10-2007

Enforcing Corporate Fiduciary Duties in Bankruptcy

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I. INTRODUCTION

The conventional wisdom regarding the appropriate response to mismanagement of a bankrupt corporation holds that Chapter 11 trustees should almost never be appointed,[1] and state law remedies and procedures governing corporate management should apply within a federal bankruptcy case.[2] The conventional wisdom is wrong. While corporate law is the province of the states, state law remedies and procedures are not always the best means by which to regulate a

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1. The conventional wisdom in this regard arises because of the perception that a Chapter 11 trustee must replace the debtor's management entirely. This misunderstanding pervades the law and the literature on the subject. For example, in *Commodity Futures Trading Comm'n v. Weintraub*, the Supreme Court, in deciding whether a Chapter 11 trustee had authority to waive a corporation's attorney client privilege, found that "Congress contemplated that when a trustee is appointed, he assumes control of the business, and the debtor's directors are 'completely ousted,'" so that the trustee may conduct an investigation of those directors unimpeded by any authority they may maintain. 471 U.S. 343, 352–53 (1985). *See also* Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 577 (3d Cir. 2003) ("disallowing derivative suits and forcing creditors' committees to move to appoint trustees would amount to 'replac[ing] the scalpel of derivative suit with a chainsaw'"); CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 63 (1997) (noting that, if appointed, a trustee usually takes over entirely for the debtor in possession). Bankruptcy litigants are therefore hesitant to move for the appointment of a trustee unless presented with an extreme case that warrants removing all of a debtor's current management. Such cases are understandably rare. This Article demonstrates that this conventional belief and the inappropriate deference to state law it generates are unfounded and serve to prevent debtors from availing themselves of all of the protections against harmful corporate leadership the Bankruptcy Code provides.

2. *See* La. World Exposition v. Fed. Ins. Co., 858 F.2d 233, 237 (5th Cir. 1988) (adapting the bankruptcy of a nonprofit corporation to allow creditors to pursue state law derivative causes of action against the debtor's management because the creditors sought to bring the suits using state law causes of action rather than bankruptcy remedies); David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 491 (1994) (noting that bankruptcy courts defer to state law corporate governance principles). This Article explains why state law corporate governance mechanisms do not translate well into a bankruptcy setting, and why, even if bankruptcy law were to adapt to incorporate those procedures, they still would not protect a debtor corporation as well as the provisions of the Bankruptcy Code.

corporation once it files bankruptcy. Bankruptcy law alters some of the operations and priorities of a debtor corporation in order to serve the distinct goals of a reorganizing company—goals state corporate law is not designed to accommodate. Unfortunately, bankruptcy courts remain very deferential to state laws concerning corporate governance even though that body of law does not consider problems peculiar to insolvent corporations.[3]

One consequence of the sometimes uneasy and uncertain relationship between state corporate law and federal bankruptcy law is that, when a corporation files bankruptcy, state law actions against the corporation's directors for breaches of fiduciary duty often get lost in the application of the automatic stay, or in the provisions of a plan of reorganization, and die without receiving any sort of hearing on their merits.[4] It may appear, then, that there is no remedy available to a debtor corporation held hostage by disloyal, or even grossly incompetent managers. The remedy suggested by the Bankruptcy Code (the "Code")—the appointment of a trustee—is often cast aside as an extreme and inordinately disruptive remedy.[5] As such, the appointment of a trustee is only rarely pursued by a debtor's various parties in interest.[6]

Insistence upon the use of the state law derivative suit to remedy significant problems with a corporation's management, instead of appointment of a Chapter 11 trustee, is misplaced. Bankruptcy remedies and procedures, *particularly* the appointment of a Chapter 11 trustee, should be the first resort for parties in interest having a serious grievance with a debtor's management. The Code has always required this approach, and Congress has emphasized that requirement in its most recent amendments to the Code.[7] Bankruptcy courts should refuse to

3. Skeel, *supra* note 2, at 474–75. The result of this gap in the law governing the management of insolvent corporations is what Professor Skeel refers to as a "vestigialization" problem. *Id.* at 474. Insolvent corporations that choose to reorganize under state law must avail themselves of "inefficient and often ineffective corporate governance rules" and corporations in bankruptcy fall victim to a bankruptcy court's deference to state corporate governance law that is not well-adapted to insolvent firms. *Id.* at 491.

4. *See, e.g.*, Seinfeld v. Allen, 169 F. App'x 47, 49 (2d Cir. 2006) (noting a shareholder may assert a derivative cause of action against a corporation in bankruptcy only in certain circumstances); Agostino v. Hicks, 845 A.2d 1110, 1126 (Del. Ch. 2004) (holding "federal law [under the Supremacy Clause] operated to extinguish plaintiff's claims entirely"). Skeel refers to this phenomenon as "bankruptcy's 'black hole effect.'" Skeel, *supra* note 2, at 500.

5. *See* Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1, 10–11 (1989) (noting Chapter 11 trustees have been abandoned as a remedy).

6. *Id.*

7. *See generally* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-9, 119 Stat. 23 (2005) (codified as amended primarily in scattered sections of Chapter 11 of

hear motions for leave to pursue a derivative suit alleging a breach of fiduciary duty by the debtor's current management until the concerned parties in interest have presented a motion for the appointment of a trustee.

Although § 1104 of the Code, which provides for the appointment of a trustee or an examiner in a Chapter 11 bankruptcy, may have been overlooked because a trustee is regarded by bankruptcy courts as an expensive and severe remedy, it supplies the Code's only account of what types of corporate governance concerns matter within a bankruptcy case.[8] The first part of the provision defines "cause" that would justify the appointment of a trustee to assume management of the corporate debtor.[9] Next, the section allows the bankruptcy court to appoint a trustee if the court finds such an appointment would be in the "best interests" of the relevant parties.[10] This latitude enables a bankruptcy court to make a purely discretionary judgment about how best to operate the debtor. The most recent addition to § 1104, subsection (e), requires the United States Trustee (the "UST") to move for the appointment of a Chapter 11 trustee when the UST has "reasonable grounds to suspect" that members of the debtor's *current* management have engaged in "actual fraud, dishonesty, or criminal conduct in the management of the debtor or [in its] public financial reporting."[11] The suspicions that would prompt such a motion by the UST mirror causes of action for violations of the securities laws.[12] The fact that Congress wants bankruptcy courts to hear about possible violations of those laws, whether or not the UST could establish the requisite "cause" by clear and convincing evidence, reveals that in Congress's judgment, discovering corporate managers who violate securities laws and removing them through the bankruptcy process is more important to bankruptcy than removing or pursuing suits against those managers on account of breaches of fiduciary duty. Still, § 1104(e) does not signal a death knell for derivative suits in bankruptcy. On the contrary, it reveals how a bankruptcy case should proceed in the face of such an action.

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the United States Code).

8. *See* 11 U.S.C.A. § 1104 (West Supp. 2007) (providing statutory authority for appointment of a trustee).

9. *Id.* § 1104(a)(1).

10. *Id.* § 1104(a)(2)–(3).

11. *Id.* § 1104(e).

12. *See* Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11 The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L. J. 603, 618–19 (2005) (questioning whether restated financials resulting from bankruptcy constitutes "reasonable grounds to suspect" actual fraud, dishonesty, or criminal conduct).

Just as a UST would be required to move for the appointment of a trustee under § 1104 if a sufficiently meritorious suit alleging securities law violations by the debtor's current management were pending during a bankruptcy case, the UST, creditors' committee, or any other party in interest could decide to make such a motion if a similarly meritorious derivative suit were brought under state law.[13] In § 1104(e), Congress has required the UST to bring alleged or suspected problems with the debtor's management before a bankruptcy court as a motion for the appointment of a trustee. Courts may use the development of the common law to expand on the explicit provisions and hints provided by Congress in § 1104, particularly in subsection (e), to create a consistent approach to allegations of severe mismanagement. This Article argues that this approach should include a requirement that parties in interest who wish to allege mismanagement by the debtor in possession's officers and directors, or who seek to redress injuries inflicted on the corporation or its parties in interest under state law corporate governance mechanisms, first move for the appointment of a trustee under § 1104.

Granted, to depose a debtor in possession ("DIP")[14] is an extreme and expensive remedy, and not the one preferred by state law when management has breached its fiduciary duties. The misperception that the appointment of a trustee necessarily leads to the complete replacement of the debtor's management gives rise to the mistaken conventional wisdom that a motion under § 1104 should be a party in interest's *last* resort; to be pursued only after all state law remedies have been exhausted.[15] The key consideration to remember, though, is that once the corporation files bankruptcy, *bankruptcy* rules, remedies, and procedures apply and are often vastly different from the norms under state or other non-bankruptcy law.[16] With its provisions for the appointment of a trustee in the face of serious problems with DIP

13. Any party in interest or the UST may, "at any time after commencement of the case but before confirmation of a plan" of reorganization, move for the appointment of a trustee under § 1104(a). 11 U.S.C.A. § 1104(a).

14. A debtor in possession is a legal fiction created in order to organize many different functions of a debtor in bankruptcy and is also a term used to indicate the status of the debtor corporation. Nimmer & Feinberg, *supra* note 5, at 20–21. A "debtor in possession" still manages its own affairs with managers and external professionals of its choosing. *Id.* at 21. For this reason, the term "DIP" is "most closely associated with the *management* of the business: the officers, directors, retained professionals, and business managers." *Id.* at 20.

15. Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (*In re* W.R. Grace & Co.), 285 B R. 148, 158 (Bankr. D. Del. 2002) ("[T]he Court recognizes that appointing a trustee must be considered a last resort.").

16. *See* Daniel J. Bussel, *Creditors' Committees as Estate Representatives in Bankruptcy Litigation*, 10 STAN. J.L. BUS. & FIN. 28, 34 (2004) ("The Bankruptcy Code preempts otherwise applicable state law and alters substantive rights all the time and in a myriad of ways.").

management, § 1104 signals a preference for removing or more carefully supervising troubled managers, rather than necessarily having to pursue an expensive derivative suit to recover monetary damages. Whenever cause to appoint a trustee is established, which is necessarily true in every case of a meritorious derivative suit, bankruptcy courts are required to appoint a Chapter 11 trustee.[17] The trustee may then decide whether pursuing a derivative cause of action is in the estate's best interest. A court may decide to appoint a trustee for the sole purpose of pursuing particular causes of action on behalf of the estate or taking responsibility for financial reporting, and leave the debtor's management in power to care for the rest of the debtor's operations.[18] Therefore, a successful motion under § 1104 for the appointment of a trustee does not necessarily result in the replacement of a DIP's management by a trustee.[19] Such a motion may have the additional advantage of bringing problems with a debtor's managers to the bankruptcy court's attention. The mechanisms provided by § 1104 allow a court to take any number of actions that it can tailor to the situation at hand to provide the best and most efficient solution for the estate. The exercise of this discretion will allow a common law approach to develop regarding the appropriate response to significant problems with a debtor's management, with § 1104 serving merely as a starting point in the analysis.

This Article describes how the bankruptcy system should use § 1104 of the Code to find a consistent approach to suits against the debtor's management alleging wrongdoing on the part of officers or directors. The Article particularly focuses on a proposed treatment of derivative actions brought by shareholders, but its arguments can be easily extended by analogy to other actions against officers and directors for breaches of their obligation to the corporation and its shareholders. The framework provided by § 1104 may lead to outcomes different than those reached in similar situations under non-bankruptcy law, but it does so by honoring the distinct bankruptcy law priorities of efficiency and a forward-looking reorganization of a corporate debtor that preserves as much of the estate's going concern value as possible. The academy has long been in an uproar about the proposed amendments to the Code that were passed two years ago as the Bankruptcy Abuse Prevention and Consumer

17. *See infra* Part III.A.1.

18. *See In re* Intercat, Inc., 247 B.R. 911, 925 (Bankr. S.D. Ga. 2000) (holding the UST shall appoint a trustee to, in part, investigate and prosecute all estate causes of action); Dardarian v. La Sherene, Inc. (*In re* La Sherene, Inc.), 3 B.R. 169, 176 (Bankr. N.D. Ga. 1980) ("While the debtor in possession may be the norm, the facts here require the exception. A trustee is demanded and will be appointed.").

19. *In re Intercat*, 247 B.R. at 925.

Protection Act of 2005 ("BAPCPA"). Some of those complaints take issue with the vagueness and ambiguity of § 1104(e).[20] This ambiguity may be a disguised blessing, however, as it will allow bankruptcy courts to develop common law surrounding § 1104 that molds its provisions to particular circumstances in a manner that will best serve the corporate debtor. BAPCPA is the law, at least for the immediately foreseeable future, and it is best to find ways to adapt to and use its ambiguities, irrationalities, and loopholes in order to create a more cohesive and predictable process.

Part II of this Article explores and refutes the conventional wisdom regarding the appropriate response to severe mismanagement of a corporate debtor. Part III discusses the state of the law regarding the appointment of Chapter 11 trustees and the law concerning state law derivative suits. Part III explains how each regime works separately as well as how they operate together. Part IV surveys policy considerations that inform the treatment of derivative suits and other corporate governance concerns of a corporate debtor. Part IV makes clear why the unique circumstances of a bankruptcy justify using the procedures and remedies supplied by the Code rather than trying to force the square peg of state law into the round hole that is a Chapter 11 reorganization. Part V then describes how application of § 1104 of the Code can provide a complete framework within which to address problems with a debtor's management. Finally, the Article concludes that federal bankruptcy courts should require parties in interest alleging severe mismanagement of the debtor to bring a motion for appointment of a trustee before resorting to state law remedies.

II. THE CONVENTIONAL WISDOM

Bankruptcy courts have a strong practice of deferring to state law principles, procedures, and remedies when confronting severe problems with a DIP's management.[21] They turn to the remedy provided by the Code—the appointment of a Chapter 11 trustee—only rarely, and avoid it if at all possible. This is because of the common belief that a trustee must completely replace a DIP's current management, which in most cases would constitute an extreme and unnecessarily expensive response to most instances of mismanagement. This Part will explore the reasons for the prevailing practice among bankruptcy courts faced with rogue

20. Levin & Ranney-Marinelli, *supra* note 12, at 618–20.

21. Skeel, *supra* note 2, at 474.

DIP managers and will conclude the conventional wisdom is wrong and not justified by either law or policy.

A. Deference to State Law

Whenever possible, bankruptcy courts incorporate, rather than override, state law principles.[22] That practice, combined with the primacy of state law in the law of corporate governance, means that bankruptcy law not only strongly defers to state law when faced with severe mismanagement, but also lacks a well-developed jurisprudence on the subject.[23] The result is that courts will entertain derivative actions brought to enforce state law fiduciary duties, and will decide whether or not those suits can proceed, given who is bringing them and the posture of the bankruptcy case. Upon finding that such a suit cannot go forward without the DIP's approval, any argument about the unsoundness of the DIP's management is dropped and the case proceeds without any sort of change in, or reprimand of, the DIP's officers or directors.

In most situations, it is the debtor's parties in interest who prefer to pursue state law causes of action when injured by the effects of poor management. Sometimes the suit in question is a derivative suit brought by shareholders before or shortly after the bankruptcy case is filed.[24] Sometimes creditors seek standing to pursue a derivative action modeled after the state law shareholder derivative suit during the course of a bankruptcy case.[25] A derivative suit presents an opportunity for the debtor's residual claimants, or their attorneys working on a contingency basis, to recover money from directors and officers who have injured the corporation and left it in its bankrupt state. Barring special provisions in a loan agreement, the appointment of a trustee does not result in any hope of increased monetary recovery for the shareholders and creditors

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22. *Id.* at 491.

23. *See id.* (explaining that because of bankruptcy courts' deference to state corporate law, and state law's inattention to circumstances particular to insolvent companies, there is a gap in the corporate law regarding the regulation of managers).

24. *See, e.g.*, Mitchell Excavators, Inc. v. Mitchell, 734 F.2d 129, 131–32 (2d Cir. 1984) (holding once bankruptcy case was filed, shareholder no longer had a right to pursue derivative action against debtor's officers and directors); Agostino v. Hicks, 845 A.2d 1110, 1126 (Del. Ch. 2004) (lamenting that a derivative suit brought in state court before a bankruptcy filing was properly released by debtor's plan of reorganization, and that shareholder could no longer pursue that cause of action).

25. *See, e.g.*, La. World Exposition v. Fed. Ins. Co., 858 F.2d 233, 235–36 (5th Cir. 1988) (discussing whether committee of creditors has standing, not usually afforded creditors under Louisiana law absent allegations of fraud, to bring a derivative suit on behalf of the debtor against its managers).

of an estate, other than that resulting from having more honest and perhaps more efficient leadership at the helm of the debtor. Bankruptcy courts have most often responded to derivative litigation by deciding whether the instant suit can proceed and, usually finding it cannot, leaving the DIP undisturbed.

The most significant problem with this approach is, of course, that derivative suits brought by shareholders on behalf of a corporation that eventually enters bankruptcy belong to the debtor itself and cannot continue without first being abandoned or released to the shareholders by either the DIP or a Chapter 11 trustee.[26] The cause of action for breach of fiduciary duty belongs to the estate[27] and the automatic stay prevents parties other than the DIP or trustee from exercising control over property of the estate without permission from the bankruptcy court, DIP, or trustee.[28] As a consequence, derivative suits tend to disappear under the control of DIP management, and are not an effective way to enforce the fiduciary duties corporate managers owe to the debtor.[29] Bankruptcy courts are correct to defer to the substantive standards for corporate governance provided by state law fiduciary duties for all of the reasons that they defer to derivative suits at all. However, those standards are difficult, if not impossible, to enforce according to state law remedies and procedures within a bankruptcy case.

The Code provides its own means to hold managers accountable for and protect a debtor corporation from the kind of severe mismanagement that constitutes a breach of fiduciary duty—the appointment of a Chapter 11 trustee. Because the appointment of a Chapter 11 trustee can be such a flexible remedy, it can quickly and efficiently solve a problem with a debtor's management without lengthy litigation. However, a debtor's shareholders and creditors are hesitant to move for the appointment of a trustee except in the most extreme circumstances, because of the common misperception that a Chapter 11 trustee must assume complete control over the debtor.[30] Bankruptcy courts' reluctance to use the discretion granted them under the Code to creatively devise the best use of an appointed trustee unfortunately squanders the potential usefulness of the remedy. As this Article will explain, bankruptcy courts can and should use their discretion to make the appointment of a trustee a less

26. *Mitchell Excavators*, 734 F.2d at 131–32.

27. *Id.* at 131.

28. 11 U.S.C.A. § 362(a)(3) (West 2004); *see infra* Part III.B.3.

29. *Agostino*, 845 A.2d at 1126; Skeel, *supra* note 2, at 500.

30. *See supra* note 15 and accompanying text.

severe response to gross mismanagement. The two misunderstandings that make up the conventional wisdom are related and feed each other.

