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Feature

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Emerging Trends and Lingering Criticisms: A CRO Retention Update



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Since the use of chief restructuring officers (CROs) in chapter 11 cases first became prevalent in the 1990s, the process of retaining a CRO has evolved, and while § 327(a) of the Bankruptcy Code had long been the traditional statutory basis for CRO retention, it had never been used exclusively.¹ In his October 2011 *Journal* article, **Kevin M. Baum** (Katten Muchin Rosenman LLP; Rockville Centre, N.Y.) described four alternative statutory bases for retaining a CRO: §§ 327(a), 327(b), 363(b)(1) and 363(c)(1).² In the last several years, however, a trend appears to have emerged under which most CRO retention applications are made pursuant to §§ 105(a) and 363(b)(1), rather than § 327(a) or (b), or § 363(c)(1).

This article will first discuss the basics of CRO retention pursuant to §§ 105(a) and 363(b)(1), and describe the expansion of this approach from the Southern District of New York to jurisdictions throughout the country. Next, this article will describe the advantages that CRO retention pursuant to §§ 105(a) and 363(b)(1) offers compared with § 327(a). Finally, this article will discuss specific concerns with CRO retention pursuant to §§ 105(a) and 363(b)(1) that have been raised in certain jurisdictions, and identify steps that debtors can take to increase the likelihood of successfully retaining a CRO pursuant to §§ 105(a) and 363(b)(1).

CRO Retention Pursuant to §§ 105(a) and 363(b)(1)

Traditionally, CROs were retained in the same fashion as other professionals in chapter 11 cases, pursuant to § 327(a), which provides that a debtor, subject to court 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 debtor].”³ Recently however, a trend appears to have emerged under which most CRO retention applications are made pursuant to §§ 105(a) and 363(b)(1).

The argument for CRO retention pursuant to §§ 105(a) and 363(b)(1) is straightforward. Paying a CRO is a use of the debtor’s funds other than in the ordinary course of business permitted by § 363(b)(1), which provides that a debtor, “after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.”⁴ Further, pursuant to § 105(a), the “court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”⁵ In considering a debtor’s application to retain a CRO pursuant to § 363(b)(1), a court will evaluate whether there is a sound business purpose for the CRO retention.⁶

Courts that approve a debtor’s application to retain a CRO pursuant to §§ 105(a) and 363(b)(1) will often require the debtor to comply with the so-called “Jay Alix Protocols.”⁷ These protocols were developed in 2001 as part of a settlement between the U.S. Trustee and Jay Alix & Associates concerning applications by debtors in two chapter 11 cases in the District of Delaware to retain one of the

3 11 U.S.C. § 327(a); see, e.g., *In re Bartley Lindsay*, 120 B.R. 507, 512 (Bankr. D. Minn. 1990).

4 11 U.S.C. § 363(b)(1).

5 11 U.S.C. § 105(a). Although most CRO retention applications filed pursuant to § 363(b) also rely on § 105(a), this is not always the case. Compare *In re Saint Vincent’s Catholic Med. Ctrs. of N.Y.*, No. 10-11963 (Bankr. S.D.N.Y. 2010) (filed pursuant to §§ 363(b) and 105(a)), with *In re Grede Foundries Inc.*, No. 09-14337 (Bankr. W.D. Wis. 2009) (filed pursuant to § 363(b)).

6 *In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 153 (Bankr. D. Del. 1999) (considering whether to approve key officer- and employee-incentive programs).

7 Kelly Beaudin Stapleton, John D. Penn and Andrew R. Vara, “Business Ethics: Maginot Lines? Examining and Enforcing the Duties Owed by Officers, Financial Advisors and Counsel,” 100110 ABI-CLE 285, *9-11 (2010).

