Too Many Chiefs Make for a CROwded Reorganization: Ethics

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Too Many Chiefs Make for a CROwded Reorganization

(Retention of CROs under Sections 363 and 327)

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Introduction

"What's good for the Goose is good for the Gander."[1] The idiom that virtually every child hears at one time or another seeks to capture the idea that what is good for one is equally good for another, despite irrelevant differences between the two. The Rules of Professional Conduct add a twist to this old saying, requiring what is good for an attorney to also be good for his client.[2] It is in that vein that a lawyer retained to represent a debtor in a bankruptcy proceeding must meet the requirements of 11 U.S.C. § 327, a fact that practically no attorney challenges. Large corporate debtors, in addition to their bankruptcy counsel, often turn to another animal to help them navigate the murky waters of bankruptcy, a Chief Restructuring Officer ("CRO"). A CRO, like a debtor's bankruptcy attorney, is a fiduciary of the debtor and responsible for the debtor's activities while in bankruptcy. Why then have bankruptcy courts allowed CROs, who arguably owe their clients the same fiduciary duties as an attorney, to be retained under Section 363 of the Bankruptcy Code (the "Code")?

The fact is that certain U.S. Trustees and judges do not think that CROs should be retained under Section 363 and have forced CROs to abide by the more arduous provisions of Section 327. While most courts still adhere to the idea that "what is good for Jay Alix is good for any CRO," a string of outliers have rekindled the debate about what section of the Code is most suited for governing the retention of CROs. At what level courts should require CROs to clear conflicts of interest is a question that remains open today. When it comes to CROs and lawyers, it appears that what is good for the goose is not always good for the gander. However, there are compelling arguments that it should be.

This article will explore the roles of a CRO and the ethical implications of those roles. With that background, we will examine the historical construct for retaining CROs, look at the potential pitfalls that construct may engender, and finally investigate how various courts have dealt with the conundrum of CRO retention under Sections 327 and 363 of the Code.

The Role of the CRO

The company's primary lender and largest creditor, a major national bank, just shut off the company's last line of credit. The bank is concerned about growing inventories, aged receivables, and the departure of several executives from the company in the past couple of months. On top of these "minor" troubles facing the company, a payment is due to a second lender within the next couple of weeks. The company cannot cover the payment out of its operating accounts. This scenario, and others like it, are usually a prelude to bankruptcy. Often times, this is also when a board makes the decision to retain the services of a CRO. To say that CROs function in a high stress environment is probably an understatement. CROs are often hired when the company's current leadership has not been able to overcome adversity facing the organization.

When a CRO is hired, his role in the company, and the direction provided by the board or ownership on that role, could ultimately determine whether a reorganization effort is a success or a failure. The role and responsibility of the CRO must be clearly defined because the future of the company depends on it. As Martha E. M. Kopacz recognized in her article, *The Missing Link to Successful Company Turnarounds*, the "ultimate outcome" of restructuring is often dependent on "the management team's leadership, skills and execution, not the balance sheet management."[3] Because the role of the CRO is so critical to a company's success in bankruptcy, any discussion on CRO retention must start with a discussion about that role.

Daniel Dooley, in his article *CROs Can Be Driving Force for Good Corporate Governance*, provides a concise framework for the role of a CRO.[4] He identifies eight functions that must be part of a CRO's role for him to be effective: 1) hire insolvency counsel and other professionals to mitigate risk; 2) oversee the exercise of due care by senior leadership; 3) deconflict corporate and equity interests; 4) open lines of communication with stakeholders; 5) establish a collaborative relationship with other management; 6) develop a turnaround plan; 7) assume a leadership role with the company; and 8) establish visibility with stakeholders.[5] Put another way, the CRO, in his role as a corporate officer, must be a corporate turnaround leader having financial, operational and management expertise and be skilled in the complex and painstaking process of crafting consensus among all stakeholders around a common outcome.[6]

While a CRO's role with a debtor company is certainly diverse, it comes with inherent ethics responsibilities and obligations. As an officer of the corporation (or comparable entity), a CRO owes duties of care and loyalty to the corporation.[7] A CRO is a fiduciary of the company and as an appointee of the board, takes on the board's fiduciary responsibilities. He or she also maintains insulation from creditor attacks for any breach of the duty of care as long as its business decisions are made in good faith and upon a reasonable belief that the action it is pursuing is in the best interests of the company. As CROs are frequently referred to a debtor by another party in interest, typically a lender, they must be mindful of the duty of loyalty owed to the corporation.[8]

CROs carry great responsibility in their role with a company. They can manage operations, make financial decisions, work with stakeholders, and provide strategic direction. Despite this high level responsibility, CROs are outsiders. After all, to address issues that divide corporate interests from equity interests, they must be. CROs usually come from consulting companies or other third-party sources and are generally retained on a contractual basis.

