Corporate Crisis Managers and Disinterestedness Under the Bankruptcy Code

The Committee on Bankruptcy and Corporate Reorganization

Companies experiencing financial difficulty frequently hire crisis managers[1] or workout specialists to help them avoid filing for bankruptcy protection under chapter 11 or to assist them in preparing for bankruptcy cases and in operating their businesses thereafter. In an effort to increase the efficiency and effectiveness of crisis managers, companies commonly appoint crisis managers as officers or directors. However, the stringent disinterestedness requirements of section 327(a) of title 11 of the United States Code (the "Bankruptcy Code") often inhibit the retention of a firm whose crisis manager held such a position prior to the company filing for bankruptcy protection.[2]

1. The term "crisis manager" as used in this article encompasses individuals and entities who are regularly hired by enterprises in financial difficulty to oversee turnarounds or orderly liquidations of the enterprises.

2. Section 327(a) of the Bankruptcy Code states "[e]xcept 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." When the statute refers to a "trustee" it includes a debtor-in-possession pursuant to section 1107(a) of the Bankruptcy Code. 11 U.S.C. § 327(a) (2005).

Some courts—recognizing that serving in such prepetition dual capacities should not, logically, preclude postpetition employment—have struggled for ways to circumvent the literal prohibitions of section 327(a) of the Bankruptcy Code with a variety of theories. Such theories include that crisis managers (i) are not "professional persons" and therefore their retentions are not governed by the strictures of section 327(a) of the Bankruptcy Code, (ii) are employed in connection with the use, sale or lease of property of the estates and therefore are covered by section 363 of the Bankruptcy Code and not section 327(a), (iii) are salaried employees covered by sections 327(b) and 1107(b) of the Bankruptcy Code or (iv) are employable under the broad scope of authority given to bankruptcy courts pursuant to section 105(a) of the Bankruptcy Code. Courts should not be forced to engage in such machinations to achieve a result desired by the debtor and, for the most part, all other parties-in-interest. The existing statutory prohibitions as interpreted by most courts appear to be incompatible with the increasing importance and predominance of the use today of crisis managers by many financially troubled companies.

This article reviews the historical development of the requirement of "disinterestedness" for most professional persons since the Bankruptcy Act[3] analyzes the current state of the case law governing crisis managers and disinterestedness, discusses the attempts of some courts to permit crisis managers to be retained as professionals under the Bankruptcy Code, notwithstanding an apparent lack of disinterestedness due to prepetition officer or director posts held by a principal of the crisis manager and, finally, suggests a legislative change to the statutory definition of disinterestedness to permit crisis managers to be retained as professional persons despite previous service as officers or directors.

HISTORICAL DEVELOPMENT OF DISINTERESTEDNESS UNDER THE BANKRUPTCY CODE

The Bankruptcy Code's requirement of "disinterestedness" has its origins in the Depression-era Chandler Act Amendments[4] to the Bankruptcy Act. Congress introduced a requirement of disinterestedness in the Bankruptcy Act in an effort to eliminate pervasive self-dealing and conflicted

3. "Bankruptcy Act" means the Bankruptcy Act of 1898 as amended, which was repealed by § 401(a) of Public Law 95-598.

4. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, as amended by the Chandler Act of June 22, 1938, ch. 575, 52 Stat. 840.

interests that plagued practice under the Bankruptcy Act, as explained by the Donovan Report of 1929[5] and in *Weil v. Neary*.[6]

The development of the concept of disinterestedness under the Bankruptcy Act did not occur in a vacuum. The disinterestedness requirements were adopted to try to eliminate a perceived systematic pattern of abuse and conflict of interest that had developed in bankruptcy practice due to the lack of sufficient oversight of professionals in the administration of bankruptcy cases. These requirements were adopted to try to further the best interests of creditors and the administration of justice.

The definition of a disinterested person in the Bankruptcy Act was very similar to that now contained in section 101(14) of the Bankruptcy Code.[7] The focus of disinterestedness under the Bankruptcy Act and case law primarily involved trustees and attorneys. Crisis managers were not in common use in the restructurings of the day.

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5. *See* Donovan Report of 1929 (detailing an investigation of the administration of bankruptcy law in the Southern District of New York in the 1920s which administration was marked by widespread and systematic abuse and persistent conflicts of interest), *cited in* REPORT OF COMMISSION ON THE BANKRUPTCY LAWS OF THE U.S., H.R. DOC. NO. 93-137, pts. I and II (1973).

6. As explained by Chief Justice Taft in an early case under the Bankruptcy Act:

> Many abuses have occurred in the bankruptcy practice, and none is more frequent than that by which the attorney for petitioning creditors [in an involuntary case] becomes counsel for the trustees subsequently appointed. This mingling of interests, frequently conflicting, is generally regarded by courts as working to the detriment of one of the parties and to the undue advantage of another. Experience has shown the wisdom and necessity of separating the function and obligation of counsel by forbidding the employment in different interests of the same person.

Weil v. Neary, 278 U.S. 160, 168 (1929).

