courts have developed criteria for determining whether a case is a bad faith filing.\footnote{Courts have employed the following factors: 1) the debtor has only one asset; 2) the debtor has few unsecured creditors whose claims are small in relation to the claims of the secured creditors; 3) the debtor has few employees; 4) the real property is subject to a foreclosure proceeding; 5) the debtor's financial problems involve a two party dispute between it and the secured creditor which can be resolved in state court; and 6) the timing of the filing of the petition evidences an effort by the debtor to thwart the legitimate rights of the secured creditor. In re Phoenix Piccadilly, at 1394–95.} However, the bad faith criteria are irrelevant to unsecured creditors because they focus on the rights of secured creditors and whether the filing of the case was intended to thwart their rights to foreclose under nonbankruptcy law. As the bad faith criteria reflect, bad faith cases are usually two-party disputes between a mortgagee and a debtor that do not involve unsecured creditors. Therefore, the bad faith criteria are not a useful mechanism for protecting unsecured creditors and enforcing fiduciary duties.

There are also other factors that make dismissal an unattractive and ineffectual remedy. As previously discussed, there are transaction costs, and an unsecured creditor might be unwilling to make a motion to dismiss because the costs of making the motion will outweigh any tangible benefit derived from prevailing on the motion.\footnote{The vast majority of bad faith dismissal motions are made by secured creditors which are usually financial institutions. They can afford to make motions to dismiss because they usually have significant amounts of money involved in these transactions.} In addition, the dismissal of the bankruptcy case might not be in the interests of the unsecured creditors. The dismissal of the case would destroy any possibility of an orderly liquidation of the estate, would destroy any possibility of collective action by the unsecured creditors, would compel unsecured creditors to commence litigation to obtain judgments, and would compel unsecured creditors to incur more legal fees. Moreover, dismissal is detrimental to the interests of the unsecured creditors.
creditors because a trustee would not be appointed to conduct an investigation and commence appropriate litigation. Thus, dismissing a Chapter 11 case is contrary to the interests of the unsecured creditors.

2. Motion to Convert to Chapter 7

An unsecured creditor may also seek to have the Chapter 11 case converted to Chapter 7. Although a motion to convert may appear to be an attractive remedy, securing the granting of a motion to convert to Chapter 7 during the initial stages of a Chapter 11 is difficult to obtain. A case that exemplifies this is In re Rentclub, Inc. There, within the debtor's exclusive period to file a reorganization plan, Transamerica Rental Finance Corporation ("Transamerica") made a motion to convert or dismiss. Transamerica alleged that the case should be dismissed or converted because the debtor was unable to effectuate a plan of reorganization. The debtor, within its exclusive period, had filed a reorganization plan, and for two months had a positive cash flow. The court denied the motion. The case was still in its infancy, and the debtor should be granted an opportunity to reorganize within a reasonable period of time.

Rentclub reflects the problems that plague the current system. The heavy emphasis on debtor protection and rehabilitation has significant costs. Creditors are sometimes unjustly prevented from not only exercising their Code remedies, but also nonbankruptcy entitlements, and sometimes the unsecured creditors are involuntarily compelled to subsidize a debtor's futile attempt to reorganize. The

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63 See, e.g., In re Providence Television Ltd. Partnership, 75 B.R. 139 (Bankr. N.D. Ill. 1987); In re Economy Cab & Tool Co., 44 B.R. 721 (Bankr. D. Minn. 1984).
65 Id. at 237.
66 The court stated:

The record clearly would support the proposition that the Debtor's projection for its economic survival is somewhat questionable, and its chance to achieve reorganization under this Chapter is not without doubt. However, this Chapter 11 case is still in its embryonic stage and the Debtor is proceeding with due speed toward reorganization. Therefore, the Debtor should be given a reasonable chance to conclude this Chapter 11 case without delay. In light of the precarious economic condition of this Debtor, while this Court is satisfied it should be given a short opportunity to achieve rehabilitation, this Chapter 11 case is to be put on the fast track, and unless the Debtor obtains confirmation of a Plan of Reorganization not later than August 1, 1992, this Court will consider to revisit this Motion and enter such Order as appears to be appropriate.