When a company files for bankruptcy, the CRO's role takes on even greater importance. The CRO is not just a turnaround officer; the CRO is responsible for leading the company through the bankruptcy process with the help of debtor's counsel. As a company officer tasked with navigating the bankruptcy process, there is little doubt that the CRO is a professional. As such, the CRO must obtain the bankruptcy court's approval to continue in his role. How a CRO goes about obtaining that approval has been the subject of extensive debate since the early 1990s. Given the scope of the CRO's role and responsibilities, it is our belief that the proper mechanism for retention is Section 327 of the bankruptcy Code.

The Current State of CRO Retention

Today the overwhelming majority of CROs retained in a bankruptcy case are retained under Section 363(b)(1). The reason for this form of retention is two-fold. First, debtors and CROs favor retention under Section 363. Second, bankruptcy courts, led by the District of Delaware, have acquiesced to the practice when it is done with certain safeguards. Section 363(b)(1) allows a debtor to "use, sell, or lease, other than in the ordinary course of business, property of the estate." In an application under Sections 363(b)(1) and 105(a) a debtor must show only that there is a sound business purpose for the retention.[9] Given the importance of the role of a CRO, as discussed above, it is not a stretch to demonstrate the need and sound business purpose for a CRO under Section 363(b)(1). Thus, debtors, eager to ensure they can retain a CRO, embrace Section 363(b)(1) retention. Likewise, CROs eager to keep their position and get paid favor Section 363(b)(1) retention over retention under the more burdensome Section 327. Finally, debtors also favor the appointment of a CRO because it can help insulate them from the appointment of a Trustee or the unethical conduct of prior management.[10]

While most, but not all, courts have moved to a Section 363 retention model for CROs, they have not done so on blind faith in the individuals or companies that fill CRO positions. Rather, most courts follow a construct established by the Delaware courts known as the Jay Alix Protocol (the "Protocol").[11] The Protocol originated in September 2001 as a negotiated settlement between the United States Trustee for Region 3 (Delaware) and Jay Alix & Associates to resolve disputes over the qualification and compensation of Jay Alix & Associates in the *Safety-Kleen* and *Harnischfeger* cases.[12] The Protocol prevents a single individual or company from being retained as both a financial advisor under Section 327 and a CRO under Section 363. The Protocol also places other restrictions on a CRO. For instance, a CRO cannot be a member of the debtor's board or have served in that capacity in the two years prior to the bankruptcy.[13] The CRO must also disclose his relationship to any interested parties.[14] With respect to compensation, the Protocol requires the CRO's fees to be approved at the end of the case under a reasonableness standard and there is no requirement to file formal fee applications.[15] Additionally, it should be noted that a CRO's pre-petition fees are not subject to avoidance and can be paid when a CRO is retained under the Protocol, providing additional incentive for this means of retention.

The Alternative: Retention Under 11 U.S.C. § 327

Despite the Protocol and bankruptcy courts' recent reliance on Section 363, the Code already contains a specific section for the retention of professionals in Chapter 11 cases. 11 U.S.C. § 327 states that the debtor "may employ one or more attorneys, accountants, appraisers, auctioneers or other professional persons that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist [the debtor]." When the concept of a CRO first emerged in the early 1990s, they were generally retained pursuant to Section 327.[16] Section 327 imposes a far higher set of hurdles for a CRO before he can be retained by a debtor.

First, the CRO is required to be conflict free. Section 327(a) of the Bankruptcy Code sets forth a two-part, overlapping test for retention of professionals for a debtor. 11 U.S.C. § 327(a).[17] First, the professional must not hold an adverse interest to the bankruptcy estate.[18] Second, the professional must be a "disinterested person, a term which includes one who does not have an interest materially adverse to the interest of the estate . . . by reason of any direct or indirect relationship to, connection with, or interest in, the debtor . . . or for any other reason."[19] An actual conflict of interest is not required for a professional to hold an adverse interest and even potential conflicts of interest may disqualify a potential CRO.[20] Obviously, the two-part overlapping test is far more stringent than simply not being a member of the debtor's board during the previous two years. This test eliminates virtually any executive that previously worked for the debtor and that may have an interest in the debtor's reorganization.