7. Section 158 of the Bankruptcy Act provided:

> A person shall not be deemed disinterested, for the purposes of section 156 and section 157 of this Act, if –
>
> (1) he is a creditor or stockholder of the debtor; or
>
> (2) he is or was an underwriter of any of the outstanding securities of the debtor or within five years prior to the date of filing of the petition was the underwriter of any securities of the debtor; or
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> (3) he is, or was within two years prior to the date of filing of the petition, a director, officer, or employee of the debtor or any such underwriter, or an attorney for the debtor or such underwriter; or
>
> (4) it appears that he has, by reason or any other direct or indirect relationship to, connection with, or interest in the debtor or such underwriter, or for any reason an interest materially adverse to the interests of any class of creditors or stockholders.

Bankruptcy Act § 158 (former 11 U.S.C. § 558).

The section of the Bankruptcy Act concerning disinterestedness makes reference to two other sections of the Act: sections 156 and 157. Section 156 applied only to corporate reorganization cases under chapter X[8] of the Bankruptcy Act and required a disinterested trustee to be appointed in cases with $250,000 or more in indebtedness.[9] Chapter X of the Bankruptcy Act required appointment of a trustee in an attempt to ensure that entrenched interests would not perpetuate or secure control of the reorganization process, as had become common in equity receiverships and in section 77B proceedings[10] prior to the enactment of chapter X of the Bankruptcy Act.[11]

Under the Bankruptcy Act, trustees were required to be "independent and disinterested so far as possible."[12] A trustee had to be "divested of any scintilla of personal interest which might be reflected in his decision concerning estate matters."[13] Similar requirements applied to attorneys who represented a trustee under the Bankruptcy Act.

8. The Supreme Court has explained the difference between chapters X and XI of the Bankruptcy Act as follows:

> Chapter X [was] devised as a substitute for the equity receivership, is specially adapted to the reorganization of large corporations whose securities are held by the public, and sets up a special procedure for the protection of widely scattered security holders and the public through the intervention of the Securities and Exchange Commission, while chapter XI, which is peculiarly adapted to the speedy composition of debts of small individual and corporate businesses, omits the machinery for reorganization set up by chapter X.

Securities and Exch. Comm'n v. U.S. Realty & Improvement Co., 310 U.S. 434, 437 (1940).

9. "Any trustee appointed under this chapter shall be disinterested. . . ." Bankruptcy Act, § 156 (former 11 U.S.C. § 556).

10. Congress enacted section 77B of the Bankruptcy Act, 48 Stat. 912 (1934), as amended, 11 U.S.C. § 207, in 1934 for the reorganization of financially troubled companies and to prevent abuses that had existed in equity receiverships. *See Duparquet, Huot & Moneuse Co. v. Evans,* 297 U.S. 216, 218-20 (1936). Chapter X of the Bankruptcy Act replaced section 77B in 1938.

11. *See* H.R. Rep. No. 75-1409, at 37-38 (1937); S. Rep. No. 75-1916, at 21 (1938). See *also*, Ferber, et al.*, Conflicts of Interest In Reorganization Proceedings Under the Public Unity Holding Company Act of 1935 and Chapter X of the Bankruptcy Act,* 28 Geo. Wash. L. Rev. 319, 330 (1959).

12. *In re Ocean City Auto. Bridge Co.,* 184 F.2d 726, 729 (3d Cir. 1950) (disqualifying the trustee because the trustee's wife owned, among other things, stocks and bonds of the debtor). *See also Meredith v. Thralls*, 144 F.2d 473 (2d Cir. 1944) (disqualifying the trustee because the trustee was employed by the parent of the debtor and a corporation doing business with the debtor).

13. *In re Realty Assocs. Sec. Corp.,* 56 F. Supp. 1007, 1007 (E.D.N.Y. 1944). See *also* 11 Harold Remington, Remington on Bankruptcy § 4487 (1961 revised ed.) ("Trustees must not have any conflicting interests, and should keep themselves free from entanglements.")

Section 157 of the Bankruptcy Act provided that an "attorney to represent a trustee under [Chapter X] shall also be disinterested."[14] However, section 157 provided further that, if the representation was not general representation of the trustee, the attorney did not have to be disinterested.[15]

The Bankruptcy Act's disinterestedness requirements were a logical solution to the history of abuses by interested attorneys and trustees. However, crisis managers have no such history of abuse. Arguably, because the present Bankruptcy Code favors leaving management in place as a debtor-in-possession in chapter 11, the postpetition retention of crisis managers who were prepetition officers and directors is consistent with the goals of the Bankruptcy Code. Nevertheless, recent case law shows that courts often reach the opposite conclusion.

CURRENT CASE LAW ON CRISIS MANAGERS AND DISINTERESTEDNESS

Most courts have evaluated motions to retain crisis managers under section 327(a).[16] Thus, to be retained, the crisis manager must not hold an adverse interest to the debtor or its estate, and the crisis manager must be disinterested.[17] Most courts hold that a crisis manager who was or is an

14. Bankruptcy Act § 157 (former 11 U.S.C. § 557).

15. *See id.* ("For any specified purpose other than to represent a trustee in conducting the proceeding under this chapter the trustee may, with the approval of the judge, employ an attorney who is not disinterested.")