B. Avoidance of Trustee Remedy

Bankruptcy courts, debtors, creditors, and other parties in interest often hesitate to use the remedy for mismanagement specifically provided by the Code—the appointment of a Chapter 11 trustee—because it is considered an extreme and expensive remedy, necessary only in the most egregious circumstances in which a DIP's current management is unfit to serve in any capacity.[31] Such circumstances certainly exist and it is in these few instances of glaring fraud or incompetence that a trustee is appointed to replace a debtor's management. Replacement of a debtor's management is extraordinarily expensive and disruptive and certainly only warranted in the most extreme cases. However, nothing in the Code requires that a trustee depose a DIP's management. The removal of a DIP is not a required, or even the most effective use of the trustee remedy.[32]

The current conventional wisdom is simply an understanding of what the appointment of a trustee meant under the former Bankruptcy Act (the "Act") which the Code replaced. Under the Act, large public companies filed for bankruptcy under Chapter X, which required appointment of a trustee who would exercise significant control over the estate and usually displace the debtor's management entirely.[33] The problem with the mandatory approach to the appointment of a trustee was that corporate managers were understandably hesitant to file bankruptcy in time to save a corporation because doing so likely meant the loss of their jobs.[34] When Congress promulgated the Code, the two business bankruptcy chapters of the prior Act, Chapters X and XI, were condensed into one chapter—Chapter 11—and the requirement of a trustee was removed.[35] Still, the idea of what the appointment of a trustee *meant* did not change.

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31. *See* Schuster v. Dragone (*In re* Dragone), 266 B.R. 268, 272 (D. Conn. 2001) (finding insufficient evidence of "fraud, dishonesty, incompetence, or mismanagement" to justify appointment of a Chapter 11 trustee).

32. *See infra* Part III.A.

33. *See* Barry L. Zaretsky, *Trustees and Examiners in Chapter 11*, 44 S.C. L. REV. 907, 917–21 (1993) (describing the history of the use of a trustee in business bankruptcies beginning with the prior Bankruptcy Act).

34. *See id*. at 920–21. The practice of reorganizing under Chapter 11 "supported the view that if appointment of a trustee was mandatory, debtors would not commence reorganization proceedings until they were forced to do so—a time that might be too late to salvage the business." *Id.*

35. *Id*. at 925–26.

Thus, a trustee still represents the replacement of DIP management as far as most courts and bankruptcy practitioners are concerned.[36] The court in *In re W.R. Grace*[37] found support for this position in the Code, claiming without discussion that §§ 521(a)(4), 704, and 323 require a trustee to become the sole representative of the estate and assume control over all estate property.[38] A careful examination of these Code sections and those that apply directly to Chapter 11 trustees reveals that the Code does not prohibit courts from appointing trustees in limited capacities, but rather, grants courts the discretion to define the scope of a trustee's duties in the manner most likely to advance the successful reorganization of the relevant debtor.[39]

Section 521(a)(4) provides that a debtor must "surrender to the trustee all property of the estate and any recorded information . . . relating to property of the estate" if a trustee has been appointed.[40] This simply means that the debtor must open its books and records to the trustee and must not deny the trustee access to or control over estate property when such access and control is necessary to the completion of the trustee's duties. In fact, subsection (a)(4) is listed immediately after a provision requiring the debtor to "cooperate with the trustee as necessary" to allow the trustee to perform her duties.[41] The language added to both subsections (a)(3) and (a)(4) by BAPCPA sheds further light on the statutory interpretation problem. BAPCPA adds "an auditor serving under . . . this Title" as a party with whom the debtor must cooperate and to whom it must surrender property and records.[42] Certainly no one would argue that an appointed auditor must replace the DIP management entirely and take charge of the operation of the debtor. If § 521 does not extend that mandatory authority to appointed auditors, it cannot be said to have that effect on the discretion courts have to fashion the trustee remedy as appropriate on a case-by-case basis.

The next section listed by the *W.R. Grace* court, § 704, relates to Chapter 7 trustees.[43] Chapter 7 applies most often to individual

36. *See, e.g.*, Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 352–53 (1985) (holding that "Congress contemplated that when a trustee is appointed, he assumes control of the business, and the debtor's directors are completely 'ousted'"); Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (*In re* W.R. Grace & Co.), 285 B.R. 148, 157 (Bankr. D. Del. 2002) (finding the court was without authority to appoint a "limited purpose trustee").

37. 285 B.R. 148.

38. *Id.* at 157.

39. 11 U.S.C.A. §§ 323, 521(a)(4), 704, 1104, 1107, & 1108 (West 2004 and Supp. 2007).

40. *Id.* § 521(a)(4) (West Supp. 2007).

41. *Id.* § 521(a)(3).

42. *Id.* § 521(a)(3)–(a)(4).

43. *Id.* § 704.

consumer liquidation cases, and the appointment of a trustee to monitor and manage the estate of a Chapter 7 debtor is automatic and mandatory. A Code provision regarding Chapter 7 trustees, therefore, has no bearing on the very different circumstances of a business's Chapter 11 filing and the possible appointment of a Chapter 11 trustee.

Finally, § 323 simply provides that "[t]he trustee in a case under this title is the representative of the estate."[44] The *W.R. Grace* court interprets this provision to mean that an appointed trustee is the one and only representative of the estate and so cannot be assigned limited duties.[45] This interpretation of the Code section is consistent with conclusions reached by other courts and may, standing alone, support the contention that a trustee must replace the DIP as the sole representative and operator of the estate.[46] Still, an analysis of the Code's provisions regarding the purpose and required role of a Chapter 11 trustee is incomplete without a consideration of the relevant provisions of Chapter 11.

First and foremost, § 1104(a), which provides the standard for the appointment of a trustee in Chapter 11, makes clear that the use of the remedy is not always left to a bankruptcy court's discretion. Where "cause" exists, the appointment of a trustee is mandatory.[47] Cause to appoint a trustee includes "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management."[48] Once a court has decided that the appointment of a trustee is required by a debtor's circumstances or that such an appointment is in the estate's best interests, how to fashion that remedy is left to the court's discretion.[49] Sections 1107 and 1108 of the Code describe the rights and

44. *Id.* § 323(a) (West 2004).

45. Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (*In re* W.R. Grace & Co.), 285 B.R. 148, 157 (Bankr. D. Del. 2002).

46. *See* Rooney v. Thorson (*In re* Dawnwood Props./78), 209 F.3d 114 (2d Cir. 2000) (holding that only the appointed trustee may initiate proceedings). The holding in *Dawnwood Properties*—that once a trustee is "appointed to maximize the assets of the Chapter 11 bankruptcy estate," the debtor corporation and its principal lack standing to initiate adversary proceedings on the estate's behalf—is limited to its facts. *Id.* at 116. There, the appointed trustee was explicitly given control over the debtor to protect the debtor and its creditors from the debtor's principal. *Id.* The court does not hold that that use of a trustee is mandatory, only that when a trustee has been appointed to replace a debtor's management, the debtor's management can no longer act to initiate or pursue adversary proceedings on the estate's behalf.

47. Section 1104(a) states that a court "shall," meaning *must*, appoint a trustee upon a finding of cause. 11 U.S.C.A. § 1104(a) (West Supp. 2007).

48. *Id.* § 1104(a)(1).

49. The mandatory nature of the trustee remedy upon a finding of cause necessitates giving courts the freedom to define the scope of a trustee's duties as appropriate. A requirement that courts completely replace a debtor's current management with a trustee would exact far too great a cost to the debtor. Such an extreme remedy is not appropriate in most circumstances. The discretionary

duties of DIPs and Chapter 11 trustees and allow bankruptcy courts to define the roles of both in any given case. Section 1107(a) provides that a debtor in possession will have all of the rights and duties of a Chapter 11 trustee "[s]ubject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes."[50] That language gives a bankruptcy court the authority to apportion the powers, rights, and duties attendant to operating a debtor among a DIP and a trustee as the bankruptcy court sees fit. Further, § 1108 states that, "[u]nless the court . . . orders otherwise, the trustee may operate the debtor's business."[51] This supports the conclusion that courts have the authority to order the trustee and DIP to work together.[52] The ability of a court specifically to tailor the trustee remedy to the circumstances of the case before it further confirms that the appointment of a trustee can be an efficient and precise remedy in the face of disloyalty or gross incompetence on the part of a debtor's managers.

The availability of a Chapter 11 trustee with limited duties to a debtor and its parties in interest is explored and developed more completely later in this Article.[53] The conventional wisdom preferring state law derivative actions in the face of breaches of fiduciary duty by a debtor's managers is misguided and robs bankruptcy courts and debtors of a potentially useful and efficient remedy. It is not the substantive state law of fiduciary duties that should be left behind, but the inefficient state law remedy of a derivative action that cannot proceed effectively once a corporation has filed bankruptcy. In such instances, the appointment of a trustee is the required remedy, and it is a bankruptcy court's responsibility to devise a way to use that remedy in order to protect the estate's parties in interest without causing the debtor to incur undue injury and expense. Courts have balked at striking this balance and have refused to appoint a trustee where one may be required, finding that a trustee would be too disruptive to the estate.[54] However, the appointment

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nature of the remedy is a necessary corollary to its required use in situations constituting cause.

50. 11 U.S.C.A. § 1107(a) (West 2004).

51. *Id.* § 1108.

52. *See, e.g.*, *In re* Intercat, Inc., 247 B.R. 911, 923–25 (Bankr. S.D. Ga. 2000) (citing §§ 1107 and 1108 in support of its decision to appoint a trustee to supervise the debtor and pursue particular causes of action on its behalf while retaining the debtor's management to assist with the reorganization and operation of the debtor's business); Dardarian v. La Sherene, Inc. (*In re* La Sherene, Inc.), 3 B.R. 169, 176 (Bankr. N.D. Ga. 1980) (appointing a trustee to operate the debtor's business and attend to the financial aspects of the reorganization because of the incompetence of the debtor's management).

53. *See infra* Part III.

54. *See, e.g.*, La. World Exposition v. Fed. Ins. Co., 858 F.2d 233 (5th Cir. 1988). In *La. World Exposition*, the court held Louisiana law governed the derivative suit that creditors sought to pursue against the managers of a Chapter 11 debtor, and although Louisiana law did not give creditors

of a trustee is only necessarily disruptive if a court refuses to use its discretion to give a trustee the smallest role possible in the bankruptcy that will allow the trustee to protect the debtor from severe mismanagement.

III. THE STATE OF THE LAW REGARDING CHAPTER 11 TRUSTEES AND DERIVATIVE SUITS

Because of the uneasy fit between state corporate law and federal bankruptcy law, derivative suits brought under state law before a corporation files bankruptcy "disappear" upon the bankruptcy filing.[55] The methods for the control and monitoring of the corporate governance of a debtor provided by the Code should dominate over complimentary state provisions. Currently, shareholder plaintiffs move for relief from the automatic stay or ask the trustee or debtor in possession to abandon the derivative cause of action in the hope that they can continue the litigation outside of the purview of the bankruptcy court.[56] Not only is such relief from the stay unlikely, it is not even necessarily the best means to solve significant problems with a debtor's management. Section 1104 of the Code is the bankruptcy system's mechanism for responding to significant mismanagement of a DIP. It should be the first resort for shareholders and creditors dissatisfied with the debtor's managers. This Part first looks at the process and policy of appointing a trustee in bankruptcy. It then considers state law derivative suits both within and without the confines of a bankruptcy case.

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standing to bring derivative suits against managers of for-profit corporations, creditors could pursue a derivative action against managers of a member-less non-profit corporation. *Id.* The court also declined to appoint a trustee because the debtor's management stated it would rather let the creditors pursue the derivative action than see a trustee appointed. *Id. See also* Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. *(In re* W.R. Grace & Co.), 285 B.R. 148, 157–58 (Bankr. D. Del. 2002) (holding the court was without power to appoint a limited purpose trustee to pursue litigation on behalf of the estate, and refusing to appoint a trustee at all even though the court acknowledged that cause to appoint a trustee probably existed); Agostino v. Hicks, 845 A.2d 1110, 1126 (Del. Ch. 2004) (lamenting the disappearance of a derivative suit in a bankruptcy case in which no trustee was appointed).

55. Skeel, *supra* note 2, at 500 (referring to the death of derivative suits upon bankruptcy as "bankruptcy's 'black hole effect'" and discussing how bankruptcy gives plaintiff's attorneys incentive to underinvest in derivative suits).

56. *See, e.g.*, Shepard v. Patel (*In re* Patel), 291 B.R. 169, 175 (Bankr. D. Ariz. 2003) (denying motion for relief from the automatic stay); *In re* RNI Wind Down Corp., 348 B.R. 286, 299–300 (Bankr. D. Del. 2006) (denying motion for relief from the automatic stay); DeSouza v. PlusFunds Group, Inc., No. 05 Civ. 5990 RCCJCF, 2006 WL 2168478 (S.D.N.Y. Aug. 1, 2006) (denying defendants' motions to extend automatic stay).

A. The Appointment of a Trustee in a Chapter 11 Case

Courts have faithfully observed a presumption in favor of retaining the DIP to manage a Chapter 11 debtor.[57] The appointment of a trustee is considered an extreme remedy and a party moving for appointment of a trustee must establish its necessity by clear and convincing evidence.[58] If a trustee is appointed, she usually takes over for the DIP completely and becomes primarily responsible for operating the debtor and for negotiating and composing a plan of reorganization.[59] However, current management is often more familiar both with the debtor's business and the industry as a whole.[60] Further, DIP management may enjoy established relationships with key suppliers and creditors and is undoubtedly better acquainted with the debtor's financial landscape.[61] Adequately educating a trustee so that she may operate a large, financially troubled business is, therefore, both expensive and disruptive at a time when the corporation can least afford it.[62] In order to curtail some of the expense of a trustee, bankruptcy courts have exercised broad discretion in defining the scope of the trustee's role and responsibilities.[63] The trustee may not necessarily take the business over from the DIP management entirely, but might instead work with current management or simply assume particular, perhaps bankruptcy-specific, operations.[64]

57. *See, e.g.*, Comm. of Dalkon Shield Claimants v. A.H. Robins Co., 828 F.2d 239, 241 (4th Cir. 1987) (refusing to appoint trustee without cause); Schuster v. Dragone (*In re* Dragone), 266 B.R. 268, 271 (D. Conn. 2001) (explaining appointment of trustee "is a factual determination committed to the discretion of the Bankruptcy Judge"); *In re* Evans, 48 B.R. 46, 47–48 (Bankr. W.D. Tex. 1985) (appointing a Chapter 11 trustee because "the protection and potential recovery for the estate through appointment of a trustee far outweighs the cost"); *In re* Eichorn, 5 B.R. 755, 758 (Bankr. D. Mass. 1980) (finding the costs of appointing a trustee outweighed the benefits).

58. *In re* William A. Smith Constr. Co., 77 B.R. 124, 126 (Bankr. N.D. Ohio 1987). *But see* Tradex Corp. v. Morse, 339 B.R. 823, 832 (D. Mass. 2006) (reasoning that a holistic interpretation of the Code reveals that a party moving for the appointment of a trustee must only establish cause by a preponderance of the evidence).

59. TABB, *supra* note 1, at 63.

60. *In re* Marvel Entm't Group, 140 F.3d 463, 471 (3d Cir. 1998).

61. *See In re* Sharon Steel Corp., 871 F.2d 1217, 1226–27 (3d Cir. 1989) (describing debtor management's familiarity with debtor corporation's financial circumstances); *In re* Intercat, Inc., 247 B.R. 911, 924 (Bankr. S.D. Ga. 2000) (describing debtor's management as "heart and soul" of company).

62. *See* Nimmer & Feinberg, *supra* note 5, at 10–11 (discussing the cost and learning curve associated with appointing a trustee to make decisions for a bankrupt company).

63. *See, e.g.*, *In re Intercat*, 247 B.R. at 923–25 (limiting the trustee's duties and maintaining a role for debtor's management); Dardarian v. La Sherene, Inc. (*In re* La Sherene, Inc.), 3 B.R. 169, 176 (Bankr. N.D. Ga. 1980) (finding interests of creditors and other parties in interest better served by the appointment of a trustee "unrestricted by the inertia of past policy and limited business planning, financial experience and discipline of current management").

64. *In re Intercat*, 247 B.R. at 924; *In re La Sherene*, 3 B.R. at 176.

The potential expense posed by the appointment of a Chapter 11 trustee, combined with the strong presumption in favor of the DIP, sets a high bar for movants looking to depose a DIP. Courts fully expect to find some degree of mismanagement in the pre-petition history of most corporate debtors.[65] Movants under § 1104(a)(1) carry a heavy burden to establish cause for the appointment of a trustee that evinces "'something more aggravated than simple mismanagement.'"[66] A history of imprudent business decisions that contributed to the financial downfall of a corporation certainly would not warrant the removal of current management in bankruptcy anymore than imprudent but good faith business judgments would unseat the reigning management of a solvent company.[67] A court must order the appointment of a trustee only when a movant establishes "cause" or when the court determines that such an appointment would be in the best interests of creditors.[68] The Code partially defines the nature of "cause" that would be sufficient to merit the appointment of a trustee, but leaves much of the decision to the bankruptcy court's sound discretion. Section 1104 allows a bankruptcy court to appoint a trustee when it determines that such an appointment would be "in the interests" of the debtor, its creditors, shareholders, or other claimants.[69] The provision offers courts guidance and defines what

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65. Nimmer & Feinberg, *supra* note 5, at 56 ("'[S]light evidence of mismanagement in the form of imprudent or poor business decisions or use of resources are to be expected and will not alone overcome the presumption of a debtor in possession.'" (quoting *In re La Sherene*, 3 B.R. at 174)).

66. Schuster v. Dragone (*In re* Dragone), 266 B.R. 268, 272 (D. Conn. 2001) (quoting *In re* Clinton Centrifuge, Inc., 85 B.R. 980, 984 (Bankr. E.D. Pa. 1988)).

67. In *In re* Eichorn, the court explained:

> [T]he presumption is that the debtor will remain in possession and continue to manage his affairs. Consistent with this presumption is that neither the filing for relief, nor the debtor's insolvency, nor a showing of imprudent business decisions by the debtor are conclusive of the debtor's lack of integrity or his inability to superintend the reorganization.

5 B.R. 755, 757 (Bankr. D. Mass. 1980).

68. 11 U.S.C.A. § 1104(a)(1)–(2) (West Supp. 2007).

69. Section 1104(a) states, in relevant part:

> 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—
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> (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement 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;
>
> (2) if such appointment is in the interests of creditors, any equity security 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 . . . .

Id.

factors should lead to the appointment of a trustee, but does not do so in such a way as to prevent courts from developing a cohesive approach to corporate governance problems in bankruptcy through common law.