Section 327's significant burdens do not end with the conflicts. Compensation is also affected when a CRO is retained under Section 327. When a CRO obtains court consent to retention under Section 327, that CRO's fees are governed by Section 330. Section 330 permits "reasonable compensation for actual, necessary services . . . [and] reimbursement for actual, necessary expenses." Practically speaking, the bankruptcy courts evaluate the reasonableness of interim and final fee applications looking back over the retention period and reviewing the "nature, the extent, and the value" of the services rendered.[21] In determining what is reasonable compensation, section 330(a)(3) directs the Court to review and award fees taking into account the following factors:

> (A) the time spent on such services;
> (B) the rates charged for such services;
> (C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;
> (D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed;
> (E) with respect to a professional person, whether the person is board certified or otherwise has demonstrated skill and experience in the bankruptcy field; and
> (F) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.
> Professionals seeking fees under section 330 bear the burden of proof to justify allowance under the requirements of the Bankruptcy Code.[22]

Again, the scrutiny a court applies under Section 327 is significantly stricter than a CRO is subjected to under Section 363 and the Protocol. The 363 reasonableness standard pales in comparison. CROs interested in ensuring receipt of their fees are naturally drawn toward retention under Section 363.

One other advantage exists for a CRO that is retained under Section 363. If reduced disclosure and easier fee approval were not enough to convince a CRO to seek retention under Section 363, the ability to reduce liability should tip the scales. A CRO that obtains court approval pursuant to §§ 105(a) and 363(b)(1) can use a debtors' insurance and receive indemnification from the debtor.[23] A debtor may indemnify a CRO retained pursuant to §§ 105(a) and 363(b)(1) and provide insurance the same way that it indemnifies its other officers and directors. Section 327(a) does not allow for the same type of protection.

Why Are CROs Special?

The opportunity to be retained and paid pursuant to Section 363 is a privilege CROs enjoy over their professional peers who are subject to the more onerous procedures of Section 327 and 330. Some logic beyond the U.S. Trustee's decision to acquiesce in *Safety-Kleen* and *Harnischfeger* must support this precedent. CROs are likely to argue that their role is so crucial that the increased flexibility afforded them by Section 363 is warranted. However, the roles of debtor's counsel or debtor's accountant are arguably just as crucial. Without counsel, debtors cannot pursue voluntary bankruptcy in the first place. A more skeptical view of 363 CRO retention is that it is more a product of timing than of function.

It is common for a distressed company, often at the urging of its lenders, to engage a financial advisor as CRO before the company fines for bankruptcy.[24] A proactive company will want to try to avoid a filing and a CRO provides new management perspective to that end. In some cases retention is an attempt to effectuate a turnaround outside bankruptcy. In other instances, a CRO may be able to achieve a negotiated out-of-court settlement to avoid a bankruptcy filing. However, most cases involve a CRO that is hired to prepare the company for a planned bankruptcy filing.[25] Regardless of purpose, the CRO is often engaged by the debtor weeks or months ahead of filing. If recommended by the lender, the CRO will no doubt have ties to both the lender and the debtor by the time the actual petition is filed. If the pre-petition CRO is effective, it makes little sense to force the debtor to change leadership midstream, after a bankruptcy filing as this may damage the recovery to the creditors[26].

Pre-petition retention does not fit conveniently into Section 327's paradigm. Section 327 requires a professional retained by the debtor to be "disinterested" and Section 101(14)(B) specifically states that a person is not disinterested if that person was an officer of the company in the two years prior to the petition date. Under the Protocol, a CRO can be retained by the debtor and serve as an officer pre-petition, he just cannot be a member of the company's board. The Protocol explicitly addresses the disinterestedness issue where the financial advisor who seeks to be retained also served as an officer pre-petition by setting forth that service as an officer pre-petition will not per se disqualify the financial advisor.[27] Ultimately, the disinterested problem seems to be the basis for bankruptcy court's willingness to allow Section 363 as a tool to retain CROs. Bankruptcy courts seem willing to allow CROs to pass from the pre-petition debtor to the post-petition debtor to allow for continuity of leadership during trying times.