16. *See infra* notes 23-27 and accompanying text.

17. A "disinterested person" means person that—

> (A) is not a creditor, an equity security holder, or an insider;
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> (B) is not and was not an investment banker for any outstanding security of the debtor;
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> (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale or issuance of a security of the debtor;
>
> (D) is not and was not, within two years before the date of the filing of the petition, a director, officer or employee of the debtor or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and
>
> (E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph or for any other reason.

11 U.S.C. § 101(14) (2003).

officer or director of the debtor is *per se* not disinterested pursuant to section 101(14)(D).[18]

With respect to the retention of crisis managers pursuant to section 327, the term "professional person" is not defined in the Bankruptcy Code. Therefore, a crisis manager may be outside of the definition of a professional person. In the bankruptcy context and under case law, "professional person" is a term of art that does not necessarily refer to people with a high degree of expertise in their fields but rather refers to individuals who take active roles in the bankruptcy case. [19] However, the courts are split as to the precise definition of "professional person." The majority of courts have adopted a quantitative analysis, finding a professional person to be a person[20] playing a central role in the administration of the estate and the bankruptcy case.[21] Other courts have adopted a qualitative analysis and look to see whether the person has a large degree of autonomy or discretion with respect to the administration of the estate.[22] To add to the confusion, some courts have used hybrid tests incorporating both qualitative and quantitative analyses.[23] If under the appropriate test the individual is not deemed to be a professional person, then court approval is not required. The majority of the reported decisions suggest that crisis managers are deemed to be professional persons and therefore require that they be retained pursuant to section 327(a).[24]

As stated above, to be retained pursuant to section 327(a), a profes-

18. *See infra* notes 24-27 and accompanying text.

19. *See Comm. of Asbestos-Related Litigants and/or Creditors v. Johns-Manville Corp. (In re Johns-Manville Corp.),* 60 B.R. 612, 619 (Bankr. S.D.N.Y. 1986) (finding a professional lobbyist was not a "professional person" under section 327 because the lobbyist was retained in the ordinary course of business). *See also In re Sieling Assoc. Ltd. P'ship*, 128 B.R. 721, 723 (Bankr. E.D. Va. 1991) (finding an environmental consultant not to be a "professional person" since his position, while professional in nature, was not central to the bankruptcy proceeding).

20. "Person" means an "individual, partnership and corporation" and certain governmental units. 11 U.S.C. § 101 (41) (2003).

21. *See, e.g., In re Seatrain Lines, Inc.*, 13 B.R. 980, 981 (Bankr. S.D.N.Y. 1981).

22. *See, e.g., In re Fretheim*, 102 B.R. 298, 299 (Bankr. D. Conn. 1989).

23. *See, e.g., In re First Merchants Acceptance Corp.*, No. 97-1500, 1997 WL 873551, at *2, 3 (D. Del. Dec. 15, 1997).

24. *See, e.g., In re Authorized Factory Serv., Inc.*, 283 B.R. 684, 687-88 (Bankr. W.D. Pa. 2002); *In re Madison Management Group, Inc.*, 137 B.R. 275, 283-84 (N.D. Ill. 1992); *In re Carolina Sales Corp.*, 45 B.R. 750, 752-53 (Bankr. E.D.N.C. 1985); *In re WFDR, Inc.*, 22 B.R. 266 (Bankr. N.D. Ga. 1982).

sional person must show that the following two requirements are satisfied: (i) that the person does not hold or represent an interest adverse to the estate and (ii) that the person is a disinterested person under section 101(14). Section 101(14) defines what it means to be disinterested, and creditors, directors, officers[25] and employees are not disinterested.[26] The majority of the courts strictly construe the term "disinterested person" with respect to professionals hired by debtors.[27] In other words, the majority of courts consider the issue of disinterestedness without regard to the facts of the case, equitable considerations or judicial economy. For example, the Ninth Circuit held in *In re Capitol Metals Co.* that a consultant acting as the prepetition chief financial officer was not disinterested for purposes of section 327 and, therefore, could not be retained postpetition.[28]

While professional persons who were prepetition officers or directors appear to be *per se* precluded from being retained postpetition, individuals who were officers and employees may still be retained as professional persons under section 327(b) or 1107(b). As a general rule, section 327(b) covers salaried employees who do not play a central role in the bankruptcy.[29] Section 1107(b) covers employees whose sole violation of the disinterestedness requirement is their prior employment by the debtor. [30]

25. The term "officer" is not defined in the Bankruptcy Code. Instead, the courts look to state corporate law to decide whether an individual is an officer.

26. *See* 11 U.S.C. § 101(14) (2003). Directors, officers and employees are not disinterested if they held such status either at the time of the filing or within two years before the filing date. *See* 11 U.S.C. 101(14)(D) (2003).

27. *See, e.g., Childress v. Middleton Arms, Ltd. P'ship (In re Middleton Arms, Ltd. P'ship)*, 934 F.2d 723, 725 (6th Cir. 1991) ("Section 327(a) clearly states, however, that the court cannot approve the employment of a person who is not disinterested. . . . By forbidding employment of all interested persons, section 327 prevents individual bankruptcy courts from having to make determinations as to the best interest of the debtors in these situations").

