Behavioral Effect of New Bankruptcy Law on Management and Lawyers: Collage of Recent Statutes and Cases Discouraging Chapter 11 Bankruptcy

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Prologue: My Remembrance of Dean Richard Atkinson As Somebody I Want To Be

Much more than most people, Dick Atkinson was a humanitarian—in general and in particular. He had only recently joined the Law School faculty at the University of Arkansas when I began teaching there in 1976. Dick was generously caring and kind to me from the start of our friendship. He never changed. He was the same through the last evening we shared together in Little Rock (along with former Arkansas and Emory Dean David Epstein and other friends) only weeks before Dick suddenly died.

I had graduated from law school in Arkansas, my native state, only a year or so before I returned there to join Dick on the faculty in Fayetteville. I spent the in-between time at Columbia getting further degrees of law and consanguinity. Now I was back home at Arkansas as a teacher among my teachers.

I was dumpy and wore a brown suit.

I was scared to death. The general rule assumed (and still persists) that only graduates of a very few law schools are truly qualified to teach law. A corollary of this rule is that the most

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unqualified people are graduates of any of the other law schools who return to teach where they were taught.

I was bound to fail.

Dick was sure to succeed and, in fact, was already enjoying success.

He was physically beautiful (and that, too, never changed). He was tall and athletic looking with great hair; and, throughout his entire adult life, his weight never noticeably varied from, I would guess, Apollo’s perfect weight.

In cooler weather, he often wore a sweater like a cape with the arms tied around his neck or waist, as in a magazine. He must have acquired the habit up North. Sweaters (especially with arms) were not common in Arkansas, and nobody at home wore a sweater like a cape except kids pretending to be Superman or Wonder Woman.

Dick was disarmingly warm and charming. Socially, he was as smooth as the finest silk, and he was very well credentialed and smart. He was a graduate of Yale Law School and personally very close to the other two young Yale graduates who had also recently joined the Arkansas faculty and later moved into the White House.

In 1976, when I became his friend and colleague, Dick instinctively encouraged and nurtured me. His always cheerful, very bright friendship helped melt my fear of failing and lighted a path that led to a great love of teaching and, equally important to Dick, genuine affection for my students.

I knew from the start: Dick was somebody I was not and wanted to be.

He saw everybody as someone he wanted to be his friend, even including dumpy, brown-clad me. It’s true. He genuinely embraced everybody—emotionally and often literally. He was a hugger of people and life, which he embraced like a saint loving the beauty of the world.

And it’s honestly true that he never said anything unflattering about anybody. In response to criticism of somebody, Dick would always smile and object with a smiling, singsong, “Well . . . ,” that lingered on a rising note and was followed by a full report of everything flattering about the would-be victim of the conversation.
To an extraordinary extent, and somewhat ironically, Dick deeply believed in—and taught—equality, fairness, and justice for all people and every person, even though law and society did not treat equally and fairly all preferences that were important to him. Around Dick, however, and because of him, even the most stubborn people—within and beyond the classroom—would surrender their prejudice and share the wisdom and kindness of common humanity that, much more than most people, Dick Atkinson felt, lived, and taught.

For this reason—then, now, and for the rest of my life—Dick Atkinson is somebody I want to be.
I. INTRODUCTION—THE FUTURE OF CHAPTER 11 AFFECTED BY BAPCPA, OTHER "NEW BANKRUPTCY LAW," AND HUMAN BEHAVIOR

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") substancially changed the Bankruptcy Code. Public attention has mainly focused on changes affecting consumer bankruptcy, but the BAPCPA focuses equally on business bankruptcy. Richard Levin has done the math and calculated that "over half of this 195-page law is devoted to business bankruptcy."2

The House Report, however, is very slim and undescriptive in explaining, under the heading "Purpose and Summary," the reasons for the changes affecting business bankruptcy, saying only that with "respect to business bankruptcy, [the law intends] to heighten administrative scrutiny and judicial oversight of small business bankruptcy cases [and] to reduce systemic risk in the financial marketplace . . . ."3 Presumably, the changes in business bankruptcy are also justified, to some extent, by the overarching goal of the law to "ensure that the system is fair [as defined by Congress] for both debtors and creditors."4

Fair seems to mean reducing the effectiveness of bankruptcy for debtors and thereby reducing the occurrence of bankruptcy. By this definition, the BAPCPA gives a greater portion of "fairness" to creditors. The new law narrows Chapter 7 for consumers by way of "means testing,"5 which is a statutory formula that essentially requires dismissing the case of any individual whose median income exceeds the state average.

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3. H.R. REP. NO. 109-31, pt.1, at 3 (2005). For the proposition that changes are needed to reduce systemic risk and that this law makes these changes, the House Report cites a letter from Federal Reserve Chairman Alan Greenspan. H.R. REP. NO. 109-31, at 2. This letter is not prominent in the public domain but is short and addresses a relatively tiny issue not involved in typical business bankruptcy cases. Letter from Alan Greenspan, Chairman, Federal Reserve Board, to Congressman F. James Sensenbrenner, Jr., Chairman, Committee on the Judiciary, House of Representatives (Sept. 3, 2002) (on file with author). The letter is a two-paragraph endorsement of the financial contract netting provisions included in the BAPCPA of 2002. Id.
Debtors whose cases are thereby dismissed can choose to convert to Chapter 13, but the BAPCPA makes Chapter 13 tougher for them, as well as for debtors who originally filed under Chapter 13. The likely results (and probably, too, the intended results) of the toughening of Chapter 13 are that fewer debtors will file Chapter 13 as an initial choice, and fewer debtors—both those debtors who originally file Chapter 13 and the debtors who file after their cases are dismissed under Chapter 7—will complete their plans.

The BAPCPA toughens Chapter 11, too, in the sense that the amended Bankruptcy Code (compared to the original Code) reduces the debtor’s rights, benefits, and advantages relative to creditors. The changes the BAPCPA makes in Chapter 11 cases are peppered throughout the BAPCPA and appear throughout the amended Bankruptcy Code. Each change, in itself, is not hugely significant. The collective combination of changes, however, is arguably serious with respect to favoring creditors and may reduce the occurrence of Chapter 11 cases.

The future of Chapter 11 bankruptcy is not solely dependent, however, on the substance and language of the new statutory law. The future also depends very significantly—

6. For example, the usual length of the plan is extended from three to five years, 11 U.S.C.A. § 1322(d) (West Supp. 2005); the percentage of future income that must be devoted to funding the plan is increased because of a new standardized, formularized calculation of disposable income, 11 U.S.C.A. § 1325(b) (West Supp. 2005); and the list of debts excepted from discharge is shortened, 11 U.S.C.A. § 1328(a) (West Supp. 2005).

7. For purposes of this article, the “original Bankruptcy Code” means the Code as of 2005 before the BAPCPA.


maybe even more substantially—on judicial interpretation of the new statute and other new developments in case law and related, non-bankruptcy statutes that, in combination with either the original or amended Bankruptcy Code, cause a change in the balance of rights and duties between debtor and creditors in bankruptcy. This article defines “new bankruptcy law” to include the BAPCPA, new developments in case law and other statutes affecting bankruptcy, and the combination of them with the original Bankruptcy Code.

A. Behavioral Effect Helps Determine Impact of New Law

Words of statutes and opinions of courts do not, by themselves, define the effects of the new bankruptcy law, including whether or not the new law reduces the occurrence of Chapter 11 bankruptcy. These effects are also driven by shifts in people’s perceptions and reactions with respect to bankruptcy caused by the different incentives and disincentives of the new law. These shifts in perceptions and reactions are, collectively, the behavioral effect of the new law.

Undoubtedly, the behavioral effect is largely defined by the substance of the new law, that is, the re-balancing of rights and advantages between debtor and creditors. Any change in the dollar cost of Chapter 11 is also an important, defining factor. Presumably, therefore, the behavioral effect of the new law will be to discourage debtors from filing Chapter 11 to the extent the new law makes Chapter 11 more expensive for them and tips the balance of substantive rights in favor of creditors. Simply put, and quite obviously in terms of simple economic analysis, increased dollar costs and decreased substantive benefits to debtors will tend to discourage them from filing Chapter 11.

The behavioral effect should not be predicted, however, only in terms of the rational actor model of traditional economic analysis. Modern legal scholarship has systematically begun to consider people’s actual behavior in analyzing legal rules, not just the supposed theoretical behavior of an economically rational, hypothetical person. This scholarship is based

fundamentally on "behavioral biology" that already has "focused on a wide variety of discrete individual legal features, such as environmental issues, the sense of justice, sex differences, privacy, apology, cooperation, memetics, child abuse, morality and norms, emotions, sexual aggression, and the irrational behaviors of interest to scholars of law and behavioral economics."10 Despite the relative newness of this field, generally and as applied to law, "behavioral economics"11 has, in turn, already been extensively applied to corporate law12 and


11. One commentator notes:

Behavioral economics is really the application of methods from other social sciences—particularly psychology—to economics. . . . The study of prices, quantities, and economic organization does not completely succeed if conducted only from the paradigm of rational optimization. . . . The discovery of behavioral economics in the past decade or two is really a return to reality from an untenable position that the rational optimizing model is the only framework for economics.

Robert J. Shiller, Behavioral Economics and Institutional Innovation, 72 S. ECON. J. 269, 269-71 (2005). It recognizes that "individual behavior tends to deviate from the norms established by conventional economic theory" and that "individuals tend to be systematically error prone and possibly irrational," and so the field "raises key questions about the importance of empirically based behavioral assumptions in constructing economic theory, whether the behavior of economic agents is typically rational, whether the context or frame within which individual behavior takes place is an important determinant of human action, and whether the context or frame affects the predictions of economic theory." Morris Altman, The Nobel Prize in Behavioral and Experimental Economics: A Contextual and Critical Appraisal of the Contributions of Daniel Kahneman and Vernon Smith, 16 REV. POL. ECON. 3, 4, 6 (2004); see also Morris Altman, Behavioral Economics, Power, Rational Inefficiencies, Fuzzy Sets, and Public Policy, 39 J. ECON. ISSUES 683 (2005); Jessica L. Cohen & William T. Dickens, A Foundation for Behavioral Economics, 92 AM. ECON. REV. 335 (2002); Herbert A. Simon, Theories of Decision-Making in Economics and Behavioral Science, 49 AM. ECON. REV. 253 (1959); Sharla A. Stewart, Can Behavioral Economics Save Us from Ourselves?, 97 U. CHI. MAG., Feb. 2005, available at http://magazine.uchicago.edu/0502/features/economics.shtml.

aspects of bankruptcy, including the implications for management making decisions for insolvent firms, and is best viewed as supplementing traditional economic analysis rather than displacing it.


14. “Notwithstanding on-going debates, there is a growing willingness to accept the psychologists’ empirical claims seriously and ‘behavioral economics’ has become an accepted sub-discipline within economics.” Licht, supra note 12, at 181.

Years ago, I participated in a symposium at Virginia that focused on the economic debate about the puzzle of secured debt. To advance this debate, and the larger problem of bridging the extreme edges of efficiency and fairness in debtor-creditor law, I urged some common language—a multivalent analysis of law—that would accommodate and blend apparently opposing stories. As a follow-up, two colleagues and I suggested “fuzzifying” the analysis by incorporating fuzzy logic to recognize how the law interrelates and compromises competing interests. Edward S. Adams, Steve H. Nickles, & Thomas Harju Ressler, Wedding Carlson and Schwartz: Understanding Secured Credit as a Fuzzy System, 80 VA. L. REV. 2233 (1994).

In a similar way, economic analysis should accommodate irrational behavior (that is, behavior not guided by the single motivation of maximizing utility) predicted by prospect and other theory to better understand decision-making and better predict individual conduct. Proper analysis does not require a choice between drivers of human behavior but a fuzzy mix of them. For an intriguing model that accommodates the standard economic model that assumes humans will respond rationally to changes in incentives as well as important findings about irrationality from the field of cognitive psychology (and its cognates variously known as behavioral economics and behavioral decision theory), see Owen D. Jones, Time-Shifted Rationality and the Law of Law’s Leverage: Behavioral Economics Meets Behavioral Biology, 95 NW. U. L. REV. 1141 (2001). Some theorists critically argue, however, against an accommodation and for “retiring” the rational actor model even as modified by economic behavioralism. See generally, e.g., Jon Hanson & David Yosifon, The Situational Character: A Critical Realist Perspective on the Human Animal, 93 GEO. L.J. 1 (2004).
This article also focuses on the decision-making behavior of directors and officers but without any pretense of fitting within the formal, systematic framework of behavioral economics. Instead, this article, against a faint background of a few basic assumptions of cognitive and behavioral psychology, proceeds informally and with a modest purpose: to survey some aspects of new bankruptcy law that may influence the behavior of management, within the frame or context of Chapter 11 bankruptcy, so as to cause management to act for themselves and their personal interests rather than for the firm and its interests.

B. Behavioral Effect on Firms Determines How the New Law Affects Management and Lawyers

An assumption throughout this article is that the behavioral effect of the new bankruptcy law will not be limited to a rationally or otherwise determined calculation of the costs and benefits to the firm. The behavioral effect of the new law on Chapter 11 bankruptcy will also be defined by how directors and managing officers (whom this article refers to collectively as “managers” or “management”) are personally affected by the new law and how they perceive the new law can personally affect them. The basis for this assumption is a very simple, four-step reasoning framework:

1. Management decides whether or not the firm files bankruptcy;16

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15. Readers are warned that the helpfulness of relying on broad, generalized principles of behavioral psychology is debatable and is debated. Compare Gregory Mitchell, Tendencies Versus Boundaries: Levels of Generality in Behavioral Law and Economics, 56 Vand. L. Rev. 1781 (2003), with Robert A. Prentice, Chicago Man, K-T Man, and the Future of Behavioral Law and Economics, 56 Vand. L. Rev. 1663 (2003). So, any value in this article is perhaps the core text—between the beginning and the end—which is straightforward analysis of new statutes and cases, which may have some small worth in itself.

16. This decision is often orchestrated by major creditors who are in a position to both dictate substantial changes in top management and affect these changes, that lead to bankruptcy, without leaving footprints. As several experts explain:

creditors may get control of the debtor by forcing a change of management. Indeed, in a great many public-company chapter 11s (including some of the most notorious), this is exactly what happens: Creditors force out the old management before the chapter 11 begins, and so the nominal [debtor in
2. This decision, though made for and on behalf of the firm, is affected in part by management's own personal self-interests;

3. These self-interests tend to diverge from the firm’s interests and more acutely diverge when the firm is financially distressed.

possession ("DIP") is someone in whom creditors have faith, sent in to clean up the mess that others left behind.

John D. Ayer et al., Bad Words to a Debtor's Ear, 24 AM. BANKR. INST. J. 20 (Mar. 2005) [hereinafter Ayer et al., Bad Words]. These creditors must be careful to cover their tracks because of the risk that they could later be found to be controlling parties who therefore assume fiduciary duties themselves and become accountable to the firm and its creditors. See infra note 140.

17. In other words, the incentives of those controlling the firm are not perfectly aligned with the interests of those who own the firm (the shareholders), who for various reasons cannot ensure perfect alignment and may not even know the full extent of the divergence. Melvin Aron Eisenberg, The Structure of Corporation Law, 89 COLUM. L. REV. 1461, 1471-74 (1989). This divergence results in the familiar notion of "agency costs," which is a subject long and widely studied by economists and legal scholars. Indeed, the very root of modern theories of the firm—and a principal focus of corporate governance—is the agency problem that results from the separation of ownership and control of the firm, considering that managers act to maximize their own utility rather than to maximize corporate wealth. See generally Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 AM. ECON. REV. 777 (1972); Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976); Eric W. Orts, Shirking and Sharking: A Legal Theory of the Firm, 16 YALE L. & POLICY REV. 265 (1998) (arguing that the standard economic accounts of the firm are inadequate absent legal theory that explains the importance of legal relationships). For an extensive survey of the literature, see Andrei Shleifer & Robert W. Vishny, A Survey of Corporate Governance, 52 J. FIN. 737 (1997).

Especially costly is opportunism, which means,

The central decision maker . . . divert[s] organizational resources to its own benefit rather than the good of the organization and its constituents.

In the corporate setting, the potential for opportunism arises because of the very separation of ownership and control that makes the corporate form feasible. When the directors hire equity capital from shareholders, the directors undertake a contractual obligation to maximize the value of the shareholders’ residual claim on the corporation’s assets. . . . Because shareholders exercise so little direct control over the board of directors, however, shareholders have minimal ability to prevent directors from appropriating corporate assets that should have gone into the residue against which the shareholders have their claim.

Director opportunism is not limited to instances of intentional self-dealing. Instead, it can extend to such other forms of "shirking" as negligence, oversight, incapacity, and even honest mistakes.

18. It is generally accepted that in directing the debtor-in-possession during bankruptcy, management is influenced by its own self-interest because managers are interested in their own salaries and benefits and in preserving the company to save their jobs. See Martin J. Bienenstock, Bankruptcy Reorganization 66 (1987) ("To whatever extent management . . . may be motivated to put its survival ahead of shareholder interests, bankruptcy exacerbates . . . that motivation.").

Admittedly, there are good reasons for leaving management at the helm, including its familiarity with the business and the cost of replacing it with a trustee. But . . . one result of leaving management in place is to create an expectation on the part of stockholders that management will negotiate on their behalf, even though bankruptcy is precisely the time when the ills commonly attributed to the separation of corporate ownership from control—managerial unaccountability and self-interest—are likely to be most exacerbated. When the company is in Chapter 11, the zeal with which management advocates on behalf of stockholders is likely to be tempered by the desire of managers to keep their jobs, to elicit the support of creditors, and to maintain trade and bank credit.


Even in deciding where to file bankruptcy, managers forum shop and "will generally select a jurisdiction that promotes their self-interest, which is frequently to preserve their positions within the firm . . . ." Robert K. Rasmussen & Randall S. Thomas, Timing Matters: Promoting Forum Shopping by Insolvent Corporations, 94 NW. U. L. Rev. 1357, 1368 (2000).

The natural extension of self-interest working in these ways is that management will also act out of self-interest in deciding, as an initial matter, whether or not to take the firm into Chapter 11 bankruptcy. See Douglas G. Baird, The Initiation Problem in Bankruptcy, 11 Int'l Rev. L. & Econ. 223, 230 (1991) ("At the time that the bankruptcy petition needs to be filed, the managers are likely to see a bankruptcy proceeding as the only way in which they can keep their jobs, at least for a time. Managers act out of self-interest when they file bankruptcy . . . ."); Lawrence Ponoroff, Enlarging the Bargaining Table: Some Implications of the Corporate Stakeholder Model for Federal Bankruptcy Proceedings, 23 Cap. U. L. Rev. 441, 484 (1994) ("In companies where there is a separation of ownership and management, the self-interested incentive of management in voluntary cases may not alone be adequate to ensure filing at the most propitious time."); Prentice, Behavioral Observations, supra note 12, at 1426 n.132 ("The traditional economic assumption is that managers' interests are aligned with those of corporate owners, but this ceases to be the case in a "final period" scenario when managers fear that they are about to lose their jobs and will not be able to secure comparable jobs in the labor market."); Ramesh K.S. Rao et al., Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a
4. Faced with the possibility of bankruptcy, and framing the situation as involving likely loss to the firm as well as to themselves, management will increasingly act to avert the loss (and thus Chapter 11) as the likelihood of loss—including the occurrence and size of loss—increases.

The first three steps are based on fairly standard, widely-believed assumptions of agency theory. The assumptions of the last step are perhaps less known but are based on thinking from behavioral and cognitive psychology that are not new to legal analysis. The fourth step works in a compounding or, perhaps, independent way. Partly behind the assumptions of this step is prospect theory,¹⁹ which is a basic descriptive model of decision-making. Prospect theory claims that individuals act according to felt or perceived gains and losses, and they become acutely loss averse in making decisions perceived as reducing loss rather than maximizing gains. Thus, in a loss situation, individuals will reject conduct that leads to certain loss in favor of conduct that could lead to lesser or greater loss. They will “bet the farm” in the hope of reducing loss to it.

Especially because of the new bankruptcy law, filing Chapter 11 bankruptcy implies potential or certain loss for the firm and management. A worse outcome is possible by not taking advantage of bankruptcy, but a better outcome is possible, too. Prospect theory suggests that the manager will act to avoid Chapter 11 in an effort to prevent or reduce loss, and this article assumes that the aversion is even greater when the manager attempts to avoid loss to the company and management itself.

How the manager perceives or frames the situation is critical. Presumably, the increased personal risks to management under the new bankruptcy law will help create a perception of loss and therefore an aversion to Chapter 11. This tendency is reinforced by separate cognitive forces, involving

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¹⁹ This assumption is based on extrapolating basic principles of “prospect theory.” See infra notes 435-39 and accompanying text.
cognitive biases and ego-involvement, that can lead management to believe that avoiding the certain loss of Chapter 11 is the better course.

Another assumption of this article is that, in making the decision whether or not to file Chapter 11, management is also influenced to some extent by the advice of the attorneys for the debtor firm. They are the lawyers or counsel to whom this article refers unless otherwise specified explicitly or by the context. These lawyers, too, have self-interests that can be affected by the debtor’s bankruptcy and that can affect the advice the lawyers give management about taking the firm into bankruptcy. Thus, the behavioral effect of the new law is also partly defined, though in smaller part, by the actual or perceived personal effects of the debtor’s bankruptcy on the debtor’s lawyers.20

C. Preview of New Law That May Affect Behavior of Management and Lawyers in Deciding Whether or Not to File Chapter 11

This article focuses on selected pieces of the new bankruptcy law21—as broadly defined for this article—that may adversely affect the self-interests of management and counsel if the firm files Chapter 11 and may thereby influence them not to file. None of these pieces is likely, by itself, to have such a general behavioral effect. The effect, if any, comes from the combination of pieces knitted together into a coincidental network of changes that, to some extent, work together to compound their adverse effect on the personal self-interests of management and the debtor’s lawyers.

Following this Part I introduction, Part II of this article considers new bankruptcy law that affects management

20. In this article, any reference to lawyer or counsel means lawyers for the firm and, if the firm files bankruptcy, lawyers for the corporate debtor.

21. This preview is incomplete. There are more pieces of the new bankruptcy law with possible behavioral effects. Some of these other pieces are covered in the main text of this article as incidental or connected to the pieces previewed here. Other new laws and risks are beyond the intended scope of this article or beyond the imagination of the author. The reason for saying so now is to emphasize a very important notion: the behavioral effect of the new bankruptcy law is not in the individual significance of each change in the law but in the number and accumulation of the changes that are larger than this article can describe.
compensation by focusing on two little changes in the Bankruptcy Code that can adversely affect management’s income if the firm files Chapter 11. An entirely new provision, § 503(c), limits the payment in bankruptcy of retention bonuses and severance pay to insiders.22 A change in § 548(a) targets pre-bankruptcy compensation of insiders by explicitly subjecting such compensation to avoidance as a fraudulent transfer.23 New cases questioning the ordinariness and reasonableness of executive compensation under the old language of § 548 add force to this avoiding power in both its original and amended forms.

Part III collects pieces of new bankruptcy law that increase the risk of liability for a firm’s management for breach of fiduciary duties. New case law developments make it procedurally easier to sue management in bankruptcy for breach of fiduciary duties to the firm24 and perhaps widen the substantive scope of this liability both in terms of the size of fiduciary duties and the range of beneficiaries.25 Related is more new case law making it harder to “discharge” or otherwise insulate management from this and other liability by way of a third-party release in the firm’s Chapter 11 plan.26

Compounding the significance of these case law developments is another change in the Bankruptcy Code itself: the increased opportunity, under the amended statute, for the appointment of a Chapter 11 trustee.27 A trustee would take control of the bankruptcy away from management and, presumably, scrutinize more closely (in search of liability) the conduct of management. Also, new developments strengthen the role of committees in Chapter 11 cases and clarify when a creditors’ committee, whether or not a trustee is appointed, can pursue management and other insiders for breaching fiduciary duties.28 Standing room remains, too, for creditors acting for themselves to bring related actions against management.29

22. See infra notes 35-57 and accompanying text.
23. See infra notes 58-138 and accompanying text.
24. See infra notes 145-60 and accompanying text.
25. See infra notes 161-94 and accompanying text.
26. See infra notes 195-204 and accompanying text.
27. See infra notes 205-16 and accompanying text.
28. See infra notes 217-43 and accompanying text.
29. See infra notes 244-48 and accompanying text.
Part IV of this article reviews how an increase in the possibility of management liability carries with it an increase in the possibility that the firm’s counsel could be liable. This lawyer represents the firm but, practically speaking, works for management. The lawyer is directly accountable to the firm for putting management’s interests ahead of the firm’s interests. Additionally, when management’s fiduciary duties extend to creditors and other parties (as happens when a firm approaches insolvency), the chances increase that the firm’s counsel will be sued for breaching duties that the lawyer owes directly to these other parties or for aiding and abetting management’s breach of duties to them. An increased risk of personal liability for management, or firm counsel if the firm files bankruptcy, means an increased risk of personal bankruptcy and a corresponding dilution of personal wealth.

Finally, therefore, Part V of this article considers pieces of the new bankruptcy law that dilute personal bankruptcy protection for management and lawyers who themselves file bankruptcy. The new bankruptcy law (along with provisions of the original Bankruptcy Code) leaves post-petition wealth virtually unprotected against liability for breaching fiduciary duties. The new law also adds additional means for invading prepetition wealth, including limits on exemptions and another little provision of the BAPCPA, § 548(e), which allows the trustee to avoid domestic asset protection trusts. An even greater risk to management’s and lawyers’ personal wealth is the firm’s Chapter 11 estate using traditional avoiding powers to trace and recover property, in specie, transferred to the individuals in the form of excessive prepetition compensation or in connection with their breach of fiduciary duties to the firm.

