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Complex Chapter 11 Case Developments You Need to Know

Retention of Investment Bankers and Turnaround Advisors

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I. Retention of Professionals under the Bankruptcy Code

A. General

Section 327 of the Bankruptcy Code governs a chapter 11 debtor's retention of professionals. Section 327(a) of the Bankruptcy Code states:

> 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.

Professional persons include, without limitation, real estate brokers, investment advisors, management companies, business consultants, employment agencies, oil and gas operators and persons in those occupations which play a central role in the administration of the debtor's proceeding.[1] The United States Bankruptcy Court for the District of Delaware framed a list of factors to be considered when determining whether a person qualifies as a professional for purposes of Section 327(a).[2] The factors include the following: (i) whether the employee controls, manages, administers, invests, purchases or sells assets that are significant to the debtor's reorganization; (ii) whether the employee is involved in negotiating the terms of a plan of reorganization; (iii) whether the employment is directly related to the type of work carried out by the debtor or to the routine maintenance of the debtor's business operations; (iv) whether the employee is

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[1] *See In re CNH, Inc.*, 304 B.R. 177, 179 (Bankr. M.D. Pa. 2004); *citing In re Haley*, 950 F.2d 588, 590 (9th Cir. 1991); *In re Bicoastal Corp.*, 149 B.R. 216, 218 (Bankr. M.D. Fla. 1993); *In re Lowry Graphics, Inc.*, 86 B.R. 74, 78-79 (Bankr. S.D. Tex. 1988); *In re First Merchants Acceptance Corporation*, 1997 WL 873551, at *2 (D. Del. 1997); *In re First Security Mortgage Co., Inc.*, 117 B.R. 1001, 1006-7 (Bankr. N.D. Okla. 1990); *In re Fretheim*, 102 B.R. 298, 299 (Bankr. D. Conn. 1989).

[2] *See In re First Merchants Acceptance Corp.,* 1997 WL 873551, at *3 (Bankr. D. Del. 1997).

given discretion or autonomy to exercise his or her own professional judgment in some part of the administration of the debtor's estate; (v) the extent of the employee's involvement in the administration of the debtor's estate; and (6) whether the employee's services involve some degree of special knowledge or skill, such that the employee can be considered a "professional" within the ordinary meaning of the term.[3] Investment banking firms, turnaround firms and their members would be considered professionals pursuant to the foregoing factors and are subject to Section 327(a) of the Bankruptcy Code.

Generally, courts do not consider a debtor's officers to be professional persons; therefore, their employment is not subject to the requirements of Section 327(a).[4] Members of turnaround firms hired as officers of the debtor corporation are also not considered professional persons subject to the requirements of Section 327(a).[5]

B. Adverse Interests

Section 327(a) of the Bankruptcy Code implements a two prong analysis for determining the eligibility of professionals for which a chapter 11 debtor seeks to retain. The first prong requires that the professional not hold or represent an interest adverse to the debtor's bankruptcy estate. The Bankruptcy Code does not define "adverse interest" but the phrase has been interpreted to mean "(i) the possession or assertion of any economic interest that would tend to lessen the value of the bankruptcy estate or create an actual or potential dispute with the estate as a rival claimant, or (ii) a

[3] *See id.*
[4] *See In re eToys, Inc.*, 331 B.R. 176, 201 (Bankr. D. Del. 2005).
[5] *See id.*

predisposition of bias against the estate."[6] Courts have determined the existence of a adverse interest in instances in which the professional person represented the debtor's officers, provided prior service to the debtor as an officer or director, held a pre-petition claim against the debtor's estate or acted as agent for a major equity holder of the debtor.[7]

C. Disinterested Person

The second prong of Section 327(a) requires that the professional seeking retention by the debtor be a disinterested person. Section 101(14) defines a disinterested person as a person that:

> (1) is not a creditor, an equity security holder, or an insider;
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> (2) 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
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> (3) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.[8]

A creditor is defined within the Bankruptcy Code as an entity that holds a claim against the debtor[9] and an equity security holder is defined within the Bankruptcy Code as the holder of an equity security of the debtor.[10] Equity securities include stock in a corporation, limited partner interest in a limited partnership or rights to purchase an