Id. at 236–37.
inability to exercise important creditor remedies such as conversion during the initial phases of a reorganization case is significant. It is during the initial phases of the reorganization case that a debtor’s management makes important decisions concerning the business plan and restructuring, and these decisions should be made to further the interests of the unsecured creditors rather than solely to further the interests of management or the equity security holders. An unsecured creditor’s inability to effectively utilize Code § 1112(b) during the initial phases of a reorganization limits an unsecured creditor’s ability to effectively enforce management’s fiduciary duties. The threat of conversion to Chapter 7 if management misbehaves is a powerful inducement to compel management to act in the interests of the unsecured creditors. The threat of conversion is only effective if the creditors’ committee has the resources to make the motion, and bankruptcy courts are inclined to grant these motions. The making and granting of motions to convert will be a stimulus for the enforcement of fiduciary duties by management and will make corporate reorganization cases beneficial for unsecured creditors.

III. PROPOSED SOLUTION: VOTE OF NO CONFIDENCE

A. Reform is Necessary

As the preceding discussion reflects, there are significant problems with the creditor protection devices offered by the Code. One of the major problems with the current creditor protection devices is transaction costs. To utilize one of these remedies usually entails a major expenditure, which individual unsecured creditors are usually reluctant to expend. Not only does litigation require the outlay of significant sums of money, but also, sometimes, a significant

67 In the same vein, it is during the initial phases of the reorganization that a distribution for the creditors can be salvaged before a debtor accumulates major losses and significant administrative expenses and the value of the estate is significantly diminished. When some reorganization cases are finally converted to Chapter 7 pursuant to Code § 1112(b)(1), the debtor has failed to earn a profit and sustained significant losses. See, e.g., In re Express Freight Lines, Inc., 119 B.R. 1006 (Bankr. E.D. Wis. 1990) (operating losses of $18,000 a month); In re Photo Promotion Assoc., 47 B.R. 454 (Bankr. S.D.N.Y. 1985) (the debtor sustained total monthly losses of $2,000,000); In re CCN Realty Corp., 23 B.R. 261 (Bankr. S.D.N.Y. 1982) (failure to collect rent and pay real property taxes led to diminution in value of the estate); In re Pappas, 17 B.R. 662 (Bankr. D. Mass. 1982) (continuing erosion of the debtor’s equity because of unpaid property taxes and failure to service the secured debt).

68 The exception is a judgment creditor who has obtained a large judgment, and thereby, has an economic incentive to energetically seek the enforcement of its rights.
investment of time. These are deterrents which prevent unsecured creditors from exercising their rights, protecting their interests, and enforcing the fiduciary duties owed to them by management. Therefore, any proposed remedy should seek to reduce transaction costs, make the enforcement of fiduciary duties in a bankruptcy case more efficient, and make it unnecessary to resort to litigation to enforce fiduciary duties.

Another problem associated with the creditor protection devices is the enormous amount of discretion that bankruptcy courts have in determining whether the creditor protection device will be utilized. As the bankruptcy system is currently constructed, courts have enormous discretion in adjudicating motions made pursuant to Code §§ 1104(a) and 1112(b). The employment of this discretion can often lead to incorrect and inconsistent decisions which are deleterious to the interests of unsecured creditors. Another goal of a proposed remedy should be to reduce a court's discretion, and thus, make the enforcement of a remedy a certainty.

Equally important, the current system is too debtor oriented. The presumptions made in favor of debtor rehabilitation can lead to exploitation of Chapter 11, and to non-enforcement of fiduciary duties. Any reform should attempt to reach an equilibrium between debtor rehabilitation and creditor protection, which will foster the enforcement of fiduciary duties.

B. The Vote of No Confidence

The Supreme Court in Commodity Futures Trading Commission v. Weintraub, stated that the filing of a bankruptcy petition creates fundamental changes in the corporate relationships, and the interests of the shareholders become subordinated to those of the creditors. However, the Supreme Court failed to specify how bankruptcy should alter those relationships and how those new relationships should be enforced. In order to recognize and formalize the effect that the commencement of a corporate reorganization case has on corporate

69 Unlike secured creditors, which are usually financial institutions that have a significant amount of time and money invested in the transaction, unsecured creditors may not have invested a significant amount of time or money into the transaction. Consequently, unsecured creditors usually do not have the same incentives for litigating as do secured creditors.


