AMERICAN BANKRUPTCY INSTITUTE

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The Closely Held Business in Financial Trouble: Unraveling Conflicts Within the "Family"

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Is Reconstituting or Disbanding the Committee Ever an Option?

An official committee owes a fiduciary duty to the entire class of creditors that it represents in a debtor's bankruptcy case.[1] By design, however, a committee is comprised of different members which may hold divergent views based on the members' specific individual claims against the debtor. Consistent with their fiduciary obligations, the committee members are required to put the interests of the unsecured creditor body above their own interests with respect to their committee work. What happens if they are unable to do so—or if other parties suspect, based on the committee members' identities, that they will be unable to do so? What options, if any, do concerned parties have regarding specific members of the committee or the committee composition generally? Can a Bankruptcy Court reconstitute, or even disband, a committee?

I. Background Regarding Committee Formation.

As soon as practicable after commencement of a Chapter 11 case, the United States Trustee is required to appoint a committee of creditors holding unsecured claims, and may appoint additional committees as deemed appropriate.[2] At the request of a party in interest in a

[1] See e.g., In re SPM Mfg. Corp., 984 F.2d 1305, 1315 (1st Cir. 1993) ("the committee's fiduciary duty… runs to the parties or class it represents…. It is charged with pursuing whatever lawful course best serves the interests of the class of creditors it represents.")

[2] 11 U.S.C. § 1102(a)(1).

case where the debtor is a small business debtor, the court may order, for cause, that a committee not be appointed.[3] A committee of unsecured creditors shall ordinarily consist of the persons willing to serve that hold the seven largest claims against the debtor of the kinds represented on such committee.[4] While some courts have noted that failure to appoint one of the seven largest creditors to the committee "may well be an abuse of discretion,"[5] other courts have held that the statutory text regarding the makeup of the committee is "precatory" and "nonbinding" and "affords no right of membership" to the debtor's seven largest creditors.[6] The court may order the United States trustee to increase the number of members of a committee to include a creditor that is a small business concern (as described in the Small Business Act) [7], if the court determines that the creditor holds claims which, in comparison to the annual gross revenue of that creditor, are disproportionately large.[8]

The duties of the committee may include the following:[9]

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3 11 U.S.C. § 1102(a)(3) .

4 11 U.S.C. § 1102(b)(1).

5 Matter of Enduro Stainless, Inc., 59 B.R. 603, 605 (Bankr. N.D. Ohio 1986).

6 In re Drexel Burnham Lambert Group, Inc., 118 B.R. 209, 212 (Bankr. S.D.N.Y. 1990) (citing H.R. Rep. No. 95-595, at 401 (1977)).

7 Section 3(a)(1) of the Small Business Act provides:

> A small-business concern, including but not limited to enterprises that are engaged in the business of production of food and fiber, ranching and raising of livestock, aquaculture, and all other farming and agricultural related industries, shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation.

15 U.S.C. § 632(a)(1).

8 11 U.S.C. § 1102(a)(4).

9 11 U.S.C. § 1103(c)(1)-(5).

a. consulting with the trustee or debtor in possession concerning administration of the case;

b. investigating the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;

c. participating in the formulation of a plan, advising those represented by such committee of such committee's determinations as to any plan formulated, and collecting and filing with the court acceptances or rejections of a plan;

d. requesting the appointment of a trustee or examiner under 11 U.S.C. § 1104; and

e. performing such other services as are in the interest of those represented.

Committees are also required to provide access to information for similarly-situated creditors who are not members of the committee and also to solicit and receive comments from such creditors.[10] The Chapter 11 trustee or debtor in possession is required to meet with the committee to transact such business as may be necessary and proper as soon as practical after appointment of such committee.

II. Reconstitution of Committees.

Pursuant to Bankruptcy Code § 1102(a)(4), on request of a party in interest and after notice and a hearing, the court may order the United States Trustee to change the membership of a creditors committee if the court determines that the change is necessary to ensure adequate representation of creditors.[11]

The phrase "adequate representation" is not defined in the Bankruptcy Code. Courts that have examined adequacy of representation under Bankruptcy Code § 1102(a)(4) have reviewed

[10] 11 U.S.C. § 1102(b)(3)(A)-(B).

[11] 11 U.S.C. § 1102(a)(4).

factors including the following: (i) the ability of the committee to function, (ii) the nature of the case, (iii) the standing and desires of the various constituencies, (iv) the ability for creditors to participate in the case without an official committee, (v) the possibility that different classes would be treated differently under a plan and need representation, (vi) the motivation of the movants, (vii) the delay and additional cost of granting the motion, (viii) the point in the proceeding when the motion is made, (ix) the tasks the committee is to perform, and (x) any other relevant factors.[12] (The factors used for examining adequacy of representation, and related analysis, are in many cases adapted from analysis of Bankruptcy Code § 1102(a)(2), which addresses appointment of additional committees of creditors if necessary to assure adequate representation of creditors.) Analysis of whether reconstitution of a committee is necessary to ensure adequate representation of creditors is done on a case-by-case basis.[13]

In Park West Circle Realty, LLC, creditor Constantine Cannon LLP, a law firm that had previously represented the debtors, moved for a Bankruptcy Court order directing the United States trustee to appoint it to the unsecured creditors committee in the debtors' bankruptcy case. Constantine Cannon's claim of over $2 million "dwarf[ed]" the other committee members' claims and represented over 50% of the debtors' debt.[14] After reviewing the factors referenced above, the court ultimately determined that the size of Constantine Cannon's claim, coupled with its personal guaranty and that the outstanding debt was the primary contributor to the debtors'

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[12] See e.g., In re Park West Circle Realty, LLC, 2010 WL 3219531, *2 (Bankr. S.D.N.Y. Aug. 11, 2010), citing In re Dana Corp., 344 B.R. 35, 38 (Bankr. S.D.N.Y. 2006)

[13] Id.

[14] Constantine Cannon also held a personal guarantee against the debtor's principals for a portion of its claim, which "could arguably be a basis not to appoint an entity to an unsecured creditor's committee", but the court found that the conflict issue was adequately addressed in light of the uncertain value of the personal guarantee claim, the existence of other personal guarantees held by secured creditors, and the size of Constantine Cannon's claim relative to other creditors' claims. Id. at *3.

Chapter 11 filing, favored a finding that Constantine Cannon's interests were not adequately represented by the existing committee. Notably, neither the debtors nor any other creditors objected to Constantine Cannon's request, and one existing committee member offered to withdraw from the committee if Constantine Cannon were appointed instead. Further, although the United States trustee had objected to Constantine's Cannon's motion based on concerns about whether, as a member of the committee, Constantine Cannon would be able to separate its more general knowledge about the debtors' business from the privileged information it had acquired based on its prior attorney/client relationship with the debtors, that objection was subsequently resolved.

In In re Shorebank Corp., three creditors—a former director of one of the debtors, a former officer and director, and a personal injury claimant—filed a motion shortly after appointment of the committee seeking an order directing the United States Trustee to reconstitute the committee. [15] As selected by the United States trustee, the committee members included two trust preferred security claimants holding subordinated notes and one former director (who immediately resigned due to his concerns about serving on a committee where the subordinated note-holders would constitute the majority).[16] The moving creditors argued that the structure of the debtors' plan gave the committee an incentive to act in the subordinated note-holders' economic interest, including by pursuing high risk strategies.[17] The committee responded that the movants were less concerned about adequate representation of their interests on the committee but instead wanted to control the committee and pursue their own agenda—i.e., ensuring that

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15 In re Shortbank Corp., 467 B.R. 156, 157-8 (N.D. Ill. 2012).

16 Id.

17 Id. at 158-9.

they could prevent investigation of claims against officers and directors and prevent objections to releases of such claims in the plan.[18]

After determining that the sole issue for decision was whether the existing committee should be changed to ensure adequate representation of creditors, the court denied the movants' motion because the "assertion that these creditors will breach their fiduciary duties as committee members and act contrary to the interests of the creditors they represent is currently no more than vague and unsupported speculation."[19] In addition to identifying the factors mentioned above for assessing "adequate representation" on a committee, the Shorebank court also considered whether members of the committee had conflicts of interest. Noting that "the mere presence of conflicts… is insufficient to show a lack of adequate representation" and that "conflicts are inherent in any committee", the court determined that there must be specific evidence that the conflicted committee members have breached or are likely to breach their fiduciary duties before such conflict of interest necessitates reconstitution of the committee.[20] In this case, the court determined that the movants' "wholly speculative" argument was not enough to warrant reconstitution. The court also noted that there is no Bankruptcy Code requirement that committees be formulated to reflect the specific exact composition of the creditor body.[21]

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18 Id.

19 Id. at 160.

20 Id. at 161 (citations omitted).

21 Id. at 164 ("Would a committee with the membership that the movants suggest be more 'balanced' than the current committee? Probably. Is a more balanced committee necessary to achieve 'adequate representation of creditors' in this case? No—not, at least at this juncture in the case and on the current record.")

III. Disbanding Committees.

The Bankruptcy Code confers no specific authority on any party to disband a committee. At least one court, however, has relied upon Bankruptcy Code § 105(a) to do so[22], while another court has found that Bankruptcy Code § 105(a) confers no such power.[23]

In In re City of Detroit, a chapter 9 municipal bankruptcy case, the debtors filed a motion to vacate appointment of the official committee of unsecured creditors. In its primary holding, the court found that Bankruptcy Code § 1102(a)(1) does not apply in chapter 9 cases and that the appointment was null and void because the U.S. trustee lacked the statutory authority to appoint the committee.[24] The court also concluded that even if Bankruptcy Code § 1102(a)(1) applied, the court was nonetheless authorized to vacate the appointment of the committee pursuant to Bankruptcy Code § 105 because the committee had rejected mediation (in which the court had previously ordered all parties to participate), it was "virtually certain" that any issues the committee would raise would be duplicative, participation by other groups of unsecured creditors in the case had been "extraordinary", and the cost of the committee's professionals would likely be "enormous."[25]

In In re Caesars, on the other hand, the court found that it had no power to disband an official committee of second priority noteholders. Unhappy with the appointment of the noteholders committee in addition to the official committee of unsecured creditors, the debtors moved for an order disbanding the noteholders committee, arguing that (i) an intercreditor agreement to which the committee members were parties would prevent the committee from

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22 In re City of Detroit, Mich., 519 B.R. 673 (E.D. Mich. 2014).