The question that lingers is whether the debtor is harmed by its CRO not being a completely disinterested party? Should the protections of 327 apply to protect both creditors and debtors from an interested actor or is continuity paramount?

The Outliers: Instances Where Courts Have Refused to Accept 363 Retention

While the majority of jurisdictions have embraced CRO retention under Section 363 and the Protocol, there have been dissenters. A review of those cases and each court's basis for denying Section 363 retention may reveal partial answers to the questions above.

BlueStone

One of the first criticisms of Section 363 retention came out of the Middle District of Florida in the case of *In re Blue Stone Real Estate, Constr. & Dev. Corp.*, 392 B.R. 897, 907 (Bankr. M.D. Fla. 2008). In *Bluestone*, the debtor sought to retain a CPA as its CRO to (i) review the debtor's books and records and conduct the necessary investigation to ensure that the schedules and statements of financial affairs are accurately prepared and, if not, prepare and file corrected ones, (ii) conduct a thorough inventory of the assets, (iii) negotiate with and verify the financial viability of all potential purchasers of any of the debtors' assets, and (iv) oversee and monitor the liquidation of the debtor's assets.[28] The United States Trustee and two secured creditors opposed the relief requested by the debtor. All three parties argued that the CRO would be controlled or directed by debtors' CEO and that she would be able to hide assets or documents from the CRO.[29] The objectors essentially argued that the CRO could not be a disinterested party. The U.S. Trustee had also filed a motion that would have appointed a Chapter 11 Trustee in lieu of a CRO. The U.S. Trustee argued that only a Chapter 11 Trustee could function as a disinterested party in the case.

The *Bluestone* Court quickly dismissed the U.S. Trustee's argument and chastised the U.S. Trustee for its position that only a Chapter 11 trustee could act as a disinterested party. However, the *Bluestone* Court also rebuked the debtor's effort to retain the CRO under Section 363 stating:

> The two main purposes of section 327 are to permit the Court to control administrative expenses in the form of professionals' compensation and ensure that the professional is conflict free and impartial. Absent such judicial oversight and the opportunity for continuing party-in-interest scrutiny of both a professional's retention and compensation, these important goals of the Bankruptcy Code cannot be met. The so-called "Jay Alix" protocol that depends upon section 363 for retention of an executive officer does not provide the Court the same ability to meet the twin goals of section 327 when the candidate for employment is also a professional. Indeed, one part of the protocol abdicates to a board of directors the decision to employ executive officers who may be professionals, as Mr. Oscher would be in these cases, as well as the decision to remove professionals. Somewhat surprisingly, this protocol is apparently embraced by the United States trustee's office even in a case where an executive officer would be deemed to be a professional subject to section 327(a) under the First Merchants and Bartley Lindsay analyses. This is a failing of the protocol in such cases.[30]

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In the end, the *Bluestone* Court recognized the need for a CRO and granted the debtor's motion, but the Court refused to grant the relief under Section 363. Instead, it turned to Section 327 for the appointment and required the CRO to file fee applications pursuant to Section 330.

It is important to note that in *Bluestone* the Court was not faced with a pre-petition employment conflict. The debtor had been in Chapter 11 for almost two years and the CRO which the debtor sought to be appointed was clearly a disinterested party without any ties to the debtor or any creditors.

Copenhaver

The Court in *In re Copenhaver, Inc.*, 506 B.R. 757, 759 (Bankr. C.D. Ill. 2014) dealt head on with the problem of a former officer of the company being appointed as the CRO. The debtor sought to retain its former president, to be its chief restructuring officer and a consultant.[31] The former president had extensive knowledge of the company and its Chapter 11 liquidation, but the debtor could no longer afford to pay him his full time salary. Additionally, the CRO had already left the company and gone to work for a creditor of the debtor. The *Copenhaver* court did recognize that the CRO was the "common sense" choice for the position despite his inability to pass Section 327's disinterested criteria. What followed was an explanation for the Court's consent for retention under Section 363 and the court's justification for oversight of the CRO's fees.