71 Id. at 355.
relationships, a new mechanism called "A Vote of No Confidence" should be adopted in insolvent corporate reorganization cases.\textsuperscript{72}

Under the Vote of No Confidence, if the debtor is insolvent, the unsecured creditors would be granted the right to determine whether current management should be displaced with a Chapter 11 trustee.\textsuperscript{73} The vote would occur at the first § 341 meeting of creditors.\textsuperscript{74} At least two weeks prior to the meeting, unless the court ordered otherwise, unsecured creditors would be provided with copies of the petition, the schedules, the statement of financial affairs, and any other documents that the debtor desired to furnish to the unsecured creditors. The debtor would be permitted to make a presentation concerning the necessity to file for Chapter 11, its business plan and current operations, and its proposal concerning a disclosure statement and reorganization plan. The creditors would have the right to question, under oath, the debtor and its accountant concerning the corporate reorganization case. If a creditor desired, it could obtain a Federal Rule of Bankruptcy Procedure 2004 examination of the debtor prior to the § 341 meeting.\textsuperscript{75} Moreover, creditors would have the opportunity to

\textsuperscript{72} In order to determine whether a debtor is insolvent, the definition of insolvency contained in Code § 101(32) would be employed. Therefore, if a debtor's liabilities exceeded its assets, then it would be subject to a Vote of No Confidence.

\textsuperscript{73} The Vote of No Confidence would be inapplicable if the debtor were solvent. Under these circumstances, the equity security holders still have an interest in the corporation and their nonbankruptcy entitlements and contractual rights should be enforced.

\textsuperscript{74} Code § 341(a) states:

Within a reasonable time after the order for relief in a case under this title, the United States trustee shall convene and preside at a meeting of creditors.


\textsuperscript{75} The pertinent portion of Federal Rule of Bankruptcy Procedure 2004 states:

(a) Examination on Motion. On motion of any party in interest, the court may order the examination of any entity.

(b) Scope of Examination. The examination of an entity under this rule or of the debtor under § 343 of the Code may relate only to the acts, conduct, or property or the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge. In a family farmer's debt adjustment case under chapter 12, an individual's debt adjustment case under chapter 13, or a reorganization case under chapter 11 of the Code, other than for the reorganization of a railroad, the examination may also relate to the operation of any business and the desirability of its continuance, the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration given or offered therefor, and any other matter relevant to the case or to the formulation of a plan.

(c) Compelling Attendance and Production of Documentary Evidence. The attendance of an entity for examination and the production of documentary
discuss and assess the debtor's plight and whether it is desirable to permit current management to continue in control. The creditors would vote to determine whether a trustee should be appointed, and the rules governing the election of a trustee contained in Code § 702 would apply to a Vote of No Confidence.76

IV. JUSTIFICATIONS FOR THE VOTE OF NO CONFIDENCE

A. Bankruptcy Theory

1. The Creditors' Bargain

The economic theorists known as either the "collectivists" or "creditors' bargain theorists" view bankruptcy's primary goal as serving as an efficient debt collection procedure.77 The creditors' bargain is the centerpiece of these theories, and it posits that bankruptcy should not alter a creditor's nonbankruptcy entitlements to achieve purely distributional goals.78 The creditors' bargain is based on the

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76 The pertinent provisions of Code § 702 state:

(a) A creditor may vote for a candidate for trustee only if such creditor—
   (1) holds an allowable, undisputed, fixed, liquidated, unsecured claim of a kind entitled to distribution under section 726(a)(2), 726(a)(3), 726(a)(4), 752(a), 766(h), or 766(i) of this title;
   (2) does not have an interest materially adverse, other than an equity interest that is not substantial in relation to such creditor's interest as a creditor, to the interest of creditors entitled to such distribution; and
   (3) is not an insider.

(b) At the meeting of creditors held under section 341 of this title, creditors may elect one person to serve as trustee in the case if election of a trustee is requested by creditors that may vote under subsection (a) of this section, and that hold at least 20 percent in amount of the claims specified in subsection (a)(1) of this section that are held by creditors that may vote under subsection (a) of this section.

(c) A candidate for trustee is elected trustee if
   (1) creditors holding at least 20 percent in amount of the claims of a kind specified in subsection (a)(1) of this section that are held by creditors that may vote under subsection (a) of this section vote; and
   (2) such candidate receives the votes of creditors holding a majority in amount of claims specified in subsection (a)(1) of this section that are held by creditors that vote for a trustee.


78 See Jackson & Scott, supra note 1, at 156. It has been written:
Supreme Court's decision in *Butner v. United States*, which held that property interests in bankruptcy cases are determined by reference to nonbankruptcy law.

Bankruptcy is a response to the common pool problem that occurs when a debtor's assets are insufficient to pay all of the creditors' claims in full. In response to the common pool problem, bankruptcy is supposed to be a collective proceeding that will maximize the value of the estate and the distribution to creditors. Bankruptcy accomplishes this goal by preventing individualistic and opportunistic behavior that would be detrimental to collective creditor action. Therefore, bankruptcy law stays individual creditor collection activity, which could prematurely dismantle the estate and prevent the credi-

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[1] In its role as a collective debt-collection device, bankruptcy law should not create rights. Instead, it should act to ensure that the rights that exist are vindicated to the extent possible. Only in this way can bankruptcy law minimize the conversation costs of transferring an insolvent debtor's assets to its creditors.