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

2 Kevin M. Baum, “The Basics for Retaining a CRO,” *Am. Bankr. Inst. J.*, 8, 50-51, 71, October 2011.

firm's partners as a CRO pursuant to § 363(b)(1).⁸ The key elements of the protocols include the following:

- The professional may only serve in one capacity (*i.e.*, as a CRO, crisis manager, financial adviser, claims agent or investor);
- The professional may not be a member of the debtor's board or have served on the board within the two years prior to the petition date;
- The professional must disclose its relationships with all interested parties; and
- The professional's compensation will be reviewed under a reasonableness standard at the end of the case; however, the professional is not required to file a formal fee application, and any success fees payable to the professional must be approved at the conclusion of the case.⁹

Despite the fact that they are not binding law, the Jay Alix Protocols have become *de facto* requirements for CRO retention pursuant to §§ 105(a) and 363(b)(1) in the Southern District of New York and the District of Delaware,¹⁰ and in recent years, the practice of approving CRO retentions pursuant to §§ 105(a) and 363(b)(1) and adopting the Jay Alix Protocols in CRO retention orders has expanded to other jurisdictions throughout the country.¹¹ Considering the advantages that CRO retention pursuant to §§ 105(a) and 363(b)(1) offers as compared to § 327(a), it is no surprise that many debtors seeking to retain a CRO now take this approach.¹²

Advantages of CRO Retention Pursuant to §§ 105(a) and 363(b)(1)

CRO retention pursuant to §§ 105(a) and 363(b)(1) offers several advantages as compared to retention of a CRO as a "professional person" pursuant to § 327(a). Perhaps the most notable is that a CRO retained pursuant to §§ 105(a) and 363(b)(1) is not required to file fee applications pursuant to §§ 330 and 331 of the Bankruptcy Code. Nevertheless, frequently at the U.S. Trustee's urging, courts that approve CRO retention pursuant to §§ 105(a) and 363(b)(1) will often require the CRO to file monthly "staffing reports" disclosing the time that the CRO and his or her firm's employees have spent on various aspects of the debtor's engagement. Preparing these reports is significantly less burdensome than preparing a typical fee application that complies with §§ 330 and 331 and satisfies other requirements that may be imposed by the U.S. Trustee and bankruptcy courts in various jurisdictions.

Nor is a CRO retained pursuant to §§ 105(a) and 363(b)(1) required to be disinterested.¹³ Accordingly, the CRO is not

required to disclose its connections with the debtor, creditors and other parties in interest, as a professional seeking to be employed pursuant to § 327(a) would be.¹⁴ Nevertheless, CROs often make such disclosures voluntarily in order to overcome potential objections by the U.S. Trustee or other parties in interest.¹⁵ By voluntarily making such disclosures, CROs might also be able to reduce exposure to claims based on alleged conflicts of interest. However, because such disclosures are voluntary, they may be made only to the extent and in the manner that the CRO desires, unless ordered otherwise by the court.

Finally, a CRO retained pursuant to §§ 105(a) and 363(b)(1) may obtain additional protections from liability not afforded to professionals retained pursuant to § 327(a). For example, a CRO retained pursuant to §§ 105(a) and 363(b)(1) may be covered under the debtors' directors and officers liability insurance policy. Further, a debtor may indemnify a CRO retained pursuant to §§ 105(a) and 363(b)(1) to the same extent that it indemnifies its other officers and directors, whereas a debtor will ordinarily be limited in the indemnification that it can provide to a professional retained pursuant to § 327(a).

Lingering Criticisms of CRO Retention Pursuant to §§ 105(a) and 363(b)(1)

Although the trend is to retain CROs pursuant to §§ 105(a) and 363(b)(1), this practice is not without its critics. At least two courts that have granted CRO retention applications made pursuant to §§ 105(a) and 363(b)(1) have questioned the wisdom of permitting a CRO to be retained on that basis rather than pursuant to § 327(a).