28. *See Official Comm. of Unsecured Creditors v. ABC Capital Mkts. Group (In re Capitol Metals Co.),* 228 B.R. 724 (B.A.P. 9th Cir. 1998). [This decision may also be found at 1998 Bankr. LEXIS 2029, where it is erroneously captioned *In re: Captain Blythers, Inc., Debtor, Captain Blythers, Inc., Appellant, v. Tevis T. Thompson, Jr., Chapter 7 Trustee, Appellee.*]

29. Section 327(b) states that 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." 11 U.S.C. § 327(b) (2003).

30. Section 1107(b) provides that notwithstanding "section 327(a) of this title, a person is not disqualified for employment under section 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case." 11 U.S.C. § 1107(b) (2003).

The majority of the reported cases, nevertheless, do not find these exceptions applicable to the retention of crisis managers.[31]

Section 327(b) does not require court approval for a trustee to retain a professional person who is regularly employed or in a salaried position that is regularly offered by the debtor.[32] This section is narrowly construed and does not cover all employees who worked for the debtor prepetition. Presently, courts disagree over the type of employment that complies with this section and even over what test should be used to evaluate such employment. One court used an expansive reading of section 327(b) and held that workout specialists (that is, crisis managers) hired prepetition as officers could be retained postpetition under section 327(b).[33] Other courts have stated that a professional person, for purposes of section 327(b), may be retained if working on only minor transactions in the ordinary course of the debtor's business.[34] Other cases have linked authorization of employment with the manner of payment (for example, salaried rather than on commission) and the party paying the salary to the crisis manager.[35]

Section 1107(b) allows a debtor-in-possession (but not a trustee) to retain an employee even if that employee is deemed not disinterested, but only if the disqualification arises solely because of her employment with the debtor.[36] The majority of courts interpret section 1107(b) narrowly and allow debtors to retain professionals whose failure to be disinterested is caused *solely* by their prior employment.[37] In other words, if any other

31. *See Michel v. Federated Dep't Stores, Inc. (In re Federated Dep't Stores, Inc.)*, 44 F.3d 1310, 1318-19 (6th Cir. 1995) ("Where a professional is disqualified for other reasons expressly listed in the statutory definition of an interested person, § 1107(b) does not apply") (citations omitted); *Stahl v. Bartley Lindsay Co. (In re Bartley Lindsay Co.),* 137 B.R. 305, 309 (Bankr. D. Minn. 1991) (finding that president and CEO of business also employed as financial consultant constituted both an officer of the debtor as well as a professional person and thus did not qualify under 327(b)).

32. *See* 11 U.S.C. § 327(b) (2003).

33. *See In re Phoenix Steel Corp.*, 110 B.R. 141, 142 (Bankr. D. Del. 1989).

34. *See In re Bartley Lindsay Co.,* 137 B.R. at 309.

35. *See, e.g., In re Carolina Sales Corp*., 45 B.R. 750, 753 (Bankr. E.D.N.C. 1985). In these cases, the party paying the crisis manager's salary was dispositive. That is, courts are more likely to allow the retention under 327(b) when the debtor pays the salary of the crisis manager rather than if the crisis management firm pays the salary.

36. *See* 11 U.S.C. § 1107(b) (2003). *See, e.g., Childress v. Middleton Arms, Ltd. P'ship (In re Middleton Arms, Ltd. P'ship*), 934 F.2d 723, 725 (6th Cir. 1991).

37. *See In re Federated Dep't Stores, Inc.*, 44 F.3d at 1318; *In re Eastern Charter Tours, Inc.,* 167 B.R. 995 (Bankr. M.D. Ga. 1994); *In re Watervliet Paper Co. Inc.*, 111 B.R. 131 (Bankr. W.D. Mich. 1989).

facts exist that would make that professional person not disinterested (such as a prepetition fee outstanding that has not been waived), then the professional person may not be retained. A few courts have permitted the retention of a professional if, in addition to prepetition employment, the only other disinterestedness factor was that the professional person held a claim arising from prepetition employment where the size of the claim was *de minimis* compared to the size of the bankruptcy estate.[38] One court stated that section 1107(b) allows a debtor-in-possession to retain a workout specialist, that is, a crisis manager, regardless of whether the person is disinterested.[39]

One commentator has suggested that even though section 327(a) is the accurate provision to govern employment of crisis managers, section 363(c) might provide a more flexible option.[40] Section 363(c)(1) provides that the debtor may employ certain entities without court approval in the ordinary course of business, so long as those entities were not employed pursuant to section 327(a).[41] To determine whether a transaction is in the ordinary course of business, courts have developed a "horizontal dimension" test and a "vertical dimension" test, both of which must be satisfied.[42] The horizontal dimension test focuses on an industry-wide perspective to determine if the transaction is common among companies in the industry.[43] The vertical dimension test focuses on the creditor's perspective to determine if the transaction is in line with the risks the creditor anticipated at the time the creditor extended credit to the debtor.[44] The author of the article suggests that both tests could be fulfilled.[45] He points to certain industries, including steel, retail shopping and telecommunications, that are prevalent in bankruptcy filings, and suggests that

38. *See In re Microwave Prod. of Am., Inc.,* 94 B.R. 971, 974 (Bankr. W.D. Tenn. 1989).