Jackson, supra note 1, at 22.


80 The enforcement of nonbankruptcy entitlements in bankruptcy is vital for the creditors' bargain. It has been observed:

First, unless the rules regulating bankruptcy access were perfectly drawn, the recognition that bankruptcy provides a method of distributing entitlements that differs from state law would create incentives that would motivate parties to use the bankruptcy process strategically. Unsecured creditors and equity owners would opt for bankruptcy when their share of the bankruptcy estate exceeded the value of their entitlements under state law. These actions would be undesirable whenever the expectation of a greater share stemmed solely from the claimant's ability to use the bankruptcy process strategically to delay liquidation. Secured creditors, on the other hand, would prefer nonbankruptcy law if bankruptcy would force them to share their state law entitlements. Furthermore, once the ex ante bargain is struck, individual claimants would thereafter bargain in the shadow of both nonbankruptcy and bankruptcy law, exploiting provisions unfavorable to the opposing side as a means of obtaining a favorable readjustment of their bargained-for entitlements. As parties maneuver strategically to obtain the most favorable individual outcome, they generate unnecessary social costs, including a costly enforcement structure and a narrowing of the distinctions among different classes of claimants.

Jackson & Scott, supra note 1, at 161-62.

81 See Jackson, supra note 1, at 197.

82 See Jackson & Scott, supra note 1 at 162-63.

tors from collectively determining what is the best use for the assets of the estate. 84

The creditors' bargain theorists disdain traditional bankruptcy theorists' conceptions of the purpose of a corporate reorganization case. 85 The traditionalists' notion, that it is beneficial that creditors be compelled to support a struggling business while it attempts to re-organize, is incorrect. 86 The creditors' bargain theorists posit that the

84 See Karobkin, supra note 1, at 729–30.
85 Dean Baird has stated:

This view of bankruptcy law as a common pool problem treats corporate reorganizations as simply a different kind of collective proceeding in which rights are frozen and ownership interests reallocated according to non-bankruptcy entitlements. The more traditional view of corporate reorganizations is strikingly different. Under this view, reorganizations provide breathing space for troubled enterprises. They do not exist to implement the investors' bargain (more specifically, the effective exercise of their withdrawal rights). Rather, they exist to prevent the creditors' individual (or collective) interests from destroying a firm as a going concern by forcing it to liquidate piecemeal, destroying both jobs and assets in the process. Bankruptcy law, under this view, tries to ensure that a firm survives, quite apart from whether the owners as a group want it to or not. The filing of bankruptcy petition stays collection efforts of creditors to give a debtor an opportunity to recover from a "temporary cash-flow problem" or a cyclical downturn in the economy. I have criticized elsewhere any justification of bankruptcy law that gives any investor (or indeed anyone else) substantive rights in bankruptcy that they did not have outside of bankruptcy. This approach to bankruptcy law frequently seems to assume that we are always better off if a particular firm stays in business. It does not squarely face the possibility that all interested parties might be better off as a group if the firm's assets were put to a different use.

Baird, supra note 1, at 133–34.

86 It has been written:

We think that this view is, as a matter of bankruptcy policy, fundamentally wrong. Fashioning remedies for all the harm a failing business may bring is difficult and beyond the competence of a bankruptcy court. The wider effects of the failure of a particular enterprise are not easy to assess. A principal characteristic of a market economy is, after all, that some firms fail, and postponing the inevitable or keeping marginal firms alive may do more harm than good. Forcing investors to keep assets in a relatively unproductive enterprise may limit the freedom of the same or different investors to use those assets in a different and more productive one. Keeping a firm in one town from closing may have the indirect effect of keeping a new one in a different town from opening. Moreover, limiting the ability of investors to reclaim their assets may reduce their incentive to invest (rather than consume) in the first instance. Instead of weighing those effects equally, a bankruptcy judge is likely to focus on the demonstrable harms of those who are before him.

