Northeast Bankruptcy Conference and Consumer Forum

Ethics

PLENARY SESSION

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AMERICAN BANKRUPTCY INSTITUTE
2023 Northeast Conference & Northeast Consumer Forum

Plenary Session–Ethics:

Who is Your Client? Navigating Thorny Engagement Issues.

Materials by Bodie B. Colwell

Employment of Estate Professionals

Bankruptcy Code section 327 allows a debtor-in-possession, committee, or trustee to employ professionals to represent them, or assist in the case. 11 U.S.C. § 327(a):

> Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

11 U.S.C. § 327(a); *see also In re Arazi*, 492 B.R. 587, 591 (Bankr. D. Mass. 2013) (quoting 11 U.S.C. § 327(a)). ("To employ a professional person under this section of the Code, two requirements must be met. First, the professional must not 'hold or represent an interest adverse to the estate.' And second, that person must also be a 'disinterested person[ ].'")

The concepts of whether a professional is disinterested and whether the professional holds a materially adverse interest "are somewhat intertwined." *In re Martin*, 817 F.2d 175, 179 (1st Cir. 1987). "These statutory requirements—disinterestedness and no interest adverse to the estate—serve the important policy of ensuring that all professionals appointed pursuant to section 327(a) tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities." *Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994).

Disinterested Person

11 U.S.C. § 101(14) defines "disinterested person" as a person who is not a creditor, an equity security holder, an insider; not a director, officer or employee of the debtor within two (2) years from petition date; and "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders,

by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason."

"Courts interpreting § 101(14) have required that professionals be free of any 'scintilla of personal interest' which might impact upon the professional's decisions in estate matters." *In re El San Juan Hotel Corp.* 239 B.R. 635, 646 (B.A.P. 1st Cir. 1999), *aff'd*, 2000 WL 1425118, 230 F.3d 1347 (1st Cir. 2000). "The most modest interest or relationship will undo a person's disinterestedness if it would even faintly color the independence and impartial attitude required by the Code and Bankruptcy Rules*." In re Vebeliunas*, 231 B.R. 181, 192 (Bankr. S.D.N.Y. 1999)(internal quotation marks omitted).

Case examples:

In re Springfield Med. Care Sys., Inc., No. 19-10285, 2019 WL 6273385 (Bankr. D. Vt. Nov. 22, 2019): The debtor sought to employ a financial advisor to assist in a chapter 11 reorganization. The debtor had worked with the financial advisor for approximately twenty years prior to the bankruptcy case. The financial advisor waived its pre-petition claim for unpaid fees; however, it could have been the target of avoidance of preferential transfers in the amount of $48,500. The Bankruptcy Court for the District of Vermont found that the financial advisor met the statutory definition of a disinterested person because (a) its pre-petition claim was waived, and (b) any preference litigation was at best speculative, and "hence, not a disqualifying factor under the caselaw of this Circuit." *Id.* at *3.

In re Vebeliunas, 231 B.R. 181 (Bankr. S.D.N.Y. 1999): Bias of the chapter 7 trustee's counsel against the debtor constituted a lack of disinterestedness. Prior to any 341 meeting or other examination of the debtor, the chapter 7 trustee's attorney made statements to the effect that he believed debtor to be a liar. Further, in his affidavits the counsel stated his belief that the debtor did not deserve the opportunity to explain himself because he was a convicted felon. These actions indicated predisposition not to trust, listen to, believe in, or have confidence in debtor. Because a trustee and their counsel owe fiduciary duties to the debtor as well as the entire creditor body, "the trustee's disinterested counsel must treat the debtor in accordance with the high standards of conduct expected from fiduciaries in bankruptcy." *Id.* at 192. "The bottom line concern is that counsel's independent judgment should not be compromised in any way. If the goal is disinterestedness, whether an attorney holds a bias or instead suffers from the likelihood of tainted judgment as a result of a conflict of interest, the wrong is the same, for his or her ability to maintain independence of judgment will be negatively affected." *Id.* at 193.

Interest Adverse to the Estate: Actual or Potential Conflicts of Interest?

The First Circuit Court of Appeals in *In re Martin*, 817 F2d 175, 180 (1st Cir. 1987) stated that bankruptcy courts have the "responsibility to monitor the integrity of the proceedings before it . . . a duty which demands that the court root out impermissible conflicts of interest between the attorney and client . . . ." The inquiry is case-specific and requires full and timely disclosure." *In re ESJ Towers, Inc.,* 2022 WL 7721668, *6 (Bankr. D.P.R. Oct. 13, 2022). "The screening includes the appearance of impropriety upon a fact-specific inquiry to determine if there is an impermissible conflict of interest." *Id.*

> The bankruptcy court must engage in a case-specific analysis to determine if there is a disqualifying conflict of interest. Disapproval of an application for employment is mandatory if there is an actual conflict. Determining whether there is a potential conflict in a large case requiring a competent professional requires considering whether the possibility of a potential conflict is remote and balancing the needs for employing the professional person in question.

Id. at *6. A professional "may be employed by a debtor if the two prong test of 11 U.S.C. 327(a) is satisfied, that is, that said attorney: (1) does not hold or represent an interest adverse to the estate; and (2) that he or she is a disinterested person." *In re ESJ Towers, Inc.* 2022 WL 7721668 at * 7.

The Bankruptcy Code does not define "interest materially adverse to the interest of the estate", however, courts in the First Circuit interpret it as "the possessing or asserting of any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant or possessing a predisposition under circumstances that render such a bias against the estate." *In re El San Juan Hotel Corp.* 239 B.R. at 646. Similarly, the Court of Appeals for the Second Circuit has adopted this definition of "hold or possess an interest adverse to the estate":

> (1) to possess or assert any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute in which the estate is a rival claimant; or (2) to possess a predisposition under circumstances that render such a bias against the estate.

In re AroChem Corp., 176 F.3d 610, 623 (2d Cir. 1999).

"Generally stated, the adverse interest test is objective and precludes 'any interest or relationship, however slight, that would even faintly color the independence and impartial attitude required by the Code and Bankruptcy Rules.'" *In re Black & White Stripes, LLC*, 623 B.R. 34, 50 (Bankr. S.D.N.Y. 2020)(quoting *In re Granite Partners*, *L.P.*, 219 B.R. 22, 33 (Bankr. S.D.N.Y. 1998)). Where there are claims among multiple debtors, it is scrutinized closely. *Black & White Stripes*, 623 B.R. at 50.

An actual conflict is disqualifying. When it comes to potential conflicts, courts in the First Circuit have taken a more flexible view.[1] Hon. Joan N. Feeney (Ret.), Hon. Michael G. Williamson, Michael J. Stepan, Bankruptcy Law Manual, 5th Edition 2022 § 4:23. For potential conflicts, the First Circuit Court of Appeals stated that the question is "not necessarily whether a conflict exists—although an actual conflict of any degree of seriousness will obviously present a towering obstacle—but whether a potential conflict, or the perception of one, renders the lawyer's interest materially adverse to the estate or the creditors." *In re Martin*, 817 F.2d at 182 (construes § 327(a) as only requiring disqualification where the attorney was previously owed an outstanding balance for unrelated matters); *but see Rome v. Braunstein*, 19 F.3d at 60 ("since section 327(a) is designed to limit even appearances of impropriety to the extent reasonably practicable, doubt as to whether a particular set of facts gives rise to a disqualifying conflict of interest normally should be resolved in favor of disqualification.")

The Court of Appeals for the Second Circuit has similarly stated that "counsel will be disqualified under section 327(a) only if it presently holds or represents an interest adverse to the estate, notwithstanding any interests it may have held or represented in the past." *In re AroChem Corp.*, 176 F.3d at 623.

Prior employment by the debtor does not necessarily disqualify a professional from employment. 11 U.S.C. § 327(c). However, § 327(c) provides that if there is an actual conflict of interest, the court shall disapprove of the employment:

> In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

Case examples:

In re Black & White Stripes, LLC, 623 B.R. 34 (Bankr. S.D.N.Y. 2020). Debtors sought to employ a law firm as counsel to two debtors in their Subchapter V bankruptcy cases. The firm previously represented the debtors and the debtors' principals in state court. Potential avoidance actions against the principals were anticipated to be among the estates' most significant assets. The bankruptcy court held that the firm's prior representation of the debtors' principals was a disqualifying conflict.

[1] In contrast to the more stringent rule adopted in the Fourth, Sixth, and Eighth Circuits that disqualifies professionals where there is a potential conflict. *See In re Harold & Williams Development Co*., 977 F.2d 906, 909–10 (4th Cir. 1992); *In re Federated Dept. Stores, Inc.*, 44 F.3d 1310 (6th Cir. 1995); and *In re Pierce*, 809 F.2d 1356 (8th Cir. 1987).

In re Vascular Access Centers, L.P., 613 B.R. 613 (Bankr. E.D. Pa. 2020). Proposed counsel to the debtor-in-possession represented the general partner of the debtor prior to the bankruptcy case. The court found that the firm's brief representation of the general partner was a potential conflict of interest, given that the general partner and the debtor had adverse interests. However, because the firm did not represent the debtor and the general partner simultaneously, the court concluded that the potential conflict of interest did not rise to an actual conflict of interest. Proposed counsel also failed to disclose the brief representation of the partner. The failure to disclose was sanctionable under FRBP 2014 in the form of loss of compensation.

Rome v. Braunstein, 19 F.3d 54 (1st Cir. 1994). Counsel ("Rome") was employed for the debtor-in-possession in a chapter 11 case. After the debtor was unable to confirm three different plans, a chapter 11 trustee as appointed. An involuntary chapter 7 case was filed against the debtor's principal, and Rome served as counsel for the principal in the involuntary chapter 7. Rome also represented the principal's secretary in her bid to purchase property from the chapter 11 estate. The chapter 11 case then was converted to a chapter 7 case. The court found that there was an actual conflict of interest in the representation of the former secretary as a bidder/purchaser. Additionally, counsel could not represent a debtor and its principal where the principal was a potential target of a preference action.

In re Aearo Tech. LLC, 642 B.R. 891 (Bankr. S.D. Ind. 2022). Kirkland & Ellis ("K&E") sought employment as debtors' counsel. The non-debtor indirect parent of the debtors ("3M") paid K&E's retainer on the debtors' behalf. K&E disclosed that connection to 3M in its employment application/declaration. K&E serves as lead counsel for 3M in litigation involving allegedly faulty earplugs. The U.S. Trustee's ("UST") counsel objected to K&E's employment as debtors' bankruptcy counsel, arguing that (a) the interests of 3M and the debtors were not aligned because they were co-defendants in the faulty earplug tort action, (b) 3M allegedly owed the debtors billions of dollars under a pre-petition funding agreement, and (c) 3M might have claims against the debtors arising from that funding agreement. According to the UST, K&E did not have undivided loyalty to the debtors.

The court overruled the UST's objection, finding that K&E did not represent an interest adverse to the bankruptcy estate. The court concluded that the debtors and 3M did not have conflicting interests because they were working on a settlement that would resolve the faulty earplug litigation. The court noted, however, that a conflict could arise in the future, which might give rise to a basis for disqualification or disallowance of fees. "Kirkland & Ellis is navigating a minefield," Judge Graham said. "This isn't a blanket endorsement saying that K&E is in the driver's seat no matter what happens in the future."