39. *See In re Madison Management Group, Inc.*, 137 B.R. 275, 284 (N.D. Ill. 1992).

40. *See* Kurt F. Gwynne, *Employment of Turnaround Management Companies, "Disinterestedness" Issues Under the Bankruptcy Code, and Issues under Delaware General Corporation Law*, 10 AM. BANKR. INST. L. REV. 673, 679-681 (Winter 2002).

41. *See* 11 U.S.C. 363(c)(1) (2003). *See also In re Sieling Assocs. Ltd. P'ship*, 128 B.R. 721, 723 (Bankr. E.D. Va. 1991).

42. *See In re Roth Am., Inc.*, 975 F.2d 949, 952 (3d Cir. 1992).

43. *See In re Roth Am., Inc.*, 975 F.2d at 953.

44. *See id.*

45. *See* Kurt F. Gwynne, *Employment of Turnaround Management Companies, "Disinterestedness" Issues Under the Bankruptcy Code, and Issues under Delaware General Corporation Law*, 10 AM. BANKR. INST. L. REV. at 680-81.

it may be common for them to engage crisis managers, thus satisfying the horizontal test.[46] The vertical test may be satisfied if the creditor is deemed to expect the debtor borrower to employ a crisis manager if its business operations begin to decline.[47] The terms of each retention agreement would have to be examined to ensure that the provisions are in line with both the industry standards and the creditor's expectations.[48] The author, however, acknowledged that 327(a) is a much more specific provision than 363(c) and is better equipped to govern the retention of a crisis manager.[49]

Bankruptcy courts have determined that crisis management firms must also be disinterested, as a firm is considered a professional person under section 327(a).[50] The question arises whether, if an individual is disqualified from being retained as a professional person because of his or her lack of disinterestedness, that individual's disqualification would be imputed to the crisis management firm as a whole.

Few cases discuss imputing lack of disinterestedness to all of the individuals in a crisis management firm. Cases allowing debtors to hire a firm, despite the disqualification of a member, involve law firms, not crisis management firms.[51] In these cases, the courts reviewed the relevant attorney ethical rules for the appropriate jurisdiction along with the Bankruptcy Code and found that neither requires *per se* disqualification of the entire firm.[52] One case involving a consulting firm acknowledged that there is no *per se* disqualification of the firm.[53] In that case, however, the court did disqualify the firm in its entirety, since the only person working for that consulting firm was the one who was not disinterested.[54]

46. *See id.*

47. *See id. at 681.*

48. *See id.*

49. *See id.*

50. *See In re Yuba Westgold, Inc.*, 157 B.R. 869, 872 (Bankr. N.D. Iowa 1993); *Wetzel Spring Improvement Corp. v. Fidelity Savings and Loan Co. (In re Hospitality, Ltd.)*, 86 B.R. 59, 65 (Bankr. W.D. Pa. 1988).

51. *See U.S. Trustee v. S.S. Retail Stores Corp. (In re S.S. Retail Stores Corp.*), 211 B.R. 699 (B.A.P. 9th Cir. 1997); *In re Timber Creek, Inc.,* 187 B.R. 240 (Bankr. W.D. Tenn. 1995); *Capen Wholesale Inc. v. Michel (In re Capen Wholesale, Inc.),* 184 B.R. 547 (N.D. Ill. 1995); *In re Creative Rest. Mgmt., Inc.*, 139 B.R. 902 (Bankr. W.D. Mo. 1992).

52. *See, e.g., In re Creative Rest. Mgmt., Inc.*, 139 B.R. at 909-14.

53. *See Official Comm. of Unsecured Creditors v. ABC Capital Mkts. Group (In re Capitol Metals Co.),* 228 B.R. 724, 727 (B.A.P. 9th Cir. 1998).

54. *See id. at* 727 (stating that by deciding otherwise, "the disinterestedness standard would be eradicated by corporate form over substance").

UNREPORTED DECISIONS WHERE CRISIS MANAGERS HAVE BEEN RETAINED DESPITE FAILURE TO BE DISINTERESTED

While the reported case law suggests that crisis managers must satisfy the requirements of section 327(a) in order to obtain court approval of their retention, several recent unreported bankruptcy court orders have indicated that retention may be allowed under other sections of the Bankruptcy Code. The Bankruptcy Court for the District of Delaware,[55] the Bankruptcy Court for the Central District of California,[56] and the Bankruptcy Court for the Southern District of New York,[57] have all held that crisis managers need not be subjected to the obstacles of section 327 but, instead, may be retained under section 363.[58] The focus of section 363 is on the debtor's proposed use of its assets and, if the debtor's determination to use such assets to retain a crisis manager represents a reasonable business judgment, the bankruptcy court should approve such use.[59] Therefore, the authority to retain crisis managers under section 363 would be more flexible in the employment of such professionals, since the crisis manager would not be disqualified solely for having served prepetition as an officer or director. Section 363 does not contain a disinterestedness requirement. In *In re Adelphia Communications Corp.*, however, the debtors filed affidavits disclosing adverse conflicts of the crisis managers, even though they recognized that section 363 did not require them to do so.[60] No reported opinions uphold this authority under section 363, the orders approving such retentions by the Delaware, California and New York Bankruptcy Courts notwithstanding.

