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**Retaining the CRO Post-Petition**

**Background on Chief Restructuring Officers**

A Chief Restructuring Officer (“CRO”) is a seasoned turnaround professional with crisis management experience. He or she is an outsider to the distressed company who brings an objective and unbiased perspective to the restructuring process. The CRO manages the bankruptcy process and has the operational knowledge and strategic focus to guide the company to recovery. The retention of a CRO frees up the CEO to stay focused on the day-to-day operations of the company.

Once retained by a distressed company, the CRO must assess the long-term viability of the company and determine the path to maximize value for shareholders. A critical component to this process is shoring up the balance sheet. Typically, the CRO will focus on cash flow and seek out methods to maximize liquidity. At the same time, the CRO needs to retain as much corporate value as possible for the creditors. The CRO will often look to improve working capital by stretching payables and shortening the collection period for receivables. In addition, the CRO may review the company’s physical assets and identify opportunities to convert non-essential assets to cash. Through these and other methods, the CRO works to improve liquidity and prepare the company for reorganization.

In addition to his or her primary responsibility of cleaning of the balance sheet, the CRO is charged with maintaining transparent and unbiased communications with all stakeholders. A successful restructuring often hinges on the cooperation of key creditors and stakeholders and the credibility of information communicated by the CRO. Therefore, the CRO has experience negotiating with creditors and is able to engender consensus among the disparate stakeholders involved in a bankruptcy.

Finally, the CRO is well-versed in the bankruptcy code and understands the nuances of the restructuring process. This skill is pivotal as there are numerous reporting requirements and deadlines that are specific to bankruptcy. One such reporting requirement is the Monthly Operating Reports (“MORs”) that are filed with the bankruptcy court. In addition, the Debtor-in-Possession (“DIP”) loan often has reporting requirements attached in addition to standard financial covenants. Having an experienced professional such as a CRO managing the bankruptcy-related reporting is a key step to navigating the process successfully.

### **The Standard for Retention: §327**

General authority for the Debtor to hire professionals is section 327(a) of the bankruptcy code. “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. Section 327(c) mandates disqualification of a professional if there is an “actual conflict of interest.” Section 327(a) requires that the professional to be employed must be a “disinterested person” defined as a person that-

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

### **The Disinterestedness Problem**

If the financial advisor serves as an Officer of the company pre-petition, can he/she be disinterested post-petition? It is not unusual for a company in distress, often at the urging of its lenders, to engage a financial advisor as CRO before the company files for bankruptcy. In some cases this is to attempt a negotiated out-of-court settlement to avoid a bankruptcy filing, but in other cases it is to prepare the company for a planned bankruptcy filing. If the pre-petition CRO is effective, it makes little sense to force the Debtor to change leadership after a bankruptcy filing as this may damage the recovery to the creditors. However 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.

### **The Protocol Solution**

In a settlement between Jay Alix & Associates and the United States Trustee’s Office, a protocol for the engagement of financial advisors who serve in officer roles in pre and/or post-petition service to companies was established (the “Protocol” attached as exhibit 1). This Protocol has subsequently been used by financial advisors seeking retention in bankruptcy in several jurisdictions including Delaware and Southern District of New York. The general rules involve the establishment of a service company that would be retained under §363. The Protocol also established rules for disclosure, compensation and governance. In its retention the financial advisor shall disclose the individuals indentified for executive officer positions as well as the names and proposed functions of any additional staff to be furnished. In the event the Debtor or the financial advisor seeks to assume additional or different executive officer positions, or to modify materially the functions of the persons engaged, a motion to modify the retention shall be

filed. In addition, the financial advisor shall file with the Court with copies to the UST and all official committees a report of staffing on the engagement for the previous month. Such report shall include the names and functions filled of individuals assigned.

The Protocol also sets up disclosure requirements in the event of a §363 retention including:

Any connection, relationship or affiliation with secured creditors, post-petition lenders, significant unsecured lenders, equity holders, current or former officers and directors, prospective buyers, or investors.