In re Ampal-Am. Israel Corp., 691 F. App'x 12, 13 (2d Cir. 2017). The debtor had filed a chapter 11 case which after contentious disputes in the case, converted to chapter 7. The chapter 7 trustee sought to have his firm employed as his counsel. Prior to the time that the trustee sought to employ the firm, the law firm had represented a creditor and another entity with interests adverse to the chapter 7 estate. The firm's representation of the creditor and related entity had ended prior to the trustee's engagement of counsel.

The Court of Appeals for the Second Circuit affirmed the bankruptcy court's findings and held that the law firm did not have an actual conflict of interest because the representation of the creditor and related entity had ended prior to the trustee's engagement of counsel.

Representation of Affiliated Debtors

While it is possible for a single attorney or law firm to represent multiple debtors, where the debtors have or are likely to have claims against each other, a disqualifying conflict likely exists. *Black & White Stripes*, 623 B.R. at 50–51 (discussing, among other cases, *In re Interwest Bus. Equip., Inc.*, 23 F.3d 311, 314 (10th Cir. 1994) and *In re JMK Constr. Group Ltd.*, 441 B.R. 222-225 (Bankr. S.D.N.Y. 2010)).

Case examples:

In re JMK Constr. Grp., Ltd., 441 B.R. 222 (Bankr. S.D.N.Y. 2010). The court denied retention of a law firm and other professionals by multiple debtors where the debtors may have held claims for contribution against each other and some debtors were creditors of others.

In re Easterday Ranches, Inc., 2022 WL 17184713 (Bankr. E.D. Wash. Nov. 23, 2022). Affiliated debtors filed separate bankruptcy cases and proposed employment of common counsel. Debtors were owned and managed by members of the same family. One debtor operated a cattle ranching business; the other debtor was involving in farming. President of the cattle ranching business engaged in a scheme to defraud certain creditors by charging them for non-existent cattle. Farming debtor did not participate in the fraud but was liable with cattle ranching debtor for some of the debt owed to defrauded creditors. After debtors managed to confirm a plan, the U.S. Trustee objected to fourth interim fee application filed by debtors' counsel, arguing that, during the negotiation of the plan, the farming debtor's stakeholders' interests were impermissibly subordinated to those of the cattle ranching debtor, giving rise to an actual conflict of interest on the part of debtors' counsel.

The court concluded that counsel did not inappropriately represent an interest adverse to either bankruptcy estate. Getting to consensual confirmation of the plan and resolution of the cases was "undoubtedly in the best interests of both debtors and the

collective interest of all their stakeholders." "The proposal of a joint plan advancing the common good for both Ranches and Farms is permissible" under the per plan framework of 11 U.S.C. § 1129(a)(10). The court also discussed the difference between affirmative litigation to determine the merits of a claim and negotiating the settlement or release of a claim for conflict purposes: "the acts of proposing and filing a chapter 11 plan are part of a negotiation process. This process differs both substantively and procedurally from affirmative litigation prosecuted via adversary complaint."

Who is a professional person?

Section 327(a) lists "attorneys, accountants, appraisers, auctioneers, or other professional persons" as needing to meet the requirements for employment. The Bankruptcy Code does not define "professional person." "A professional person is one who plays a central role in the administration of the bankruptcy estate and in the bankruptcy proceedings." *In re Ponce Marine Farm, Inc.*, 269 B.R. 484, 494 (D.P.R. 2001). The relevant inquiry focuses on the person's duties. *Id.* "If the duties involved are central to the administration of the estate such duties are professional in nature." *Id.* (quoting *In re That's Entertainment Marketing Group, Inc.*, 168 B.R. 226, 230 (N.D. Cal. 1994)).

Other professional persons under § 327(a) include: real estate brokers, *see e.g. In re Jarvis*, 53 F.3d 416 (1st Cir. 1995); financial advisors, see e.g. *In re High Voltage Eng'g Corp.*, 311 B.R. 320 (Bankr. D. Mass. 2004); business brokers, *see e.g. In re Channel 2 Assocs.*, 88 B.R. 351 (Bankr. D.N.M. 1988); and certain consultants, see e.g. *In re Getchell Agency*, No. 16-10172, 2017 WL 2703522 (Bankr. D. Me. June 22, 2017).

On the flip side, so-called "ordinary course professionals" are not required to be employed under 11 U.S.C. § 327(a). *See e.g. In re Ponce Marine Farm, Inc.*, 269 B.R. at 494 (stating that most courts that have addressed the issue have found that court authorization is not necessary for the retention of an expert witness); *In re Johns-Manville Corp.*, 60 B.R. 612 (Bankr. S.D.N.Y. 1986) (non-attorney lobbyists employed by the debtor who did not play a part in negotiating the debtor's plan were not "professional persons"); *In re Parkinson Seed Farm, Inc.*, 640 B.R. 218 (Bankr. D. Idaho 2022) (independent contractor who provided administrative, technological, and financial services in connection with debtor's farming operation was not a professional under § 327(a)).

Case examples:

In re Crafts Retail Holding Corp., 378 B.R. 44 (Bankr. E.D.N.Y. 2007). The court denied a financial advisor's request for reimbursement, as an out-of-pocket expense, of legal fees of a law firm that it had retained without court approval. By implication, the law

firm was a "professional person" who should have been retained with court approval in order to receive payment from the estate.

Disclosure of Connections

Pursuant to Federal Rule of Bankruptcy Procedure 2014(a), employment of professionals can only be approved on application. The application must be accompanied by a verified statement of the person to be employed that sets forth any connections that person has with various parties in the case.

Bankruptcy Rule 2014(a) states:

> An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to §327, §1103, or §1114 of the Code shall be made only on application of the trustee or committee. The application shall be filed and, unless the case is a chapter 9 municipality case, a copy of the application shall be transmitted by the applicant to the United States trustee. The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

What Connections Should be Disclosed?

According to the Bankruptcy Court for the District of Vermont, Bankruptcy Rule 2014 requires professionals

> disclose all connections with the debtor, creditors, any other party in interest, as well as the attorneys and accountants for such parties. However, the extent and format of such disclosures may vary from case to case, as the circumstances of each case will define the "connections" that must be disclosed to provide the Court and parties in interest with sufficient information to determine whether the applicant is disinterested.

In re Fibermark, Inc., No. 04-10463, 2006 WL 723495, at *11 (Bankr. D. Vt. Mar. 11, 2006).

"It is the duty of the debtor's attorney to disclose all connections which bear on the disinterestedness of an applicant, so the Court has sufficient information to make a sound determination of whether the applicant is disinterested and eligible for appointment." *In re Springfield Med. Care Sys., Inc.*, No. 19-10285, 2019 WL 6273385, at *3. "The crucial point is that an applicant is not authorized to pick and choose which connections to disclose; the applicant must disclose all connections. The Court must be able to rely on the application and, based on the application, determine whether any of the disclosed connections impair the applicant's disinterestedness." *Id.* at * 4. "The requirement to comply meticulously with the disclosure requirements must be tempered with practicality, to strike a balance through which the purposes and goals of the disclosure requirements are met without creating financial disincentives to the professionals whose participation in bankruptcy cases would likely advance reorganization efforts, for the benefit of debtors and creditors alike." *Id.* at *5.

"The professional's duty under Rule 2014 to disclose is self-policing." *In re Level 8 Apparel LLC*, No. 16-13164 (JLG), 2023 WL 2940489, at *7 (Bankr. S.D.N.Y. Apr. 13, 2023). "Absent the spontaneous, timely and complete disclosure required by section 327(a) and Fed. R. Bankr. P. 2014(a), court-appointed counsel proceed at their own risk." *Rome v. Braunstein*, 19 F.3d at 59.

Failure to disclose can be an independent basis for denial of fees: "[b]ecause the integrity of the Court's appointment of such professionals depends on the candidness of the applicant, failure to disclose facts material to potential conflict may provide totally independent ground for denial of fees, quite apart from the actual representation of competing interests." *In re Arazi*, 492 B.R. at 593 (internal quotation marks omitted); *see also In re Everest Crossing, LLC*, 2011 WL 4352119, *10 (Bankr. D. Mass. Sept. 16, 2011) ("Even where nondisclosure is not accompanied by a disqualifying conflict, it is not the case that nondisclosure is harmless."); *In re Enron Corp.*, No. 02 CIV. 5638 (BSJ), 2003 WL 223455, at *4 (S.D.N.Y. Feb. 3, 2003) ("Rule 2014 disclosures are to be strictly construed and failure to disclose relevant connections is an independent basis for the bankruptcy court to disallow fees or to disqualify the professional from the case."). Indeed, the Court of Appeals for the Tenth Circuit has stated that disgorgement of attorney fees should be the default sanction. *In re Stewart*, 970 F.3d 1255 (10th Cir. 2020) ("While full disgorgement of attorney's entire fee is not always the appropriate sanction for debtor's attorney's violation fee disclosure obligations, it should be the default sanction, and there must be sound reasons for anything less.")

It is worth noting that the Bankruptcy Rule 2014 disclosure is submitted under penalty of perjury and is subject to the bankruptcy fraud statute. *See* 28 U.S.C. § 1746; 18 U.S.C. §§ 152(2)–(3).

Case examples:

In re Nir West Coast, Inc., 638 B.R. 441 (Bankr. E.D. Cal. 2022). Subchapter V debtor's sole shareholder was a co-debtor and guarantor of debtor, a recipient of preferential transfers, and a creditor of the estate, and a co-defendant with debtor in pre-petition state court wage and hour class action. Proposed debtor's counsel had represented debtor and shareholder in the pre-petition litigation, which settled. Both debtor and shareholder were liable under settlement. Proposed debtor's counsel did not disclose its connection to debtor's shareholder in employment application, and later disclosed only after a creditor and Subchapter V trustee raised the issue. Debtor's counsel then filed a fee application, which the bankruptcy court declined to approve. The bankruptcy court concluded that counsel represented an interest adverse to the estate and also that the court had a basis to deny compensation for lack of disclosure:

> The message of this Opinion is twofold. First, when employment violates 11 U.S.C. § 327(a), the bankruptcy court may invoke 11 U.S.C. § 328(c) to deny all compensation and the reimbursement of all expenses. Second, the bankruptcy court has inherent authority to deny all compensation and the reimbursement of all expenses under Bankruptcy Rule 2014 (a) for nondisclosure or when disclosure is delayed or less than complete.

Id. at 442–43.

KLG Gates LLP v. Brown, 506 B.R. 177 (E.D. N.Y. 2014). Firm filed a statement disclosing all of its 483 former and current clients, in alphabetical order, who may have conflicts with the debtor. The firm failed, however, to disclose that its leading billing partner personally represented lien creditors in other bankruptcy cases. The court found that the firm's disclosure of connections was insufficient.