55. *See In re Bill's Dollar Stores, Inc.,* No. 01-0435 (Bankr. D. Del. Mar. 14, 2001) (approving the retention of two officers with significant turnaround experience*); In re Imperial Home Décor Group, Inc.,* No. 00-19 (Bankr. D. Del. June 14, 2000) (approving the retention of a chief executive officer). *See also In re ICG Comm. Inc.,* No. 00-4238 (Bankr. D. Del. Feb. 26, 2001) (approving the retention of consultants).

56. *See In re Clothestime, Inc.,* No. SA95-22533-JW (Bankr. C.D. Cal. Feb 13, 1997) (approving the retention of a vice president).

57. *See In re Adelphia Communications Corp.*, No. 02-41729 (REG) (Bankr. S.D.N.Y. July 31, 2002).

58. Section 363(b) provides, in relevant part, that a debtor-in-possession "after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363 (2003).

59. *See, e.g.,Fulton State Bank v. Schipper (In re Schipper),* 933 F.2d 513, 515 (7th Cir. 1991); *Stephens Indus., Inc. v. McClung*, 789 F.2d 386, 390 (6th Cir. 1986); *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.),* 722 F.2d 1063, 1071 (2d Cir. 1983).

60. *See In re Adelphia Communications Corp.*, No. 02-41729 (REG) (Bankr. S.D.N.Y. July 12, 2002).

In addition, the Bankruptcy Court for the District of Delaware recently provided further support for the retention of crisis managers under section 363 by approving a settlement agreement[61] between Alix Partners, LLC (f/k/a Jay Alix & Associates), a prominent crisis management firm, and the United States Trustee. The settlement agreement resolved the Trustee's objections to Alix Partners, LLC's employment and compensation in two bankruptcy cases: *In re Harnischfeger Industries, Inc.*[62] and *In re Safety-Kleen Corp.*[63] According to the settlement agreement, if Alix Partners, LLC seeks to be retained as a debtor's crisis manager in future bankruptcy cases, it must do so under section 363. However, the settlement agreement appears to curtail the flexibility of section 363 retention because Alix Partners, LLC must disclose certain conflicts of interest or material adverse interests to the court in its application.[64] Also, Alix Partners, LLC may serve in only one capacity in a bankruptcy case (for example, as financial advisor, claims agent/administrator or investor/acquirer) and, upon confirmation of a plan, continue to serve only in a like capacity. Additionally, Alix Partners, LLC must file an application for compensation, subject to objections and review by the Court.

The Bankruptcy Court for the Southern District of New York has also approved retention of crisis managers under section 105(a), which provides courts with the broad authority to issue any order that "is necessary or appropriate to carry out the provisions of this title."[65] The flexibility of

61. Pursuant to the terms of the settlement agreement, Alix Partners, LLC agreed to disgorge approximately $3.25 million in fees and follow certain guidelines when seeking retention in chapter 11 cases pending in Region 3.

62. *See In re Harnischfeger Indus. Inc.*, No. 99-2171 (Bankr. D. Del. Oct. 4, 2001). Alix Partners, LLC was retained under section 327 as a financial advisor and the Trustee objected to such retention, in part, because several of Alix Partners, LLC's principals held director or officer positions with the debtors.

63. *See In re Safety-Kleen Corp.*, No. 00-2303 (PJW) (Bankr. D. Del. Oct. 4, 2001). Alix Partners, LLC sought retention as a restructuring consultant under section 327. The Trustee's objection to Alix Partners, LLC's application was based on, among other things, the fact that a principal of Alix Partners, LLC served prepetition as the debtors' CFO, and a principal of Alix Partners, LLC was to serve as an officer of the debtors during the bankruptcy cases.

64. Alix Partners, LLC's disclosure must include (1) its connections with creditors, equity holders, and the debtor's officers and directors, (2) its involvement as a creditor, (3) its prepetition role as an officer, director, employee or consultant, (4) its prepetition involvement in voting on the Board's decision to engage Alix Partners, LLC, (5) information on the composition of the Board so the Trustee can determine if the Board is truly independent, (6) existence of unpaid prepetition balances, and (7) any prepetition claims the debtors may have against Alix Partners, LLC from its prepetition engagement.