23 In re Caesars Entertainment Operating Co., Inc., 526 B.R. 265 (2015).

24 In re City of Detroit, Mich., 519 B.R. at 678.

25 Id. at 680-681.

performing many of its statutory functions; (ii) the noteholders were sophisticated business entities who did not need official committee representation; and (iii) administrative costs would be dramatically increased with no corresponding benefit on account of the second committee.[26]

In developing its ruling, the court listed the powers available to the bankruptcy court regarding committee appointment:[27]

> The rest of section 1102(a) spells out the powers left to the bankruptcy court. Section 1102(a)(2) says the court "may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation…" 11 U.S.C. § 1102(a)(2). Section 1102(a)(3) says that in a small business case the court "may order that a committee of creditors not be appointed." 11 U.S.C. § 1102(a)(3). And section 1102(a)(4) says the court can order the U.S. Trustee "to change the membership of a committee" if a change is "necessary to ensure adequate representation of creditors or equity security holders." 11 U.S.C. § 1102(a)(4).

After listing its powers regarding committee appointment, the court determined that "[b]ecause section 1102(a) grants specific powers, and because the power to disband a committee is not one of them, the only fair reading of the statute is that there is no such power."[28] It also determined that Bankruptcy Code § 105 only gives bankruptcy courts the power to implement existing Bankruptcy Code provisions and, therefore, it did not have the authority to disband the committee that the U.S. trustee had appointed.[29]

It has been noted that the In re Caesars opinion was issued after the Supreme Court held in Law v. Siegel that "[a] bankruptcy court has statutory authority to 'issue any order, process or

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[26] Id. at 267.

[27] Id. at 268.

[28] Id.

[29] Id. at 269-270. ("Section 105(a) thus is not a vehicle for reading into section 1102(a)(1) a power to do away with statutory committees when section 1102(a)(1) itself grants no such power—and especially when section 1102(a) grants other powers but not that one.")

judgment that is necessary or appropriate to carry out the provisions of' the Bankruptcy Code…. But in exercising those statutory and inherent powers, a bankruptcy court must not contravene specific statutory provisions."[30] However, as the Supreme Court has yet to specifically address the issue of whether the fact that the Bankruptcy Code addresses certain aspects of committee appointments necessarily means that a bankruptcy court is powerless to vacate the United States Trustee's appointment, litigation regarding this question will likely remain.[31]

[30] Kinel, N., Does a Bankruptcy Court Have the Authority to Disband an Official Committee?, New York Law Journal, Vol. 253, No. 105 (June 3, 2015).

[31] Id.

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THE PERMISSIBILITY OF THIRD-PARTY RELEASES

I. Introduction and Overview of Issues.

When seeking to confirm a chapter 11 plan, a debtor or plan proponent often includes provisions in the plan which extend releases and other protections typically only afforded to chapter 11 debtors to certain non-debtor parties. Such "third-party releases" might include releases by a debtor of various third parties or releases by creditors of direct claims or causes of action against third parties. The release provisions might also exculpate parties (typically, professionals and other estate fiduciaries) for conduct that occurred during the bankruptcy case or permanently enjoin releasing parties from pursuing released claims. The range of third parties who might benefit from release, exculpation or injunction provisions in a plan include, among others, directors and officers of the debtor, a plan sponsor, a secured creditor, a debtor-in-possession lender, and professionals or other representatives of the creditor's committee, plan proponent or other case constituents.

Bankruptcy courts will often consider and determine the permissibility and scope of third-party releases in the context of confirming the plan. At issue for courts to consider is the interplay between the apparent prohibition on releasing non-debtor liabilities set forth in 11 U.S.C. § 524(e) and § 1141(d)(1)(A) and the extent of the bankruptcy court's 11 U.S.C.

§ 105(a) equitable powers to determine that non-debtor releases are necessary or appropriate to confirm a plan.

These materials discuss the analysis a bankruptcy court will undertake in evaluating and determining the permissibility of a third-party release in a chapter 11 plan. The discussion concludes with an overview of practical considerations when drafting or negotiating third-party release provisions.

II. Legal Analysis and Relevant Case Law.

A. Majority and Minority Views.

The majority of courts, including the Second, Third, Fourth, Sixth, Seventh and Eleventh Circuit Courts of Appeals, hold that third-party releases or exculpation or injunction provisions benefitting third parties are permissible in certain limited or unique circumstances.[1] Courts adopting the majority view reason that the Bankruptcy Code contains no express prohibition on third-party releases and, therefore, bankruptcy courts can exercise discretion under 11 U.S.C. § 105(a) to authorize third-party releases consistent with other provisions of the Bankruptcy Code.[2] The minority view, however, adopted by the Fifth, Ninth and Tenth Circuit Courts of Appeal, is that 11 U.S.C. § 524(e) explicitly prohibits a release or discharge of a non-debtor (unless in the asbestos context as specifically set forth in 11 U.S.C. § 524(g)) and, thus, the

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1 See, e.g., In re Seaside Eng'g and Surveying, Inc., 780 F.3d 1070 (11th Cir. 2015); In re Airadigm Commc'ns, Inc., 519 F.3d 640 (7th Cir. 2008); In re Metromedia Fiber Network, Inc., 416 F.3d 136 (2d Cir. 2005); In re Dow Corning Corp., 280 F.3d 648 (6th Cir. 2002); In re Cont'l Airlines, Inc., 203 F.3d 203 (3d Cir. 2000); In re Drexel Burnham Lambert Grp, Inc., 960 F.2d 285 (2d Cir. 1992), cert. dismissed, 506 U.S. 1088 (1993); In re A.H. Robins Co., Inc., 880 F.2d 694 (4th Cir. 1989), cert. denied, 493 U.S. 959 (1989).

2 See, e.g., 11 U.S.C. § 1123(b)(6) (providing that subject to the mandatory requirements set forth in § 1123(a), "a plan may . . . include any other appropriate provision not inconsistent with the applicable provisions of this title."); see also In re Quincy Med. Ctr., Inc., 2011 WL 5592907 *1, *1 (Bankr. D. Mass. 2011) ("Courts taking the permissive approach interpret § 524(e) as declaring merely that the discharge itself does not affect the liability of non-debtor parties but that the statute does not preclude the bankruptcy court from limiting the liability of non-debtors in appropriate circumstances.").

bankruptcy court has no discretionary authority under 11 U.S.C. § 105(a) to release liabilities of non-debtors.[3]

B. Legal Standards for Determining Permissibility of Third-Party Releases.

Where courts have permitted releases of non-debtor third parties, they have made specific findings showing that such releases are appropriate and necessary to the success and viability of a plan of reorganization.[4] In determining whether a third-party release is appropriate and necessary, many courts employ (either precisely or some variation of) the multi-factored analysis developed by the Bankruptcy Court for the Western District of Missouri in In re Master Mortg. Inv. Fund, Inc.[5] Under the Master Mortg. analysis, the existence of the following factors supports the approval of third-party releases:

(1) There is an identity of interest between the debtor and third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate;

(2) The non-debtor being released has contributed substantial assets to the reorganization;

(3) The proposed injunction is essential to the reorganization and without it, there is little likelihood of success;

(4) A substantial majority of the creditors agree to the injunction, specifically, the impacted classes have "overwhelmingly" voted to accept the proposed plan treatment; and

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[3] See, e.g., In re Pac. Lumber Co., 584 F.3d 229 (5th Cir. 2009); In re Lowenschuss, 67 F.3d 1394 (9th Cir. 1995), cert. denied, 517 U.S. 1243 (1996); In re Zale Corp., 62 F.3d 746 (5th Cir. 1995); Abel v. West, 932 F.2d 898 (10th Cir. 1991); In re W. Real Estate Fund, Inc., 922 F.2d 592 (10th Cir. 1990), as amended; In re Am. Hardwoods, Inc., 885 F.2d 621 (9th Cir. 1989).

[4] See supra footnote 1; see also Metromedia, 416 F.3d at 143 ("No case has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique."); Dow Corning, 280 F.3d at 658-59 (noting that court must make specific factual findings to support its conclusions in the context of approving non-debtor releases).

[5] See In re Master Mortg. Inv. Fund, Inc., 168 B.R. 930 (Bankr. W.D. Mo. 1994).

(5) The plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.[6]

Courts undertaking the Master Mortg. analysis do not require that all five factors be met before authorizing a third-party release in a plan.[7] Instead, the inquiries underlying the test are intended to assist in deciphering whether the releases at issue are integral to the success of the proposed plan.[8]

C. Issues Regarding Consent to Third-Party Release Provisions.

One issue which is often litigated under the Master Mortg. factors and other similar analyses is whether a third-party release is consensual. In approving a third-party release provision, therefore, courts will frequently require creditors to "consent" to release of their claims either affirmatively or implicitly through the voting and balloting process.[9] As a result, courts have declined to approve the granting of broad releases by creditors who are not afforded the opportunity to vote – either unimpaired creditors who are deemed to accept a plan or impaired creditors who are deemed to reject a plan.[10] Courts have, however, deemed creditors to have consented to third-party releases where

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6 See id. at 934-35.

7 See In re Washington Mutual, Inc., 442 B.R. 314, 346 (Bankr. D. Del. 2011); see also In re Charles St. African Methodist Episcopal Church of Boston, 499 B.R. 66, 100 (Bankr. D. Mass. 2013); Quincy Med., 2011 WL 5592907 at *2.

8 See Washington Mutual, 442 B.R. at 346 ("These factors are neither exclusive nor conjunctive requirements, but simply provide guidance in the Court's determination of fairness.").