In re Level 8 Apparel LLC, No. 16-13164 (JLG), 2023 WL 2940489 (Bankr. S.D.N.Y. Apr. 13, 2023). Debtors' bankruptcy counsel did not disclose the firm's connections to debtors' insiders. The court found that counsel violated the disclosure requirements under Rule 2014 in failing to disclose its representation of a director of one of the debtors, his wife, and a related company.

In re Arazi, 492 B.R. 587 (Bankr. D. Mass. 2013). Firm's failure to update disclosures to disclose that it was representing parties in post-petition litigation against the debtor warranted reduction in fees.

In re NNN 400 Capitol Ctr. 16 LLC, 632 B.R. 243 (D. Del. 2021), *aff'd sub nom. In re NNN 400 Capitol Ctr. 16 LLC.*, No. 21-3013, 2022 WL 17831445 (3d Cir. Dec. 21, 2022). Special counsel employed by the bankruptcy estate was obligated to disclose its pre-petition representation of debtor's property manager, one of the largest unsecured creditors in the case.

Guidance from the United States Trustee on Connections, Affiliates, and Investments

The Office of the United States Trustees' position is that professionals are required to disclose all their connections to a case, even if they have a contractual arrangement to keep information confidential.

Memorandum from Clifford J. White III, Director of Executive Office for United States Trustees (Dec. 4, 2019) (available at: https://www.justice.gov/ust/file/generalprinciplesdisclosureconflicts.pdf/download

Affiliates

Affiliates is defined in 11 U.S.C. § 101(2). To simplify: affiliation to the debtor exists where there is (1) ownership of 20% or more of debtor's voting securities; (2) control of 20% or more of debtor's voting securities; or (3) the holding of 20% or more of debtor's voting securities if the holder has the power to vote the securities. *In re Serendipity Labs, Inc.*, 620 B.R. 679, 686 (Bankr. N.D. Ga. 2020)

Generally, the United States Trustee takes the position that estate-retained professionals must disclose connections with all affiliates. *See* Memorandum from Clifford J. White III, Director of Executive Office for United States Trustees (Dec. 4, 2019)

Connections relating to Investments

The investments that matter are those held in parties involved in the case or in the debtor's industry. *See* Memorandum from Clifford J. White III, Director of Executive Office for United States Trustees (Dec. 4, 2019). The Office of the United States Trustee will scrutinize investments carefully, focusing on: applicant's knowledge and applicant's control. If the applicant knew or should have known about the investment; or if the applicant controlled or could have controlled the selection of the investment, the United States Trustee will require disclosure.

U.S. Department of Justice

Executive Office for United States Trustees

Office of the Director *Washington, DC 20530*

December 4, 2019

MEMORANDUM

TO: United States Trustees

FROM: Clifford J. White III
Director

SUBJECT: Principles to Guide USTP Enforcement of the Duty of Professionals to Disclose Connections to a Bankruptcy Case Under 11 U.S.C. §§ 327 and 1103 and Fed. R. Bankr. P. 2014

Pursuant to 28 U.S.C. § 586(a)(3)(I), the United States Trustee Program (USTP) has an important responsibility to review applications in chapter 11 cases to employ law and other professional firms ("professional firms")[1] that will seek payment from the bankruptcy estate. Due to the multiplicity of interests in a case—from large to small creditors, from employees to other stakeholders—the Bankruptcy Code and Rules mandate that professional firms disclose their connections to other parties in the case and satisfy conflict of interest standards.

Although all parties in a case may object to the adequacy of a professional firm's disclosures and to a professional firm's retention because of potential or actual conflicts, it is usually only the USTP that makes inquiries or files objections. Our role as the "watchdog" of the bankruptcy system is to faithfully read and apply the Code and Rules and to raise issues that we have identified so that the court may make the ultimate determination on a professional firm's employment.

The organizational structure of many professional firms seeking to be retained in bankruptcy cases has grown more complex in recent years. Some professional firms are affiliates of larger businesses that provide a variety of services to clients, both inside and outside of the bankruptcy system. In addition, some professional firms (including parents and affiliates) sponsor funds that invest in their business clients, in distressed debt that may be at issue in a bankruptcy case, or in industries (including competitors of their business clients) to which they provide services.

[1] As used herein, this term includes the individual professionals of a professional firm.

The increasingly complex profile of professional firms subject to the disclosure and conflict provisions of 11 U.S.C §§ 327 and 1103 and Fed. R. Bankr. P. 2014 makes both our review of employment applications and the court's decision on such applications more challenging. Accordingly, set forth below are the general principles that should guide you, as USTP personnel, in reviewing applications to employ professional firms in bankruptcy cases.

1. **Enforce the Law**. The USTP's responsibilities start and stop with a textual reading and expert application of the Bankruptcy Code and Rules. Although professional firms may adopt internal protocols that guide their processes for compliance, these internal protocols cannot change substantive law. Nor can these protocols provide a safe harbor for a firm that does not meet the strict legal requirements governing disclosures and conflicts.

2. **Disclose Connections on the Public Record.** It is the USTP's position that relevant bankruptcy law requires professional firms to disclose on the public record their connections to a case, even if they have a contractual arrangement to keep client information, including client names, confidential. The USTP will argue that a professional firm required to disclose information must either publicly disclose it on the record or file a properly supported motion to seal it under section 107 of the Bankruptcy Code for the court to adjudicate. Should the professional firm choose to file a motion to seal rather than publicly disclose the required information on the record, the USTP has a responsibility to object to any motion that does not satisfy the high bar for sealing.

3. **Disclose Affiliate Connections**. It is the USTP's position that a professional firm being employed must disclose the connections of all its affiliates. Every case is fact specific and, in some circumstances, a professional firm may be able to show that it is sufficiently separate from its affiliates to excuse affiliate disclosure.[2] The applicant seeking to employ the professional firm bears the burden of proof and only the court has authority to excuse affiliate disclosure.

4. **Disclose Connections Based on Investments**. Investments by the professional firm's investment affiliates or by their individual professionals may create conflicts and, depending on the circumstances, those conflicts can be just as serious as conflicts created by working for clients with adverse interests. It is the USTP's position that relevant bankruptcy law requires the professional firm to disclose connections that extend to investments in clients and other entities that may be a party in interest in the case, such as a stalking horse bidder, DIP lender, or other creditor. Investments include direct investments in such entity, as well as investments made through third parties.

In deciding whether investments must be disclosed, the USTP will analyze two key factors: (1) knowledge and (2) control. If the professional firm knew or could have known about the investment in a particular entity that may be involved in the case or an investment in the debtor's industry, then it is the USTP's position that the investment should be disclosed. Or, if the professional firm controlled or could have controlled the selection of the investment in a

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[2] Separate incorporation may not be dispositive of whether affiliate disclosure may be excused. Professional firms routinely disclose connections of their separately incorporated affiliates when, for example, the separate legal entities belong to an international cooperative.

relevant entity or industry, then it is the USTP's position that the investment must be disclosed. Thus, for example, a typical investment in a diversified mutual fund that is managed by an independent outside advisor need not be disclosed. But a professional firm that sponsors pooled investments in clients who may be parties in interest in the case may be required to disclose those investments.

It is vital that the USTP acts consistently from district to district in this and other legal matters. Please ensure that all staff who review chapter 11 retention applications are familiar with these general disclosure principles. Each case will have unique facts that should be considered in a manner consistent with these principles.

The Office of the General Counsel should be consulted if there are any questions regarding these principles or their application in specific cases. This memorandum may be expanded and will be incorporated into the USTP Policy and Practices Manual, which will be made available to the public.[3] This memorandum is an internal directive to guide USTP personnel in carrying out their duties, but the ultimate determination on the obligations of professionals under section 327 and Fed. R. Bankr. P. 2014 resides solely with the court. Nothing in this memorandum has any force or effect of law, and nothing stated herein imposes on parties outside the USTP any obligations that go beyond those set forth in the Bankruptcy Code and Rules.

Thank you for your continued cooperation and diligence in this important area of responsibility.

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[3] The USTP will continue to review and update this internal guidance, as appropriate. Moreover, nothing in this internal guidance: (1) limits the USTP's discretion to request additional information necessary for the review of a particular application; (2) limits the USTP's discretion to file comments or objections to applications, including as to whether a professional firm is disinterested or otherwise satisfies the statutory standards for retention in the case; or (3) creates any private right of action on the part of any person enforceable against the USTP or the United States.

On Our Watch

By Clifford J. White III, Walter W. Theus, Jr. and Nan Roberts Eitel

Disclosures and Conflicts

The USTP's Perspective on Professional Employment

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The U.S. Trustee Program (USTP) plays an important role in bankruptcy by reviewing applications to employ debtor-in-possession (DIP) and official committee professionals.[1] Given the multiplicity of interests in a case — from large to small creditors and from employees to other stakeholders — the Bankruptcy Code and Federal Rules of Bankruptcy Procedure require that professionals seeking to represent the DIP or an official committee disclose their connections to parties in the case and satisfy conflict-of-interest standards.[2]

Although all parties-in-interest have standing to object to the adequacy of disclosures and to a professional's retention because of conflicts, it is usually only the U.S. Trustee who objects. As the "watchdog" of the bankruptcy system, the USTP applies a strict reading of the Code and Rules, and raises conflict and disclosure issues so that courts may adjudicate professional employment applications. In fiscal year 2020, the USTP made 2,476 inquiries and formal objections related to professional employment under §§ 327 and 1103.[3]

This article discusses the USTP's application of the law's disclosure requirements, as well as three settlements between the USTP and several high-profile professional firms arising from their disclosure omissions. It also describes increasingly complex fact patterns and challenging conflict-of-interest issues presented by several retention applications to which the USTP has objected.

General Legal Principles of Disclosure

Rule 2014 does not define "connection," and § 327(a) of the Code does not define "adverse interest." In *In re Enron Corp.*, the court observed that "[t]he purpose of Rule 2014(a) is to provide the court and the [U.S. Trustee] with information to determine whether the professional's employment is in the best interests of the estate."[4] For this reason, the duty of disclosure is not merely critical; it is "sacrosanct."[5] The disclosure required by professionals "goes to the heart of the integrity of the bankruptcy system."[6] Thus, courts universally require broad and complete disclosure of all connections with debtors, creditors and any other party-in-interest.[7]

Professionals must disclose all connections and may not pick and choose the connections to disclose and those to ignore as unimportant or trivial.[8] The reason for broad disclosure is simple: "The decision as to what facts may be relevant should not be left up to the professional, 'whose judgment may be clouded by the benefits of potential employment.'"[9] Moreover, professionals may not place the burden on the court or other parties to "ferret out pertinent information from other sources."[10] Nor can DIPs, committees and their proposed professionals withhold disclosures based on their decision that no conflict exists;[11] that decision is for the court alone, and the court should be provided full disclosure of all connections.