The Court eventually found:

> The employment of Mr. Moravec under § 363(b) is appropriate here although granting the approval is, quite frankly, somewhat of a stretch. He is not disinterested and that is a problem. But his tasks will be limited and the unique circumstances here compel the result. Nothing herein should be construed, however, as suggesting that § 363(b) creates a broad basis for employment of professionals or may serve as an alternative method of employment at the discretion of a debtor. To the contrary, absent unique and compelling circumstances, § 327 controls the employment of professionals.[32]

The *Copenhaver* court also required the CRO to submit detailed fee applications that would be reviewed by the Court. The court justified its oversight under Section 503 and Rule 2016 since Section 330 was not applicable.[33]

While *Copenhaver* did use Section 363 as a basis for a CRO's retention, its commentary is poignant. The judge's recognition that Section 327 is the "normal" provision for retention of professionals and that Section 363 is only appropriate in unique circumstances is a critique of wholesale retention of CROs under Section 363 and the Jay Alix Protocols. This critique is not isolated to *Copenhaver* and *Bluestone*. A number of other courts have also declined to appoint a CRO under Section 363.[34]

These decisions demonstrate that the debate over which section to appoint a CRO under remains alive.

BR Festivals

Another case where the court refused to allow retention of a CRO under Section 363 that provides some insight into the larger debate is *In re BR Festivals LLC.*[35] The debtor sought to retain a CRO. The U.S. Trustee objected on the basis that employing the CRO was not consistent with the Bankruptcy Code and not necessary in the debtor's chapter 11 liquidation.[36] The U.S. Trustee further argued that the Code only authorizes the appointment of a chapter 11 trustee under 11 U.S.C. § 1104 to act as an estate fiduciary.[37] The Court agreed with the U.S. Trustee finding the debtor's efforts to retain a CRO was an "end run" around the U.S. Trustee's statutory role in appointing a chapter 11 trustee. The Court based its decision, in part, on *In re Adelphia Commc'ns Corp.*, 336 B.R. 610 (Bankr. S.D.N.Y.).

The Court's decision flew in the face of the judge's commentary in *Bluestone.* There the Court cited to legislative history

> The court may order appointment [of a Chapter 11 trustee] *only if* the protection afforded by a trustee is needed and expenses of a trustee would not be disproportionately higher than the value of the protection afforded. The protection afforded by a trustee would be needed, for example, in cases where the *current* management of the debtor has been fraudulent or dishonest, or has grossly mismanaged the company, or where the debtor's management has abandoned the business.[38]

The *Bluestone* Court also noted that case law supports the view that the appointment of a Chapter 11 trustee is an "extraordinary remedy."[39]

Whether one sides with the *Bluestone* court or the judge in *BR Festival*, the matter remains undecided. U.S. Trustees, at least in jurisdictions that have not adopted the Jay Alix Protocol, are likely to continue to say the power to appoint an estate fiduciary remains with the U.S. Trustee alone, not the debtor in possession.

Conclusion - Section 327 Preserves CRO Integrity and Court Oversight But Practical Considerations May Dictate That Retention Occur Under Section 363

CROs have become a crucial piece in the bankruptcy puzzle. They provide unique professional services to debtors in the bankruptcy process. Despite over 25 years of CROs participating in the bankruptcy process, the method for retention has yet to be set in stone. While the majority of bankruptcy courts and U.S. Trustees embrace retention under Section 363 and 105, outliers still exist. Those outliers have a strong statutory basis for their position−Section 327 specifically addresses retention of professionals by the debtor. The development of the Jay Alix Protocol by the Delaware U.S. Trustee's office and Delaware Bankruptcy Court at the turn of the century created some middle ground between the two extremes but does not fully address the ethical dilemma that is created when a creditor presents a CRO to be retained pre-petition.

While jurisdiction currently seems to be the deciding factor in the manner in which a CRO must be retained, an argument could be made for the proposition that the circumstances of the case, not jurisdiction, should ultimately determine the method of retention.

Certain courts have looked to make Section 327 the norm. As it does for other professionals, Section 327 prevents conflicts and allows for close court oversight of professionals hired by a debtor. Retention under Section 327 also places Section 330 fee requirements on the CRO ensuring court oversight of the CRO's fees. Neither requirement places any greater burden on a CRO than is already placed on debtor's counsel. Courts embracing Section 327 look to both their obligation of oversight and the plain language of the statute to support their position.