1. Involvement as a creditor, service provider or professional of any entity with which the financial advisor or any affiliate has an alliance agreement, marketing agreement, joint venture, referral arrangement or similar agreement.
2. Any prepetition role as officer, director, employee or consultant, but service as a pre-petition officer will not per se cause disqualification.
3. Any prepetition involvement in voting on the decision to engage the financial advisor in the bankruptcy case, and/or any prepetition role carrying the authority to decide unilaterally to engage the financial advisor.
4. Information regarding the size, membership and structure of the Board so as to enable the UST and other interested parties to determine that the Board is independent.
5. Whether the executive officers and other staff for the engagement are expected to be engaged on a full time or part time basis, and if part-time whether any simultaneous or prospective engagement exists that may be pertinent to the question of conflict or adverse interest.
6. The existence of any unpaid balances for prepetition services.
7. The existence of any asserted or threatened claims against the financial advisor or any person furnished by the financial advisor arising from any act or omission in the course of a prepetition engagement.

Hiring and supervision of the financial advisor retained under this Protocol is explicitly the duty of the board of directors. Persons furnished by the financial advisor for executive officer positions shall be retained in such positions upon the express approval thereof by obligations as required under applicable law (“Board”), and will act under the direction, control and guidance of the Board and shall serve at the Board’s pleasure (*i.e.*, may be removed by majority vote of the Board.) Special procedures are established for compensation. The application to retain the financial advisor shall disclose the compensation terms including hourly rates and the terms under which any success fee or back-end fee may be requested. The financial advisor shall file with the Court, and provide notice to the UST and all official committees, reports of compensation earned and expenses incurred on at least a quarterly basis. Such reports shall summarize the services provided, identify the compensation earned by each executive officer and staff employee provided, and itemize the expenses incurred. The notice shall provide a time period for objections. All compensation shall be subject to review by the Court in the event an objection is filed (*i.e.*, a “negative notice” procedure.) Success fees or other back-end fees shall

be approved by the Court at the conclusion of the case on a reasonableness standard and shall not be pre-approved under section 328 (a). no success fee or back-end fee shall be sought upon conversion of the case, dismissal of the case for cause or appointment of a trustee.

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. Through the establishment of the disclosure requirements and the compensation procedures the retention under 363 following the protocol does not differ materially from retention under section 327 except that pre-petition service as an officer of the company is exempt from disqualification resulting from not being disinterested.

### **Blue Stone**

The Blue Stone case contrasts the role of the CRO with the role of a chapter 11 trustee. The court first addressed whether the role of the Debtor (and therefore the CRO acting as an officer of the Debtor) could be expanded to the equivalency of a Chapter 11 trustee. This first issue does not directly address the roles and responsibilities of the CRO. The questions raised by the Court are therefore left for another discussion. It is understood that the CRO, as an officer of the company, is empowered to act in the capacities of the company. The second issue is more relevant to this discussion of the protocol for hiring a CRO. In the Blue Stone decision the court posits that it can insulate the CRO from any taint of the incumbent management and their actions by removing the board from supervision of the CRO. The protocol is not a Chinese menu. In order to address U. S. Trustee concerns about failure to meet the disinterestedness requirement under section 327 an entire protocol was put into place that included elements addressing disclosure, governance, and compensation procedures. A key element of the Protocol is the direct supervision of the CRO by the board of directors. Without this supervision the Protocol cannot be used to for retention for the CRO under section 363. In the case of Blue Stone the CRO the court properly instructed that the CRO would need to be retained under 327 as the conditions prescribed in the Protocol cannot be met. And considering that the CRO retention in Blue Stone is occurring after the filing of the case the disinterestedness problem does not exist and 327 would be the appropriate retention.