9 See, e.g., In re Genco Shipping & Trading Ltd., 513 B.R. 233 (Bankr. S.D.N.Y. 2014); In re Indianapolis Downs, LLC, 486 B.R. 286 (Bankr. D. Del. 2013); see also Quincy Med., 2011 WL 5592907 at *4; In re Adelphia Commc'ns. Corp., 368 B.R. 140, 268 (Bankr. S.D.N.Y. 2007); Washington Mutual, 442 B.R. at 351-52. But see Charles St., 499 B.R. at 102 ("I do not hold that no nonconsensual release, however narrowly tailored and otherwise justified, can ever be approved. Certainly, however, no nonconsensual release can be approved where the plan does not replace what it releases with something of indubitably equivalent value to the affected creditor.").

10 See, e.g., Genco, 513 B.R. at 270-271 ("The Court agrees that simply classifying a party as unimpaired does not mean that they should be somehow automatically deemed to grant a release where the requirements of *Metromedia* have not been met.").

creditors are able to affirmatively opt-out of third-party releases on the voting ballot but where they fail to do so.[11]

Depending on the nature of the underlying claims subject to a release, the permissibility of *nonconsensual* third-party releases, on the other hand, may raise interesting questions regarding a bankruptcy court's constitutional adjudicatory authority. For example, in a recent decision of the United States District Court for the District of Delaware in In re Millennium Lab Holdings II, LLC, the District Court considered whether the bankruptcy court prior to confirmation of the plan of reorganization had assessed the extent of its post-Stern v. Marshall adjudicatory authority to enter a final order discharging certain lenders' non-bankruptcy state law claims against third-parties without the lenders' consent.[12] The District Court ultimately remanded the case back to the bankruptcy court to consider whether it has authority to approve the nonconsensual release of fraud and RICO claims.[13] Pursuant to the District Court's ruling, if the bankruptcy court determines it does not have the requisite authority to adjudicate the claims at issue, it is to submit proposed findings of fact and conclusions of law regarding final disposition of the claims or, in the alternative at the District Court's suggestion, the court may strike the nonconsensual release from the confirmation order.[14] Regardless of how the issues in Millennium Lab ultimately resolve, practitioners should consider and may have to overcome Stern v. Marshall challenges when seeking approval of nonconsensual third-party releases.

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[11] See, e.g., In re Chassix Holdings, Inc., 533 B.R. 64 (Bankr. S.D.N.Y. 2015); see also Genco, 513 B.R. at 271; Indianapolis Downs, 486 B.R. at 304-06; Adelphia, 368 B.R. at 267-68.

[12] See In re Millennium Lab Holdings II, LLC, 2017 WL 1032992 *1, *1-*4, *10 (D. Del. 2017).

[13] See id. at *14.

[14] See id.

III. Practical Considerations.

Notwithstanding the divergent views on the scope and permissibility of third-party releases, such releases are powerful tools available to bankruptcy practitioners when negotiating chapter 11 plans. To increase the likelihood of approval of any non-debtor release, injunction or exculpation provision in a plan, the provisions themselves should be narrowly-tailored and appropriately justifiable as necessary to the success of the plan. If possible, the classes granting non-debtor releases should be appropriately limited (i.e., to those creditors entitled to vote to accept or reject the plan) and the "opt-out election", if offered, should have no impact on whether the voting creditor is entitled to participate in the distribution to its class under the plan. Practitioners should also carefully consider the proposed voting and solicitation procedures and the forms of ballot and notices as they relate to any proposed third-party releases. Given the emphasis of the case law on "consent", where it is feasible, the release, exculpation, and injunction provisions and related voting and opt-out procedures should be summarized and explained succinctly and conspicuously noted in boldface type in both the ballot and notice of the hearing to consider confirmation of the plan.[15]

[15] See, e.g., Fed. R. Bankr. P. 2002(c)(3) (setting forth mandatory requirements for inclusion in a notice of hearing on confirmation when the plan provides for an injunction not otherwise enjoined under the Bankruptcy Code).

THE CLOSELY HELD BUSINESS IN FINANCIAL TROUBLE- UNRAVELING PROBLEMS WITH THE "FAMILY"

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Issue 1: Employment Applications Under 11 U.S.C. § 327

Professionals often represent closely held businesses, privately owned entities and their directors and officers, in different proceedings prior to a bankruptcy filing. Professionals need to be aware of how their prior representation of a closely held business and its insiders may affect their ability to serve as a professional for the debtor in possession if the business files a chapter 11 petition. Professionals must also be aware of the disclosure requirements set forth in Bankruptcy Rule 2014. As discussed more below, the failure to make adequate disclosures of relationships with the debtor and insiders can lead to a denial of fee compensation, as well as raise ethical problems.

Section 327(a) of Title 11, United States Code (the "Bankruptcy Code" or "Code") allows a trustee to employ professional persons, including lawyers, accountants, appraisers, auctioneers, real estate brokers, etc., subject to prior approval by the bankruptcy court. A debtor in possession has the same right to employ a professional because "section 1107(a) of the Code vests a debtor in possession with all of the rights, duties and powers (subject to certain limitations) of a trustee serving in a case under chapter 11, other than the right to receive compensation under section 330 of the Code." 3 Collier on Bankruptcy P. 327.02 (16th Ed. 2017). Counsel seeking employment pursuant to Section 327(a) must meet two criteria: (1) not hold or represent an interest adverse to the estate, and (2) be "disinterested." The term "adverse interest" is not defined in the Bankruptcy Code but has been interpreted to mean "a competing economic interest tending to diminish estate values or to create a potential or actual dispute in which the estate is a rival or claimant or a predisposition of bias against the estate. See In re Tinley Plaza Assocs., L.P., 142 B.R. 272 (Bankr. N.D. Ill. 1992). "Courts are split as to whether a professional's relationship must give rise to an actual conflict or merely a potential conflict of interest. Some courts hold that there is no distinction between a potential and actual conflict of interest. Other courts require a showing of actual conflict." 2 Norton Bankr. L. & Prac. 3d § 30:5, p. 30-17 (2015). Common situations in which conflicts arise are when an attorney represents general or limited partners of a debtor, principals or shareholders, related entities, and creditors of the debtor. Id.[1] The prevailing view is that whether one holds an adverse interest or not will be evaluated on a case by case basis.

11 U.S.C. § 101(14) defines a "disinterested person" as a person that :

(A) Is not a creditor, an equity security holder, or an insider;
(B) Is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and

[1] See, e.g. In re W.F. Development Corp., 905 F.2d 883 (5th Cir. 1990) ("when one attorney represents both limited and general partners in bankruptcy, there will always be a potential for conflict, and disqualification is proper.")

(C) Does not have an interest materially adverse to the interest of the estate or any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connect with, or interest in, the debtor, or for any other reason.

The analysis of whether one holds an adverse interest and whether one is disinterested often overlaps.

There are limited exceptions in Sections 327(c) and 327(e) to the prohibitions set forth in subsection (a). "Subsection (c) provides that 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." 11 U.S.C. § 327(c). This provision prevents disqualification based *solely* on the professional's prior representation of or employment by a creditor -- it "does not preempt the more basic requirements of subsection (a)." Thus, if there is an actual conflict, disqualification is still mandatory. In re AroChem Corp., 176 F.3d 610, 621 (2d Cir. 1999). As the Second Circuit noted it still "remains important to determine whether the person is disqualified on any other ground, e.g,. an adverse interest to the estate."[2] Id. at 621

Being a creditor of the debtor for pre-petition claims for professional fees is a situation that would give rise to an actual conflict. To avoid this, "[i]n many cases, a professional seeking to be employed under § 327(a) is ordered, or voluntarily agrees, to waive any prepetition claim against the debtor." In re 7677 E. Berry Ave, Assocs., L.P. 419 B.R. 833 (Bankr. D. Colo. 2009); see also In re American Home Mortg. Holdings, Inc., 411 B.R. 169, 172 (Bankr. D. Del. 2008) (professional agreed to waive prepetition fee of $ 92,847.67 in order to be employed under section 327(a)); In re Printcrafters, Inc., 208 B.R. 968, 977 (Bankr. D. Colo. 1997), rev'd on other grounds by In re Printcrafters, Inc., 233 B.R. 113 (D. Colo. 1999) ("On the eve of the bankruptcy filing many counsel draw from a retainer sufficient funds to pay all prepetition fees and expenses in order to create disinterested status. Other counsel waive the amount owed for prepetition services in order to accomplish the same objective.").

Obviously, "[a]lawyer retained by an entity owes allegiance to the entity and not its shareholders or partners." 9 Norton Bankr. & Prac. 3d § 172:8, pp. 172-60 to 172-71 (2017). Courts have, however, recognized the challenges inherent with closely-held businesses because counsel will have often represented the business and its officers in the past. As one court stated "it may be more difficult to draw the line between individual and corporate representation. But representing such a corporation does not inherently mean also acting as counsel to the individual director-shareholders." In re Tetzlaff, 31 B.R. 560, 563 (Bankr. E.D. Wis. 1983). This is why

[2] Bankruptcy Code Section 327(e) allows a debtor, with the bankruptcy court's approval, to "employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed."

some courts have stated that "the dual representation of a closely held corporation and its principal has been disfavored by various bankruptcy courts." In re N. John Cunzolo Assocs., 423 B.R. 735, 737 (W.D. Pa. 2010). Courts take differing approaches in construing the disinterestedness requirements of Section 327. Some courts disqualify counsel based on the potential for conflicts of interest, whereas others disqualify counsel only with evidence of an actual adverse interest. See 9 Norton Bankr. L. & Prac. 3d § 172:8, p. 172-62 (2017).

Regardless of the approach a court will take in analyzing actual and potential conflicts, courts strictly adhere to the disclosure requirements of Bankruptcy Rule 2014(a). "Rule 2014(a) requires a professional seeking an order for employment in a bankruptcy case to submit a verified statement setting forth the professional's connections to the debtor, creditors, or any other party in interest, including their counsel and accountants." In re Tribeca Mkt., LLC, 516 B.R. 254, 278 (S.D.N.Y. 2014). Case law is clear that the burden of disclosure is upon the person making the application for disclosure and must disclose all relevant facts that bear on disinterestedness. Counsel cannot "usurp the court's function by choosing, *ipse dixit*, which connections impact disinterestedness and which do not." Id. at 278. "So important is the duty of disclosure that the failure to disclose relevant connections is an independent basis for the disallowance of fees or even disqualification." In re Leslie Fay Cos., 175 B.R. 525, 533 (Bankr. S.D.N.Y. 1994).