The obligation to disclose connections is an independent obligation, and any failure to disclose can warrant sanctions, including disqualification or disgorgement, even absent a conflict of interest.[12] The court need not find intent.[13]

USTP Disclosure Principles

The increasingly complex organizational structure of many professional firms makes both the USTP's review of applications to employ and the court's decision on them more challenging. Accordingly, the following general principles guide the USTP's positions in reviewing retention applications.[14]

The USTP seeks to act consistently across districts and regions in this and other legal matters. All USTP personnel who review chapter 11 retention applica-

1 *See* 28 U.S.C. § 586(a)(3)(E), (I).
2 11 U.S.C. §§ 327(a), 1103; Fed. R. Bankr. P. 2014(a).
3 Congress recently encouraged the USTP "to continue its efforts to ensure a fair and transparent bankruptcy process for stakeholders and for the public" and required the USTP to report its efforts in FY 2020 and FY 2021 to enforce professionals' compliance with the disclosure requirements of Bankruptcy Rule 2014(a). *See* Explanatory Statement for Commerce, Justice, Science, and Related Agencies Appropriations Act 2021, accompanying the Consolidated Appropriations Act 2021 (Pub. L. No. 116-260).
4 No. 02-5638, 2003 WL 223455, at *4 (S.D.N.Y. Feb. 3, 2003).
5 *In re eToys Inc.*, 331 B.R. 176, 189 (Bankr. D. Del. 2005).
6 *In re Universal Bldg. Prods.*, 486 B.R. 650, 663 (Bankr. D. Del. 2010) (quoting *In re B.E.S. Concrete Prods. Inc.*, 93 B.R. 228, 236-38 (Bankr. E.D. Cal. 1988)).
7 *See, e.g., In re Leslie Fay Cos. Inc.*, 175 B.R. 525 (Bankr. S.D.N.Y. 1994).
8 *In re Jore Corp.*, 298 B.R. 703, 726 (Bankr. D. Mont. 2003).
9 *In re Fibermark Inc.*, No. 04-10463, 2006 WL 723495 at *8 (Bankr. D. Vt. March 11, 2006) (quoting *In re Lee*, 94 B.R. 172, 177 (Bankr. C.D. Cal. 1988)).
10 *In re Saturley*, 131 B.R. 509, 517 (Bankr. D. Me. 1991). *See also In re BH & P Inc.*, 949 F.2d 1300, 1317-18 (3d Cir. 1991).
11 *See In re Granite Partners LP*, 219 B.R. 22, 44 (Bankr. S.D.N.Y. 1998) ("The trustee broke the cardinal principle of Rule 2014(a). He arrogated to himself a disclosure decision that the Court must make.").
12 *In re Universal Bldg. Prods.*, 486 B.R. at 663.
13 *See, e.g., In re Indep. Eng'g Co. Inc.*, 232 B.R. 529, 532 (B.A.P. 1st Cir. 1999).
14 Memorandum from Clifford J. White III, Director, Executive Office for U.S. Trustees, to U.S. Trustees, "Principles to Guide USTP Enforcement of the Duty of Professionals to Disclose Connections to a Bankruptcy Case Under 11 U.S.C. §§ 327 and 1103 and Fed. R. Bankr. P. 2014," (Dec. 4, 2019), *available at* justice.gov/ust/file/generalprinciplesdisclosureconflicts.pdf/download (unless otherwise specified, all links in this article were last visited on June 30, 2021).

tions are familiar with these principles. Each case will have unique facts to be considered consistent with these principles.

Enforce the Law

The USTP's responsibilities start and stop with a textual reading and strict application of the Code and Rules. Although professionals may adopt internal protocols governing their compliance process, those cannot change substantive law. Nor can internal protocols establish a safe harbor for professionals who do not satisfy the law's strict disclosure and conflict requirements.

Disclose Connections on the Public Record

Bankruptcy law requires that professionals seeking to be paid from the estate disclose on the public record their connections to a case, even if they have agreed to keep client information (including names) confidential. Professionals can only seek to be excused from public disclosure on the record if they file a properly supported motion to seal the information under § 107 of the Bankruptcy Code for the court to adjudicate. The USTP also has a responsibility to object to a professional's motion to seal the required information if the motion does not satisfy the statute's high bar.

Disclose Affiliate Connections

The professional firm's connections — and that of its affiliates and practice areas — must be disclosed; the requirement to disclose is not confined to professionals working on the bankruptcy engagement. To assess whether there are disabling conflicts, the court, USTP and all parties are entitled to know the connections of the entire organization. For example, if the proposed professional's parent company represents another client interest adverse to the DIP (or the committee's constituency), that information must be disclosed.

Every case is fact-specific, and in rare circumstances, an applicant may be able to establish that the firm is sufficiently separate from affiliated companies or practices by filing a Rule 2014(a) verified statement containing detailed information sufficient to excuse affiliate disclosure. Only the court has the authority to excuse affiliate disclosure.

Disclose Connections Based on Investments

Investments by professionals may create conflicts just as serious as those created by working for clients with adverse interests. A professional's duty to disclose connections extends to investments in entities that are connected with the case. Under the Code and Rules, the disclosure is mandatory, and it is the court that decides whether any connection precludes employment. In recent years, new issues have arisen with the proliferation of professional firms' investment units and their sponsorship of investment funds. For example, firms may provide partners with investment opportunities in clients,[15] or they may have affiliated retirement funds for their employees.

In deciding whether to object to the adequacy of investment disclosures, the USTP will analyze two factors: knowledge and control. If the professional knew or could have known about the investment in an entity that might be involved in the case or in the debtor's industry, that investment should be disclosed. Furthermore, if the professional firm controlled or could have controlled the investment decision in a relevant entity or industry, the investment must be disclosed. Thus, for example, a typical investment in a diversified mutual fund managed by an independent outside advisor need not be disclosed. However, a professional firm that sponsors pooled investments in clients who may be parties-in-interest in the case should disclose those investments.

> **The USTP's role is to ensure that the bankruptcy system functions with integrity and efficiency, and this is best accomplished by strict adherence to the Code and Rules, including on matters of disclosure and conflicts of interest.**

Three Recent Disclosure Settlements

The USTP has vindicated the importance of disclosures with three high-profile settlements. The first settlement involved a financial advisor that did not disclose the identity of its clients who were parties-in-interest in the case. As a result of discovery and lengthy settlement negotiations, the advisor paid $15 million to the estates of three chapter 11 cases to be distributed to creditors in accordance with the confirmed plans.

The second settlement involved the same advisor's retention application in one of those three cases. The USTP objected, arguing that the firm's disclosures remained insufficient. The firm initially failed to disclose its connections with clients it deemed confidential and the connections of all of its affiliates; it also failed to make adequate disclosures regarding its investments in entities that could create conflicts of interest. The advisor agreed to withdraw the application and to waive payment of its fees and expense reimbursements from the estate.

The third settlement involved three global law firms employed by the DIPs as special counsel to defend claims related to the sale, marketing and distribution of the debtors' products. A major issue in the bankruptcy case was whether and to what extent the DIPs' shareholders shared liability with the DIPs for these claims. Long after the court approved the law firms' retention, the USTP learned that the DIPs and their counsel had previously entered into a joint defense and common interest agreement with the DIPs' shareholders in ongoing tort litigation. The undisclosed joint-defense agreement created obligations for both the debtors and their special litigation counsel toward the shareholders. During the course of the bankruptcy case, the DIPs invoked the agreement to rebuff discovery sought by the official committee of unsecured creditors. After the USTP prepared a motion to disgorge fees based on the firms' failures to dis-

15 Angela M. Allen & Richard Levin, "A Review of Potential Conflicts in Private-Equity Representation," XXXVIII *ABI Journal* 1, 54-55, 66, January 2019, *available at* abi.org/abi-journal.

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close, it negotiated a settlement with the firms, which the court approved. Under the settlement, the firms agreed to an aggregate reduction of $1 million in fees and supplemental disclosures regarding the common interest agreement.[16]

Conflicts of Interest and Case Studies

In addition to navigating disclosure issues, the task of identifying whether a professional possesses a disqualifying conflict of interest has become more challenging due to the increasingly complex organizational structure of professional firms, the growth in their size and the broad range of services they offer. Because parties-in-interest rarely object, even though they might have relevant information, it is incumbent upon the USTP to carefully review the professional's disclosures, seek clarification or supplementation where possible, and object as necessary so that the court may adjudicate whether there is a conflict.

The three case studies herein are drawn from actual cases in which the USTP objected to — and, perhaps surprisingly, the court approved — retention. These cases reflect fact patterns that are increasingly common and on which courts have reached differing conclusions. The USTP will continue to strictly read the law and help ensure that courts decide conflict issues only after the professionals provide a sufficient record to support their employment.

Denial of Retention "Too Disruptive"

In one case, the DIP sought to retain a large, sophisticated law firm, which disclosed that it represented the proposed DIP lender and affiliated stalking-horse bidder in unrelated matters. Those parties provided 4 percent of the firm's annual revenue, which was multiple millions of dollars. The firm also represented, in unrelated matters, the bank's collateral agent for the debtor's asset-based lenders, whose pre-petition claim was paid in full as part of a sale motion approved on the case's first day. This bank represented about 1 percent of the firm's annual revenue.

The USTP objected because the professional's significant and deep connections to other parties who were negotiating transactions integral to the case tainted the firm and rendered it not disinterested. In the USTP's view, because the law firm and the debtor filed the retention application knowing those connections, their complaint — that compliance with the Code would be "too disruptive" to the debtor's attempt to fast-track the chapter 11 case — was contrived.

Professionals' Conflict Found Not Disqualifying Because They Did Not Act on It

In another case, the DIP sought to retain a major law firm that also represented a private-equity company (PEC), including the PEC's acquisition of 70 percent of the debtor's equity. In the bankruptcy case, the DIP sought quick approval to sell its remaining equity to the PEC, which was also the DIP lender. The law firm disclosed its representation of the PEC in a variety of unrelated matters, which accounted for 1 percent of the law firm's revenues (approximately $21.5 million).

The USTP objected to the proposed retention, arguing that the law firm's continuing representation of the PEC in significant unrelated matters, combined with its prior representation of the PEC in its acquisition of a controlling stake in the debtor, constituted a disqualifying conflict of interest. The court found that 1 percent of firm revenue — despite its high dollar value — was insufficient to influence the firm's independence. The court also independently reviewed the sale terms and determined that they were fair to the DIP. The court concluded that the law firm had adequately represented its client in the sale and had not acted on the alleged conflict by favoring its nondebtor client over the DIP.

However, other courts have held that conflict determinations should be based on the facts in the retention application, not on actions in the case: The court cannot approve a professional's employment using "the benefit of hindsight" and a finding of "no harm, no foul" based on "the quality of the unapproved representation" to establish that the professional did not act on the conflict.[17] Simply put, the Code not only prohibits professionals from *acting* on adverse interests; it prohibits them from *having* them in the first instance.[18]

Conflict from Representing Debtors' Parent Cured by "Conflicts Counsel," Even on an Issue Central to the Reorganization

This is another variation on the same theme. A large law firm filed chapter 11 petitions for several subsidiaries of a parent entity that was the firm's long-term and continuing client. Every officer, director and employee of the DIPs was also employed by the parent. Nevertheless, in response to the USTP's objection to the firm's retention, the firm stated that it could represent the DIPs in investigating the parent's role in a questionable initial public offering (IPO) that was controversial among the debtors' creditors and a central issue in the case. The court approved the retention.