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[6] *See In re Granite Partners, L.P.,* 219 B.R. 22, 33 (Bankr. S.D.N.Y 1998).
[7] *See* COLLIER ON BANKRUPTCY ¶327.04[2][b]; *citing In the Matter of Tauber on Broadway, Inc.*, 271 F.2d 766, 770 (7th Cir. 1959); *In re Wells Benrus Corp.*, 48 B.R. 196, 198 (Bankr. D. Conn. 1985); *In re Gallegos*, 68 B.R. 584, 586-7 (Bankr. D.N.M. 1986); *In re Gray*, 64 B.R. 505, 507-8 (Bankr. E.D. Mich. 1986); *In re Kendavis Indus. Int'I Inc.*, 91 B.R. 742, 748 (Bankr. N.D. Tex 1988).
[8] *See* 11 U.S.C. § 101(14).
[9] *See* 11 U.S.C. § 101(10).
[10] *See* 11 U.S.C. §§ 101(17).

interest in a corporation or partnership.[11] Courts routinely hold creditors[12] and holders of equity security interests[13] to not be disinterested persons, and therefore ineligible for retention as a professional for the debtor. A debtor's insiders, as defined in Section 101(31) of the Bankruptcy Code, are also not disinterested persons.[14] Insiders include officers, directors, shareholders, general partners or other persons in control of the debtor. Finally, a disinterested person must not have an interest materially adverse to the interest of the estate. This "catch all" provision is considered by many courts to be duplicative of the first "adverse interest" prong.[15]

The courts are split as to scrutiny applied to the "disinterested person" standard and whether a professionals potential conflicts of interest result in a per se disqualification.[16] Other courts review retention of professionals on a case by case

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[11] *See* 11 U.S.C. § 101(16).

[12] *See In re Fulgham Enterprises, Inc.*, 181 B.R. 139 (Bankr. N.D. Ala. 1995); *In re Eastern Charter Tours, Inc.*, 167 B.R. 995 (Bankr. M.D. Ga. 1994); s*ee also* COLLIER ON BANKRUPTCY ¶327.04[2][a][iii][A]; *citing United States Trustee v. Price Waterhouse,* 19 F.3d 138 (3d Cir. 1994)*; In re Martin,* 817 F.2d 175 (1st Cir. 1987)*; In re Siliconix, Inc.,* 135 B.R. 378 (N.D. Cal. 1991)*; In re Roberts,* 75 B.R. 402 (D. Utah 1987)*; In re LKM Indus., Inc*., 252 B.R. 589 (Bankr. D. Mass. 2000)*; In re Princeton Med. Mgmt., Inc.,* 249 B.R. 813 (Bankr. M.D. Fla. 2000)*; In re Hub Business Forms, Inc., 146 B.R. 315 (*Bankr. D. Mass. 1992)*; In re Viking Ranches, Inc.,* 89 B.R. 113 (Bankr. C.D. Cal. 1988)*; In re Flying E Ranch Co.,* 81 B.R. 633 (Bankr. D. Colo. 1988); *In re Boro Recycling, Inc.,* 67 B.R. 3 (Bankr. E.D.N.Y. 1986); *In re Gray,* 64 B.R. 505 (Bankr. E.D. Mich. 1986); *In re Estes,* 57 B.R. 158 (Bankr. N.D. Ala. 1986); *In re Nashville Union Stockyard Restaurant, Co.,* 54 B.R. 391 (Bankr. M.D. Tenn. 1985); *In re Patterson,* 53 B.R. 366 (Bankr. D. Neb. 1985); *In re Codesco, Inc.,* 18 B.R. 997 (Bankr. S.D.N.Y. 1982).

[13] *See* COLLIER ON BANKRUPTCY ¶327.04[2][a][iii][B]; *citing In re See Apex Mgmt. Corp. v. WSR Corp., 225 B.R. 640, 645 (3d Cir. 2002); See In re Anver Corp. 44 B.R. 615 (Bankr. D. Mass. 1984); In re The Cropper Co., 35 B.R. 625 (Bankr. M.D. Ga. 1983).*

[14] *See In re Silver Oak Homes, Ltd.,* 167 B.R. 389 (Bankr. D. Md. 1994)*; In re Lakeside I Corp.,* 120 B.R. 231 (Bankr. M.D. Fla. 1990)*; In re Essential Therapeutics, Inc,* 295 B.R. 203 (Bankr. D. Del. 2003)*; In re United Color Press, Inc.,* 129 B.R. 143 (Bankr. S.D. Ohio 1991)*; In re San Juan Hotel Corp.,* 71 B.R. 413 (D. Puerto Rico 1987).