Alone and at face value, each of the many pieces of the new bankruptcy law this article discusses seems small and insignificant. Taken together, however, their effects may be to increase the personal risks to officers and directors (and, indirectly, the personal risks to the debtor’s counsel). Thereby, for behavioral reasons that Part VI summarizes, management

30. See infra notes 249-313 and accompanying text.
31. See infra notes 320-34 and accompanying text.
32. See infra notes 335-89 and accompanying text.
33. See infra notes 346-52 and accompanying text.
(and counsel), fearful for both the firm and their own interests, may be discouraged from taking a firm into bankruptcy.\(^{34}\)

In turn, this reluctance will contribute to defining the behavioral effect—and thus the overall effect—of the BAPCPA on Chapter 11 bankruptcy. In sum, these changes in statutory and case law, by working to discourage firms from filing Chapter 11, could contribute to reducing the occurrence of Chapter 11 bankruptcy. For this reason, these little things, because of their possible effect on the behavior of management and lawyers caused by increased risks to personal wealth and liability, become a little more important, especially when considered in combination. As a collage, the total number of separate risks is large and covers a fairly wide range of conduct. More important, the different reasons for liability work together so as to compound the likelihood and consequences of exposure.

II. DECREASING MANAGEMENT'S COMPENSATION

A. Eliminating Post-Petition Payment of Employee Retention Contracts and Other Employment Benefits—Section 503(c)

Just days before Enron filed bankruptcy in December 2001, the company reportedly approved bonuses to some employees ranging from $1000 to $5 million, with a total of more than $100 million, for the stated purpose of inducing the employees to stay with the company during bankruptcy, though they were required

34. The idea is not new that management will avoid taking a firm into Chapter 11 because of their concern about the risks to personal interests of the kinds this article discusses. For example, Professor Mechele Dickerson recently wrote:

Managers have no incentive to file an early bankruptcy petition because they know that, in most instances, they will be replaced or forced to resign and any ownership interests they have in the firm will become virtually worthless. Moreover, if they know they have violated criminal laws, they will have an incentive to delay filing hoping to delay or prevent prosecution. Similarly, if they are in the process of misappropriating funds or are attempting to sell their interest in the business before filing, they have an incentive to delay to make sure they can reap inappropriate financial benefits from the firm before turning it over to creditors in bankruptcy.

A. Mechele Dickerson, The Many Faces of Chapter 11: A Reply to Professor Baird, 12 AM. BANKR. INST. L. REV. 109, 133 (2004) (footnotes omitted). This article highlights the increased risks of the new bankruptcy law and offers some further support, based on behavioral psychology, as to why these risks will deter management from filing Chapter 11. See generally id.
to stay only ninety days. These kinds of bonuses, or promises of them, are not unusual. "In large Chapter 11 bankruptcy cases it is fairly common for senior management to be provided monetary incentives to remain under a program often referred to as "key employee retention program"." ("KERP"). In fact, KERPs are becoming the norm in bankruptcies both big and small.

These "creative bonus and other incentive programs" give employees "the opportunity to earn compensation beyond their base salaries." The ostensible purposes are "to minimize turnover, attract competent new employees and motivate key employees to work diligently and productively to maximize enterprise value and to achieve a successful reorganization." In actuality, however, say practitioners, these programs enable "debtors to allocate scarce resources to insiders at the expense of other creditors." This allows a "bankrupt company to provide significant compensation to the same officers and other executives who caused the company's financial demise." New § 503(c) severely limits key employee retention programs and severance plans. In bankruptcy, no KERP benefit can be "allowed" or "paid" to an insider, which includes


39. Id.
40. Id.
41. Id.
42. 11 U.S.C.A. § 503(c) (West Supp. 2005).
management, unless the bankruptcy court finds evidence in the record that: (1) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation, and (2) the services provided by the person are essential to the survival of the business.\(^43\) Even then, § 503 caps the amount of a KERP benefit that can be allowed and paid to any individual.\(^44\)

In other words, not only are KERP payments capped, nothing—not a cent—is allowable under a key employee retention program, and nothing—not a cent—is payable under such a program to a key management employee unless the debtor shows that the employee: (1) has another offer, (2) will accept the other offer absent a KERP benefit, and (3) is “essential” to the debtor’s “survival.” Ken Klee, who is a well-known Chapter 11 debtor’s lawyer and UCLA professor, concludes that because of these requirements, § 503(c) “will for all intents and purposes eliminate a company’s ability to receive court approval for a KERP.”\(^45\)

It gets worse for management who are expecting to be paid other employment benefits as part of the firm’s bankruptcy. Section 503 also forbids making any severance payment to an insider unless “the payment is part of a program that is generally applicable to all full-time employees . . . .”\(^46\) Additionally, a catch-all provision outlaws all “other transfers or obligations

\(^{44}\) The cap is:

(i) . . . an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or

(ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred . . . .

\(^{45}\) Klee, supra note 8, at 18.

\(^{46}\) 11 U.S.C.A. § 503(c)(2)(A). Even if this requirement is satisfied, a severance payment is limited to an amount “not greater than 10 times the amount of the mean severance pay given to nonmanagement employees . . . .” 11 U.S.C.A. § 503(c)(2)(B).
that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition."\textsuperscript{47}

Practitioners have said these restrictions on payment of employee benefits by a firm in bankruptcy "create disincentives for current management of a troubled or financially distressed company to remain, particularly where such individuals could work for non-financially distressed companies without [such] restrictions . . . .\textsuperscript{48} Also, especially if individuals cannot find other work because their company has become financially distressed or for other reasons prefer to stay where they are, these restrictions create disincentives to take the firm into Chapter 11.

Despite its wide scope, which includes KERP and severance payments and all other transfers or obligations to insiders out of the ordinary course of business, \textsection{503} only applies to payments that would be made during the bankruptcy case.\textsuperscript{49} It does not cover bonuses and other employee benefits paid to insiders before bankruptcy. These kinds of transfers are nevertheless vulnerable to the trustee’s avoiding powers, such as §§ 544(b),\textsuperscript{50} 547,\textsuperscript{51} and 548,\textsuperscript{52} which the BAPCPA amended to deal explicitly with employment benefits paid to insiders before the firm files bankruptcy.\textsuperscript{53}

Bankruptcy lawyers are well aware of these avoiding powers but still recommend that if a company is planning to file Chapter 11, KERP and like payments should be paid before bankruptcy.\textsuperscript{54} "Doing so may prevent the need to obtain bankruptcy court approval . . . under the strict standards imposed by \textsection{503} and place the burden on other parties to affirmatively

\begin{footnotes}
\textsuperscript{47} 11 U.S.C.A. \textsection{503}(c)(3).
\textsuperscript{48} McGowen, supra note 36, at 5.
\textsuperscript{49} See 11 U.S.C.A. \textsection{503}(c).
\textsuperscript{50} 11 U.S.C. \textsection{544}(b) (2000) (naming or deeming trustee as successor to creditors under state law).
\textsuperscript{53} See infra notes 58-138 and accompanying text.
\textsuperscript{54} Kaplan, supra note 37, at 6.
\end{footnotes}
seek to avoid [the] pre-bankruptcy payments made to executives . . . .”\textsuperscript{55} Also, the lawyers are aware that the chances of the trustee recovering payments made prepetition under the avoiding powers are probably less than the chances of getting court approval of post-petition payments under § 503.\textsuperscript{56} On the other hand, paying employee benefits before bankruptcy in order to avoid the scrutiny of bankruptcy can, in itself, increase the chances of avoidance.\textsuperscript{57}

B. Targeting Salary and Other Employment Benefits Paid to Insiders Before Bankruptcy—Avoiding Powers and the New § 548(a)—\textit{In re D.C.T., Inc.} and \textit{In re Enron Corp.}

Property of the bankruptcy estate ordinarily includes only property that the debtor owns at the time bankruptcy is filed.\textsuperscript{58} Generally, therefore, property the debtor transferred before filing is beyond the reach of the bankruptcy. The transferees can safely keep the property.

Important, exceptional rules, known as the trustee’s avoiding powers, permit the trustee or the debtor in possession in a Chapter 11 case to recover some transfers of property, and reverse some obligations, the debtor made before bankruptcy. Most important are the trustee’s powers to avoid preferences under § 547\textsuperscript{59} and fraudulent transfers or obligations using either § 548\textsuperscript{60} or § 544(b)\textsuperscript{61} (which effectively incorporates state fraudulent transfer law\textsuperscript{62}).

For recovering salary and other benefits paid to employees before the firm filed bankruptcy, § 548 has seemingly been the trustee’s favorite weapon. Section 548 has always allowed the trustee to avoid both transfers of property made and obligations incurred with actual intent to hinder, delay, or defraud creditors.\textsuperscript{63} Alternatively, transfers or obligations have always

\textsuperscript{55} Id.
\textsuperscript{56} Id.
\textsuperscript{57} See infra notes 105-28 and accompanying text.
\textsuperscript{59} 11 U.S.C.A. § 547.
\textsuperscript{60} 11 U.S.C.A. § 548.
\textsuperscript{61} 11 U.S.C. § 544(b).
been avoidable without proof of actual fraud if the trustee can prove constructive fraud.\textsuperscript{64} Constructive fraud requires proving that the debtor: (1) made the transfer or incurred the obligation, (2) in exchange for less than reasonably equivalent value, and (3) under certain (alternative) circumstances,\textsuperscript{65} including that the debtor was insolvent at the time the transfer was made or the obligation was incurred or was rendered insolvent because of the transfer or obligation. An additional requirement for either actual or constructive fraud is that the transfer was made or obligation incurred within a limited "reach-back" period before bankruptcy.\textsuperscript{66} The BAPCPA extended this reach-back period from one year to two years.\textsuperscript{67}

The BAPCPA also added new language to § 548 that explicitly targets compensation or other employment benefits paid or otherwise transferred to an insider within the newly-extended two-year reach-back period.\textsuperscript{68} This means that benefits are avoidable and recoverable in the event of actual fraud or a new brand of constructive fraud. In the former case involving actual fraud, under § 548(a)(1)(A), the usual requirement applies—actual intent to hinder, delay, or defraud.\textsuperscript{69} In the latter case involving constructive fraud, under § 548(a)(1)(B), actual intent is irrelevant and the requirements are: (1) a transfer to or for the benefit of an insider, (2) for less than reasonably equivalent value, (3) under an employment contract, and (4) not in the ordinary course of business.\textsuperscript{70}

\textsuperscript{64} 11 U.S.C.A. § 548(a)(1)(B).
\textsuperscript{66} 11 U.S.C.A. § 548(a)(1).
\textsuperscript{67} 11 U.S.C.A. § 548(a)(1).
\textsuperscript{69} The statute states:
The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . . made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted . . .
\textsuperscript{70} 11 U.S.C.A. § 548(a)(1)(A) (emphasis added).
\textsuperscript{70} This section states:
The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the
Section 548 has always empowered the trustee to avoid compensation or other employment benefits paid to an insider or anybody else in the event of actual fraud.\textsuperscript{71} Also, before and after BAPCPA, the trustee can avoid such a transfer as constructively fraudulent, whether in or out of the ordinary course of business, if the debtor received less than reasonably equivalent value and was insolvent when the transfer was made or became insolvent as a result of the transfer.\textsuperscript{72}

The new language that BAPCPA added to § 548(a)(1)(B) creates the possibility of avoidance, even if the transfer was made when the debtor was solvent, if the transfer was out of the ordinary course of business.\textsuperscript{73} Section 548 does not define "ordinary course of business."\textsuperscript{74} For other purposes, however, some courts have used a two-step "horizontal and vertical test."\textsuperscript{75} This test considers the reasonableness of the transaction from an industry-wide perspective and from the viewpoint of a creditor: "The inquiry deemed horizontal is whether, from an industry-wide perspective, the transaction is of the sort commonly undertaken by companies in that industry. The inquiry deemed vertical (more appropriately characterized as the creditor’s expectation test) analyzes the transactions from the vantage point of a hypothetical creditor and [the inquiry is] whether the transaction subjects a creditor to economic risk of a nature different from those he accepted when he decided to extend credit."\textsuperscript{76}

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\textsuperscript{75} See generally 11 U.S.C.A. § 548.

\textsuperscript{76} In re Crystal Apparel, Inc., 207 B.R. 406, 409 (S.D.N.Y. 1997).

\textsuperscript{76} Id. (quoting In re Roth, 975 F.2d 949, 953 (3d Cir. 1992) (quoting In re Johns-Manville Corp., 60 B.R. 612, 616 (Bankr. S.D.N.Y. 1986))).
This two-step test may also be explained as judging ordinariness in both subjective and objective terms. In any event, such multidimensional tests, however explained, are naturally harder to satisfy than a test that is met if the debtor’s conduct matches either the debtor’s history or industry practice.  

An even more threatening view of ordinary course, with respect to prepetition retention payments and the like, was expressed in the recent case In re D.C.T., Inc. In that case, the trustee sued to avoid certain payments that the corporate debtor had paid to its chief financial officer (“CFO”) before the company filed bankruptcy. The payments were made pursuant to a “Key Employee Retention Program and Agreement” that promised the CFO $85,000 if he stayed with the company through a restructuring period or sale of the business. The trustee argued that the payments were avoidable as preferences under § 547 and as fraudulent conveyances under state law that the trustee could assert through § 544.  

An exception to state fraudulent transfer law would have protected the payments if they had been made in the ordinary course of business. The CFO argued that the retention agreement was made in the ordinary course because it was negotiated in a typical arms-length transaction. The court quickly and flatly disagreed: “this argument does nothing to establish that the payments were in the ordinary course of business between the debtor” and the CFO because the “retention payments were, by their very nature, unusual and out

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77. Proving this point is a change the BAPCPA made in § 547, which provides for avoiding prepetition preferences. 11 U.S.C.A. § 547(b). Subsection 547(c), which lists exceptions to avoidable preferences, was amended to except from avoidance a debt payment made by the debtor in the ordinary course of business upon a showing that the transfer was made “in the ordinary course of business or financial affairs of the debtor and the transferee” or, alternatively, “according to ordinary business terms” in the industry. 11 U.S.C.A. § 547(c)(2). Before the change, the exception applied only if the transfer was in the ordinary course for the debtor and in line with industry practice.

79. Id. at 237.
80. Id.
81. 11 U.S.C.A. § 547(b).
84. Id.
of the ordinary.”

Why were these payments by their very nature unnatural? According to the court, because they “were made in connection with the termination of the debtor’s operations.”

However ordinary course is defined for purposes of the new language that the BAPCPA added to § 548(a)(1)(B), a trustee cannot avoid and recover prepetition payments of compensation and other employee benefits to management unless the debtor received “less than a reasonably equivalent value in exchange” for the payments. Also, the meaning of ordinary course becomes irrelevant if the debtor was insolvent when the challenged transfer was made or obligation incurred (or rendered so because of the transfer or obligation). In this event, the insolvency itself, coupled with the lack of reasonably equivalent value, spells constructive fraud without separate, independent proof that the transfer or obligation was not in the ordinary course of business. However, both older and brand new cases suggest that the issue of reasonably equivalent value considers, in part, whether or not the transfer was in the ordinary course of business.

Typically, when compensation the debtor had paid to management is challenged as fraudulent, the debtor has generally received services in exchange for its payments. Section 548 defines “value,” and the definition does not


86. In re D.C.T., 295 B.R. at 239.


explicitly include services. The courts agree, however, that for purposes of § 548, value includes services.

The real issue is whether or not the services were reasonably equivalent to, or reasonably worth, what the debtor paid for them. The Bankruptcy Code does not define "reasonably equivalent." The courts generally agree, however, that reasonable equivalence implies a fair economic exchange without requiring a penny-for-penny exchange and measures—usually in terms of market value when the transfer was made—what the debtor obtained rather than what the transferee gave up, though all of the direct and indirect benefits received by the debtor are counted.

The easier cases involve bonuses and the like paid to employees without any consideration or any other recognizable benefit to the debtor. Essentially, the payment was a gift and

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89. For purposes of § 548, "value" means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor.” 11 U.S.C.A. § 548(d)(2)(A).

90. 2 Epstein, Nickles, & White, supra note 62, at § 6-49, at 23; see also In re Financial Federated Title & Trust, Inc., 309 F.3d 1325, 1332 (11th Cir. 2002).

91. 2 Epstein, Nickles, & White, supra note 62, at § 6-49, at 32.

92. Id. at § 6-49, at 33-35. "When evaluating a transfer for reasonable equivalency of value as compared to a money payment, a court must examine the whole transaction and measure all the benefits—whether they be direct or indirect.” In re Southern Health Care of Ark., Inc., 309 B.R. 314, 319 (B.A.P. 8th Cir. 2004).


A related but different question is the meaning of "exchange," that is, whether exchange requires that the transfer be the quid pro quo for the value the debtor received. There is case law suggesting that an exchange, for purposes of deciding reasonably equivalent value, means quid pro quo. See, e.g., In re Young, 82 F.3d 1407, 1415 (8th Cir. 1996), vacated on other grounds sub nom., Christians v. Crystal Evangelical Free Church, 521 U.S. 1114 (1997); see also In re Congrove, No. 04-8049, 2005 WL 2098956, at *4 (B.A.P. 6th Cir. Aug. 31, 2005); In re Southern Health Care of Ark., 309 B.R. at 319-20; In re Richards & Conover Steel, Co., 267 B.R. 602, 612 (B.A.P. 8th Cir. 2001); In re Lindell, 334 B.R. 249, 254 (Bankr. D. Minn. 2005); In re Sun Valley Prods., Inc., 328 B.R. 147, 156 (Bankr. D.N.D. 2005); In re Fox Bean Co., 287 B.R. 270, 281-82 (Bankr. D. Idaho 2002); In re Churchill Mortgage Inv. Corp., 256 B.R. 664, 679 (Bankr. S.D.N.Y. 2000); In re Gomes, 219 B.R. 286, 293 (Bankr. D. Or. 1998); In re Gailey, Inc., 119 B.R. 504, 513.
not part of a negotiated compensation package. In these cases, the debtor received no recognizable value, and the payments are recoverable as constructively fraudulent if the other requirements of constructive fraud are satisfied. 94 Gifts are nice, and may create psychic benefit, but warm and fuzzy feelings are not counted as value for purposes of fraudulent transfer law. 95

The harder cases involve bonuses, salary, or other employee benefit payments that were part of a compensation package or otherwise benefited the debtor. The payments are challenged not for lack of any value but rather as being excessive. Undoubtedly, the “quality of professional services [i.e., whether the services were reasonably worth what the debtor paid for them] is within the scope of a fraudulent conveyance action.” 96

In such a case, the issue is not whether the debtor received value in exchange; rather, the issue is whether or not the value the debtor received, i.e., the service performed, was reasonably equivalent to what the debtor paid for it. Contract law is not concerned with any lack of equivalence in an exchange so long as the exchange was bargained for, but in an action for constructive fraud, when the debtor is insolvent, the enforceability of the exchange under contract law is not the issue, and equivalency or lack of equivalency matters. It is the decisive issue.

In these cases, the courts often list the usual factors generally used to judge equivalency. They sometimes add other factors to the list, including good faith. The courts also consider factors not included in their lists. A good example of this can be

(Bankr. W.D. Pa. 1990). In many cases, the courts seem to overlook the issue and find reasonably equivalent value without deciding whether there was a quid pro quo exchange of transfer for value.

94. See supra note 70 and accompanying text.

95. Something economically beneficial to the debtor is required. 2 EPSTEIN, NICKLES, & WHITE, supra note 62, at § 6-49, at 20-25; see also, e.g., Brandon v. Anesthesia & Pain Mgmt. Assocs., Ltd., 419 F.3d 594, 597 (7th Cir. 2005) (deciding the case under state fraudulent conveyance law); Stone v. Moore, 375 F.2d 110, 112 (5th Cir. 1967) (deciding the case under the Bankruptcy Act, which preceded both the original and amended Bankruptcy Code); In re Burbank Generators, Inc., 48 B.R. 204, 205, 208 (Bankr. C.D. Cal. 1985) (deciding that a corporate debtor’s payment of legal fees incurred by a key employee was a fraudulent transfer).

seen in the case of In re Nelco, Ltd. The trustee in that case went after, among other things, an $800,000 bonus paid to the corporate debtor’s president, Nelson, before the company filed Chapter 11.

In deciding whether the corporate debtor received reasonably equivalent value, the court, in traditional fashion, announced a two-step process: “(1) did the debtor receive value, and (2) was the payment reasonably equivalent to the value extended?” According to the court, the debtor got value “from the services of Nelson” because Nelson operated the business of Nelco, and when the bonus was paid management believed that Nelco had generated substantial profits for the company during 1995. Nelson was essential to Nelco’s business operations: he was the founder of the company, and it was through his efforts that Nelco operated as a successful computer leasing company until the discovery of the stealth fraud. In exchange for the bonus payment, Nelco received the continuing goodwill and loyalty of Nelson in his capacity as president of the debtor.

The court then turned to the issue of whether or not this value was reasonably equivalent to the amount of the bonus paid. To decide this issue, the court recited four factors as important: “(1) the good faith of the transferee; (2) the amount of discrepancy between the amount paid and fair market value; (3) the ratio or percentage of the amount paid to fair market value; and (4) whether there was an arms length transaction between willing parties.” However, the specific facts the

98. Id. at 794.
99. Id. at 813.
100. Id.
101. Id.
102. In re Nelco, 264 B.R. at 813-14. Very recent cases list the same factors. See, e.g., In re Unglaub, 332 B.R. 303, 316 (Bankr. N.D. Ill. 2005); In re Sun Valley Prods., 328 B.R. at 156-57; In re General Search.com, 322 B.R. 836, 844 (Bankr. N.D. Ill. 2005); In re Zeigler, 320 B.R. 362, 375 (Bankr. N.D. Ill. 2005); In re Burry, 309 B.R. 130, 137 (Bankr. E.D. Pa. 2004). Significantly, the “arms-length” factor shows up in other lists. See, e.g., In re Lindell, 334 B.R. at 255-56. However, while the fact that the transaction was not arms-length typically counts against reasonably equivalent value, the existence of arms-length negotiations does not conclusively show that the debtor received reasonably equivalent value. See In re c2 Commc’ns, Inc., 320 B.R. 849, 858 (Bankr. N.D. Tex. 2004).
court emphasized, beyond good faith, were that "Nelson’s bonus payment . . . was not substantially higher than in previous years," and "the bonus payments made to Nelson were [not] substantially above the fair market value for CEO’s [sic] in [the debtor’s industry]." In effect, therefore, the court considered whether or not the transfer was in the ordinary course of business, judged vertically and horizontally or subjectively and objectively.

Essentially the same approach was followed very recently by Bankruptcy Judge Robert McGuire in deciding whether or not to avoid bonuses paid to certain Enron employees shortly before the company filed Chapter 11 on Sunday afternoon, December 2, 2001, in the massive Enron bankruptcy case, In re Enron Corp. Judge McGuire focused on "performance bonuses" paid to two groups of employees that the creditors’ committee had sued to recover prepetition payments.

The defendants in this proceeding were former energy traders, marketers, and individuals who had supported the trading operation. The creditors’ committee targeted bonuses for 2001 which, in exact sums, were negotiated and paid by cashier’s and bank trust checks around November 29, 2001. The defendants’ employment contracts provided for performance bonuses, which had been paid in previous years. So, bonuses of some size were regular and were not simply gifts in return for which Enron received no benefit.

The court decided, however, that the bonuses (about $20 million in this proceeding) were avoidable for a variety of

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104. Id. For examples of other cases finding that paying compensation to management was not constructively fraudulent, see In re Southern Textile Knitters, 65 F. App’x 426, 429, 433, 435-36 (4th Cir. 2003); In re Munford, Inc., 98 F.3d 604, 611-12 (11th Cir. 1996) (analyzing severance or retention payments); In re Terrific Seafoods, Inc., 197 B.R. 724, 735 (Bankr. D. Mass. 1996) (discussing services); In re Auto Specialties Mfg. Co., 153 B.R. 457, 497-99 (Bankr. W.D. Mich. 1993) (describing compensation of team-around specialist).
106. Id. at 7-9.
107. Id. at 6.
108. Id. at 20.
109. Id. at 11.
110. In re Enron Corp., slip op. at 7-9.
reasons, including that the bonuses were paid when Enron was insolvent and for which the company did not receive reasonably equivalent value in return. The factors Judge McGuire considered in *Enron* were very similar to those relied on by the court in *Nelco*, but the facts dictated a very different result. The most important, pertinent facts of *Enron* showed that the 2001 bonuses were much larger than the bonuses paid in 2000 (which was thought to be Enron’s best year) and that the 2001 bonuses were higher than the market data suggested and more than Enron’s human resources consultant had recommended and approved.

Additionally, the 2001 bonuses, which would normally have been paid in February 2002, instead were paid at the end of November 2001, “prior to the events they acknowledged,” and just days before Enron filed bankruptcy amidst reigning chaos at the company. Worse, the court concluded:

The payments were made in direct anticipation of the imminent filing of the Enron bankruptcy and to avoid the perceived delays in timely obtaining authority from the bankruptcy court, if any such authority could be obtained, to (1) pay bonuses and (2) pay bonuses in such large amounts.