1. Cause

While a bankruptcy court may move *sua sponte*[70] for the appointment of a trustee and is widely considered to have broad discretion in its application of § 1104(a), the Code requires a court to appoint a trustee if it finds "cause" as defined in the non-exclusive list in § 1104(a)(1) or otherwise. A DIP must assume the duties the Code would otherwise assign to a trustee in bankruptcy, as it is expected to hold the estate's assets in trust for creditors.[71] The DIP is, therefore, a fiduciary of the estate's creditors and must "'refrain[] from acting in a manner which could damage the estate, or hinder a successful reorganization of the business.'"[72] A failure to uphold these duties that falls "within the penumbra of fiduciary neglect" constitutes cause for the appointment of a trustee to replace the DIP management.[73] The most common reasons cited "'for appointing a trustee under § 1104(a)(1) [are] gross mismanagement and incompetence.'"[74] Because the definition of cause in § 1104(a)(1) is not exclusive, courts have discretion to define particular management failures in terms of cause to appoint a trustee if they find that the situation warrants it. Sins of corporate governance constituting cause may be as simple as a failure to make adequate reports to the bankruptcy court,[75] or as complex as behaviors that create such severe animosity between the debtor and its creditors that the creditors no longer have faith in the debtor's ability to effect a successful reorganization.[76]

70. Fukutomi v. U.S. Trustee (*In re* Bibo, Inc.), 76 F.3d 256, 258 (9th Cir. 1996).

71. Nimmer & Feinberg, *supra* note 5, at 22 n.50 (citing 11 U.S.C. § 1107(a) (1982 & Supp. 1986)) (stating that, in most Chapter 11 cases, the DIP has the same basic functions and duties as a trustee).

72. *In re* Ionosphere Clubs, Inc., 113 B.R. 164, 169 (Bankr. S.D.N.Y. 1990) (quoting *In re* Sharon Steel Corp., 86 B.R. 455, 457 (Bankr. W.D. Pa. 1988), *aff'd*, 871 F.2d 1217 (3d. Cir. 1989)).

73. *In re* V. Savino Oil & Heating Co., 99 B.R. 518, 527 (Bankr. E.D.N.Y. 1989).

74. *In re Ionosphere Clubs*, 113 B.R. at 169 (quoting *In re Sharon Steel*, 86 B.R. at 458).

75. *See, e.g.*, *In re* AG Serv. Ctrs., L.C., 239 B.R. 545, 550 (Bankr. W.D. Mo. 1999) (appointing trustee for failure to comply with court orders); *In re V. Savino Oil*, 99 B.R. at 526–27 (appointing trustee for failure to disclose information openly and honestly to the court); *In re* Paolino, 53 B.R. 399, 401 (Bankr. E.D. Pa. 1985) (appointing trustee for failure to keep accurate financial records and to file required operating statements).

76. *See, e.g.*, *In re* Marvel Entm't Group, Inc., 140 F.3d 463, 471–73 (3d Cir. 1998) (finding intense acrimony between debtor and creditor can constitute cause for the appointment of a trustee); *In re* Colo.-Ute Elec. Ass'n, 120 B.R. 164, 176 (Bankr. D. Colo. 1990) (finding creditors "sincerely

a. Lack of Financial Reporting

Bankruptcy often uncovers business managers who have sloppy record-keeping habits and who have not kept the company's creditors adequately informed of the debtor's financial position. Because the duty of disclosure is one of the most important obligations a DIP has, when the failure to keep creditors apprised of the corporation's business and finances continues after a bankruptcy filing, the court often appoints a Chapter 11 trustee.[77] One of the central justifications for keeping a bankrupt corporation's management in place is the assurance that the court will be closely monitoring the debtor's affairs.[78] This supervision is impossible if the DIP is uncooperative or does not file the requisite disclosures. While not listed specifically as "cause" in § 1104(a)(1), the failure to file financial statements, keep accurate financial records, or disclose important facts about the business's health or reorganization prospects constitutes cause for the appointment of a trustee.[79]

The addition of subsection (e) to § 1104 confirms the importance of financial reporting to the bankruptcy process. Subsection (e) requires the UST to move for the appointment of a trustee when there are "reasonable grounds to suspect" that members of the debtor's current management have "participated in actual fraud, dishonesty, or criminal conduct in . . . the debtor's public financial reporting."[80] This language demonstrates the importance of a transparent reorganization process, achieved both through required securities disclosures prior to bankruptcy and the financial reports and statements submitted during the bankruptcy case itself.

If a DIP is not discharging these disclosure duties diligently and honestly, then cause exists to appoint a trustee.[81] The Code *requires* the UST to bring lapses in reporting to a court's attention under § 1104. When those lapses constitute cause, a trustee *must* be appointed. Even if a court will allow the continuation of a securities suit against directors on

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and justifiably lack confidence in management" and appointing a trustee).

77. *In re Paolino*, 53 B.R. at 401.

78. Nimmer & Feinberg, *supra* note 5, at 60 (stating the presumption that, upon bankruptcy, the current management is retained and the court is given the ability to replace management "only if it would be in the best interests of all parties in the case").

79. *In re AG Serv. Ctrs.*, 239 B.R. at 550; *In re V. Savino Oil*, 99 B.R. at 526; *In re Paolino*, 53 B.R. at 401.

80. 11 U.S.C.A. § 1104(e) (West Supp. 2007).

81. *In re AG Serv. Ctrs.*, 239 B.R. at 550; *In re V. Savino Oil*, 99 B.R. at 526; *In re Paolino*, 53 B.R. at 401.

account of violations of reporting requirements, the matter must first be addressed within the context of a motion under § 1104.

b. DIP Conflict of Interest with Creditors

In their development of a common law understanding of § 1104(a), courts have acknowledged a more amorphous conception of cause where significant animosity and distrust between the DIP and its creditors have impaired the reorganization effort.[82] Conflicts of interest between management and the creditors, or particularly egregious incompetence on the part of the DIP, may cause creditors to become considerably suspicious of management.[83] For example, in *In re Colorado-Ute Electric Ass'n*,[84] the management acted diligently and in good faith in its attempt to reorganize the debtor, but the corporation's inherent structure, combined with management's relative inexperience in such matters, made it impossible for the DIP's management to work on the debtor's reorganization and rendered the appointment of a trustee necessary.[85]

The kinds of severe problems with corporate management that warrant the appointment of a trustee in bankruptcy or result in successful civil judgments against managers do not reflect common circumstances. In fact, there are necessarily conflicts of interest between the DIP and the parties in interest in a bankruptcy as well as among those parties in interest themselves that do not warrant the intervention of a trustee.[86] These conflicts arise because the DIP's fiduciary duty runs to all parties in interest that have claims against the debtor.[87] The DIP is expected to manage and resolve such conflicts honestly and in a balanced manner that effectuates the primary goal of maximizing the value of the estate.[88]

82. *In re Marvel Entm't Group, Inc.*, 140 F.3d at 474 (citing Petit v. New England Mortgage Servs. Inc. (*In re* Petit), 182 B.R. 64, 70 (D. Me. 1995)).

83. *Id.* at 473.

84. 120 B.R. 164 (Bankr. D. Colo. 1990).

85. *Id.* at 175. The Colorado-Ute's board of directors was composed of directors nominated by its co-op members, who became its angry creditors upon the filing of the bankruptcy case. *Id.* at 167. Some of the Colorado-Ute board members also served as directors of the co-ops. *Id*. Another similarly structured electrical utility company experienced the same difficulty in its reorganization, and a trustee took over that reorganization as well. *In re* Cajun Elec. Power Coop., Inc., 191 B.R. 659, 661 (M.D. La. 1995), *vacated by* 69 F.3d 746 (5th Cir. 1995), *withdrawn by* 74 F.3d 599 (5th Cir. 1996).

86. Nimmer & Feinberg, *supra* note 5, at 2 ("[T]he fiduciary obligations of the DIP involve an inherent conflict.").

87. *Id*. ("The DIP has a bifurcated responsibility that runs jointly to creditors, equity investors and other owners.").

88. *See id.* (discussing how governance issues determine how the DIP must deal with conflicts, rather than how conflicts can be avoided).

It is only when the DIP cannot possibly navigate the conflicts of interest inherent in a Chapter 11 reorganization that the appointment of a trustee is justified on account of those conflicts.

Because state law mechanisms for replacing a corporation's management do not translate well in bankruptcy,[89] the remedy provided by § 1104 is not only the mandatory, but also the most efficient response to severe conflict of interest problems during a bankruptcy case. Rather than attempting to alter a corporation's structure or elect a new slate of directors within the confines of a bankruptcy proceeding, a bankruptcy court can appoint a trustee and define the trustee's duties in a way that will be most helpful to the particular needs of the debtor. This approach obviates the need of a bankruptcy court to assign the rights and responsibilities of shareholders to a different party in interest,[90] and prevents a lengthy and expensive process when a debtor corporation can least afford it. After a reorganized corporation emerges from bankruptcy, it can again return to state law procedures for director elections and the definition of a corporate structure that are designed to operate in the long term for a solvent company.

c. Incompetence

As specifically stated in subsection 1104(a)(1), a court may find cause to appoint a trustee when the debtor's current management demonstrates "incompetence" in its operation of the debtor corporation,

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89. *See* Skeel, *supra* note 2, at 474–75. Skeel discusses how state lawmakers fail to consider insolvency issues because bankruptcy is regulated by the federal government, even though federal bankruptcy courts look to state law for guidance on corporate governance issues. *Id.* at 491. He argues the solution to this problem is to give lawmaking authority over corporate bankruptcy to the states, while continuing to allow the federal government to address personal bankruptcy issues. *Id.* at 475. *See also infra* Part III.B.2.

90. Often, shareholders do not have a financial interest in a bankrupt corporation because most corporations that file Chapter 11 are insolvent. Shareholders, therefore, have little or no incentive to reconstitute a board of directors or reconfigure a corporation's governance structure. Skeel, *supra* note 2, at 500–01. *But see* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990). Professors LoPucki and Whitford found that shareholders often receive a distribution of an insolvent debtor's estate even though there is no legal basis for them to do so. *Id.* at 194. Shareholders, through their attorneys, exert particular pressures on the debtor's counsel (through threatened litigation or simply through threats of professional awkwardness and estrangement) so that the debtor's counsel feels duty bound to play nice and give the shareholders a cut of the estate's insufficient assets. *Id.* at 195. Because shareholders do not have a legal right to distributions from an insolvent company, the fact that they may be able to coax money out of debtors' counsel should not lead them to depend on such distributions. Thus, shareholders should not let all of their behavior or incentives in the bankruptcy case be determined by the mere possibility of finding an amenable DIP attorney.

either before or after the commencement of the bankruptcy case.[91] For an example of gross incompetence that leads to a distrust of management by creditors and other parties in interest, consider *In re Ionosphere Clubs, Inc.*[92] In *Ionosphere Clubs*, the court found clear and convincing evidence supporting cause to appoint a trustee based on the DIP management's incompetence in operating the debtor post-petition.[93] After the debtor had been in bankruptcy for a year and after many significant financial losses and disappointments, the Official Committee of Unsecured Creditors (the "Committee") moved for the appointment of a trustee, claiming that the DIP management was grossly incompetent.[94] The final straw came when management had to modify its loss projection for the year 1990 because its original prediction had been $184.4 million too low.[95] Management continually modified its financial forecasts as well as its plans for reorganization.[96] Further, the debtor continued to hemorrhage money at the expense of the estate's unsecured creditors.[97] Here, the management's "incompetence" could be characterized as a series of poor business decisions and inaccurate predictions. Management could navigate neither the troubled waters of the airline industry nor those occasioned by its own bankruptcy. The creditors therefore lost confidence in management, and notified the court that they would refuse to support the debtor's further use of escrowed unencumbered cash unless a trustee was appointed.[98] The court concluded that in light of the DIP management's incompetence, evidenced by its inability to formulate a business plan, make reliable operating projections, or stem the tide of enormous and continuing operating losses, the unsecured creditors should not be expected to continue to support or gamble on the success of such an obvious failure.[99] The court decided that a "highly qualified airline executive" who had the authority to retain the help of the debtor's current management team could operate the debtor better.[100] The court only unseated the chief executive, not the debtor's entire group of

91. 11 U.S.C.A. § 1104(a)(1) (West Supp. 2007).

92. 113 B.R. 164 (Bankr. S.D.N.Y. 1990). This bankruptcy case refers to that of both Eastern Airlines, Inc. and its affiliate Ionosphere Clubs, Inc. The cases were consolidated for procedural purposes and the two debtors are, together, defined as "Eastern" or the "Debtors" in the opinion.

93. *Id*. at 170.

94. *Id.* at 166.

95. *Id.*

96. *Id.* at 168–69.

97. *Id.* at 168.

98. *Id*. at 171.

99. *Id.* at 170–71.

100. *Id*. at 171.

managers.[101] That decision was designed to improve the debtor's operations without causing it to incur all of the potentially high costs of completely replacing the DIP's management, and to allow the trustee to govern the DIP as she thought best.[102]

Ionosphere Clubs illustrates how a bankruptcy court can depose a DIP's management simply because that management is doing a bad job. While shareholders have the ability to remove directors by voting them out of office when they are not managing a corporation successfully, shareholders are not able to do so as quickly or decisively as a bankruptcy judge can at the conclusion of one summary hearing. In this regard, the bankruptcy law regarding corporate governance is stricter in its oversight of management than state law. Further, shareholders would not prevail in a derivative action alleging good faith managerial incompetence.[103] As long as the officers and directors of a corporation are adequately informed, have not engaged in self-dealing, and are acting in good faith for the best interests of the corporation, they are not guilty of a breach of fiduciary duty.[104] State law has always emphasized the importance of not holding directors personally liable for mere incompetence, or even standard negligence,[105] for fear that well-qualified people would shun such positions or would not take the risks necessary to maximize profits for shareholders.[106] In the *Ionosphere Clubs* court's application of § 1104, the bankruptcy system demonstrated that it will not tolerate incompetent management, even if managers guilty of incompetence would not face personal liability under state law.

While all successful, or meritorious, derivative actions would support a finding of cause, a court may find cause where a derivative action for breach of fiduciary duty would not be successful. In circumstances where a derivative suit is not, or would not be successful,

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101. *Id.* at 171–72.

102. *Id.* at 172.

103. Shareholders may find a breach of the duty of care in extreme incompetence, but still would not be likely to recover damages from directors on account of that breach. *See infra* Part III.B.1.

104. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 777–78 (Del. Ch. 2005), *aff'd*, Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.), 906 A.2d 27 (Del. 2006). The *Disney* opinion has set this bar particularly high.

105. In Delaware, a court must find at least gross negligence to find a breach of fiduciary duty by directors. Gross negligence only results in liability where the corporation has not opted out of the duty of care. Joel Seligman, *The Fifth Abraham L. Pomerantz Lecture The New Corporate Law*, 59 BROOK. L. REV. 1, 7–8 (1993).

106. William T. Quillen, *The Federal-State Corporate Law Relationship—A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law*, 59 BROOK. L. REV. 107, 118–19 (1993) (stating that the decision in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), "discourag[ed] qualified outsiders from serving on corporate boards . . . because the risk of personal liability . . . was not worth the reward of serving on a corporate board").

the debtor may still be injured under the leadership of severely incompetent managers. Bankruptcy has, therefore, provided a distinct remedy for just these kinds of circumstances.

2. Best Interests Test

Balancing the need to protect the estate's parties in interest by appointing a trustee against the costs of appointment, and considering the policy implications of appointing a trustee, is consistent with the bankruptcy court's role as a court of equity and with the flexible "best interests" standard articulated in subsection 1104(a)(2). There is certainly some overlap between a finding of cause and a determination that the appointment of a trustee would be in the best interests of the estate. Rarely does a court find one where it would not also find the other.[107] In the cases where courts have found cause to appoint a trustee because of acrimony between the DIP and its creditors, they also found that the appointment of a trustee would be in the best interests of the estate.[108] While a bankruptcy court may decide that appointment of a trustee is in the best interests of the estate and its creditors by considering "'practical realities and necessities'" without being bound by "'rigid absolutes,'"[109] the common law has crystallized considerations that may help a court in this determination. The common law focuses on four factors: "(i) the trustworthiness of the debtor; (ii) the debtor in possession's past and present performance and prospects for the debtor's rehabilitation; (iii) the confidence—or lack thereof—of the business community and of creditors in present management; (iv) the benefits derived by the appointment of a trustee, balanced against the costs of appointment."[110]

The standard that emerges from these four factors is subjective, but it still tracks the priorities identified in the only slightly more clearly defined concept of "cause." The first two factors, which can be loosely summarized as dishonesty and incompetence, respectively, are indeed elements of cause listed in the Code section. A lack of confidence of others in the DIP's management was a component of cause when courts

107. *See* Nimmer & Feinberg, *supra* note 5, at 58–59 (stating that, in many cases, there will be both a display of mismanagement and a legitimate concern that replacing management is in the best interests of creditors).

108. *In re* Marvel Entm't Group, Inc., 140 F.3d 463, 472 (3d Cir. 1998); *In re* Colo.-Ute Elec. Ass'n, Inc., 120 B.R. 164, 177 (Bankr. D. Colo. 1990).

109. *In re Colo.-Ute Elec. Ass'n*, 120 B.R. at 176 (quoting *In re* Ionosphere Clubs, Inc., 113 B.R. 164, 168 (Bankr. S.D.N.Y. 1990)).

110. *Id.* *See also In re* Ionosphere Clubs, Inc., 113 B.R. at 168.

found animosity or an inability to work together on the part of creditors and the debtor. The primary difference between the two subsections is that the best interests test allows courts full discretion in deciding whether to appoint a trustee, rather than mandating appointment upon the establishment of certain factors.[111] A party does not have to make any particular showing "by clear and convincing" evidence under § 1104(a)(2).[112] A court may simply conduct a cost/benefit analysis to decide whether current management should remain in control of the debtor or if a trustee is necessary.[113]

Courts and scholars alike have pondered the costs and benefits of the appointment of a Chapter 11 trustee.[114] There is a presumption against the appointment of a trustee in a Chapter 11 case because such a tactic is considered very costly and inefficient.[115] Again, it could be very disruptive to replace completely or shake up the management of an already struggling company. Further, corporate officers and directors may be less likely to file for bankruptcy relief in the first place if doing so posed a significant threat to their employment.[116] The court in *Colorado-Ute* pointed out additional costs, such as the trustee's fees and those of her counsel, the time the trustee will need to learn about the debtor's operations and the history of the bankruptcy case, the trustee's bond, and any expenses the trustee must pay to outside professional advisors.[117] The court was able to justify those expenses and ultimately decided to appoint a trustee after considering the possible benefits. The most important benefit a trustee provides is capable and objective control of the debtor. Other parties in interest are likely to have more confidence in a trustee than they would in a debtor with questionable management.[118] The costs a trustee would incur in hiring outside counsel and other professionals would not necessarily exceed those the debtor

111. *In re Marvel Entm't Group*, 140 F.3d at 474.

112. *See In re Ionosphere Clubs*, 113 B.R. at 168 (describing § 1104(a)(2) as a "flexible standard").

113. *See In re Colo.-Ute Elec. Ass'n*, 120 B.R. at 176 (describing the cost-benefit analysis as one of the "two most relevant factors").

114. *See generally* Edward S. Adams, *Governance in Chapter 11 Reorganizations Reducing Costs, Improving Results*, 73 B.U. L. REV. 581 (1993); Nimmer & Feinberg, *supra* note 5; Glenda M. Raborn, Note, *Setting the Standards for Appointment of a Chapter 11 Trustee Under § 1104(a)(1) of the Bankruptcy Code Can a Debtor Cooperative Remain in Possession?*, 18 MISS. C. L. REV. 509 (1998).