Six weeks later, the debtors sought to employ conflicts counsel to represent new independent directors appointed to handle matters involving the parent, including the IPO. The allegedly unconflicted firm now admitted that its conflict prevented it from representing the debtors *vis-à-vis* their parent despite having represented previously that it could. Moreover, conflicts counsel would represent the debtors' interest in pursuing perhaps the most important assets of the estate: claims against the parent. Although the court approved the retention over the USTP's objec-

16 *See In re Molten Metal Tech. Inc.*, 289 B.R. 505, 514 n.20 (Bankr. D. Mass. 2003) (holding that joint defense agreements must always be disclosed and ordering disgorgement of all fees for counsel's failure to disclose).

17 *In re Interwest Bus. Equip. Inc.*, 23 F.3d 311, 317 (10th Cir. 1994). In addition, professionals have a continuing duty to disclose and to remain conflict free.

18 *See In re Big Rivers Elec. Corp.*, 355 F.3d 415, 434 (6th Cir. 2004) (discussing adverse interests of trustees and examiners).

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tion, other courts have declined to allow the employment of conflicts counsel where § 327(a) general bankruptcy counsel had a conflict of interest on a matter "central to the bankruptcy."[19]

19 *See In re Project Orange Assocs. LLC*, 431 B.R. 363, 375-76 (Bankr. S.D.N.Y. 2010) (stating that use of conflicts counsel in case was "fig leaf" and that counsel "has not provided the Court with any case law indicating that the use of conflicts counsel warrants retention under section 327(a) where the proposed general bankruptcy counsel has a conflict of interest with a creditor that is central to the debtor's reorganization").

Conclusion

The USTP's role is to ensure that the bankruptcy system functions with integrity and efficiency, and this is best accomplished by strict adherence to the Code and Rules, including on matters of disclosure and conflicts of interest. When proposed professionals make insufficient disclosures or hold disabling conflicts, the USTP will object and thereby contribute to the continued development of case law in this area. abi

On Our Watch

By Clifford J. White III, William K. Harrington and Nan Roberts Eitel[1]

Future of USTP'S CRO "Protocol"

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Seventeen years ago, the U.S. Trustee Program (USTP) entered into settlement agreements regarding the terms for the retention of firms providing chief restructuring officers (CROs) and other staff to assist debtors in possession (DIPs) with their chapter 11 duties. These settlements, which have come to be known as the "J. Alix Protocol" after the firm involved, apply the conflict-of-interest provisions of the Bankruptcy Code to the hiring of CROs, who are charged with mixed professional and business-management duties. Courts have approved hundreds of these settlements, which allow employment under § 363(b) (the use of estate property outside the ordinary course of business) while applying the relevant conflict protections of § 327(a) (the employment of professionals).

These settlements have brought predictability and consistency to CRO engagements. Nonetheless, after almost two decades during which the complexity of bankruptcy reorganizations and CRO industry practices have changed significantly, the USTP began outreach to stakeholders more than a year ago to discuss how to update the J. Alix Protocol without disturbing its essential features. While that process unfolds, the USTP will continue to follow the J. Alix Protocol and object to applications that do not comply with it.

Background

In 2001, in *In re Safety-Kleen Corp.*[2] and *In re Harnischfeger Industries Inc.*,[3] bankruptcy courts approved the USTP's settlements of its objections to the DIPs' applications to retain a CRO and the CRO's firm as a restructuring advisor. These cases provided a template for USTP agreements on the employment of CROs that allowed the CROs' employment under § 363 and applied § 327(a)'s relevant conflict protections, such as the bar on a professional's service as a director. CROs, which are hybrids of professional responsibilities covered by § 327(a) and executive functions covered by § 363, did not exist 40 years ago when the Bankruptcy Code was adopted.

Although DIPs retain the authority to appoint *traditional* corporate officers and *salaried* professionals without court approval,[4] the hybrid nature of the CRO's engagement makes them neither fish nor fowl, or (perhaps more accurately) both fish *and* fowl. CROs are not wholly traditional corporate officers, no matter how traditional many of their duties might be, and a DIP's decision to hire a CRO is, by definition, outside the ordinary course of business.[5]

In settling, the USTP recognized the dual nature of the engagements, the litigation risk arising from a CRO's legally uncertain status under a Bankruptcy Code that never contemplated their existence, and the debtors' legitimate need for CRO services at the time of a crisis. The USTP's goal was twofold: (1) Take a principled approach in harmonizing the applicable Code provisions,[6] and (2) provide notice of the USTP's litigating position on this complex issue.

As the U.S. Supreme Court has stated many times, statutory interpretation is a "holistic" endeavor[7] that should avoid (1) rendering other statutory provisions unnecessary and (2) interpreting them inconsistently with the policy of another provision.[8] Statutory construction requires reading "the statutes to give effect to each if we can do so while preserving their sense and purpose."[9] Consistent with these canons, the J. Alix Protocol gives the fullest effect to all of the pertinent Code provisions, including §§ 363(b) and 327(a).

The J. Alix Protocol has no force of law. It merely telegraphs to the bankruptcy community how the USTP interprets and will apply the law in carrying out its statutory duty to review applications to employ. Even though a few courts have criticized the J. Alix Protocol as being too accommodating to the CRO industry,[10] most courts and the CRO firms

1 Mr. White served as an *ex officio* member of ABI's Commission to Study the Reform of Chapter 11 and currently serves in the same capacity on ABI's Commission on Consumer Bankruptcy.
2 Case No. 00-2303 (Bankr. D. Del. 2000).
3 Case No. 99-2171 (Bankr. D. Del. 1999).
4 *See Jacobson v. AEG Capital Corp.*, 50 F.3d 1493, 1500 (9th Cir. 1995) ("[D]irectors still have the power to elect officers.") (quotation omitted); 11 U.S.C. § 327(b) (professionals regularly employed on salary are subject to § 327(b), not § 327(a)).
5 Restructuring in bankruptcy can never be considered "ordinary course" for any business, and courts have approved the retention of restructuring professionals under § 363(b). *See, e.g., In re Liberty Asset Mgmt. Corp.*, No. 16-13575 (Bankr. C.D. Cal. June 9, 2016), Docket No. 94; *In re Interfaith Med. Ctr.*, No. 12-48226 (Bankr. E.D.N.Y. Jan. 25, 2013), Docket No. 177; *In re Qualteq Inc.*, No. 11-12572 (KJC) (Bankr. D. Del. Sept. 2, 2011), Docket No. 135; *In re Hartford Computer Hardware Inc.*, No. 11-49744 (PSH) (Bankr. N.D. Ill. April 12, 2012), Docket No. 270; *In re Colad Grp. Inc.*, 324 B.R. 208, 215 (Bankr. W.D.N.Y. 2005).
6 Section 327(a)'s rigorous disinterestedness requirement makes any officer ineligible for professional employment notwithstanding § 363's more deferential business-judgment standard. It is this statutory conflict and the hybrid nature of CRO engagements that was the genesis for the protocol in 2001.
7 *United Sav. Ass'n v. Timbers of Inwood Forest Assocs. Ltd.*, 484 U.S. 365, 371 (1988).
8 *Ratzlaf v. United States*, 510 U.S. 135, 140 (1994); *Timbers of Inwood*, 484 U.S. at 371.
9 *Matter of Spanish Peaks Holdings II LLC*, 872 F.3d 892, 899 (9th Cir. 2017) (quoting *Watt v. Alaska*, 451 U.S. 259 (1981)).
10 *See, e.g., In re Mirant Corp.*, 354 B.R. 113, 127 n.29 (Bankr. N.D. Tex. 2006) ("The [U.S. Trustee] and other parties acquiesced in this method of retention [under § 363] (which was intended to avoid application to AP of the disinterestedness test of 11 U.S.C. § 101(14) due to AP's personnel serving as officers of Debtors). The court is not satisfied that use of Code § 363 is appropriate for such a purpose, but need not here reach that issue." *Id.*; *contra In re Ajubeo LLC*, 2017 WL 5466655, *4 (Bankr. D. Colo. Sept. 27, 2017) (approving CRO's retention under § 363 and stating that the "[c]ourt believes it is enforcing the Code").

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have widely accepted and followed the J. Alix Protocol. Therefore, the USTP intends to continue to follow the J. Alix Protocol and to enforce it consistently. Likewise, if proposed CROs deviate from the J. Alix Protocol, the USTP will continue to object to their employment applications under § 327.

Key Provisions of the CRO Protocol

The key ethical and disclosure components of the protocol can be summarized in the following manner.

- *The J. Alix Protocol incorporates §§ 327(a) and 101(14)'s prohibition on serving, or having served within two years, on a debtor's board*. This is important, because the two-year ban is a bright-line rule set forth in statute. Directors — not officers — are vested with ultimate management authority and owe a duty of loyalty to the corporation. A board must be independent of the CRO in order to prevent actual or apparent conflicts of interest, which are key aspects of § 327(a). For example, if the CRO serves on the board while that same board decides to retain the CRO's firm, this insider transaction presents a conflict of interest.
- *The J. Alix Protocol incorporates § 327(a)'s conflict-of-interest rules to bar those with an actual conflict of interest from being retained*. The protocol also avoids conflicts of interest by preventing the CRO from managing the engagement to the financial benefit of the CRO's firm. It does so by establishing the so-called "one hat rule: allowing the professional to serve in only one capacity, such as CRO, crisis manager, financial advisor, claims agent or investor. Similarly, it also bans the CRO's firm from investing in the DIP for two years after the engagement concludes.
- *The J. Alix Protocol incorporates the disclosure requirements governing a § 327(a) application by requiring an affidavit setting forth connections with parties and professionals*. These disclosures are analogous to those required under Fed. R. Bankr. P. 2014. Disclosure and transparency are key to evaluating potential conflicts of interest and enhancing public confidence in the integrity of the system.
- *The J. Alix Protocol requires disclosure of staffing and compensation, as well as a court review of compensation under a "reasonableness" standard, which is analogous to the review of compensation of professionals employed under § 327(a)*. Approval of retention under § 363 alone would deprive the court and the parties of their critical role in protecting the estate by evaluating the justifications for the fees and other payments made to key players who are employed to guide the debtor company through the bankruptcy process.

USTP Consistently Follows J. Alix Protocol

The USTP widely disseminated and posted the J. Alix Protocol, as well as gave notice that the USTP would object under § 327 to any CRO employment application that failed to comply with every component of the protocol.[11] As stated in the USTP manual posted online, "[I]f the debtor or crisis manager rejects any term of the [*J. Alix Protocol*], the [U.S.] Trustee retains the right to object to all issues regarding the crisis manager's employment, including the request to be retained under section 363 rather than section 327."[12] It is fair to say that the USTP's reserved § 327 objection for violations of the J. Alix Protocol is as much a part of the protocol itself as are the conflict and disclosure provisions.

The USTP has occasionally, but rarely, been forced to object to CRO retentions under § 327.[13] More commonly, the USTP resolves these objections once the CRO comes into compliance with the protocol or the debtor withdraws its application if compliance is not possible. The relative absence of CRO retention litigation over the last 17 years is a testament both to the J. Alix Protocol's widespread acceptance and to the CRO firms' adherence to it.