When payments were requested and distributed, Enron knew it was going to file bankruptcy immediately thereafter. Enron’s management was unwilling to allow Enron’s creditors and the bankruptcy court the right to participate in any decision concerning how Enron spent the $104 million three days before the bankruptcy. Thus, the bonuses were placed outside the advance scrutiny of the creditors and the bankruptcy court.

Moreover, with respect to what the defendants themselves knew:

As of late November 2001, it was obvious to [the] defendants and Enron that Enron’s 2001 profits, if any,

111. *Id.* at 96.
112. *Id.*
113. *Id.* at 47, 97.
114. *Id.* at 96.
116. *Id.* at 86 (citations omitted).
from which to pay any 2001 bonuses would be significantly lower than in prior years or non-existent. As of November 29, 2001, the . . . Defendants were aware of Enron’s imminent bankruptcy.\textsuperscript{117}

These facts proved lack of good faith, which had several effects in deciding the case. The lack of good faith added to the reasons for finding lack of reasonably equivalent value and constructive fraud.\textsuperscript{118} Also, it meant that the defendants could not rely on defenses that allow a transferee, in effect, a complete or pro tanto defense to the extent of the value that the debtor did receive in exchange for the payments the debtor made.\textsuperscript{119} Finally, the lack of good faith went a long way in finding that the payments were made with an intent to hinder, delay, or defraud creditors and therefore in establishing that the payments were made with actual fraud, in addition to constructive fraud.\textsuperscript{120}

The Enron defendants tried to inflate the value of their services that the company received by re-casting the bonuses they received as retention payments to induce them to stay with the company.\textsuperscript{121} The defendants had agreed, in accepting the bonuses, to stay with Enron until February 29, 2002, or ninety days.\textsuperscript{122} The court did not buy this argument because the amounts of the payments were too large for only a ninety-day commitment.\textsuperscript{123}

In any event, even if Enron had received reasonably equivalent value for the payments, equivalency of exchange was not a defense to avoiding the payments for two other reasons. First, the company’s contractual commitment to pay the bonuses was an antecedent debt, and the payments themselves were avoidable preferences.\textsuperscript{124} Significantly, payments to management, as insiders, extends the preference reach-back

\textsuperscript{117} Id. at 96 (footnote omitted).
\textsuperscript{118} Id. at 94, 96.
\textsuperscript{119} Id. at 48, 90, 94; see also 11 U.S.C. §§ 548(c), 550(b), (e) (2000).
\textsuperscript{120} In re Enron Corp., slip op. at 86, 94.
\textsuperscript{121} Id. at 96.
\textsuperscript{122} Id.
\textsuperscript{123} Id. at 96-97.
\textsuperscript{124} Id. at 37, 94.
period. Furthermore, if the company was insolvent at the
time, preference liability may widen under state law, enforced in
bankruptcy through § 544(b) with respect to payments and
other transfers to insiders. Second, as already noted, the
payments in Enron were actually, as well as constructively,
fraudulent. Neither preference nor actual fraud is erased by
the transfer having been made for reasonably equivalent value.

In sum, cases like Enron show that even without the new
language of constructive fraud that the BAPCPA added to
§ 548, the courts can and will, in appropriate cases, avoid
compensation paid to management before the firm files
bankruptcy. The real importance of the new language, in
terms of increasing risks to management if the firm files Chapter
11, is perhaps in adding not a wider basis for avoidance but in
adding attention, and thus bringing greater scrutiny, to
employment benefits given to insiders.

Greater scrutiny separately results from the interest in
executive compensation among the general public, popular
press, and, maybe because the public and press are interested,
the Securities and Exchange Commission. More important,
greater scrutiny may result from the need to fund a bankruptcy

125. In the case of a transfer to an insider, the reach-back period is extended from
ninety days to one year before the debtor’s bankruptcy filing. 11 U.S.C.A. § 547(b)(4)(B).
126. 11 U.S.C. § 544(b).
127. See In re Congrove, 2005 WL 2089856, at *7; HBE Leasing Corp. v. Frank, 48
F.3d 623, 634 (2d Cir. 1995) (stating preferences to a corporation’s management are
deemed not to be transfers for fair consideration, a/k/a reasonably equivalent value);
2004); Smith v. Cox, 831 P.2d 981, 983 (N.M. 1992) (acknowledging that a majority of
jurisdictions do not allow an insolvent corporation to prefer its own officers and directors);
see also UNIF. FRAUDULENT TRANSFER ACT § 5(a) (1984).
128. In re Enron Corp., slip op. at 86, 94, 96.
130. See generally, e.g., In re Apex Auto. Warehouse, L.P., 238 B.R. 758 (Bankr.
(Bankr. S.D.N.Y. 1999); In re Americana Servs., Inc., 175 B.R. 1018 (Bankr. W.D. Mo.
131. Very recently, on January 17, 2006, the SEC voted to publish for comment
proposed rules that would significantly amend and strengthen disclosure requirements for
executive and director compensation. Press Release, U.S. Securities and Exchange
Commission, SEC Votes to Propose Changes to Disclosure Requirements Concerning
press/2006-10.htm; see also http://www.sec.gov/rules/proposed/33-8655.pdf (last visited
May 24, 2006).
estate that is diluted by recent changes in state law and the new bankruptcy law. This new explicit attention to employee benefits may also embolden interested parties wanting to hold insiders accountable for, in their view, driving the firm into bankruptcy. Practitioners believe that “[c]reditors will be carefully scrutinizing executive compensation paid or other obligations incurred (i.e., severance agreements) to challenge any extraordinary transactions entered into by the debtor within two years before the bankruptcy case . . . .”

Naturally, the debtor—being managed by the management insiders who would be targets—is unlikely to attack these kinds of transfers under § 548. The court, however, can authorize prosecution of actions on behalf of the estate by committees and even by individual creditors. Even worse for insiders, acrimony between them and creditors may contribute to the court appointing a trustee and taking control of the bankruptcy away from management. The appointment of a Chapter 11 trustee is maybe slightly easier and more likely under the amended Bankruptcy Code.

A final transitional note is worth adding here on the issue of the excessive or otherwise inappropriate compensation paid to management. The possibility that the payments will be avoided and recovered by a representative of the estate is not the only risk. In the recent case, In re Farmland Industries, Inc., the liquidating trustee for a Chapter 11 debtor complained about a $700,000 bonus paid to the debtor’s chief executive officer (“CEO”). The trustee’s purpose, however, was not avoidance. Rather, the trustee claimed that the payment amounted to a breach of fiduciary duties the CEO and the

132. McGowen, supra note 36, at 5; see also Levin & Ranney-Marinelli, supra note 2, at 623 (“This provision will likely require careful scrutiny of executive compensation paid or obligations incurred within two years before bankruptcy.”).


134. See infra notes 205-16 and accompanying text.

135. See infra notes 210-12 and accompanying text.

debtor's directors owed to the firm.\textsuperscript{137} The trustee sued all of them and successfully defeated the defendants' motion to dismiss on at least one count.\textsuperscript{138} 

The effect of \textit{Farmland} is to widen accountability beyond people who were the initial or later transferees of an avoided transfer because the action looks beyond a particular transfer of the debtor's property. It re-focuses more broadly on liability for misfeasance in operating the firm and spreads liability to all responsible persons. The risk of this broader liability for breaching fiduciary duties and the like is increasing.

\section*{III. INCREASING MANAGEMENT'S LIABILITY FOR BREACH OF FIDUCIARY DUTIES}

A widely-shared assumption among economists and other scholars is that risk-taking by management increases as a firm approaches insolvency or otherwise begins to experience financial stress. Fiduciary duties act as a brake on this conduct and also, more generally, provide remedies against management for taking action that favors management's self-interests over the interests and well being of the firm.

Suits against management for breaching fiduciary duties are seemingly increasing everywhere, beyond and within bankruptcy. The alleged breaches occur before and after the onset of insolvency and before and during bankruptcy, but the seeming increase in these suits more commonly involves management conduct when the firm is insolvent or near insolvency and ends up in Chapter 11. In this event, causes of action based on management's prepetition conduct become part of the bankruptcy estate and are commonly pursued by various representatives of the estate,\textsuperscript{139} not just the debtor in possession,

\begin{flushright}
137. \textit{id.} \\
138. \textit{id.} \\
139. There are many cases evidencing that bankruptcy trustees and other proper representatives of the estate commonly, seemingly increasingly, sue management and lawyers for breach of fiduciary duties and other people, who also owe these duties to a debtor firm. See generally Smith v. Arthur Andersen LLP, 421 F.3d 989 (9th Cir. 2005); Cantor v. Perelman, 414 F.3d 430 (3d Cir. 2005); \textit{In re} Hechinger Inv. Co. of Del., 327 B.R. 537 (D. Del. 2005); Continuing Creditors' Comm. of Star Telecomms. v. Edgecomb, 385 F. Supp. 2d 449 (D. Del. 2004); \textit{In re} Unifi Commc'ns, Inc., 317 B.R. 13 (D. Mass. 2004); \textit{In re} Yes! Entm't Corp., 316 B.R. 141 (D. Del. 2004); \textit{In re} Boston Reg'l Med. Ctr., Inc., 328 F. Supp. 2d 130 (D. Mass. 2004); \textit{In re} Farmland Indus., Inc., 335 B.R. 398
\end{flushright}
and are perhaps becoming easier to pursue in Chapter 11 because of changes in bankruptcy and non-bankruptcy law. Undoubtedly, management conduct while the firm is insolvent is more closely scrutinized, and the risk of liability is larger because fiduciary duties multi-dimensionally widen in the event of insolvency or near-insolvency.

The ordinary fiduciary duties that management owes the firm and shareholders include duties of care and loyalty\(^\text{140}\) and

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Fiduciary duties are not limited to people who run corporations and also apply, though in differing ways and means, to people running other forms of business associations. See generally Paula J. Dalley, To Whom It May Concern: Fiduciary Duties and Business Associations, 26 DEL. J. CORP. L. 515 (2001).

Additionally, fiduciary duties are not always limited to people who officially manage the firm and may attach to persons who are de facto in charge, such as an intended buyer of a Chapter 11 debtor’s assets that obtained control of the debtor and “called the shots.” See In re Grumman Olson Indus., 329 B.R. at 426-27. Other situations include controlling a shareholder who exercises actual control over the debtor’s business dealings and a creditor who usurps control of the debtor’s business. See In re Del-Met Corp., 322 B.R. at 809; In re OODC, 321 B.R. at 142.

When a firm approaches insolvency, the beneficiaries of management’s fiduciary duties extend beyond the firm and shareholders to other constituents, including creditors.
an obligation of good faith either as a separate fiduciary duty or as part of the duties of good faith and loyalty. The fiduciary duty of due care requires that directors "use that amount of care which ordinarily careful and prudent men would use in similar circumstances," and "consider all material information reasonably available" in making business decisions..." The "duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally." Good faith requires "'honesty of purpose,' and a genuine care for the fiduciary's constituents..." Officers and directors who violate any of these duties are personally liable to the firm. Outside of bankruptcy, either the corporation itself sues management directly, or shareholders sue derivatively on the corporation's behalf. Within bankruptcy, the trustee or other person representing the estate can sue to hold management accountable for breaching fiduciary duties.

A. Making It Easier to Sue Management in Bankruptcy

1. Lower Standard of Pleading to Avoid Dismissal—
   In re Tower Air, Inc.

Delaware case law is unusually important in defining and enforcing management’s fiduciary duties because so many firms are incorporated in Delaware and also because courts everywhere give unusual deference to decisions of the Delaware courts. In turn, the Delaware Supreme Court is fairly deferential

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See infra notes 172-76 and accompanying text. Whether or not fiduciary duties are owed by management or the firm to other stakeholders (beyond stockholders) when the firm is solvent is a very different, very large issue that is hotly debated primarily among economists and business ethicists and is very far beyond the bounds of this article.


to management in suits against officers and directors for breach of fiduciary duties based on management’s business decisions. The Delaware court has traditionally believed that courts should not hold management liable for decisions and other conduct just because the conduct falls short of ideal, and that the stockholders, rather than law, are the better force for holding management and firms accountable for business decisions.\textsuperscript{145} The role of law is relatively small, and legal accountability is comparatively rare.

An important tool for carrying out this policy and limiting legal accountability of management for business decisions is the business judgment rule. This rule

\begin{quote}
  is an acknowledgment of the managerial prerogatives of . . . directors . . . It is 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. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.\textsuperscript{146}
\end{quote}

If “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,”\textsuperscript{147} i.e., unless management’s decision or other conduct cannot be “attributed to any rational business purpose.”\textsuperscript{148}

Whether or not non-director officers, as well as directors, should be equally protected by the business judgment rule is

\begin{footnotes}
\textsuperscript{145} See Brehm, 746 A.2d at 255-56.
\textsuperscript{147} In re Walt Disney Co. Derivative Litig., 2005 WL 2056651, at *31.
\textsuperscript{148} Sinclair Oil Corp. v. Leven, 280 A.2d 717, 720 (Del. 1971).
\end{footnotes}
The general assumption, however, is that the rule more or less protects, even if to varying degrees, all of management, including directors and officers who are not directors.

Delaware's business judgment rule is entwined with, and expressed through, procedural law, and that traditionally makes it very difficult to state a claim against officers and directors for breach of their fiduciary duties. A particular difficulty is the exacting specificity required of the plaintiff in alleging facts to support the cause of action. Delaware law imposes "stringent requirements of factual particularity that differ substantially from . . . permissive notice pleadings," ordinarily required, for example, under the federal rules. Commonly, plaintiffs suing management derivatively for breach of fiduciary duties do not satisfy these demanding pleading requirements, and their suits are dismissed, which has the effect of denying plaintiffs the opportunity to use discovery to uncover the necessary particular facts.

Suing management in bankruptcy for breach of their fiduciary duties to the company is now a little easier, even when Delaware law applies, because of the Third Circuit's decision in In re Tower Air, Inc. In this case, the debtor company filed Chapter 11 in 2000. A trustee was appointed (which may be more common after BAPCPA amended the reasons and process for appointing a trustee in Chapter 11 cases). In June 2001, the trustee (as Tower Air's representative and for the benefit of its creditors and other parties in interest) sued Tower

149. See Lyman P.Q. Johnson, Corporate Officers and the Business Judgment Rule, 60 BUS. LAW. 439 (2005) (stating that the business judgment rule "does not and should not be extended to corporate officers in the same broad manner in which it is applied to directors"); see also Lawrence A. Hamermesh & A. Gilchrist Sparks III, Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson, 60 BUS. LAW. 865, 865-66 (2005) (agreeing that the rule should not be applied as broadly to officers as to directors but arguing that the rule should protect officers with respect to their exercise of discretionary delegated authority and shield them from liability for ordinary negligence).

150. The pleading requirements in a derivative action, especially in establishing demand futility, are "inextricably bound to issues of business judgment and the standards of that doctrine's applicability." Aronson, 473 A.2d at 812.

151. Brehm, 746 A.2d at 254.

152. 416 F.3d 229 (3d Cir. 2005).

153. Id. at 233.

154. Id.

Air’s directors and officers for monetary and punitive damages and other relief. In October 2001, the trustee filed an amended complaint alleging “that the defendants breached their fiduciary duties of loyalty, good faith, and due care, grossly mismanaged Tower Air, and wasted corporate assets.” Since Delaware law controlled, the district court in Tower Air dismissed the trustee’s complaint for failing to state a claim because the plaintiff was required to plead facts with great specificity.

The Court of Appeals reversed, holding:

The District Court erred by assuming that Delaware’s notice pleading cases are interchangeable with federal notice pleading cases. They are not. By requiring [the trustee] to allege specific facts, the District Court erroneously preempted discovery on certain claims by imposing a heightened pleading standard not required by Federal Rule of Civil Procedure 8.

Naturally, by allowing the case to proceed and discovery to occur, the plaintiff is more likely to uncover facts necessary to prove its case. Also, the time frame of the suit is not limited to the time before confirmation. Suits for breach of duties can be heard in bankruptcy post-confirmation under the court’s “related to” jurisdiction.

2. Relaxing the Business Judgment Rule and Raising Expectations of Conduct Necessary to Satisfy Fiduciary Duties

In recent years, courts in Delaware and elsewhere may have relaxed—if only a tiny bit—the business judgment rule. In Brehm v. Eisner, the Delaware Supreme Court partly reversed the chancery court, and uncharacteristically gave the plaintiffs another chance to state claims against the Walt Disney

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156. In re Tower Air, 416 F.3d at 233.
157. Id. at 233-34.
158. Id. at 234-35.
159. Id. at 237. Significantly, complaints in federal court based on fiduciary duty are governed by Rule 8 of the Federal Rules of Civil Procedure, which apply general pleading standards, rather than the heightened standards of Rule 9, which apply to allegations of fraud and the like. See, e.g., Rahl v. Bande, 328 B.R. 387, 412-13 (S.D.N.Y. 2005).
company’s board of directors for breach of fiduciary duties with respect to the employment of Michael Ovitz.161 After remand, the plaintiffs successfully avoided a motion to dismiss when the chancery court tested their complaint by a standard that seems to increase the risk of director and officer liability.162

After a full trial and about a decade after the litigation began, the same chancery court entered judgment for the defendants in August 2005.163 Management’s victory, however, is not complete or certain. The case was a very close call; the chancellor found that the transaction involving the challenged conduct of management was not material (i.e., no real harm, no foul)164 and that the comparative context for management’s conduct was ten years old and probably more lenient and forgiving than today’s standards. The chancellor was also very critical of management’s conduct even when compared to the expectations of ten years ago. The case has been appealed. So, as an expert practitioner might view it, this decision in the Disney saga is not a strong reason for management to feel safe from liability and, even if it withstands appeal, is a narrow precedent for today’s cases.165

Apart from Disney, other recent cases in Delaware and elsewhere seem to imply a trend of decisions decreasing—if even only slightly—the traditionally large deference the courts will give to the business judgment of officers and directors by easing either the procedure or substance necessary to prove breach of fiduciary duties.166 At the same time, management’s

161. 746 A.2d at 248.
163. Id. at *52.
164. Id. at *49 n.577.
fiduciary duties may widen under state law if, as it appears, the requirement of good faith is more certainly developing as a fully separate, independent requirement that stretches fiduciary obligations and does not simply repeat the duties of care and loyalty.\textsuperscript{167} An alternative view is that even if the substantive law with respect to the size of fiduciary duties and the force of the business judgment rule are not changing, “there are evolving expectations of corporate directors in carrying out their fiduciary duties.”\textsuperscript{168} In any event, whether state law respecting fiduciary duties is easing with respect to liability or the conduct that satisfies this law is narrowing, the result is the same: the scope of liability increases.

Also, the fairly new federal Sarbanes-Oxley Act may have preemptively widened the scope of fiduciary duties under state law.\textsuperscript{169} Additionally, management accountability may also be

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L. Reese & Kelly A. Herring, Recent Developments in Delaware Corporate Law, 7 DEL. L. REV. 177 (2004).

\textsuperscript{167} E. Norman Veasey, former Chief Justice of the Delaware Supreme Court, Remarks at the J.L. Kellogg School of Management, 2004 Corporate Governance Conference (May 4, 2004), in THE METROPOLITAN CORP. COUNS. (Mountainside, N.J.), Oct. 2004, at 1, available at http://www.metrocorpcounsel.com/current.php?artType=view &artMonth=May&artYear=2006&EntryNo=1767 (“[O]ne area where the common law approach of the Delaware law of fiduciary duty has been progressing . . . is the issue of good faith. As I see it, the development of the common law in this area is the antithesis of the ‘one size fits all’ rigidity of certain aspects of [federal laws].”) [hereinafter Veasey, Remarks].

\textsuperscript{168} Id.; see also DeMott, supra note 140 (suggesting that directors’ duty of loyalty has broadened).

A number of recent decisions have led many to question whether courts are now cutting back on the extent to which they are prepared to grant deference to the business judgment of presumably independent directors . . .

None of these cases sets forth dramatically new principles of law applicable to director conduct . . . but what they do show is that . . . courts appear to be applying existing legal principles in a much more strict fashion. Claims that were ordinarily dismissed a few years ago are surviving today.


Thus, a primary reason that the latest trial court judgment for management in the Disney case is a small precedent and small comfort for management is that even if the law itself remains unchanged in defining fiduciary duties, the Disney “situation unfolded almost 10 years ago, in a climate much different than the one facing directors in this post-Enron world [where] the actions required to meet [fiduciary] duties are certainly different” in the sense of being more demanding. See High, supra note 165, at 22.

\textsuperscript{169} See Lyman P.Q. Johnson & Mark A. Sides, The Sarbanes-Oxley Act and Fiduciary Duties, 30 WM. MITCHELL L. REV. 1149 (2004); see also Veasey, Remarks,
increasing under separate federal law respecting securities fraud, which is just as important as state fiduciary law in guiding and disciplining management conduct.

Correspondingly, for all these reasons, management’s risk of liability for breach of fiduciary duties and the like is trending up, maybe especially in bankruptcy. At the very least, increasing liability is perceived or is considered more likely, which is probably sufficient to affect the behavior of management in deciding whether or not to take the firm into Chapter 11.

3. Expanding Duties in the “Zone of Insolvency”

Compounding this increasing risk of liability for management, for violating fiduciary duties to the firm, is the effect of the “zone of insolvency.” Arguably, the business judgment rule does not apply when the firm is insolvent or close to insolvency. In this event, management conduct during the firm’s insolvency, even before and apart from bankruptcy, is not insulated by the business judgment rule for ordinary malfeasance liability to the firm.

More certainly, even if the business judgment rule applies when the firm is insolvent or near insolvency, a higher level of scrutiny applies in the vicinity of insolvency. Also, separate or additional condemnable conduct that the rule does not protect is perhaps more common when the firm is insolvent or near it.

supra note 167 (“Many of us in Delaware believe these issues [i.e., indirect enforcement of Sarbanes-Oxley] may play out to some extent in Delaware courts—and with no certain outcome.”).


171. Even though “courts hold that the protection of the business judgment rule is available to the board of directors of a corporation that is in the zone of insolvency,” courts have denied management the protection of the rule “because of the directors’ failure to satisfy the requirements of the business judgment rule, as by failing to exercise care or loyalty or by seeking to apply the rule where no decision has been made.” Andrea A. Wirum et al., Corporate Governance and Fiduciary Duties to Creditors of Insolvent
maybe because management risk-taking increases when the firm is financially stressed.

Most certainly, officers and directors who are aware that the corporation is insolvent—i.e., that the firm is within the "zone of insolvency"—have expanded fiduciary duties that include fiduciary obligations to creditors of the corporation.\textsuperscript{172} The principle and reasoning are as follows: "Typically, creditors may not allege fiduciary duty claims against corporate directors. It is presumed that creditors are capable of protecting themselves through the contractual agreements that govern their relationships... with firms."\textsuperscript{173} However, when a firm has reached the point of insolvency,... the firm's directors are said to owe fiduciary duties to the company's creditors. This is an uncontroversial proposition and does not completely turn on its head the equitable obligations of the directors to the firm itself. The directors continue to have the task of attempting to maximize the economic value of the firm. That much of their job does not change. But the fact of insolvency does necessarily affect the constituency on whose behalf the directors are pursuing that end. By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders—that of residual risk-bearers. Where the assets of the company are insufficient to pay its debts, and the remaining equity is underwater, whatever remains of the

\textit{Corporations, in 25TH ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY & REORGANIZATION, at 1183, 1201 (Practising Law Institute Apr. 2003).}

\textsuperscript{172} For discussion and debate about this issue, see Carriera v. Jobs.com Inc., 393 F.3d 508, 534 n.24 (5th Cir. 2004); In re Hechinger Inv. Co. of Del., 327 B.R. 537, 547-48 (D. Del. 2005); In re LTV Steel Co., 333 B.R. at 425, 429; In re McCook Metals, 319 B.R. at 594; In re JTS Corp., 305 B.R. 529, 538 (Bankr. N.D. Cal. 2003); \textit{Production Res. Group}, 863 A.2d at 790-91; see also Royce de R. Barandes, \textit{Fiduciary Duties of Officers and Directors of Distressed Corporations}, 7 GEO. MASON L. REV. 45, 63 (1998); Daniel B. Bogart, \textit{Liability of Directors of Chapter 11 Debtors in Possession: "Don't Look Back—Something May Be Gaining On You,"} 68 AM. BANKR. L.J. 155, 180 (1994); Alon Chaver & Jesse M. Fried, \textit{Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors}, 55 VAND. L. REV. 1813, 1815 (2002); Cieri et al., \textit{Breaking Up, supra} note 170, at 555 & n.82; Cieri & Riela, \textit{Protecting Directors, supra} note 170, at 303; Bruce A. Markell, \textit{The Folly of Representing Insolvent Corporations: Examining Lawyer Liability and Ethical Issues Involved in Extending Fiduciary Duties to Creditors}, 6 J. BANKR. L. & FRAC. 403 (1997). However, the "Delaware Supreme Court has never directly addressed the vicinity of insolvency issue..." Veasey with Di Guglielmo, \textit{supra} note 140, at 1432.

\textsuperscript{173} \textit{Production Res. Group}, 863 A.2d at 787 (footnotes omitted).
company’s assets will be used to pay creditors, usually either by seniority of debt or on a pro rata basis among debtors of equal priority.