115. Nimmer & Feinberg, *supra* note 5, at 55 ("Chapter 11 presumes that current management will continue to operate the business . . . .").

116. *Id.* (discussing the impact that the routine appointment of trustees would have on a debtor's willingness to file for Chapter 11 bankruptcy).

117. *In re Colo.-Ute Elec. Ass'n*, 120 B.R. at 177.

118. *In re* Marvel Entm't Group, Inc., 140 F.3d 463, 475 (3d Cir. 1998).

would have sustained in performing the reorganization itself.[119] The most significant concerns the bankruptcy system has expressed regarding the appointment of a trustee are those regarding the general upheaval that would result from displacing a DIP's management.[120] Bankruptcy courts have used the flexibility provided by the Code to mitigate that cost.

3. Appointment of a Trustee Is a Discretionary Remedy

Even when a court must appoint a trustee because it has found sufficient evidence of cause, it need not require that the trustee displace the DIP's current management entirely. A trustee may elect to keep the debtor's current management on board, or may be ordered by the court to do so.[121] Courts have carefully tailored the scope of a trustee's duties to serve the needs of the debtor in order to minimize any potential disruption.[122] For example, in *In re La Sherene*,[123] the court found that the debtor's current management was incompetent to run the debtor given its poor business skills.[124] However, the DIP management's unique creativity, sales, and marketing talents were very important to the success of the debtor's business in the future and its reorganization.[125] The court decided to appoint a trustee to operate the debtor and to attend to the business and financial aspects of its reorganization while retaining the DIP management to market and produce its unique product.[126]

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119. *Id*. (citing *In re* Sharon Steel Corp., 86 B.R. 455, 466 (Bankr. W.D. Pa. 1988) ("In a case of this magnitude, the cost of having a trustee in place is insignificant when compared with the other costs of administration and when compared with the enormous benefit to be achieved by the establishment of trust and confidence in . . . management").

120. *See* Ralph Brubaker, *Creditor/Committee Derivative Litigation Of Textualism and Equitable Powers*, BANKR. L. LETTER, Nov. 2002, at 1, 3–5.

121. *See* Chesapeake R & D Ltd. P'ship v. N. Am. Commc'ns, Inc. (*In re* N. Am. Commc'ns, Inc.), 138 B.R. 175, 176 (Bankr. W.D. Pa. 1992) (granting motion to appoint a trustee, but ordering that certain company activities would remain under the sole control of the debtor's current management); Dardarian v. La Sherene, Inc. (*In re* La Sherene, Inc.), 3 B.R. 169, 175–76 (Bankr. N.D. Ga. 1980) (describing the necessity of appointing a trustee with business acumen to compliment the artistic and creative talents of the debtor's management). *But see* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 352–53 (1985) ("Congress contemplated that when a trustee is appointed, he assumes control of the business, and the debtor's directors are 'completely ousted,'" so that a trustee may conduct an investigation of those directors unimpeded by any authority they may maintain.).

122. *In re* Intercat, Inc., 247 B.R. 911, 924 (Bankr. S.D. Ga. 2000); *In re La Sherene*, 3 B.R. at 176.

123. 3 B.R. 169.

124. *Id.* at 175.

125. *Id.*

126. *Id*. at 175–76.

A more recent example of this approach is *In re Intercat, Inc.*[127] The debtor's management was guilty of causing the corporation to incur $22 million in patent infringement liability, misappropriating corporate funds for personal use, self-dealing, and other acts of dishonesty and severe mismanagement.[128] Despite the many transgressions of the debtor's principal, the court noted that he was "its 'heart and soul'" and that the corporation's success depended on the relationships he built with the debtor's clients over the years.[129] Therefore, the court found that, Intercat's principal should remain with the company, though in a limited capacity.[130] A trustee was appointed to supervise the financial management of Intercat and to investigate and pursue any causes of action that might exist on the estate's behalf, including any suits the estate could maintain against insiders.[131] Intercat's management remained to assist in the reorganization under the supervision of a court-appointed trustee.[132] In this case, the court was able to appoint a trustee to assure creditors and the bankruptcy system itself that the reorganization was being managed competently, fairly, and in a manner that would maximize the estate's value for creditors without completely replacing the debtor's knowledgeable management.

Bankruptcy courts have found a legal basis for tailoring the trustee's duties in numerous cases by turning to §§ 1107 and 1108.[133] The Code affords bankruptcy courts almost complete discretion in deciding whether and exactly how they will decide to appoint a trustee in a Chapter 11 case. Section 1104 is designed to respond to corporate governance concerns in bankruptcy. When there are problems with a DIP's management, parties with an interest in the debtor should look to § 1104 to respond to the mismanagement in a way that is most efficient and profitable for the estate. By providing a suitable, bankruptcy-appropriate federal remedy, the provisions of § 1104 and the flexibility left to the bankruptcy courts by the statutory language should close the "black hole" into which state law derivative suits would otherwise fall once a corporation files bankruptcy.

127. 247 B.R. 911.
128. *Id.* at 922–23.
129. *Id*. at 924.
130. *Id.* at 925.
131. *Id*.
132. *Id.*
133. *Id*. at 923–24.

B. Derivative Suits

This section considers how derivative suits operate outside of bankruptcy and what happens to them in the context of a bankruptcy case. First, this section will describe the current state of the law of derivative suits in Delaware, which serves as a helpful example of how derivative suits are most often conducted. The role derivative suits can realistically play in corporate governance has diminished significantly,[134] particularly in light of recent decisions further curtailing what constitutes a breach of fiduciary duty for which a director is personally liable.[135] Next, the section will turn to what happens to a state law derivative suit when a bankruptcy case is filed, and will also consider how creditors have tried to use the derivative mechanism to force a DIP or trustee to pursue certain causes of action that may bring money, in the form of damages, into the estate. Comparing the plight of the state law cause of action with the parallel procedures adopted when creditors try to assert derivative standing will shed light on the bankruptcy priorities and procedures that will help shape a cohesive policy to determine how bankruptcy courts should address derivative suits and the allegations they bring against DIP management.

1. Derivative Suits Under State Law

When a corporation's directors[136] have wronged the company, the corporation can sue them to recover the appropriate damages. The problem with that mechanism is, of course, the board of directors decides whether to pursue litigation on behalf of the corporation.[137] Realizing that asking directors to sue themselves or their fellow directors presents

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134. Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1357 (2005).

135. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 757–58 (Del. Ch. 2005) (holding the president's acceptance of a non-fault termination package did not breach the duty of loyalty to the corporation), *aff'd*, Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.), 906 A.2d 27 (Del. 2006)).

136. From this point forward, "directors" will refer to officers and directors. The same liability rules and standards of fiduciary duties apply to both. Rachel V. Jepsen, *Landstrom v. Shaver Has South Dakota Adopted a Strict Good Faith Fiduciary Standard for Close Corporations?*, 43 S.D. L. REV. 218, 230–31, 231 n.104 (1998) ("[A] full-time, high-level managing officer may owe substantially the same duties to the corporation as a director." (quoting ROBERT W. HAMILTON, CORPORATIONS 304 (1986))); *see also* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (stating corporate officers and directors "stand in a fiduciary relation to the corporation and its stockholders").

137. Zapata Corp. v. Maldonado, 430 A.2d 779, 786–87 (Del. 1981).

an inevitable conflict of interest,[138] the Delaware common law grew to allow shareholders to bring suits on behalf of the corporation. These suits are called "derivative suits" because the shareholder's standing and right of action derive from an injury to the corporation.[139] The injury to be redressed in a derivative suit is one suffered by the corporation itself, so any recovery obtained as a result of the suit is paid into the corporation.[140] Shareholders theoretically benefit, albeit indirectly, from the enhanced value of the company.

Derivative suits usually allege a breach of the fiduciary duties directors owe to the corporation. Directors owe two fiduciary duties to a corporation: a duty of care, and a duty of loyalty.[141] The duty of care requires that directors observe the quality of care a prudent person would use in similar circumstances, in part, by informing themselves of the potential consequences of a business decision and considering "'all material information reasonably available.'"[142] In Delaware, directors can only be held liable for breach of the duty of care if they are grossly negligent.[143] Derivative suits do not often allege violations of the duty of care, however, because most corporations opt out of director liability for breach of that duty as permitted by section 102(b)(7) of the Delaware General Corporation Law.[144] Corporations may not excuse director

138. Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 366 (Del. 2006) ("[B]y its very nature [a] 'derivative action impinges on the managerial freedom of directors.'" (quoting Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984), *overruled on other grounds by*, Brehm v. Eisner, 746 A.2d 244 Del. 2000))).

139. Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 271 (1986).

140. *Zapata*, 430 A.2d at 784 ("Derivative suits enforce corporate rights and any recovery obtained goes to the corporation."); *see also* Taormina v. Taormina Corp., 78 A.2d 473, 476 (Del. Ch. 1951) ("[T]he fundamental basis of a derivative stockholder's action . . . is to enforce a corporate right."); Keenan v. Eshleman, 2 A.2d 904, 912–13 (Del. 1938) (explaining that in derivative suits, the recovery must be given to the corporation, not the individual shareholders, because the action was brought for the benefit of the corporation and allowing the shareholders to recover would constitute a gift).

141. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 745 (Del. Ch. 2005), *aff'd* Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.), 906 A.2d 27 (Del. 2006).

142. *Id*. at 749 (quoting *Brehm*, 746 A.2d at 258); *see also* Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (stating the presumption that, in making business decisions, "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"), *overruled in part on other grounds by Brehm*, 746 A.2d 244.

143. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 287 (2002).

144. *Disney*, 907 A.2d at 750. DEL. CODE ANN. tit. 8 § 102(b)(7) (2006) states that corporations may include in their articles of incorporation "a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of" the fiduciary duty of care. This provision does not protect officers from monetary liability for breach of the duty of care. Because most corporations have elected to include such a provision in their articles of incorporation, derivative actions against directors for breaches of the duty of care have all but

liability for breaches of the duty of loyalty or for actions taken in bad faith.[145] The duty of loyalty prohibits directors from using their position of power within the corporation for personal gain to the detriment of the interests of the corporation.[146] A director of a corporation must make the interests of the corporation and its shareholders his primary concern when making business decisions on the corporation's behalf.[147] The duty of loyalty, then, is largely a prohibition against self-dealing and conflicts of interest.[148] As long as directors are not engaged in self-dealing or fraud, and are acting in good faith, their business decisions are upheld and they are not held personally liable for what turn out to be bad business judgments.

Directors of a corporation are protected from overly intrusive judicial review by the business judgment rule, which prevents courts from second-guessing an "informed and disinterested director decision that the director 'rationally believes . . . is in the best interests of the corporation.'"[149] Courts presume that directors make informed and

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disappeared. Even if successfully maintained, such derivative actions would not be likely to result in a net recovery for the estate. *See also* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 367 (Del. 2006) (stating that defendant corporation's certificate of incorporation could exculpate directors from monetary liability for a breach of the duty of care, but not for a breach of the duty of loyalty).

145. Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 191 (Del. Ch. 2005) ("No safe-harbor exists for divided loyalties in Delaware."); *Disney*, 907 A.2d at 751–52. DEL. CODE ANN. tit. 8 § 102(b)(7) states that, while corporations may include provisions eliminating personal liability for a breach of the duty of care, they may not include provisions eliminating or limiting the liability of a director for "any breach of the director's duty of loyalty to the corporation or its stockholders" or "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."

146. *Disney*, 907 A.2d at 750–51 (stating that "[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests" and that directors must have an "undivided and unselfish loyalty to the corporation" (citing Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939))); *see also Benihana*, 891 A.2d at 191 (describing the duty of loyalty as a rule that requires that "'the best interest of the corporation and its shareholders take[s] precedence over any interest possessed by a director, officer or controlling shareholder'" (quoting Cede & Co. v. Technicolor, Inc. 634 A.2d 345, 361 (Del. 1993))); *Cede*, 634 A.2d at 362 (stating that examples of director self-interest include "a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally").

147. *Stone*, 911 A.2d at 370 ("[A] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest." (citing Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)); *see also* Larry E. Ribstein & Kelli A. Alces, *Directors' Duties in Failing Firms*, 1 U. MD. J. BUS. & TECH. 529, 532 (2007) ("Corporate directors clearly owe a fiduciary duty of unselfishness to the corporation.").

148. Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1469 (2006); Ribstein & Alces, *supra* note 147, at 532; *see also* Quillen, *supra* note 106, at 110 ("'The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self interest.'" (quoting *Guth*, 5 A.2d at 510)).

149. Ribstein & Alces, *supra* note 147, at 534 (citing ALI Code § 4.01); *see also Cede*, 634 A.2d at 360 ("The [business judgment] rule operates as both a procedural guide for litigants and a

disinterested decisions provided there is "no evidence of fraud, bad faith, or self-dealing" and uphold the business decision at issue "unless it cannot be attributed to any rational business purpose."[150] If the plaintiffs in the suit cannot rebut the presumption of the business judgment rule, they receive no remedy on account of the unsuccessful business decision unless they can demonstrate waste occurred.[151]

Whether directors are protected by the business judgment rule depends, in part, on whether they acted in good faith. Given the Delaware Supreme Court's decision in *Eisner*,[152] directors are only stripped of the protection of the business judgment rule in the most unlikely and egregious of cases. Chancellor Chandler held:

> [t]he concept of intentional dereliction of duty, a conscious disregard for one's responsibilities is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is . . . conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.[153]

A director is deemed to have acted in bad faith, then, when he has violated the law, failed to perform duties that he was obligated to perform, or has been intentionally motivated by a purpose other than advancing the best interests of the corporation and its shareholders.

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substantive rule of law."); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (explaining that the business judgment rule creates a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"), *overruled in part on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Ribstein, *supra* note 148, at 1469.

150. *Disney*, 907 A.2d at 747 (citing Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971), *aff'd*, 332 A.2d 139 (Del. 1975); *see also* Solomon v. Armstrong, 747 A.2d 1098, 1111–12 (Del. Ch. 1999) ("Under the business judgment rule, the burden of pleading and proof is on the party challenging the decision to allege facts to rebut the presumption. Usually those facts include allegations that the board . . . breached one or both of the duties of care and loyalty."), *aff'd*, 746 A.2d 277 (Del. 2000); *Cede*, 634 A.2d at 361 ("The [business judgment] rule posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be 'attributed to any rational business purpose.'" (quoting *Sinclair*, 280 A.2d at 720)).

151. *Disney*, 907 A.2d at 747 ("When a plaintiff fails to rebut the presumption of the business judgment rule, she is not entitled to any remedy, be it legal or equitable, unless the transaction constitutes waste."); *see also* W. Point-Pepperell, Inc. v. J.P. Stevens & Co. (*In re* J.P. Stevens & Co. S'holders Litig.), 542 A.2d 770, 780–81 (Del. Ch. 1988) ("A court may, however, review the substance of a business decision made by an *apparently* well motivated board for the limited purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."). Waste is extremely rare.

152. Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.), 906 A.2d 27 (Del. 2006).

153. *Id*. at 85 (quoting *Disney*, 907 A.2d at 755).

Gross negligence in observance of the duty of care does not constitute bad faith.[154]

Derivative suits for breach of fiduciary duty respond to only a narrow range of very egregious cases.[155] They do not help shareholders recover for breach of the duty of care in most cases. Directors may even engage in transactions that would otherwise be perceived as self-dealing if the transaction is approved by a majority of disinterested directors.[156] Further, directors' decisions are protected by the business judgment rule unless the directors intentionally take an action that is not in the best interests of the corporation or have committed an "intentional dereliction of duty" or "conscious disregard" of their responsibilities.[157] Thus, only completely clueless or mal-intentioned directors suffer liability under state law derivative suits.[158]

2. Derivative Liability v. Appointment of a Trustee

Removal of an officer or director once a corporation has filed bankruptcy, or even just demotion of that manager in favor of a trustee, is a much less severe response to a problem with management than the

154. *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369 (Del. 2006) ("[A] failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence)."); *see also* McMillan v. Intercargo Corp., 768 A.2d 492, 502 (Del. Ch. 2000) ("[I]f a board unintentionally fails, as a result of gross negligence and not of bad faith or self-interest, to follow up on a materially higher bid . . . then the plaintiff will be barred from recovery . . . ."); *In re* Lukens, Inc. S'holders Litig., 757 A.2d 720, 731–32 (Del. Ch. 1999) ("If a complaint merely alleges that the directors were grossly negligent in performing their duties . . . without some factual basis to suspect their motivations, any subsequent finding of liability will, necessarily, depend on finding breaches of the duty of care, not loyalty or good faith."), *aff'd*, Walker v. Lukens, Inc., 757 A.2d 1278 (Del. 2000).

155. *See* Fischel & Bradley, *supra* note 139, at 271 (discussing problems with the use of liability rules as a corporate governance mechanism).

156. *Disney*, 907 A.2d at 747–48, n.412 ("[T]he burden can shift back to the plaintiffs in the event of ratification by disinterested directors or shareholders."); *see also* Solomon v. Armstrong, 747 A.2d 1098, 1115 (Del. Ch. 1999) (stating that when a self-interested transaction is submitted for approval by disinterested directors or shareholders, that submission serves as a "'voluntary addition of an independent layer of shareholder approval in circumstances where such approval is not legally required'" (quoting *In re* Wheelabrator Techs. S'holders Litig., 663 A.2d 1194, 1202 n.4 (Del. Ch. 1995)), *aff'd* 746 A.2d 277 (Del. 2000); Ribstein, *supra* note 148, at 1469 (describing the business judgment rule as "insulat[ing] from judicial scrutiny an informed and disinterested director decision that the director 'rationally believes . . . is in the best interests of the corporation'").

157. *Eisner*, 906 A.2d at 64 (affirming the lower court's definition of "bad faith"); *see also Stone*, 911 A.2d at 370 ("Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.").

158. *See* Peter V. Letsou, *Implications of Shareholder Diversification on Corporate Law and Organization The Case of the Business Judgment Rule*, 77 CHI.-KENT L. REV. 179, 179–81 (2001) (discussing the shield that the business judgment rule provides for directors).

imposition of personal liability would be.[159] Thus, the standard for appointing a trustee in bankruptcy is much lower than that required to impose personal liability on a director. There are reasons for this. If corporate managers were to face personal liability in the amount of the corporation's loss for every bad, or ultimately unsuccessful, business decision they made, they would be much less likely to take the kinds of risks that are often most profitable for shareholders.[160] The frequent imposition of personal liability would also discourage the most talented corporate managers from becoming directors in the first place.[161] If directors could be persuaded to expose themselves to so much potential liability, they would demand much higher salaries and the cost of insuring them would increase exponentially.[162] None of these would be profitable outcomes for shareholders.