Baird & Jackson, supra note 83, at 102.
principal justification for bankruptcy law is to provide incentives for creditors to act collectively to maximize the distribution to the creditor body.\textsuperscript{87}

The Vote of No Confidence is consistent with the creditors' bargain theory. The theory underlying the Vote of No Confidence is that a corporate reorganization case should be managed to maximize the welfare of the creditors. Creditors should not be compelled to subsidize a moribund firm while it futilely attempts to reorganize because such attempts are inefficient and contrary to their interests. The Vote of No Confidence enables creditors to determine at the inception of a reorganization case whether it is more prudent to wait to be paid through a reorganization plan, or to liquidate and be paid immediately.\textsuperscript{88}

Central to the Vote of No Confidence are the concepts of financial and economic distress. A firm is in economic distress when its operating revenues are less than its operating costs.\textsuperscript{89} Such a firm is not viable and should be liquidated immediately.\textsuperscript{90} On the other hand, a firm that is in financial distress has financial problems which

\textsuperscript{87} It has been stated:

A principal justification for bankruptcy law, then, is to provide incentives for individual claimants such that each of them, as well as constituent groups, finds it optimal either to wait or to collect immediately, depending on the underlying empirical realities and on the interests of the claimants as a whole. Whichever course the law encourages parties to take, maximizing the total welfare of the group will necessarily be the central objective.

\textsuperscript{88} It has been stated:

Even after collective action begins, the choice between liquidation and rehabilitation will often be difficult. If the going concern value of the firm exceeds its liquidation value, then the debtor's claimants as a group would prefer not to have the firm liquidated but rather would prefer to have the business sold as a debt-free entity. Indeed, if the debtor's long-term prospects were sufficiently bright, the claimants would prefer to delay collection altogether and allow the debtor to recover. Going concern value does not exceed liquidation value in all cases, however. The assumption of greater going concern value depends upon the existence of two factors: the debtor's assets must be worth more in combination than if they were broken up and sold, and the long-term prospects of the debtor must be brighter than the short-term prospects. In cases where either of these factors does not hold, total group welfare would be enhanced by a prompt liquidation of the debtor, as opposed to a collective proceeding in which some interests might gain greater shares at the expense of others.


\textsuperscript{90} It has been stated:
are primarily related to its capital structure; enterprises that are experiencing financial distress are viable companies and should be reorganized.

One of the major problems with current corporate reorganization law is that there is no self-executing mechanism that enables creditors to determine whether a firm is experiencing economic or financial distress, and thus, whether the firm is an economically viable enterprise. Corporate reorganization law's failure to distinguish between economic and financial distress promotes abuse of Chapter 11, and is detrimental to unsecured creditors. The Vote of No Confidence confronts the issue of economic and financial distress in a manner that promotes creditor welfare maximization because, at the inception of the case, the unsecured creditors determine which course of action will maximize their wealth. The concept of welfare maximization is the mechanism that measures and enforces fiduciary duties in a corporate reorganization case because the ultimate goal for an unsecured creditor is to receive as great a distribution as possible. In addition, by selecting to retain current management or to obtain the appointment of a trustee, the unsecured creditors are selecting fiduciaries whom they believe will act in their best interests, namely to maximize their distributions. This acts to rectify one of the major problems of the current system, agency costs, in which current management will futilely attempt to revive a moribund enterprise in the hope of saving their employment and salvaging some value for the equity security holders. The Vote of No Confidence ensures that bankruptcy will be employed as an efficient debt collection procedure which maximizes creditor welfare. Therefore, the Vote of No Confidence is not only consistent with the creditors' bargain, but more im-

Such a firm should not continue in business. Its continued existence drains the economy. Indeed, in some instances, allowing the firm to continue in operation under the protection of the bankruptcy law may lead to widespread losses in the industry in which it operates. From a societal point of view, there is little justification in attempting to prop up firms which have failed in the market place.

*Id.* at 87-88.

91 See *id.* at 88.

92 It has been written:

For example, when Johns-Manville, Federated Department Stores and Texaco filed for bankruptcy protection, few if any thought that these firms should be closed. They all were healthy firms in that their operating revenues exceeded their operating costs. The problem was their capital structure. In all cases, through various means, the firms had incurred more debt than they could pay off. They all were suffering from financial distress.