In representing closely-held businesses, it is also important to remember the issues that arise from the payment of a retainer. Often times, it may be a director or insider who pays the retainer to a professional on behalf of the business. This may render the professional not disinterested for purposes of Section 327. "Courts have taken two approaches when deciding if payment of a bankruptcy retainer by a third-party is a disqualifying interest. Some courts have found that payment of a retainer by a third party is a per se disqualification, while other courts have held that the totality of the circumstances surrounding the retainer payment must be scrutinized before deciding if a disqualifying conflict exists." In re Am. Int'l Refinery, Inc., 676 F.3d 455 (5th Cir. 2012). Several courts apply the test set forth in In re Kelton Motors Inc., 109 B.R. 641, 658 (Bankr. D. Vt. 1989), which requires that:

> (1) the arrangement must be fully disclosed to the debtor/client and the third party payor/insider;
>
> (2) the debtor must expressly consent to the arrangement;
>
> (3) the third party payor/insider must retain independent legal counsel and must understand that the attorney's duty of undivided loyalty is owed exclusively to the debtor/client;
>
> (4) the factual and legal relationship among the third party payor/insider, the debtor, the respective attorneys, and their contractual arrangement concerning the

fees, must be fully disclosed to the Court at the outset of the debtor's bankruptcy representation;

(5) the debtor's attorney/applicant must demonstrate and represent, to the court's satisfaction, the absence of facts which otherwise create non disinterestedness, actual conflict, or impermissible potential for a conflict of interest.

However, "some courts flatly [hold] that any fee payment by a third party is an actual conflict of interest disqualifying a professional from employment 'absent a showing that the interests of the third party and the bankruptcy estate are identical' upon notice to all parties." 9 Norton Bankr. L. & Prac. 3d § 172:10, p. 172-71 (2017), citing In re Hathaway Ranch P'ship, 116 B.R. 208 (Bankr. C.D. Cal. 1990).

The Bankruptcy Code gives the court the power to impose sanctions on counsel or other professionals who fail to remain disinterested throughout their representation. "The most common consequences of nondisinterestedness is termination of the representation, with fee denial or disgorgement of interim payments, although sanctions may be as serious as jail or suspension from practice for blatant nondisclosure violations." 9 Norton Bankr. L. & Prac. 3d § 172:15, p. 172-111 (2017).[3] Under Section 328(c), "[a] court may deny compensation for services provided by an attorney who holds such an adverse interest." Both the First and Second Circuit do not follow the per se or bright line rule requiring the denial of all compensation because of a conflict of interest, recognizing that bankruptcy judges should have the discretion to make such determinations on a case by case basis. See In re El San Juan Hotel Corp., 239 B.R. 635, 648 (B.A.P. 1st Cir. 1999), aff'd, 230 F.3d 1347 (1st Cir. 2000); In re N.Y., New Haven & Hartford R.R. Co., 567 F.2d 166, 175 (2d Cir. 1977). "Complete denial of fees may be within the permissible range of discretion in response to a serious undisclosed conflict . . . but it is not required." In re Tribeca Mkt., LLC, 516 B.R. 254, 280 (S.D.N.Y. 2014) (affirming bankruptcy court's only 40 percent reduction of fees); see also In re Kendavis Indus. Int'l, Inc., 91 B.R. 742, 762 (N.D. Tex. 1988) (reducing fee award by 50 percent due to conflict of interest). In making this determination, courts may consider whether, despite the counsel's failure to remain disinterested, counsel nevertheless provided a benefit to the bankruptcy estate. See Rome v. Braunstein, 19 F.3d 54, 61 (1st Cir. 1994) (citing Code Section 330(a)(1) that "compensation may be based on assessment of 'the value of such services'"). However, as some of the cases below demonstrate, an intentional or egregious failure to make disclosure will often warrant imposition of the harshest sanctions.

The following case law offers examples of scenarios in which courts have applied Section 327 in cases involving closely held businesses.

[3] Citing to U.S. v. Gellene, 182 F.3d 578 (7th Cir. 1999). See also In re Creative Desperation, Inc., 415 B.R. 882 (Bankr. S.D. Fla. 2009) (ordering disgorgemnt of fees and suspending counsel from practice).

CASE LAW

Rome v. Braunstein, 19 F.3d 54 (1st Cir. 1994)

Facts: The attorney, Rome, was the corporate clerk and outside counsel for the debtor CHM. He prepared CHM's chapter 11 petition and filed an application for appointment of counsel pursuant to 11 U.S.C. § 1107(a) and § 327(a). Rome subsequently filed three chapter 11 reorganization plans that would have unfairly advantaged certain CHM insiders, including its president and sole shareholder, Arnold Leavitt. All three plans failed to win creditor approval and eventually a trustee was appointed (Braunstein). Prior to the appointment of the trustee, Rome served as counsel to Leavitt in an involuntary chapter 7 proceeding prior to the appointment of a trustee. He later represented Sandra Dickerman, Leavitt's secretary at CHM, in her ultimately successful bid to purchase property belonging to the CHM bankruptcy estate. Rome filed a fee application and the trustee objected. The trustee represented to the bankruptcy court that Leavitt made several transfers to family members of CHM assets prior to the filing of the CHM chapter 11 petition and that Rome obstructed creditor efforts to investigate CHM's financial condition to the benefit of Leavitt's interests.

Analysis: The Court affirmed the denial of Rome's fee application in its entirety. It based its decision largely on counsel's failure to make timely disclosures. The Court cautioned that "[a]bsent 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*." (Emphasis in original.) Id. at 59. Rome raised three issues on appeal from the bankruptcy court decision. First, he argued that he did not represent Leavitt from December 1989 until May 1990, and therefore should have received compensation for that period. Second, he argued that it was not him, but rather the chapter 7 trustee that represented Leavitt in his personal bankruptcy case. Third, he argued that none of the transfers from CHM to Leavitt and others prior to CHM's chapter 11 petition had yet been proven fraudulent.

The Court rejected these arguments. First, it noted that the fact that Rome did not represent Leavitt until May 1990 was immaterial because "section 328(c) expressly empowers the bankruptcy court to disallow compensation if court appointed counsel, 'at any time,' is either not a 'disinterested' person" or represents an adverse interest." Id. at 60.

In regard to the second argument, the court noted that regardless of who represented Leavitt in his chapter 7 case, "Rome's post-May 1990 representation of chapter 7 debtor Leavitt, against whom the CHM chapter 11 estate also represented by Rome held claims for the avoidance of alleged preferential and fraudulent transfers, created a clear conflict of interest *without regard to whether the Leavitt chapter 7 estate itself was represented by a trustee in*

bankruptcy." (Emphasis in original). Id. In regard to the third argument, the Court noted that it was bound by the bankruptcy court's fact finding unless clearly erroneous, and regardless, Rome's conduct created the "appearance of impropriety." The court noted that the bankruptcy court found that in regard to Leavitt's allegedly fraudulent transfers, "Rome had shown considerable intransigence to efforts . . . to obtain access to certain CHM records.' The Court also concluded that Rome's representation of Dickerman to purchase estate assets created a conflict of interest. It noted that, regardless of the fact that Dickerman was the highest bidder for the assets, or even the only bidder, "Rome's longtime position as corporate clerk and counsel to CHM presumably afforded him unique access to inside information" regarding the value of corporate assets that could have been used to potentially chill the bidding process. Id. at 61. The Court rejected the proposition that a disqualifying conflict can only be found if there is proof of actual loss or injury.

In re Lee, 94 B.R. 172 (Bankr. C.D. Cal. 1988)

Facts: An attorney sought to represent both a corporation, Seoul, and its two sole shareholders, Chile Lee and Hae Sook Lee. The corporate debtor filed a chapter 11 petition and the Lees filed in a separate chapter 11 case. The attorney received a retainer from the Lees which he did not disclose in his employment application in the Seoul Corporation case. In this case, the court concluded that simultaneous representation of the corporation and its principals was impermissible. It also highlights an important issue that a shareholder/director involved in a separate bankruptcy proceeding cannot avoid a conflict by agreeing to waive a claim against a corporate debtor. The attorney in this case argued that there was no conflict of interest because Chile Lee agreed to waive his claim against the corporation.

Analysis: The bankruptcy court noted that the individual debtor "does not have the power to unilaterally waive a claim of his estate against the corporation." The court noted that as Chile Lee, as a debtor in possession, had a fiduciary obligation to assert any claim against Seoul Corporation for the benefit of his creditors. The court also faulted counsel for his failure to adhere to the disclosure requirements of Bankruptcy Rule 2014. The court in this case also adopted the approach that for two or more related cases, there is a presumption that it is improper to appoint the same counsel for the trustees or debtors in possession where creditors of the debtors have dealt with debtors as an economic unit, there is a substantial overlap of creditors, and the affairs of the respective debtors are substantially entangled, such as an individual debtor being a guarantor for the corporate debtor. The court, however, did not impose the most extreme remedy of denying all compensation and instead allowed counsel the opportunity to choose which debtors to represent.

In re Balco Equities, 345 B.R. 87 (Bankr. S.D.N.Y. 2006)

Facts: The Balco Equities case shows the serious consequences of failing to make an adequate disclosure pursuant to Rule 2014. The firm Cohen Estis was denied compensation in its entirety

of attorney's fees in the amount of $113,000 and was required to disgorge the balance of a retainer fee of almost $43,000 for failure to disclose that it represented the principal and largest unsecured creditor of the debtors, as well as another major creditor, an estate, of which the principal and largest unsecured creditor was the former executor. The debtors in this case were three entities, Balco Equities, Ltd. ("Balco"), Haddon Holdings, Ltd., and Sarah Enterprises, Intl. ("Sarah"). Balco was the sole shareholder of Haddon, who was the sole shareholder of Sarah. Cohen Estis previously represented the debtor's principal, Donald Boehm in numerous state court matters, including defending Boehm in a foreclosure action on his personal residence, which served as collateral for the debtor's largest secured creditor. Cohen Estis also represented the estate of Frederic Warmers, of which Boehm had previously served as an executor. The estate was listed as a secured creditor of the Balco bankruptcy estate, holding two secured claims of more than $1 million each. Cohen Estis provided services to the estate of Frederic Warmers up to less than one month prior to Balco's chapter 11 bankruptcy petition. Cohen Estis also defended Boehm and two non-debtor entities that he owned in a state court proceeding in which the state court held Boehm in contempt for fraudulently transferring funds to Haddon. In the bankruptcy proceedings, Boehm filed an unsecured claim against Balco, Haddon, and Sarah, and the Frederic Warmers trust filed secured claims against Balco. Additionally, a trust owned by the president of Balco, Nancy Cook, filed an unsecured claim against Balco.