[15] *See* COLLIER ON BANKRUPTCY ¶327.04[2]; *citing In re Vebeliunas*, 231 B.R. 181, 189 (Bankr. S.D.N.Y. 1999); *In re Envirodyne Indus., Inc.*, 150 B.R. 1008, 1017 (Bankr. N.D. Ill. 1993); *In re Tinley Plaza Assocs., L.P.*, 142 B.R. 272, 277 (Bankr. N.D. Ill. 1992); *In re Martin*, 817 F.2d 175, 179 n.6 (1st Cir. 1987); *In re Mercury*, 280 B.R. 35, 53 (Bankr. S.D.N.Y. 2002); *In re Roberts*, 46 B.R. 815, 828 (Bankr. D. Utah 1985); *In re Cropper Company, Inc*., 35 B.R. 625, 631 (Bankr. M.D. Ga. 1983).

[16] The Fifth, Sixth and Eighth Circuits hold the "disinterested" standard to be a per se rule. *See In re Consolidated Bankshares, Inc.*, 785 F.2d 1249, 1256 (5th Cir. 1986); *In re Middleton Arms, L.P.*, 934 F.2d 723, 725 (6th Cir. 1991); *See In re Pierce*, 809 F.2d 1356 (8th Cir. 1987).

approach.[17] The First Circuit Court of Appeals adopted a case by case approach and enumerated certain specific considerations in determining whether a professional was a disinterested person for purposes of retention under section 327(a) of the Bankruptcy Code.[18] Specifically, the Court recommended the following considerations when reviewing whether a professional is eligible for retention by the debtor:

> (i) the reasonableness of the arrangement and whether it was negotiated in good faith; (ii) whether the security demanded was commensurate with the predictable magnitude and value of the foreseeable services (iii) whether it was a needed means of ensuring the engagement of competent counsel; (iv) whether or not there are telltale signs of overreaching; (v) the nature and extent of the conflict and the likelihood that a potential conflict might turn into an actual one; (vi) the influence the putative conflict may have in subsequent decision making; (vii) how the matter likely appears to creditors and to other parties in legitimate interest; (viii) whether the existence of the security interest threatens to hinder or to delay the effectuation of a plan; (ix) whether it is (or could be perceived as) an impediment to reorganization; and (x) whether the fundamental fairness of the proceedings might be unduly jeopardized (either by the actuality of the arrangement or by the reasonable public perception of it).[19]

Other courts have followed this approach and reviewed the totality of circumstances surrounding a debtor's retention of a professional.[20]

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[17] *See* COLLIER ON BANKRUPTCY ¶327.04[2][a][i]; *discussing In re Martin*, 817 F.2d 175, 182 (1st Cir. 1987); *In re Pacific Express, Inc.*, 56 B.R. 859 (Bankr. E.D. Cal. 1985); *In re O'Connor*, 52 B.R. 892, 899 (Bankr. W.D. Okla. 1985).
[18] *See In re Martin*, 817 F.2d 175, 182 (1st Cir. 1987).
[19] *See id.*
[20] *See also In re Automend, Inc.*, 85 B.R. 173, 176 (Bankr. N.D. Ga. 1988); *In re Harold & William Dec. Co.*, 977 F.2d 906, 909 (4th Cir. 1992).

II. Retention of Investment Bankers and Turnaround Advisors

A. The Revised Definition of Disinterested Person

Prior to Congress' passage of the Bankruptcy Abuse Prevention & Consumer Protection Act of 2005 (the "Act"), investment bankers and their counsel involved with the offer, sale or issuance of a debtor's securities were not disinterested persons due to a specific reference in section 101(14) of the Bankruptcy Code. The Act revised the definition of disinterested person and deleted all references to investment bankers or their counsel from section 101(14) of the Bankruptcy Code. Therefore, due to Congress' revisions, investment bankers are no longer automatically disqualified from retention by chapter 11 debtors as disinterested persons. Nevertheless, their retention is still subject to the requirements of Bankruptcy Code section 327(a) as previously discussed herein.