Just as the USTP seeks to bring integrity and efficiency to the bankruptcy system, it also seeks to bring predictability and stability through consistent litigating positions. Any major changes in the jurisprudence governing CRO retentions would create uncertainty and inefficiency for all parties, the court and the USTP.

One recent court decision calls into question the future viability of the J. Alix Protocol and could reopen previously settled questions about CRO retentions going forward. In *Nine West*, the debtors sought to retain a restructuring firm to provide an interim CEO and retain the firm itself to provide additional restructuring services.[14] The CEO had served on one debtor's board of directors for several years and resigned only once a bankruptcy filing was imminent. Thus, given the failure to comply with the J. Alix Protocol's *sine qua non* of an independent board, the USTP objected to the retention under § 327.[15]

The *Nine West* court seemingly approved of the J. Alix Protocol and its ethical protections, noting that "[r]equiring parties to comply with the Protocol has served as a way to avoid conflicts of interest."[16] However, in overruling the USTP's § 327 objection, the court applied neither § 327 nor the J. Alix Protocol and instead ruled that "nothing precludes the Debtors from relying on section 363(b) to seek authorization for the retention of [the restructuring firm and CEO]."[17]

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11 *See* "Volume 3: Chapter 11 Case Administration," *available at* justice.gov/ust/file/volume_3_chapter_11_case_administration.pdf/download (hereinafter the "USTP Manual"; unless otherwise specified, all links in this article were last visited on July 26, 2018).

12 *Id.* at 106-07.

13 *See, e.g., In re Patriot Nat'l Inc.* (Bankr. D. Del. 2018); *Ajubeo*, 2017 WL 5466655; *In re Adams Res. Exploration Corp.* (Bankr. D. Del. 2017); *In re The Adoni Grp. Inc.* (Bankr. S.D.N.Y. 2014); *In re Revstone* (Bankr. D. Del. 2013).

14 *In re Nine West Holdings Inc.*, 2018 WL 3238695 (Bankr. S.D.N.Y. July 2, 2018).

15 The USTP has never knowingly failed to object to a CRO's and his/her firm's retention when a firm member has served on a debtor's board. For example, in *In re Allen Systems Grp.* (Bankr. D. Del. 2015), one of the principals of the CRO's firm had served on the board pre-petition in violation of the J. Alix Protocol. The USTP filed an objection under § 327, and the firm withdrew its application because the conflict could not be remedied.

16 *Nine West* at *6. The court further recognized that the J. Alix Protocol is "designed to avoid the 'inherent conflict' between an advisor's duty to a debtor and its own business interests where the advisory firm serves both as a financial advisor retained pursuant to § 327 of the Bankruptcy Code and as a crisis manager with firm staff serving as officers of the debtor corporation." *Id.*

17 *Id.* at *8.

If case law develops that § 363 is the sole hurdle for CRO applicants, then the J. Alix Protocol might become obsolete and other unintended consequences could follow. For example, because § 363 independently imposes no disclosure requirements or conflict-of-interest standards,[18] the result could be little transparency and accountability for those arguably serving in the most critical role in the chapter 11 case. Furthermore, a "§ 363 only" rule renders future CRO applications susceptible to ad hoc standards, thereby depriving debtors and the CRO industry of the predictability and stability that the J. Alix Protocol affords. If officers provided by restructuring firms are like any other corporate officers and are not subject to § 327's constraints incorporated in the protocol, then those officers are likely insiders for all purposes, including § 503(c)'s limits on insider compensation and bonuses for the firm.

Future of the J. Alix Protocol

Like all policies and practices, the J. Alix Protocol is worthy of reevaluation from time to time. Indeed, the USTP has publicly stated, "We have reached out to participants in the restructuring business and other stakeholders for information on how the Protocol should be updated to account for the facts of modern practice, while remaining faithful to the conflict of interest provisions of the Code."[19] In this outreach to stakeholders, we have explained that in considering any changes to the J. Alix Protocol, we will follow a process similar to that followed for the large-case fee guidelines issued in 2013: Acquire information, publish for comment (even though the Administrative Procedure Act does not apply), convene a public meeting, and issue an updated CRO protocol for final publication.

The USTP should be prudent and careful when considering whether to modify longstanding policy on which creditors, debtors and professionals alike have relied. Thus, we are considering potential consequences as we deliberately reevaluate and study the J. Alix Protocol. For now and the foreseeable future, however, the USTP intends to continue to abide by the protocol and consistently enforce it as we have for almost two decades, because we believe the J. Alix Protocol to be a legally principled approach for employing CROs.

Conclusion

The USTP understands the valuable role that CROs play in business reorganizations. We developed the J. Alix Protocol as a workable framework for analyzing employment applications in a manner that faithfully follows the law and ensures that statutory safeguards against conflicts of interest are observed. With the growing complexity of the CRO industry, some modifications to the protocol might be appropriate. However, it would be a mistake and contrary to statute to jettison the conflict and disclosure provisions of the J. Alix Protocol that govern all other professional retentions in chapter 11.

The USTP stands ready to listen to stakeholders about updating the J. Alix Protocol in a way that does not violate statutory mandates. Unless and until changes are made to the protocol or law, however, the bankruptcy community can continue to rely on the USTP to follow the protocol and to object to employment applications that deviate from its terms. abi

18 At least, not beyond what would be necessary to show a proper exercise of a DIP's business judgment as opposed to the more rigorous standards of § 327 imported into the J. Alix Protocol.

19 "Director's Remarks Delivered at the 33rd Annual Bankruptcy and Restructuring Conference of the Association of Insolvency and Restructuring Advisors," June 7, 2017, *available at* justice.gov/ust/speeches-testimony/remarks-director-33rd-annual-bankruptcy-and-restructuring-conference-association.

Protocol for Engagement of Jay Alix & Associates and Affiliates

I. Retention Guidelines

A. Jay Alix & Associates ("JA&A") is a firm that provides turnaround and crisis management services, financial advisory services, management consulting services, information systems services and claims management services. In some cases the firm provides these services as advisors to management, in other cases one or more of its staff serve as corporate officers and other of its staff fill positions as full time or part time temporary employees ("crisis manager"), and in still other cases the firm may serve as a claims administrator as an agent of the Bankruptcy Court. JA&A and its affiliates[1] will not act in more than one of the following capacities in any single bankruptcy case: (i) crisis manager retained under Sec. 363, (ii) financial advisor retained under Sec. 327, (iii) claims agent/claims administrator appointed pursuant to 28 U.S.C. § 156(c) and any applicable local rules or (iv) investor/acquirer; and upon confirmation of a Plan may only continue to serve in a similar capacity. Further, once JA&A or one of its affiliates is retained under one of the foregoing categories it may not switch to a different retention capacity in the same case. However, with respect to subsequent investments by Questor this prohibition is subject to the time limitations set forth in IV.B below.

B. Engagements involving the furnishing of interim executive officers[ss] whether prepetition or postpetition (hereinafter "crisis management" engagements) shall be provided through JA&A Services LLC ("JAS").

C. JAS shall seek retention under section 363 of the Bankruptcy Code. The application of JAS shall disclose the individuals identified for executive officer positions as well as the names and proposed functions of any additional staff to be furnished by JAS. In the event the Debtor or JAS seeks to assume additional or different executive officer positions, or to modify materially the functions of the persons engaged, a motion to modify the retention shall be filed. It is often not possible for JAS to know the extent to which full time or part time temporary employees will be required when beginning an engagement. In part this is because the

[1] Affiliates of JA&A presently are System Advisory Group (an organization that provides information services), JA&A Services LLC (an entity that provides temporary employees), Questor Management Company LLC, an organization that manages Questor Partners Fund, Questor Partners Fund II, and various Side-by-Side entities, which are limited partnerships that invest in underperforming and troubled companies, and ACT Two (an entity that owns and operates a private airplane). Future affiliates of JA&A, if any, will be subject to the limitations set forth herein.

[2] "Executive officers" shall include but is not necessarily limited to Chief Executive Officer, President, Chief Operating Officer, Treasurer, Chief Financial Officer, Chief Restructuring Officer, Chief Information Officer, and any other officers having similar roles, power or authority, as well as any other officers provided for in the company's bylaws.

extent of the tasks that need to be accomplished is not fully known and in part it is because JAS is not yet knowledgeable about the capability and depth of the client's existing staff. Accordingly, JAS shall file with the Court with copies to the UST and all official committees a report of staffing on the engagement for the previous month. Such report shall include the names and functions filled of individuals assigned. All staffing shall be subject to review by the Court in the event an objection is filed.

D. Persons furnished by JAS for executive officer positions shall be retained in such positions upon the express approval thereof by an independent Board of Directors whose members are performing their duties and obligations as required under applicable law ("Board"), and will act under the direction, control and guidance of the Board and shall serve at the Board's pleasure (*i.e.* may be removed by majority vote of the Board).

E. The application to retain JAS shall make all appropriate disclosures of any and all facts that may have a bearing on whether JAS, its affiliates, and/or the individuals working on the engagement have any conflict of interest or material adverse interest, including but not necessarily limited to the following:

1. Connection, relationship or affiliation with secured creditors, postpetition lenders, significant unsecured lenders, equity holders, current or former officers and directors, prospective buyers, or investors.

2. Involvement as a creditor, service provider or professional of any entity with which JA&A or any affiliate has an alliance agreement, marketing agreement, joint venture, referral arrangement or similar agreement.

3. Any prepetition role as officer, director, employee or consultant,[3] but service as a pre-petition officer will not *per se* cause disqualification.

4. Any prepetition involvement in voting on the decision to engage JA&A or JAS in the bankruptcy case, and/or any prepetition role

[3] In no case shall any principal, employee or independent contractor of JA&A, JAS and affiliates serve as a director of any entity while JA&A, JAS or any affiliate is rendering services in a bankruptcy proceeding, and JA&A, JAS and their affiliates shall not seek to be retained in any capacity in a bankruptcy proceeding for an entity where any principal, employee or independent contractor of JA&A, JAS and affiliates serves or has previously served as a director of the entity or an affiliate thereof within two years prior to the petition date. During such two year period, neither JA&A, JAS or affiliates shall have provided any professional services to the entity nor shall any individuals associated with JA&A, JAS and affiliates have served as an Executive Officer.

carrying the authority to decide unilaterally to engage JA&A or JAS.

5. Information regarding the size, membership and structure of the Board so as to enable the UST and other interested parties to determine that the Board is independent.

6. Whether the executive officers and other staff for the engagement are expected to be engaged on a full time or part time basis, and if part-time whether any simultaneous or prospective engagement exists that may be pertinent to the question of conflict or adverse interest.

7. The existence of any unpaid balances for prepetition services.

8. The existence of any asserted or threatened claims against JA&A, JAS or any person furnished by JA&A/JAS arising from any act or omission in the course of a prepetition engagement.

F. Disclosures shall be supplemented on a timely basis as needed throughout the engagement.

G. Where JA&A does not act as a crisis manager its retention will be sought as a financial advisor under section 327 of the Code or as a Court appointed claims representative.