In *Mirant*, the court reviewed and approved a fee application filed by AP Services LLP, an affiliate of AlixPartners, whose employee served as the debtor's CRO.¹⁶ The court noted that "AP was retained pursuant to Code § 363 because part of its role was to provide the Debtors with a [CRO]."¹⁷ The court then observed that "[t]he [U.S. Trustee] and other parties acquiesced in this method of retention (which was intended to avoid application to AP of the disinterestedness test of 11 U.S.C. § 101(14) due to AP's personnel serving as officers of [the] Debtors). The court is not satisfied that use of Code § 363 is appropriate for such a purpose, but need not here reach that issue."¹⁸

The court in *Blue Stone* was similarly critical of CRO retention pursuant to §§ 105(a) and 363(b)(1).¹⁹ In that case, the debtor sought the authority to retain a CRO while the U.S. Trustee sought conversion of the case from chapter 11 to chapter 7.²⁰ The court granted the debtor's CRO retention application, but in so doing stated:

13 Daniel F. Dooley, Brian J. Fox, Edward T. Gavin, Melissa A. Hager, Allen G. Kadish, Edward A. Phillips, Kenneth A. Rosen, Jarrett K. Vine and Christopher A. Ward, *The Chief Restructuring Officer's Guide to Bankruptcy: Views from Leading Insolvency Professionals*, page 10 (ABI, 2013). This book is available for purchase at bookstore.abi.org (members must log in first to receive the member-only discount).

14 Fed. R. Bankr. P. 2014(a).

15 See, e.g., *In re Ctr. European Distrib. Corp.*, No. 13-10738 (Bankr. D. Del. 2013); *In re WP Steel Venture LLC*, No. 12-11661 (Bankr. D. Del. 2012); *In re Dippin' Dots Inc.*, No. 11-51077 (Bankr. W.D. Ky. 2011); *In re BI-LO LLC*, No. 09-02140 (Bankr. D.S.C. 2009).

16 *In re Mirant Corp.*, 354 B.R. 113, 127 (Bankr. N.D. Tex. 2006).

17 *Id.*

18 *Id.* at 127 n.29. Notably, despite the reservations expressed in *Mirant*, the U.S. Bankruptcy Court for the Northern District of Texas has subsequently approved CRO retention applications pursuant to §§ 105(a) and 363(b)(1). *In re Rangers Equity Holdings LP*, No. 10-43624 (Bankr. N.D. Tex. 2010); *In re Rangers Equity Holdings GP LLC*, No. 10-43625 (Bankr. N.D. Tex. 2010).

19 *In re Blue Stone Real Estate, Constr. & Dev. Corp.*, 392 B.R. 897, 907 n.14 (Bankr. M.D. Fla. 2008).

20 *Id.* at 900-01.

8 *In re Harnischfeger Indus. Inc.*, No. 99-2171 (Bankr. D. Del. 1999); *In re Safety-Kleen Corp.*, No. 00-02303 (Bankr. D. Del. 2000).

9 See "Business Ethics: Maginot Lines?"

10 *In re Ctr. European Distrib. Corp.*, No. 13-10738 (Bankr. D. Del. 2013); *In re Trident Microsystems Inc.*, No. 12-10069 (Bankr. D. Del. 2012); *In re WP Steel Venture LLC*, No. 12-11661 (Bankr. D. Del. 2012); *In re Hostess Brands Inc.*, No. 12-22052 (Bankr. D. Del. 2012); *In re Dewey & LeBoeuf LLP*, No. 12-12321 (Bankr. S.D.N.Y. 2012); *In re Delta Petroleum Corp.*, No. 11-14006 (Bankr. D. Del. 2011); *In re PJ Fin. Co. LLC*, No. 11-10688 (Bankr. D. Del. 2011); *In re Real Mex Rest. Inc.*, No. 11-13122 (Bankr. D. Del. 2011); *In re Hussey Copper Corp.*, No. 11-13010 (Bankr. D. Del. 2011); *In re Saint Vincent's Catholic Med. Ctrs. of N.Y.*, No. 10-11963 (Bankr. S.D.N.Y. 2010).