Most Courts recognize that when a debtor engaged a CRO pre-petition, it makes sense to afford the debtor some flexibility in retaining that CRO post-petition, especially where the CRO can offer significant value to the debtor over a CRO brought on post-petition. Common sense dictates an alternative method of retention. If Section 327's disinterested requirements disqualify a CRO that would otherwise benefit both the debtor and creditors, a court's use of Section 363 as an alternative makes perfect sense.

Courts have options when employing CROs. Both Sections 363 and Sections 327 are available. At the end of the day, the old saying may not work—what is good for the goose (CROs) is not always good for the gander (all professionals).

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[1] The ancient phrase dates to the mid-16th century where it emerged in literature as the saying "as deep drinketh the goose as the gander" JOHN HEYWOOD, THE PROVERBS, EPIGRAMS, AND MISCELLANIES OF JOHN HEYWOOD 82 (1562).
[2] *See* MODEL CODE OF PROF'L CONDUCT r. 1.2, 1.7 (AM. BAR ASS'N 2016) (regarding scope of representation and conflict of interests).
[3] Martha E. M. Kopacz, *The Missing Link to Successful Company Turnarounds*, AM. BANKR. INST. J., Mar. 2014, at 32.
[4] Dan F. Dooley, *CROs Can Be Driving Force for Good Corporate Governance*, J. CORP. RENEWAL, Oct. 2007, at 14, 18.
[5] *Id.*
[6] Anthony Horvat, MBA, CIRA, *Defining the Role of the Cro the Strategic and Tactical Benefits of A Seasoned Professional*, AM. BANKR. INST. J., Sep. 2005, at 46.
[7] Thomas Moers Mayer et al., *15th Annual New York City Bankruptcy Conference: Who's Running the Company?*, 051613 ABI-CLE 395 (May 16, 2013).
[8] *Id.*

[9] Timothy W. Brink & James R. Irving, *Emerging Trends and Lingering Criticisms: A CRO Retention Update*, AM. BANKR. INST. J., Sep. 2013, at 18.

[10] *See, e.g., In re 1031 Tax Group, LLC*, 374 B.R. 78, 91 (Bankr. S.D.N.Y. 2007) (existence of a CRO "independent, unconflicted, and in no way beholden to prior management" was sufficient to refute a prima facie showing of "cause" based on prior management's misconduct).

[11] Kelly Beaudin Stapleton, John D. Penn & Andrew R. Vara, *UMKC Midwestern Bankruptcy Institute and Consumer Forum: Business Ethics: Maginot Lines? Examining and Enforcing the Duties Owed by Officers, Financial Advisors and Counsel*, 100110 ABI-CLE 285 (Oct. 1, 2010).

[12] William K. Snyder, *Testimony Before the American Bankruptcy Institute Commission to Study the Reform of Chapter 11*, AM. BANKR. INST. 7 (Nov. 1, 2013), http://commission.abi.org/sites/default/files/statements/01nov2013/ABI-BK-Reform-committee-CRO-Governance-testimony-for-Nov-1-2013.pdf.

[13] James R. Irving, *Further Precedent Supporting the Retention of CROs*, L. J. NEWSL. (Aug. 2014), http://www.lawjournalnewsletters.com/issues/ljn_bankruptcy/31_10/news/retention_of_cros-159850-1.html. The key elements of the "Jay Alix Protocols" are as follows: 1) professionals can only serve in one capacity (i.e., as a CRO, financial adviser or claims agent); 2) the professional may not be a member of a board of the debtor or have served on the board in two years; 3) the professional's relationships with interested parties are disclosed; 4) compensation is subjected to a review for reasonableness, often by the filing of quarterly fee statements which are much less onerous to prepare than fee applications submitted pursuant to section 330(a) of the Bankruptcy Code; and 5) all success fees are approved at the end of the case. *Id.*

[14] Brink & Irving, *supra* note 9.

[15] *Id.*

[16] *See* In re Bartley Lindsay, 120 B.R. 507, 512 (Bankr. D. Minn. 1990).

[17] Hon. Barbara J. Houser et al., *20th Annual Winter Leadership Conference: The Good, the Bad and the Very, Very Ugly: Pitfalls of Improper or Incomplete Disclosures by "Professionals,"* 120408 ABI-CLE 753 (Dec. 4, 2008).

[18] *Id.*

[19] 11 U.S.C.A § 101(14)(C) (West 2016).