II. Compensation

A. Compensation in crisis management engagements shall be paid to JAS.

B. The application to retain JAS shall disclose the compensation terms including hourly rates and the terms under which any success fee or back-end fee may be requested.

C. JAS shall file with the Court, and provide notice to the UST and all official committees, reports of compensation earned and expenses incurred on at least a quarterly basis. Such reports shall summarize the services provided, identify the compensation earned by each executive officer and staff employee provided, and itemize the expenses incurred. The notice shall provide a time period for objections. All compensation shall be subject to review by the Court in the event an objection is filed (*i.e.*, a "negative notice" procedure).

D. Success fees or other back-end fees shall be approved by the Court at the conclusion of the case on a reasonableness standard and shall not be pre-approved under section 328(a). No success fee or back-end fee shall

be sought upon conversion of the case, dismissal of the case for cause or appointment of a trustee.

III. Indemnification

A. Debtor is permitted to indemnify those persons serving as executive officers on the same terms as provided to the debtor's other officers and directors under the corporate bylaws and applicable state law, along with insurance coverage under the debtor's D&O policy.

B. There shall be no other indemnification of JA&A, JAS or affiliates.

IV. Subsequent Engagements

A. Pursuant to the "one hat" policy as stated above, after accepting an engagement in one capacity, JA&A and affiliates shall not accept another engagement for the same or affiliated debtors in another capacity.

B. For a period of three years after the conclusion of the engagement, Questor shall not make any investments in the debtor or reorganized debtor where JA&A, JAS or another affiliate has been engaged.

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ABI EXCLUSIVE

JULY 9, 2018

U.S. Trustee Criticized for Dumping the 'Jay Alix Protocol'

> New York bankruptcy judge approves retention of a crisis manger under Section 363(b) who might be disqualified under Section 327(a).

A palpably angry bankruptcy judge excoriated the U.S. Trustee in New York for abandoning the so-called Jay Alix Protocol by contending that management consultants hired before bankruptcy cannot fill executive roles after a chapter 11 filing if the firm does not satisfy the strictures of the disinterestedness test.

However, a spokeswoman for the Department of Justice told ABI that the U.S. Trustee Program has not changed its policy.

In her July 2 opinion, Bankruptcy Judge Shelley C. Chapman of Manhattan said that forcing the debtor to jettison crisis managers who had been on board for four years before bankruptcy "would put the success of the entire reorganization at risk," producing "an absurd result, to say the least."

Four years before filing under chapter 11, Nine West Holdings Inc., formerly known as Jones Apparel Group, had hired Alvarez & Marsal North America LLC to provide the company with an interim chief executive and other management personnel. At the time, the company had given no thought to bankruptcy. Judge Chapman said that A&M was to provide "vital management services" and oversee "virtually all aspects of their day-to-day operations."

Before bankruptcy, the chief executive provided by A&M had served as a director for several of the company's subsidiaries. He was not a director of the parent company.

On filing under chapter 11, the company submitted an application to retain A&M under Section 363(b) to continue managing the debtor's daily operations. Section 363(b) gives a debtor in possession the power to use, sell or lease property of the estate.

The U.S. Trustee objected, contending that A&M could only be retained as a professional under Section 327(a). The U.S. Trustee evidently believed that the firm was not disinterested under Section 101(14) and thus did not qualify for retention under Section 327(a), perhaps on account of the CEO's service as a director of subsidiaries.

Creditors up and down the capital structure uniformly opposed the U.S. Trustee and urged the court to approve A&M's retention, Judge Chapman said.

In her 31-page opinion designated for publication, Judge Chapman overruled the U.S. Trustee's objection and approved A&M's retention under Section 363(b) to provide the debtor with an interim CEO and additional managerial personnel.

Judge Chapman focused her opinion on the Jay Alix Protocol, promulgated in the Southern District of New York 14 years ago. It appears on the website of the U.S. Trustee Program. To read the Protocol, **click here**.

Judge Chapman explained that the Protocol, now national policy, was developed to allow chapter 11 debtors to retain their pre-petition crisis managers by engaging the firms under Section 363(b), rather than under Section 327(a), where they might fail the disinterestedness test. The Protocol has four principal requirements: (1) The firm may serve in only one capacity; (2) the retention must be under Section 363(b), and the retained firm must disclose all relationships to show that it is not otherwise disinterested; (3) the firm must file monthly reports subject to court review; and (4) the

persons providing services must be approved by and act under an independent board of directors.

Until the Nine West case, Judge Chapman said the U.S. Trustee had not objected to dozens if not hundreds of retentions over the last 14 years "where such consultants have purportedly followed the Protocol." She said the U.S. Trustee's objection "fails to mention the Protocol at all, let alone A&M's compliance in all material respects with each of its requirements." Instead, she said that the U.S. Trustee "makes the unequivocal statement that . . . '[a] debtor cannot use Section 363(b) to employ a professional person.'"

Judge Chapman said that the purpose of the Protocol "has not been violated by A&M here," because the CEO provided by the firm had not been a director of the parent corporation and thus was not in a position to approve his or his colleagues' pre- or postpetition retention and compensation.

For 14 years, Judge Chapman said, "the crisis and interim management industry has relied on the implicit consent of the U.S. Trustee that such firms can be retained . . . pursuant to Section 363 rather than Section 327 if they meet the requirements of the Protocol." By suddenly objecting in the Nine West case, she said the U.S. Trustee is "implying that there was clear error in every case in which a bankruptcy court has in the past approved" retentions under the Protocol.

"The only explanation" for the "stunning reversal of policy," Judge Chapman said, was the chief executive's "*de minimis* board service; the economic disruption that his departure would cause is of no concern to the U.S. Trustee." Blocking the firm's engagement, she said, "could . . . put the success of the entire reorganization at risk."

The Protocol, according to Judge Chapman, has allowed the "[e]ngagement of management consultancy firms prior to a bankruptcy filing and their continuing retention postpetition [to enable] companies to achieve business continuity during their darkest hour." If only Section 327 and its strict disinterestedness requirement were available, she said that "previously provided firm personnel . . . must be jettisoned when a company files chapter 11 . . . ."

Having decided that Section 327(a) was not the only pigeonhole, Judge Chapman ended her opinion by finding that A&M was not providing services of a professional because

"they could have been performed by existing company personnel." Since the engagement also satisfied the business-judgment rule, she approved the retention under Section 363(b).

In response to an inquiry from ABI, Nicole Navas Oxman, a spokeswoman for the Department of Justice, said in an email that the "U.S. Trustee Program has not changed its legal position as reflected in the Jay Alix Protocol." A "key provision" in the Bankruptcy Code, she said, "requires that professionals not have served on the Board of Directors. As stated in court, we believe that provision was violated in this case."

Opinion Link

http://www.nysb.uscourts.gov/sites/default/files/opinions/282176_465_opinion.pdf

Case Details

Judge Name	Shelley C. Chapman
Case Citation	In re Nine West Holdings Inc., 18-10947 (Bankr. S.D.N.Y. July 2, 2018)
Case Name	In re Nine West Holdings Inc.
Case Type	Business
Court	2nd Circuit New York New York Southern District
Bankruptcy Tags	Corporate Governance Ethics Financial Advisors Practice and Procedure Professional Compensation/Fees Business Reorganization

ABI EXCLUSIVE

MAY 26, 2020

Houston Judge Rejects the Jay Alix Protocol, Allows Retention Under Section 327(a)

> Bankruptcy Judge David Jones finds the Jay Alix Protocol to be 'completely unnecessary.'

When it comes to the retention of a financial advisory firm whose personnel had served as officers of the debtor before bankruptcy, Bankruptcy Judge David R. Jones of Houston has decided that the so-called Jay Alix Protocol "is completely unnecessary."

In his May 20 opinion, Judge Jones concluded that the "transparent process of Section 327(a)" is best suited for the continued retention of financial advisors who had assisted a company before bankruptcy.

To avoid a perceived "disinterestedness" problem, the Jay Alix Protocol was promulgated to permit retention of financial professionals under Section 363(b), which deals with use of estate property outside of the ordinary course of business. Judge Jones rejected reliance on Section 363(b), saying it does not

deal with "the conditions under which a professional person may be employed."

The Genesis of the Protocol

Judge Jones described the history of the Jay Alix Protocol, which was designed by the U.S. Trustee Program so that chapter 11 debtors could continue using financial professionals who began work before filing. Typically, a professional from a financial firm would have served before bankruptcy as a company executive, perhaps as chief restructuring officer. Pre-filing service as an officer was seen by some as rendering the officer and the firm not disinterested and thus ineligible for continued retention after filing.

The protocol appears on the website of the U.S. Trustee Program. To read the protocol, **click here**.

Judge Jones explained the statutory maze that gave rise to the protocol. Section 327(a) allows the retention of "professional persons" who are "disinterested" and do not "represent an adverse interest." In Section 101(14), someone is not disinterested if that person has been "a director, officer, or employee of the debtor" within two years of bankruptcy.

It was therefore widely believed that a pre-bankruptcy financial professional who served as an officer would not be disinterested and thus not eligible for retention under Section 327(a). The protocol therefore utilized Section 363(b), which by its terms contains no provisions regarding the retention of financial professionals.

Judge Jones pointed out how Section 1107(b) states that a "person is not disqualified for employment under section 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case."

Judge Jones cited decisions where the protocol has been both endorsed and criticized. Although the protocol was "innovative at its inception," he said it had "become a tool to avoid transparency and create inequity."

Problems with the Protocol

Judge Jones recited shortcomings in the protocol and its implementation:

- "Applicants routinely push more and more services under the auspices of § 363(b) to avoid court oversight through the fee application process and the accompanying public transparency.
- "Invoices are provided to limited parties in lumped fashion and kept from public scrutiny.
- "Financial advisory services are inappropriately categorized as 'back office' support services;" and
- "Success fees are mentioned only in a back-page disclosure."

Judge Jones said, "These examples are but a sampling and tarnish the sanctity of a process that demands complete transparency. Moreover, the protocol is completely unnecessary."

Imputed Lack of Disinterestedness

Judge Jones believes the protocol to be unnecessary because he concurred with his Houston colleague, Bankruptcy Judge Marvin Isgur, who found no *per se* rule imputing a single member's disinterestedness to the member's firm. *See In re Cygnus Oil and Gas Corp.*, 07-32417, 2007 WL 1580111 (Bankr. S.D. Tex. May 29, 2007). Judge Jones said that a "majority" of courts agree with *Cygnus*.