Because of the insolvency scenario that state law never contemplated, state corporate governance mechanisms do not function as intended in bankruptcy.[163] Bankruptcy courts can afford to appoint a trustee as needed in less egregious circumstances. Where shareholder elections of directors or derivative suits might be adequate procedures for a corporation working toward long term growth and a certain stability and quality of management over time, a Chapter 11 reorganization is but a particular and peculiar moment in a corporation's life. A corporate debtor is primarily concerned with stopping the bleeding of assets from the estate while availing itself of the unique procedures and protections afforded a debtor by the Code. The appointment of a trustee under § 1104 provides a specific, short term solution to help a debtor achieve a successful reorganization that may otherwise be very difficult, if not impossible. Appointing a trustee may be necessary to help a debtor's

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159. *See* Fischel & Bradley, *supra* note 139 (discussing the negative effects of derivative suits).

160. *See id.* at 266 (explaining that shareholders want managers to take risks, but if managers are sued whenever risky decisions turn out badly, "they will tend to avoid risky projects"); Ribstein, *supra* note 148, at 1469 ("[I]mposing liability on directors for bad decisions deters them from making risky but value-increasing moves that diversified shareholders would want them to make."); Ribstein & Alces, *supra* note 147, at 533–34 ("[L]iability could cause managers to shy away from [risky] decisions because, while shareholders would capture most of the gain, the managers would bear the risk.").

161. *See* Fischel & Bradley, *supra* note 139, at 270 ("The greater the threat of litigation, the less willing those who remain with the firm will be to make firm-specific investments of human capital."); Quillen, *supra* note 106, at 119 (explaining that, for many directors, the "risk of personal liability for a breach of the duty of care [is] not worth the reward of serving on a corporate board").

162. Justice Quillen argues that the costs incurred by managers involved in derivative suits "will simply be passed on indirectly to stockholders and consumers in the form of higher insurance premiums." Quillen, *supra* note 106, at 120.

163. *See* Skeel, *supra* note 2, at 489–90 (arguing "that the separation between corporate law and bankruptcy is responsible for . . . 'vestigialization'").

management through bankruptcy even in circumstances where those same managers could not have incurred liability and may not have been removed by shareholders under state corporate law. Further, even when corporate officers and directors have breached their fiduciary duties to the debtor corporation, either before or after the bankruptcy filing, the great cost of pursuing derivative litigation and the reality of recovery it actually provides often make derivative suits an ineffective means of protecting the debtor from its managers in bankruptcy.

Bankruptcy has sound reasons for removing or demoting managers who may be acting in good faith and pose less of a threat to the health of a corporation than those who would be found liable in a state law derivative suit. A debtor corporation is fragile and management has often already demonstrated some level of incompetence by putting the corporation in its insolvent state.[164] Keeping the same managers in place simply to dig a deeper hole, particularly when the creditors do not trust the debtor's management and lack faith in the DIP's ability to turn the debtor around, is counterproductive, and defeats the primary goals of Chapter 11 bankruptcy: "to allocate the consequences of financial failure" according to bankruptcy's priority scheme and "reposition the business assets in a manner that reduces the net overall loss suffered by the parties."[165] Appointing a trustee either to take over the operation of the debtor entirely or simply assist the DIP and perform particular tasks to improve the debtor's prospects for an effective reorganization is not necessarily an extreme remedy. Unless the management is affirmatively harmful to the debtor, engages in fraud, or otherwise impedes the debtor's progress toward reorganization, a court is unlikely to, and need not, completely depose the DIP. The discretion afforded bankruptcy courts under § 1104 allows a court to decide exactly how much it will diminish the role of a debtor's management. A trustee may be appointed simply because management has demonstrated great incompetence by making a series of poor and costly business decisions or by failing to keep proper records or simply by being unable to work productively with the estate's parties in interest.[166]

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164. *See* Nimmer & Feinberg, *supra* note 5, at 4 ("A Chapter 11 case involves an effort to restructure or to liquidate a business that encountered economic difficulty due to general business conditions, poor management, bad luck or any of a myriad of other possible causes. By the time a debtor files a Chapter 11 bankruptcy petition, the circumstances that cause economic loss have already begun to influence the debtor's business.").

165. *Id*.

166. *See In re* Ionosphere Clubs, Inc., 113 B.R. 164, 169 (Bankr. S.D.N.Y. 1990) (describing debtor management's shortcomings as a qualified safe-guarder of the estate); *In re* V. Savino Oil & Heating Co., 99 B.R. 518, 526 (Bankr. E.D.N.Y. 1989) (discussing debtor management's

The effectiveness of the derivative suit as a state law means of regulating director behavior is diminished by the obtuse procedure plaintiffs must undergo to bring the suit in the first place.[167] Because the decision of whether to bring a suit on behalf of the corporation belongs to the directors,[168] a shareholder wishing to initiate the suit must first demand that the directors sue the disloyal among them. Shareholders may be excused from this demand requirement if they are able to establish that demand on the board would have been futile because the directors could not make an independent judgment about the merits of the derivative suit.[169] If demand on the board is excused, then the board can appoint an independent special litigation committee to review the merits of the suit and make a recommendation to the court about whether the case should proceed.[170] Special litigation committees almost always recommend dismissal of a potential derivative suit and courts usually follow their recommendations.[171] The numerous and expensive stages of bringing a derivative suit to a trial on the merits are purposefully prohibitive. Recall that state law generally disfavors derivative suits for strong policy reasons.[172] Because most shareholders' investments are well-diversified and few own a substantial stake in any one corporation, their interests are not necessarily aligned with those of the corporation as a whole or even those of the majority of shareholders.[173] Further, allowing one shareholder to bring a suit questioning the bona fides of any business decision that she simply disagrees with or that is unsuccessful would be exceptionally burdensome to the corporation and its efficient management and operation.[174] Only a very few cases are allowed to

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responsibilities to keep court and creditors informed).

167. *See* Seligman, *supra* note 105, at 28–29, 35–36 (describing the hurdles plaintiffs must overcome to bring a derivative suit, and stating that "as much as seventy-one percent of a recent random sample of settlements of shareholder claims have apparently been litigated under the federal securities laws, not state corporate law . . . [t]his . . . appears to reflect the reality that state corporate law has become a less effective means of protecting shareholder interests").

168. As do all material decisions regarding the operation of the corporation. DEL. CODE ANN. tit. 8, § 141(a) (2006).

169. Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981).

170. Seligman, *supra* note 105, at 23. Under section 141(c) of the Delaware Code, the board of directors may delegate "all of its authority" to a committee. *Zapata*, 430 A 2d at 785.

171. Seligman, *supra* note 105, at 24 ("'[T]here but for the grace of God go I' empathy might influence directors on a litigation committee . . . ." (citing *Zapata*, 430 A.2d at 787)).

172. *See supra* text accompanying notes 157–62.

173. Ribstein, *supra* note 148, at 1466–67 ("While shareholders can approve major corporate transactions, individual shareholders owning bits of firms in diversified portfolios have little incentive to inform themselves or determine the appropriate course of action because they would expend their own time and money while other shareholders take a free ride on their actions.").

174. To allow a shareholder to gain complete control over the pursuit of derivative litigation would "recognize the interest of one person or group to the exclusion of all others within the

proceed past the initial pleadings, ensuring that the courts and the corporations themselves are not burdened with the overuse of what is, in practice, a very narrow remedy.

Another reality of the manner in which derivative suits are brought and prosecuted that affects how easily the suits can translate to an insolvency or bankruptcy scenario is that the real parties in interest in derivative suits are the plaintiffs' attorneys.[175] Because shareholders do not own a significant interest in any one corporation, they do not have an incentive to monitor the good faith or loyalty exercised in reaching any one business decision. Furthermore, since any recovery available from directors who have breached their fiduciary duties will be paid to the corporation, that recovery will not provide substantial financial gain to any one shareholder.[176] Rather, it will simply enhance the value of the corporation in which the shareholder has invested.

There are strong incentives for a derivative suit to settle before a trial on the merits. Once a suit is allowed to proceed past the initial demand procedure and motion to dismiss, settlement becomes the best option for all parties (except the corporation, which bears most of the expense of a settled derivative suit).[177] If directors are found to have engaged in self-dealing or bad faith in their decision-making on behalf of the corporation, they will face personal liability for breach of fiduciary duty. On the other hand, if a director "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation," then the corporation may indemnify her against "expenses (including attorneys' fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action."[178] Most directors would rather not take the chance of losing a derivative action brought against them if they can settle the suit and be indemnified by the corporation. The corporation must also reimburse the plaintiff for attorney's fees and expenses.[179] Plaintiffs' attorneys

corporate entity." *Zapata*, 430 A 2d at 785.

175. Ribstein, *supra* note 148, at 1472 ("The derivative remedy creates conflicts between the plaintiff or plaintiff's attorney and other shareholders . . . . The plaintiff is a nominal holder while the real party at interest is the lawyer who stands to receive a contingency fee by winning or . . . settling the case."); Skeel, *supra* note 2, at 498 (discussing how in derivative suits attorneys are the true parties in interest).

176. *Zapata*, 430 A.2d at 784.

177. Seligman, *supra* note 105, at 33 n.135 (citing Roberta Romano, *The Shareholder Suit Litigation Without Foundation?*, 7 J L. ECON. & ORG. 55, 58–61 (1991)). Romano's study examined a random sample of 535 public corporations and found a high rate of settlement. *Id.* at 32. Sixty-five percent of the claims were settled and there was monetary recovery in approximately fifty-five percent of the settled claims. *Id.* at 32–33.

178. DEL. CODE ANN. tit. 8, § 145(b) (2006).

179. WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE:

negotiate settlements that will provide them with substantial fees while saving the costs of a lengthy litigation.[180] It is not idle speculation to suggest that the interests of plaintiffs' attorneys may not be aligned with those of the majority of stockholders, or for that matter, those of the corporation. Rather, incentives are in place to encourage plaintiffs' attorneys to bring and settle suits at the expense of the corporation.[181] The fact that the attorneys who bring the action do not share common interests with the shareholders on whose behalf they are acting is further evidence that derivative suits are not the best, most efficient method by which to regulate the loyalty and good faith decision making of corporate managers.[182] While derivative suits serve an important deterrent purpose outside bankruptcy, a debtor cannot afford this sort of inefficiency in bankruptcy. Creditors deserve a more economical and direct manner of resolving particular problems with a debtor's management.[183]

State law uses methods other than the derivative suit to address less egregious problems with management outside of bankruptcy. Shareholders may simply decide to remove incompetent directors from their seats on the board. A change in the composition of the board of directors may also result in a change in the corporation's officers. Realistically, shareholders have no incentive to pay very much attention to who the directors of any one corporation are.[184] While institutional

LEGAL AND ECONOMIC PRINCIPLES 205 (9th ed. 2004).

180. As previously mentioned, plaintiff's attorneys are often the real parties in interest in derivative suits. Attorneys have incentives to maximize their own fees, rather than maximizing the return for the shareholders they represent. Therefore, attorneys will often accept inadequate settlement offers because settlements eliminate the risk of litigation and allow attorneys to control the amount of fees they receive. Skeel, *supra* note 2, at 498–99.

181. The procedural barriers to derivative suits erected by Delaware courts may have been successful in mitigating this problem. A study of derivative suits in Delaware conducted by Professors Robert B. Thompson and Randall S. Thomas of Vanderbilt University reveals that in 1999 and 2000, approximately forty derivative suits per year were brought against public companies. Of those, thirty percent provided relief to the corporation and the other seventy percent were usually dismissed. Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1749, 1792 (2004).

182. This incentive problem has "reduced the role derivative suits play in corporate governance." Ribstein, *supra* note 148, at 1472–73 (discussing the problem of how the board, which has the least incentive to bring suit against itself, has the responsibility of deciding whether to sue, while the plaintiff's attorney, who has no interest in the success of the corporation, has the most incentive to bring suit); *see also* Fischel & Bradley, *supra* note 139, at 273–74 (discussing that derivative suits are often ineffective because of the combination of the attorney's poor incentives and the court's lack of business expertise).

183. None of this is intended to suggest, however, that a DIP or trustee could not or should not pursue a derivative action within the bankruptcy case if such a suit would result in a net benefit to the estate. This Article argues that, in the face of severe problems with a debtor's management, the appointment of a trustee must be the remedy of first resort. Then, the Chapter 11 trustee may decide whether pursuing derivative litigation against insiders is in the debtor's best interests.

184. *See* Ribstein, *supra* note 148, at 1466–68 (discussing the shareholder free rider problem and

shareholders and other significant stakeholders may be able to influence a director election, shareholders have very little incentive to invest time or resources in reconstituting the corporation's board once a corporation is insolvent or enters bankruptcy.[185] Creditors become the residual equity holders when the corporation's stock is worthless, but they cannot elect directors.[186] This is an example of the "vestigialization" that occurs when state corporate structures meet the insolvency scenario they never contemplated.[187] With the state law voting mechanism rendered useless, bankruptcy procedures take over and present different solutions.[188] In the circumstance of incompetent or harmful directors, the procedures and standards provided in § 1104 may respond more consistently, reliably, and particularly to whatever severe shortcomings a DIP's management may have. Further, § 1104 can reach problems with corporate officers more precisely than shareholder elections because shareholders only elect directors who then choose the corporate officers. Through § 1104, a bankruptcy court can directly remove or demote a rogue officer.

To address this vestigialization issue within the structures provided by state corporate law, Professor David Skeel recommends that unsecured creditors simply replace the shareholders in director elections held in bankruptcy.[189] This recommendation solves only half of the problem and ignores the speed and efficiency with which a bankruptcy must proceed. A corporation in bankruptcy does not have the time for a

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how it affects shareholder incentives to properly inform themselves).

185. Skeel, *supra* note 2, at 501–04. Shareholders have no valuable stake in the corporation any longer because their shares are worthless and they will not receive anything from the bankruptcy reorganization.

186. *See id*. at 502–03 ("Because unsecured creditors, unlike shareholders, are likely to receive most or all of the benefit of each additional dollar brought into the estate, the unsecured creditors' committee has much better incentives with respect to the decision whether or not to pursue a given derivative suit.").

187. *Id*. at 474–75, 474 n.7 (explaining that "after the separation of state corporate law and federal corporate bankruptcy, the interaction between these two areas of law is based upon the remnants of what might otherwise have been a cohesive, integrated policy" and that this results in bankruptcy courts finding only a vestige of a wholly integrated policy decision).

188. Some bankruptcy courts have allowed shareholders to hold shareholder meetings and director elections during bankruptcy. *Id*. at 507 (citing Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 801 F.2d 60, 68 (2d Cir. 1986)). Because of the lack of shareholder incentive to pay attention to shareholder meetings at all, particularly in bankruptcy, director elections during a bankruptcy case are no more efficient than moving for the appointment of a trustee when current management is corrupt or grossly incompetent. The debtor's management would be replaced, or significantly changed, under either approach. The appointment of a trustee would be no more disruptive.

189. *Id*. at 508–09. In his article, Professor Skeel argues that state law should control corporate bankruptcy. While this Article does not join the debate about whether state or federal law is best equipped to govern corporate bankruptcy as a whole, Skeel's suggestions about how to use state law corporate governance mechanisms within a federal bankruptcy case are considered.

director election or to allow a new board of directors to decide what course of action it will take or who it will choose to run the day-to-day operations of the company. The trustee remedy can be a more precise instrument with which to respond to particular, though not necessarily all-consuming, management problems. In cases in which only one or two managers pose a threat to the reorganization or where a trustee is only necessary to address particular problems or to perform certain, bankruptcy-specific functions, a director election is far too blunt an instrument. In those situations, a trustee can provide trusted oversight while the debtor continues to operate without completely changing the make-up or direction of the debtor's governance. On the other hand, where a corporation's management is so corrupt that a trustee and her professionals must take over for the DIP entirely, a director election is far too time consuming and would not impose any less of a cost on the estate than that incurred by educating the trustee about the debtor's operations and how best to proceed.[190] Bankruptcy may have, therefore, developed the best remedy for itself when a DIP's management must be removed or supplemented and trying to adhere to state law mechanisms would be inefficient and would not produce a better substantive result. The Article now turns to the treatment of various suits on the debtor corporation's behalf within a bankruptcy case.

3. Derivative Suits in Bankruptcy

When a shareholder brings a state law derivative suit and the corporation files for bankruptcy protection before the suit proceeds to trial or is dismissed, the shareholder loses control over the suit to the bankruptcy estate.[191] Under § 541 of the Code, all rights of action that the debtor corporation possesses are considered property of the estate.[192] Because derivative suits are prosecuted by shareholders only on the corporation's behalf and actually belong to the corporation, derivative rights of action become property of the estate and thereby fall under the control of the DIP or trustee.[193] The automatic stay protects the debtor

190. The reorganized debtor, emerging from bankruptcy as a "new" corporation, must have a board of directors and a slate of officers in place to operate the company. The corporation will not leave bankruptcy without leadership in place. A trustee can help bridge the gap between old and new management, however, and can provide continuity, at least during the bankruptcy case, while the corporation finds qualified new managers and integrates them into its business and plans for the future.

191. *See* Mitchell Excavators, Inc. v. Mitchell, 734 F.2d 129, 131 (2d Cir. 1984).

192. *Id.*

193. *Id*.

and property of the estate from enforcement of a judgment against it, the "commencement or continuation . . . of [an] action or proceeding against the debtor," and any other action "to obtain possession of property of the estate," "exercise control over property of the estate," or otherwise attempt to collect on or enforce any claim or lien against the debtor or property of the estate.[194] A shareholder plaintiff and his attorney, therefore, would violate the automatic stay if the shareholder or attorney continued to pursue a suit for breach of fiduciary duty against the corporation's directors derivatively because the prosecution of that suit would constitute an attempt to "exercise control over property of the estate."[195] In order for the shareholder to regain control over the suit and proceed derivatively, the DIP or trustee would have to abandon the estate's interest in the suit.[196]

a. What Happens to State Law Derivative Suits in Bankruptcy

Because the DIP is managed by the same directors who may be the target of the derivative suit, and who may have refused a demand to bring the suit or have been deemed too interested in the suit for demand to be required, the same circular problem presents itself in the bankruptcy context as is encountered in state law. In bankruptcy, however, the DIP takes complete control over the derivative cause of action, and so may choose to release a derivative suit, much the same way a board of directors can refuse a shareholder's demand that a derivative suit be brought.[197]

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194. 11 U.S.C.A. § 362(a)(i)–(8) (West 2004 & Supp. 2007).

195. *In re* Interpictures, Inc., 86 B.R. 24, 28 (Bankr. E.D.N.Y. 1988) (quoting 11 U.S.C. § 362(a)(3) (1988)).