[20] *See, e.g.,* In re Leslie Fay Cos., 175 B.R. 525, 532 (Bankr. S.D.N.Y. 1994) (emphasis added).

[21] Stapleton, Penn & Vara, *supra* note 11.

[22] *Id.* Bankruptcy Rule 2014 also imposes an affirmative duty upon professionals to disclose all connections with parties-in-interest, regardless of whether the professional believes the relationship to be relevant or trivial. Under 11 U.S.C. 328(c), "the Court may deny the allowance of compensation for services rendered and reimbursement of expenses to a professional employed under § 1103 if, at any time during such professionals employment, such professional is not disinterested, or represents or holds an interest adverse to the estate with respect to the matter on which such professional is employed." In re Enron Corp., No. 01-16034(AJG), 2002 WL 32034346 (Bankr. S.D.N.Y. May 23, 2002).

[23] Brink & Irving, *supra* note 9.

[24] David B. Stratton et al., *Concurrent Committee Educational Session: Professional Compensation: Current Trends and Perspectives in Connection with the Retention and Employment of Professional Persons under the Bankruptcy Code*, 040109 ABI-CLE 357 (Apr. 1, 2009).

[25] *Id.*

[26] *Id.*

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[27] *Id.*
[28] In re Blue Stone Real Estate, Const. & Dev. Corp., 392 B.R. 897, 899-900 (Bankr. M.D. Fla. 2008)
[29] *Id.*
[30] *Id.*; Brink & Irving, *supra* note 9.
[31] In re Copenhaver, Inc., 506 B.R. 757, 759 (Bankr. C.D. Ill. 2014).
[32] *Id.* at 764-65.
[33] *Id.* at 763.
[34] *See* In re Nesbitt Portland Property LLC, et. al., No. 12-12883, 2012 WL 4472442 (Bankr. N.D. Cal. 2012); In re Miles Props. Inc., No. 10-60797 (Bankr. N.D. Ga. 2010); In re Blue Ridge Limousine & Tour Serv., Inc., No. 12-17551-BFK, 2014 WL 4101595, at *4 (Bankr. E.D. Va. Aug. 20, 2014).
[35] In re BR Festivals LLC, No 14-10175 (Bankr. N.D. Cal. Feb 18, 2014).
[36] Jarret K. Vine, *Nothern District of California Weighs In on the Debate about Retaining CROs*, AM. BANKR. INST. (Jan. 5, 2015), http://www.abi.org/committee-post/northern-district-of-california-weighs-in-on-the-debate-about-retaining-cros.
[37] *Id.*
[38] H.R. REP. NO. 95–595 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6358 (emphasis added).
[39] In re 1031 Tax Group, LLC, 374 B.R. 78, 85 (Bankr. S.D.N.Y.2007).

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<u>The 1% Rule:</u>
The Intersection of Disinterestedness and Law Firm Politics

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Required Disclosures By Debtors' Counsel

Pursuant to Section 327(a) of the Bankruptcy Code, a debtor may employ, with the court's approval, professionals that are (1) disinterested and (2) do not hold or represent an interest adverse to the estate.

A professional is a disinterested person if, among other things, they do "not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or ***for any other reason***." 11 U.S.C. § 101(14)(C)(emphasis added). Unlike the disinterested prong, "adverse interest" is not defined in the Bankruptcy Code. Courts have defined an adverse interest as "any economic interest that would tend to lessen the value of the bankruptcy estate or that would create either an actual or potential dispute,"[39] as well as "a predisposition under circumstances that render such bias against the estate."[39] The key question is ultimately "whether an attorney has meaningful incentive to act contrary to the best interests of the estate."[39] Regardless of the definition employed, the concept is somewhat murky, and often overlaps with an analysis of disinterestedness. In complex chapter 11 reorganizations that involve large numbers of creditors and parties-in-interest, it is understandably difficult for a debtor to engage counsel who is both disinterested and holds no adverse interest, given the likely representation of creditors by others within the law firm. Accordingly, Section 327(c) provides an exception that a professional is not automatically disqualified under subsection (a) by virtue of representing a creditor, unless either a creditor or the U.S. Trustee objects, and the court funds an actual conflict of interest exists.