Analysis: Cohen Estis's initial Rule 2014 disclosures significantly downplayed or omitted the firm's previous representation of the debtors and the related insiders. There were several subsequent disclosures and there was eventually an adversary proceeding regarding Cohen Estis retainer in the amount of $68,500. There were conflicting accounts of who was the transferor of the retainer fee. Ultimately, the Court denied compensation to Cohen Estis in its entirety. It concluded that the failure to disclose the extensive prior representation of the parties to the bankruptcy proceedings could not have been the result of mere mistake. The Court noted that "at a minimum, failure to disclose is an exacerbating factor warranting the reduction or denial of fees for lack of disinterestedness. Regardless of the precise application, willful or intentional failure to disclose merits the harshest sanctions." Id. at 112.

In re Straughn, 428 B.R. 618 (Bankr. W.D. Pa. 2010)

Facts: This case involved two debtors, an individual, Tammy Straughn, and the corporate debtor, J.T. Trucking, Inc. ("J.T."). Straughn was the majority shareholder and president of J.T. The debtors filed separate chapter 11 petitions and sought to employ the same attorney, Calaiaro, as counsel. The bankruptcy court noted that there were a number of ties between the debtors. For example, Straughn owned 80% of J.T. and was also a creditor with a claim of $7,700. She also was a co-debtor or guarantor on a number of J.T.'s obligations. Straughn agreed to pay a proposed counsel a $6,500 retainer. She paid $3,000 and the balance needed to be approved by the bankruptcy court. She claimed that the only other minority shareholder of J.T. agreed to waive any conflicts but did not offer anything in the record to support such claim.

The Court, however, concluded that a waiver did not cure any actual or potential conflicts. The court stated that "consent by a Chapter 11 debtor to waive conflicts is insufficient to cure any potential conflicts because the ultimate parties in interest are the bankruptcy estate's debtors." Id. at 627. The Court noted that Straughn's waiver of her claim against J.T would be to the detriment of her personal creditors. The Court concluded by noting the problems with representing closely-held entities and their principals. It stated "[a]s a practical matter, given the nature of the relationship between a sole shareholder and the related corporation, it is difficult to imagine a situation where both parties in Chapter 11 cases could be represented by a single attorney. In most cases of this type, similar to the present situation, conflicts abound over issues such as the amount of the shareholder's salary, the appropriate amount of rental payments between the parties, joint liabilities or liabilities for which the shareholder serves as co-obligor or guarantor, a debtor-creditor relationship between the parties, or situations in which transfers between the parties have occurred prior to the filing date. These types of relationships require debtor's counsel to analyze and ponder the effect of these actual or potential conflict situations in the bankruptcy context before the case is even filed. Where circumstances are presented that interfere with counsel's exercise of independent judgment on behalf of client and creditors, the wise choice is not to assume a dual representation relationship." Id. at 628. The Court offered a final warning that "going forward, the Court will be more vigilant concerning the review of dual representation issues." Id. at 628 n.9.

In re Angelika Films 57th, 227 B.R. 29 (Bankr. S.D.N.Y. 1998)

Facts: The bankruptcy court denied an application for compensation pursuant to Section 330 in its entirety when counsel for the debtor in possession filed a motion to assume and assign a lease to the debtor's principal at a price substantially below what counsel had previously represented was the market value of the lease. The firm Tenzer Greenblatt (Tenzer) sought to represent the debtor, Angelika Films 57th, a movie theater, in its chapter 11 case. In the retention application, Tenzer disclosed that it was already representing the debtor in a state court replevin action and was representing the debtor's principal, Joseph Saleh, in several personal matters stemming from a matrimonial dispute. Eventually, the case reached a point where the parties agreed to a proposed order that if the debtor did not find a party to assume and assign its lease, a chapter 11 trustee would be appointed. The debtor made efforts to market the lease but could not find a party willing to assume it. Tenzer filed a motion to extend the deadline to appoint a trustee. Shortly thereafter, Tenzer filed a motion to assign the lease to Saleh for the price of $100,000. The court noted that four days earlier, Tenzer had represented that the value of the lease was $500,000.

Analysis: The court noted that there were four actual conflicts of interest. These included "1) [an] arrangement whereby the retainer was funded by Ms. Saleh, 2) the guaranty by Mr. Saleh to pay [Tenzer's] attorneys' fees, 3) the management contract with . . . a company controlled by Joseph Saleh, and 4) the filing of the Motion to Assign." The court concluded

that Tenzer's representations of the debtor and Saleh constituted an actual conflict from the inception of the case.

> The court "recognize[d] that in chapter 11 cases involving closely-held corporations, such as this case, proposed bankruptcy counsel often has a pre-existing relationship with the principal of the debtor. That relationship may make it difficult for an attorney to determine at each turn when the interests of the debtor and those of the principal are aligned, or are in conflict. However, in this case, we are not in a "gray area" regarding issues of conflicts of interest that may confront counsel in the course of its representation of a closely-held corporation. Rather, the instant case involves circumstances in which the interests of the Debtor and of the principal clearly diverged yet counsel chose to promote the interests of the principal to the detriment of the Debtor -- a choice that Tenzer apparently made at the commencement of its representation of the Debtor.

Id. at 41.

In considering the fee application, the Court stated that it "does not follow the per se rule that requires all fees be automatically denied for services performed in the period after the actual conflict. Id. at 43. It stated that courts will consider whether the representation provided an actual benefit to the estate and noted that they have "broad discretion to decide whether to deny all or part of the fee request." The Court noted that "the Bankruptcy Code provision declaring that the bankruptcy court may deny compensation when a professional employed by the bankruptcy estate ceases to be disinterested does not require denial of legal fees or disgorgement of previously paid fees in all cases. Id. at 42. Courts retain discretion to weigh the equities in deciding to deny fees when counsel fails to remain disinterested. In the case, the Court nevertheless concluded that any benefit Tenzer provided to the estate was undermined by filing the motion to assign the lease to the debtor's insider. The Court also concluded, pursuant to its discretion under Section 328(c), that denial of all fees would serve as a deterrent.

In re 7677 East Berry Ave. Associates, L,P., 419 B.R. 833 (Bankr. D. Colo. 2009)

Facts: In this case, there were three debtors, 7677, EDC Denver, and Everest Holdings. 7677 was a limited partnership that developed and operated a luxury residential, retail, and entertainment development. The general partner of 7677 was EDC Denver, and the sole member of EDC Denver was Everest Holdings. An individual, Davidson, was the manager of both EDC Denver and Everest Holdings. All of these entities were co-debtors to NexBank, a creditor that objected to the application for employment filed by BFHS as counsel for all three debtors.

Davidson was also the executive officer of a related entity not in bankruptcy, Everest Marin. BHFS disclosed that it had represented Everest Marin and would continue to do so post-petition, except in respect of Everest Marin's claims or other relationships with the debtors. 7677's

primary assets were planned communities known as the Landmark and Meridian Tower Residences and Everest Marin's primary asset was a development known as the European Village. The two developments had entered into various agreements with each other and BHFS had been primary counsel for both developments.

Nexbank took issue with a pre-petition transaction in which BHFS sold its account receivable of legal fees (about $663,000) due from 7677 to Everest Marin. Everest Marin in exchange executed a promissory note for the amount of the receivable payable to BHFS. BHFS disclosed that the promissory note was secured by a security agreement, financing statement, and assignment of rents and leases on the European Village. BHFS represented that it would not represent Everest Marin with respect to collection of the receivable now owed to Everest Marin by the debtor 7677. The Creditor's Committee did not object to this arrangement and described it as "ingenious." The effect of the transaction was that BHFS no longer was a creditor in this case.

Analysis: The Court approved the employment application for all three debtors. It noted that there were no transfers or claims between the debtors and BHFS stated that it would not participate in any matters adverse to the debtors. In regard to prior representation of entities affiliated with the debtor, BHFS properly disclosed its prior relationship. It prepared an "acknowledgement of duty of loyalty letter" in which BHFS advised that its duty was solely to 7677 and that related entities must retain independent counsel if they sought legal representation for any issue involving 7677. In regard to the prior representation of Davidson, the court concluded that such representation was relatively minor and because BHFS agreed not to represent him post-petition, the Court concluded that it did not hold an adverse interest and was disinterested.

In regard to the pre-petition sale of accounts receivable, the Court expressed concern that it was "suspicious at first glance." Nevertheless, it concluded that the transaction put BHFS in a "situation where it is not dependent upon the success of the Debtors for payment" of the pre-petition obligation because the shift of risk of nonpayment shifted to Everest Marin. Id. at 854. The evidence further established that Everest Marin had sufficient equity to pay the BHFS obligation, thus the court concluded that payment of the obligation was not dependent on any payment by the Debtors in the bankruptcy case. It seems that the detailed disclosures by BHFS in its application made a difference in the Court's analysis regarding the firm's ability to remain disinterested.

Issue 2: Insider Compensation, Fraudulent Transfers and Trustee Issues

In closely-held businesses, many of the employees, officers or directors may be family members. When the business subsequently files for bankruptcy, this can raise concern that compensation paid to some family members may be voidable as a fraudulent transfer to an

insider. Moreover, employment terms, compensation and benefits provided to family members and insiders will be subject to scrutiny by creditors and the bankruptcy court.