11 *In re Clare Oaks*, No. 11-48903 (Bankr. N.D. Ill. 2011); *In re Dippin' Dots Inc.*, No. 11-51077 (Bankr. W.D. Ky. 2011); *In re Rangers Equity Holdings LP*, No. 10-43624 (Bankr. N.D. Tex. 2010); *In re Rangers Equity Holdings GP LLC*, No. 10-43625 (Bankr. N.D. Tex. 2010); *In re BI-LO LLC*, No. 09-02140 (Bankr. D.S.C. 2009); *In re Grede Foundries Inc.*, No. 09-14337 (Bankr. W.D. Wis. 2009); *In re LandAmerica Fin. Grp. Inc.*, No. 08-35994 (Bankr. E.D. Va. 2008).

12 The ABI Winter Leadership Conference (Dec. 5-7, 2013, at the Terranea Resort in Rancho Palos Verdes, Calif.) will feature a panel on the Jay Alix Protocol. To register, visit www.abiworld.org/WLC13/.

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.²¹

Based on this rationale, the court employed its equitable powers under § 105(a) and granted the application pursuant to § 327(a) rather than § 363(b)(1).²²

In two recent cases outside of the Southern District of New York and the District of Delaware, the U.S. Trustee has voiced similar concerns about CRO retention pursuant to §§ 105(a) and 363(b)(1). In *Miles Properties*,²³ the debtors sought to retain a CRO pursuant to § 327(a), and the U.S. Trustee objected to the debtor's application on multiple grounds, including that the application should be filed pursuant to § 327(a) because the CRO was a "professional person."²⁴ The debtors noted that the retention application was filed pursuant to § 327(a) and explained that they did this because in order to retain the CRO pursuant to § 363(b)(1), the CRO and his firm would have had to comply with the Jay Alix Protocols, which would have been impractical.²⁵ The court was seemingly satisfied with the debtor's responses to the U.S. Trustee's objection and granted the retention application.²⁶

In *Nesbitt Portland Property*,²⁷ the debtor filed an application to retain a CRO pursuant to §§ 105(a) and 363(b)(1), and the U.S. Trustee objected that the debtor's passing reference in its application to §§ 105(a) and 363(b)(1) did not provide sufficient grounds to retain a CRO.²⁸ The debtor explained the business purpose for its proposed CRO retention and cited *Blue Stone* as authority for its reliance on §§ 105(a) and 363(b)(1).²⁹ The court granted the retention application, but as in *Blue Stone*, it did so pursuant to § 327(a) rather than §§ 105(a) and 363(b)(1).³⁰

Specific Steps to Strengthen CRO Retention Applications

These criticisms and objections reflect the unease that some bankruptcy courts and the U.S. Trustees in some jurisdictions continue to have with CRO retention pursuant to §§ 105(a) and 363(b)(1) rather than § 327(a). Given the advantages of retaining a CRO pursuant to §§ 105(a) and 363(b)(1), however, a debtor will want to make the strongest case possible for this approach. To do so, several steps are recommended.

First, the proposed CRO retention should — at a minimum — comply with the Jay Alix Protocols. Second, the retention application should explain how compliance with the Jay Alix Protocols mitigates the concerns raised by the *Blue Stone* court about lack of court oversight over the disinterestedness and compensation of CROs retained pursuant to §§ 105(a) and 363(b)(1). Finally, the retention application should be explicit about the statutory basis for the relief it seeks and cite the numerous cases in which courts have granted similar relief. **abi**

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21 *Id.* at 907 n.14.

22 *Id.* at 907 n.15.

23 *In re Miles Props. Inc.*, No. 10-60797 (Bankr. N.D. Ga. 2010). Docket No. 33.

24 *Id.*, Docket No. 182.

25 *Id.*

26 *Id.*, Docket No. 457.

27 *In re Nesbitt Portland Prop. LLC, et al.*, No. 12-12883 (Bankr. C.D. Cal. 2012). Docket Nos. 265 and 296.

28 *Id.*

29 *Id.*, Docket No. 301.

30 *Id.*, Docket No. 322.