In insolvency, creditors, as residual claimants to a definitionally-inadequate pool of assets, become exposed to substantial risk as the entity goes forward; poor decisions by management may erode the value of the remaining assets, leaving the corporation with even less capital to satisfy its debts in an ultimate dissolution. The elimination of the stockholders’ interest in the firm and the increased risk to creditors is said to justify imposing fiduciary obligations towards the company’s creditors on the directors.\(^\text{174}\)

Compounding this expansion of management’s fiduciary duties to creditors upon the firm’s insolvency, the standard of conduct thus required by the firm toward creditors is, arguably, unusually high,\(^\text{175}\) and management’s “deepening” of a firm’s insolvency can amount, in itself, to a breach of fiduciary duty owed to creditors and the firm itself.\(^\text{176}\)

\(^{174}\) Id. at 790-91 (footnotes omitted).

\(^{175}\) The debate is whether or not to apply the so-called “trust fund doctrine” under which management is liable for losses to creditors even though loss resulted from nothing more than management’s poor judgment. See, e.g., In re JTS Corp., 305 B.R. at 535-41.

\(^{176}\) Under the . . . trust fund doctrine, directors of an insolvent corporation are considered to be trustees of the corporation’s remaining assets for the benefit of all the creditors. Therefore, [for example,] the payment of a corporation’s debt to a director, or to any entity owned or controlled by him, when the corporation is insolvent, is an impermissible preference . . . .

Moreover, the business judgment rule and other rules applicable to solvent corporations are of no effect in the context of insolvency and serve as no defense to a preferential transfer action under the trust fund doctrine.

Askanase v. Fatjo, Civ. A. No. H-91-3140, 1993 WL 208440, at *1, 5 (S.D. Tex. 1993). “This concept of a director or officer of an insolvent or near-insolvent corporation as a ‘trustee’ arises from the old trust fund doctrine, and provides that a director or officer may be held liable under a simple negligence standard without the benefit of the business judgment rule.” Cieri & Riel, Protecting Directors, supra note 170, at 304.

A stricter standard may apply, in any event, when the firm’s insolvency directly results from specific action of management, such as an LBO-inspired distribution to stockholders that renders the firm insolvent. See, e.g., In re Healthco Int’l, Inc., 208 B.R. 288, 306 (Bankr. D. Mass. 1997).

Whether or not the standard of conduct is higher, it may be that the duties widen or that there are more duties such as, for example, a duty of impartiality to creditors. See Production Res. Group, 863 A.2d at 798 n.77; see also UNIF. FRAUDULENT TRANSFER ACT § 5(a).

\(^{176}\) ‘‘Deepening insolvency’’ refers to the ‘‚fraudulent prolongation of a corporation’s life beyond insolvency,’ resulting in damage to the corporation caused by
Also, liability is further compoundable within the zone of insolvency. Not only does the range of people increase to whom fiduciary duties are owed within the zone, the risk of breaching fiduciary duties to all beneficiaries is increased because of human nature and organizational behavior. Even traditional accounts of the effects of insolvency on a firm’s management hold that risk-taking increases during such a period.

Behavioral economics explains this managerial conduct in terms that are deeper than the bounded rationality theory of traditional economics.177 In a very readable, very insightful piece, Georgetown Professor Donald Langevoort writes, “social cognitions and norm structures within organizations . . . can lead to a ‘loose coupling’ between day-to-day activities and instrumental rationality for reasons that go well beyond managerial opportunism.”178 Cognitive conservatism, over-optimism, overconfidence in the ability to control events and risk, self-serving biases, and other cognitive forces “lead to a

increased debt.” In re Global Serv. Group L.L.C., 316 B.R. 451, 456 (Bankr. S.D.N.Y. 2004) (quoting Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983)). “Prolonging an insolvent corporation’s life, without more, will not result in liability . . . [O]ne seeking to recover for ‘deepening insolvency’ must show that the defendant prolonged the company’s life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt.” Id. at 458; see also William Bates, III, Deepening Insolvency: Into the Void, 24 AM. BANKR. INST. J. 1, 60 (Mar. 2005); Jo Ann Brighton, Deepening Insolvency: Secured Lenders and Bankruptcy Professionals Beware: It Is Not Just for Officers and Directors Anymore, 23 AM. BANKR. INST. J. 34 (Apr. 2004); Sabin Willett, The Shallows of Deepening Insolvency, 60 BUS. LAW. 549 (2005).

In some states, deepening insolvency is a distinct cause of action. See In re Total Containment, 335 B.R. at 619; In re LTV Steel Co., 333 B.R. at 421. In a pair of recent cases, two bankruptcy judges decided that deepening insolvency is recognized as a cause of action in Delaware, New York, and North Carolina. See In re Oakwood Homes Corp., 340 B.R. 510, 527-37 (Bankr. D. Del. 2006); In re Monahan Ford Corp. of Flushing, 340 B.R. 1, 39-41 (Bankr. E.D.N.Y. 2006). In other states, deepening insolvency is not, by itself, an independent tort. In re Vartec Telecom, Inc., 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005). In any event, it is an element of a breach of fiduciary duty or other wrong because there is no doubt that a firm is harmed by management and other people prolonging the life of the firm and causing the firm to dissipate assets that would not have been spent had the company dissolved in a more timely fashion. Smith v. Arthur Andersen LLP, 421 F.3d 989, 1004 (9th Cir. 2005); see also In re Unifi Commc’ns, 317 B.R. at 17.

177. See supra notes 11-14 and accompanying text.

skewed perception of reality by senior officials”\textsuperscript{179} that, in turn, contributes to wrongdoing and explains “many sorts of ‘corporate misconduct’ cases.”\textsuperscript{180} Incumbent management indulge in self-serving, self-deceptive inferences “as if” their selfish behaviors “were good business judgment.”\textsuperscript{181}

Paradoxically, this behavior and its consequences are amplified, or certainly not dulled, by “highly indeterminate legal standards—such as those based on ‘reasonableness’ or ‘good faith,’”\textsuperscript{182} which are the kinds of standards by which liability for breach of fiduciary duties is determined. These standards fail to deter misconduct because “managerial bias is to perceive the firm’s actions as both reasonable and in good faith,” and because “managers fail to perceive unreasonableness and bad faith, they cannot modify their conduct in response to the legal rule.”\textsuperscript{183}

Additionally, faced with the prospect of loss in the vicinity of insolvency, people generally become loss averse. “[I]ndividuals generally make risk-averse choices when selecting between options framed as gains and risk-seeking choices when selecting between options framed as losses.”\textsuperscript{184} In the latter case, managers prefer “riskier actions to avoid an anticipated loss altogether over less risky options to merely minimize the loss” to “preserve their utility.”\textsuperscript{185}

When Professor Langevoort’s ideas are combined with basic prospect theory, the lesson is that, in the vicinity of insolvency, managers naturally become loss averse and take riskier actions, whether to protect the firm or themselves. Their actions are based on managerial bias de-coupled from rationality. This behavioral recipe would certainly seem to

\textsuperscript{179} Id. at 164.
\textsuperscript{180} Id. at 168; see generally Jon D. Hanson & Douglas A. Kysar, Taking Behavioralism Seriously: The Problem of Market Manipulation, 74 N.Y.U. L. Rev. 630 (1999) (giving a very thorough review of behavioral research including optimistic, confirmatory, and cognitive biases).
\textsuperscript{181} Langevoort, Organized Illusions, supra note 178, at 150.
\textsuperscript{182} Id. at 169.
\textsuperscript{183} Id.
increase the likelihood of managerial legal liability based on standards of objective reasonableness and the like that managers ignore. Naturally, as liability for officers and directors widens, so too does the possible or potential liability of the debtor’s lenders, the debtor’s lawyers, and other persons for breach of their own fiduciary duties to the firm and for aiding and abetting the breach of fiduciary duties by other people, including management and other insiders.  

4. Limiting Effect of Exculpatory Provision in Corporate Charter

When management is sued for breach of fiduciary duties, a favorite defense is an exculpatory provision in the firm’s corporate charter. It purports to immunize directors against personal liability to the corporation or its stockholders for monetary damages for breach of fiduciary duties. Such a provision is commonly included in corporate charters and is also commonly, explicitly approved by state law.

In addition to Delaware, many other states approve exculpatory provisions. For example, North Carolina requires a director to act:

1. In good faith;
2. With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
3. In a manner he reasonably believes to be in the best interests of the corporation.

The very same section also provides, however, that a “director’s personal liability for monetary damages for breach of a duty as a director may be limited or eliminated” as permitted elsewhere in the state’s corporation law statute. Elsewhere, the statute approves the company charter, including a “provision limiting or eliminating the personal liability of any director arising out of an

186. See Brighton, supra note 176, at 34.
action whether by or in the right of the corporation or otherwise for monetary damages for breach of any duty as a director.”

As a result, even when directors’ fiduciary duties extend to creditors because of conduct within the zone of insolvency, any claim by a creditor or other plaintiff for a breach of these duties would be blocked, under state law, by an exculpatory provision in the firm’s charter. In bankruptcy, such a claim belongs to the estate but is generally subject to whatever defenses attend the claim under state law. Concomitantly, when a representative of the bankruptcy estate asserts a claim for breach of fiduciary duties against management, an exculpatory clause in the corporate charter works equally well to block the bankruptcy representative’s claim.

Typically, though, an exculpatory provision in the company’s charter is not, under state law or in bankruptcy, a complete or certain shield against management’s personal liability for breaching fiduciary duties. To begin with, a typical statute authorizing an exculpatory clause in a corporate charter only allows a clause protecting directors, so that officers are not protected. Second, an exculpatory clause only covers breaches of the duty of care. It does not prevent liability for violating the duty of loyalty or good faith and certain other conduct. Claims based on management’s lack of loyalty or

193. See, e.g., In re Farmland Indus., 335 B.R. at 415 (finding an officer to not be protected even though he was also a director). Commonly, however, officers are indirectly protected, as far as the law allows, by indemnification agreements or other like arrangements.
194. See DEL. CODE ANN. tit. 8, § 102(b)(7)(i)-(iv). The North Carolina statute provides that an exculpatory provision is not effective with respect to (i) acts or omissions that the director at the time of such breach knew or believed were clearly in conflict with the best interests of the corporation, (ii) any liability [for unlawful distributions], (iii) any transaction from which the director derived an improper personal benefit, or (iv) acts or omissions occurring prior to the date the provisions became effective.
good faith, rather than management’s malpractice based on lack of care, have been the usual bases of successful actions for breaches of fiduciary duties. These claims (breach of duty of loyalty and good faith) typically subsume facts that would be the basis of a claim for breaching the duty of care. Also, plaintiffs suing officers and directors of a bankrupt firm typically pursue a host of theories that are not based on fiduciary duties and are not shielded to any extent by an exculpatory provision in the firm’s charter.

These and all causes of action against officers and directors may nevertheless be covered by an exculpatory provision in the firm’s Chapter 11 plan. However, this protection, too, is now less reliable.

B. Making It Harder to Discharge Management Liability
Through the Firm’s Chapter 11 Plan—
In re Metromedia Fiber Network, Inc.

Not uncommonly, a debtor’s Chapter 11 plan includes a provision that aims to give management complete immunity to liability claimed by just about anybody. Such a provision is commonly called a “third-party release” whereby insiders often seek to limit or eliminate the risk of liability that they may incur while employed by the debtor. The debtor may request that the bankruptcy court issue an order releasing or otherwise barring all claims and enjoining all suits against insiders relating to their employment with the debtor either temporarily or permanently. These are generally termed “third party releases.” Alternatively, the debtor may ask the bankruptcy court to issue an order—a “channeling” injunction—directing all or part of the litigation against the debtor or insiders toward a single fund or group of assets. Not unusually, the provisions typically provide shelter from liability to the debtor, its insiders, and

N.C. GEN. STAT. § 55-2-02(b)(3); see also In re Hechinger, 327 B.R. at 550 n.21; Edgecomb, 385 F. Supp. 2d at 467 n.16; Gowe v. Bedard, No. Civ.03-198-B-S, 2004 WL 2677216, at *10 (D. Me. Nov. 23, 2004); In re LTV Steel Co., 333 B.R. at 426; Production Res. Group, 863 A.2d at 795.
members of the insolvency community involved in the
case.\textsuperscript{195}

The courts have disagreed "on whether bankruptcy courts
have the equitable authority to approve plans of reorganization
containing releases and permanent injunctions in favor of third-
parties, including directors ..."\textsuperscript{196} The most recent addition to
the stack of cases is \textit{In re Metromedia Fiber Network, Inc.}\textsuperscript{197}
The Second Circuit, which has allowed third-party releases,
strongly emphasized the limits of this allowance and the limited
enforceability of these releases.\textsuperscript{198}

The Second Circuit had said more than a decade ago that in
"bankruptcy cases, a court may enjoin a creditor from suing a
third party, provided the injunction plays \textit{an important part} in
the debtor's reorganization plan."\textsuperscript{199} The court had not
explained, however, when a nondebtor or third-party release is
sufficiently "important" for a bankruptcy court to approve it. In
\textit{Metromedia}, the Second Circuit clarified, and arguably
tightened, the requirements for approving such a release, saying
that "such a release is proper only in rare cases," requires a
"finding of circumstances that may be characterized as unique,"
and, absent affected creditors' consent, usually requires
somehow otherwise compensating enjoined claims.\textsuperscript{200}

Two reasons justify these stringent requirements. First, the
Code does not explicitly authorize third-party releases.
"Second, a nondebtor release is a device that lends itself to
abuse. By it, a nondebtor can shield itself from liability to third
parties. In form, it is a release; in effect, it may operate as a
bankruptcy discharge arranged without a filing and without the
safeguards of the Code."\textsuperscript{201}

\textsuperscript{195} George W. Kuney, \textit{Hijacking Chapter 11}, 21 E\textsc{mory} Bankr. Dev. J. 19, 90-91
\textsuperscript{196} Myron M. Sheinfeld & Judy Harris Pippitt, \textit{Fiduciary Duties of Directors of a
Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case}, 60
\textsuperscript{197} 416 F.3d 136 (2d Cir. 2005).
\textsuperscript{198} \textit{Id.} at 141-42.
\textsuperscript{199} \textit{In re} Drexel Burnham Lambert Group, Inc., 960 F.2d 285, 293 (2d Cir. 1992)
(emphasis added).
\textsuperscript{200} \textit{In re Metromedia Fiber Network}, 416 F.3d at 141-42.
\textsuperscript{201} \textit{Id.} at 142.
In the Metromedia case, the bankruptcy court had approved a third-party release that protected "numerous third parties" from "any claims relating to the debtor, whether for tort, fraud, contract, violations of federal or state securities laws, or otherwise, whether known or unknown, foreseen or unforeseen, liquidated or unliquidated, fixed or contingent, matured or unmatured." \(^{202}\) The debtor in possession defended the release on the basis that the creditors were allocated a plan distribution, thus received consideration, and therefore were estopped from complaining about the release. \(^{203}\) The Second Circuit rejected this argument and concluded that the "bankruptcy court's findings were insufficient. A nondebtor release in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release terms important to the success of the plan..." \(^{204}\)

C. Widening Accountability of Management in Bankruptcy

1. Appointment of Chapter 11 Trustee Causing Loss of Management Control of Bankruptcy and Enhancing Risk of Management Liability

Management's increased risk of liability for mismanagement is behaviorally and otherwise less significant in the event that: (1) the firm files Chapter 11 and (2) the same management remains in control of the debtor firm and also

\(^{202}\) Id. at 142-43.

\(^{203}\) Id. at 143.

\(^{204}\) Id.; see also In re M.J.H. Leasing, Inc., 328 B.R. 363, 371-72 (Bankr. D. Mass. 2005) (holding an order enjoining action against a principal of a debtor, as provided for in a Chapter 11 disclosure statement, "can be granted only upon a showing of exceptional circumstances"). Even under other approaches to deciding the validity of exculpatory clauses, "nondonor releases remain a 'rare thing' possible only upon showing 'exceptional circumstance.'" In re Metromedia Fiber Network, Inc.: Second Circuit's Review of "X-Clause" Interpretations and Nondonor Releases in Plans of Reorganization (Shearman & Sterling LLP, New York, N.Y.), Aug. 17, 2005, at 3, http://www.shearman.com/br_081705 (quoting In re Master Mortgage Inv. Fund, Inc., 168 B.R. 930, 937 (Bankr. W.D. Mo. 1994)).

Another, simpler approach is that exculpatory provisions protecting non-debtors are flatly illegal under the Bankruptcy Code. See Simmons v. 22 Acquisition Corp., No. Civ.A. 2:05-CV-169, 2005 WL 3018726, at *3 (E.D. Tex. Nov. 10, 2005) (deciding that a defendant's conduct was not within the terms of an exculpatory clause of a debtor's Chapter 11 plan and, in any event, such a clause protecting non-debtors violates 11 U.S.C. § 524(e) (2000), which, the court said, prohibits the discharge of non-debtors).
controls the decision of whether or not to sue to enforce this liability, which is usually the case. Ordinarily, a trustee is not appointed in a Chapter 11 case. The debtor in possession ("DIP") remains in control of or as the debtor, and the DIP enjoys all of the rights, powers, and duties of a trustee, including the rights to continue operating the business and exclusively control, in the beginning, formation of a plan of reorganization. The DIP is essentially the firm’s management, and this management is typically constituted of the same people who controlled the firm before bankruptcy.

This control of a firm in bankruptcy by the DIP has never been complete or completely assured. Creditors’ committees and even individual creditors can sometimes sue on behalf of the debtor. Also, even before the BAPCPA, the Bankruptcy Code provided for the displacement of the DIP in a Chapter 11 case and the appointment of a trustee. Rarely, though, was a trustee appointed under the original Bankruptcy Code.

Occasionally, though, it happened under the original Code. Mismanagement and the like by the DIP was not the only basis. Acrimony between the DIP and creditors was also grounds for appointing a trustee, and presumably remains so, when the former’s interests conflict with the latter’s interests to such an extent that appointing a trustee is the only effective way to pursue reorganization. Acrimony seems likely to increase if, as this article suggests, the new bankruptcy law increases the risks of liability for management. Creditors will become more emboldened and aggressive against management, and management will become more defensive with respect to creditors.

The BAPCPA changed the Code so that the appointment of a trustee is, perhaps, more likely. The amended Code greatly

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206. 11 U.S.C. § 1108 (2000) (stating that the trustee, and so the DIP, may operate the debtor’s business).
207. Section 1121 gives the debtor the right to file a plan, and the right is exclusive for 120 days. 11 U.S.C. § 1121(a)-(b) (2000). In the absence of a trustee, debtor means the same thing as DIP. 11 U.S.C. § 1101(1) (2000).
208. See infra text accompanying notes 217-43.
209. In re Marvel Entm’t Group, Inc., 140 F.3d 463, 478 (3d Cir. 1998); In re Cajun Elec. Power Coop., Inc., 74 F.3d 599 (5th Cir. 1996), adopting on reh’g the opinion of the dissent in 69 F.3d 746, 751 (5th Cir. 1995) (Garza, J., dissenting).
expands the list of grounds on the basis of which a creditor can move for dismissing or converting a case or, alternatively, having a trustee appointed.\textsuperscript{210} Also, the procedural burden for convincing the court to do so may have slightly shifted and thus lightened.\textsuperscript{211} Practitioners believe that, overall, "these changes should make it easier for creditors to obtain . . . appointment of a Chapter 11 trustee."\textsuperscript{212}

Additionally, the United States trustee is explicitly directed to move for the appointment of a trustee in any case in which the debtor's chief officers and directors participated in "dishonesty" in the management of the firm,\textsuperscript{213} which is potentially a very broad basis for appointing a trustee. Bankruptcy practitioners also believe that it "is likely that the Office of the U.S. Trustee will embrace this change as an opportunity to more readily move for the appointment of a trustee."\textsuperscript{214}

This structural change in Chapter 11 is, in itself, a reason for management to decide against taking the firm into bankruptcy because of the increased risk that management will lose control of the bankruptcy. Ironically and significantly, a major innovation of the Bankruptcy Code of 1978 was the notion that management could control bankruptcy reorganization through the DIP. Before then, a trustee was appointed in corporate reorganization cases if liabilities exceeded $250,000,\textsuperscript{215} which is about $1 million today. Providing for DIP control of Chapter 11 cases was intended, by the 1978 law, to induce management to take a firm into bankruptcy and to do so earlier rather than later when the chance for a successful


\textsuperscript{211} The movant is required to establish grounds, and the procedural requirements for doing so are challenging under some existing case law. \textit{See In re G-I Holdings, Inc.}, 385 F.3d 313, 315 (3d Cir. 2004) (requiring clear and convincing evidence). \textit{But see Tradex Corp. v. Morse}, 339 B.R. 823, 826-32 (D. Mass. 2006) (stating that the factual predicate for appointing a Chapter 11 trustee is proved by the standard of preponderance of the evidence, not clear and convincing evidence). In any event, if grounds are established, the new law shifts the burden in the sense that the court must ordinarily grant the relief absent a specific finding of "unusual circumstances . . . that the requested [relief] is not in the best interests of creditors and the estate . . . ." 11 U.S.C.A. § 1112(b)(1); \textit{see also} 11 U.S.C.A. § 1104(a)(3).

\textsuperscript{212} Zuckin et al., \textit{supra} note 38; \textit{see also} Ayer et al., \textit{Bad Words, supra} note 16.

\textsuperscript{213} 11 U.S.C.A. § 1104(e).

\textsuperscript{214} Morgan, Lewis & Bockius LLP, \textit{supra} note 8.

reorganization is greater.\textsuperscript{216} The new bankruptcy law thus slightly reverts to the structure of the pre-1978 law and concomitantly creates a disincentive for management to file Chapter 11.

There is also an additional, more personal reason why the increased possibility of the appointment of a trustee works against management deciding to file Chapter 11. Such an appointment enhances the chances that management's conduct of the business will be investigated for breaches of fiduciary duties as the trustee—much more certainly than management itself—would pursue liability for such breaches, which may have widened.


Management's fiduciary duties are generally owed to the firm. Breaches of these duties create causes of action that belong to the firm and, outside of bankruptcy, are pursued by the firm or by shareholders on behalf of the firm in derivative actions. If the firm files bankruptcy, these causes of action become property of the bankruptcy estate. Generally, in any kind of bankruptcy case, only the trustee or a DIP, as representative of the estate, can assert causes of action of any kind that belong to the bankruptcy estate, including actions against management in a Chapter 11 case for prepetition breaches of fiduciary duties to the firm.\textsuperscript{217}

\textsuperscript{216} See generally Miller & Waisman, supra note 8. These authors add that "[o]ther provisions further enhanced the 'comfort zone' that Chapter 11 provided to debtors and management and encouraged filing before a debtor's financial position deteriorated beyond the point that rehabilitation would no longer be feasible." \textit{Id.} at 143. In contrast, because of changes that the BAPCPA makes in Chapter 11, "management may delay commencing a Chapter 11 case even longer, leading to increased recidivism." \textit{Id.} at 166.

\textsuperscript{217} As a general rule, "the Bankruptcy Code assigns to the trustee or debtor-in-possession various actions on behalf of the estate," \textit{In re} Baltimore Emergency Servs. II, Corp., 432 F.3d 557, 560 (4th Cir. 2005). "Absent authorization by the bankruptcy court, the Trustee is the only party who can assert a claim for damages on behalf of the bankruptcy estate," although a debtor in a Chapter 7 case has standing to seek removal of the trustee. \textit{In re} Davis, 312 B.R. 681, 685 (Bankr. D. Nev. 2004). So, even a shareholder derivative action that could be maintained outside of bankruptcy cannot be maintained anywhere against a Chapter 11 debtor unless the derivative claims are abandoned in bankruptcy. Scinfeld v. Allen, No. 05-2680, 2006 WL 461385, slip op. at 2-3 (2d Cir. Feb.
In appropriate circumstances, however, the court in any kind of bankruptcy case can authorize other persons to prosecute causes of action that belong to the estate and that ordinarily would be pursued by the trustee or a DIP.218 The usual, alternative tests for this authorization in a Chapter 11 case are: (1) the person "has the consent of the debtor in possession or trustee, and . . . the court finds that suit by the committee [or other person] is (a) in the best interest of the bankruptcy estate, and (b) is 'necessary and beneficial' to the fair and efficient resolution of the bankruptcy proceedings";219 or (2) the DIP or trustee has unjustifiably refused to prosecute the action.220 In this latter case, of course, the consent to the action by the trustee or DIP is unnecessary for granting authority to a committee or individual creditor to proceed with the action.

As recently summarized by the court in In re Industrial Commercial Electrical, Inc., the "Bankruptcy Code . . . allows

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218. See generally In re Housecraft Indus. USA, Inc., 310 F.3d 64 (2d Cir. 2002) (authorizing secured creditor to pursue avoidance action in Chapter 7 case); In re National Forge Co., 326 B.R. 532 (W.D. Pa. 2005) (granting retroactively a creditors' committee derivative standing to pursue avoidance claims against banks in a Chapter 11 case); see also In re Unifi Comm'ns, 317 B.R. at 16-18 (finding that a creditors' committee suing in the name of the trustee had standing to pursue a claim for management's breach of fiduciary duty); In re Yes! Entm't Corp., 316 B.R. at 144-46 (stating that an individual creditor had standing to pursue claims for fraudulent transfers and breaches of fiduciary duties) (relying on The Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 580 (3d Cir. 2003)); In re Boston Reg'l Med. Cir., 328 F. Supp. 2d at 134 (involving a committee of unsecured creditors suing to vindicate rights of the estate for breaches of fiduciary duties); In re LTV Steel Co., 333 B.R. at 413 (finding that an administrative claimants' committee had standing to pursue various claims, including claims for breach of fiduciary duties, on behalf of a Chapter 11 estate against officers and directors); In re Adelphia Comm'ns Corp., 330 B.R. at 386 (stating that committees could sue lenders for aiding and abetting breach of fiduciary duties); In re Enron Corp., 319 B.R. at 133 (allowing an employment-related issues committee to pursue avoidance actions); In re American Paper Mills of Vt., Inc., 322 B.R. 84, 91-92 (Bankr. D. Vt. 2004) (concluding that an unsecured creditors' committee had standing for a suit to recover damages for collusion in connection with the sale of assets of a Chapter 11 estate).