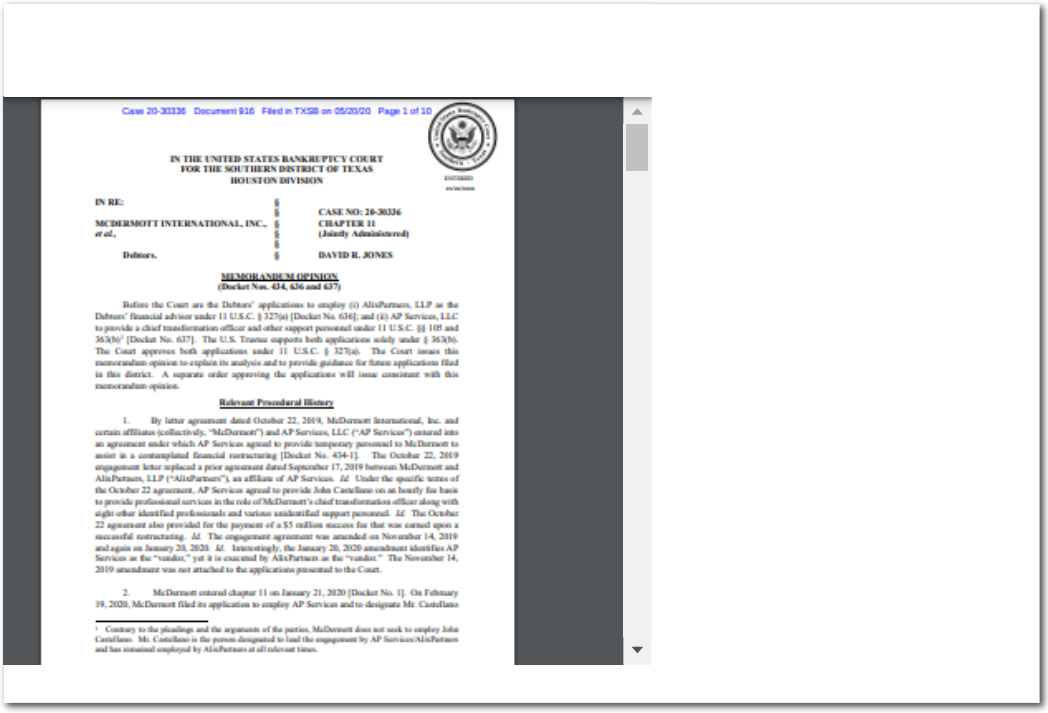
In siding with Judge Isgur, Judge Jones noted that a bankruptcy court in Delaware saw a *per se* disqualification. *See In re Essential Therapeutics, Inc.*, 295 B.R. 203 (Bankr. D. Del. 2003).

In deciding that the financial professionals were eligible for retention under Section 327(a), Judges Jones noted that the firm was not a creditor, equity holder or insider. Likewise, the firm had not been an officer, director or employee of the debtor within two years. Critically, he found "no evidence to suggest" that the "alleged [lack of] disinterestedness" by the pre-bankruptcy restructuring officer "should be imputed" to the firm.

In the future, Judge Jones said he "expects to see a single application for employment [of financial professionals] under Section 327(a)." He authorized the designation of the pre-bankruptcy chief transformation officer as the chief restructuring officer for the debtor in possession.

Opinion Link

PREVIEW



Case 20-30336 Document 916 Filed in TXSB on 05/20/20 Page 1 of 10

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

IN RE: §
§
MCDERMOTT INTERNATIONAL, INC., § CASE NO: 20-30336
et al., § CHAPTER 11
§ (Jointly Administered)
Debtors. § DAVID R. JONES

MEMORANDUM OPINION
(Docket Nos. 434, 636 and 637)

Before the Court are the Debtors' applications to employ (i) AlixPartners, LLP as the Debtors' financial advisor under 11 U.S.C. § 327(a) [Docket No. 636]; and (ii) AP Services, LLC to provide a chief transformation officer and other support personnel under 11 U.S.C. §§ 105 and 363(b)[1] [Docket No. 637]. The U.S. Trustee supports both applications solely under § 363(b). The Court approves both applications under 11 U.S.C. § 327(a). The Court issues this memorandum opinion to explain its analysis and to provide guidance for future applications filed in this district. A separate order approving the applications will issue consistent with this memorandum opinion.

Relevant Procedural History

1. By letter agreement dated October 22, 2019, McDermott International, Inc. and certain affiliates (collectively, "McDermott") and AP Services, LLC ("AP Services") entered into an agreement under which AP Services agreed to provide temporary personnel to McDermott to assist in a contemplated financial restructuring [Docket No. 434-1]. The October 22, 2019 engagement letter replaced a prior agreement dated September 17, 2019 between McDermott and AlixPartners, LLP ("AlixPartners"), an affiliate of AP Services. *Id.* Under the specific terms of the October 22 agreement, AP Services agreed to provide John Castellano on an hourly fee basis to provide professional services in the role of McDermott's chief transformation officer along with eight other identified professionals and various unidentified support personnel. *Id.* The October 22 agreement also provided for the payment of a $5 million success fee that was earned upon a successful restructuring. *Id.* The engagement agreement was amended on November 14, 2019 and again on January 20, 2020. *Id.* Interestingly, the January 20, 2020 amendment identifies AP Services as the "vendor," yet it is executed by AlixPartners as the "vendor." The November 14, 2019 amendment was not attached to the applications presented to the Court.

2. McDermott entered chapter 11 on January 21, 2020 [Docket No. 1]. On February 19, 2020, McDermott filed its application to employ AP Services and to designate Mr. Castellano

[1] Contrary to the pleadings and the arguments of the parties, McDermott does not seek to employ John Castellano. Mr. Castellano is the person designated to lead the engagement by AP Services/AlixPartners and has remained employed by AlixPartners at all relevant times.

https://abi-opinions.s3.amazonaws.com/McDermott+Alix.pdf

Case Details

Case Citation In re McDermott International Inc., 20-30336 (Bankr. S.D. Tex. May 20, 2020)

Case Name	In re McDermott International Inc.
Case Type	Business
Court	5th Circuit Texas Texas Southern District
Bankruptcy Tags	Ethics Financial Advisors Practice and Procedure Professional Compensation/Fees Business Reorganization First-day Motions Labor/Employment

Faculty

Hon. Janet E. Bostwick is a U.S. Bankruptcy Judge for the District of Massachusetts in Boston, appointed on Sept. 27, 2019. Prior to her appointment, she practiced as a bankruptcy attorney with more than 30 years of experience with financially troubled companies, dealing with chapter 11 business reorganizations, liquidations and wind-downs, loan workouts and creditor negotiations. From 2001-19, Judge Bostwick practiced at her own firm, Janet E. Bostwick, PC, which focused on business bankruptcy and restructuring. Before launching her firm, she practiced at the Boston firms of Goldstein & Manello, PC and Sherin and Lodgen, LLP. Judge Bostwick is a member of the American College of Bankruptcy and serves as a member of its board of directors. She also serves on the *Pro Bono* Committee of the American College of Bankruptcy Foundation, which is the largest funder of bankruptcy *pro bono* projects and grants. Judge Bostwick frequently lectures on bankruptcy topics for professional organizations and bar organizations. She is a member of the American Bar Association, where she serves as co-chair of the Administration and Courts Subcommittee of the ABA Business Bankruptcy Law Committee. She also is a member of the National Conference of Bankruptcy Judges, where she serves on the Public Outreach, Next Generation, and Engaging Young Professionals Committees. Judge Bostwick is a longstanding member of the International Women's Insolvency and Restructuring Confederation (IWIRC) and is the founding chair of the IWIRC-New England Network. In 2005, IWIRC recognized her contributions to the organization by awarding her the Melnik Award for Exceptional IWIRC Member. Judge Bostwick is a member of the Boston Bar Association, for which where she served as chair of its Bankruptcy Committee, as well as a member of the BBA Council and as trustee for the Boston Bar Foundation. In 1998, she received the first Special Achievement Award from the BBA's Bankruptcy Law Committee in recognition of her efforts in organizing and administering a special program to provide *pro bono* counsel for clients of bankruptcy attorneys who had been suspended or disbarred. From 2005-16, Judge Bostwick was co-chair of the M. Ellen Carpenter Financial Literacy Program, a joint program of the U.S. Bankruptcy Court for the District of Massachusetts and the BBA. In 2016, the U.S. Bankruptcy Court for the District of Massachusetts awarded her the District of Massachusetts *Pro Bono* Award for her work with the program as well as her other *pro bono* activities over the years. Judge Bostwick received her B.A. in economics and mathematics from the State University of New York at Albany and her J.D. from Cornell Law School.

Bodie B. Colwell is Of Counsel with Preti, Flaherty, Beliveau & Pachios, Chtd., LLP in Portland, Maine, and represents businesses in financial distress both in and out of court. She also helps banks and businesses recover money owed to them. Ms. Colwell represents chapter 7 trustees of corporate and consumer debtors in the liquidation of assets and litigation matters, buyers of assets in bankruptcy, and distressed health care businesses in out-of-court workouts and liquidations. She also represents lenders in commercial and consumer matters and creditors in matters involving preference and fraudulent transfer avoidance claims. Ms. Colwell is an emerging leader in bankruptcy and restructuring. She has authored articles for the *ABI Journal* and is actively engaged in ABI committees, serving as co-chair for its Young and New Members Committee. In addition, she is a member of the International Women's Insolvency & Restructuring Confederation (IWIRC) and is the first New England-area attorney to be named as a semi-finalist for the IWIRC Rising Star Award. Ms. Colwell received her B.A. in 2004 from the University of Southern Maine and her J.D. *cum laude* from the University of Maine School of Law.

Jacen A. Dinoff, CTP is co-founder and CEO of KCP Advisory Group LLC in Burlington, Mass. He is a corporate restructuring advisor with accounting, finance, management and operations experience, and he has technical expertise in bankruptcy case administration and financial advisory. His career has included financial and operational restructurings, asset divestitures, and senior debtor/creditor advisor roles for many companies, both publicly and privately held. Mr. Dinoff received his B.S. in business administration from the Whittemore School of Business and Economics at the University of New Hampshire and his M.B.A in finance from Bentley College.

Jeffrey R. Hellman is with the Law Offices of Jeffrey Hellman, LLC in New Haven, Conn., where his practice is focused on the representation of individuals and businesses in complex commercial litigation. He has worked on contract disputes, prosecution and defense of preference and fraudulent transfer litigation, partnership and intercompany disputes, and various types of debtor and creditor disputes. His practice also includes various types of real estate litigation including title disputes, lease disputes and trespass actions. Mr. Hellman recently defended a fiduciary in a case involving numerous trusts in a trial that lasted about three months. He regularly appears in the Connecticut Superior Court, the U.S. District Court for the District of Connecticut and the U.S. Bankruptcy Court for the District of Connecticut. Mr. Hellman has lectured to the Connecticut Bar Association and the Norton Bankruptcy Litigation Institute. He has been a member of the Executive Committee of the Federal Practice Section of the Connecticut Bar Association since 1996 and a member of the Section since 1989, and he is chair of the Connecticut Committee of the Federal Bar Council. He is also a member of the Commercial Law and Bankruptcy Section of the Connecticut Bar Association. Mr. Hellman was an assistant district attorney in Philadelphia from 1986-89. He is admitted to the Bars of Pennsylvania, Massachusetts and Connecticut, and is a contributing editor to *Norton Bankruptcy Law and Practice* (3d ed. West 2012). Mr. Hellman received his A.B. *magna cum laude* in 1983 from Duke University and his J.D. *cum laude* in 1986 from Harvard University.

Richard T. King is an Assistant U.S. Trustee with the Office of the U.S. Trustee in Worcester, Mass.