Section 548 provides that a "trustee may also avoid any transfer to or for the benefit of an insider under an employment contract that was not in the ordinary course of business." 4 Norton Bankr. L. & Prac. 3d § 67:8, p. 67-23 (2017) quoting 11 U.S.C. § 548(a)(1)(B)(ii)(IV). Furthermore, unlike other transfers under Code Section 548, a trustee does not have to establish that the debtor was insolvent at the time the contract was executed. One leading treatise states that this "evidences a trend, also mirrored in other changes made by the 2005 Amendments, to more closely scrutinize a debtor's relationship with insiders and employees." 4 Norton Bankr. L. & Prac. 3d § 67:8, at p. 67-23 (2017). To state a prima facie case, the trustee needs to prove that the employment agreement "(1) was not in the ordinary course of business; and (2) was one in which the debtor/employer did not receive reasonably equivalent value." Id. at p. 67-23. Pursuant to Section 550(a), a trustee "to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made." Kapila v. Clark, 431 B.R. 263, 289 (Bankr. S.D. Fla. 2010) ("management fees" paid to insider voided as fraudulent transfer). In addition, there may be liability under state versions of the Uniform Fraudulent Transfer Act for payments made to insiders. See, e.g. Cadle Co. v. Ogalin, 495 F. Supp. 2d 278 (D. Conn. 2007); In re Felt Mfg. Co., 371 B.R. 589 (Bankr. D. N.H. 2007).

In chapter 11 cases, the management of closely held businesses need to be aware of the possibility that a trustee can be appointed. 11 U.S.C. § 1104(a) sets forth three alternative grounds in which a chapter 11 trustee may be appointed. "Subsection (a)(1) provides that the court shall appoint a trustee for 'cause,' including fraud or gross mismanagement by current management. Subsection (a) (1) requires the court to appoint a trustee if such appointment is in the best interests of the creditors, equity security holders or other interested holders. . . Subsection (a)(3) . . . provides that the court shall appoint a trustee if grounds exist to convert or dismiss the debtor's Chapter 11 case under Code Section 1112 , but the court determines that the appointment of a trustee or examine is in the best interests of creditors and the estate." 5 Norton Bankr. L. & Prac. 3d § 99:3, pp. 99-10 to 99-11 (2008). "It is the moving party's burden to establish that there is cause to appoint a trustee, and absent a showing of need for the appointment of a trustee, there is a strong presumption that the debtor should be permitted to stay in possession." In re Costa Bonita Beach Resort, 479 B.R. 14, 44 (D.P.R. 2012). Courts are split as to the burden of proof required for the appointment of a trustee. See In re Bayou Group, LLC, 564 F.3d 541, 546 (2d Cir. 2009) (applying clear and convincing standard); In re Lopez-Munoz, 553 B.R. 179, 189-90 (B.A.P. 1st Cir. 2016) (noting that the First Circuit has not determined the appropriate standard and citing cases within the district and bankruptcy courts of the First Circuit applying a preponderance of the evidence standard).

However, "where there are questionable inter-company financial transfers and the principals of the debtor company occupy conflicting positions in the transferee companies, a trustee should be appointed in the best interests of creditors and all parties in interest to investigate the financial affairs of the debtor." In re McCorhill Pub., Inc., 73 B.R. 1013, 1017 (Bankr. S.D.N.Y. 1987) (appointing trustee in which debtor made undocumented loans to principals that were never repaid); see also In re Oklahoma Refining Co., 838 F.2d 1133, 1136 (10th Cir. 1988) ("There are many cases holding that a history of transactions with companies affiliated with the debtor company is sufficient cause for the appointment of a trustee where the best interests of the creditors require.").

CASE LAW

Fraudulent Transfers

In re TC Liquidations LLC, 463 B.R. 257 (Bankr. E.D.N.Y. 2011)

Facts: The debtor, Tiffen Manufacturing Corp., was an S corporation that sold photographic supplies. The original owners were Nathan and Helen Tiffen, the parents of the defendants Steven Tiffen, Ira Tiffen, Barbara Mendelson, and Sandra Cohen. In 1984, the parents gifted 48 percent of their stock in TMC to their children. They later sold their remaining interest to their children. As a result of the sale Steven became president of TMC, Ira was an employee and an officer in the company, and the husband of Sandra, Jeffrey Cohen, was employed as a VP of sales. In 1998 TMC expanded and acquired two companies. To finance this sale, the defendants borrowed $7 million dollars personally (Saunders Loan). The loan was structured through the defendants for tax purposes to preserve the S corporation status of TMC. As the borrowers, the defendants were liable for the Saunders Loan, not TMC. However, they received distributions from TMC each month to make the loan payments. They also received distributions to cover the tax liabilities from the business because as shareholders in an S corporation they were personally liable for the payments. As a result of the transactions, TMC expanded, eventually obtaining a licensing agreement with Kodak. The defendants' roles expanded and they received bigger salaries from TMC. Eventually, however, the business declined and the company filed a chapter 11 bankruptcy petition. It was later converted to a chapter 7 and a trustee, the plaintiff in this case, was appointed. The trustee sought to recover the loan dividends, the tax dividends, and the increased salary payments as fraudulent transfers under Section 548(a)(1)(B) and N.Y. state law.

Analysis: The court concluded that the loan dividends were not fraudulent transfers. It noted that to prevail on a claim of constructive fraudulent transfer, the plaintiff must prove by a preponderance of the evidence that " (1) the debtor did not receive fair consideration for the transfer, and (2) the debtor was either insolvent at the time of the transfer or was rendered insolvent because of the transfer." Id. at 267. The court determined that the debtor received fair consideration for the loan dividends because it benefited from the proceeds of the loans and

required the defendants to should the personal liability. The debtor received the benefit of being able to use the proceeds to expand its business and build its customer base.

In regard to the salary increases, the court likewise concluded that they were not fraudulent transfers. It stated that "[c]ase law has established that payments of salary are presumed to be made for fair consideration, and in order for a trustee to avoid them [the trustee] must establish that the salary payments were excessive in light of the Defendants'' employment responsibilities." Id. at 269. The court concluded that the trustee failed to meet this burden. The salaries did increase but the increases were concurrent with an rapid expansion of the debtor's business and an increase in the defendants' responsibilities.

In regard to the tax dividends, the court concluded that those payments were constructive fraudulent transfers. The defendants plainly used them to satisfy their own personal tax obligations and the debtor did not receive any benefit. The court concluded that these transfers were also actual fraudulent transfers under 11 U.S.C. § 548(a)(1)(A). The court stated the trustee demonstrated all six "badges of fraud" set forth in In re Kaiser, 722 F.2d 1574, 1582 (2d Cir. 1983). These require the court to consider (1) the lack or inadequacy of consideration; (2) the family, friendship or close associate relationship between the parties; (3) the retention of possession, benefit or use of the property in question; (4) the financial condition of the party sought to be charged both before and after the transaction in question; (5) the existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors; and (6) the general chronology of the events and transactions under inquiry. Id. at 276.

Cadle Co. v. Ogalin, 495 F. Supp. 2d 278 (D. Conn. 2007).

Facts: This case demonstrates the interplay between the Bankruptcy Code and state fraudulent transfer statutes. The plaintiff, the successor in interest of the bankruptcy trustee, alleged that defendants Cristina Ogalin, Verna Ogalin, and Drywall Construction Corporation ("DCC") engaged in or were the recipients of fraudulent transfers in violation of the Connecticut Uniform Fraudulent Transfer Act ("CUFTA") and the Bankruptcy Code. The plaintiff's claims arose out of the chapter 7 proceedings of the Ogalins relative, Frank Ogalin. The case proceeded to a jury trial in which the jury concluded that salaries paid to the defendants were fraudulent transfers in violation of CUFTA. The defendants filed a renewed motion for judgment as a matter of law and motion for new trial.

At trial, evidence was presented that Frank Ogalin and his brother Jeffrey operated an ultimately unsuccessful drywall construction business knowns as Walls & Ceilings, Inc. They terminated W&C and formed DCC, which was formally incorporated by their mother Margaret. The original shareholders were Verna and Marie Ogalin, who each held 50% interests. Jeffrey Ogalin was the president and Frank Ogalin was VP. Verna Ogalin (Frank's wife) eventually acquired 100% of the shares, which she transferred to her then fifteen year old daughter

Christina, with 25% to her individually and 75% to be held in trust for her siblings. Christina and Verna Ogalin then began working for DCC. Eventually Christina earned a salary up to $149,770 annually. The transfers of stock and the allegedly excessive salaries were the focus of the fraudulent transfer claims. Ultimately, the jury returned a verdict in favor of the plaintiff in the amount of $774,649.00.

Analysis: The defendants argued that Frank Ogalin, the debtor in the chapter 7 case, never actually owned the shares of stock or had control over the allegedly excessive salaries. The court, however, concluded that there was evidence in the record for the jury to determine that Frank Ogalin had an equitable interest in DCC and that the initial transfer to his wife and the payments of excess salary were all fraudulent conveyances under Connecticut law.

In regard to the salary payments, the Court concluded that there was evidence in the record for the jury to conclude that they were unjustifiably excessive and made to avoid payment to creditors. The plaintiff presented expert testimony regarding the national salary averages based on the defendants' age and occupation, and heard testimony from the defendants themselves about the services they performed for DCC.

In re Aqua Clear Techs., Inc., 361 B.R. 567 (S.D. Fla. 2007)

Facts: The debtor, Aqua Clear Technotlogies, Inc., was a small business that provided home water softening systems. It was owned by Harvey and Barabra Jacobson. Barbara Jacobson was the president, although she stated that she had nothing to do with the operation of the business. Harvey Jacobson stated that he was an independent contractor, but the court found that he was responsible for running the day-to-day operations of the business. The debtor made a number of payments on behalf of the Jacobsons, including paying for one of the Jacobsons' cars. The court also noted that "no compensation agreement or formula set a salary for Harvey or Barbara Jacobson. Rather, Harvey Jacobson testified that he and his wife took cash out of the business and received compensation whenever he decided that the Debtor had sufficient funsds available for them to do so." Id. at 572. The debtor filed a chapter 7 petition and the trustee sought to recover several payments made to the Jacobsons.