65. 11 U.S.C. (105)(a) (2003). *See In re Maidenform Worldwide, Inc.*, No. 97-44869 (CB) (Bankr. S.D.N.Y. Oct. 31, 1997). *See also In re Bidermann Indus. U.S.A., Inc.*, No. 95-43098

employment under section 105(a) was reduced, however, in *In re Maidenform Worldwide*, where the debtors submitted affidavits, disclosing adverse conflict of the crisis managers, not required by section 105.[66] Additionally, the bankruptcy court in *In re Maidenform Worldwide* required that the crisis managers' compensation was subject to approval pursuant to section 330, which grants the bankruptcy court discretion to approve the compensation of professional persons employed under section 327,[67] even though the court permitted the employment under section 105 and not section 327.[68]

SUGGESTED LEGISLATIVE CHANGE

Crisis managers are being increasingly employed by financially troubled companies as prepetition officers or directors of debtors. However, the confused state of the reported and unreported decisions governing crisis managers and disinterestedness suggests the need to modify the definition of disinterestedness in the Bankruptcy Code. The most straightforward legislative amendment would create an exception in the definition of "disinterested person" contained in § 101(14) of the Bankruptcy Code substantially as follows:

> § 101 Definitions
>
> In this title–
>
> * * *
>
> (14) "disinterested person" means a person that –
>
> (A) is not a creditor, an equity security holder, or an insider;
>
> (B) is not and was not an investment banker for any outstanding security of the debtor;
>
> (C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor;
>
> (D) is not and was not, within two years before the date of the filing of the petition, *(i)* a director, officer or employee of the

(TLB) (Bankr. S.D.N.Y. Sep. 21, 1995); *In re Forstmann & Co., Inc.*, No. 95-44190 (JLG) (Bankr. S.D.N.Y. Dec. 7, 1995).

66. *See In re Maidenform Worldwide, Inc.*, No. 97-44869 (CB) (Bankr. S.D.N.Y. Sept. 30, 1997).

67. *See* 11 U.S.C. 330 (2003).

68. *See In re Maidenform Worldwide, Inc.*, No. 97-44869 (CB) (Bankr. S.D.N.Y. Oct. 31, 1997).

> debtor *except where such person is or was a director, officer or employee of the debtor solely in connection with and during the employment of such person (or an entity of which such person is an employee or principal) as a crisis manager or workout specialist employed by the debtor to oversee a turnaround or liquidation of the debtor or (ii) a director, officer, or employee* of an investment banker specified in subparagraph (B) or (C) of this paragraph; and
>
> (E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in the subparagraph (B) or (C) of this paragraph, or for any other reason.

11 U.S.C. § 101(14) (2003) (suggested insertion in italics).

This statutory amendment should lessen the pressure on courts to shoehorn crisis manager retentions into other sections and permit the retention of crisis managers pursuant to section 327(a), provided that the section's other requirements are satisfied. Furthermore, continuing to require crisis manager retention under section 327(a) should be sufficient (i) to disqualify persons from employment where other aspects of their relationships with parties-in-interest create true conflicts with their continued employment and (ii) to circumscribe postpetition conduct of crisis managers who seek to deal inappropriately with debtors-in-possession or their assets. Additionally, employment under 327(a) would assure the prerequisite of submitting an application for allowance of compensation and having that compensation approved by the court under sections 328, 330 and 331. A court may limit the compensation agreed upon by the parties for a crisis manager employed under section 327 if it finds, among other things, the amount to be unreasonable or that the professional person is not disinterested.[69]

It should be noted that, even with the exception for crisis managers effected by the legislative change, a crisis manager may still not be disinterested for purposes of section 101(14)(A). Section 101(14)(A) provides that a person is not disinterested if that person is a "creditor" or "equity security holder."[70] These terms are defined in sections 101(10) and 101(17) of the Bankruptcy Code, respectively.[71] A "creditor" holds a "claim" against

69. *See* 11 U.S.C. § 328(a) and (c); 11 U.S.C. § 330; 11 U.S.C. § 331 (2003).

70. 11 U.S.C. § 101(14)(A) (2003).

71. *See* 11 U.S.C. § 101(10) (2003) (defining "creditor"); 11 U.S.C. § 101(17) (2003) (defining "equity security holder").

the estate that "arose at the time of or before the order for relief."[72] An "equity security holder" holds a residual interest in the debtor.[73] If a crisis manager holds a prepetition claim against the estate or an equity interest in the debtor, the crisis manager is not disinterested.[74] This can be dealt with by the debtor and the crisis manager, in the retention agreement, by not giving an equity interest to the crisis manager prepetition or postpetition.[75] Additionally, the debtor should ensure that the crisis manager does not hold a claim against the estate, as of the petition date, by prepaying the crisis manager for its services or by having the crisis manager waive the claim.[76] The debtor should also ensure that the crisis manager does not hold a prepetition indemnification claim or a postpetition indemnification claim for prepetition acts.[77] Special care should be taken in drafting the retention agreement with a crisis manager who serves as an officer or director, since the corporation's by-laws may provide for a contingent indemnification claim.[78]

72. 11 U.S.C. § 101(10) (2003); 11 U.S.C. § 101(5) (2003) (defining "claim").

73. 11 U.S.C. § 101(16) (2003) (defining "equity security"); 11 U.S.C. § 101(17) (2003) (defining "equity security holder").