> **§ 327 Employment of Professionals**
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> (a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, ***that do not hold or represent an interest adverse to the estate, and that are disinterested persons***, to represent or assist the trustee in carrying out the trustee's duties under this title.
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> (b) If the trustee is authorized to operate the business of the debtor under section 721, 1202, or 1108 of this title, and if the debtor has regularly employed attorneys, accountants, or other professional persons on salary, the trustee may retain or replace such professional persons if necessary in the operation of such business.
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> (c) In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

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(d) The court may authorize the trustee to act as attorney or accountant for the estate if such authorization is in the best interest of the estate.

(e) The trustee, with the court's approval, may 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.

(f) The trustee may not employ a person that has served as an examiner in the case.

Federal Bankruptcy Rule 2014(a) requires that a debtor in possession seeking to retain a professional must file an application, accompanied by an affidavit signed by the professional, disclosing all of the professional's business, financial and personal connections with the debtor, creditors, other parties-in-interest, their counsel and accounts, and the U.S. Trustee's office.

Rule 2014. Employment of Professional Persons

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

Conflicts and the 1% Rule

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It should come as no surprise that in a large chapter 11 case, debtor's proposed counsel will have connections, and likely will have represented certain creditors of the bankruptcy estate. Although these situations may be unavoidable, a U.S. Trustee will reviewing an application to employ debtor's counsel will certainly view them carefully and with an eye towards whether the representation by a firm of both debtors and creditors in that specific instance creates an irremediable conflict of interest. To that end, the Office of the U.S. Trustee for several regions require law firms, seeking to be employed as debtor's counsel, to disclose whether a secured creditor accounts for more than 1 percent of the law firm's annual revenue. Where the secured creditor generated less than 1 percent of the annual revenue, the representation would be considered an acceptable level of conflict. Conversely, a secured creditor who generates more than 1 percent of the law firm's annual revenue would likely be viewed by the U.S. Trustee and the Court as a level of conflict that would prevent the proposed counsel from being eligible under Section 327.

By example, in In re Project Orange Assocs., the debtor sought to retain DLA Piper as its bankruptcy counsel, and as part of the employment application, DLA Piper disclosed that it represented affiliates of the debtor's largest secured creditor in matters unrelated to the bankruptcy.[39] The work for those affiliates accounted for between 1 and 2 percent of DLA Piper's annual revenue. Additionally, although the specific creditor was not a client of DLA Piper, it was a client of DLA Piper International LLP, an affiliate of the law firm. Because the debtor had retained conflicts counsel, and because the secured creditor had granted the law firm a conflict waiver allowing it to negotiate with and represent parties adverse to the secured creditor in certain situations, the debtor and the law firm took the position that DLA Piper satisfied the disinterested requirement of Section 327. The U.S. Trustee, however, objected and the Bankruptcy Court ultimately found that the law firm could not be retained as counsel to the debtor. The Court rejected the argument that conflicts counsel prevented the law firm from being disqualified, and focused on the facts that DLA Piper's conflict was with a creditor "central to the debtor's reorganization" and which, along with its affiliates, was a significant client of the law firm. The Court ultimately determined that because of the scope of DLA Piper's representation of the secured creditor and its affiliates, because the secured creditor would have an active and central role in most if not all aspects of the bankruptcy, DLA Piper could not effectively represent the debtor.

So it stands to reason that when a secured creditor or group of creditors represents more than 1 percent of a law firm's annual revenue, seeking employment of that firm as debtor's counsel is going to be a difficult, if not impossible, hurdle to surmount. But this raises the inevitable question: does the fact that a client represents less than 1 percent of the firm's annual revenue really mean the conflict is deminimus? The world's 100 largest law firms, by revenue, range from $342 million to $2.54 billion. If the 1 percent rule is applied strictly, then in theory a secured creditor who represents less than $3.42 million of annual revenue would be considered an inconsequential conflict. At that scale, the 1 percent rule cannot possibly address whether the lawyers working on a debtor's case would be influenced by their firm's representation of the secured creditor, even with a Chinese wall, conflicts counsel and a conflict waiver in place. Perhaps the even greater difficulty is convincing the partner responsible for that secured creditor's relationship that they should request a conflict waiver and pursue the debtor representation in the first place. At the very least, it is not going to be a comfortable conversation amongst colleagues.

As a final note, the analysis under the Bankruptcy Code and the 1 percent rule should never be assumed to automatically satisfy applicable state rules of professional conduct governing conflicts of interest.