*Id.*
portantly, it also effectuates the principles underlying the creditors’ bargain.\textsuperscript{93}

\textbf{B. The Vote of No Confidence is an Efficient and Effectual Mechanism for the Enforcement of Fiduciary Duties in Insolvent Corporate Reorganization Cases}

When an insolvent company files for Chapter 11, there are inherent conflicts of interest among the different parties in interest.\textsuperscript{94} For example, the equity security holders have interests that are different from those of the unsecured and secured creditors. For instance, the equity security holders would be likely to deem it in their best interests if management pursues speculative ventures with a potential high rate of return.\textsuperscript{95} They have little to lose and a lot to gain if such ventures

\begin{footnotesize}
\textsuperscript{93} Creditors effectively own insolvent firms. See Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1360 (7th Cir. 1990). Thus, once a firm files a corporate reorganization case, its creditors should not be deemed a hostile outside force. See Forum Group, Inc. v. Harrell (\textit{In re} Forum Group, Inc.), 181 B.R. 379, 383 (Bankr. S.D. Ind. 1995), aff'd, 82 F.3d 159 (7th Cir. 1996). The primary goal of a debtor-in-possession is to get the creditors paid. See \textit{In re} Pied Piper Casuals, Inc., 40 B.R. 723, 727 (Bankr. S.D.N.Y. 1984). The creditors' bargain theory makes a significant contribution to bankruptcy policy because it posits that, regardless of whether a bankruptcy case is in Chapter 7 or Chapter 11, the ultimate goal is maximization of creditor wealth through maximizing the value of the estate. The Vote of No Confidence provides an efficient and effectual mechanism for the implementation of this policy because the unsecured creditors should be able to determine what is in their best interests. The Vote of No Confidence is intended to prevent equity and management from exploiting Chapter 11 to extract concessions from the creditors, and thus, unnecessary wealth transfers between unsecured creditors and equity security holders.

\textsuperscript{94} It has been observed:

In our view, the fiduciary obligations of the DIP involve an inherent conflict. The DIP has a bifurcated responsibility that runs jointly to creditors, equity investors and other owners. This places the officers, directors and managing partners in a conflicting position in all cases. Since the interests of the groups they owe obligations to are not always parallel, actions that benefit one group may harm the others. Yet, by creating the debtor in possession, Chapter 11 explicitly countenances this conflict.


\textsuperscript{95} See Martin J. Bienenstock, \textit{Conflicts Between Management and the Debtor in Possession's Fiduciary Duties}, 61 U. Cin. L. Rev. 543, 544–45 (1992); see also Christopher W. Frost, \textit{Running the Asylum: Governance Problems in Bankruptcy Reorganizations}, 34 \textit{Ariz. L. Rev.} 89, 109–10 (1992) ("As the corporation approaches insolvency, shareholder-creditor conflicts become more pronounced. Shareholders put less and less capital at risk in each new business decision as the value of the corporation declines. Thus, shareholders' appetite for risk in the use of assets can be expected to increase.").
\end{footnotesize}
are successful. On the other hand, the unsecured and secured creditors will prefer business decisions that are more conservative and preserve asset value. The preceding problems are exacerbated because management in Chapter 11 cases is selected by the shareholders and not the unsecured creditors. Under these circumstances, management might not embark on a strategy that seeks to maximize or maintain asset value, but rather, they might engage in a strategy that unjustifiably dissipates the value of the estate through increased risk taking and deprives the unsecured creditors of receiving any distribution. This inherent conflict deprives bankruptcy of its utility for the unsecured creditor because the equity security holders will seek to exploit the bankruptcy process to salvage their investment at the expense of the unsecured creditors. Under these circumstances, bankruptcy is an inefficient debt collection device; instead, it is a process under which equity security holders attempt to extinguish the claims of unsecured creditors while attempting, in one form or another, to rescue their nonexistent interests in the corporation.

Under the present structure of Chapter 11, management also suffers from significant conflicts of interests. Management may prefer to pursue a course of action that is contrary to the best interests of the unsecured creditors. This reflects "agency costs" which are a major

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97 See Bienenstock, supra note 95, at 544–45 (1992).
98 One commentator has written:

The bankruptcy fiduciary duty points management in the direction of acting in the interests of both creditors and shareholders. Management is called upon to operate the business in accordance with this principle—maximizing the value of the assets of the reorganizing company while attempting to sort out the conflicts among pre-bankruptcy owners in some reasoned way. This role necessarily places management in a conflicting position in making actual decisions. The interests of the various creditors and shareholders almost always will be in conflict in the Chapter 11 process because the process involves a zero sum game in which there will be winners and losers.

Frost, supra note 95, at 118–19.
99 It has been stated:

While management owes fiduciary duties to creditors, management’s concerns with preserving or improving its positions with the reorganized debtor can affect its negotiation of a Chapter 11 plan in several respects. First, management will not likely want to liquidate substantial assets during the Chapter 11 case or as part of the Chapter 11 plan if the liquidation is not essential to survival and will materially decrease the business to be managed after confirmation of a plan. Second, if two or more classes of creditors exist to nego-
problem since management’s interests are not necessarily aligned with those of the unsecured creditors.\textsuperscript{100} Agency problems are exacerbated in insolvent corporate reorganization cases because management is not selected by the unsecured creditors. The Vote of No Confidence is intended to alleviate conflicts of interests and agency costs. Unless management is amenable to implementing policies and strategies that are beneficial to the unsecured creditors, it is highly probable that management would lose a Vote of No Confidence. The Vote of No Confidence is a mechanism that reduces the conflict of interest problems and the “agency costs” in insolvent corporate reorganization cases, thereby facilitating the enforcement of fiduciary duties.