**Protocol for Engagement of Jay Alix & Associates and Affiliates****I. Retention Guidelines**

- A. Jay Alix & Associates (“JA&A”) is a firm that provides turnaround and crisis management services, financial advisory services, management consulting services, information systems services and claims management services. In some cases the firm provides these services as advisors to management, in other cases one or more of its staff serve as corporate officers and other of its staff fill positions as full time or part time temporary employees (“crisis manager”), and in still other cases the firm may serve as a claims administrator as an agent of the Bankruptcy Court. JA&A and its affiliates<sup>1</sup> will not act in more than one of the following capacities in any single bankruptcy case: (i) crisis manager retained under Sec. 363, (ii) financial advisor retained under Sec. 327, (iii) claims agent/claims administrator appointed pursuant to 28 U.S.C. § 156(c) and any applicable local rules or (iv) investor/acquirer; and upon confirmation of a Plan may only continue to serve in a similar capacity. Further, once JA&A or one of its affiliates is retained under one of the foregoing categories it may not switch to a different retention capacity in the same case. However, with respect to subsequent investments by Questor this prohibition is subject to the time limitations set forth in IV.B below.
- B. Engagements involving the furnishing of interim executive officers<sup>2</sup> whether prepetition or postpetition (hereinafter "crisis management" engagements) shall be provided through JA&A Services LLC ("JAS").
- C. JAS shall seek retention under section 363 of the Bankruptcy Code. The application of JAS shall disclose the individuals identified for executive officer positions as well as the names and proposed functions of any additional staff to be furnished by JAS. In the event the Debtor or JAS seeks to assume additional or different executive officer positions, or to modify materially the functions of the persons engaged, a motion to modify the retention shall be filed. It is often not possible for JAS to know the extent to which full time or part time temporary employees will be required when beginning an engagement. In part this is

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

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

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

- D. Persons furnished by JAS for executive officer positions shall be retained in such positions upon the express approval thereof by an independent Board of Directors whose members are performing their duties and obligations as required under applicable law ("Board"), and will act under the direction, control and guidance of the Board and shall serve at the Board's pleasure (*i.e.* may be removed by majority vote of the Board).
- E. The application to retain JAS shall make all appropriate disclosures of any and all facts that may have a bearing on whether JAS, its affiliates, and/or the individuals working on the engagement have any conflict of interest or material adverse interest, including but not necessarily limited to the following:
  - 1. Connection, relationship or affiliation with secured creditors, postpetition lenders, significant unsecured lenders, equity holders, current or former officers and directors, prospective buyers, or investors.
  - 2. Involvement as a creditor, service provider or professional of any entity with which JA&A or any affiliate has an alliance agreement, marketing agreement, joint venture, referral arrangement or similar agreement.
  - 3. Any prepetition role as officer, director, employee or consultant,<sup>3</sup> but service as a pre-petition officer will not *per se* cause disqualification.
  - 4. Any prepetition involvement in voting on the decision to engage JA&A or JAS in the bankruptcy case, and/or any prepetition role carrying the authority to decide unilaterally to engage JA&A or JAS.
  - 5. Information regarding the size, membership and structure of the Board so as to enable the UST and other interested parties to determine that the Board is independent.

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

6. Whether the executive officers and other staff for the engagement are expected to be engaged on a full time or part time basis, and if part-time whether any simultaneous or prospective engagement exists that may be pertinent to the question of conflict or adverse interest.
  7. The existence of any unpaid balances for prepetition services.
  8. The existence of any asserted or threatened claims against JA&A, JAS or any person furnished by JA&A/JAS arising from any act or omission in the course of a prepetition engagement.
- F. Disclosures shall be supplemented on a timely basis as needed throughout the engagement.
- G. Where JA&A does not act as a crisis manager its retention will be sought as a financial advisor under section 327 of the Code or as a Court appointed claims representative.

## II. Compensation

- A. Compensation in crisis management engagements shall be paid to JAS.
- B. The application to retain JAS shall disclose the compensation terms including hourly rates and the terms under which any success fee or back-end fee may be requested.
- C. JAS shall file with the Court, and provide notice to the UST and all official committees, reports of compensation earned and expenses incurred on at least a quarterly basis. Such reports shall summarize the services provided, identify the compensation earned by each executive officer and staff employee provided, and itemize the expenses incurred. The notice shall provide a time period for objections. All compensation shall be subject to review by the Court in the event an objection is filed (*i.e.*, a "negative notice" procedure).
- D. Success fees or other back-end fees shall be approved by the Court at the conclusion of the case on a reasonableness standard and shall not be pre-approved under section 328(a). No success fee or back-end fee shall be sought upon conversion of the case, dismissal of the case for cause or appointment of a trustee.

## III. Indemnification

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

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

IV. Subsequent Engagements

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

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