B. Specific Issues Concerning Retention of Investment Bankers and Turnaround Advisors

As previously discussed, a professional seeking employment by a debtor may not be a creditor of the debtor's estate. Investment banking firms and turnaround firms seeking to be employed by a debtor may often hold pre-petition claims against the debtor in connection with either their involvement in the pre-petition offer, sale or issuance of a debtor's securities or their pre-petition employment as restructuring advisors. Obviously, the simplest resolution of a pre-petition claim conflict would be a waiver of such claims by the investment banking firm or turnaround firm. Alternatively, debtors may seek to assume their pre-petition agreements with these professionals pursuant to section 365 of the Bankruptcy Code or seek approval of these arrangements

pursuant to section 363 of the Bankruptcy Code as a use of the debtor's property outside the ordinary course of business.[21]

Professionals seeking retention by a chapter 11 debtor may not hold an equity interest in the debtor in order to satisfy the disinterested standard. Therefore, investment banking firms must sale any of the debtor's securities it may own prior to seeking court approval of its retention as a professional. Some courts have allowed an affiliate of the investment banking firm seeking retention to hold securities of the debtor so long as the affiliate firm did not provide services to the debtor during its bankruptcy case.[22] Other courts reject the retention of an investment banking firm if its affiliate owns the debtor's securities.[23]

Investment banking firms and turnaround firms must also be careful that their members are not "insiders" of the debtor.[24] As previously discussed, insiders can be officers, directors or other persons in control of the debtor. This issue is of particular significance for turnaround firms. In many complex chapter 11 cases, the debtors utilize specific members of a turnaround firm to act as chief restructuring officer or chief financial officer during the pendency of the chapter 11 case. Because officers are not professionals subject to section 327(a) of the Bankrupty Code, they are most often hired by the debtor pursuant to section 363(b) of the Bankruptcy Code. However, this presents

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[21] *See* American Bankruptcy Institute Mid Atlantic Bankruptcy Workshop, *Retain, Maintain, Contain: The Latest on Retention of Professionals*, ¶ I.E.2 (August 2005).

[22] *See* James Bromley and Sean O'Neil, *Bankruptcy Reform Act Loosens Restrictions on the Engagement of Investment Bankers*, THE M & A LAWYER (May 2005); *discussing In re Enron Corp.,* 2003 WL 223455 (Bankr. S.D.N.Y. 2003); *Vergos v. Timber Creek, Inc.,* 200 B.R. 624 (Bankr. W.D. Tenn. 1996); *In re Chicago South Shore and South Bend R.R.,* 101 B.R. 10 (Bankr. N.D. Ill. 1989).

[23] *See* James Bromley and Sean O'Neil, *Bankruptcy Reform Act Loosens Restrictions on the Engagement of Investment Bankers*, THE M & A LAWYER (May 2005); *discussing In re Essential Therapeutics, Inc.*, 295 B.R. 203 (Bankr. D. Del. 2003); *In re Trust Am. Ser. Corp.*, 175 B.R. 413 (Bankr. M.D. Fla. 1994).

[24] Investment banking firms can not be disinterested if their investment bankers are officers, shareholders or directors of the debtor. *See* C.R. "Chip" Bowles, *A Weird New World: Disinterestedness for Investment Bankers under New 11 U.S.C. § 101(14)*, AM. BANKR. INST. J. (February 2006); *discussing Matter of Krehl*, 86 F.3d 737 (7th Cir. 1996).

a significant problem should the debtor also desire to retain the turnaround firm as its professional restructuring and financial advisor.[25] Restructuring and financial advisors are professionals and therefore subject to section 327 of the Bankruptcy Code. Retention of specific members of the turnaround firm as officers of the debtor prevents the turnaround firm from being "disinterested" pursuant to section 101(14)(A) of the Bankruptcy Code. In an effort to remedy this potential conflict, the U.S. Trustee for Region 3 (Delaware, New Jersey and Pennsylvania) established procedural guidelines for a chapter 11 debtor's retention of turnaround firms (the "Guidelines").[26] The Guidelines allow debtors to either (i) hire the turnaround firm pursuant to section 363(b) of the Bankruptcy Code to provide its members as officers of the debtor; or (ii) hire the turnaround firm pursuant to section 327 of the Bankruptcy Code to act as restructuring and financial advisors to the debtor.[27] Although helpful, the Guidelines are not without fault. The complexity of many chapter 11 cases necessitates an individual member of a turnaround firm to act as chief restructuring officer and a turnaround firm to provide professional restructuring and financial advisory services.[28] Therefore, rather than require debtors to choose between two crucial needs or run the risk of its professionals not being disinterested, the chapter 11 debtor may prefer to utilize the services of two turnaround firms, one firm to provide its members to serve as officers of the debtor while the other provides its services as the debtor's professional restructuring and financial