C. Equity Security Holders Have No Real Interest in an Insolvent Corporation Because the Unsecured Creditors are the Real Parties in Interest

In theory, when a debtor is insolvent the unsecured creditors are the real parties in interest, and the debtor should be operated to further the interests of the unsecured creditors.\textsuperscript{101} Indeed, the priority provisions of the Code provide that creditors must be paid in full prior to any junior class receiving any distribution under a reorganization plan.\textsuperscript{102} Thus, when a company is insolvent, management should

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\textsuperscript{100} Professor Ayer has written:

The first of these is the notion of “agency costs,” otherwise known as the problem of “other people’s money”—an idea so pervasive in commerce that at least two good works on commercial wrongdoing have chosen it as a title. To the non-specialist, the agency problem is the elementary insight that in any situation where there is both a principal and an agent, the agent will have different motivations than the principal and will have an instinct to “shirk” or similarly to degrade the management contract.


\textsuperscript{101} The interests of shareholders are subordinated to those of the creditors in bankruptcy. \textit{See} Commodity Futures Trading Comm’n v. Weintraub, 471 U.S. 348, 355 (1985). Creditors effectively own insolvent firms. \textit{See} Kham & Nate’s Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1360 (7th Cir. 1990).

\textsuperscript{102} The absolute priority rule provides that a dissenting class of unsecured creditors must be paid in full before a junior class is entitled to receive a distribution of property under a reorganization plan. \textit{See} Norwest Bank Worthington v. Ahlers, 485
pursue strategies and policies which will enhance the welfare of the unsecured creditors. The Vote of No Confidence enforces the principles underlying the absolute priority rule and corporate finance. When a Chapter 11 debtor is insolvent the unsecured creditors should be allowed to select management that will pursue their interests, and not be beholden or subject to the control of the shareholders because, quite simply, an equity security holder does not have a financial interest in an insolvent corporation.

D. The Vote of No Confidence Will Have a Salutary Impact on the Corporate Reorganization Process

The current Chapter 11 system permits the debtor to remain in control in order to encourage financially troubled companies to seek bankruptcy relief. The proposed Vote of No Confidence will still


103 A prominent bankruptcy practitioner has stated:

This tension is exacerbated in those situations in which the debtor unequivocally is insolvent, with little hope of enhancing values to attain solvency. Because the Bankruptcy Code provides that creditors have priority over stockholders in the hierarchy of dividends and distributions of consideration, the argument may be made that an insolvent debtor should pursue actions that further the interests of creditors despite the potentially negative effect on its stockholders. Because stockholders of an insolvent debtor are entitled to no distribution under a plan of reorganization if the absolute priority rule is applied, the argument may be made that stockholders of an insolvent corporation in Chapter 11 have no pecuniary interest in the case and should not have any standing to be heard to impede the progress of the case.


In Manville Corp. v. Equity Security Holders Committee, 801 F.2d 60 (2d Cir. 1986), the Equity Committee was dissatisfied with the plan of reorganization that the Board of Directors had negotiated, and it sought to have a shareholders' meeting so that the Board of Directors could be displaced. The Second Circuit held that the Equity Committee was entitled to have a shareholders' meeting. Significantly, the court noted that the result would be different if Manville were insolvent and stated: “We note that if Manville were determined to be insolvent, so that the shareholders lacked equity in the corporation, denial of the right to call a meeting would likely be proper, because the shareholders would no longer be real parties in interest.” Id. at 65 n.6.

104 One commentator has noted:

The Bankruptcy Code is substantially more “user friendly” than its predecessor, the Bankruptcy Act of 1898. Under the Bankruptcy Act of 1898, corporations seeking to reorganize were required to demonstrate they were insolvent or unable to pay their debts as they matured. Furthermore, once
encourage financially distressed companies to seek Chapter 11 relief if they have the ability to reorganize. The Vote of No Confidence will compel a debtor and its counsel to earnestly assess whether the company is financially viable and can reorganize, and whether the company's problems are related to economic or financial distress. The threat that the unsecured creditors might elect to appoint a trustee will discourage economically distressed companies from exploiting Chapter 11.