219. In re Commodore Int'l Ltd., 262 F.3d 96, 100 (2d Cir. 2001).

220. In re Housecraft Indus. USA, 310 F.3d at 70.
other parties in interest to act on the estate’s behalf in Chapter 11 cases on these grounds:

Under 11 U.S.C. § 1109(b), any party in interest in a Chapter 11 case may raise and may appear and be heard on any issue in the case. Section 1103(c) gives a creditors’ committee broad powers to consult with the trustee or debtor in possession regarding case administration, to investigate the debtor’s business and conduct, to participate in plan formation, and to take other appropriate actions with respect to the case. Moreover, the Bankruptcy Code clearly contemplates that creditors may sometimes take legal action on behalf of the estate, subject to the Bankruptcy Court’s approval. If a debtor in possession in bad faith refused to bring an action that would obviously benefit the estate, a creditors’ committee could bring the action itself, although there may be some question as to whether it would need the Bankruptcy Court’s authorization to do so.

Thus, Congress clearly envisioned a system where a creditors’ committee may cooperate with the trustee or debtor in possession on behalf of the estate, or may even bring suit itself when such suit is consistent with the purposes of the Bankruptcy Code.

So, in a Chapter 11 case, a trustee—who is appointed to displace the DIP—is not the only person who can pursue causes of action that belong to the estate. Also, whether or not a trustee is appointed, the court can authorize prosecution of these actions—on behalf of the estate—by committees and even by individual creditors, especially actions against management for prepetition breaches of fiduciary duties owed to the firm. Consequently, management that are vulnerable for violating fiduciary duties are not immunized against accountability in a Chapter 11 case simply because a trustee is not appointed and they, through or as the DIP, remain in control of the estate.

Two related developments with respect to committees are also important. First, on request of a creditor, the court may order the United States trustee to change the membership of a creditors’ or equity holders’ committee to ensure adequate

221. 319 B.R. 35, 53 (D. Mass. 2005) (involving the right of creditor’s committee to object to an administrative claim).
222. Id. (citations omitted).
223. See supra note 133 and accompanying text.
representation.\textsuperscript{224} Also, committees must provide access to information for holders of claims and interests who are not members of the committees.\textsuperscript{225} These changes may mean that committees become more vital and, perhaps, more probative of management conduct.

However, a common problem confronts the trustee, committee, or other representative of the estate pursuing these actions against management for breach of fiduciary duty. These actions against them for harm to the firm are often entangled with claims for harm to individual creditors that a trustee or other representative of the estate lacks standing to pursue.

Whether a claim belongs to individual creditors or to the estate is not a false issue with respect to management’s risk of liability. For reasons of efficiency and scale, trustees, committees, or other persons suing collectively are more likely to press claims than individual creditors. Also, the likelihood of avoiding or settling liability is probably smaller, and the costs of doing so probably higher, when the claims belong to the estate.

In the case \textit{In re Rahab Trust and Management Co.}, Bankruptcy Judge Craig Whitley very clearly and succinctly lays down the fundamental principles for solving the standing problem—i.e., deciding if the estate or individual creditors own claims for purposes of standing.\textsuperscript{226} In this case, the trustee sued insiders for various wrongs that collectively amounted to looting the company.\textsuperscript{227} Defendants moved to dismiss the action, arguing that the causes of action pursued by the trustee belonged to the creditors and that the trustee therefore could not pursue the claims for the estate or on the creditors’ behalf.\textsuperscript{228}

Judge Whitley explained that

\begin{itemize}
\item 226. \textit{See generally} No. 01-3182, 2002 Bankr. LEXIS 1876 (Bankr. W.D.N.C. Mar. 4, 2002).
\item 227. \textit{See id. at *5}.
\item 228. \textit{See id. at *9}.
\end{itemize}
to the extent that the Trustee seeks to assert causes of action which: (1) belong to the debtor and are estate property; (2) seek to avoid transfers under the Bankruptcy Code; or (3) seek to avoid transfers under applicable state law which could have been brought by a creditor, then the Trustee has standing to do so.\(^{229}\)

On the other hand, the trustee cannot act on behalf of creditors to pursue claims that state law gives them individually, such as fraud, civil conspiracy, and unfair trade practices.\(^{230}\)

Clearly, a claim against management for breaching fiduciary duties owed to the firm is a cause of action that is property of the estate and is properly pursued by the DIP, trustee, or other representative of the estate. Remember, though, that when a firm enters the zone of insolvency, fiduciary duties enlarge and extend to creditors.\(^{231}\) Who has standing to pursue claims based on breaches of these duties to creditors? Under the general principles stated in \textit{In re Rahab Trust}, the answer depends on whether such a claim belongs to the estate or to the individual creditors who were harmed.

A very recent case, \textit{Smith v. Arthur Andersen LLP}, explains that these claims belong to the estate, not to creditors

\(^{229}\) \textit{Id.} at *17.

\(^{230}\) \textit{Id.} at *16-17; \textit{see also}, e.g., Moratzka v. Senior Cottages of Am., LLC, No. 05-809 (DWF), 2005 U.S. Dist. LEXIS 17595, at *8 (D. Minn. Aug. 18, 2005) (holding that a trustee cannot pursue claims that may belong to the estate if the trustee’s complaint states that the action is aimed at recovering funds on behalf of creditors) (citing \textit{In re Ozark Rest. Equip. Co.}, 816 F.2d 1222, 1224 (8th Cir. 1987)); \textit{In re Student Fin. Corp.}, 334 B.R. 776, 778-79 (D. Del. 2005); \textit{In re Greater Se. Cnty. Hosp. Corp.}, 333 B.R. at 517-22; \textit{In re Stewart}, 329 B.R. 910, 913-14 (Bankr. M.D. Ga. 2005); \textit{In re Senior Cottages of Am., LLC}, 320 B.R. 895, 901-02 (Bankr. D. Minn. 2005); \textit{cf. In re Parmalat Sec. Litig.}, 377 F. Supp. 2d 390, 419-21 (S.D.N.Y. 2005) (determining that a person appointed by a foreign government to a position similar to that of a bankruptcy trustee cannot pursue individual claims of creditors).

On the other hand, the trustee—acting for the estate on behalf of all creditors—can resist and try to defeat the personal claim of a creditor that the trustee herself lacks standing to pursue. \textit{In re Kreisler}, 331 B.R. 364, 374-75 (Bankr. N.D. Ill. 2005).

Also, as Judge Whitley recognizes, a creditor’s personal claim for fraud, which the trustee cannot pursue, is different from a claim to avoid a fraudulent transfer, which the trustee can pursue to the exclusion of any creditor who could have pursued such a claim under state law. \textit{See generally In re Rahab Trust}, 2002 Bankr. LEXIS 1876; \textit{see also In re Tessmer}, 329 B.R. 776 (Bankr. M.D. Ga. 2005) (noting that the right to avoid a fraudulent transfer belongs to the trustee, any recovered property belongs to the estate, and the actual creditor harmed by the transfer loses the right to sue unless the trustee abandons the claim).

\(^{231}\) \textit{See supra} text accompanying notes 172-76.
individually. The *Smith* case involved the bankruptcy of Boston Chicken. The Chapter 11 trustee filed a 225-page complaint, which asserted forty-five separate claims against former officers and directors, attorneys, auditors, and investment bankers. Eventually, the trustee reached settlements with some of the defendants. The non-settling defendants argued that the trustee lacked standing to pursue claims based on the breach of fiduciary duties owed to creditors. This duty is based on the common rule of corporation law under which directors of insolvent firms, even outside of bankruptcy, owe fiduciary duties to creditors as well as to the firm and its stockholders.

The Ninth Circuit’s opinion on this issue in *Smith* begins where Judge Whitley’s opinion in *In re Rahab Trust* ended, with the former repeating the law so well explained in the latter. The Ninth Circuit started its analysis in *Smith* by writing:

A bankruptcy trustee is the representative of the bankrupt estate, and has the capacity to sue and be sued. Among the trustee’s duties is the obligation to “collect and reduce to money the property of the estate.” The “property of the estate” includes “all legal or equitable interests of the debtor in property as of the commencement of the case,” including the debtor’s “causes of action.” Thus, “[u]nder the Bankruptcy Code the trustee stands in the shoes of the bankrupt corporation and has standing to bring any suit that the bankrupt corporation could have instituted had it not petitioned for bankruptcy.”

However, “[i]t is well settled that a bankruptcy trustee has no standing generally to sue third parties on behalf of the estate’s creditors, but may only assert claims held by the bankrupt corporation itself.” This principle derives from the Supreme Court’s decision in [*Caplin v. Marine Midland Grace Trust Co.*](#238) “in which the Court concluded that a reorganization trustee under Chapter X had no standing

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232. 421 F.3d 989.
233. *Id.* at 994.
234. *Id.* at 995.
235. *Id.* at 996.
236. *Id.* at 1005.
under the old Bankruptcy Act to assert, on behalf of the holders of the debtor's debentures, claims of misconduct against a third party.” [T]he holding of Caplin remains valid under the current version of the Bankruptcy Code, and is equally applicable to both reorganization and liquidation trustees. 239

The wrinkle in Smith is that, in some sense, the claims “belong” to both the company and the creditors. The court reasoned:

Although the line between “claims of the debtor,” which a trustee has statutory authority to assert, and “claims of creditors,” which Caplin bars the trustee from pursuing, is not always clear, the focus of the inquiry is on whether the Trustee is seeking to redress injuries to the debtor itself caused by the defendants’ alleged conduct. If the debtor suffered an injury, the trustee has standing to pursue a claim seeking to rectify such injury. But, “[w]hen a third party has injured not the bankrupt corporation itself but [has injured only] a creditor of that corporation, [then it is only in this event that] the trustee in bankruptcy cannot bring suit against the third party.” 240

The court finally concluded:

Although creditors may attain standing to assert fiduciary duty claims upon a firm’s insolvency as a matter of state corporate law, it does not follow that a trustee, who represents the debtor, lacks standing to assert such claims as a matter of federal bankruptcy law. Again, the ultimate question in determining whether a trustee has standing is whether the debtor corporation has been injured. . . .

Thus, the Non-Settling Defendants might be correct that Boston Chicken’s creditors could have asserted fiduciary duty claims outside the bankruptcy context similar to those pressed by the Trustee, but this does not prove that the Trustee is asserting “creditors’ claims” within the meaning of Caplin. Rather, it is simply because state law often


240. Id. at 1002-03 (quoting Steinberg v. Buczynski, 40 F.3d 890, 893 (1994)) (citation omitted).
permits creditors to pursue derivative claims on an insolvent corporation’s behalf when the corporation itself has been injured by breaches of fiduciary duty. 241

Smith is perhaps especially significant to the risk of management liability if, as has been suggested, this risk is increased by classifying claims as belonging to the estate rather than to individual creditors that an estate representative must thereby pursue because individual creditors lack standing to do so. The significance is in the court’s suggestion that to some extent, the ownership of claims for management breaches of fiduciary duties—and thus standing to pursue these claims—is not controlled by state law. 242 Rather, federal bankruptcy law controls the issue that, on the facts of cases like Smith, favors collective rather than individual action. For different and additional reasons, therefore, Smith is like Tower Air 243 in applying preemptive federal procedure with the result of increasing the likelihood of management liability in Chapter 11 for breach of fiduciary duty.

3. Suits by Creditors for Themselves Against Management

Another effect of the Smith case, in taking standing away from creditors in actions for breach of fiduciary duty, is to embolden persistent creditors to find other grounds for suing the debtor and management and thereby possibly widen the range of management liability. Interspersed through the case reporters, which are filled with Chapter 11 and other bankruptcy cases in which the debtor or a representative sues management, are also

241. Id. at 1005-06 (emphasis added); see also Farace, 413 F.3d at 342 (noting that creditors lack standing where the injury is to all of them, and the trustee may bring an action on the generalized injury); In re Unifi Commc’ns, 317 B.R. at 16-18 (holding that a creditors’ committee suing in the name of the trustee had standing to pursue a claim for management’s breach of fiduciary duty to creditors that caused considerable harm to those creditors); In re OODC, 321 B.R. at 135-37 (concluding that a Chapter 11 trustee has standing to pursue breach of fiduciary duty claims resulting from a leveraged buyout that harmed all creditors); In re McCook Metals, 319 B.R. at 594-96 (“As a representative of creditors, a bankruptcy trustee may assert creditors’ collective claims for breach of [a corporation’s fiduciary] duty to a business enterprise in bankruptcy.”).

242. It is not uncommon for courts simply to assume, without discussion, that state law determines whether a claim is direct and belongs to an individual creditor or derivative and belongs to the debtor-estate. See, e.g., In re At Home Corp., 154 F. App’x 666 (9th Cir. 2005).

243. See supra text accompanying notes 152-60.
cases in which creditors pursue claims commonly related to breach of fiduciary duty that the creditors personally, individually own. 244

The creditors pursue these claims for themselves, and the DIP, trustee, or other representative of the estate lacks standing to pursue the claims either for the benefit of the estate or on behalf of the injured creditors. 245 Significantly, defendants in these cases are not protected by an exculpatory clause in the debtor’s corporate charter, which protects them from liability in other cases: “Any claims that creditors possessed themselves [personally]—such as claims for breach of contract or for common law or statutory torts like misrepresentation and fraudulent conveyance—would not be barred by the exculpatory charter provision because those claims do not belong to the corporation or its stockholders.” 246

Alternatively or additionally, creditors acting for themselves also sue the debtor’s lawyers on a variety of theories. 248 The debtor’s lawyers, like management, risk personal liability—to the debtor and creditors—for conduct occurring both before and after the debtor files Chapter 11 that amounts to or is often related to breach of fiduciary duties.

IV. EXPOSING DEBTOR’S COUNSEL TO INCREASED RISK OF LIABILITY

A. Pre-Bankruptcy Complicity with Management—Weakening of the In Pari Delicto Doctrine and the Wagoner Rule—In re Fuzion Technologies Group, Inc.

Outside of bankruptcy, the firm’s lawyers owe professional duties to the client, i.e., the firm, rather than management. If

244. See generally, e.g., In re Rahab Trust, 2002 Bankr. LEXIS 1876; see also supra notes 226-31 and accompanying text.

There is uncertainty as to whether or not a representative of the estate can pursue individual creditors’ claims that are assigned to the representative. Compare In re CBI Holding Co., 318 B.R. 761, 765-67 (S.D.N.Y. 2004), with In re Southwest Supermarkets, L.L.C., 315 B.R. 565, 569-71 (Bankr. D. Ariz. 2004); see also In re AgriBioTech, Inc., 319 B.R. 207 (D. Nev. 2004).

245. For a discussion of standing, see supra notes 217-43 and accompanying text.

246. See supra text accompanying notes 187-94.


248. See infra text accompanying notes 249-66.
management breaches its fiduciary duties to the firm, the firm’s lawyers risk breaching their own personal duties to the firm by not protecting the firm from management misconduct or, worse, participating in the misconduct themselves. In bankruptcy, a representative of the estate can sue to hold the lawyers accountable for breaching their duties to the firm.

The base theory against the lawyers is legal malpractice. Often, the bankruptcy plaintiff—who is the trustee or other representative of the estate—lays arguments that the lawyers separately breached fiduciary duties to the firm\textsuperscript{249} or aided and abetted management’s breach of its duties.\textsuperscript{250} Whether


\textsuperscript{250} The argument based on this theory is that the lawyer helped management in the breach of its fiduciary duties to the firm. Where recognized, the cause of action involves three elements:

The first element is “a breach by a fiduciary of obligations to another,” of which the aider and abettor had “actual knowledge.” The second element is “that the defendant knowingly induced or participated in the breach”; and the third element is “that plaintiff suffered damage as a result of the breach.”


malpractice and breach of fiduciary duty are the same or different claims is uncertain, but this is often a moot issue.

An excellent starting place for illustrating the lawyer's liability is the recent case, In re Del-Met Corp., decided by Bankruptcy Judge Keith M. Lundin. Three related companies—the Del-Met companies ("DMC," "DMT," and "DMW")—supplied parts to the automobile industry. Several of the companies' principal customers effectively took control of the business and, in cahoots with principal lenders, operated the business for their benefit. In doing so, the controlling customers transferred substantial portions of the assets of DMC and DMT to DMW and eventually caused a controversial sale of


The claim, however, is governed by state law, and the aiding-and-abetting theory is unavailable to the trustee when the applicable state law does not recognize it. See Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1156-57 (11th Cir. 2006); In re Student Fin. Corp., 335 B.R. at 550-51.

DMW’s assets after DMC and DMT filed Chapter 7 bankruptcy.\textsuperscript{254}

The trustee sued the controlling customers who had become de facto directors, the lenders, and Del-Met’s lawyer, Carson Fischer.\textsuperscript{255} The trustee complained that throughout the controlling customers’ effective takeover of the Del-Met business, Mr. Fischer failed to protect the separate interests of the Del-Met sister companies and, in fact, was conflicted in representing them and their 100\% owner, Michael Buerger.\textsuperscript{256} The trustee characterized Fischer’s conduct as both malpractice in representing the debtor companies and breach of fiduciary duties owed to them.\textsuperscript{257}

Judge Lundin carefully noted that a lawyer’s breach of fiduciary duty to the firm and malpractice by a firm’s lawyer are not necessarily two names for a single wrong. “Some state courts recognize breach of fiduciary duty as a tort distinct from professional negligence or malpractice.”\textsuperscript{258} He explained that the latter is a “‘failure to perform,’” and the former is a failure “‘to represent the client with undivided loyalty,’” and “[f]ailing to give undivided loyalty does not necessarily mean that the attorney performed legal services negligently.”\textsuperscript{259} In this case, however, distinguishing the wrongs was unnecessary because the facts the trustee alleged amounted to nothing more “than traditional [professional negligence or] malpractice.”\textsuperscript{260} Judge Lundin seems to say that even if the two claims are different, the lawyer nevertheless committed malpractice, and legal malpractice is a wrong by the lawyer against the debtor companies that the trustee can pursue—against the lawyer—on behalf of the estate in the debtors’ bankruptcy case.\textsuperscript{261}

\textsuperscript{254} \textit{Id.} at 792-93.
\textsuperscript{255} \textit{Id.} at 789-90.
\textsuperscript{256} \textit{In re Del-Met Corp.}, 322 B.R. at 822.
\textsuperscript{257} \textit{Id.} at 823.
\textsuperscript{258} \textit{Id.} at 824.
\textsuperscript{259} \textit{Id.} at 823-24 (quoting Raydene Anderson & Walter W. Steele, Jr., \textit{Fiduciary Duty, Tort and Contract: A Primer on the Legal Malpractice Puzzle}, 47 SMU L. REV. 235, 236 n.4 (1994)).
\textsuperscript{260} \textit{Id.} at 824-25.
\textsuperscript{261} Several courts have found lawyers, accountants, and other professionals liable to the debtor in bankruptcy for malpractice. See, e.g., \textit{In re R & R Assocs. of Hampton}, 402 F.3d 257 (1st Cir. 2005); \textit{In re Student Fin. Corp.}, 335 B.R. 539; \textit{In re AgriBioTech}, 319 B.R. 216 (accountants); \textit{In re CBI Holding Co., Inc.}, 311 B.R. 350 (S.D.N.Y. 2004).
Similarly, in *In re JTS Corp.*, the corporate debtor’s lawyers were also sued for both malpractice and (along with the debtor’s directors and other controlling persons) breach of fiduciary duty. The challenged underlying conduct involved prepetition transactions in which the firm transferred millions of dollars of assets that, in bankruptcy, the trustee sought to recover. One of these transactions was a sale of real property for less than reasonably equivalent value. The trustee sued the lawyer who papered the deal, Anna Pope, arguing that Pope had “breached fiduciary duties owed to JTS and engaged in legal malpractice because she failed to advise the board of directors that the property was being sold for less than fair market value” and thus “could have adverse legal consequences for the company.”

In this case, too, the bankruptcy judge, Marilyn Morgan, found no need to distinguish a lawyer’s breach of fiduciary duty to the corporate debtor from the lawyer’s legal malpractice in representing the firm because “the essential elements are virtually identical. Each requires proof of a duty, a breach of that duty and damage proximately caused by the breach.” Judge Morgan seems to say that even if breach of fiduciary duty and malpractice are different claims, they overlap on these facts, and the conduct of Pope and other lawyers in the case was possibly doubly wrong.

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(accounting firm); *In re Porter McLeod*, 231 B.R. 786 (lawyers); *In re Greater Se. Cnty. Hosp. Corp.*, 333 B.R. 506, 529-30 (Bankr. D.D.C. 2005); *In re Hampton Hotel Investors*, 289 B.R. 563. Even a lender can be liable for malpractice for “improvident lending,” as well as other related or similar civil wrongs. *In re OODC*, 321 B.R. at 146-47. There are many recent cases illustrating this potential modern-day liability, including two especially thorough cases showing the range of possible claims against lenders. See generally *In re Oakwood Homes Corp.*, 340 B.R. 510 (involving a complaint that stated causes of action against a Chapter 11 debtor’s banks for breach of fiduciary duty, negligence, unjust enrichment, and deepening insolvency); *In re Monahan Ford Corp. of Flushing*, 340 B.R. 1 (Bankr. E.D.N.Y. 2006) (involving a trustee’s complaint in a bankruptcy case of an automobile dealership that adequately alleged claims against the lender and others for fraud, aiding and abetting fraud, conspiracy to defraud, deepening insolvency, and conspiracy to violate a state statute dealing with automobile dealers).

263. *Id.*
264. *Id.* at 541-42.
265. *Id.* at 551.
266. *Id.*
The lawyer’s best friend in these cases is the common-law doctrine in pari delicto. The doctrine is also relied on by other professionals who provided services for a firm that files bankruptcy and are sued by the estate for their prepetition professional negligence toward the firm.

In pari delicto is “the ‘principle that a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing.’” Outside of bankruptcy, the doctrine most often operates—either as an equitable defense or a reason to deny standing to the plaintiff—to immunize third parties against liability to a company for harmful conduct committed by the third parties against the company in complicity with management misconduct. The management misconduct or knowledge of it is imputed to the firm. Therefore, the firm—as a derivative wrongdoer itself—cannot recover from the third parties with respect to wrongs in which the firm derivatively, through its management, participated. In bankruptcy, the courts have traditionally held that “in pari delicto is available in an action by a bankruptcy trustee [suing on behalf of the estate of a corporate debtor] against [a third party for harm to the debtor] if the defense could have been raised against the debtor.”

Related to the in pari delicto doctrine, at least in this context, is the less widely followed rule from the case of Shearson Lehman Hutton, Inc. v. Wagoner (“the Wagoner rule”), which is characterized as a rule regarding standing that prevents a trustee from suing third parties and not a defense of


268. Id. at 836; see also Edwards, 437 F.3d at 1152; Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356-57 (3d Cir. 2001) (holding that claims brought by a creditors’ committee are subject to the in pari delicto doctrine); Baena v. KPMG LLP, 389 F. Supp. 2d 112, 118 (D. Mass. 2005); In re Advanced Risc Corp., 324 B.R. 10, 15-16 (D. Mass. 2005); In re CBI Holding Co., 318 B.R. 761 (holding that the Wagoner rule—a/k/a in pari delicto—protects third-party professionals); American Tissue, 351 F. Supp. 2d at 89, 99-104 (finding an investment banking firm to be protected against an action by the DIP for malpractice but not for breach of fiduciary duty); In re MS55, Inc., 338 B.R. 883 (Bankr. D. Colo. 2006) (concluding that in pari delicto prevented the trustee from suing the debtor’s counsel); In re Total Containment, 335 B.R. at 619-20; In re Stanwich Fin. Servs. Corp., 317 B.R. 224, 228-29 (Bankr. D. Conn. 2004); cf. In re Parmalat, 383 F. Supp. 2d at 593, 595 (involving an action by the extraordinary commissioner of certain bankrupt Italian companies against a bank for fraud, unjust enrichment, and conspiracy).

269. 944 F.2d 114 (2d Cir. 1991).
the third parties against the trustee. *Wagoner* holds that when third parties harm a firm with cooperation of management, the wrongdoing is sometimes imputed to the firm, and as a consequence, claims against the third parties belong to creditors of the firm rather than to the firm itself.\(^{270}\) As a result, when the firm files bankruptcy, the trustee lacks standing to assert the claims.\(^{271}\) The *Wagoner* rule, which is based on New York law, is more commonly used by a defendant third party to defeat an action by the trustee than as a basis to give creditors standing to sue.\(^{272}\) So used, the *Wagoner* rule is practically redundant of *in pari delicto*, and limits on the latter usually apply equally to the former. Therefore, for purposes of this article and especially the following discussion, *in pari delicto* includes the *Wagoner* rule.