196. *See* Seinfeld v. Allen, 169 F. App'x 47, 49 (2d Cir. 2006) (dismissing the shareholder's derivative action as barred by the corporation's Chapter 11 plan); *Mitchell*, 734 F.2d at 132 (explaining that shareholders can "petition the court to compel the trustee to either bring suit or abandon the claim"). When the trustee or DIP abandons a cause of action, it will revert to the debtor corporation itself and cease to be property of the estate. *See* Ball v. Nationscredit Fin. Servs. Corp., 207 B R. 869, 872 (N.D. Ill. 1997); JAMES ANGELL MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY 245 (1956). Under those circumstances, if those wishing to bring a derivative suit on behalf of the debtor are able to obtain relief from the automatic stay (and they may not be because of indemnity provisions), then any recovery would inure to the benefit of the post-bankruptcy, reorganized corporation. If those shareholders or plaintiffs' attorneys are not able to obtain relief from the stay, they may be able to bring the abandoned suit after the conclusion of the bankruptcy case. A trustee or DIP may only abandon property of the estate, including potential causes of action the estate holds, if it is "*burdensome* to the estate or . . . of inconsequential *value* and *benefit* to the estate." TABB, *supra* note 1, at 314 (citing 11 U.S.C. § 554(a)–(b)). That may signal something important about the potential merits of the action to a state court reviewing a motion to dismiss once the suit is allowed to proceed outside of the bankruptcy case.

197. Agostino v. Hicks, 845 A.2d 1110, 1116–17 (Del. Ch. 2004).

Derivative suits are often settled, compromised, and released in the plan of reorganization.[198] If a shareholder or creditor believes that the suit is being improperly released or that it should be pursued derivatively rather than by the DIP, then the shareholder or creditor can ask the DIP to abandon the suit or ask that the court appoint a trustee to litigate it.[199] In such situations, the court performs a kind of balancing analysis to decide whether it is prudent for the estate to pursue the cause of action in some way and which party in interest should control the litigation.[200] The factors courts would consider in such circumstances present a combination of the calculus bankruptcy courts use in deciding whether to appoint a trustee and the analysis they perform in deciding how an avoidance action should be pursued when the trustee or DIP refuses to bring it. This combined process will be discussed in more detail later.[201] For now, it is important to note that the DIP or trustee will control a suit brought on the debtor corporation's behalf the instant the bankruptcy petition is filed. Any other party in interest wanting to wrest control of the suit from the DIP or trustee must petition the court.[202] Otherwise, the DIP or trustee may release or settle the suit on its own as part of a plan of reorganization.[203]

Even when a bankruptcy court allows a derivative suit or some other suit to proceed against the directors of a corporation, directors have found ways to use the automatic stay to protect them from defending the cause of action, at least temporarily.[204] The most common argument

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198. *See, e.g.*, Rosenberg v. XO Commc'ns, Inc. (*In re* XO Commc'ns, Inc.), 330 B.R. 394, 430 (Bankr. S.D.N.Y. 2005) (discussing how this case did not fit mold of derivative action that would have been extinguished by the corporation's bankruptcy); *Agostino*, 845 A.2d at 1125–26 (describing why the corporation's bankruptcy extinguished the shareholder's derivative action).

199. *Seinfeld*, 169 F. App'x at 49; *Mitchell*, 734 F.2d at 132.

200. This is similar to the decision state courts are allowed to make under the *Zapata* opinion.

201. *See infra* Part III.B.3.b.

202. *Seinfeld*, 169 F. App'x at 49; *Mitchell*, 734 F.2d at 132.

203. *Agostino*, 845 A.2d at 1125–26; *In re XO Commc'ns*, 330 B.R. at 427–430.

204. One such argument—that the directors are too busy reorganizing the debtor and the reorganization would suffer irreparable harm if the current management were forced to defend the suit—seems rather absurd. Directors are usually very busy, even when the corporation is healthy, and in any event, usually delegate a fair amount of the restructuring work required in bankruptcy to outside counsel and other professionals. To say a corporation would be hurt if its managers were distracted during a bankruptcy case suggests that a solvent corporation would be similarly injured if its managers were so encumbered. Still, suits against corrupt managers of solvent corporations persist. The "they are too busy" argument has been successful in the context of fraud suits against directors where the pending suit did not have a great likelihood of success on the merits. There, the requirements of an injunction postponing the prosecution of the cause of action against the directors until the bankruptcy case is completed are met. For an example of two such cases, see Lomas Fin. Corp. v. N. Trust Co. (*In re* Lomas Fin. Corp.), 117 B.R. 64 (S.D.N.Y. 1990) N. Star Contracting Corp. v. McSpedon (*In re* N. Star Contracting Corp.), 125 B.R. 368 (S.D.N.Y. 1991). In these two cases, the court determined the suit against the directors was really brought to try to collect on a

made in this context is that when there is a sufficient identity of interest between the debtor and the defendant in the suit, the automatic stay will protect the non-debtor defendant in order to fully protect the debtor.[205] An identity of interest may be found in situations where a third party defendant, such as a corporate director, is entitled to indemnity from the debtor.[206] In circumstances where the corporation is required to indemnify its directors and officers against suits by shareholders or other parties in interest, a court may find that "'there is such identity between the debtor and the third party defendant that the debtor may be said to be the real party defendant and that a judgment against the third party defendant will in effect be a judgment or finding against the debtor.'"[207] This indemnity problem is yet another consideration courts will have to take into account in deciding whether a suit against managers for injury to the corporation should proceed during the bankruptcy case.[208] It may make sense to allow the automatic stay to protect directors from derivative suits if the debtor is likely to have to foot most of the bill of prosecuting and defending the action. If the debtor is not likely to realize a net financial gain, then a bankruptcy court will not allow a suit against directors to proceed.

Skeel points out that one consequence of the disappearance of derivative suits upon a bankruptcy filing is that plaintiffs' attorneys will under-invest in the derivative suits they bring because of the chance that the firm may enter bankruptcy.[209] The plaintiffs these attorneys represent are shareholders whose stake in the firm becomes worthless upon the corporation's insolvency.[210] If the stockholders are not going to share in a distribution of the firm's assets because there is no equity remaining,

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claim owed by the corporation as a way to circumvent the automatic stay. While these two cases are not necessarily analogous to the situation presented by derivative suits, they are instructive because similar arguments could be used by directors to gain the protection of the automatic stay when they are sued for any reason related to their employment by the debtor during the pendency of a bankruptcy case.

205. *See In re* Interpictures, Inc., 86 B.R. 24, 28 (Bankr. E.D.N.Y. 1988) (explaining that "the right to address wrongs inflicted upon the debtor is property of the estate" in insolvency situations and therefore derivative actions attempting to fix the problems run counter to the automatic stay provision).

206. *In re Lomas Fin. Corp.*, 117 B.R. at 68.

207. *Id*. (quoting A.H. Robins Co. v. Piccinin, 788 F.2d 994, 999 (4th Cir. 1986)).

208. In Gillman v. Continental Airlines, Inc. (*In re* Continental Airlines), the corporation had negotiated transaction-specific indemnity for its directors with regard to the transaction the shareholders sought to challenge in their derivative suit. 177 B.R. 475 (D. Del. 1993). Under those circumstances, the court found that the identity of interest between the debtor and the directors was so strong that letting the shareholders proceed with the action would hurt, rather than help, the debtor. *Id.* at 479.

209. Skeel, *supra* note 2, at 499–500.

210. *Id.* at 500.

then they will not have the incentive, or even standing, to sue on the corporation's behalf.[211] When a corporation is insolvent, its creditors, not its shareholders, are the residual equity holders.[212]

When the corporation is insolvent or has filed bankruptcy, the shareholders have no incentive to sue any longer and creditors cannot sue for a breach of fiduciary duty that occurred before the corporation's insolvency because they were not the beneficiaries of the director's fiduciary duties at that point.[213] There is some debate about whether creditors can assert derivative standing in bankruptcy in order to pursue avoidance actions on behalf of the bankruptcy estate,[214] and it is even less clear whether creditors can bring an action for breach of fiduciary duty on the firm's behalf.[215] Even if shareholders somehow maintain the desire and ability to pursue a suit on the estate's behalf after the corporation files bankruptcy, the attorneys who initiated the suit may have to forfeit control over the cause of action to a Chapter 11 trustee, thereby losing the benefit of, and even the ability to be compensated for, work they have done on the suit.[216] A bankruptcy court will not allow the estate to settle a suit at significant expense without a recovery for the debtor. Derivative suits against directors of a bankrupt corporation would, therefore, not necessarily be profitable to plaintiffs' attorneys.

Bankruptcy courts are not particularly sympathetic to the plight of plaintiffs' attorneys. When the shareholders of a debtor corporation seek to continue to prosecute a derivative suit they have filed in state court, or to maintain control of the suit in bankruptcy, it may be apparent to the

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211. *Id*. at 500–01.

212. Ribstein & Alces, *supra* note 147, at 531 (stating that, during insolvency, creditors are the residual claimants because they are entitled to all of what the corporation owns).

213. *Id*. at 18. Directors do not owe fiduciary duties specifically to creditors in the zone of insolvency; creditors' interests are just included in corporate interest upon insolvency. *Id.* Creditors may be able to sue for post-petition breaches, but shareholders are long out of the game at that point anyway. *Id.*

214. Keith Sharfman, *Derivative Suits in Bankruptcy*, 10 STAN. J.L. BUS. & FIN. 1, 1–3 (2004) (evaluating the legal arguments and policy rationales for permitting creditor derivative suits in bankruptcy).

215. Ribstein & Alces, *supra* note 147, at 545. Creditors should be able to bring suits alleging breaches of fiduciary duty against directors if they can bring other suits on a corporation's behalf. This is particularly true in bankruptcy because there is a clearly recognized fiduciary duty to creditors in bankruptcy. Creditors may not be able to bring derivative suits for breaches of duty that occurred pre-petition, or pre-insolvency, however, because they were not the beneficiaries of the directors' duties at that time.

216. Skeel, *supra* note 2, at 501 ("The most obvious problem from the attorneys' perspective is their significant loss of control over the suit in bankruptcy . . . . Derivative attorneys must then justify both the litigation and their fee arrangements to a potentially skeptical bankruptcy judge. If a trustee has been appointed, derivative attorneys also run the risk of losing control of the suit to the trustee.").

court that the plaintiffs' attorneys (the real parties in interest in the derivative action) are the ones who want to regain control of the suit. For example, in *In re Consolidated Bancshares, Inc.*,[217] shareholders of the debtor corporation known as the "Grubbs group" filed a derivative suit in state court three months before the debtor's bankruptcy filing.[218] The UST formed an equity shareholders' committee,[219] a step it will only take when it believes the debtor has equity,[220] to represent the interests of the debtor's shareholders in the bankruptcy proceedings.[221] When the committee proposed a plan of reorganization that settled the derivative suit brought by the Grubbs group, the Grubbs group, through its attorneys, objected to the confirmation of the plan and argued that the bankruptcy court did not have the authority to settle the derivative suit over their objection.[222] It is curious that shareholders composing the Grubbs group would object to a settlement reached by an equity shareholders' committee purportedly representing their interests. The possibility that it was really the Grubbs group *attorneys* who objected to the settlement becomes clear when reading the Fifth Circuit's opinion denying the fee application filed by the Grubbs group attorneys. The opinion states that the Grubbs group attorneys did not assist the equity committee or contribute to a settlement of the derivative suit in a way that benefited the debtor at all.[223] The Grubbs group shareholders would not have any particular interest in whether their attorneys were compensated as long as their interests were appropriately represented by the equity committee. If the equity committee was not doing an adequate job of representing all shareholder interests, it would have been appropriate for the Grubbs group attorneys to intervene or bring the relevant motion to the court on their client's behalf. The Grubbs group attorneys took no such action. Because the Grubbs group did not participate in the DIP's negotiation of a settlement of the suit with the equity committee, it appears that they did not have separate interests their attorneys needed to protect.

Consolidated Bancshares highlights the problems with state law derivative suits. That is, the plaintiffs' attorneys do not necessarily share an interest with the majority of shareholders, or even the shareholders

217. Pierson & Gaylen v. Creel & Atwood (*In re* Consol. Bancshares, Inc.), 785 F.2d 1249 (5th Cir. 1986).

218. *Id.* at 1251.

219. *Id.*

220. TABB, *supra* note 1, at 783.

221. *In re Consol. Bancshares, Inc.*, 785 F.2d at 1251.

222. *Id.* at 1251–52.

223. *Id*. at 1254–55.

they represent, and the attorneys stand to gain, and lose, the most from the prosecution of a derivative suit. If the Grubbs group attorneys had been interested in representing the interests of the Grubbs group, they should have petitioned to help advise the equity committee and contributed the significant research they completed to the equity committee's cause.[224] But as the Grubb group attorneys knew, when they lost control of the state court derivative suit, they lost the ability to collect on the substantial fees accumulated. Indeed, the bankruptcy court determined that the equity committee adequately represented the Grubbs group's interests, and therefore, there was no injury to the plaintiffs resulting from the assumption of the settlement of the derivative action by the DIP and equity committee.[225] Maintaining control over the derivative action in the party that initiated the suit was not in the best interests of the estate.

Consolidated Bancshares is a good example of how nimble bankruptcy procedures can eradicate state law inefficiencies without entirely denying the shareholders a remedy. Because there was equity in the company, the court was able to devise an appropriate remedy for shareholders by appointing a committee to represent them without losing a giant portion of the settlement to attorney fees. The procedures bankruptcy courts have developed to address creditors' requests for derivative standing to pursue avoidance actions on behalf of the estate are instructive in determining how courts should most effectively approach state law derivative suits against corporate managers when the firm files bankruptcy.

b. What Creditor Derivative Standing in Bankruptcy Tells Us

In recent years, creditors have petitioned bankruptcy courts to pursue avoidance actions to recover money for the estate, and thereby for them, when the DIP or trustee decides against or flatly refuses to pursue the action.[226] While scholars have debated whether creditors should be granted derivative standing at all,[227] the analysis here will use the cases that have addressed the issue to focus, instead, on the procedures

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224. *Id.* at 1253.

225. *Id.* at 1252.

226. *See, e.g.*, Scott v. Nat'l Century Fin. Enters., Inc. (*In re* Balt. Emergency Servs. II, Corp.), 432 F.3d 557 (4th Cir. 2005); Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548 (3d Cir. 2003).

227. *See* Bussel, *supra* note 16, at 33–36 (arguing that creditor derivative suits should be permitted). *Contra* Sharfman, *supra* note 214, at 26 (arguing that creditor derivative suits should not be permitted).

developed and the factors the courts have considered in allowing derivative standing in bankruptcy. There are certainly significant differences between the quest for derivative standing by creditors in bankruptcy and the derivative standing of shareholders under state law. Courts have drawn on the similarity between the principals to inform their decision-making. That analysis reveals how bankruptcy priorities and goals may be brought to bear on the state law derivative action.

While some doubt the appropriateness of characterizing a creditor committee's action to avoid a fraudulent transfer on behalf of the estate as "derivative,"[228] the creditors' right does indeed derive from an injury to the bankruptcy estate, much like a shareholder's right of action in a state law derivative suit derives from an injury to the corporation for which it is a residual equity holder. Recall that creditors are the residual equity holders once a corporation is deemed insolvent.[229] The idea that creditors could bring a suit on the estate's behalf, using the debtor as a nominal plaintiff, in order to recover fraudulently distributed funds for the benefit of the debtor's estate runs exactly parallel to the reasoning supporting the derivative suit mechanism under state law. In bankruptcy, the same principles should guide the application of each. The courts[230] and scholars[231] that have considered the question of creditor derivative standing in bankruptcy have illuminated the policies and practices that apply there. The same reasoning should guide the treatment of state law derivative suits once the corporate debtor files bankruptcy. Establishing how, when, and whether creditors have the authority to sue directors on the debtor's behalf is therefore crucial to understanding how to treat state law derivative suits against corporate managers in bankruptcy.

As mentioned above, the derivative cause of action belongs to the debtor and so is managed first by the DIP or trustee.[232] If the DIP or trustee abandons the cause of action or consents to allow the shareholders to bring the suit on the estate's behalf, then the shareholders

228. Bussel, *supra* note 16, at 33–34.

229. *See* Skeel, *supra* note 2, at 502–03 ("Because unsecured creditors, unlike shareholders, are likely to receive most or all of the benefit of each additional dollar brought into the estate, the unsecured creditors' committee has much better incentives with respect to the decision whether or not to pursue a given derivative suit.").

230. For examples of courts debating this issue, see *Cybergenics Corp.*, 330 F.3d 548; *In re Balt. Emergency Servs. Corp.*, 432 F.3d 557; United Phosphorus, Ltd. v. Fox (*In re* Fox), 305 B.R. 912 (10th Cir. B.A.P. 2004); Unsecured Creditors Comm. of Debtor STN Enters., Inc. v. Noyes (*In re* STN Enters.), 779 F.2d 901 (2d Cir. 1985).

231. For examples of scholars debating this issue, see Sharfman, *supra* note 214; Bussel, *supra* note 16; Brubaker, *supra* note 120.

232. Seinfeld v. Allen, 169 F. App'x 47, 48–49 (2d Cir. 2006).

may reclaim control over their derivative suit.[233] The analysis concerning the derivative standing of creditors outlines a clear progression from DIP control over an adversary proceeding to derivative standing in bankruptcy. Shareholder suits can mirror this progression in the derivative suit journey from control by a DIP or trustee to the unlikely event shareholders and their original attorneys under state law would regain control of the suit. If a DIP unreasonably refuses to bring a cause of action available to the estate on its behalf—that is, there is a cause of action that the court believes would have a reasonable likelihood of resulting in a net benefit to the estate and the DIP refuses to initiate that proceeding—then the court must designate another party to bring it.[234] Under such circumstances, where the DIP is shirking its fiduciary duty to take the necessary actions to maximize the value of the estate for the benefit of creditors, the creditors or even shareholders may move for the appointment of a trustee.[235]

Supporters of derivative standing for creditors have argued that placing the appointment of a trustee before granting derivative standing to creditors "'amounts to replac[ing] the scalpel of [a] derivative suit with a chainsaw.'"[236] That conclusion ignores the scalpel that the trustee remedy has become. Bankruptcy courts have not hesitated to limit the role of the trustee when only particular assistance to or supervision of the DIP is necessary.[237] For example, one court appointed a trustee just to pursue particular avoidance actions it did not trust the DIP to adequately prosecute.[238] Because the Code has designated the remedy of trustee appointment to provide an impartial party with the interests of the estate as its focus to act on the estate's behalf if the DIP is not upholding its duty in that regard, that remedy must be the first recourse in such situations. The flexibility the Code provides allows bankruptcy courts to use the remedy of a Chapter 11 trustee in a manner that best serves the estate's interests and prevents that remedy from necessarily inflicting more of a cost on the estate than awarding standing to a somewhat less impartial creditors' committee or group of shareholders would.

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233. *Id*. at 49.

234. *See In re Fox*, 305 B.R. at 915–16 ("[I]f a trustee refuses for whatever reason to pursue a valuable asset, the creditors' remedy is his or her removal under 11 U.S.C. § 324.").

235. Sharfman, *supra* note 214, at 24.

236. Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 577 (3d Cir. 2003).

237. *See supra* Part III.A.3.

238. *See In re* Intercat, Inc., 247 B.R. 911, 925 (S.D. Ga. 2000) (stating the "Debtor needs [the principal's] expertise").