Analysis: The court had little trouble concluding that several of the transactions were fraudulent transfers pursuant to Section 548. The court concluded that the Jacobsons were obviously insiders of the debtor and none of the transfers provided reasonably equivalent value to the debtor. The Jacobsons failed to establish that the funds they contributed to the Debtor were loans or salary. The court also concluded that the transfers were voidable pursuant to Florida law regarding fraudulent transfers.

In re M. Davis Mgmt. Inc., No. 6:09-bk-02071-KSJ, 2011 Bankr. LEXIS 3068 (Bankr. M.D. Fla. July 19, 2011)

Facts: In this case, the reorganized debtor, M. Davis Management, sought to avoid pre-petition transfers of more than $1 million paid to its former VP, director and CEO Dennis Zink and his wife, Michele Zink, the 51% shareholder of the company and company president. The transfers at issue were numerous payments made pursuant to purported monthly service contracts. Prior th the company's chapter 11 bankruptcy petition, there was a dispute between the Zinks and the 49% shareholder of the company, Faith Fairbrother. She left the company but retained her shares. After her departure, the Zinks began paying Deniss Zink as a contract employee and stopped making equity distributions to shareholders (Michele Zink and Fairbrother). Previously, equity distributions had been made on an average of $595,000 per year. Pursuant to the contracts, Dennis Zink began receiving payments between $19,250 to $19,900 per month. (Payments above $20,000 would have required the approval of all three directors pursuant to the company's equity participation agreement.) Before Fairbrother left, Dennis Zink received a salary on average of $65,000 per year. In 2008, he received total payments of $663,008.

Analysis: The Court concluded that the transfers were actual fraudulent transfers under Section 548(a)(1)(A) and Florida law. The payments were made for the purpose of avoiding compensation to Fairbrother, a creditor in the bankruptcy case. The fact that the transfers were made at a time when the company's revenues were dramatically declining to a company insider who completely controlled the company evidenced a fraudulent intent. The court also concluded that the transfers to Dennis Zink were constructive fraudulent transfers under Section 548(a)(1)(B) because they were made to or for the benefit of an insider under an employment contract outside of the ordinary course of business. It noted that this new provision was not available to void the transaction pursuant to state law. It stated that this allows a plaintiff to "avoid a transfer as constructive fraudulent irrespective of any insolvency analysis or actual fraudulent intent." Id. at *22. The court concluded that the substantially increased salary paid to Zink did not provide additional benefit to the debtor.

> Applying this test to these undisputed facts, the company transferred $1,030,241 to Dennis Zink in the 22-month prepetition period. Dennis Zink's own testimony establishes that the transfers were made for less than reasonably equivalent value. He previously has testified that the *sole* basis for the amounts he received under the service contracts was the Zinks' annualized historical earnings and equity distributions, *not* the value of the services he provided to the company. Before Fairbrother left the company, Dennis Zink received, at most, an annual salary of $65,000 that may have been paid directly to Michele Zink. After Fairbrother left the company, he received an average salary of $46,000 per month. Granted, Dennis Zink likely performed additional services with Fairbrother's departure; however, *no* evidence supports a conclusion that the additional services were worth the amount of the challenged transfers.

Id. at *20.

Appointment of a Trustee or Examiner

In re Soundview Elite, Ltd., 503 B.R. 571 (Bankr. S.D.N.Y. 2014)

Facts: This case involved six jointly administered chapter 11 cases of six debtors, Soundview Elite, Ltd., Soundview Premium Ltd., Soundview Star, Ltd. (referred to as the Limited Debtors), Elite Designated, Premium Designated and Star Designated (referred to as the SPV Debtors). All of the debtors were within the Fletcher Family of Funds, managed by Fletcher Asset Management under the leadership of Alphonse Fletcher. The court considered several motions in the case, including a motion filed by the U.S. Trustee for appointment of a chapter 11 trustee pursuant to 11 U.S.C. § 1104(a)(1) and (2).

Analysis: The court concluded that appointment of a trustee was appropriate under both subsections. The court noted that, although it did not yet find that management had acted fraudulently or incompetently, the U.S. Trustee identified "numerous matters of concern that raise issues in that regard" that required a trustee to investigate. Id. at 582. These included a $2 million dollar transfer of assets, "the payment of management fees to Fletcher Asset Management based on seemingly inflated values for assets under management; the failure to produce audited financials for five years; the failure to produce net asset value statements for three years; continued payments of management fees to Fletcher Asset Management at the same time redemption requests were not being honored; and the use of funds of one or more of the Limited Debtors for a lawsuit brought by Mr. Fletcher against [a property management company] that at this juncture appears to have been principally, if not entirely, advancing Mr. Fletcher's private concerns" Id. at 581-82. The court also expressed concern with apparent self-dealing. It noted that the management fees paid by the debtors to Fletcher Asset Management were based on "Mr. Fletcher's own asset valuations and accounting techniques that he approved, exemplify[ing] self-dealing and conflicts that are matters of concern in a bankruptcy case." The court concluded that a trustee was necessary because "we cannot expect the Debtors' management, so long as the debtors remain in possession, to investigate themselves." Id.

Tradex Corp. v. Morse, 339 B.R. 823 (D. Mass. 2006)

Facts: The president and sole shareholder, Frank Gitto, appealed the bankruptcy court's appointment of a chapter 11 trustee to take possession of the debtor in possession, Tradex Corporation. The bankruptcy court appointed a trustee after considering evidence and

testimony submitted by the U.S. Trustee and the testimony of the debtor through its principal. There was evidence that the debtor made inaccurate and inconsistent disclosures during the Section 341 process. Gitto did not attend the meeting of creditors and asserted his Fifth Amendment privilege due to an ongoing grand jury investigation into fraud claims regarding pre-petition transactions of the debtor. There was also evidence that Gitto had "engaged in questionable inter-company transactions and commingled the affairs of Tradex with those of [a related entity] to grant a mortgage on its assets" to allow the related entity to obtain financing. Furthermore, the U.S. Trustee presented evidence that Gitto had taken excessive "management fees" from the debtor.

Analysis: The district court affirmed the decision to appoint a trustee, concluding that there was sufficient evidence under both Section 1104(a)(1) and Section 1104(a)(2). The court concluded that the failure to file accurate financial reports and make proper disclosure of estate assets contravenes one of the most fundamental duties of a debtor in possession. Id. at 833 ("Any failure to file accurate financial statements is an omission contributing to cause for appointment of a trustee." The court noted that the ongoing criminal investigation also weighed in favor of appointing a trustee, due to the likelihood that the investigation would impede the debtor's business. The court also concluded that "questionable business transactions with related companies" also served as grounds for appointing a trustee. The court concluded that there was independent grounds to appoint a trustee pursuant to Section 1104(a)(2). It stated that based on the evidence before the bankruptcy court, it was reasonable for the court to determine that appointing a trustee was in the best interests of creditors.

Issue 3: Sales Pursuant to 11 U.S.C § 363 and Issues in Reorganization Plans

For closely held business cases, issues can also arise regarding asset sales pursuant to 11 U.S.C § 363. Lack of resources or efforts by insiders to impose conditions on sales can make it difficult for debtors to sell assets in a chapter 11 proceeding. A primary concern when seeking approval of an asset sale is demonstrating a sound business reason for the sale and maximizing the value of the asset. Section § 363(b)(1) of the Bankruptcy Code authorizes a trustee or debtor in possession to use, sell, or lease property of the estate other than in the ordinary course of business subject to notice of the sale and the Bankruptcy Court approval. As one treatise has stated, "in determining whether to approve a proposed sale under section 363, courts generally apply standards that, although stated various ways, represent essentially a business judgment test." 3 Collier on Bankruptcy P. 363.02[4] (16th Ed. 2017). However, unlike the business judgment test in the general corporate law realm which protects directors from liability so long as they exercise due care and are not self-interested, a "bankruptcy court reviews the trustee's (or debtor in possession's business judgment to determine independently whether the judgment is a reasonable one." Id. To obtain approval in a chapter 11 of a sale of substantially all of the estate's assets, a trustee must show "a sound business reason." In making this analysis, the bankruptcy courts will consider (1) the proportionate value of the asset to be sold as a whole; (2)

the amount of time elapsed since the filing; (3) the likelihood that a plan of reorganization will be proposed and confirmed in the near future; (4) the effect on the proposed distributions in a future plan or reorganization; (5) the proceeds to be attained from the disposition vis-à-vis the appraisals of the property; (6) the proposed alternatives for the use, sale, or lease of the assets; and (7) whether the asset is increasing or decreasing in value. See, e.g., In re Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983).

"Once a court is satisfied that there is a sound business reason or an emergency justifying the pre-confirmation sale, the court must also determine that the trustee has provided the interested parties with adequate and reasonable notice, that the sale price is fair and reasonable and that the purchaser is proceeding in good faith." In re Del. & H. R. Co., 124 B.R. 169, 176 (D. Del. 1991). Courts will impose stricter requirements if the sale is to be made on an expedited basis or if the transaction involves an insider. See 2 Norton Bankr. L. & Prac. 3d § 44:17, p. 44-44 (2014); see also In re Au Natural Restaurant, Inc., 63 B.R. 75 (Bankr. S.D.N.Y. 1986) (lack of support for need to sell asset on expedited basis); Westship, Inc. v. Trident Shipworks, Inc., 247 B.R. 856, 866 (M.D. Fla. 2000) ("While a transaction involving insiders is not prohibited, it is subject to heightened scrutiny."); see also In re Family Christian, LLC, 533 B.R. 600 (W.D. Mich. 2015) (denying motion to approve sale despite overwhelming support from debtor's stakeholders because proposed purchaser was an insider and debtor failed to articulate a sound business purpose). "Although a trustee normally would be expected to sell to the highest bidder at auction, there may be sound business reasons to accept a lower bid, particularly in a negotiated sale. For example, the payment terms may be more favorable, or the trustee may have substantial reason to doubt the ability of the highest bidder to raise the case necessary to complete the purchase." 3 Collier on Bankruptcy P 363.02[4] (16th Ed. 2017). Courts will engage in a case by case analysis of the terms of the sale.