Recent cases confirm important limits on *in pari delicto* that effectively dilute its reliable usefulness to protect third-party defendants, especially the debtor’s lawyers, from actions against them for harming the debtor firm. To start, the *in pari delicto* doctrine does not apply when the claim is breach of a fiduciary duty owed to the firm or, more broadly stated, when the defendant is an insider.\(^{273}\) Arguably, therefore, a lawyer sued by the firm’s bankruptcy estate cannot rely on *in pari delicto* to the extent the lawyer’s malpractice or other misconduct amounts, separately or additionally, to breach of a fiduciary duty owed the firm.

Other recent cases further limit defendants from successfully asserting *in pari delicto* against a representative of a

\(^{270}\) See generally id.

\(^{271}\) See id. at 120.

\(^{272}\) Indeed, if *Wagoner* is used to give creditors standing to pursue claims that belong to the estate, it is not clear how the rule gets around the *in pari delicto* doctrine if the creditors are suing on behalf of the estate. If, instead, *Wagoner* allows creditors to pursue the claims for themselves, it is not clear how the rule is squared with the substantial case law holding that, as a matter of federal bankruptcy law, creditors lack standing to pursue for themselves claims that belong to the estate. See *supra* text accompanying notes 232-41.

\(^{273}\) *In re Student Fin. Corp.*, 335 B.R. at 547 (“*In pari delicto* will not operate to bar claims against insiders of the debtor corporation.”); *American Tissue*, 351 F. Supp. 2d at 98 (involving an investment banking firm); *In re Greater Sc. Cmty. Hosp. Corp.*, 333 B.R. at 538 (“Simply put, fiduciaries [such as officers and directors] cannot assert the *in pari delicto* defense against claims for breach of fiduciary duty.”); *In re Grumman Olson Indus., Inc.*, 329 B.R. 411, 424-25 (Bankr. S.D.N.Y. 2005); *In re Adelphia Commc'ns Corp.*, 322 B.R. at 529 n.18 (“The defense is inapplicable [when] the cause of action is brought against an insider.”).
bankruptcy estate.\textsuperscript{274} Especially important is the “adverse interest exception.” According to this exception, the in pari delicto doctrine is inapplicable when management’s misconduct was prompted by interests that were adverse to the corporation and not for the corporation’s benefit. In such a case, the management misconduct cannot be imputed to the firm; therefore, the firm is not considered to be complicit with management, and thus the firm is not in pari delicto.\textsuperscript{275} In this situation, a debtor’s lawyer who was in pari delicto with management cannot assert the in pari delicto doctrine against the representative of the firm’s bankruptcy estate that is suing the lawyer for breach of his duties to the debtor.

Most significantly, a Florida bankruptcy court recently decided that the doctrine of in pari delicto is not applicable when a trustee sues a debtor’s lawyer even for simple negligence and even though the lawyer was not actively complicit in management misconduct. The case is In re Fuzion Technologies, Inc.,\textsuperscript{276} decided by Bankruptcy Judge Raymond Ray. In the Fuzion case, Boyce dominated and controlled several entities, including Fuzion and Capital Investment Group.

\textsuperscript{274} In re Parmalat, 383 F. Supp. 2d at 599 (determining that in pari delicto does not apply to claims that insiders looted the company); In re CBI Holding Co., 311 B.R. at 371-72 (discussing the innocent insider exception); In re Edgewater Med. Ctr., 332 B.R. 166 (Bankr. N.D. Ill. 2005) (stating that in pari delicto does not apply when, before bankruptcy, a receiver was appointed so that the person who was in pari delicto is removed); In re Del-Met Corp., 322 B.R. at 817-20 (finding that in pari delicto does not apply as a matter of law to claims against insiders who took charge of the debtor’s business and operated the business for their own benefit).

A few courts have discussed, without adopting, the possibility of an “innocent insider” exception to in pari delicto: the defense “only applies where all relevant shareholders and/or decisionmakers are involved in the fraud” so that the defense does not apply if there was “an innocent member of... management who would have been able to prevent the fraud had he known about it.” Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P., 212 B.R. 34, 36 (S.D.N.Y. 1997); see also In re CBI Holding Co., 311 B.R. at 371; In re Adelphia Commc’ns Corp., 330 B.R. at 380; In re Grumman Olson Indus., 329 B.R. at 425-26.


\textsuperscript{276} 332 B.R. 225 (Bankr. S.D. Fla. 2005).
Over a period of time, Boyce managed to unlawfully transfer millions of dollars of Fuzion’s assets to CIG. After Fuzion filed Chapter 11, the bankruptcy trustee went after all of Fuzion’s officers and directors for negligence and breach of fiduciary duty and eventually settled with them.

The trustee also sued Proskauer Rose LLP (“Proskauer”), which was Fuzion’s general corporate lawyer during the time of Boyce’s misconduct. Proskauer admitted negligence but argued in pari delicto: Boyce’s knowledge of his own misconduct was imputed to the company and would prevent the company from suing Proskauer under state law because of the in pari delicto doctrine. This would prevent the trustee from suing Proskauer because the trustee steps fully into the company’s shoes in asserting the claim against Proskauer.

Judge Ray incidentally decided, on the narrow basis of the adverse exception rule, that the in pari delicto doctrine did not apply in this case. Boyce’s knowledge of his misconduct was not imputed to Fuzion and thus to the trustee because Boyce was acting solely for himself and not for the company’s benefit.

Judge Ray’s primary decision was that “as a matter of law, the in pari delicto defense does not apply to the bankruptcy trustee.” The core of his reasoning is very clear and straightforward. The in pari delicto doctrine is invoked to prevent a plaintiff who has participated in wrongdoing from recovering damages resulting from the wrongdoing. The doctrine is equitable, not absolute, and is not applied blindly and across the board regardless of the circumstances. In bankruptcy, the circumstances are such that the trustee’s job is partly to act for creditors, such as by maximizing the estate.

277. Id. at 228.
278. Id. at 229.
279. Id.
280. Id.
282. See supra text accompanying notes 274-75.
284. Id. at 236. Judge Ray also, though much more summarily, rejected the Wagoner rule. Id. at 230.
285. Id.
286. Id. at 233.
partly for their benefit. Moreover, in bankruptcy, "there are safeguards in place to ensure that recovery by trustees will go to the creditors[,] not to the wrongdoers," and it would be inequitable "for negligent third parties to enjoy a windfall by gaining absolution from liability for their negligence while the innocent creditors bear the loss."288

On this reasoning, Judge Ray seems to conclude that *in pari delicto* does not apply in bankruptcy as a matter of federal law, whether or not the doctrine is available in comparable situations under state law. Supporting this reasoning, or subsumed within it, however, is the alternative, equally forceful conclusion that the state law behind the *in pari delicto* doctrine denies application of the doctrine when the claims are brought under state law by a receiver.289 Analogizing bankruptcy to a receivership, *in pari delicto* is not available, as a matter of state law, in bankruptcy.

In any event, the *in pari delicto* doctrine very certainly does not apply when the claims against the lawyers are asserted not by a representative of the estate, but rather by a creditor who argues that the lawyers’ misconduct harmed the creditor directly and individually. These claims are increasingly common because, during the time the firm spends in the “zone of insolvency” outside of bankruptcy, the scope of management’s fiduciary obligations is extended beyond the firm to include the firm’s creditors.290 Normally, the professional responsibilities of the firm’s lawyer do not extend to a third person who is not a client,291 but in some special cases, an attorney’s accountability may directly extend to third parties, including the client’s creditors, as for common-law and securities fraud.292

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288. *Id.* at 236. In another recent case, *In re Adelphia Communications Corp.*, Bankruptcy Judge Robert Gerber separately questions—in dicta—the reason and sense of applying the *in pari delicto* doctrine in bankruptcy cases, at least when the insider wrongdoers have been ousted. See 330 B.R. at 380.

289. *In re Fuzion Techs.*, 332 B.R. at 234-35; see also *In re Edgewater Med. Ctr.*, 332 B.R. at 177 (deciding that *in pari delicto* does not apply when a receiver was appointed before bankruptcy so that the person who was *in pari delicto* is removed).

290. See *supra* notes 170-86 and accompanying text.


event, a firm’s lawyer may be indirectly liable to third parties for aiding and abetting the firm’s breach of its duties to the creditors.\textsuperscript{293}

Even ten years ago, then Professor (now Bankruptcy Judge) Bruce Markell observed that “[m]any nonbankruptcy courts have recently resurrected, revitalized, or just created fiduciary duties for insolvent corporations” outside of bankruptcy.\textsuperscript{294} In Judge Markell’s opinion, “these cases signal almost inevitable conflicts of interest for attorneys advising insolvent corporations. Coupled with those conflicts is the potential that simply by representing the insolvent corporation, the lawyer will incur liability directly or indirectly to the client’s creditors.”\textsuperscript{295} His bottom line is simple and scary: “no ethical or rational lawyer should ever willingly represent an insolvent corporation outside bankruptcy.”\textsuperscript{296}

Commonly, however, lawyers take the risk. Increasingly, they will find themselves being sued by creditors when the firm files Chapter 11 bankruptcy. The lawyers’ risk of liability is increasing because, as discussed throughout this article, management’s risk of liability in Chapter 11 is increasing for having breached prepetition fiduciary duties. The risk to lawyers tracks the increasing risk to the management because more instances of management liability for breaching its fiduciary duties to the firm means correspondingly more chances that the firm’s lawyer is liable for having not protected the firm from management misconduct or, worse, for having participated in the misconduct. This increased risk of liability may influence the firm’s lawyer, as well as management, to avoid taking the firm into Chapter 11 bankruptcy.

B. Conflicts of Interest and Liability Within Bankruptcy

The lawyer who represented the firm before bankruptcy can continue to represent the firm in bankruptcy and typically does so. The Bankruptcy Code permits the debtor to employ lawyers and other professionals in a Chapter 11 case even though these people have represented the debtor before bankruptcy if they are

\textsuperscript{293} See supra note 250.
\textsuperscript{294} Markell, supra note 172, at 403.
\textsuperscript{295} Id.
\textsuperscript{296} Id.
otherwise disinterested. However, whether or not the lawyer continues to represent the firm in Chapter 11, the lawyer’s liability for prepetition conduct does not go away. Also, whoever represents the firm in the bankruptcy case, management and the firm’s lawyer risk fresh or additional liability for postpetition conduct, including lost compensation for the bankruptcy work, and also affirmative liability for breaching fiduciary or professional duties.

In a Chapter 11 case, the debtor is the debtor in possession ("DIP"), and the debtor’s lawyer represents the DIP, not its management. The DIP owes fiduciary duties to the corporation, shareholders, creditors, and other

298. See supra notes 262-66 and accompanying text.
300. “An attorney who represents a debtor owes allegiance to the debtor, and not to its stockholders, officers or directors.” In re Metropolitan Envtl., Inc., 293 B.R. 871, 883 (Bankr. N.D. Ohio 2003); see also Bergrin v. Eerie World Entm’t, LLC, No. 03 Civ. 4501(SAS), 2003 WL 22861948, at *2 (S.D.N.Y. Dec. 2, 2003) (“Counsel for a chapter 11 debtor owes a fiduciary duty of loyalty and care to his client, the debtor-in-possession, and not to the debtor’s principals.”); In re Wilde Horse Enters., Inc., 136 B.R. 830, 840 (Bankr. C.D. Cal. 1991) (“[C]ounsel for a corporate Chapter 11 debtor in possession owes a fiduciary duty to the corporate entity estate—the client—and represents its interests, not those of the entity’s principals.”); see also generally Sonderby & McGuire, supra note 299, at 240; Frost, supra note 299, at 26-27.
301. Although directors of solvent corporations generally do not owe fiduciary duties to creditors, upon the occurrence of the corporation’s insolvency the relationship between corporate directors and creditors changes. Indeed, as several courts and commentators have discussed, it appears well settled that once a corporation becomes insolvent, directors owe a fiduciary duty to creditors.
beneficiaries, though the degree or standard of the fiduciary duty is debated. In turn, the debtor’s lawyer owes a fiduciary duty to the DIP, and the lawyer is also subject to the standards

Trost & Schwartz, supra note 299, at 274. "It is common knowledge that managers of an insolvent entity are fiduciaries for creditors, inside or outside bankruptcy—even though managers of a solvent entity may be fiduciaries for shareholders only.” Ayer, Professional Responsibility, supra note 299, at 12.

Analogous to the fiduciary obligations of care and loyalty owed by officers and directors of solvent companies outside of bankruptcy, the Code imposes fiduciary duties on the DIP with respect to operation of the business in bankruptcy. The courts frequently state that the DIP’s fiduciary duty runs to creditors. In addition, the prevailing view is that the DIP also acts as a fiduciary for the interests of the equity holders.


[If] a debtor remains in possession—that is, if a trustee is not appointed—the debtor’s directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession. Indeed, the willingness of courts to leave debtors in possession “is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.”


302. See Bogart, supra note 172, at 221; Thomas G. Kelch, The Phantom Fiduciary: The Debtor in Possession in Chapter 11, 38 WAYNE L. REV. 1323, 1335 (1992); see also Trost & Schwartz, supra note 299, at 296.

A majority of courts and commentators have reached the conclusion that counsel for a debtor-in-possession owes fiduciary duties to both the debtor-in-possession and to the bankruptcy estate as a whole. In holding that counsel for a debtor-in-possession owes fiduciary duties to the bankruptcy estate, courts and commentators have emphasized both (i) the role of counsel as an officer of the court and (ii) the derivative nature of the fiduciary obligations owed by counsel for the debtor-in-possession.

Id. at 296-97 (footnotes omitted).


304. “[C]ounsel to a chapter 11 debtor owe a broad-based duty of care, candor, and undivided loyalty to the chapter 11 debtor.” In re R & R Assocs. of Hampton, 402 F.3d at 266. “In a Chapter 11 proceeding, the attorney for debtor in possession, as an officer of the court charged to perform duties in the administration of the case, has a high fiduciary duty to the estate represented.” In re Wilde Horse Enters., 136 B.R. at 840.

Because of the unique nature of a bankruptcy estate and the concept that the debtor-in-possession is a fiduciary for that estate, courts have imposed a fiduciary duty upon counsel for a debtor. When representing the debtor-in-possession, its attorney has a duty to look to the interests of the estate and not to the interests of its principals, shareholders, officers or directors.

established by professional ethics and the restrictions imposed by the Bankruptcy Code that governs the employment of professional persons. 305

Management, too, owes fiduciary duties to the DIP and its many constituents. But in many circumstances, "management's self-interest may come into conflict with a debtor-in-possession's fiduciary duty toward beneficiaries of the estate." 306 In this event, the debtor's lawyer is "placed in the uncomfortable position of questioning the judgment of the business'[s] decision-makers," 307 and the lawyer breaches her fiduciary duties to the debtor by advancing the conflicting interests of management. 308

Chapter 11 case and, therefore, the debtor's lawyer owes no fiduciary duty to a non-existent estate. See generally 220 B.R. 434. There is, however, a debtor in possession, which is something beyond the debtor's principals and different from an estate as a fictional, separate entity that Chapter 11 creates. Undoubtedly, the debtor's lawyer owes fiduciary duties to the DIP and its shareholders, creditors, and other constituents, which are collectively sometimes referred to (loosely) as the estate—differently defined. So, despite Hansen, the debtor's lawyer owes fiduciary duties to the DIP and the estate—so loosely and differently defined.

On the other hand, even though an attorney for a debtor in possession owes a fiduciary duty to the DIP and the bankruptcy "estate" as a whole (meaning the whole group of claimants and interested parties, including creditors), "this duty cannot be extended to justify the imposition of a fiduciary duty running from counsel for the debtor-in-possession directly to a particular creditor that would support a separate civil action for breach . . . ." ICM Notes, Ltd. v. Andrews & Kurth, L.L.P., 278 B.R. 117, 123 (S.D. Tex. 2002), aff'd, 324 F.3d 768 (5th Cir. 2003).

305. "[C]ounsel to a chapter 11 debtor owe a broad-based duty of care, candor, and undivided loyalty to the chapter 11 debtor. [T]he source of such a duty arises unambiguously, both from federal bankruptcy law, and from applicable state law." In re R & R Assocs. of Hampton, 402 F.3d at 266 (emphasis added) (citations omitted); see also 11 U.S.C. § 327 (2000); In re Congoleum Corp., 426 F.3d 675, 676 (3d Cir. 2005).

306. Sonderby & McGuire, supra note 299, at 240; see also John D. Ayer, How to Think About Bankruptcy Ethics, 60 AM. BANKR. L.J. 355, 387-95 (1986); Martin J. Bienenstock, Conflicts Between Management and the Debtor in Possession's Fiduciary Duties, 61 U. CHI. L. REV. 543, 545-46 (1992) (noting a situation in which management has a fiduciary duty to do what is best for the estate and creditors but a potentially conflicting interest in doing what is best for management); Kelch, supra note 302, at 1354 (recognizing that the conflicting interests of the various parties in a Chapter 11 case include the interests of those in control of the debtor in possession); Norberg, supra note 301, at 526; Nancy B. Rapoport, Turning and Turning in the Widening Gyre: The Problem of Potential Conflicts of Interest in Bankruptcy, 26 CONN. L. REV. 913, 935-36 (1994); Ostrow, supra note 299 (illustrating conflicts between insiders and the DIP, and arguing for management having its own lawyer when the firm files bankruptcy).


Indeed, the debtor’s lawyer is obligated to go well beyond refusing to side with management in the event of conflict. The lawyer must, in essence, supervise management to ensure that management does not obstruct the debtor’s performance of its fiduciary duties.

Because of the way chapter 11 of the Bankruptcy Code works, counsel for a debtor has an unusual role. In chapter 11, the norm is for a debtor to remain in control of its business and in possession of the bankruptcy estate. However, a debtor, as debtor in possession, is also charged with the duties of a fiduciary, holding the estate and operating the business for the benefit of that debtor’s creditors and equity owners.

Counsel to a debtor in possession thus serves as attorney for an accidental fiduciary: unlike a person selected to be a trustee who has a clear understanding of his fiduciary role, management of a debtor in possession is burdened with a trustee’s responsibilities. It is not uncommon—especially in cases like that before the court, where management and ownership are the same—for those controlling the debtor to have interests potentially at odds with those of general creditors. For example, guaranteed corporate debt, insider loans and compensation are areas where management of a debtor and its creditors may have incompatible interests.

Counsel’s job is to guide the debtor’s management to ensure that it performs its fiduciary duties in dealing with the debtor’s business and its control of the estate. While counsel to a debtor in possession may not owe a duty directly to creditors, counsel does have an obligation to ensure the debtor properly maintains the estate.309

246 B.R. 176 (S.D.N.Y. 2000); In re Office Prods. of Am., Inc., 136 B.R. 983 (Bankr. W.D. Tex. 1992); In re Wilde Horse Enters., 136 B.R. 830; In re Kendavis Indus. Int’l, Inc., 91 B.R. 742 (Bankr. N.D. Tex. 1988); cf. In re R & R Assocs. of Hampton, 402 F.3d 257 (concluding that the lawyer for a partnership in Chapter 11 violated a fiduciary duty to the debtor and was liable for damages by protecting financial interests of the two general partners); In re Hampton Hotel Investors, 289 B.R. 563 (involving a trustee who stated causes of action against the lawyers for the debtor, a partnership, for the lawyers’ misconduct during a Chapter 11 case).


Because the attorney for debtor in possession is a fiduciary of the estate and an officer of the Court, the duty to advise the client goes beyond responding [to] the client’s requests for advice. It requires an active concern for the
There is more: the debtor’s lawyer is required to advise management not to pursue their self-interests at the expense of the debtor and to report to the court if this advice is ignored. As explained by the Bankruptcy Appellate Panel for the Second Circuit:

The debtor’s attorney, while not a trustee, nevertheless is charged with the duty of counseling the debtor in possession to comply with its duties and obligations under the law. When a debtor in possession is in breach of its fiduciary obligations, counsel must advise the client “to follow a lawful course.” “The attorney has a duty to remind the debtor in possession, and its principals, of its duties under the Code, and to assist the debtor in fulfilling those duties.”

In the nonbankruptcy context, absent ongoing fraud or criminal activity, an attorney’s obligation is to advise the client and, if the client disagrees, resign. But because “[b]ankruptcy causes fundamental changes in the nature of corporate relationships,” obligating the corporation’s board of directors to consider the best interests of creditors, and because counsel for the debtor in possession has fiduciary obligations not ordinarily foisted upon the attorney-client relationship, the attorney for the debtor in possession may not simply resign where the client refuses the attorney’s advice concerning the client’s fiduciary obligations to the estate and its creditors. Counsel must do more, informing the court in some manner of derogation by the debtor in possession.\(^{310}\)

\(^{310}\) \textit{Id.}

\textit{Id.}. \textit{In re JLM, Inc.}, 210 B.R. 19, 26 (B.A.P. 2d Cir. 1997) (quoting CONN. R. PROF’L CONDUCT 1.6 cmt.; \textit{In Re Wilde Horse Enters.}, 136 B.R. 840; Commodity Futures Trading Comm’n v. Weintraub, 471 U.S. 343, 355 (1985)) (citations omitted); see also \textit{In re Phoenix Group Corp.}, 305 B.R. 447 (Bankr. N.D. Tex. 2003) (holding that counsel to a debtor-in-possession cannot be penalized for failing to comply with directives of the debtor’s management, if they required counsel “to act illegally, unethically, or contrary to his or her fiduciary responsibilities”).
Not surprisingly, therefore, the "most dangerous" conflicts confronting lawyers who represent debtors in possession, and probably the toughest, are the conflicts resulting from choices the debtor’s lawyer must make, in every Chapter 11 case, between the desires of management and the DIP’s fiduciary duties to creditors and shareholders.\textsuperscript{311} In representing a debtor in possession, these dangerous conflicts are "inherent" in the job and "unavoidable."\textsuperscript{312} Professor Christopher Frost has even suggested that debtors’ lawyers monitoring and policing these conflicts, on pain of sanction or loss of compensation, is practically important to effective corporate governance in bankruptcy.\textsuperscript{313}

V. INCREASING RISK OF PERSONAL BANKRUPTCY AND NEW THREATS TO PERSONAL WEALTH OF DEBtor’S MANAGEMENT AND LAWYERS

An increasing risk of liability for a firm’s management and lawyers means an increasing need for them to seek, personally and individually, bankruptcy protection. However, new law has weakened bankruptcy protection for these persons who are more likely than most individual debtors to have enjoyed larger incomes and to have taken steps to save and protect that income. With sizeable or complex estates, Chapter 7 liquidation bankruptcy is probably not desirable, and perhaps not even possible.\textsuperscript{314} The same is true of reorganizing under Chapter 13, which the BAPCPA makes more burdensome and which is likely unavailable because the debts of management and lawyers are too large.\textsuperscript{315} Reorganizing under Chapter 11 and thereby

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{311} See Frost, \textit{supra} note 299, at 27.
\item \textsuperscript{312} Jay Lawrence Westbrook, \textit{Fees and Inherent Conflicts of Interest}, 1 AM. BANKR. INST. L. REV. 287, 287 (1993).
\item \textsuperscript{313} Christopher W. Frost, \textit{The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations}, 72 AM. BANKR. L.J. 103, 137-47 (1998). Professor Frost writes that this monitoring-policing role for debtors’ lawyers results not only from the fiduciary duties the debtor in possession and its counsel owe, but also from the practical need for someone to watch management because the courts and United States Trustee are overburdened and lack both the time and money to perform the role themselves.
\item \textsuperscript{314} See \textit{infra} note 332 and accompanying text.
\item \textsuperscript{315} “Only an individual with regular income that owes, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts of less than $307,675 and noncontingent, liquidated, secured debts of less than $922,975 . . . may be a debtor under chapter 13 of this title.” 11 U.S.C.A. § 109(e) (2000 & West Supp. 2005).
\end{itemize}
\end{footnotesize}
escaping Chapter 13-like burdens is no longer possible. Newly-amended Chapter 11 is, in essence, the same as Chapter 13 for individuals.\textsuperscript{316} Chapter 11 (like Chapters 7 and 13) provides a discharge for individuals.\textsuperscript{317} However, under every chapter of the amended Bankruptcy Code, the discharge is perhaps less wide for corporate managers and lawyers who have harmed the firm or its creditors\textsuperscript{318} so that post-petition income is less protected.

Because of new bankruptcy law, prepetition income saved and "stored" in homes and trusts is also less protected.\textsuperscript{319} This weakened bankruptcy protection for a firm's managers and lawyers worsens the consequences of personal liability. Therefore, to some extent (admittedly indirect and small), the weakened protection enhances the increased risk of personal liability for managers and lawyers if the firm files Chapter 11 and gives them a further reason for not taking the firm into bankruptcy.

A. Limiting Exemptions of Property

The bankruptcy estate primarily consists of "all legal or equitable interests of the debtor in property as of the commencement of the case."\textsuperscript{320} So, when a debtor files any kind of bankruptcy case, all the debtor's interests in property, with a few exceptions, pass to the estate. In a Chapter 7 case, an individual debtor can take back and keep property that is exempt. Almost always, the principal legal basis for exemptions is state law.

Very often, the debtor's most valuable exemption is her homestead. The BAPCPA created new limits on the homestead exemption that can reduce the value of the debtor's exemptible interest in homestead property. A new, indirect limit is the requirement that a debtor must have been domiciled in a state for

318. See infra text accompanying notes 390-411.
319. See infra text accompanying notes 336-56.
a significant period in order to claim the state’s exemptions.321 The purpose was to reduce the possibility that, as part of pre-bankruptcy planning, an individual debtor would move to a state with a generous homestead exemption and pour her non-exempt assets into a new, expensive home.