Appointment of an impartial trustee is the Code's preferred remedy for a reason and it should not be ignored simply because it can, under some circumstances, be an extreme response to problems with a debtor's management. A bankruptcy court may either decide for itself whether a DIP's refusal to bring a particular cause of action on behalf of the estate is reasonable and in good faith, or it may appoint an examiner to investigate the cause of action further and report to the court about the merits of the potential suit. If a trustee is appointed before the "demand" to bring a suit on the estate's behalf and unreasonably refuses to bring the action, then the court may either replace that trustee with another,[239] or grant derivative standing to the shareholders or creditors,[240] depending on which party wants to bring the action or which has the strongest incentive to pursue it actively. There is a clear preference in the Code, however, for having a fiduciary for the estate act on the debtor's behalf wherever possible, before parties such as a creditors' committee (which may sometimes share an interest with the estate, but may also have adverse interests) act in the DIP's or trustee's stead.[241]

In the context of derivative suits against directors for breaches of fiduciary duty, deciding whether the bankruptcy estate should pursue the cause of action at all is more important than deciding who should bring the suit. When deciding whether a derivative suit against directors should be dismissed or prosecuted by the estate, bankruptcy courts will engage in a cost-benefit analysis to determine whether it is worthwhile to incur the expense of the derivative litigation. The factors courts consider when deciding whether to allow state law derivative suits to proceed over the DIP's objection or refusal are the same as those they would look at to determine whether creditors should be granted standing to pursue an avoidance action when the DIP has refused to do so.[242] In each case, the court is making its own determination after the DIP has decided that it is not in the estate's best interests to pursue a particular cause of action. When that happens, the court may first appoint an examiner to determine whether the potential suit has merit.[243] An inquiry and subsequent report by an examiner would help a court decide what probability of success the

239. *In re Fox*, 305 B.R. at 915–16.

240. An equity committee should be granted standing in these circumstances to represent the interests of all shareholders, just as a creditor's committee should be used to pursue the action on behalf of all creditors, rather than awarding standing to any one shareholder or creditor.

241. Scott v. Nat'l Century Fin. Enters., Inc. (*In re* Balt. Emergency Servs. II, Corp.), 432 F.3d 557, 562 (4th Cir. 2005).

242. Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 561, 566, 571 (3d Cir. 2003).

243. 11 U.S.C.A. § 1104(c) (West Supp. 2007).

suit in question might have and what the potential financial recovery would be for the estate in the event the suit is successful. If an examiner is unnecessary or would be too costly under the circumstances, the court can request that the parties brief the issue and that those wanting to pursue the cause of action make the necessary showing that it would likely be profitable to the estate.[244] The cost-benefit analysis helps the court determine if the suit is worth pursuing and whether the DIP is being unreasonable in its refusal.[245]

One snapshot of a stage in the development of Delaware's common law regarding the derivative suit provides a preview of how bankruptcy procedures could be more efficient than state law mechanisms in determining whether a derivative suit is worth pursuing. Once again, the supervision the bankruptcy court, and possibly a trustee, can provide allows neutral parties with only the estate's interests in mind to make a judgment based on a cost-benefit analysis about what course of action would be most beneficial to the estate. In *Zapata Corp. v. Maldonado*,[246] the Delaware Supreme Court set out a two-step procedure for deciding whether a derivative suit would proceed when demand on the board was not required.[247] If the special committee appointed by the board recommends dismissal of the suit,[248] it must prove that it was independent, acted in good faith, and had reasonable bases for its conclusion.[249] If the committee does not meet that standard, then the court will deny its motion to dismiss the derivative suit.[250] If the court finds that the committee does meet the standard, then the court will exercise its own independent business judgment to decide whether the derivative suit should proceed.[251] The Delaware Supreme Court acknowledged in *Zapata* that it may still be in the corporation's best interest to dismiss even a non-frivolous suit if the expected costs of the suit exceed the expected benefit.[252] *Zapata* is a rare instance in which a Delaware court suggests a circumstance in which a court should

244. Unsecured Creditors Comm. of Debtor STN Enters. v. Noyes (*In re* STN Enters.), 779 F.2d 901, 904 (2d Cir. 1985).

245. *Id*. at 904–06.

246. 430 A.2d 779 (Del. 1980).

247. *Id.* at 788–89.

248. *See id.* at 788 (stating that "an independent committee may cause its corporation to file a pre-trial motion to dismiss," if the motion is "in the best interests of the corporation").

249. *Id*. at 788.

250. *Id.* at 789.

251. *Id.*

252. *See id.* at 785 (stating "a board has the power to choose not to pursue litigation" if the "suit would be detrimental to the company").

substitute its judgment for that of a board.[253] One party argues in favor of dismissal and the other argues to maintain the suit and the court decides whether to allow the suit to go forward.

In bankruptcy, the DIP must ask the court's permission before undertaking business transactions outside of the debtor's ordinary course of business. Parties opposed to the transaction at issue may have an opportunity to be heard. This is just another example of the hands-on oversight bankruptcy courts provide on a regular basis in a bankruptcy case. Once in the hands of the DIP, a state law derivative suit against directors becomes just another cause of action the DIP may decide to bring or not. If a bankruptcy court determines that the DIP has unreasonably refused to bring suit against directors, then it may appoint a trustee for the sole purpose of pursuing that cause of action.[254] In some circumstances, a trustee may already be operating the debtor corporation and she may unreasonably refuse to bring a given cause of action.[255] If a court determines that this refusal does not constitute a breach of the trustee's fiduciary duty to the estate, but that the suit should be litigated anyway, the court may turn to a shareholders' or creditors' committee to pursue the action. If the trustee has breached her duty by refusing to prosecute the cause of action, then the court may decide to replace that trustee with another before turning to specific parties in interest to sue on the estate's behalf. With the bankruptcy court exercising this gatekeeping role, it can ensure that the estate is not forced to participate in a suit against directors that would only recover enough to pay the lawyers, as is the case with most state court derivative actions.[256] Rather, if a suit against directors would be beneficial, the court can craft a flexible remedy to allow the estate to pursue it without falling into the tangled web that is the state law procedure for derivative suits.[257]

Bankruptcy courts are accustomed to hearing motions and objections from either side of a significant business decision the DIP must make and

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253. The *Zapata* procedure is not used very often anymore because it is considered too expensive and there is some risk that a court would ignore a special litigation committee's report, which report is very costly and time-consuming to generate. To have such an expensive investigation ignored may be too wasteful to be a helpful procedure. Quillen, *supra* note 106, at 123–24.

254. Scott v. Nat'l Century Fin. Enters., Inc. (*In re* Balt. Emergency Servs. II, Corp.), 432 F.3d 557, 560 (4th Cir. 2005).

255. *Id*.

256. *Cf.* Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 574–75 (3d Cir. 2003) (stating how the court handles "value-dissipating" suits in light of arguments against the court's gatekeeper role).

257. *See id.* at 576–80 (holding that "bankruptcy courts can authorize creditors' committees to sue derivatively . . . for the benefit of the estate"); Seligman, *supra* note 105, at 23.

then deciding whether to authorize a particular transaction. The bankruptcy system can take, and has taken, a parallel approach to state law, particularly the procedure outlined in the *Zapata* case, in deciding whether to proceed with derivative suits before it. While the bankruptcy procedure mirrors that of *Zapata*—an examiner or trustee can serve the functions of a special litigation committee and the bankruptcy court makes an ultimate determination about whether to proceed with the suit—the bankruptcy process is able to move more expeditiously in reaching a final decision about whether to pursue a derivative suit on behalf of the estate.[258]

After completing the necessary cost-benefit analysis and taking into account the particularly small probability of success of most derivative suits against directors, a bankruptcy court may decide that it is perfectly reasonable for a DIP to release a suit or to simply settle it as part of a plan of reorganization. The remedy, therefore, loses some of its power when it becomes the property of a bankruptcy estate. The court in *Agostino* noted that "[w]hen a Delaware corporation files for bankruptcy, meritorious derivative claims often disappear," and that this phenomenon is "contrary to the effort of Delaware law to protect shareholders who have been wronged."[259] The next Part of this Article considers whether that assertion is accurate and whether the "disappearance" of derivative suits in bankruptcy poses a problem for the corporate governance mechanism.

IV. POLICY GOALS OF THE TREATMENT OF DERIVATIVE SUITS IN BANKRUPTCY

Once a corporation files bankruptcy, the Code and its attendant policies and goals for corporate reorganizations control the operation of the debtor. Almost every business decision the corporation makes during its bankruptcy case is guided and driven by bankruptcy rules and principles. The decision of whether to pursue a state court derivative suit brought against directors before the bankruptcy case is filed is no different. Before deciding what, if anything, should be done about the disappearance of state law derivative suits in bankruptcy, it is important

258. State law may be able to learn from the expediency gained from federal procedures or enhanced judicial review of derivative actions. Any such gains would certainly have countervailing costs. This Article does not aim to suggest how the state law of corporate governance could operate better. Rather, it argues that bankruptcy procedures are better suited to address problems with corporate governance within bankruptcy than complementary provisions under state law.

259. Agostino v. Hicks, 845 A.2d 1110, 1126 (Del. Ch. 2004).

to determine whether, given bankruptcy goals and policies, derivative suits are a valuable remedy that should be preserved.

The primary goal of Chapter 11 is the efficient maximization of the value of the debtor's estate through the reorganization of its liabilities.[260] Where state collections law is ordered around a "first in time is first in right" philosophy, bankruptcy law tries to "enhance the collective welfare of the group of creditors."[261] Bankruptcy law necessarily devises different procedures and approaches to some problems that have already been addressed by a complete body of state law. For example, the Code alters the order in which creditors are paid, avoids liens, disallows claims, and discharges the otherwise enforceable claims of creditors.[262] Bankruptcy frequently departs from the provisions of non-bankruptcy law when doing so is necessary to advance other goals and priorities. Because the management of the corporation faces different circumstances and concerns within a bankruptcy case and encounters challenges that are not contemplated or accounted for by state law,[263] management should be governed by different policies and procedures in bankruptcy than those apposite under state law.

When it comes to monitoring corporate managers in bankruptcy, there is a strong preference for leaving the DIP management in place and requiring those managers to seek court approval for business transactions outside the ordinary course.[264] Otherwise, the court defers to the reasonable business judgment of the DIP.[265] The removal or direct supervision of managers is required when cause is established under § 1104, which provides that the bankruptcy system will not countenance "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor" or similar indiscretions by the DIP management.[266] A bankrupt corporation will keep its management unless those managers

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260. TABB, *supra* note 1, at 73.

261. *Id*. at 10.

262. Bussel, *supra* note 16, at 34–35 (describing non-bankruptcy law as a "baseline, but . . . a baseline frequently departed from in order to advance other goals").

263. *See* Skeel, *supra* note 2, at 495–96 ("Because an insolvent corporation is much more likely to file for bankruptcy than to invoke a state's collectivized insolvency procedure, states have little incentive to pay much attention to their insolvency provisions. As a consequence, state insolvency procedures are likely to be flawed in significant and troubling respects.").

264. "Most courts adopt a view that leaves operation of the business to a large extent at the discretion of the DIP and frequently enforce the choices made by the DIP management on operational matters even if the choices affect loss allocation." Nimmer & Feinberg, *supra* note 5, at 12.

265. *See id*. at 13 ("In the absence of an expressly contrary statutory standard . . . the business actions and choices of the DIP are reviewed only to determine if they reflect the exercise of rational business judgment.").

266. 11 U.S.C.A. § 1104(a)(1) (West Supp. 2007).

are hurting the debtor or are threatening the maximization of the value of the estate or hampering its successful reorganization in some way. If a corporate manager is a weight upon the reorganization process, then the appropriate remedy under bankruptcy law is to remove her.[267] If a manager has received a fraudulent conveyance from the corporation or has committed a tort against it, then the estate may proceed against that manager as it would against any tortfeasor—in an adversary proceeding based on the non-bankruptcy law creating the particular cause of action.[268] Derivative suits against managers have fallen into disfavor under state law and there are better ways to monitor corporate management under both non-bankruptcy and bankruptcy law. Shareholders do not lose a significant remedy by the disappearance of derivative suits in bankruptcy, because they do not stand to benefit from any recovery by the debtor. Therefore, bankruptcy law should not try to adapt itself to this state law remedy. The bankruptcy system should instead approach the problems highlighted by meritorious derivative suits using the mechanisms provided by the Code and with bankruptcy goals in mind.

The fact that derivative suits must overcome a complicated process before they are allowed to proceed to a trial on the merits suggests a bias against them under state law.[269] The expense numerous strike suits could impose on a corporation and its directors means that all derivative suits shareholders demand must undergo significant scrutiny at a very early stage if they are to proceed over management's objection.[270] Too much personal liability for directors for imprudent business decisions would discourage outside directors from serving on boards and would increase the risk assumed by taking a position as a director or officer of a public corporation.[271] Increased liability for corporate managers would also

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267. Sharfman, *supra* note 214, at 24 ("If incumbent management is so incompetent or untrustworthy that it has unreasonably failed to bring cases whose prosecution would benefit the estate, then what sense does it make to trust it to run the firm's affairs in other respects?").

268. Seligman, *supra* note 105, at 7–8 ("The difference between a duty of loyalty review of a transaction where the defendants have the burden of persuading a court that the transaction was fair . . . and a business judgment rule analysis, where the plaintiff must persuade the court that a director or officer did not rationally believe that his or her business judgment was in the best interests of the corporation . . . is a fundamental one in corporate law.").

269. "Even if courts could effectively second-guess business decisions, the procedural mechanisms for doing so are problematic." Ribstein, *supra* note 148, at 1472–73 (explaining the complications in the process of filing a derivative suit).

270. Quillen, *supra* note 106, at 127–28 (describing the demand requirement as "a sensitive device for sorting out frivolous claims at an early stage in litigation").

271. *Id*. at 118–19 (stating that the seminal case of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) "had the negative effect of discouraging qualified outsiders from serving on corporate boards as independent directors because the risk of personal liability for a breach of the duty of care was not

cause an increase in the cost liability insurance corporations would have to purchase on corporate managers' behalf.[272]

While meritorious derivative suits may serve as an important check on corrupt management, such suits are rare.[273] More common are merely colorable suits that result in settlements that benefit the plaintiffs' attorneys at the expense of the corporation they claim to protect.[274] Because of these inefficiencies, and the disincentives of using the derivative suit remedy, Delaware courts continue to narrow the range of situations in which suits against directors and officers in their personal capacity for breach of fiduciary duty to the corporation can be successful.[275] Now that derivative suits are only likely to be successful in a very small set of egregious circumstances, using extensive procedural protections to limit the burden frivolous strike suits can impose on a corporation's management is important to the efficient operation of a corporation in the face of shareholders who may disagree with particular business decisions, or want to recover for unsuccessful transactions. Although the inefficiencies inherent in the derivative suit process make those suits a poor method of enforcing director duties under state law, there are viable and more effective alternatives for monitoring corporate managers.

A. Bankruptcy Supervision of DIP Management

Perhaps the most obvious form of DIP supervision available in bankruptcy is that provided by the bankruptcy court in its monitoring of the debtor's operation. The requirement that a DIP obtain bankruptcy court approval for any action taken outside the ordinary course of the debtor's business means that the court must approve most of the truly important decisions a DIP makes about new financing and the reorganization of the estate's assets and liabilities.[276] Other parties in interest may then object to a particular course of action chosen by the DIP, and submit that objection for bankruptcy court review.[277]

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worth the reward of serving on a corporate board").

272. *Id*. at 119 (emphasizing the fact that problems in the directors' and officers' liability insurance market appeared at the same time as the *Van Gorkom* decision).

273. *See* Ribstein, *supra* note 148, at 1473 (stating that "impediments to suit have reduced the role derivative suits play in corporate governance"); Fischel & Bradley, *supra* note 139, at 287.

274. *See* Seligman, *supra* note 105, at 32 (stating a plaintiff's attorney "may be an 'unfaithful champion' in shareholder litigation more interested in attorney's fees than corporate recoveries").

275. *See supra* text accompanying notes 148–58.

276. TABB, *supra* note 1, at 75.

277. *Id*.

In large corporate bankruptcies, the UST almost always appoints a creditors' committee to represent the interests of all unsecured creditors.[278] The creditors' committee serves an important supervisory role as one of the most influential parties in interest that may offer a valuable opinion regarding a DIP's business decisions. Because unsecured creditors are the residual equity holders when an insolvent corporation files bankruptcy,[279] the creditors' committee has a keen interest in the maximization of the value of the estate, much the same way shareholders demand that corporate directors maximize the value of the corporation for their benefit when the corporation is solvent. DIP management owes fiduciary duties to the creditors of an insolvent corporation, and it is for their benefit that managers seek to maximize the value of the estate.[280] Courts have allowed creditors to exercise derivative standing when a DIP refuses to bring a cause of action the creditors believe would recover assets for the estate, just as shareholders are permitted to do when a corporation is insolvent.[281] However, the derivative procedure in bankruptcy requires only court approval of the action after the DIP has refused to bring it, rather than any sort of special litigation committee investigation.[282] Simple federal pleading rules apply rather than the extensive pleading requirements for derivative actions under Delaware state law.[283]

As discussed above, the creditors' committee should follow the protocol provided in the Code by first moving for the appointment of a trustee if it believes that the DIP is shirking its fiduciary duties to the estate by refusing to bring a particular cause of action or otherwise.[284] The active role the creditors' committee plays in the oversight of the DIP's decisions, and its ability to take some actions for the DIP or move for the removal or close supervision of some or all of the DIP management, emphasizes its power as a party in interest and its ability to truly monitor the DIP more closely than shareholders can monitor

278. *Id*. at 67.

279. While insolvency is not a requirement of Chapter 11 bankruptcy, almost all corporations that file bankruptcy are insolvent.

280. TABB, *supra* note 1, at 773.

281. *See supra* Part III.B.3.b.

282. Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 553 (3d Cir. 2004).

283. Seligman, *supra* note 105, at 27–28. The Delaware Supreme Court has stated that in bankruptcy derivative suits, "[t]he plaintiff need only allege specific facts; he need not plead evidence." Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1983), *overruled in part on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

284. *Supra* Part III.B.3.b.

managers under state law.[285] A DIP is more closely watched, second-guessed, and criticized in a bankruptcy case than corporate managers are when a firm is solvent.[286]

Creditors are now providing even more oversight in the form of DIP financing. When a corporation files bankruptcy, it often needs cash to continue to operate the business.[287] Post-petition lenders receive administrative expense claims against the debtor's estate, meaning their claims are paid first, before those of any other unsecured creditors.[288] This priority of their claims gives DIP lenders significant control over the debtor. This can be a problem where the DIP lender, as the highest-ranked unsecured creditor, and in some cases a secured lender as well, has interests very different from those of other creditors or the estate.[289] The DIP loan can contain specific terms that dictate what actions the debtor's management should take and how they should organize the debtor's finances.[290] The DIP lender has an interest in monitoring the debtor's management and keeping it from injuring the estate or decreasing its value. To this end, it can be a valuable monitoring tool, albeit one that should be closely supervised by the bankruptcy court. Still, if a court determines that the DIP should be supervised more closely, that an action should be pursued that the DIP refuses to bring, that the DIP needs help performing certain bankruptcy functions of the debtor or in guiding the corporation through bankruptcy, it should first appoint a trustee to take over any or all of the DIP's functions.[291]

The trustee remedy is specifically provided by the Code when the bankruptcy court or party in interest believes that the debtor's

285. TABB, *supra* note 1, at 67–68.

286. One commentator has said:

> If a debtor-in-possession unreasonably fails to prosecute meritorious actions against arm's-length third parties, surely that would be at least "incompetence" if not "gross mismanagement." And surely if there are meritorious avoidance actions that could be brought against current management, the managers must either have committed "fraud" or otherwise engaged in "dishonesty."