If a company is financially viable, then it should not be deterred from seeking Chapter 11 relief. Management will have the opportunity to explain to the creditors the problems that necessitated the filing of the reorganization case and management's proposals for rectifying the debtor's financial problems. The unsecured creditors will have an opportunity to evaluate management's presentation and proposals, and make an informed decision concerning the debtor's management. If the unsecured creditors can reasonably expect to receive a greater distribution if the debtor remains in business, then it is probable that the unsecured creditors will vote to retain current management and permit the debtor sufficient time to reorganize.

The ability of the unsecured creditors to select management and influence the policies and strategies that will be adopted by the debtor should facilitate the enforcement of fiduciary duties. The Vote of No Confidence compels a debtor's management to be receptive to the needs and desires of the unsecured creditors from the inception of the reorganization case which rectifies some of the problems with Chapter 11. Equally important, the Vote of No Confidence can be implemented without unsecured creditors incurring significant transaction costs. A self-executing mechanism will ensure that the Vote of No Confidence will not be dependent upon whether a creditors' committee has been appointed, whether a sole unsecured creditor is willing to absorb the legal fees and costs, or whether a bankruptcy court is inclined to grant relief.

Although some might contend that the Vote of No Confidence will deter financially distressed companies from filing for Chapter 11, the Vote of No Confidence should encourage financially troubled companies to seek Chapter 11 relief earlier while the company can be salvaged. The Vote of No Confidence is only applicable if a company is insolvent as of the date of the filing of the petition; hence, as a company nears insolvency it has an incentive to file for Chapter 11 relief before it is deemed insolvent. Under these circumstances, the Vote of No Confidence encourages financially distressed companies to seek Chapter 11 relief, and thus fosters debtor rehabilitation for financially viable enterprises.

V. CONCLUSION

Although some might contend to the contrary, Chapter 11 is currently skewed in favor of debtors to the detriment of the unsecured creditors.\textsuperscript{105} Indeed, in Chapter 11 cases unsecured creditors are placed in an untenable position because it is difficult, if not impossible, for them to enforce the fiduciary duties owed to them by debtors-in-possession. The proposed concept of the Vote of No Confidence is a self-executing mechanism to ensure that the unsecured creditors are granted a voice in the operation of the debtor. One of the merits of the "Vote of No Confidence Proposal" is that it will not require a major overhaul of the Code, and therefore, will be simple to enact and effect. The implementation of the Vote of No Confidence will effectively correct the imbalances in the current system and thereby transform Chapter 11 into an efficient vehicle for maximizing distribution to creditors, which is the ultimate fulfillment of fiduciary duties owed to the unsecured creditors and the enforcement of the creditors' bargain.\textsuperscript{106}

\textsuperscript{105} One commentator has suggested:

\begin{quote}
Despite the seemingly broad powers of the DIP, several sources prohibit absolute discretion. There are five important restrictions on the power of the debtor in possession. They include the power of the court to limit the discretion of the debtor in possession; the ability of the creditors' committee to monitor the DIP; the potential for the conversion of the case from Chapter 11 to Chapter 7; the possibility of the appointment of an examiner or trustee; and the potential for the court to order the DIP to cease business operations.
\end{quote}

\textsuperscript{106} It has been written:

John T. Roache, Note, \textit{The Fiduciary Obligations of a Debtor in Possession}, 1993 U. Ill. L. Rev. 133, 142. As previously discussed, these alleged restraints are inefficient and nonexistent such that the fiduciary obligations of a debtor-in-possession are mythical.
In the opinion of these authors, although there are indisputably certain drawbacks in seeking the appointment of a trustee, where warranted, the advantages far outweigh the disadvantages and make the motion to appoint a trustee a powerful tool for the protection of creditors' rights. In the prosaic words of Bankruptcy Judge King in *In re Hotel Associates, Inc.* "[t]he trustee will seek to benefit all the creditors and will bring a refreshing air of objectivity and impartiality to a business . . . ." More specifically, the trustee will hopefully keep accurate and trustworthy records, attempt to cooperate with creditors in the pursuit of a plan, and provide invaluable intangible support for the reorganization potentiality of the debtor. Moreover, the trustee's objective management of the business may make it possible to sever uneconomical loyalties to favored suppliers, customers or employees, sell off or abandon unprofitable or marginal divisions or product lines, reduce overhead by cutting out inefficiencies, waste and excess, and otherwise instill the confidence of the creditors, equity security holders, and the bankruptcy judge who appointed the trustee.