Whichever state’s law governs the debtor’s homestead exemption, the size of the exemption is now subject to other limitations imposed by the BAPCPA. Two of these new limitations are most significant. First, because of § 522(p),322 the debtor cannot exempt—beyond $125,000—the aggregate amount of interest in the homestead “that was acquired by the debtor during the 1215-day period preceding the date of the filing of the petition . . . .”323 The result is that even if the debtor has lived in a single state forever and thus avoids the choice-of-law issues with respect to exemptions, she cannot successfully engage in pre-bankruptcy planning by adding a new wing to her house in order to get the full value of her state’s homestead exemption. However, according to the first judicial interpretation of § 522(p), this limitation does not prevent her from taking non-exempt assets and paying down the mortgage.324 But this tactic may violate another limitation on homestead, § 522(o),325 that reduces the value of the debtor’s interest to the extent the value is attributable to property the debtor disposed of with the intent to hinder, delay, or defraud creditors.326

The second new limitation on homestead that is significant for purposes of this article is § 522(q).327 It flat-out limits a debtor’s homestead exemption to $125,000, without regard to the source of the exemption law, if the debtor owes a debt arising from any violation of federal or state securities law. Any such debt is also excepted from a bankruptcy discharge in every

kind of bankruptcy case.\footnote{328} This exception to discharge is explained later;\footnote{329} also explained is the effect of other new law federalizing the liability of management and lawyers for breaching corporate fiduciary duties.\footnote{330} The effect of this federalization is that management and lawyers who incur this liability (the risk of which is increasing) will also face both an increasing risk that the liability is excepted from discharge in addition to the fact that their homestead exemption is seriously limited under § 522(q).\footnote{331}

Probably, though, the biggest effect of the BAPCPA on the exemptions of management and professionals in bankruptcy is, practically and indirectly, to deny them any such exemptions by denying them voluntary access to Chapter 7. Very likely, the new “means testing” under Chapter 7 will force such an individual who wants bankruptcy protection (and who also wants to liquidate voluntarily) into Chapter 11 or 13.\footnote{332}

Exemptions are much less important in Chapter 11 and 13 cases. The debtor keeps possession of all of the property she owns at the time of filing, whether exempt or not, but commits all of her future disposable income to paying the debts she owes at the time of filing.\footnote{333} Exempt income is not excluded; the exempt character of property the debtor owns when she files bankruptcy is not considered when the effect of the repayment plan is to require her, coincidentally, to dispose of existing property to fund the plan,\footnote{334} or to pursue a lifestyle that the plan denies funding from future income.

\footnote{329} See infra text accompanying notes 403-09.
\footnote{330} See infra text accompanying notes 410-11.
\footnote{331} 11 U.S.C.A. § 522(q).
\footnote{332} See 11 U.S.C.A. § 707(b) (West Supp. 2005). If an individual were forced into Chapter 7 by involuntary petition, means testing would not apply. Indeed, none of the reasons that § 707(b) gives for dismissal or consensual conversion applies because § 707(b) applies only to a “case filed by an individual . . . .” 11 U.S.C.A. § 707(b)(1).
\footnote{334} Two possibilities come to mind. One is that the debtor has a large home or very nice car. Each is exempted wholly or to some extent. The court decides that either or both of these properties are not reasonably necessary to support the debtor or that the amounts required to fund them are not justified. The court does not order the debtor to sell the house or the car, but the debtor must sell them to lower those expenses in order to meet the other aggregate obligations under the plan.

The other possibility (and admittedly a real long shot) is that a debtor owns very valuable assets and is so committed to preserving them that she will reduce her lifestyle to
B. Losing Prepetition Transfers of Property

In a Chapter 11 or 13 case, property the debtor owned before bankruptcy is more directly vulnerable if the property was the subject of an avoidable transfer. Formally, Chapters 11 and 13 require the debtor to propose a plan for paying creditors from future income. They do not contemplate conscripting prepetition property to help fund the plan. However, prepetition property may be pursued and taken for the benefit of creditors if the property was the subject of an avoidable transfer, either because the debtor transferred the property away or received the property by way of such a transfer.

1. Avoiding Transfers the Debtor Made—Domestic Asset Protection Trusts

In every bankruptcy case, the bankruptcy estate consists of property the debtor owned at the time she filed the case. Property she transferred away before filing, then, is ordinarily beyond the effects of her bankruptcy. In limited circumstances, however, the estate can avoid prepetition transfers. The best examples are transfers that are preferences or fraudulent transfers.

Usually, the debtor is not concerned about avoidance. She transferred away the property, and what happens to it now, in her bankruptcy case, usually does not affect or concern her. It is different, however, if the property was transferred to someone who holds and uses it for the benefit of the debtor, the debtor’s spouse, or her children. In this event, avoiding the transfer and taking the property back directly affects the wealth and well-being of the debtor or her family.

Just this effect would result from avoidance under § 548(e), which provides a new avoiding power that the

whatever extent necessary to fund the plan from future income. It is possible, though not likely, that the court would dismiss the reorganization case, whether or not the assets are exempt, if the amount the plan pays creditors is sufficiently low.

BAPCPA added to the Bankruptcy Code. It is designed to combat a prepetition transfer that has recently been made lawful under the laws of a few states: transfers by a debtor to a domestic asset protection trust ("DAPT"). A DAPT is basically a self-settled trust benefiting the settlor or the settlor’s family. It "purports to protect the properties of the trust from creditor claims even though the settlor of the trust may exercise control over the trust and may receive distributions from the trust."\footnote{340} The long-standing, common-law rule is that self-settled trusts are ineffective in creating immunity against the claims of the settlor’s creditors.

Recently, however, several states have enacted DAPT statutes trumping the common-law rule and giving effect to the purpose of these trusts, which is to shield the settlor’s property from creditors’ claims.\footnote{341} Generally, these statutes authorize[] the creation of an irrevocable, self-settled, discretionary, spendthrift trust. Each statute requires that (1) the trust have at least one trustee from the host state, (2) the trust instrument invoke the law of the host state, (3) some part or all of the administrative acts must be performed within the host state, and (4) some part or all of the trust property must be deposited or held within the host state.

The . . . domestic APT statutes protect the interests of the settlor (and any other beneficiary) from typical creditor claims. The standout features of the . . . domestic APT


\footnote{341} The states with the best known DAPTs include Alaska, Delaware, Missouri, Nevada, Oklahoma, Rhode Island, South Dakota, and Utah. In all of these states, the laws recognizing DAPTs are new—none was enacted earlier than 1997. See ALASKA STAT. § 34.40.110 (Repl. 2004); DEL. CODE ANN. tit. 12, §§ 3570-3576 (Repl. 2001 & Supp. 2004); MO. ANN. STAT. §§ 456.5-503 to -504 (West Supp. 2006); NEV. REV. STAT. § 166.040(1)(b) (2005); OKLA. STAT. ANN. tit. 31, §§ 10-18 (West Supp. 2006); R.I. GEN. LAWS §§ 18-9.2-1 to -7 (2003); S.D. CODIFIED LAWS §§ 55-16-1 to -16 (Supp. 2005); UTAH CODE ANN. § 25-6-14 (Supp. 2005).

States compete for business in many ways that are far less subtle than economic development incentives to attract new factories. DAPTS are more subtle examples, and there is, in fact, a developing interstate competition for trust funds. See Robert H. Sitkoff & Max M. Schanzenbach, Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes, 115 YALE L.J. 356, 380-85 (2005). Even if more states fail to enact protective DAPT laws, debtors’ money may migrate to the states with these laws, which will raise interesting issues of conflicts and choice of laws.
statutes are striking. Without negating the spendthrift/creditor-protection provisions, (1) the trustee may be authorized to make discretionary distributions of income or principal to the settlor, (2) the settlor may be authorized to veto any distributions from the trust, and (3) the settlor may be given a testamentary special power of appointment over the trust. Under the laws . . . , the creditor protections are not available if any part of the trust income or principal must be distributed to the settlor. Accordingly, an . . . APT may permit discretionary distributions to the settlor (and the settlor may be the only permissible distributee during the life of the settlor), but the creditor protections do not apply if the APT requires distributions to the settlor. The law of Delaware, on the other hand, is more generous. The settlor of a Delaware APT may retain the right to the trust income (but not principal) without negating the spendthrift/creditor-protection provisions.\textsuperscript{342}

A variant of the DAPT is the "killer rabbit trust," which is

[a]n asset protection trust created initially as a domestic trust, with the idea that if a serious problem arises the trust will migrate to an offshore jurisdiction where its assets will be protected from creditors. Planners who form these trusts theorize (perhaps "wish" is a better term) that U.S. judges will treat these trusts better than foreign asset protection trusts that were formed offshore in the first place. The somewhat derisive but apt nickname for this type of trust derives from the scene in Monty Python's The Holy Grail where King Arthur's men confront a harmless bunny rabbit, and then flee shouting "Run Away! Run Away!" when the bunny turns vicious. [It is a]lso sometimes referred to as a "Flight Trust" or "Fleeing Trust" or "Domestic/Offshore Trust (DOT).\textsuperscript{343}

To the extent state law validates the inalienability of a DAPT—that is, gives the trust immunity to creditors' claims—the trust is arguably excluded from the estate in the event the settlor files bankruptcy. Section 541(c)(2) provides: "A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is

\textsuperscript{342} Lischer, supra note 340, at 516-17 (footnotes omitted).
enforceable in a [bankruptcy] case . . .” 344 The effect is that if a trust is inalienable under state or federal non-bankruptcy law in the sense that the trust is beyond creditors’ reach, the corpus of the trust does not become part of the bankruptcy estate in any kind of bankruptcy case even if the debtor retains an interest related to the property. 345

This reasoning works for traditional spendthrift trusts that are inalienable under state law. It means, for example, that if a debtor’s parents have created a spendthrift trust for the benefit of the debtor who, because of the spendthrift features, lacks access to the principal but enjoys the rights to income, the principal does not become part of the estate if the debtor files bankruptcy. Trust income already disbursed to the debtor is included in the debtor’s estate, but the principal of the trust is excluded even if the debtor enjoys some residual property interest in the principal. Because state law puts the principal beyond creditors’ reach, federal law puts the principal beyond the reach of the bankruptcy estate.

Arguably, § 541(c)(2) works the same result for DAPT.s. In this case, the principal was accumulated by prepetition transfers of the debtor’s property, not the property of parents or other third parties. Nevertheless, if state law validates the trust in the sense of making it inalienable and unreacha ble by creditors, this restriction on alienability is respected in bankruptcy, and the principal is excluded from the debtor’s bankruptcy estate.

The new § 548(e), however, allows avoiding contributions to asset protection trusts and includes a very long reach-back period.

In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—

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345. "The natural reading of the provision entitles a debtor to exclude from property of the estate any interest in a plan or trust that contains a transfer restriction enforceable under any relevant nonbankruptcy law." Patterson v. Shumate, 504 U.S. 753, 758 (1992). In Patterson, the Court held that a debtor may exclude his interest in an ERISA-qualified pension plan from the bankruptcy estate because the plan includes an enforceable provision that benefits may not be assigned or alienated. Id. at 765-66.
(A) such transfer was made to a self-settled trust or similar device;
(B) such transfer was by the debtor;
(C) the debtor is a beneficiary of such trust or similar device; and
(D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.\textsuperscript{346}

Notice how expansive Congress made this avoiding power by using the terms “self-settled trust or similar device.”\textsuperscript{347} Section 548(e) also defines “transfer” so that for purposes of § 548(e) only, the term includes “a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by” certain violations of securities laws.\textsuperscript{348} This language, however, does not so limit—at least not patently—the meaning of transfer, which is otherwise very, very broad.

Thus, because of § 548(e), property of the debtor transferred to a DAPT or “similar device” is vulnerable to avoidance even though the principal of the trust is excluded from the debtor’s estate. The trustee or other representative of the estate\textsuperscript{349} would attack the contributions made by the debtor within the ten-year reach-back period preceding bankruptcy.

\textsuperscript{346} 11 U.S.C.A. § 548(e)(1) (emphasis added).
\textsuperscript{347} 11 U.S.C.A. § 548(e)(1)(A) (emphasis added). “[A] ‘self-settled trust or similar device’ might include a retirement plan, an IRA, a homestead, a limited partnership, a limited-liability company, or tenancy-by-the-entirety property as well as a DAPT or an offshore APT.” Richard W. Nemmo, Planning with Domestic Asset-Protection Trusts: Part I, 40 REAL PROP. PROB. & TR. J. 263, 328 (2005).
\textsuperscript{348} 11 U.S.C.A. § 548(e)(2).
\textsuperscript{349} In a Chapter 13 case, the trustee would assert this and other avoiding powers. Even if the debtor were interested in doing so, which would be unlikely, the consensus is that the debtor herself generally lacks standing to assert avoiding powers in a Chapter 13 case. See In re Hansen, 332 B.R. 8, 16 (B.A.P. 10th Cir. 2005); In re Henneghan, Adversary No. 05-1220, 2005 WL 2267185, at *7 (Bankr. E.D. Va. June 22, 2005); In re Ryker, 315 B.R. 664, 674 (Bankr. D.N.J. 2004). The answer may be different, however, if the confirmed plan empowers the debtor to bring avoidance actions. See In re Hearn, __ B.R. __, No. 05-5330, 2006 WL 266573, at *3-5 (Bankr. E.D. Mich. Feb. 3, 2006). Presumably, any recovery by the Chapter 13 estate is considered income that would help fund the plan. In a Chapter 11 case involving an individual, the debtor herself would not likely pursue avoidance, but the court can authorize other representatives of the estate to assert the avoiding powers or appoint a trustee who would do so.
The trust is then accountable for the contributions that are avoided under § 548(e) because the trust is the initial transferee of the contributions and is therefore separately liable to the trustee for them. 350

Whether or not § 548(e) is really a serious threat to DAPTs depends on how bankruptcy courts interpret the terms of the section and also on the terms and interpretation of the state law that validates DAPT. Validity of DAPT in some states requires that the beneficiary is the settlor's family, not the settlor herself. In this case, that is, the settlor is not a beneficiary, an element of § 548(e) is missing if the requirement that the debtor is a "beneficiary" of the trust is strictly, narrowly defined. Even if this requirement is satisfied, § 548(e) still requires proof that the challenged contributions to the trust were made with "actual intent to hinder, delay, or defraud" present or future creditors. However, bankruptcy courts could interpret the "actual intent" language "to cover a transfer in which asset protection is . . . implicated . . . ." 351 If this is the case, "then DAPT and offshore APT will be vulnerable in bankruptcy." 352

An alternative, wholesale way of attacking DAPT is to argue that despite inalienability under state law, the trusts nevertheless are not excluded from the estate under § 541(c)(2). Therefore, the trusts (i.e., the corpus or principal) become part of the estate to the extent the debtor retains any interest in them. Even advocates of DAPT admit: "There is an argument [based on a narrow construction of § 541(c)(2)] that [the section] was not intended to shield a self-settled DAPT in the same manner as a traditional spendthrift trust." 353 This argument is perhaps bolstered by some federal policy that overrides the usual, wide federal deference to state property law in bankruptcy. 354

352. Id.
354. "Property interests are created and defined by state law. . . . [T]here is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding," unless Congress says so or "[u]nless some [otherwise identified] federal interest requires a different result . . . ." Butner v. United States, 440 U.S. 48, 55 (1979) (emphasis added). In this instance, any overriding federal policies...
Also, even if § 541(c)(2) is constructed broadly to protect DAPTs, and even if the debtor is not a named beneficiary of the trust, a DAPT is arguably vulnerable on very traditional grounds. Notwithstanding the rule that the bankruptcy estate excludes “any power that the debtor may exercise solely for the benefit of any entity other than the debtor,”355 the usual rule of case law is that a trust for which the debtor is trustee collapses into the bankruptcy estate if the debtor’s power is excessive or if the debtor treats the trust property as her own.356 Courts interpreting state statutes making DAPTs inalienable may decide that the statutes do not completely reverse this traditional case law; or, the statutes by their own terms may exclude a DAPT from their statutory scope and protection when the debtor’s actual control or beneficial use is so large.

For another reason, a DAPT is not completely safe in bankruptcy even if: (1) the trust is perfectly valid where created, (2) the trust cannot be avoided under § 548(e) or any other avoiding power, and (3) the bankruptcy court interprets § 541(c)(2) so that a DAPT that is valid under applicable state law is excluded from the estate. The additional threat is that the court will decide that the applicable state law, for purposes of applying § 541(c)(2), comes not from the state where the DAPT was created but rather from another state, such as the forum state, that does not recognize the inalienability of DAPTs and does not protect them from creditors’ claims. In this event, to the extent the debtor retains an interest, the DAPT is part of the bankruptcy estate. This conflicts issue is unsettled.

In sum, whether or not DAPTs are seriously threatened by trustee avoidance under § 548(e) or judicial interpretation of § 541(c)(2) is uncertain. However, even a slim possibility that these sections are a real threat may encourage professionals who own such trusts to avoid risks that would put them personally, as well as their trusts, into bankruptcy.

2. Avoiding Transfers the Debtor Received

There is another risk—more indirect but more certain—to DAPTs and prepetition property of the management or lawyers who are liable to a firm that filed Chapter 11 and who themselves file bankruptcy for protection against this liability. To the extent these persons received property from the firm through transfers that are avoidable by the trustee or other representative of the firm’s estate, the representative can recover the property from the transferees even though they are also in bankruptcy.

These transfers can result from transactions that are associated with management’s or the lawyers’ breach of fiduciary duties to the firm.357 They can also result independently and for other reasons, such as the firm’s payment of prepetition compensation to professionals that the court, in the firm’s bankruptcy, finds are fraudulent transfers.358

Management’s or lawyers’ accountability for such transfers adds to the debt they owe to the firm and increases the claims against the bankruptcy estate. More important, however, the firm’s trustee or other representative can possibly trace the


358. See supra notes 89-130 and accompanying text.
proceeds of the avoided transfers into, and satisfy liability from, prepetition property of the debtor that would otherwise be excluded or exempted from the manager’s or lawyer’s bankruptcy estate, such as a homestead or DAPT.

When a trustee avoids a prepetition transfer under § 547, § 548, or other section that provides a substantive basis for avoidance, the section itself, as a result of the trustee’s success under its terms, provides for avoiding the transfer. Section 550, however, provides remedies to vindicate the avoidance by entitling the trustee to “recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property . . . .”359 So, if a firm’s trustee avoids a transfer of the firm’s property to a manager or lawyer of the firm, the trustee can recover the property from the transferee.

The transferee will likely not have acted innocently, which means that she cannot rely on the bona fide purchaser for value defense to avoidance of fraudulent transfers under § 548(c). Similarly, the bona fide purchaser defense to avoidance remedies under § 550 is not available for the same reason, and also because this defense is never available to an initial transferee of the property, whether or not she is personally innocent.360 Also, the defense of in pari delicto—which sometimes protects third parties against claims for injuring a firm—is always subject to exceptions,361 is perhaps otherwise diluted in bankruptcy,362 and “is inapplicable when a trustee brings an [avoidance] action under sections 544(a), 544(b), or 548 . . . .”363

If the transferee manager or lawyer has herself filed bankruptcy, neither this individual’s bankruptcy nor the powers or status of her estate will necessarily stop the firm’s trustee from pursuing the property. The only global limitation is that the firm’s trustee must respect the bankruptcy process.

360. The defense that the transferee took innocently applies only to a transferee beyond the initial transferee, that is, an immediate or mediate transferee of the initial transferee. The defense does not apply to the initial transferee herself. 11 U.S.C. § 550(b).
361. See supra text accompanying notes 273-83.
362. See supra text accompanying notes 273-96.
requirements of the individual’s case. So, for example, in *In re Halpert & Co.*, the Chapter 11 trustee of a company sued the company’s president and other people for breaching fiduciary duties to the company and also to set aside transfers of the company’s property to them.\(^{364}\) The court observed that “while [the firm’s trustee] may not be able to object to a homestead exemption [claimed by the individual debtor in her individual case], nothing prevents [the firm trustee] from seeking to avoid a transfer as fraudulent or to prevent [the individual] debtor’s discharge” in the individual debtor’s bankruptcy case.\(^{365}\) Moreover, the status of the trustee in the individual’s case as a hypothetical state-law lien creditor and purchaser\(^{366}\) does not always give this trustee all of the qualities that are necessary to establish the § 548(c) bona fide purchaser defense against the firm’s trustee’s fraudulent transfer avoidance action.\(^{367}\)

Also, the firm’s trustee is not stopped by the transferee having invested the proceeds of the fraudulent transfer in her homestead. The best authority, once again, is a fairly recent case that, significantly, is based on Florida law that has traditionally been generous in protecting the homestead exemption. The case is *In re Financial Federated Title & Trust, Inc.*, \(^{368}\) decided by Florida Bankruptcy Judge Raymond Ray and affirmed by the United States Court of Appeals for the Eleventh Circuit. In this case, the plan administrator (John Kozyak) of the Chapter 11 debtor (Fin Fed) discovered that funds of the firm

\(^{364}\) 254 B.R. at 109.

\(^{365}\) Id. at 126; see also *In re Personal & Bus. Ins. Agency*, 334 F.3d at 246.


\(^{367}\) In re Standard Law Enforcement Supply Co. of Wis., 74 B.R. 608, 612-13 (Bankr. E.D. Wis. 1987).

The phrase in section 544(a), “without regard to the knowledge of the trustee,” negates only “any personal knowledge the trustee may have.” It “does not give the trustee any greater rights than he, or any other person would have as bona fide purchaser or creditor under applicable state law.” Consequently, if state law would charge a real judicial lienor or bona fide purchaser with constructive or inquiry notice (even beyond record, constructive notice) that denies her priority despite her actual, subjective innocence, the trustee as hypothetical, ideal lien creditor or bona fide purchaser is similarly charged . . . .

\(^{2}\) Epstein, Nickles, & White, supra note 62, at § 6-61, at 129 (emphasis & footnotes omitted). State law controls the issue whether or not the attendant circumstances gave constructive notice effective against the trustee. *In re Roman Catholic Archbishop of Portland in Or.*, 335 B.R. 868, 877-78 (Bankr. D. Or. 2005).

\(^{368}\) 273 B.R. 706.
had been fraudulently transferred to principals of the debtor.\textsuperscript{369} The administrator traced some of the money into the homestead ("the El Caballo property") of the firm’s president and his wife (Ray and Roseann Levy) and asked the court to impose an equitable lien or constructive trust on the property.\textsuperscript{370} Another player in this scheme was the lawyer who closed the purchase on the homestead for the Levys; he was not involved in this case but was charged under federal criminal law with conspiracy and pled guilty.\textsuperscript{371}

In this proceeding against the Levys, the bankruptcy court relied on a principle of state law, which was the basis of the homestead exemption, that "the homestead ‘cannot be employed as a shield and defense after fraudulently imposing on others.’"\textsuperscript{372} In furtherance of this principle, at least where a transferee of a fraudulent transfer knew about and assisted in the fraud, an equitable lien is "a viable remedy for creditors in cases where funds obtained fraudulently [are] used to purchase, invest in or improve a homestead."\textsuperscript{373} Additionally, "[i]f the original res no longer remains, but is transformed into a different form, \ldots [t]raceable proceeds from prior fraudulent transfers, which are used to acquire a homestead, may also be subject to a constructive trust."\textsuperscript{374}

Equally important, although Judge Ray did not explain in\textit{ In re Financial Federated} the necessary level of proof to trace the proceeds, the requirement may not be exactlying precise. "[I]t could be argued that any funds generated directly or indirectly from [the fraudulent activity] are proceeds of a fraud [so that] an equitable lien can be imposed on a \ldots homestead under such a theory."\textsuperscript{375}

\begin{footnotes}
\textsuperscript{369} Id. at 708-11.
\textsuperscript{370} Id. at 710-11.
\textsuperscript{371} Id. at 710.
\textsuperscript{372} Id. at 713 (quoting Jones v. Carpenter, 106 So. 127, 130 (Fla. 1925)).
\textsuperscript{373} In re Financial Federated, 273 B.R. at 715.
\textsuperscript{374} Id. at 718; see also\textit{ In re Hicks}, 176 B.R. 466, 471 (Bankr. W.D. Tenn. 1995) (imposing an equitable trust on proceeds of property that had been fraudulently transferred upon the trustee’s avoidance of the transfer); David B. Young,\textit{ Preferences and Fraudulent Transfers}, in 27TH ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY & REORGANIZATION, at 829-34 (Practising Law Institute Mar.-Apr. 2005).
\end{footnotes}
The rule that, for purposes of tracing, "pretty close is good enough" was confirmed in another recent case, In re International Administrative Services, Inc.\textsuperscript{376} In this case, the Chapter 11 trustee in a corporate debtor's case sued to avoid and trace transfers of company property fraudulently transferred to principals and insiders of the firm.\textsuperscript{377} The defendants argued that the trustee had failed to exactly trace all of the proceeds into and out of certain accounts.\textsuperscript{378} The court agreed that the trustee had the burden of tracing the property but concluded that "proper tracing does not require dollar-for-dollar accounting."\textsuperscript{379} Particularly when the fraud is large and the amount of property is massive, as in this case, it "is not fatal to the Trustee's case that dollar for dollar, the exact funds cannot be traced."\textsuperscript{380}

Even more important is the effect of the lien on an innocent spouse. Mrs. Levy, who also owned an interest in the homestead, argued that her lack of knowledge of and involvement in her husband's fraudulent activity protected her rights with respect to the property.\textsuperscript{381} The court disagreed, noting that innocence "on the part of the person asserting the homestead exemption does not change this analysis, as it is the fraudulent nature of the funds which is of utmost importance."\textsuperscript{382} The court concluded that imposing equitable remedies on the homestead against both Levy and his wife was "necessary to prevent [them] from using the homestead exemption as an instrument of fraud and to prevent . . . unjust enrichment at the expense of . . . defrauded investors."\textsuperscript{383}

The analysis also should not change in other cases if proceeds of avoided transfers are invested in other property such as DAPTs, which may be excluded from the estate because of

\textsuperscript{376} 408 F.3d 689.
\textsuperscript{377} Id. at 694.
\textsuperscript{378} Id. at 708.
\textsuperscript{379} Id.
\textsuperscript{380} Id. For a discussion of equitable tracing, see generally Dale A. Oesterle, Deficiencies of the Restitutionary Right to Trace Misappropriated Property in Equity and in UCC § 9-306, 68 CORNELL L. REV. 172 (1982).
\textsuperscript{381} In re Financial Federated, 273 B.R. at 716.
\textsuperscript{382} Id. at 716-17 (emphasis added).
\textsuperscript{383} Id. at 719; see also In re Halpert & Co., 254 B.R. at 127 ("[T]his Court is not concerned so much with the 'sanctity of the Florida homestead exemption,' as it is with the alleged fraudulent transfer by Defendant of . . . his interest in the Florida property to his wife.").
§ 541 rather than under exemption law. Indeed, the analysis gets easier absent concerns for the policies, principles, and rules attending exempt property, and also because bankruptcy concerns are reduced inasmuch as the excluded property is wholly beyond the individual’s bankruptcy from the start of the case.