Sharfman, *supra* note 214, at 24 (arguing that if incumbent managers are untrustworthy in bringing cases that would benefit the estate, they should not be trusted to run the firm's other affairs).

287. David A. Skeel, *Doctrines and Markets Creditors' Ball The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 919 (2003).

288. 11 U.S.C.A. § 503(b) (West Supp. 2007).

289. Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 KY. L.J. 839, 848–49 (2004).

290. *See id*. at 847–48 (explaining that, under Skeel's concept of control, lenders do not have direct control over assets, but "have the ability to discipline the debtor's management and reward them for desired behavior, thus mitigating the conflicting interests between managers and creditors that might otherwise exist").

291. *See In re* Ionosphere Clubs, Inc., 113 B.R. 164, 167 (Bankr. S.D.N.Y. 1990); *In re* V. Savino Oil & Heating Co., 99 B.R. 518, 520 (Bankr. E.D.N.Y. 1989).

management has engaged in "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor."[292] Appointment of a trustee is compulsory under the Code once such cause is established.[293] In contrast, the Code allows courts great flexibility in determining whether to appoint a trustee in the absence of cause and how to craft that remedy once it is granted.[294] Recall that a trustee may be appointed either to simply pursue one cause of action or to completely displace the DIP management and operate the debtor itself.[295] Even when the trustee deposes the DIP, many of the debtor's managers may remain in the debtor's employ to assist the trustee and offer guidance based on their experience with the firm.[296] While there is a clear preference in bankruptcy for the operation of the debtor by DIP management, particularly since that management is so closely monitored during a bankruptcy case, when that management fails and threatens the efficiency or success of the reorganization or the value of the estate itself, the bankruptcy court may extend additional supervision or help in operating the corporation in the form of a trustee.[297] This method is preferred to granting derivative standing to another party in interest because this method retains an impartial party in control of the debtor's affairs, rather than giving control over part of the estate's property to an interested party whose preferences are not always aligned with those of the debtor.[298] Because a trustee can either completely take over the operation of the debtor or merely supervise or aid DIP management, and must in any event give regular reports to the bankruptcy court about her work with the debtor, a trustee can serve a valuable role in the monitoring of DIP management. Bankruptcy courts are able to decide when a debtor's management needs closer supervision than the court or the creditors can provide and design the appropriate remedy under § 1104.

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292. 11 U.S.C.A. § 1104(a); s*ee also* United Unsecured Creditors Comm. of Debtor STN Enters. v. Noyes (*In re* STN Enters.), 779 F.2d 901, 901 (2d Cir. 1985); United Phosphorus, Ltd. v. Fox (*In re* Fox), 305 B.R. 912, 914 (10th Cir. B.A.P. 2004); Dardarian v. La Sherene, Inc. (*In re* La Sherene, Inc.), 3 B.R. 169, 174 (Bankr. N.D. Ga. 1980); Sharfman, *supra* note 214, at 24.

293. *In re La Sherene*, 3 B.R. at 174.

294. *See id.* at 175.

295. *Compare In re* Intercat, Inc., 247 B.R. 911, 924 (Bankr. S.D. Ga. 2000) (appointing the trustee with limited powers), *with In re La Sherene*, 3 B.R. at 176 (displacing the DIP manager with a court appointed trustee while focusing on the creative skills of the DIP manager).

296. *See In re La Sherene*, 3 B.R. at 175–76.

297. *Id*. at 174.

298. Sharfman, *supra* note 214, at 25 ("To the extent that they enable to remain in place incompetent or untrustworthy debtors-in-possession who would otherwise be replaced, creditor derivative suits undermine the Code's objective of appointing trustees when there is cause for doing so.").

Another tool at the court's disposal under § 1104 is the appointment of an examiner to investigate "any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor" if it determines that such an appointment would be in the best interests of the debtor's parties in interest.[299] An examiner can help a court determine whether cause to appoint a trustee exists. In the event a derivative suit has been filed against the debtor's managers in state court, an examiner can help determine whether that suit would be worth pursuing within the bankruptcy case. With bankruptcy courts able to appoint an examiner to attempt to investigate the management ranks of a troubled debtor, and then able to design an appropriate level of delegation or supervision in the form of a trustee, shareholders or creditors alleging that DIP management is corrupt or harmful to the debtor will get a fair hearing and may even be awarded a careful examination of the debtor's management.[300] With those tools in place, there is no reason to believe that corrupt or grossly incompetent managers will be able to remain at the helm of a DIP without detection or intervention by a bankruptcy court. Still, in order to feel confident that corrupt managers cannot simply run to bankruptcy for safety when shareholders threaten to hold them accountable for their actions that hurt the corporation, we must determine that the absence, or rarity, of a derivative remedy against directors in bankruptcy does not rob the estate's residual equity holders and the estate itself of redress for injuries suffered at the hands of disloyal managers.

More good news for shareholders is the fact that, in bankruptcy, suits brought pursuant to the federal securities laws do not suffer the same fate as derivative suits. Because the causes of action authorized under the securities laws may be brought directly by shareholders (with the recovery only sometimes going to the corporation) or by the SEC, they do not belong to the debtor and are not property of the estate.[301] Thus, the DIP may not decide to release or quickly settle a suit authorized by securities laws, and the original plaintiff will be able to maintain the suit even over the DIP's objection. While the automatic stay may protect the corporate debtor from having to pay monetary damages for securities law

299. 11 U.S.C.A. § 1104(c) (West Supp. 2007).

300. An examiner's report can be limited in utility if the DIP management is not cooperative. Still, if the DIP management refuses to cooperate or lies to the examiner, the DIP management would be held in contempt by the bankruptcy court. Therefore, such uncooperative behavior would not necessarily help the managers in the long run.

301. Rosenberg v. XO Commc'ns, Inc. (*In re* XO Commc'ns), 330 B.R. 394, 427 (Bankr. S.D.N.Y. 2005).

violations, it does not protect the individual managers who committed the violations from monetary liability for actions taken in violation of the securities laws.[302]

B. Are Shareholders Really Losing Anything?

It is important to note that derivative suits are no longer a significant remedy under state law, and are not the preferred means of monitoring corporate management.[303] Even under the state law scheme, shareholders do not recover very much in derivative suits.[304] Successful state law derivative suits result in a small addition to the wealth of a corporation's shareholders and an unsuccessful one has a similarly small negative effect on the corporation's wealth.[305] Either way, the derivative suit does not make a significant impact on the overall value of the corporation.[306] The derivative suit's primary purpose under state law is as a deterrent against particularly egregious disloyal behavior by directors.[307] While this serves an important role in the state corporate law scheme, bankruptcy law cannot take the time to deter state law torts. Instead, bankruptcy law must ensure that it is not a safe haven for disloyal managers, that those managers do not injure the debtor corporation, and that a management scheme is in place that will allow the debtor to reorganize quickly and effectively.

Even if shareholders were to keep the derivative remedy in bankruptcy, they would not benefit from the recovery if the corporation's debt exceeds the size of the judgments against its managers. If creditors take over the derivative suit in bankruptcy, then they may receive some portion of the damage award as the increment in debtor value available for distribution to them.[308] The bankruptcy court would first have to determine that there is a good likelihood that the suit would be profitable

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302. Section 523(a)(19) of the Code, added by the Sarbanes-Oxley Act of 2002, provides that an individual debtor may not discharge a debt that "is for (i) the violation of any of the Federal securities laws . . . any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or (ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security." 11 U.S.C.A. § 523(a)(19) (West Supp. 2007).

303. Ribstein, *supra* note 148, at 1472–73.

304. Fischel & Bradley, *supra* note 139, at 282.

305. *Id*.

306. *Id*.

307. *Id*. at 286–87 (stating the derivative suit exists to deter "one-shot frauds" and to deter "other egregious derelictions by corporate managers").

308. *See* Skeel, *supra* note 2, at 503 ("A few courts . . . have permitted a creditor's committee to initiate derivative litigation on behalf of the debtor during the course of a bankruptcy case.").

to the estate before allowing it to proceed for any party's benefit.[309] Because the state law parameters for cases in which directors could be held liable for breach of fiduciary duty are so narrow, most of the derivative suits shareholders bring would not succeed in a trial on the merits.[310] The settlement scheme that has evolved is very costly to the corporation and primarily benefits the plaintiffs' attorneys.[311] A successful Chapter 11 reorganization depends upon the ability of a debtor to preserve and maximize the value of the already insufficient property of the estate. A debtor's precious resources cannot and should not be expended on the costly litigation of a derivative suit that is not likely to result in a net benefit to the estate. Instead, a bankruptcy court must use the most efficient and cost-effective means possible to prevent further injury to the corporation at the hands of grossly incompetent or disloyal managers. A Chapter 11 debtor cannot divert resources to serve a state law deterrent purpose at the expense of the bankruptcy estate. Bankruptcy is just not the appropriate forum for that kind of costly, inefficient action.

To compensate for mooting the state law derivative suit remedy of holding directors personally liable for breaches of fiduciary duty, bankruptcy law has substituted a different scheme to mitigate the damage corrupt corporate managers can do to a bankruptcy estate and to appropriately address those problems with management. There is no reason for corrupt corporate managers to believe that they can file bankruptcy to entrench themselves at the helm of a corporation or to avoid answering for their crimes against the corporation after shareholders have brought suit or begun making allegations. In fact, a pre-petition suit may be what brings problems with management to the UST's or the bankruptcy court's attention and leads to the appointment of a trustee or examiner under § 1104 when the mechanism provided by § 1104 is utilized as intended. It is within the § 1104 framework that bankruptcy law has chosen to address problems with a corporate debtor's management, and so it is appropriate to look there first to determine whether and how to proceed based on allegations of corrupt, dishonest, or otherwise harmful management.

309. *See* Unsecured Creditors Comm. of Debtor STN Enters., Inc. v. Noyes (*In re* STN Enters.), 779 F.2d 901, 905 (2d Cir. 1985) ("[T]o give the creditor's committee standing to bring an action, the court must also examine . . . whether an action asserting such claim(s) is likely to benefit the reorganization estate.").

310. *See* Fischel & Bradley, *supra* note 139, at 283 ("[T]he very generality of fiduciary duties . . . limits their application to relatively egregious cases.").

311. Sharfman, *supra* note 214, at 17.

V. THE ROLE OF SECTION 1104

Section 1104 of the Code provides for the appointment of a trustee or an examiner.[312] It is the provision in the Code designed to address problems with a Chapter 11 debtor's management. Whatever remedy a bankruptcy court determines is appropriate, whether removing the DIP management entirely, appointing a trustee to perform limited functions, or suing corrupt managers for breach of fiduciary duty,[313] the problem should be brought to the court's attention by a motion under § 1104. While this assertion may be controversial—as courts and scholars alike have an aversion to the appointment of a trustee because it is regarded as an extreme, expensive remedy[314]—the addition of subsection (e) bolsters the argument in favor of beginning with § 1104 when confronted by corrupt or grossly incompetent DIP management. In fact, § 1104 is a mandatory provision and bankruptcy courts should require that parties in interest first move for the appointment of a trustee before seeking to redress injuries caused by severe mismanagement. If a party seeking to bring a derivative suit against a debtor's current management can establish facts that would support liability for breach of fiduciary duty by those managers by clear and convincing evidence, then the same party could establish cause and require a trustee.[315] The self-dealing, waste, bad faith, and fraud that would form the basis of a derivative suit against corporate managers under state law would also constitute cause under § 1104(a)(1) of the Code. The non-exclusive list of management ailments that would constitute "cause" is far broader than that which would support personal liability for managers under state law.[316] Though there is a high bar to establish "cause" in bankruptcy, the bar is not as high as that for a successful derivative suit against directors under state law. That means that if the plaintiffs of a state law derivative suit can establish the allegations in their complaint by clear and convincing evidence, the bankruptcy court *must* appoint a trustee. By the same token, if those parties cannot establish cause, the derivative action would not have been successful and should be dismissed without costing the

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312. 11 U.S.C.A. § 1104 (West Supp. 2007).

313. *See supra* Part III.B.3. A trustee can be appointed and decide to pursue derivative causes of action against insiders.

314. *E.g.*, *In re* Eichorn, 5 B.R. 755, 758 (Bankr. D. Mass. 1980); Schuster v. Dragone (*In re* Dragone), 266 B.R. 268, 271 (D. Conn. 2001).

315. *See supra* Part III.A.

316. *See supra* Part III.A.2.

estate additional resources. The DIP management should then be left alone to continue operating the debtor as it sees fit.

In the persons of an examiner and trustee, the Code has provided bankruptcy courts with the tools to discover whether there is a significant problem with the debtor's management, how severe that problem is, and what level of supervision or control would contain the problem so that the debtor's reorganization efforts are not compromised. While there is significant discretion left to bankruptcy courts in § 1104, both in deciding whether to appoint a trustee by allowing the court to decide that such an appointment is in the best interests of the debtor, and in allowing the court to tailor the remedy to the particular situation at hand, the Code has made clear what kinds of conduct *require* the appointment of a trustee and courts cannot ignore that mandate.[317] When confronted with managers whose conduct rises to the level of "cause" to appoint a trustee under § 1104, a court's analysis must begin with that section.

New subsection 1104(e) supports the idea that Congress wants all problems with DIP management to be addressed within § 1104 first, even before any party in interest is certain, by clear and convincing evidence, that cause could be established against the managers in question. The subsection provides:

> The United States trustee *shall move* for the appointment of a trustee under subsection (a) if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.[318]

The suspicions a UST would have to have in order to bring a motion for appointment of a trustee under this section mirror causes of action under the securities laws.[319] Actions brought by the SEC against the corporation or its management are not stayed any longer and the existence of a suit based on securities law may be reasonable grounds for a UST to suspect that the debtor's management has committed one of the misdeeds enumerated in subsection 1104(e). Rather than simply

317. *See* Dardarian v. La Sherene, Inc. (*In re* La Sherene, Inc.), 3 B.R. 169, 174 (Bankr. N.D. Ga. 1980) (Court must order the appointment of a trustee for cause, defined to include fraud, dishonesty, incompetency or gross mismanagement).

318. 11 U.S.C.A. 1104(e) (West Supp. 2007) (emphasis added).

319. *See* Levin & Ranney-Marinelli, *supra* note 12, at 618–19 (discussing fraud and deficient financial reporting).

allowing the suit to proceed, the Code forces the problem to be brought to the attention of the bankruptcy court within the context of the provisions of § 1104, so the court can determine whether cause exists to appoint a trustee.

When there may be severe mismanagement of the DIP, Congress has mandated that bankruptcy courts consider the issue with an eye toward the appointment of a trustee. The fact that the Code does not require that the trustee take over for the DIP completely allows bankruptcy courts to exercise the discretion necessary to keep the remedy from being burdensome to the estate. Litigants should, therefore, abandon their current reluctance to move for the appointment of a trustee. If, in spite of a securities cause of action pending, or reasonable grounds for a UST to suspect that the debtor's management has previously engaged in the conduct described in § 1104(e), the bankruptcy court does not find cause by clear and convincing evidence and does not believe that the appointment of a trustee would be in the best interests of the estate and its parties in interest, then it may leave the DIP in complete control of the debtor's estate. There is still no provision in the Code that would allow or encourage a bankruptcy court to depose a debtor's current managers or hold them liable for honest mistakes in judgment or incompetencies they have corrected. Further, bankruptcy would not be a safe haven for managers who are guilty of fiduciary breaches, as long as the trustee's remedy is utilized and enforced as provided in the Code. When there are serious problems that the Code and courts have identified that have injured or would impede the debtor's prospects for reorganization, then the court must consider the matter under the provisions of § 1104.

Section 1104 intentionally grants bankruptcy courts the ability to exercise broad discretion in order to move a step beyond the statutory language and use the common law to develop a consistent procedure. Bankruptcy courts should use their discretion to overcome the conventional wisdom regarding the appointment of trustees and use the remedy in a way that maximizes the value of corporate debtors. That means bankruptcy courts should require parties in interest to move for the appointment of a trustee before seeking to use state law mechanisms to address severe mismanagement of the debtor. Then, if a trustee is required by a showing of cause, the trustee can decide how best to proceed in light of a pending derivative action against the debtor's managers. The added protection of a trustee is necessary, even when a derivative suit against current management will proceed, so that the debtor does not continue to suffer under the leadership of corrupt or grossly incompetent managers. Under the suggested regime, corporate managers who are defendants in colorable derivative actions will not be able to protect themselves from derivative litigation by driving the corporation into bankruptcy because they risk losing their jobs or their control over the corporation if a trustee is appointed. Therefore, the appointment of a Chapter 11 trustee is a necessary remedy in the face of troubled DIP management, and is a remedy that should become routine under the correct guidance of the common law rather than remaining one that is regarded as a "chainsaw."

VI. CONCLUSION

There are sound reasons grounded in bankruptcy policy that state law derivative suits alleging breaches of fiduciary duty against a corporation's management are lost upon the filing of a bankruptcy petition by the corporation. The bankruptcy law has its own structure for addressing serious problems with a corporation's management that is less tolerant than state fiduciary duty law of corrupt or grossly incompetent management. Still, if a bankruptcy court determines it is in the best interests of the estate to do so, the Code provides several different methods by which a cause of action based on state fiduciary duty law could be pursued against current or former officers or directors of the debtor.

Regardless of the success or merit of a given state law derivative suit, or other accusations of wrongdoing against a debtor's management, the appropriate and *mandatory* way to address them under bankruptcy law is in § 1104. From a motion for the appointment of a trustee alleging cause or stating other reasons why a trustee may be in the best interests of the estate, a bankruptcy court has significant discretion to design the appropriate remedy and to choose an optimal course of action within the strictures of § 1104. Bankruptcy courts are free to develop a common law that will guide the application of § 1104, specifically, a common law that will better effect bankruptcy policy and goals than does state law. Once a corporation files for bankruptcy, different rules apply because the business is working toward different goals than when solvent. All policies and decisions must bear in mind the ultimate goal of offering the debtor protection from its creditors while allowing it to reorganize, thereby preserving its value as a going concern. While pursuing state law causes of action may further these goals in some instances, bankruptcy law has specifically identified its own mechanisms and priorities in addressing severe problems with a debtor's management. Because this bankruptcy framework is better suited to achieving bankruptcy's goals, it cannot be ignored in favor of a vestigial state law procedure. Bankruptcy courts should insist upon hearing a motion under

§ 1104 before resorting to state law corporate governance mechanisms when faced with severe problems with a debtor's current management.