74. *See* 11 U.S.C. 101(14)(A); *In re Yuba Westgold, Inc.*, 157 B.R. 869, 872 (Bankr. N.D. Iowa 1993) (holding that "creditor" management company was not disinterested).

75. *See* Kurt F. Gwynne, *Employment of Turnaround Management Companies, "Disinterestedness" Issues Under the Bankruptcy Code, and Issues under Delaware General Corporation Law*, 10 AM. BANKR. INST. L. REV. 673, 684 (Winter 2002).

76. *See id* at 684, 85; *In LKM Indus., Inc.*, 252 B.R. 589, 595 (Bankr. D. Mass. 2000); *In re Watervliet Paper Co.*, 111 B.R. 131, 133 (W.D. Mich. 1989).

77. *See* Kurt F. Gwynne, *Employment of Turnaround Management Companies, "Disinterestedness" Issues Under the Bankruptcy Code, and Issues under Delaware General Corporation Law*, 10 AM. BANKR. INST. L. REV. at 684; *In re Amfesco Indus., Inc.*, 81 B.R. 777, 781 (Bankr. E.D.N.Y. 1988); *In re Consol. Oil & Gas, Inc.*, 110 B.R. 535, 538 (Bankr. D. Colo. 1990). The Committee recognizes that there exist strong corporate policies that would support the position that crisis managers should be permitted to serve as postpetition officers while retaining their prepetition indemnification claims, since it would be difficult, if not impossible, to retain a crisis manager prepetition with the intention that he or she continue to serve postpetition without such indemnification. The Committee also acknowledges that there is no rationale for permitting officers and directors to serve both prepetition and postpetition, retaining all of their prepetition and postpetition indemnification claims, while crisis managers who served prepetition would have to waive their prepetition indemnification claims as preconditions to serving in the same capacities postpetition. However, this issue is beyond the scope of this article and, unfortunately, not in accord with the positions taken to date by both the courts and the U.S. Trustee.

78. *See* Kurt F. Gwynne, *Employment of Turnaround Management Companies, "Disinterestedness" Issues Under the Bankruptcy Code, and Issues under Delaware General Corporation*

Special care should also be taken in drafting the retention agreement to provide that the crisis managers retain advisory positions, while the directors and officers make the final decisions regarding the business.[79] Otherwise, the crisis managers may be said to be "insiders" of the debtor under sections 101(31)(B)(iii) and (F).[80] Categorization as an insider would render the crisis manager an insider under section 101(14)(A), causing the crisis manager to be ineligible for retention under section 327(a).[81] Ensuring that the crisis manager does not control the debtor's corporate decisions or corporate policy would also prevent the crisis manager from being termed an insider who has a "sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor."[82]

This legislative change would permit crisis managers to be effective in workouts, to continue to function effectively after a bankruptcy filing and to be able to do so in a way that treats them as the professionals they are.

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Law, 10 AM. BANKR. INST. L. REV. at 684; *In re Mid-Am. Waste Sys., Inc.*, 228 B.R. 816, 821-22 (Bankr. D. Del. 1999); *In re Consol. Oil & Gas, Inc.*, 110 B.R. at 538.

79. *See* Kurt F. Gwynne, *Employment of Turnaround Management Companies, "Disinterestedness" Issues Under the Bankruptcy Code, and Issues under Delaware General Corporation Law*, 10 AM. BANKR. INST. L. REV at 690-94.

80. 11 U.S.C. 101(31)(B)(iii) deems an insider one who is "in control of the [corporate] debtor." 11 U.S.C. 101(F) deems an insider one who acts as the "managing agent of the debtor." 11 U.S.C. 101(31)(B)(iii); 11 U.S.C. 101(F) (2003).

81. *See* Kurt F. Gwynne, *Employment of Turnaround Management Companies, "Disinterestedness" Issues Under the Bankruptcy Code, and Issues under Delaware General Corporation Law*, 10 AM. BANKR. INST. L. REV. at 689, *citing Ellenberg v. William Golberg & Co. (In re Sullivan Haas Coyle, Inc.)*, 208 B.R. 239, 243 (Bankr. M.D. Ga. 1997) (discussing the standard for a "person in control") and *Rush v. Riddle (In re Standard Stores, Inc.)*, 124 B.R. 318, 323-24 (Bankr. C.D. Cal. 1991) (discussing similar standard for a "managing agent").

82. *See* Kurt F. Gwynne, *Employment of Turnaround Management Companies, "Disinterestedness" Issues Under the Bankruptcy Code, and Issues under Delaware General Corporation Law*, 10 AM. BANKR. INST. L. REV. at 695 (noting that the categories comprising "insider" under section 101(31) are not exhaustive), *citing* S. Rep. No. 95-989 § 25 (1978); H.R. Rep. No. 95-595 § 312 (1977); *In re City of Columbia Falls*, 143 B.R. 750, 766 (Bankr. D. Mont. 1992) (quoting legislative history). The Committee recognizes that this approach would not be appropriate where, *e.g.*, a crisis manager is retained as a chief executive officer who functions in both a decision-making capacity and an advisory capacity. How this issue should be dealt with is beyond the scope of this article.

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