CASE LAW

In re CPJFK, LLC, 496 B.R. 290 (E.D.N.Y. 2011)

Facts: In this case, the court approved a sale of a hotel, the major asset of the debtor. This case had an extensive procedural history, including the appointment of a trustee due to the mismanagement of the business by the directors. The court issued an order approving the sale procedures, which included allowing the trustee to retain a broker to market the property (Optimum). The debtor objected, including the following reasons that Optimum did not properly advertise the sale, Optimum should have obtained an appraisal of the hotel property, the sales prices of $13,850,000 was so low as to "shock the conscience," and that the sales procedure was misleading and prejudicial, including stating that the hotel was being at a "substantial discount to replacement cost" estimated to be $36,000,000.

Analysis: The court held a hearing on the sale. It rejected the debtor's arguments in objection to the sale. There was substantial evidence presented at the hearing that Optimum properly

marketed the property, including putting together a marketing package that included pictures, market data, competitive research, and a general description of the market. Optimum printed 7,5000 hard copies of the package, advertised it on its website, sent press releases to 152 media outlets, and sent "e-mail blasts" to 4,826 addresses. Based on these marketing efforts, there were two bids, $3 million and $13 million. The court noted that there were several reasons depressing the bids, including the fact that the hotel did not have a franchise agreement and had an existing union contract with employees. The court rejected the debtor's objection regarding the price. It noted that one of the debtor's proposed valuations of $30 million was not based on competent expert testimony, and an appraisal prepared by an appraiser valuing the hotel at $20 million was based on the hotel being converted to a Crowne Plaza hotel. The court also rejected the argument that advertising that the hotel was being sold at a substantial discount to replacement value would negatively affect the value. The court stated that such fact was "self-evident."

The Court approved the sale after analyzing the Lionel factors.

> As to the first factor, while the assets being sold consist of substantially all of the estate's property, the sale is appropriate given the inability of the Trustee to fund continued operations. As to the second factor, this case has been pending since October 4, 2010, almost six months. The Debtor (or any other party) had ample opportunity to obtain confirmation of a plan, which has not occurred. With respect to the third factor, the Debtor's current proposed plan has no reasonable likelihood of confirmation, and there has been no other plan proposed. With respect to the fourth factor, it is not clear that there will be a future plan of reorganization in any event. With respect to the fifth factor, although the Debtor's appraisal is in evidence, it is not a basis to conclude that the price is inadequate, given that the appraisal is based on the assumption that the Hotel is operating as a Crowne Plaza, which it is not, and given the evidence presented of the marketing campaign conducted by Optimum. Finally, with respect to the final Lionel actor, if the sale is not approved, and the Hotel ceases operations, value will likely be lost for many creditor constituencies, including the Landlord, the Union and Fund Creditors, administrative claimants and unsecured creditors."

Id. at 306.

In re Exaeris, 380 B.R. 741 (Bankr. D. Del. 2008)

Facts: The chapter 11 debtor, Exaeris, was a specialty pharmaceutical company and a wholly owned subsidiary of Inyx, Inc. The sole shareholder of Inyx was J. Kachkar, who provided, with court approval, post-petition financing of $2.1 million. Exaeris ceased operating and the court appointed a chapter 11 trustee. The committee of unsecured creditors, with debtor's approval, began negotiations with Kachkar to sell Exaeris to him for a credit bid of $2.1 million and a cash payment of $337,500. The debtor filed an expedited motion for approval of the sale.

Analysis: The court denied approval of the sale. It analyzed the four factors required for approval of a sale not in the ordinary course of business. (1) there is a sound business purpose; (2) the proposed price is fair; (3) the debtor has provided adequate and reasonable notice, and (4) the buyer has acted in good faith. Id. at 744.

It concluded that there was no sufficient evidence demonstrating a sound business purpose for the sale. The court noted that the committee agreed that the debtor was in desperate financial condition, but there was no other evidence regarding the potential value of Exaeris and its assets. It also expressed concern with the expedited timeline and lack of marketing. The court noted that the business was marketed over a three week period during the Christmas and New Year holidays and only four potential purchasers received notice of the sale. Furthermore, the court expressed concern of the sale to an insider on an expedited timeline during which the committee had little time or information upon which to negotiate.

Structured Dismissals

Options for closely held businesses in chapter 11 cases may be limited. A structured dismissal of the case is often considered when a plan is not feasible. The recent decision by the U.S. Supreme Court in Czyzewski v. Jevic Holding Corp., discussed below, addressed the use of structured dismissals in chapter 11 cases. In its decision, the U.S. Supreme Court made it clear that bankruptcy courts do not have the authority to alter the absolute priority rule in a distribution entered as part of a chapter 11 dismissal.

Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017)

Facts and Procedural History: The respondent Jevic Transportation (Jevic), filed its chapter 11 petition in 2008, two years after it had been acquired in a leveraged buyout by Sun Capital. Sun Capital borrowed money from CIT Group to finance the LBO. The petitioners were a group of former Jevic truck drivers. At the time of its bankruptcy filing, Jevic owed $53 million to senior secured creditors Sun Capital and CIT, and over $20 million to tax claimants and general unsecured creditors.

Jevic's bankruptcy filing led to two subsequent lawsuits. The first lawsuit was the petitioners' action in the bankruptcy court against Jevic and Sun Capital arising out of Jevic's decision to fire the petitioners prior to filing for bankruptcy. The petitioners claimed that this violated the state and federal Worker Adjustment and Retraining Notification (WARN) Acts, which required Jevic to give 60 days' notice before terminating the petitioners. The bankruptcy court granted summary judgment in favor of the petitioners against Jevic, entering a judgment in the amount of $12.4 million. About $8.3 million of the judgment was a priority wage claim under Section 507(a)(4) of the Code. Sun Capital ultimately prevailed in the WARN suit against the petitioners because it was not their employer.

In the second lawsuit, the bankruptcy court authorized the Committee representing Jevic's unsecured creditors to sue Sun Capital and CIT on behalf of the bankruptcy estate. The Committee brought preference and fraudulent transfer claims related to the leveraged buyout. The parties negotiated a settlement that provided for a structured dismissal that would result in distributions to secured creditors and a *pro rata* distribution to unsecured creditors, but which would not distribute anything to the petitioners who held a priority wage claim against the bankruptcy estate. Sun Capital insisted on a distribution that would skip distributions to the petitioners because it did not want to help finance the WARN litigation that was pending against it at the time.

The bankruptcy court approved the settlement, although it acknowledged that it failed to follow the absolute priority rule. The bankruptcy court concluded that the settlement was necessary because the bankruptcy estate was in dire financial straits and there was not a prospect for a confirmable Chapter 11 plan. The district court and Third Circuit affirmed the settlement distribution.

Holding: The Court (*Breyer, J.*) held that a bankruptcy court does not have the power to alter the absolute priority rule without consent of affected parties in a distribution scheme entered as part of a Chapter 11 dismissal.

Analysis: The Court summarized the fundamentals of Chapter 11 bankruptcy proceedings and the three possible outcomes: (1) a bankruptcy-court confirmed plan, (2) conversion of the case to a Chapter 7 proceeding, or (3) dismissal of the Chapter 11 case. The Court additionally noted the increasing trend of "structured dismissals" which the American Bankruptcy Institute defines as a "hybrid dismissal and confirmation order . . . that typically dismisses the case while, among other things, approving certain distributions to creditors, enjoining certain conduct by creditors, and not necessarily vacating orders or unwinding transactions undertaken during the case."[4]

The Court noted that although not explicitly authorized by the Bankruptcy Code, structured dismissals are becoming more common. The Court had to determine the relation between the absolute priority rule and structured dismissals. It stressed that the priority system "has long been considered fundamental to the Bankruptcy Code's operation." It cited to § 1129(b) and noted that "a priority-violating plan still cannot be confirmed over the objection of an impaired class of creditors." The absence of any language in the Code allowing structured dismissals to violate the absolute priority rule was central to the Court's analysis. It noted that it would have expected to see "some affirmative indication of intent if Congress actually meant to make structured dismissals a backdoor means to achieve the exact kind of non-consensual

[4] Sun Capital argued that the petitioners lacked standing because they would not have received a distribution even if the bankruptcy court did not approve the structured settlement. The Supreme Court rejected this argument. It concluded that the argument rested on two assumptions, (1) that it was not possible to reach a settlement without violating the absolute priority rule, and (2) without a settlement the Committee's fraudulent conveyance lawsuit had no value. The record did not support these assumptions.

priority violating final distributions that the Code prohibits in Chapter 7 liquidations and Chapter 11 plans."

The Court further supported its analysis by pointing to the sections of Chapter 11 relating to dismissal. The Court noted that the sections dealing with dismissal "seek a restoration of the pre-petition financial status quo." The structured dismissal bypassing the petitioners' claims did not do that.

The Court recognized that 11 U.S.C. § 349(b) allows a bankruptcy court in ordering a dismissal to alter the pre-petition status quo "for cause." The Court concluded, however, that this section is designed only to "make appropriate orders to protect rights acquired in reliance on the bankruptcy case." The Court then went on to distinguish interim orders that alter the absolute priority rule, (citing to In re Iridium Operating, LLC, 478 F.3d 252 (2d Cir. 2007), from final orders that violate the absolute priority rule. The Court noted the Second Circuit's observation in Iridium that it "is difficult to employ the rule of priorities" when the [outstanding] claims against [the bankruptcy estate] are not yet fully resolved." Interim orders that violate priority rules are often necessary to promote "significant Code-related objectives." The listed examples included "first-day" wage orders allowing payment of pre-petition wages, as well as other orders that would enable a successful reorganization. The Court distinguished structured dismissals that violate the priority rule because they are a final disposition of the bankruptcy case that it concluded do not serve the same Code-related objectives. In this case, it noted that the structured dismissal did not preserve Jevic as a going concern, it did not make disfavored creditors better off, it did not increase the possibility of a confirmable plan, it did not restore the status quo ante, and it did not protect any reliance interests that arose during the bankruptcy case.