Equitable remedies, however, are highly localized and uncertain under state law, and courts in bankruptcy cases (though very different kinds of cases) occasionally imply that bankruptcy law displaces equitable liens and the like. Suppose, therefore, that notwithstanding In re Financial Federated, a firm’s trustee is unable to get a lien or trust on the homestead proceeds of an avoided transfer in the bankruptcy case of a firm’s manager or lawyer who was the transferee. To the extent that the avoided transfer involved the individual’s complicity or culpability, the trustee in the individual’s bankruptcy case can argue that the new BAPCPA limit on the homestead exemption, § 522(o), applies. This section, with its ten-year reach-back period, reduces a homestead exemption to the extent of value added with the intent to defraud creditors. To the extent the value is traced to a fraudulent transfer from the firm, the firm is a creditor of the individual debtor.

Moreover, although the § 522(o) limitation applies only to homesteads, substantial case law that long predates the BAPCPA developed a judge-made restriction on exempt property of all kinds, both real and personal, acquired by the debtor with the intent to defraud creditors. The effect of this case law is that either the exemption is disallowed because of

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384. 11 U.S.C. § 541(c)(2); see also supra text accompanying notes 344-56 (discussing 11 U.S.C. § 541(c)(2)).
386. 11 U.S.C.A. § 522(o); see also supra text accompanying notes 325-26 (discussing 11 U.S.C.A. § 522(o)).
388. The exact language of § 522(o) does not require that the defrauded creditor be a creditor of the debtor. It requires only that the homestead was inflated with intent to defraud "a" creditor, which could include a creditor of somebody else. However, the Bankruptcy Code definition of creditor is an “entity that has a claim against the debtor ...” 11 U.S.C. § 101(10)(A) (2000) (emphasis added).
state or federal law or, worse, discharge is denied. The enactment of § 522(o) does not imply preemption or displacement of these other, even wider, case-based consequences of ill-gotten exemptions.

An even larger and even more certain threat to bankruptcy protection for the firm’s management and lawyers concerns not wealth existing at the time of bankruptcy, but future wealth acquired after bankruptcy. The threat does not involve denial of either exemption or discharge but, rather, exception to discharge. It is the possibility that their debts to the firm and its creditors, for having violated fiduciary duties and for conduct that makes the professionals personally accountable, are unaffected by the professional bankruptcies. The debts are not discharged; rather, the debts are excepted from discharge. Therefore, despite the professionals’ bankruptcies, creditors can keep these debts alive and pursue collection efforts against existing and future wealth to the extent allowed by state law, which means virtually forever until the debts are fully paid.

C. Limiting Discharge of Debts

A principal hallmark of bankruptcy is the discharge, which operates as a federal injunction to stop efforts to collect debts affected by the discharge. Discharge of debts is provided for under each of the chapters likely to attract an insolvent manager or lawyer. Each of these provisions for discharge, however, is subject to some extent to § 523, which excepts certain debts of individuals from discharge. For a firm’s managers and lawyers who are guilty of having breached fiduciary duties and related harms, the value of a discharge—and thus the value of personal bankruptcy for them—is diluted to the extent that § 523 excepts their liability to the firm and its creditors.

1. Section 523(a)(4)—Widening the Meaning of “Fiduciary Capacity”

Section 523(a)(4), which is not new law, looks very menacing for management and lawyers in bankruptcy who are liable for breaching fiduciary duties and the like. This provision excepts from discharge any debt of an individual “for fraud or defalcation while acting in a fiduciary capacity” and also any debt for embezzlement or larceny. For a firm’s managers and lawyers with debts for breaching fiduciary duties to the firm or its creditors, § 523(a)(4) is not as scary as it looks according to the established interpretations of its meaning and scope.

To begin with, the terms of the exceptions are defined by federal law, not state law. The federal meaning of “fiduciary capacity” is fairly rigid and does not expand to include many situations under federal and state law where fiduciary relationships and obligations, as ordinarily defined, are commonly found. “Federal courts have found that the traditional meaning of the term “fiduciary”—a relationship involving confidence, trust, and good faith—to be too broad for bankruptcy purposes.” For purposes of § 523(a)(4), “fiduciary capacity” generally exists only as a result of an express or technical trust, as in the case of an agency agreement explicitly providing that funds are held in a segregated trust for a named beneficiary.

394. In re Blaszak, 397 F.3d 386, 390 (6th Cir. 2005).
397. See, e.g., In re Blaszak, 397 F.3d at 391-92.
So defined, fiduciary capacity “is not the kind of general fiduciary status often found in non-bankruptcy law based on a relationship of trust and confidence,”398 such as the fiduciary relationship of officers and directors to a corporation. So interpreted, § 523(a)(4) does not apply to liability arising from management’s breach of fiduciary duties to the firm or the firm’s creditors.399 Similarly, the exception to discharge does not ordinarily apply to a lawyer’s debts for breaching professional duties to a client.400

A very recent case flatly disagrees and relaxes the traditional, rigid, limited interpretation of § 523(a)(4). In the case In re Rey, the court wrote: “a section 523(a)(4) claim can be based on a fiduciary relationship other than one arising from an express trust.”401 More specifically, after recognizing that the decisions are split, the court agreed with “more recent decisions” treating “officers and directors of insolvent corporations as fiduciaries of the corporation’s creditors for purposes of section 523(a)(4).”402

2. Section 523(a)(19)—The Effects of Sarbanes-Oxley

More threatening to management and their lawyers in this context is not this new case law but new, statutory bankruptcy law. Section 523(a)(19) was added to the Bankruptcy Code in 2002. The subsection started as part of the Corporate and

398. In re Dakota, 284 B.R. at 724.
399. See id.; In re Schultz, 208 B.R. 723; In re Overmyer, 53 B.R. at 957; cf. In re Carlson, 334 B.R. 626, 629-30 (Bankr. C.D. Ill. 2005) (determining that fiduciary obligations between partners are not included with § 524(a)(4)). But see In re Frain, 230 F.3d 1014, 1017-19 (7th Cir. 2000) (involving a closely-held corporation with a dominant shareholder wielding disproportionate power over the other shareholders); In re Jacks, 266 B.R. 728; In re Cummins, 166 B.R. 338, 353-54 (Bankr. W.D. Ark. 1994).
402. Id.; see also In re Picard, 339 B.R. 542, 553-54 (Bankr. D. Conn. 2006) (stating that a debtor’s officer becomes a fiduciary for purposes of § 523(a)(4) when the debtor enters the “zone of insolvency”). There is older authority that would also agree. See In re Reuscher, 169 B.R. at 401-02; In re Cummins, 166 B.R. at 353-54.
Criminal Fraud Accountability Act of 2002, 403 which was subsumed within the Sarbanes-Oxley Act of 2002. 404

Section 523(a)(19) excepts from discharge any debt of an individual that:

(A) is for—

(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), 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; and

(B) results, before, on, or after the date on which the petition was filed, from—

(i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;

(ii) any settlement agreement entered into by the debtor; or

(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor. 405

There is more here than meets the eye. The significance of this exception comes from other effects of Sarbanes-Oxley. The details of this statute and its full effects even on § 523(a)(19) are beyond the scope of this article, but a short, general explanation is sufficient to show how Sarbanes-Oxley has affected the meaning of § 523(a)(19) and enlarged its significance to the personal bankruptcies of management and lawyers who have debts for breaching fiduciary duties.

Section 523(a)(19) is limited to debts based on violation of any “securities laws.” Until recently, corporate mismanagement

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403. The legislation was introduced in the 107th Congress and became H.R. 4098 in the House and S. 2010 in the Senate.
or breach of fiduciary duty, by itself, did not ordinarily amount to a federal securities law violation. 406 Sarbanes-Oxley does not change this principle. However, the statute directly and indirectly—by its own terms and by delegation of authority to the Securities and Exchange Commission (“SEC”) and other authorities—imposes many scattered federal duties on management with respect to corporate governance. The effect, to some extent, is to federally codify some duties that have been, or perhaps should have been, required by state-law fiduciary obligations. The impact is to increase the ability of shareholders to hold management “personally liable under federal securities laws” 407 because, even though “one [still] cannot bring a federal securities law claim . . . based on a breach of . . . fiduciary duty,”

406. 3 Thomas Lee Hazen, Law of Securities Regulation § 12.20 (5th ed.) (updated 2006 pocket part); see also 3 William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 840.10 (Supp. 2005). Federal securities laws may not be invoked as an alternative means of remedying every alleged breach of fiduciary duty, nor as a mandate for the federal courts to inquire into every managerial decision of a corporation. The federal securities legislation and regulations do not represent a federal corporation law with respect to responsibility of corporate officers and directors that has supremacy over state law, at least in the absence of any direct conflict between the two.

Id.; see also 26A Michael J. Kaufman, Securities Litigation: Damages § 22:10 (Oct. 2005).

While state law fraud claims cover less forms of conduct than the federal securities laws but afford greater damages, state law breach of fiduciary duty claims cover more forms of conduct than the federal securities laws but afford less damages. The federal securities laws do not provide redress for conduct that merely amounts to corporate mismanagement or unfairness to shareholders.


407. Fairfax, supra note 140, at 420 (reviewing the provisions of Sarbanes-Oxley that tend to federalize management’s fiduciary duty of care); see also generally Johnson & Sides, supra note 169; Roberta S. Karmel, Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance, 30 Del. J. Corp. L. 79 (2005).
Sarbanes-Oxley creates "some circumstances under which federal securities laws subject [management] to liability for failing to perform their responsibilities . . . adequately." Imposing liability for this failure under federal law "has proved difficult in the past," but "Sarbanes-Oxley may enable plaintiffs to overcome this difficulty."

Sarbanes-Oxley also affects the liability of corporate lawyers. Federalizing management duties would perhaps federalize aiding and abetting violation of these duties by lawyers and other persons. More directly, Sarbanes-Oxley gave the SEC new regulatory authority over any person appearing or practicing before the Commission, including the power to discipline a person whom the SEC finds "to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder." Very pointedly, Sarbanes-Oxley explicitly required the SEC, in its regulatory rule over lawyers, to issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not

408. Fairfax, supra note 140, at 420.
409. Id.
employed directly or indirectly by the issuer, or to the board of directors.\footnote{411}

To the extent that these and other changes in federal law have the effect of making management and related lawyer misconduct a violation of federal securities laws, the effect is to widen the scope of the § 523(a)(19) exception to discharge. Concomitantly, bankruptcy protection is weakened for managers and lawyers who are held liable for breaching fiduciary duties. The risk of this liability is increasing when the firm files bankruptcy, and the net effect may be that § 523(a)(19) indirectly works to discourage management and the firm’s lawyers from taking the firm into Chapter 11.

VI. CONCLUSION—BANKRUPTCY RISKS, EFFECT ON INDIVIDUAL BEHAVIOR (LOSS AVERSION AND COGNITIVE FORCES), AND BEHAVIORAL EFFECT OF NEW LAW

There are a number of new bankruptcy laws that may possibly have a behavioral effect that reduces the occurrence of Chapter 11 because of adverse, personal effects on the firm’s management and lawyers. Imagine management and lawyers contemplating taking the firm into bankruptcy. They think not only about the advantages and disadvantages to the company, but also about the risks to them personally, including the risks described throughout this article:

1. Section 503(c)\footnote{412} effectively forbids making payments in bankruptcy to satisfy lucrative key employee retention contracts, severance packages, and other employee benefits.\footnote{413}


\footnote{413} See supra notes 35-57 and accompanying text.
2. These and other employment benefits paid before bankruptcy are targeted under § 548(a), which is invigorated by new language, new cases, and a new, more suspicious culture regarding executive compensation.

3. Proving management liability for breach of fiduciary duties is procedurally easier in bankruptcy.

4. The substantive requirements for establishing this liability under non-bankruptcy law are perhaps lessened so that management’s risk of liability for breach of fiduciary duties and the like is everywhere trending up and maybe especially in bankruptcy.

5. The likelihood that these duties are owed to creditors, as well as to the firm, is increased by the firm’s insolvency.

6. An exculpatory clause in the firm’s charter that is designed to protect against liability for breach of fiduciary duties is narrowed and increasingly less effective.

7. A third-party release in the firm’s Chapter 11 plan is also less effective—and maybe completely ineffective.

8. The strategic defense that comes from the DIP controlling the bankruptcy is less effective because the court is more likely to appoint a Chapter 11 trustee.

9. Even if a trustee is not appointed, creditors’ committees can sue on behalf of the estate to establish management liability.

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415. See supra notes 58-138 and accompanying text.
416. See supra notes 145-60 and accompanying text.
417. See supra notes 161-69 and accompanying text.
418. See supra notes 170-86 and accompanying text.
419. See supra notes 187-94 and accompanying text.
420. See supra notes 195-204 and accompanying text.
421. See supra notes 205-16 and accompanying text.
422. See supra notes 217-43 and accompanying text.
10. Individual creditors can sue for themselves to remedy the harm they personally suffered as a result of management misconduct.\textsuperscript{423}

11. As management’s risk of personal liability increases, so too does the risk of personal liability to the firm’s lawyers on an increasing variety of theories including breach of the lawyers’ own fiduciary duties to the firm and its creditors, complicity with management misconduct, and other professional misconduct for which the lawyers are personally accountable.\textsuperscript{424}

12. The lawyers’ defense of \textit{in pari delicto} is weakened and, according to new case law, might be unavailable in bankruptcy.\textsuperscript{425}

13. The related \textit{Wagoner} rule is likewise arguably unavailable.\textsuperscript{426}

14. Lawyers also risk fresh, substantial liability for conflicts of interest and other missteps when representing the debtor during the bankruptcy case.\textsuperscript{427}

15. The increased risks of personal liability for management and lawyers increase the likelihood that they will seek protection and relief for themselves in bankruptcy, but this strategic defense of personal bankruptcy is seriously weakened.\textsuperscript{428}

16. Because of their means, management and lawyers are limited in the kinds of personal bankruptcy cases they can file.\textsuperscript{429}

17. Their exemptions are newly limited, especially with regard to wealth “saved” or “stored” in homesteads.\textsuperscript{430}

18. A new avoidance power threatens to undo pre-bankruptcy transfers to domestic asset protection trusts

\textsuperscript{423} See supra notes 244-48 and accompanying text.

\textsuperscript{424} See supra notes 249-66 and accompanying text.

\textsuperscript{425} See supra notes 267-96 and accompanying text.

\textsuperscript{426} See supra notes 269-96 and accompanying text.

\textsuperscript{427} See supra notes 297-313 and accompanying text.

\textsuperscript{428} See supra notes 314-19 and accompanying text.

\textsuperscript{429} See supra notes 314-19 and accompanying text.

\textsuperscript{430} See supra notes 320-34 and accompanying text.
that, only recently, have gained sanction under state law.\textsuperscript{431}

19. Even if homesteads and DAPTs are safe from attack by the estate in the individual cases of management and lawyers, newly-interpreted law allows the firm’s estate to intervene in the individual bankruptcy cases of management and lawyers and take their homesteads, DAPTs, and other property.\textsuperscript{432}

20. Most seriously, new bankruptcy law may except from discharge—in every kind of personal bankruptcy case—the increasingly likely and potentially very large debts that management and lawyers may owe the firm and its creditors for breach of fiduciary duties.\textsuperscript{433}

The standard assumption of agency theory is that, to some extent, management’s and lawyers’ self-interests diverge from the firm’s interests.\textsuperscript{434} Another necessarily included assumption is that, to some extent, they act in their own interests rather than the firm’s interests. If these assumptions are correct, this list of Chapter 11 risks will very likely if not inevitably discourage management and lawyers from taking the firm into Chapter 11, even if doing so would be good for the firm.

Quite possibly, however, even if Chapter 11 is objectively good for the firm, natural, cognitive forces may drive management and lawyers irrationally—and maybe innocently—to conclude that bankruptcy is bad for the firm even if consciously thinking unselfishly about the firm’s interests. Certain decision-making processes and cognitive biases may, in fact, cause management and lawyers to perceive bankruptcy—even when it is an objectively good choice—to be a bad choice for the firm as well as for them.

An explanation is provided by prospect theory, an alternative to expected utility theory, which is a dominant, descriptive model of decision-making.\textsuperscript{435} Prospect theory

\textsuperscript{431} See supra notes 335-89 and accompanying text.
\textsuperscript{432} See supra notes 336-56 and accompanying text.
\textsuperscript{433} See supra notes 357-411 and accompanying text.
\textsuperscript{434} See supra note 17.
\textsuperscript{435} Daniel Kahneman & Amos Tversky, Prospect Theory: An Analysis of Decision Under Risk, 47 ECONOMETRICA 263, 263 (1979); see also supra note 19 and accompanying text.
outlines distinct ways in which people unconsciously deviate from the traditional, economic rational model of decision-making. The theory posits that decisions are not controlled by expected utility. Rather, decision-making depends on the individual’s perception or framing of gains and losses as they deviate from some set reference point.436

According to prospect theory, losses and gains are not treated equally; rather, potential losses are given much more weight than potential gains. If faced with two choices of equal value but one more risky than the other, prospect theory predicts that the individual’s level of risk aversion will rely on her perception of the situation. For instance, if the situation is perceived as a potential gain, prospect theory predicts that the individual will be more risk averse and more likely to make the choice where the gain is certain. However, if the situation is perceived as being a potential loss, the theory predicts that the individual will be more risk-seeking by taking the gamble rather than accepting a certain loss.437 In the face of this perceived loss, prospect theory predicts that individuals will act decidedly to avoid the loss. In fact, they will become acutely loss-averse.

As applied to a firm facing possible bankruptcy, prospect theory predicts that management or lawyers will likely frame the situation as a double-loss because of the effects for them personally as well as for the firm.438 Also, they will likely


438. The reference point against which all decisions are made is affected by the outlook of the decision-maker. Id. at 275, 286-87. Assessment of the reference point is critical in understanding how risk-seeking or risk averse an individual will be. Reference points are arbitrary and largely reflect the state to which the decision-maker has adapted. Dan Ariely et al., When Do Losses Loom Larger Than Gains?, 42 J. MARKETING RES. 134, 136 (2005). Therefore, a loss for one decision-maker may be considered a gain for another decision-maker who has a lower reference point. In the context of bankruptcy, I argue that the manager or lawyer will maintain a set reference point that is reflective of the status quo. As a result, all choices will be contested against a reference point that reflects not only the conditions of the company, but also the lifestyle to which the decision-maker has become accustomed. By maintaining what some might consider a selfish reference point, potential losses in personal income and status, as well as prestige, will become more salient to the manager and affect her perceptions of relative losses and gains. However, if this reference point is lowered, the manager or lawyer may become aware of the potential gains associated with filing Chapter 11. This acknowledgement of gain may change the decision-making strategy of the decision-maker.
foresee relatively more certain loss associated with bankruptcy—for both the firm and for them personally—than a strategy that keeps the firm out of bankruptcy. Filing bankruptcy is a certain loss because the size and wealth of the firm will inevitably shrink. The personal risks to management and lawyers are also more certain because of the new bankruptcy law. Avoiding bankruptcy could have the same or worse results, but management and lawyers might believe that the likelihood is less certain outside of bankruptcy. Prospect theory predicts that this overweighing of certainty will increase management's aversion to loss as well as its propensity to act in a risk-seeking manner to avoid it.\textsuperscript{439} So, management will choose the more risk-seeking option of avoiding bankruptcy in order to avoid the relatively more certain loss of filing bankruptcy.

This decision is supported and furthered by other forces. First, this tendency to avoid loss altogether creates an aversive reaction toward a decision to file bankruptcy, and consequently, management’s inaction may make the choice for them. Loss aversion has been shown to favor inaction over action, thus encouraging maintenance of the status quo.\textsuperscript{440} Second, this inaction is concomitantly bolstered by how Chapter 11 affects management and lawyers personally. Accountability and personal responsibility increase the likelihood that management and lawyers will tend to maintain the status quo.\textsuperscript{441} Deciding against taking the company into Chapter 11 allows management and lawyers to maintain the status quo and avoid immediate loss.

Third, management will assign decision weights to the options based on perceptions of probability, rather than actual probabilities. In particular, individuals will tend to overestimate small probabilities and underestimate medium and large probabilities.\textsuperscript{442} The tendency to make these weight adjustments

\textsuperscript{439} Kahneman & Tversky, \textit{supra} note 435, at 285.
\textsuperscript{440} Kahneman & Lovallo, \textit{supra} note 436, at 18.
\textsuperscript{441} \textit{Id.} at 22.
\textsuperscript{442} Kahneman & Tversky, \textit{supra} note 435, at 280-84. A manager facing possible bankruptcy will be more likely to focus on the worst possible outcome associated with both options, and she will choose according to which one is less fatal regardless of the probabilities of those outcomes occurring. The decision-maker’s disregard of probability is explained in these terms: “Decision weights measure the impact of events on the desirability of prospects, and not merely the perceived likelihood of these events.” \textit{Id.} at
further clouds the lens of the decision-maker, preventing a clear representation of reality. Therefore, management may overweight the probability of the firm avoiding loss by avoiding bankruptcy. Management, in particular, tend to approach decisions by focusing on the worst possible outcome, and they therefore focus on the absolute nature of the loss and are largely blind to the real probabilities associated with the outcome.443

This tendency to focus on loss rather than its probabilities may also cause management to focus on the increase in risk to them personally under the new bankruptcy law without considering the likelihood of actually suffering loss. So, even if the new risks are objectively small in terms of the probability of actually visiting loss on management personally, the increased risks of the new bankruptcy law may nevertheless cause an adverse effect—that is behaviorally disproportionate—in deciding whether or not the firm files Chapter 11.

Finally, certain cognitive biases and ego perceptions contribute to the extreme loss aversion and irrational estimates of probabilities that prospect theory predicts. For example, confirmation bias plays a significant role in all types of decision-making as it manipulates the perception of the decision-maker. Confirmation bias means that individuals pay attention to information that confirms their beliefs and disregard information that is contrary to their beliefs.444 Management of a firm facing possible Chapter 11 may seek out information in order to assess benefits and costs and weigh gains and losses and to account for the consequences of all courses of action. In doing so, management may fully intend to act rationally and objectively. In reality, however, managers are subject to various confirmation biases that affect the information they search for, the events or aspects of the situation they remember, as well as

280. Therefore, the potential impact of the worst possible outcome affects the decision weight that the manager will assign to both options, and this weight is not necessarily tied to any probability.


the ease with which managers are persuaded in a certain direction.\footnote{445} While cognitive biases are relevant in all decision-making situations, they are particularly relevant to a manager or lawyer because of their susceptibility to ego-involvement.\footnote{446} The closer the outcomes of the decision are to the individual, the more the ego will play a role in informing cognitive biases. Professor Anthony Greenwald presents the ego as a type of “totalitarian regime” that determines how information is processed and convinces a person of her rationality and goodness.\footnote{447} As a consequence of ego-involvement, management will tend to find support for their beliefs, resulting in an infallibility that is ignorant of contrasting information.

These cognitive forces are likely to strengthen management’s conclusion—embedded with distorted probabilities of success—that they can more cheaply fix the firm’s financial crisis outside of bankruptcy. This conclusion, in turn, leads to an alternative strategy to avoid the certain loss of bankruptcy, triggers the loss-aversion behavior that prospect theory describes, and leads to a decision not to file Chapter 11.

The personal risks to management may indirectly but forcefully affect management throughout the decision-making process even if, as prospect theory allows, management tries consciously to act only in the interests of the company. The personal risks are direct and may be stronger in deciding whether to take the firm into Chapter 11 if, as standard agency theory suggests, management acts out of self-interest.

In either case, personal risks to management and lawyers associated with a firm’s bankruptcy play a role—consciously or unconsciously—in the decision to file or not to file Chapter 11. Under either theory, an increase in these risks, compounded by distorted calculations about the significance and probability of the risks, works to discourage filing Chapter 11. The new bankruptcy law increases these personal risks to management and lawyers and will likely discourage the filing of Chapter 11 cases.

\footnote{446} See id. at 610.
\footnote{447} See generally id.