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[25] *See* Michael P. Cooley, *Two Round Holes and One Square Peg: The Employment of Turnaround Consultants under Sections 327 and 363*, AM. BANKR. INST. J. (September 2005).
[26] *See* GETTING PAID: RETENTION AND COMPENSATION IN BANKRUPTCY CASES- A GUIDE FOR NON-ATTORNEY PROFESSIONALS, 15, 149 (C.R. "Chip" Bowles ed.).
[27] *See id.* at 20.
[28] *See* Michael P. Cooley, *Two Round Holes and One Square Peg: The Employment of Turnaround Consultants under Sections 327 and 363*, AM. BANKR. INST. J. (September 2005).
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advisor.[29] Although not an ideal solution, this mechanism satisfies the dual purpose of providing competent professionals to assist the debtor in its complex chapter 11 case and compensating those professionals within the statutory framework provided by the Bankruptcy Code.

C. Disclosures Pursuant to Bankruptcy Rule 2014

In connection with the retention of a debtor's professionals, including, without limitation, investment banking firms and turnaround firms, each potential professional to be employed must comply with the disclosure requirements of Bankruptcy Rule 2014.[30] Bankruptcy Rule 2014 provides:

> 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 …. 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.

[29] *See id.* at 59, note 27.

[30] *See In re eToys, Inc.*, 331 B.R. at 197 (failure to disclose all connection with other parties in a case may result in disallowance of fees or disqualification); *see also In re Granite Partners, L.P.*, 219 B.R. at 35 (proper disclosure allows courts to decide if retention should be approved).

Because investment banking firms and turnaround firms often establish a relationship with a debtor long before the chapter 11 case is filed, it is important that all compensation received prior to filing is disclosed to the bankruptcy court. Investment banking firms and turnaround firms should also ensure that payments received ninety (90) days prior to the debtor's filing date "are both timely received and well documented" so as to avoid a potential preference.[31] Further, due to the large number of creditors in a complex chapter 11 case and the vast number of clients investment banking firms and turnaround firms represent, it is very important that such firms conduct a detailed review of all potential conflicts check to determine any and all clients that may be creditors of the debtor or other parties in interest. Most courts allow professionals to be retained despite their representation of a creditor in unrelated or non-material matters but complete disclosure is vital to any professional's application for employment.[32]

III. Conclusion

Investment banking firms and turnaround firms provide extremely valuable services to the complex chapter 11 case. Without these professionals, chapter 11 debtors would face an inability to operate theirs businesses and manage their assets in order to achieve the best possible results for their estates and their creditors. Therefore, a thorough understanding of the issues surrounding retention of these professionals is necessary in order to develop strategies for the retention of such professionals within the

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[31] *See* C.R. "Chip" Bowles, *A Weird New World: Disinterestedness for Investment Bankers under New 11 U.S.C. § 101(14)*, AM. BANKR. INST. J. (February 2006); discussing *In re Pillowtex*, 304 F.3d 246 (3rd Cir. 2002).

[32] *See* C.R. "Chip" Bowles, *A Weird New World: Disinterestedness for Investment Bankers under New 11 U.S.C. § 101(14)*, AM. BANKR. INST. J. (February 2006); *discussing In re Marvel Entertainment Group, Inc.*, 140 F.3d 463 (3rd Cir. 1998).

statutory framework provided by the Bankruptcy Code. Similar to the case by case analysis employed by the bankruptcy courts to determine a professional's eligibility for retention by a chapter 11 debtor, investment banking firms and turnaround firms must work closely with their debtor clients and counsel to determine the best mechanism for retention based on the totality of circumstances in each particular complex chapter 11 case.